EL PASO ELECTRIC CO /TX/
Form 10-K/A
November 22, 2004
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K/A

Amendment No. 1

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2003

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______ to ______

Commission file number 0-296

El Paso Electric Company

(Exact name of registrant as specified in its charter)

Texas **(State or other jurisdiction of incorporation or organization)**	**74-0607870** **(I.R.S. Employer Identification No.)**
Stanton Tower, 100 North Stanton, El Paso, Texas **(Address of principal executive offices)**	**79901** **(Zip Code)**

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

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

Title of each class	**Name of each exchange on which registered**
Common Stock, No Par Value	**New York Stock Exchange**

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

None

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). YES x NO ¨

As of June 30, 2003, the aggregate market value of the voting stock held by non-affiliates of the registrant was $586,138,226 (based on the closing price as quoted on the New York Stock Exchange on that date).

As of March 5, 2004, there were 47,588,360 shares of the Company s no par value common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for the 2004 annual meeting of its shareholders are incorporated by reference into Part III of this report.

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DEFINITIONS

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

Abbreviations, Acronyms or Defined Terms	Terms
ANPP Participation Agreement	Arizona Nuclear Power Project Participation Agreement dated August 23, 1973, as amended
APS	Arizona Public Service Company
CFE	Comisión Federal de Electricidad de Mexico, the national electric utility of Mexico
Common Plant or Common Facilities	Facilities at or related to Palo Verde that are common to all three Palo Verde units
Company	El Paso Electric Company
DOE	United States Department of Energy
FASB	Financial Accounting Standards Board
FERC	Federal Energy Regulatory Commission
Four Corners	Four Corners Generating Station
Freeze Period	Ten-year period beginning August 2, 1995, during which base rates for most Texas retail customers are expected to remain frozen pursuant to the Texas Rate Stipulation
IID	Imperial Irrigation District, an irrigation district in southern California
kV	Kilovolt(s)
kW	Kilowatt(s)
kWh	Kilowatt-hour(s)
Las Cruces	City of Las Cruces, New Mexico
MiraSol	MiraSol Energy Services, Inc., a wholly-owned subsidiary of the Company
MW	Megawatt(s)
MWh	Megawatt-hour(s)
New Mexico Commission	New Mexico Public Regulation Commission
New Mexico Restructuring Act	New Mexico Electric Utility Industry Restructuring Act of 1999
New Mexico Stipulation	Stipulation and Settlement Agreement in Case No. 03-00302-UT between the Company and all other parties to the Company s rate proceedings before the New Mexico Commission providing for a three-year freeze on base rates after an initial 1% reduction and other matters
NRC	Nuclear Regulatory Commission
Palo Verde	Palo Verde Nuclear Generating Station
Palo Verde Participants	Those utilities who share in power and energy entitlements, and bear certain allocated costs, with respect to Palo Verde pursuant to the ANPP Participation Agreement
PNM	Public Service Company of New Mexico
SFAS	Statement of Financial Accounting Standards
SPS	Southwestern Public Service Company
TEP	Tucson Electric Power Company
Texas Commission	Public Utility Commission of Texas
Texas Fuel Settlement	Settlement Agreement in Texas Docket No. 23530, between the Company, the City of El Paso and various parties whereby the Company increased its fuel factors, implemented a fuel surcharge and revised its Palo Verde Nuclear Generating Station performance standards calculation
Texas Rate Stipulation	Stipulation and Settlement Agreement in Texas Docket No. 12700, between the Company, the City of El Paso, the Texas Office of Public Utility Counsel and most other parties to the Company s rate proceedings before the Texas Commission providing for a ten-year rate freeze and other matters
Texas Restructuring Law	Texas Public Utility Regulatory Act Chapter 39, Restructuring of the Texas Electric Utility Industry
Texas Settlement Agreement	Settlement Agreement in Texas Docket No. 20450, between the Company, the City of El Paso and various parties providing for a reduction of the Company s jurisdictional base revenue and other matters
TNP	Texas-New Mexico Power Company

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EL PASO ELECTRIC COMPANY

FORM 10-K/A

INTRODUCTORY NOTE

This Amendment No. 1 to annual report on Form 10-K/A (Form 10-K/A) is being filed to amend the Company s annual report on Form 10-K for the year ended December 31, 2003, which was originally filed on March 15, 2004 (Original Form 10-K). Accordingly, pursuant to rule 12b-15 under the Securities Exchange Act of 1934, as amended, this Form 10-K/A contains the complete text of Items 6, 7, 8 and 9A of Part II and Item 15 of Part IV, as amended, as well as certain currently dated certifications. Unaffected items have not been repeated in the Amendment No. 1.

During the quarter ended September 30, 2004, the Company determined that AMT credit carryforward assets pertaining to the pre-reorganization time period were overstated by $4.5 million and reorganization-related transmission and distribution assets were understated by $4.5 million. To correct this error, the Company has restated its consolidated balance sheets as of December 31, 2002 and 2003, the consolidated statements of operations for the years ended December 31, 2001, 2002 and 2003, the consolidated statements of comprehensive operations for the years ended December 31, 2001, 2002 and 2003, the consolidated statements of changes in common stock equity for the years ended December 31, 2001, 2002 and 2003, and the consolidated statements of cash flows for the years ended December 31, 2001, 2002 and 2003. The Company has also restated the notes to consolidated financial statements as necessary to reflect the adjustments. The adjustments to the consolidated balance sheet as of December 31, 2001, include the elimination of $4.5 million of AMT credit carryforward assets, the related increase of $4.5 million in reorganization-related transmission and distribution assets, an increase of $2.8 million in accumulated depreciation, an increase of $0.7 million in deferred tax liabilities, and a decrease of $3.5 million in retained earnings. The statements of operations and comprehensive operations were adjusted by an annual increase of $0.5 million in depreciation expense. Net income and comprehensive income were reduced by $0.3 million for the years ended December 31, 2001, 2002, and 2003 as a result of the aforementioned adjustments. Please read Note P to the accompanying consolidated financial statements for a discussion of the adjustments.

This amendment does not reflect events occurring after the filing of the Original Form 10-K, which was filed on March 15, 2004. Certain other items have been revised or added in response to comments from the Securities and Exchange Commission (SEC) in its letter to the Company dated May 28, 2004. The Company will file with the SEC amendments to its quarterly report on Form 10-Q for the quarters ended March 31, 2004 and June 30, 2004 to reflect changes therein required as a consequence of the adjustments described above.

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Item 6. Selected Financial Data

As of and for the following periods (in thousands except for share data):

	Years Ended December 31,				
	2003 (Restated)	2002 (Restated)	2001 (Restated)	2000 (Restated)	1999 (Restated)
Operating revenues	$ 664,362	$ 690,085	$ 769,705	$ 701,649	$ 570,469
Operating income	79,735	110,127	167,122	168,495	156,856
Income before cumulative effect of accounting change	20,322	28,674	63,365	58,099	40,180
Cumulative effect of accounting change, net of income tax expense	39,635				
Net income applicable to common stock	59,957	28,674	63,365	58,099	27,983
Basic earnings per common share:					
Income before cumulative effect of accounting change	0.42	0.58	1.25	1.07	0.47
Cumulative effect of accounting change, net of income tax expense	0.82				
Net income	1.24	0.58	1.25	1.07	0.47
Weighted average number of common shares outstanding	48,424,212	49,862,417	50,821,140	54,183,915	59,349,468
Diluted earnings per common share:					
Income before cumulative effect of accounting change	0.42	0.57	1.23	1.06	0.47
Cumulative effect of accounting change, net of income tax expense	0.81				
Net income	1.23	0.57	1.23	1.06	0.47
Weighted average number of common shares and dilutive potential common shares outstanding	48,814,761	50,380,468	51,722,351	55,001,625	59,731,649
Cash additions to utility property, plant and equipment	77,080	65,065	70,739	64,612	51,826
Total assets	1,596,614	1,648,229	1,646,158	1,662,304	1,667,115
Long-term debt and financing and capital lease obligations	608,722	614,375	619,365	740,223	811,607
Common stock equity	495,768	452,882	446,726	408,861	418,378

The selected financial data has been restated to reflect the correction of a pre-reorganization overstatement of AMT credit carryforward assets and a related understatement of reorganization-related transmission and distribution assets, and 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.

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

Statements in this document, other than statements of historical information, are forward-looking statements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements, as well as other oral and written forward-looking statements made by or on behalf of the Company from time to time, including statements contained in the Company s filings with the Securities and Exchange Commission and its reports to shareholders, involve known and unknown risks and other factors which may cause the Company s actual results in future periods to differ materially from those expressed in any forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to: (i) increased prices for fuel and purchased power and determinations by regulators that may adversely affect the Company s ability to recover incurred fuel costs in rates; (ii) fluctuations in wholesale margins due to uncertainty in the wholesale power market; (iii) unanticipated increased costs associated with scheduled and unscheduled outages; (iv) the cost of replacing steam generators for Palo Verde Units 1 and 3 and other costs at Palo Verde; (v) the costs of legal defense and possible judgments which may accrue as the result of litigation arising out of the FERC investigation or any other regulatory proceeding; (vi) deregulation of the electric utility industry; and (vii) other factors discussed below under the headings Summary of Critical Accounting Policies and Estimates, Overview and Liquidity and Capital Resources. The Company s filings are available from the Securities and Exchange Commission or may be obtained through the Company s website, www.epelectric.com. Any such forward-looking statement is qualified by reference to these risks and factors. The Company cautions that these risks and factors are not exclusive. The Company does not undertake to update any forward-looking statement that may be made from time to time by or on behalf of the Company except as required by law.

Restatement

During the third quarter ended September 30, 2004, the Company determined that certain pre-reorganization AMT credit carryforward assets were overstated and corresponding reorganization-related transmission and distribution assets were understated. To correct this error and as more fully discussed in the Introductory Note to this Amendment No. 1, certain financial and other information contained herein has been restated to reflect the adjustments described in Note P to the accompanying consolidated financial statements. See Note P for a discussion of the adjustments.

Summary of Critical Accounting Policies and Estimates

Note A to the Consolidated Financial Statements contains a summary of the significant accounting policies utilized by the Company. The preparation of these statements requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented and actual results could differ in future periods from those estimates. Critical accounting estimates, which are both important to the portrayal of the Company s financial condition and results of operations and which require complex, subjective judgments, include the following:

- Collection of fuel expense

- Value of net utility plant in service

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Decommissioning costs

Future pension and other postretirement obligations

Reserves for tax dispute

Collection of Fuel Expense

In general, through regulation, the Company s fuel and purchased power expenses are passed through to its regulated customers. These costs are subject to reconciliation by the Texas and New Mexico Commissions. Prior to the completion of a reconciliation, the Company records fuel expenses as incurred. In the event that a disallowance occurs during a reconciliation proceeding, the amounts recorded for fuel and purchased power expenses could differ from the amounts allowed to be collected by the Company from its customers and the Company could incur a loss to the extent of the disallowance.

Value of Net Utility Plant in Service

In 1996, when it emerged from bankruptcy, the Company recast its financial statements by applying fresh-start reporting in accordance with Statement of Position 90-7 Financial Reporting by Entities in Reorganization Under the Bankruptcy Code. In this process, the Company attributed value to its integrated utility system, including its generation assets, after it had established the value of its pro forma capital structure based on management s estimates of future operating results. The Company valued its generation assets such that the depreciated value of its generation assets would be approximately equal to their estimated fair value at the end of the Freeze Period. This is important because at the beginning of retail competition in Texas, the Company will no longer be permitted to recover in rates any stranded costs , that is, the difference between the book value and the market value of its electric generation assets. If at any time the Company determines that estimated, undiscounted future net cash flows from the operations of the generation assets are not sufficient to recover their net book value, then it will be required to write down the value of these assets to their fair values. Any such writedown would be charged to earnings. The Company currently believes that its rates are sufficient to collect before 2005 substantially all costs that would otherwise be stranded under relevant laws in Texas and that future net cash flows after 2005 from the generating assets will be sufficient to recover their net book values.

Decommissioning Costs

Pursuant to the ANPP Participant Agreement and federal law, the Company must fund its share of the estimated costs to decommission Palo Verde Units 1, 2, and 3 and associated common areas. The Company records a liability for the fair value of its decommissioning obligation (ARO) in accordance with SFAS No. 143. The Company will adjust the liability to its present value periodically over time, and the capitalized costs will be depreciated over the useful life of the related asset. The determination of the liability includes various assumptions for forecasted cash flows and escalation and discount rates. The Company and other Palo Verde Participants rely upon decommissioning cost studies and make interest rate, rate of return and inflation projections to determine funding requirements and estimate liabilities related to decommissioning. Every third year, outside engineers perform a study to estimate decommissioning costs associated with Palo Verde Units 1, 2 and 3 and associated common areas. The

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Company determines how it will fund its share of those estimated costs by making assumptions about future investment returns and future cost escalations. The funds are invested in professionally managed investment trust accounts. The Company is required to establish a minimum accumulation and a minimum funding level in its decommissioning trust accounts at the end of each annual reporting period in accordance with the ANPP Participation Agreement. If actual decommissioning costs exceed estimates, the Company would incur additional expenses related to decommissioning. Further, if the rates of return earned by the trusts fail to meet expectations, the Company will be required to increase its funding to the decommissioning trust accounts. Although the Company cannot predict the results of future studies, the Company believes that the liability it has recorded for its decommissioning costs will be adequate to provide for the Company s share of the costs, assuming that Palo Verde Units 1, 2 and 3 operate over their remaining lives (which includes an assessment of the probability of a license extension) and that the DOE assumes responsibility for permanent disposal of spent fuel at plant shut down. The Company believes that its current annual funding levels of the decommissioning trust will adequately provide for the cash requirements associated with decommissioning. Historically, regulated utilities such as the Company have been permitted to collect in rates the costs of nuclear decommissioning. Under deregulation legislation in Texas, the Company expects to continue to be able to collect from customers the costs of decommissioning.

Future Pension and Other Postretirement Obligations

The Company s obligations to retirees under various benefit plans are recorded as a liability on the consolidated balance sheets. This liability is calculated on the basis of significant assumptions regarding discount rate, expected return on plan assets, rate of compensation increase and health care cost inflation. These assumptions as well as a sensitivity analysis of the effect of hypothetical changes in certain assumptions are set forth in detail in Note K Employee Benefits to the Notes to Consolidated Financial Statements. Changes in these assumptions could have a material impact on both net income and on the amount of liabilities reflected on the consolidated balance sheets.

In developing the assumptions, management makes judgments based on the advice of financial and actuarial advisors and its review of third-party and market-based data. These sources include life expectancy tables, surveys of compensation and health care cost trends, and historical and expected return data on various categories of plan assets. The assumed discount rate applied to future plan obligations is based at each measuring date on prevailing market interest rates inherent in high quality (AA and better) corporate bonds that would provide future cash flow needed to pay the benefits as they become due, as well as on publicly available bond issues. The Company regularly reviews its assumptions and conducts a full reassessment at least once a year. The Company does not expect that any such change in assumptions will have a material effect on results for 2004.

Reserves for Tax Dispute

The IRS has disputed whether the Company was entitled to deduct certain payments made in 1996 related to Palo Verde and its treatment of a litigation settlement in 1997 related to a terminated merger agreement. The Company has reached a tentative agreement, subject to IRS final approval, to settle these and all other issues relative to its 1996 through 1998 federal income tax returns. The Company expects the IRS will make a final decision regarding the proposed settlement by mid 2004.

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Should the proposed settlement be rejected by the IRS, the Company cannot predict the eventual outcome of this matter. However, the Company has established, and periodically reviews and re-evaluates, an estimated contingent tax liability on its consolidated balance sheet to provide for the possibility of adverse outcomes in tax proceedings. Although the ultimate outcome cannot be predicted with certainty, and while the contingent tax reserve may not in fact be sufficient, the Company believes that the amount at December 31, 2003 is a reasonable estimate of any additional tax that may be due.

Overview

El Paso Electric Company is an investor owned electric utility that serves retail customers in west Texas and southern New Mexico and wholesale customers in Texas and periodically in the Republic of Mexico. The Company owns or has substantial ownership interests in six electrical generating facilities providing it with a total capacity of approximately 1,500 MW. The Company s energy sources consist of nuclear fuel, natural gas, coal, wind powered resources and purchased power. The Company owns or has significant ownership interests in four major 345 kV transmission lines and three 500 kV transmission lines utilized to transfer power from Palo Verde and Four Corners, and owns the transmission and distribution network within its retail service territory. The Company is subject to regulation by the Texas and New Mexico Commissions and, with respect to wholesale power sales, transmission of electric power and the issuance of securities, by the FERC.

The Company faces a number of risks and challenges that could negatively impact its operations and financial results. The most significant of these risks and challenges are the deregulation of the electric utility industry, the possibility of increased costs especially from Palo Verde and the Company s debt service obligations.

The electric utility industry in general and the Company in particular are facing significant challenges and increased competition as a result of changes in federal provisions relating to third-party transmission services and independent power production, as well as changes in state laws and regulatory provisions relating to wholesale and retail service. In 1999, both Texas and New Mexico passed industry deregulation legislation requiring the Company to separate its transmission and distribution functions, which would remain regulated, from its power generation and energy services businesses, which would operate in a competitive market in the future. New Mexico repealed the New Mexico Restructuring Act in April 2003, and the Company s operations in New Mexico will remain fully regulated. In Texas, the Company s service territory has not yet been deregulated, but the Company is preparing for retail competition. If the Company does not enter retail competition for generating services at the end of the Freeze Period, the Company s generating services will continue to be regulated by the Texas Commission. There is substantial uncertainty about both the regulatory framework and market conditions that will exist if and when retail competition is implemented in the Company s service territory and the Company may incur substantial preparatory, restructuring and other costs that may not ultimately be recoverable. There can be no assurance that deregulation will not adversely affect the future operations, cash flows and financial condition of the Company.

The changing regulatory environment and the potential for unregulated power production have created a substantial risk that the Company will lose important customers. The Company s wholesale and large retail customers already have, in varying degrees, alternate sources of economical power,

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including co-generation of electric power. In fact, the Company has lost certain large retail customers to self-generation and/or co-generation and has seen reductions in wholesale sales due to new sources of generation. If the Company loses a significant portion of its retail customer base, the Company may not be able to replace such revenues through either the addition of new customers, an increase in rates to remaining customers, or sales in the economy market.

Another risk to the Company is potential increased costs, including the risk of additional or unanticipated costs at Palo Verde resulting from (i) increases in operation and maintenance expenses; (ii) the replacement of steam generators in Palo Verde Units 1 and 3; (iii) an extended outage of any of the Palo Verde units; (iv) increases in estimates of decommissioning costs; (v) the storage of radioactive waste, including spent nuclear fuel; (vi) insolvency of other Palo Verde Participants; and (vii) compliance with the various requirements and regulations governing commercial nuclear generating stations. At the same time, the Company s retail base rates in Texas are effectively capped through a rate freeze ending in August 2005. As a result, the Company cannot raise its base rates in Texas in the event of increases in non-fuel costs or loss of revenue. Additionally, upon initiation of competition, there may be competitive pressure on the Company s power generation rates which could reduce its profitability. The Company cannot assure that its revenues will be sufficient to recover any increased costs, including any increased costs in connection with Palo Verde or other operations, whether as a result of inflation, changes in tax laws or regulatory requirements, or other causes.

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Liquidity and Capital Resources

The Company s principal liquidity requirements in the near-term are expected to consist of interest payments on the Company s indebtedness, operating and capital expenditures related to the Company s generating facilities and transmission and distribution systems, income and other taxes, and reorganization costs related to deregulation in Texas, if and when deregulation occurs. The Company expects that cash flows from operations will be sufficient for such purposes.

The Company s contractual obligations as of December 31, 2003 are as follows (in thousands):

	Payments due by period				
	Total	2004	2005 and 2006	2007 and 2008	2009 and Later
Long-Term Debt (including interest):					
First mortgage bonds	$ 574,082	$ 36,233	$ 243,459(1)	$ 39,326	$ 255,064(2)
Pollution control bonds	212,555	12,266	200,289(3)		
Promissory note	157	122	35		
Financing Obligations (including interest):					
Nuclear fuel (4)	42,824	22,592	20,232		
Purchase Obligations:					
Capacity power contract	16,818	8,409	8,409		
Fuel contracts:					
Coal	88,350	7,068	14,136	14,136	53,010
Gas (5)	80,040	20,010	40,020	20,010	
Nuclear fuel (6)	16,652	12,427	4,225		
Retirement Plans and Other					
Postretirement Benefits (7)	4,350	4,350			
Operating lease (8)	3,400	1,000	2,000	400	
Total	$ 1,039,228	$ 124,477	$ 532,805	$ 73,872	$ 308,074

(1) In early 2004, the Company repurchased $4.0 million of its first mortgage bonds which were scheduled to mature in 2006.
(2) In early 2004, the Company repurchased $2.0 million of its first mortgage bonds which become callable in 2006.
(3) The pollution control bonds are scheduled for remarketing in 2005.
(4) Interest on nuclear fuel is based on actual interest rates at the end of 2003.
(5) This amount is based on the minimum volumes per the contract at the current market price at the end of 2003.
(6) Some of the nuclear fuel contracts are based on a fixed price adjusted for an index. The index used is the current index at the end of 2003.
(7) Includes the Company s minimum contractual funding requirements for the non-qualified retirement income plan and the other postretirement benefits for 2004. The Company has no minimum contractual funding requirement related to its retirement income plan for 2004. However, the Company may decide to fund at a higher level than the minimum contractual funding amounts and expects to contribute $7.6 million and $3.4 million to its retirement plans and postretirement benefit plan in 2004, as disclosed in Part II, Item 8, Notes to Financial Statements, Note K, Employee Benefits. Minimum contractual funding requirements for 2005 and beyond are not included due to the uncertainty of interest rates and the related return on assets.
(8) The Company has one significant operating lease for administrative offices which expires in May 2007.

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Pollution control bonds of $193.1 million are subject to remarketing in 2005, and first mortgage bonds of $182.2 million are scheduled to mature in 2006. The Company expects that these obligations and the $100 million revolving credit facility, which matures in January 2005 (against which approximately $42.2 million had been drawn for nuclear fuel purchases as of December 31, 2003) will be refinanced through the capital and credit markets. Additionally, the Company has $207.2 million of first mortgage bonds which become callable in 2006. The Company s ability to access capital and credit markets may be adversely affected by uncertainties related to operating in a competitive energy market, tight credit markets and debt rating agency actions.

Long-term capital requirements of the Company will consist primarily of construction of electric utility plant and the payment of interest on and retirement and refinancing of debt. Utility construction expenditures will consist primarily of expanding and updating the transmission and distribution systems, possible addition of new generation, and the cost of capital improvements and replacements at Palo Verde and other generating facilities, including the replacement steam generators in Palo Verde Units 1 and 3. See Part I, Item 1, Business Construction Program.

During 2003, 2002 and 2001, the Company generated $0.7 million and utilized $96.6 million and $128.0 million, respectively, of regular federal tax loss carryforwards. The Company anticipates that existing regular federal tax loss carryforwards will be fully utilized by mid-2004, should the IRS settlement for the tax years 1996 through 1998 be approved by the IRS, and that the Company s cash flow requirements for income taxes in 2004 will increase compared to the requirement for 2003.

The Company anticipates its cash flow requirements associated with its retirement plans and other postretirement benefit plans and its cash flow requirements related to contributions to the decommissioning trust funds will decrease as compared to the related cash flow requirements in 2003. The Company contributed an additional $4.7 million to the decommissioning trust funds in January 2003 and an additional $3.2 million to one of its retirement plans in September 2003 in order to meet its funding requirements as of December 31, 2002. The Company is continually evaluating its funding requirements related to its retirement plans, other postretirement benefit plans, and decommissioning trust funds.

As of December 31, 2003, the Company had approximately $34.4 million in cash and cash equivalents, a decrease of $40.7 million from the balance of $75.1 million on December 31, 2002. This decrease was primarily the result of the retirement in February 2003 of the Company s Series C First Mortgage Bonds. Any amounts not borrowed under the Company s $100 million revolving credit facility for nuclear fuel purchases may be used by the Company for working capital needs. As of December 31, 2003, approximately $42.2 million had been drawn for nuclear fuel purchases. No amounts are currently outstanding on this facility for working capital needs.

The Company has significant debt service obligations. Since inception of its deleveraging program in 1996, the Company has repurchased or retired with internally generated cash $556.5 million of first mortgage bonds, including the repayment of approximately $36.1 million of Series C First Mortgage Bonds at their maturity and the repurchase of approximately $3.3 million of first mortgage bonds during the first quarter of 2003. First Mortgage Bonds totaling $6.0 million were repurchased in

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early 2004. Common stock equity as a percentage of capitalization, including current portion of long-term debt and financing obligations, was 44% as of December 31, 2003.

The degree to which the Company is leveraged could have important consequences for the Company s liquidity, including (i) limiting the Company s ability to obtain additional financing for working capital, capital expenditures, acquisitions, general corporate or other purposes in the future, and (ii) placing the Company at a competitive disadvantage by limiting its financial flexibility to respond to the demands of the competitive market and making it more vulnerable to adverse economic or business changes.

During 2003, the Company repurchased 2.1 million shares of common stock for $24.2 million to complete its previously approved stock repurchase programs. Since the inception of the stock repurchase programs in 1999, the Company repurchased 15 million shares in total at an aggregate cost of $171.0 million, including commissions. In February 2004, the Board of Directors authorized a new stock repurchase program permitting the repurchase of up to 2 million shares of its outstanding common stock. The Company may make purchases of its stock at open market prices and may engage in private transactions, where appropriate. The repurchased shares will be available for issuance under employee benefit and stock option plans, or may be retired.

Historical Results of Operations

	Years ended December 31,				
	2003	2002		2001	
	Actual	Actual	Pro forma	Actual	Pro forma
	(Restated)	(Restated)		(Restated)	
Income before cumulative effect of accounting change (in thousands)	$ 20,322	$ 28,674	$ 33,297	$ 63,365	$ 67,808
Diluted earnings per share before cumulative effect of accounting change	0.42	0.57	0.66	1.23	1.31

Beginning on January 1, 2003, the Company adopted SFAS No. 143, Accounting for Asset Retirement Obligations, which substantially changed the reporting of the Company s decommissioning obligation at Palo Verde and Four Corners. During 2003, the Company recognized the effect of this accounting change, which increased net income by $39.6 million, net of tax. The above table compares historical results (restated) to pro forma results (restated) which assume SFAS No. 143 had been applied in both 2002 and 2001. Income before the cumulative effect of accounting change decreased $13.0 million, or $0.24 diluted earnings per share in 2003 compared to the pro forma results for 2002. This after-tax decrease resulted primarily from (i) decreased wholesale sales revenue of $17.0 million primarily related to the expiration of two long-term contracts; (ii) the impairment loss on the CIS project of $10.7 million; (iii) increased pension and benefits expenses of $3.1 million; (iv) Texas fuel disallowance of $2.8 million; (v) increased insurance expenses of $2.8 million; (vi) increased outside services of $2.2 million; and (vii) increased expense at Palo Verde of $1.3 million. These decreases were partially offset by (i) the 2002 accrual for the FERC settlements of $9.5 million with no comparable amount in 2003; (ii) increased sales and margins on economy sales of $6.3 million;

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(iii) increased retail sales of $5.6 million; (iv) decreased interest on long-term debt of $2.3 million; (v) decreased loss on extinguishment of debt of $2.1 million; and (vi) decreased MiraSol operating loss of $1.9 million.

Pro forma income before cumulative effect of accounting change (restated) decreased $34.5 million or $0.65 diluted earnings per share in 2002 compared to the pro forma results (restated) for 2001. This after-tax decrease was primarily due to (i) decreased economy sales margins of $20.3 million related to significantly reduced wholesale prices in the western United States; (ii) the FERC settlements of $9.5 million; (iii) increased demand charges of $4.5 million; (iv) decreased wholesale sales of $3.7 million; (v) increased expense at Palo Verde of $2.8 million; (vi) increased regulatory expense of $2.4 million; (vii) decreased investment performance of $2.1 million; and (viii) a reduction in the estimate of a contingent tax liability in 2001 of $2.5 million with no comparable amount in 2002. These decreases were partially offset by (i) the recovery of energy expenses in New Mexico of $6.3 million; (ii) increased retail sales of $5.4 million; and (iii) decreased interest expense on long-term debt of $4.7 million.

Operating revenues net of energy expenses decreased $16.4 million in 2003 compared to 2002 primarily due to (i) decreased wholesale sales of $25.5 million; (ii) Texas fuel disallowance of $4.5 million; and (iii) a $4.0 million decrease in revenue from the energy service operations partially offset by increased sales and margins on economy sales of $10.3 million and increased retail sales of $9.2 million.

Operating revenues net of energy expenses decreased $38.8 million in 2002 compared to 2001 primarily due to (i) decreased economy sales margins of $33.2 million related to the significantly reduced wholesale prices in the western United States; (ii) decreased revenue from the energy services operations of $10.6 million; (iii) increased demand charges of $7.3 million; and (iv) decreased wholesale sales of $6.0 million. This decrease was partially offset by the recovery of energy expenses in New Mexico in 2002 of $10.3 million, with no comparable recovery in 2001 and increased retail sales of $8.8 million.

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Comparisons of kWh sales and operating revenues are shown below (in thousands):

Years Ended December 31:	2003	2002	Increase (Decrease) Amount	Increase (Decrease) Percent
kWh sales:				
Retail:				
Residential	1,932,171	1,870,931	61,240	3.3%
Commercial and industrial, small	2,096,860	2,076,758	20,102	1.0
Commercial and industrial, large	1,197,065	1,161,815	35,250	3.0
Sales to public authorities	1,224,349	1,212,180	12,169	1.0
Total retail sales	6,450,445	6,321,684	128,761	2.0
Wholesale:				
Sales for resale	67,754	986,134	(918,380)	(93.1)(1)
Economy sales	1,920,882	1,483,465	437,417	29.5(2)
Total wholesale sales	1,988,636	2,469,599	(480,963)	(19.5)
Total kWh sales	8,439,081	8,791,283	(352,202)	(4.0)
Operating revenues:				
Base revenues:				
Retail:				
Residential	$ 171,459	$ 166,320	$ 5,139	3.1%
Commercial and industrial, small	165,434	163,553	1,881	1.2
Commercial and industrial, large	43,294	43,419	(125)	(0.3)
Sales to public authorities	73,136	70,802	2,334	3.3
Total retail base revenues	453,323	444,094	9,229	2.1
Wholesale:				
Sales for resale	3,223	32,228	(29,005)	(90.0)(1)
Total base revenues	456,546	476,322	(19,776)	(4.2)
Fuel revenues	122,761	158,650	(35,889)	(22.6)(3)
Economy sales	76,536	43,654	32,882	75.3(2)
Other	8,519	11,459	(2,940)	(25.7)(4)(5)
Total operating revenues	$ 664,362	$ 690,085	$ (25,723)	(3.7)

(1) Primarily due to the expiration of wholesale power contracts with IID on April 30, 2002 and TNP on December 31, 2002, and reduced sales to the CFE.

(2) Primarily due to increased available power as a result of the expiration of the wholesale contracts mentioned above and higher prices in the economy market.

(3) Primarily due to the expiration of wholesale power contracts with IID and TNP, decreased energy expenses passed through to Texas and New Mexico customers, and reduced sales to the CFE.

(4) Primarily due to decreased energy services revenues.
(5) Represents revenues with no related kWh sales.

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Years Ended December 31:	2002	2001	Increase (Decrease) Amount	Percent
kWh sales:				
Retail:				
Residential	1,870,931	1,789,199	81,732	4.6%
Commercial and industrial, small	2,076,758	2,069,517	7,241	0.3
Commercial and industrial, large	1,161,815	1,174,235	(12,420)	(1.1)
Sales to public authorities	1,212,180	1,185,521	26,659	2.2
Total retail sales	6,321,684	6,218,472	103,212	1.7
Wholesale:				
Sales for resale	986,134	1,460,383	(474,249)	(32.5)(1)
Economy sales	1,483,465	929,914	553,551	59.5(2)
Total wholesale sales	2,469,599	2,390,297	79,302	3.3
Total kWh sales	8,791,283	8,608,769	182,514	2.1
Operating revenues:				
Base revenues:				
Retail:				
Residential	$ 166,320	$ 159,263	$ 7,057	4.4%
Commercial and industrial, small	163,553	161,997	1,556	1.0
Commercial and industrial, large	43,419	43,644	(225)	(0.5)
Sales to public authorities	70,802	70,372	430	0.6
Total retail base revenues	444,094	435,276	8,818	2.0
Wholesale:				
Sales for resale	32,228	52,879	(20,651)	(39.1)(1)
Total base revenues	476,322	488,155	(11,833)	(2.4)
Fuel revenues	158,650	164,335	(5,685)	(3.5)
Economy sales	43,654	92,452	(48,798)	(52.8)(3)
Other	11,459	24,763	(13,304)	(53.7)(4)(5)
Total operating revenues	$ 690,085	$ 769,705	$ (79,620)	(10.3)

(1) Primarily due to the expiration of a wholesale power contract with IID on April 30, 2002 and decreased sales to CFE, partially offset by increased kWh sales to TNP.
(2) Primarily due to increased available power as a result of decreased sales to IID and increased sales at Palo Verde due to transmission constraints.
(3) Primarily due to a weaker power market in 2002 compared to the previous year.
(4) Primarily due to decreased energy services revenues.
(5) Represents revenues with no related kWh sales.

Other operations expense increased $14.6 million in 2003 compared to 2002 primarily due to (i) increased pension and benefits expense of $5.0 million resulting from declines in the financial markets; (ii) accretion expense of $4.8 million related to the implementation of SFAS No. 143;

(iii) increased insurance related expenses of $4.5 million; (iv) increased legal and consulting fees of $3.7 million; and (v) increased Palo Verde expense of $3.4 million. These increases were partially offset by decreased energy services operations expense of $7.2 million primarily due to a warranty reserve

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recorded by the Company in 2002 and the cessation of additional marketing activities by MiraSol in 2002. Other operations expense slightly increased in 2002 compared to 2001 primarily due to increased professional fees related to regulatory matters of $3.9 million and increased Palo Verde expense of $2.9 million, partially offset by decreased energy services operations expenses of $7.7 million due to the cessation of additional marketing activities in 2002.

In July 2002, the Company suspended work on its CIS project to perform an assessment of the project and of alternatives to completion of the project. This assessment included analyzing the impact of potential delays in the implementation of deregulation and resulting changes in billing requirements, and the software s ability to perform to specification. Based on this assessment and on events related to the project which occurred in 2003, the Company abandoned the CIS project and recognized an asset impairment loss of $17.6 million. The Company is now analyzing various options to meet its current and projected CIS needs.

The FERC settlements relate to the settlements with the FERC Trial Staff and principal California parties pursuant to which the Company agreed to refund $15.5 million of revenues it earned on wholesale power transactions in 2000 and 2001. These settlements were recorded in December 2002.

Maintenance expense increased slightly in 2003 compared to 2002 primarily due to maintenance outages in 2003 at local generating stations of $1.7 million offset by reduced maintenance at Palo Verde of $1.2 million due to timing of scheduled refueling and maintenance outages. Maintenance expense increased $2.0 million in 2002 compared to 2001 primarily due to the timing of refueling and maintenance outages at Palo Verde of $1.8 million.

Depreciation and amortization expense (restated) decreased $2.4 million in 2003 compared to 2002 primarily due to decreased depreciation expense of $3.7 million resulting from the implementation of SFAS No. 143. Depreciation and amortization expense (restated) remained relatively unchanged in 2002 compared to 2001.

Taxes other than income taxes decreased by $0.5 million in 2003 compared to 2002 due to a decrease in property tax. Taxes other than income taxes remained relatively unchanged in 2002 compared to 2001.

Other income (deductions) increased $6.9 million in 2003 compared to 2002 primarily due to losses on extinguishments of debt of $3.4 million recorded in 2002 with no comparable activity in 2003 and increased investment and interest income of $2.8 million primarily related to the decommissioning trust fund. Other income (deductions) decreased $3.8 million in 2002 compared to 2001 primarily due to a decrease of (i) $1.4 million in interest income on the undercollection of Texas fuel revenues; (ii) $1.1 million on investment income related to the decommissioning trust funds; and (iii) a $0.5 million insurance reimbursement recognized in 2001 with no comparable activity in 2002.

Interest charges decreased $11.8 million in 2003 compared to 2002 primarily due to (i) an $8.3 million decrease resulting from the implementation of SFAS No. 143 and (ii) a $3.5 million decrease resulting from a reduction of outstanding debt as a result of open market purchases and retirements of the Company s first mortgage bonds. Interest charges decreased $7.8 million in 2002

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compared to 2001 primarily due to (i) a $6.7 million decrease resulting from a reduction of outstanding debt as a result of open market purchases of the Company s first mortgage bonds; (ii) increased capitalized interest related to construction work in progress; and (iii) decreased interest rates.

Income tax expense (restated), excluding the tax effect of a cumulative effect of accounting change, decreased $3.3 million in 2003 compared to 2002, and $18.3 million in 2002 compared to 2001 primarily due to changes in pretax income and certain permanent differences and adjustments.

The cumulative effect of accounting change relates to the adoption of SFAS No. 143 on January 1, 2003. SFAS No. 143 provides guidance on the recognition and measurement of liabilities associated with the retirement of tangible long-lived assets. SFAS No. 143 affected the accounting for the decommissioning of the Company s Palo Verde and Four Corners Stations and changed the method used to report the decommissioning obligation.

In December 2003, the FASB issued FASB Interpretation No. 46 (FIN 46R) (revised December 2003), Consolidation of Variable Interest Entities, which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, Consolidation of Variable Interest Entities, which was issued in January 2003. The Company currently does not have a controlling financial interest in any entities through means other than voting rights and FIN 46R will not have an impact on the Company s consolidated financial statements.

SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued in May 2003. This statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The statement also includes required disclosures for financial instruments within its scope. For the Company, the statement was effective for instruments entered into or modified after May 31, 2003 and otherwise will be effective as of January 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the statement will be effective for the Company on January 1, 2005. The Company currently does not have any financial instruments that are within the scope of this statement.

For the last several years, inflation has been relatively low and, therefore, has had little impact on the Company s results of operations and financial condition.

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Item 8. Financial Statements and Supplementary Data

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Report of Independent Registered Public Accounting Firm

The Shareholders and Board of Directors

El Paso Electric Company:

We have audited the accompanying consolidated balance sheets of El Paso Electric Company and subsidiary as of December 31, 2003 and 2002, and the related consolidated statements of operations, comprehensive operations, changes in common stock equity, and cash flows for each of the years in the three-year period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of El Paso Electric Company and subsidiary as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2003, in conformity with U.S. generally accepted accounting principles.

As discussed in Note D to the consolidated financial statements, the Company changed its method of accounting for asset retirement obligations in 2003.

As discussed in Note P to the accompanying consolidated financial statements, the balance sheets as of December 31, 2003 and 2002, and the related consolidated statements of operations, comprehensive operations, changes in common stock equity, and cash flows for each of the years in the three-year period ended December 31, 2003 have been restated.

KPMG LLP

El Paso, Texas

March 10, 2004 except as to Note P,

which is as of November 8, 2004

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

ASSETS	December 31, 2003	December 31, 2002
(In thousands)		(Restated)
Utility plant:		
Electric plant in service	$ 1,788,652	$ 1,757,540
Less accumulated depreciation and amortization	595,371	568,487
Net plant in service	1,193,281	1,189,053
Construction work in progress	69,175	117,595
Nuclear fuel; includes fuel in process of $6,878 and $9,639, respectively	70,198	74,070
Less accumulated amortization	33,888	34,474
Net nuclear fuel	36,310	39,596
Net utility plant	1,298,766	1,346,244
Current assets:		
Cash and temporary investments	34,426	75,142
Accounts receivable, principally trade, net of allowance for doubtful accounts of $3,470 and $3,234, respectively	66,589	66,818
Accumulated deferred income taxes	36,248	28,149
Inventories, at cost	25,321	24,713
Undercollection of fuel revenues	12,399	6,401
Prepayments and other	27,190	11,961
Total current assets	202,173	213,184
Deferred charges and other assets:		
Decommissioning trust funds	80,475	59,923
Undercollection of fuel revenues noncurrent		12,404
Other	15,200	16,474
Total deferred charges and other assets	95,675	88,801
Total assets	$ 1,596,614	$ 1,648,229

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS (Continued)

CAPITALIZATION AND LIABILITIES	December 31, 2003	December 31, 2002
(In thousands except for share data)		(Restated)
Capitalization:		
Common stock, stated value $1 per share, 100,000,000 shares authorized, 62,487,263 and 62,389,415 shares issued, and 146,489 and 203,046 restricted shares, respectively	$ 62,633	$ 62,592
Capital in excess of stated value	264,235	262,480
Unearned compensation restricted stock awards	(878)	(1,442)
Retained earnings	350,939	290,982
Accumulated other comprehensive loss, net of tax	(9,613)	(14,421)
	667,316	600,191
Treasury stock, 15,070,266 and 12,982,995, shares respectively; at cost	(171,548)	(147,309)
Common stock equity	495,768	452,882
Long-term debt, net of current portion	588,536	588,650
Financing obligations, net of current portion	20,186	25,725
Total capitalization	1,104,490	1,067,257
Current liabilities:		
Current maturities of long-term debt and financing obligations	22,106	60,961
Accounts payable, principally trade	19,197	24,899
FERC settlements payable		15,500
Taxes accrued other than federal income taxes	15,167	17,827
Interest accrued	14,706	15,965
Overcollection of fuel revenues	10,070	
Other	20,781	20,556
Total current liabilities	102,027	155,708
Deferred credits and other liabilities:		
Asset retirement obligation (see Note D)	55,149	145,871
Accumulated deferred income taxes	144,419	102,084
Accrued postretirement benefit liability	94,510	88,569
Accrued pension liability	53,000	51,086
Other	43,019	37,654
Total deferred credits and other liabilities	390,097	425,264
Commitments and contingencies		
Total capitalization and liabilities	$ 1,596,614	$ 1,648,229

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except for share data)

	Years Ended December 31,		
	2003 (Restated)	2002 (Restated)	2001 (Restated)
Operating revenues	$ 664,362	$ 690,085	$ 769,705
Energy expenses:			
Fuel	165,367	132,413	185,449
Purchased and interchanged power	55,592	97,825	85,587
	220,959	230,238	271,036
Operating revenues net of energy expenses	443,403	459,847	498,669
Other operating expenses:			
Other operations	167,497	152,917	152,376
Impairment loss on CIS project	17,576		
FERC settlements		15,500	
Maintenance	48,246	48,022	46,009
Depreciation and amortization	87,621	90,062	89,942
Taxes other than income taxes	42,728	43,219	43,220
	363,668	349,720	331,547
Operating income	79,735	110,127	167,122
Other income (deductions):			
Investment and interest income (loss), net	1,840	(990)	2,453
Loss on extinguishments of debt	(1)	(3,410)	(3,634)
Miscellaneous other income	389	487	585
Miscellaneous income deductions	(1,885)	(2,682)	(2,161)
	343	(6,595)	(2,757)
Interest charges (credits):			
Interest on long-term debt and financing obligations	51,400	55,160	62,902
Other interest	695	8,835	7,998
Interest capitalized	(5,572)	(5,641)	(4,723)
	46,523	58,354	66,177
Income before income taxes and cumulative effect of accounting change	33,555	45,178	98,188

Income tax expense	13,233	16,504	34,823
Income before cumulative effect of accounting change	20,322	28,674	63,365
Cumulative effect of accounting change, net of tax	39,635		
Net income	$ 59,957	$ 28,674	$ 63,365
Basic earnings per share:			
Income before cumulative effect of accounting change	$ 0.42	$ 0.58	$ 1.25
Cumulative effect of accounting change, net of tax	0.82		
Net income	$ 1.24	$ 0.58	$ 1.25
Diluted earnings per share:			
Income before cumulative effect of accounting change	$ 0.42	$ 0.57	$ 1.23
Cumulative effect of accounting change, net of tax	0.81		
Net income	$ 1.23	$ 0.57	$ 1.23
Weighted average number of shares outstanding	48,424,212	49,862,417	50,821,140
Weighted average number of shares and dilutive potential shares outstanding	48,814,761	50,380,468	51,722,351

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(In thousands)

	Years Ended December 31,		
	2003 (Restated)	2002 (Restated)	2001 (Restated)
Net income	$ 59,957	$ 28,674	$ 63,365
Other comprehensive income (loss):			
Minimum pension liability adjustment	(4,234)	(21,148)	(824)
Net unrealized gains (losses) on marketable securities:			
Net holding gains (losses) arising during period	8,764	(7,657)	(5,611)
Reclassification adjustments for net losses included in net income	722	4,245	3,089
Total other comprehensive income (loss) before income taxes	5,252	(24,560)	(3,346)
Income tax benefit (expense) related to items of other comprehensive income (loss):			
Minimum pension liability adjustment	1,673	8,193	313
Net unrealized gains (losses) on marketable securities	(2,117)	1,194	883
Total income tax benefit (expense)	(444)	9,387	1,196
Other comprehensive income (loss), net of tax	4,808	(15,173)	(2,150)
Comprehensive income	$ 64,765	$ 13,501	$ 61,215

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN COMMON STOCK EQUITY

(In thousands except for share data)

	Common Stock					Accumulated	Treasury Stock		Total
			Capital in Excess of Stated Value	Unearned Compensation - Restricted Stock Awards	Retained Earnings (Restated)	Other Comprehensive Income (Loss), Net of Tax			Common Stock Equity (Restated)
	Shares	**Amount**					**Shares**	**Amount**	
Balances at December 31, 2000 as previously reported	60,705,173	$ 60,705	$ 244,528	$ (1,309)	$ 202,116	$ 2,902	9,230,786	$ (96,908)	$ 412,034
Impact of restatement					(3,173)				(3,173)
Balances at December 31, 2000	60,705,173	60,705	244,528	(1,309)	198,943	2,902	9,230,786	(96,908)	408,861
Grants of restricted common stock	187,270	187	2,410	(2,597)					
Stock options exercised or remeasured	1,396,045	1,396	7,309						8,705
Amortization of unearned compensation				1,835					1,835
Stock awards withheld for taxes	(34,995)	(35)	(416)						(451)
Forfeitures of restricted common stock	(3,196)	(3)	(27)	30					
Deferred taxes on stock incentive plan			41						41
Adjustment to state income tax valuation allowance			4,046						4,046
Net income (restated)					63,365				63,365
Other comprehensive loss						(2,150)			(2,150)
Treasury stock acquired, at cost							2,760,851	(37,526)	(37,526)
Balances at December 31, 2001	62,250,297	62,250	257,891	(2,041)	262,308	752	11,991,637	(134,434)	446,726
Grants of restricted common stock	109,240	109	1,477	(1,586)					
Stock options exercised or remeasured	280,000	280	1,966						2,246
Amortization of unearned compensation				1,865					1,865
Stock awards withheld for taxes	(23,727)	(24)	(312)						(336)
Forfeitures of restricted common stock	(23,349)	(23)	(297)	320					
Deferred taxes on stock incentive plan			(553)						(553)
Adjustment to federal valuation allowance			2,308						2,308
Net income (restated)					28,674				28,674
Other comprehensive loss						(15,173)			(15,173)
Treasury stock acquired, at cost							991,358	(12,875)	(12,875)
Balances at December 31, 2002	62,592,461	62,592	262,480	(1,442)	290,982	(14,421)	12,982,995	(147,309)	452,882
Grants of restricted common stock	63,090	63	661	(724)					
Amortization of unearned compensation				1,288					1,288
Stock awards withheld for taxes	(21,799)	(22)	(209)						(231)
Deferred taxes on stock incentive plan			1,008						1,008

Adjustment to federal valuation allowance			295						295
Net income (restated)					59,957				59,957
Other comprehensive income						4,808			4,808
Treasury stock acquired, at cost							2,087,271	(24,239)	(24,239)
Balances at December 31, 2003	62,633,752	$ 62,633	$ 264,235	$ (878)	$ 350,939	$ (9,613)	15,070,266	$ (171,548)	$ 495,768

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Years Ended December 31,		
	2003 (Restated)	**2002 (Restated)**	**2001 (Restated)**
Cash Flows From Operating Activities:			
Net income	$ 59,957	$ 28,674	$ 63,365
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of electric plant in service	87,621	90,062	89,942
Impairment loss on CIS project	17,576		
Amortization of nuclear fuel	16,374	17,968	16,272
Cumulative effect of accounting change, net of tax	(39,635)		
Deferred income taxes, net	10,063	2,328	31,469
Loss on extinguishments of debt	1	3,410	3,634
Other amortization and accretion	7,744	11,703	11,279
Other operating activities	1,432	2,918	2,261
Change in:			
FERC settlements payable	(15,500)	15,500	
Accounts receivable	(1,258)	8,207	11,622
Inventories	(366)	(357)	489
Net under/overcollection of fuel revenues	16,476	4,727	2,044
Prepayments and other	(17,687)	(2,220)	10,871
Accounts payable	(5,702)	273	(15,173)
Taxes accrued other than federal income taxes	(2,660)	1,674	(901)
Interest accrued	(1,259)	(895)	332
Other current liabilities	225	4,054	1,534
Deferred charges and credits	1,612	2,281	6,312
Net cash provided by operating activities	135,014	190,307	235,352
Cash Flows From Investing Activities:			
Cash additions to utility property, plant and equipment	(77,080)	(65,065)	(70,739)
Cash additions to nuclear fuel	(13,848)	(16,036)	(17,031)
Interest capitalized:			
Utility property, plant and equipment	(5,322)	(5,290)	(4,246)
Nuclear fuel	(250)	(351)	(477)
Decommissioning trust funds:			
Purchases	(21,079)	(19,308)	(21,791)
Sales and maturities	9,384	14,190	16,772
Other investing activities	1,467	(469)	101
Net cash used for investing activities	(106,728)	(92,329)	(97,411)
Cash Flows From Financing Activities:			
Proceeds from exercise of stock options		2,006	8,275

Purchases of treasury stock	(24,239)	(12,875)	(37,526)
Repurchases of and payments on first mortgage bonds	(39,360)	(36,344)	(91,555)
Pollution control bonds:			
Proceeds		70,400	
Payments		(70,400)	
Nuclear fuel financing obligations:			
Proceeds	15,169	18,235	19,468
Payments	(20,207)	(19,310)	(19,336)
Other financing activities	(365)	(2,542)	(617)
Net cash used for financing activities	(69,002)	(50,830)	(121,291)
Net increase (decrease) in cash and temporary investments	(40,716)	47,148	16,650
Cash and temporary investments at beginning of period	75,142	27,994	11,344
Cash and temporary investments at end of period	$ 34,426	$ 75,142	$ 27,994

See accompanying notes to consolidated financial statements.

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A. Summary of Significant Accounting Policies

General. El Paso Electric Company is a public utility engaged in the generation, transmission and distribution of electricity in an area of approximately 10,000 square miles in west Texas and southern New Mexico. El Paso Electric Company also serves wholesale customers in Texas and periodically in the Republic of Mexico.

Principles of Consolidation. The consolidated financial statements include the accounts of El Paso Electric Company and its wholly-owned subsidiary, MiraSol Energy Services, Inc. (MiraSol) (collectively, the Company). MiraSol, which began operations as a separate subsidiary in March 2001, provided energy efficiency products and services previously provided by the Company s Energy Services Business Group. On July 19, 2002, all marketing activities of MiraSol ceased. MiraSol remains a going concern in order to satisfy current contracts and warranty and service obligations on previously installed projects. See Note I. All intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Presentation. The Company maintains its accounts in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (the FERC). The Company previously determined that it does not meet the criteria for the application of Statement of Financial Accounting Standards (SFAS) No. 71, Accounting for the Effects of Certain Types of Regulation, and accordingly does not currently report the effects of certain actions of regulators as assets or liabilities unless such actions result in assets or liabilities under generally accepted accounting principles for commercial enterprises in general. The Company continues to review whether, on a prospective basis, it may meet the criteria for applying SFAS No. 71 to its general purpose financial statements for some or all of its operations.

Comprehensive Income. Certain gains and losses that are not recognized currently in the statements of operations are reported as other comprehensive income in accordance with SFAS No. 130, Reporting Comprehensive Income.

Utility Plant. Depreciation is provided on a straight-line basis over the estimated remaining lives of the assets (ranging from 5 to 31 years), except for approximately $298 million of reorganization value allocated primarily to net transmission, distribution and general plant in service. This amount is being depreciated over the ten-year period of the Texas Rate Stipulation, which ends August 2005. For all

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other utility plant, Texas and New Mexico depreciation lives are the same. The table below presents the balance of each major class of depreciable assets at December 31, 2003 (in thousands):

	Gross Plant	Accumulated Depreciation	Net Plant
Nuclear Production	$ 588,070	$ (108,765)	$ 479,305
Steam and Other	250,126	(105,313)	144,813
Total Production	838,196	(214,078)	624,118
Transmission (Restated)	338,844	(177,904)	160,940
Distribution (Restated)	532,832	(177,032)	355,800
General	71,241	(24,033)	47,208
Intangible	5,369	(2,324)	3,045
Total (Restated)	$ 1,786,482(a)	$ (595,371)	$ 1,191,111

(a) Does not include $2,170 of costs related to dry cask storage.

Amortization of intangible plant (software) is provided on a straight-line basis over the estimated useful life of the asset (ranging from 3 to 10 years). The amortization expense for intangible plant in 2003 was $0.8 million. The table below presents the estimated amortization expense for the next five years (in thousands):

2004	$ 836
2005	595
2006	477
2007	349
2008	294

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.

The cost of nuclear fuel is amortized to fuel expense on a units-of-production basis. A provision for spent fuel disposal costs is charged to expense based on requirements of the Department of Energy (the DOE) for disposal cost of approximately one-tenth of one cent on each kWh generated. The Company is also amortizing its share of costs associated with on-site spent fuel storage casks at Palo Verde over the burn period of the fuel that will necessitate the use of the storage casks. See Note C.

Impairment of Long-Lived Assets. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, long-lived assets, such as property, plant, and equipment and purchased intangibles subject to amortization, are reviewed for impairment whenever events or

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changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimate undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Capitalized Interest. The Company capitalizes interest cost to construction work in progress and nuclear fuel in process in accordance with SFAS No. 34, Capitalization of Interest Cost.

Asset Retirement Obligation. Effective January 1, 2003, the Company adopted SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 sets forth accounting requirements for the recognition and measurement of liabilities associated with the retirement of tangible long-lived assets. An asset retirement obligation (ARO) associated with long-lived assets included within the scope of SFAS No. 143 is that for which a legal obligation exists under enacted laws, statutes, written or oral contracts, including obligations arising under the doctrine of promissory estoppel. Under the statement, these liabilities are recognized as incurred if a reasonable estimate of fair value can be established and are capitalized as part of the cost of the related tangible long-lived assets. In January 2003 the Company began recording the increase in the ARO due to the passage of time as an operating expense (accretion expense). See Note D.

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

Investments. The Company s marketable securities, included in decommissioning trust funds in the balance sheets, are reported at fair market value and consist primarily of equity securities and municipal, federal and corporate bonds in trust funds established for decommissioning of its interest in Palo Verde. Such marketable securities are classified as available-for-sale securities and, as such, unrealized gains and losses are included in accumulated other comprehensive income as a separate component of common stock equity. However, if declines in fair value of marketable securities below original cost basis are determined to be other than temporary, then the declines are reported as losses in the consolidated statement of operations and a new cost basis is established for the affected securities at fair value. See Note M.

Inventories. Inventories, primarily parts, materials, supplies and fuel oil are stated at average cost not to exceed recoverable cost.

Operating Revenues Net of Energy Expenses. The Company accrues revenues for services rendered, including unbilled electric service revenues. Energy expenses are stated at actual cost incurred. The Company s Texas retail customers are presently being billed under a fixed fuel factor approved by the Texas Commission. As of June 2003, the Company s New Mexico retail customers are

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being billed under a fuel adjustment clause which is adjusted monthly, pending a final order from the New Mexico Commission in the Company s July 2003 rate compliance filing. The Company s recovery of energy expenses in these jurisdictions is subject to periodic reconciliations of actual energy expenses incurred to actual fuel revenues collected. The difference between energy expenses incurred and fuel revenues charged to the Company s Texas and New Mexico customers, as determined under Texas and New Mexico Commission rules, is reflected as net over/undercollection of fuel revenues in the balance sheets. See Note B.

Unbilled Revenues. Accounts receivable include accrued unbilled revenues of $16.5 million and $16.2 million at December 31, 2003 and 2002, respectively.

Allowance for Doubtful Accounts. Additions, deductions and balances for allowance for doubtful accounts for 2003, 2002 and 2001 are as follows (in thousands):

	2003	2002	2001
Balance at beginning of year	$ 3,234	$ 3,525	$ 3,325
Additions:			
Charged to costs and expense	3,096	2,909	3,962
Charged to other accounts (1)	981	835	689
Deductions (2)	3,841	4,035	4,451
Balance at end of year	$ 3,470	$ 3,234	$ 3,525

(1) Recovery of amounts previously written off.
(2) Uncollectible receivables written off.

Income Taxes. The Company accounts for federal and state income taxes under the asset and liability method of accounting for income taxes. Under this 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. The Company records a valuation allowance to reduce its deferred tax assets to the extent it is more likely than not that such deferred tax assets will not be realized. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the enactment date.

Earnings per Share. Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. Diluted earnings per share is computed by dividing net income by the weighted average number of shares and the dilutive impact of stock options which were outstanding during the period calculated by the treasury stock method and unvested restricted stock.

Stock Options and Restricted Stock. The Company has two stock-based long-term incentive plans and accounts for them under the recognition and measurement principles of APB Opinion No. 25,

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Accounting for Stock Issued to Employees, and related interpretations. Stock options have typically been granted with an exercise price equal to fair market value on the date of grant and, accordingly, no compensation expense is recorded by the Company. Restricted stock has been granted at fair market value. Accordingly, the Company recognizes compensation expense by ratably amortizing the fair market value of the grant over the restriction period. If compensation expense for the option portion of the plans had been determined based on the fair value of the option at the grant date and amortized on a straight-line basis over the vesting period, consistent with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, the Company s net earnings and earnings per share would have been reduced to the pro forma amounts presented below:

	Years Ended December 31,		
	2003 (Restated)	**2002 (Restated)**	**2001 (Restated)**
Net income, as reported	$ 59,957	$ 28,674	$ 63,365
Deduct: Compensation expense, net of tax	916	1,326	1,384
Pro forma net income	$ 59,041	$ 27,348	$ 61,981
Basic earnings per share:			
As reported	$ 1.24	$ 0.58	$ 1.25
Pro forma	1.22	0.55	1.22
Diluted earnings per share:			
As reported	1.23	0.57	1.23
Pro forma	1.21	0.54	1.20

The fair value for these options was estimated at the grant date using the Black-Scholes option pricing model. Weighted average assumptions and grant-date fair value for 2003, 2002 and 2001 are presented below:

	2003	**2002**	**2001**
Risk-free interest rate	4.13%	5.22%	5.06%
Expected life, in years	7.4	10	10
Expected volatility	24.72%	26.10%	27.92%
Expected dividend yield			
Fair value per option	$ 4.83	$ 6.75	$ 7.18

Compensation expense for the restricted stock awards is recognized on a fair value basis and is measured by referencing the quoted market price of the shares at the grant date, amortized ratably over the restriction period. Unearned compensation related to restricted stock awards is shown as a reduction of common stock equity.

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Other New Accounting Standards. During 2003, the Company adopted SFAS No. 132 (revised 2003), Employers Disclosure about Pensions and Other Postretirement Benefits, SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, SFAS No. 148, Accounting for Stock-based Compensation Transition and Disclosure, an Amendment of FASB Statement No. 123, SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities and FASB Interpretation No. 45, Guarantors Accounting and Disclosure Requirements of Guarantees, Including Indirect Guarantees of Indebtedness to Others, an Interpretation of FASB Statements No. 5, 57, and 107 and a Rescission of FASB Interpretation No. 34 and certain provisions of SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity. The implementation of these standards did not have a significant impact on the Company s financial position or results of operations.

Additionally, during 2003, the Company adopted SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 145 required the Company to classify gains and losses on the extinguishment of debt in other income (deductions) and the Company reclassified prior period amounts to conform with this presentation.

Reclassification. Certain amounts in the consolidated financial statements for 2002 and 2001 have been reclassified to conform with the 2003 presentation.

Restatement of Previously Issued Financial Statements. During the third quarter ended September 30, 2004, the Company determined that certain pre-reorganization AMT credit carryforward assets were overstated and corresponding reorganization-related transmission and distribution assets were understated. To correct this error certain financial and other information contained herein has been restated to reflect the adjustments. See Note P for a discussion of the adjustments.

B. Regulation

General

In 1999, both the Texas and New Mexico legislatures enacted electric utility industry restructuring laws requiring competition in certain functions of the industry and ultimately in the Company s service area. In Texas, the Company is exempt from the requirements of the Texas Restructuring Law, including utility restructuring and retail competition, until the expiration of the Freeze Period in August 2005. In April 2003, the New Mexico Electric Utility Industry Restructuring Act of 1999 (New Mexico Restructuring Act) was repealed and as a result, the Company s operations in New Mexico will continue to be fully regulated. The Company cannot predict at this time the full effects the repeal of the New Mexico Restructuring Act will have on the Company as it prepares for retail competition in Texas. However, the Company believes that the New Mexico Commission will have to approve the separation of the Company s operations if and when the Company implements utility restructuring and retail competition for compliance with the Texas Restructuring Law.

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Federal Regulatory Matters

Federal Energy Regulatory Commission. The FERC has been conducting an investigation into potential manipulation of electricity prices in the western United States during 2000 and 2001. On August 13, 2002, the FERC initiated a Federal Power Act (FPA) investigation into the Company s wholesale power trading in the western United States during 2000 and 2001 to determine whether the Company engaged in misconduct and, if so, to determine potential remedies. The Company reached settlements with the FERC and other parties in 2002 and 2003. Under the terms of the settlements, the Company agreed to refund a total of $15.5 million of revenues it earned on wholesale power transactions. In July 2003, the FERC approved the settlements and on August 5, 2003, the Company deposited the $15.5 million into an interest bearing escrow account to consummate the settlements. The Company believes the FERC s order resolved all issues between the FERC and the other parties to this investigation. Under the settlements, the Company has agreed to make wholesale sales pursuant to its cost of service rate authority rather than its market-based rate authority for the period December 1, 2002 through December 31, 2004. This agreement allows the Company to sell power into wholesale markets at its incremental cost plus $21.11 per MWh. To the extent that wholesale market prices exceed these agreed upon amounts, the Company will forego the opportunity to realize these additional revenues. Although this provision has not had a significant impact on the Company s revenues through December 31, 2003, the Company is unable to predict the effect, if any, this will have on the Company s 2004 revenues.

RTOs. FERC s rule (Order 2000) on Regional Transmission Organizations (RTOs) strongly encourages, but does not require, public utilities to form and join RTOs. The Company is an active participant in the development of WestConnect, formerly known as the Desert Southwest Transmission and Reliability Operator. As a participating transmission owner, the Company will ultimately transfer operational authority of its transmission system to WestConnect subject to receiving any necessary regulatory approvals. On October 10, 2002, FERC issued an order indicating that the Company s WestConnect proposal satisfied, or with certain modifications would satisfy, the FERC requirements for an RTO under Order 2000. WestConnect will continue to work with the FERC and two other proposed RTOs in the west to achieve a seamless market structure. The Company, however, is anticipated to be no more than a 9% participant in WestConnect and cannot control the terms or timing of its establishment. WestConnect will not be operational before the end of the Freeze Period. The establishment of an RTO in the Company s service area is an important factor in the Company s ability to establish a Qualified Power Region as defined in the Texas Restructuring Law and the timing of the operations of WestConnect could affect when and whether the Company s Texas service territory participates in the Texas deregulated market.

Department of Energy. The DOE regulates the Company s exports of power to the Comision Federal de Electricidad de Mexico (CFE) in Mexico pursuant to a license granted by the DOE and a

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presidential permit. The DOE has determined that all such exports over international transmission lines shall be made in accordance with Order No. 888, which established the FERC rules for open access.

The DOE is authorized to assess operators of nuclear generating facilities a share of the costs of decommissioning the DOE s uranium enrichment facilities and for the ultimate costs of disposal of spent nuclear fuel. See Note C for discussion of spent fuel storage and disposal costs.

Nuclear Regulatory Commission. The Nuclear Regulatory Commission (NRC) has jurisdiction over the Company s licenses for Palo Verde and regulates the operation of nuclear generating stations to protect the health and safety of the public from radiation hazards. The NRC also has the authority to conduct environmental reviews pursuant to the National Environmental Policy Act.

Texas Regulatory Matters

The rates and services of the Company are regulated in Texas by municipalities and by the Texas Commission. The largest municipality in the Company s service area is the City of El Paso. The Texas Commission has exclusive appellate jurisdiction to review municipal orders and ordinances regarding rates and services within municipalities in Texas and original jurisdiction over certain other activities of the Company. The decisions of the Texas Commission are subject to judicial review.

Deregulation. The Texas Restructuring Law required certain investor-owned electric utilities to separate power generation activities from transmission and distribution activities by January 1, 2002, and on that date, retail competition for generation services was instituted in some parts of Texas. The Texas Restructuring Law, however, specifically recognized and preserved the Company s Texas Rate Stipulation and Texas Settlement Agreement by, among other things, exempting the Company s Texas service area from retail competition until the end of the Freeze Period. The Texas Commission recently opened a project (Project No. 28971) to evaluate the readiness of the Company s service area in Texas for retail competition for generation services. In this project, the Texas Commission may specify in advance the factors that are important in deciding when and whether to open the Company s service area in Texas to customer choice. One of the key factors that will likely be utilized by the Texas Commission in its determination is the progress that has been made in developing an RTO in the Company s service area. Public hearings to discuss the readiness of the Company s service area were held on March 4, 2004 in El Paso and will be held in Austin in April 2004. There is substantial uncertainty about both the regulatory framework and market conditions that will exist if and when retail competition is implemented in the Company s service territory and the Company may incur substantial preparatory, restructuring and other costs that may not ultimately be recoverable. There can be no assurance that deregulation will not adversely affect the future operations, cash flows and financial condition of the Company.

Fuel. Although the Company s base rates are frozen in Texas, pursuant to Texas Commission rules and the Texas Rate Stipulation, the Company can request adjustments to its fuel factor to more

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accurately reflect projected energy costs associated with providing electricity and seek recovery of past undercollections of fuel revenues, subject to periodic final review by the Texas Commission in fuel reconciliation proceedings.

On March 10, 2004, the Texas Commission announced its decision in PUC Docket No. 26194, a case in which the Company sought to reconcile its Texas jurisdictional fuel costs for the period January 1, 1999 through December 31, 2001. At issue was the Company s request to recover an additional $15.8 million, before interest, from its Texas customers as a surcharge because of fuel undercollections from January 1999 through December 2001. The Texas Commission disallowed approximately $4.5 million of Texas jurisdictional expenses, before interest, consisting primarily of (i) approximately $4.2 million of purchased power expenses which the Texas Commission characterized as imputed capacity charges, and (ii) approximately $0.3 million in fees which were deemed to be administrative costs, not recoverable as fuel. In Texas, capacity charges are not eligible for recovery as fuel expenses, but are to be recovered through the Company s base rates. As the Company s base rates were frozen during the time period in question, the $4.2 million of imputed capacity charges would be permanently disallowed, and hence not recoverable from its Texas customers.

The Texas Commission s decision modifies the Proposal for Decision issued September 19, 2003 by the Administrative Law Judges (ALJs). The ALJs had recommended that approximately $21.2 million of the Company s purchased power expense should be disallowed as imputed capacity charges and not recovered from Texas jurisdictional customers.

The Company has incurred similar purchased power costs for the fuel reconciliation period beginning January 1, 2002. The Company believes that it has accounted for its purchased power costs during the reconciliation period beginning January 2002 in a manner consistent with the Texas Commission s decision in PUC Docket No. 26194. However, the Texas Commission has indicated its desire to conduct a generic rulemaking proceeding to determine a statewide policy for the appropriate pricing of capacity in purchased power contracts. There can be no assurance, however, as to the outcome of such rulemaking and the potential impact on the Company with respect to fuel recovery in future reconciliation periods if the Texas Commission adopts a different methodology in a subsequent rulemaking proceeding.

The Texas Commission s decision is subject to appeal by the various parties and the Company is unable to predict the ultimate outcome of any appeals that may be filed in this case.

Palo Verde Performance Standards. The Texas Commission established performance standards for the operation of Palo Verde pursuant to which each Palo Verde unit is evaluated annually to determine whether its three-year rolling average capacity factor entitles the Company to a reward or subjects it to a penalty. The capacity factor is calculated as the ratio of actual generation to maximum possible generation. If the capacity factor, as measured on a station-wide basis for any consecutive

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24-month period, should fall below 35%, the Texas Commission can also reconsider the rate treatment of Palo Verde, regardless of the provisions of the Texas Rate Stipulation and the Texas Settlement Agreement. The removal of Palo Verde from rate base could have a significant negative impact on the Company s revenues and financial condition. Under the performance standards as modified by the Texas Fuel Settlement, the Company has calculated the performance awards for the reporting periods ending in 2003, 2002 and 2001 to be approximately $0.8 million, $1.3 million and $1.1 million, respectively. These rewards will be included, along with energy costs incurred and revenues billed, as part of the Texas Commission s review during a future periodic fuel reconciliation proceeding as discussed above. Performance rewards are not recorded on the Company s books until the Texas Commission has ordered a final determination in a fuel proceeding or comparable evidence of collectibility is obtained. Performance penalties are recorded when assessed as probable by the Company.

Texas Renewable Energy Requirement. Chapter 39 of the Public Utility Regulatory Act (PURA), implemented by Senate Bill 7 in the 1999 legislative session, requires that, by January 1, 2009, an additional 2,000 MW of generating capacity from renewable energy technologies be installed in the state. The renewable energy requirement is to be added in increments with the cumulative installed renewable capacity in Texas totaling 1,703 MW by January 1, 2005, 2,280 MW by January 1, 2007, and 2,880 MW by January 1, 2009. The requirements of this goal are placed on retail electric providers (REPs) who provide competitive retail electric service in the state of Texas. Utilities that have not implemented retail competition may have renewable energy requirements based on orders of the Texas Commission.

Until the end of the Freeze Period, the Company is exempt from PURA Chapter 39 and Texas Commission rules implementing the renewable requirements. However, once the Freeze Period ends, any renewable energy requirement applicable to the Company could be based on the percentage of the competitive retail load that will be served by the Company (or the Company s REP) in relation to the total competitive retail load served in Texas. It is not clear when the Company will need to meet a renewable energy requirement in Texas or what the obligation will be. The Company is currently reviewing the outcome of its New Mexico RFPs, for renewable energy to assess possible scenarios for meeting possible future Texas requirements, which includes the purchase of renewable power and/or credits.

New Mexico Regulatory Matters

The New Mexico Commission has jurisdiction over the Company s rates and services in New Mexico and over certain other activities of the Company, including prior approval of the issuance, assumption or guarantee of securities. The New Mexico Commission s decisions are subject to judicial review. The largest city in the Company s New Mexico service territory is Las Cruces.

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Deregulation. In April 2003, the New Mexico Restructuring Act was repealed and as a result the Company s operations in New Mexico will continue to be fully regulated. The Company cannot predict at this time the full effects the repeal of the New Mexico Restructuring Act will have on the Company as it prepares for retail competition in Texas.

Fuel. In June 2001, the New Mexico Commission approved a fuel and purchased power cost adjustment clause. On May 31, 2003, the Company submitted a rate compliance filing whereby the Company proposed to continue a base rate recovery of $0.01949 per kWh and continue the fuel and purchased power cost adjustment to recover the remainder of fuel and purchased power costs. The Company and all intervenors entered into the New Mexico Stipulation on the Company s compliance filing.

New Mexico Rate Stipulation. On January 21, 2004, the Company and all intervenors to the rate compliance filing entered into and filed the New Mexico Stipulation whereby, among other things, the Company agreed for a period of three years beginning June 1, 2004 to (i) freeze base rates after an initial non-fuel base rate reduction of 1%; (ii) fix fuel and purchased power costs associated with 10% of the Company s jurisdictional retail sales in New Mexico at $0.021 per kWh; (iii) leave subject to reconciliation the remaining 90% of the Company s New Mexico jurisdictional fuel and purchased power costs; (iv) continue the collection of a portion of fuel and purchased power costs in base rates as presently collected in the amount of $0.01949 per kWh; (v) price power provided from Palo Verde Unit 3 to the extent of its availability at an 80% nuclear, 20% gas fuel mix (currently such power is priced at 75% nuclear, 25% gas fuel mix) and (vi) deem reconciled, for the period June 15, 2001 through May 31, 2004, the Company s fuel and purchased power costs for the New Mexico jurisdiction. The New Mexico Stipulation is subject to the New Mexico Commission s approval. The New Mexico Commission hearing on the New Mexico Stipulation was held on February 25, 2004. The Company anticipates a ruling on the New Mexico Stipulation prior to June 2004 with the new rates implemented on or about June 1, 2004. The Company cannot predict the outcome of these proceedings or how the New Mexico Commission will rule.

New Mexico Renewable Energy Requirement. The New Mexico Commission has adopted renewable energy portfolio requirements and has mandated that 5% of all New Mexico retail jurisdictional energy sales in 2006 be supplied by renewable resources or certificates. The renewable portfolio standard increases by 1% each year until 2011, and is set at 10% in 2011 and thereafter. In February 2004, the Company issued a RFP for renewable energy from certified renewable sources to meet the renewable energy portfolio requirements. Based on responses to the RFP, the Company will develop a plan to meet the New Mexico Commission s renewable energy requirements. In the 2004 New Mexico legislative session, the Renewable Energy Act was enacted which directs the New Mexico Commission to adopt a rule consistent with the law, and required rate recovery for the reasonable costs of compliance with the renewable requirements.

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Sales for Resale

The Company provides up to 10 MW of firm capacity, associated energy, and transmission service to the Rio Grande Electric Cooperative pursuant to an ongoing contract which requires a two-year notice to terminate. No such notice has been received. The Company also made sales of interruptible energy to CFE during the months of June and July 2003 of 13,711 MWh and 4,525 MWh, respectively.

C. Palo Verde and Other Jointly-Owned Utility Plant

The Company owns a 15.8% interest in each of the three nuclear generating units and Common Facilities at Palo Verde, in Wintersburg, Arizona. The Palo Verde Participants include the Company and six other utilities: Arizona Public Service Company (APS), Southern California Edison Company (SCE), Public Service Company of New Mexico (PNM), Southern California Public Power Authority, Salt River Project Agricultural Improvement and Power District (SRP) and the Los Angeles Department of Water and Power. APS serves as operating agent for Palo Verde. The operation of Palo Verde and the relationship among the Palo Verde Participants is governed by the Arizona Nuclear Power Project Participation Agreement (the ANPP Participation Agreement).

Pursuant to the ANPP Participation Agreement, the Palo Verde Participants share costs and generating entitlements in the same proportion as their percentage interests in the generating units, and each participant is required to fund its share of fuel, other operations, maintenance and capital costs. The Company s share of direct expenses in Palo Verde and other jointly-owned utility plants is presented in fuel, other operations expense, maintenance expense, other, net (miscellaneous income deductions, as amended) and taxes other than income taxes in the Company s Consolidated Statements of Operations. The ANPP Participation 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. Because it is impracticable to predict defaulting participants, the Company cannot estimate the maximum potential amount of future payment, if any, which could be required under this provision.

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Other jointly-owned utility plant includes a 7% interest in Units 4 and 5 at Four Corners Generating Station (Four Corners) and certain other transmission facilities. A summary of the Company s investment in jointly-owned utility plant, excluding fuel, at December 31, 2003 and 2002 is as follows (in thousands):

	December 31, 2003	December 31, 2002
	Pa	