EL PASO ELECTRIC CO /TX/
Form 10-Q
November 04, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

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	**74-0607870**

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

(915) 543-5711

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes ¨ No x

As of October 31, 2005, there were 48,005,900 shares of the Company s no par value common stock outstanding.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	September 30, 2005 (Unaudited)	December 31, 2004
ASSETS (In thousands)		
Utility plant:		
Electric plant in service	$ 1,858,665	$ 1,839,924
Less accumulated depreciation and amortization	(727,137)	(666,774)
Net plant in service	1,131,528	1,173,150
Construction work in progress	105,202	72,273
Nuclear fuel; includes fuel in process of $1,208 and $7,128, respectively	69,432	69,239
Less accumulated amortization	(36,505)	(34,195)
Net nuclear fuel	32,927	35,044
Net utility plant	1,269,657	1,280,467
Current assets:		
Cash and temporary investments	24,161	29,401
Accounts receivable, principally trade, net of allowance for doubtful accounts of $2,541 and $3,071, respectively	86,827	70,710
Accumulated deferred income taxes	4,272	6,509
Inventories, at cost	28,528	27,773
Undercollection of fuel revenues	36,239	18,782
Income taxes receivables	22,437	14,919
Prepayments and other	12,326	11,587
Total current assets	214,790	179,681
Deferred charges and other assets:		
Decommissioning trust funds	93,917	89,363
Undercollection of fuel revenues, non-current	27,024	
Regulatory assets	24,576	18,487
Other	19,307	12,837
Total deferred charges and other assets	164,824	120,687
Total assets	$ 1,649,271	$ 1,580,835

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS (Continued)

	September 30, 2005 (Unaudited)	December 31, 2004
CAPITALIZATION AND LIABILITIES (In thousands except for share data)		
Capitalization:		
Common stock, stated value $1 per share, 100,000,000 shares authorized, 63,225,549 and 62,665,550 shares issued, and 125,324 and 102,630 restricted shares, respectively	$ 63,351	$ 62,768
Capital in excess of stated value	274,338	268,771
Deferred and unearned compensation	1,180	1,127
Retained earnings	414,917	386,110
Accumulated other comprehensive loss, net of tax	(25,688)	(10,553)
	728,098	708,223
Treasury stock, 15,365,108 shares, at cost	(176,076)	(176,076)
Common stock equity	552,022	532,147
Long-term debt, net of current portion	590,832	359,362
Financing obligations, net of current portion	19,092	20,274
Total capitalization	1,161,946	911,783
Current liabilities:		
Current portion of long-term debt and financing obligations	20,842	214,092
Accounts payable, principally trade	41,003	34,404
Taxes accrued other than federal income taxes	16,848	15,719
Interest accrued	9,897	13,609
Other	24,025	24,726
Total current liabilities	112,615	302,550
Deferred credits and other liabilities:		
Accumulated deferred income taxes	124,581	111,991
Accrued postretirement benefit liability	103,520	98,827
Asset retirement obligation	62,883	60,388
Accrued pension liability	40,534	49,055
Regulatory liabilities	15,452	15,682
Other	27,740	30,559
Total deferred credits and other liabilities	374,710	366,502
Commitments and contingencies		
Total capitalization and liabilities	$ 1,649,271	$ 1,580,835

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands except for share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	**2004**	**2005**	**2004**
Operating revenues	$ 242,031	$ 204,941	$ 590,516	$ 542,999
Energy expenses:				
Fuel	81,096	59,014	182,151	145,867
Purchased and interchanged power	23,701	17,534	54,642	52,128
	104,797	76,548	236,793	197,995
Operating revenues net of energy expenses	137,234	128,393	353,723	345,004
Other operating expenses:				
Other operations	46,222	43,325	131,777	126,153
Maintenance	8,671	9,162	30,737	29,116
Depreciation and amortization	18,750	23,396	66,175	69,822
Taxes other than income taxes	12,313	11,928	32,762	34,421
	85,956	87,811	261,451	259,512
Operating income	51,278	40,582	92,272	85,492
Other income (deductions):				
Investment and interest income, net	1,623	906	3,561	1,618
Loss on extinguishments of debt	(30)	(854)	(19,448)	(4,692)
Miscellaneous non-operating income	55	57	770	284
Miscellaneous non-operating deductions	(1,281)	(741)	(2,955)	(2,407)
	367	(632)	(18,072)	(5,197)
Interest charges (credits):				
Interest on long-term debt and financing obligations	8,870	12,179	32,287	37,158
Other interest	221	132	448	419
Interest capitalized and AFUDC	(1,536)	(757)	(3,925)	(2,348)
	7,555	11,554	28,810	35,229
Income before income taxes and extraordinary item	44,090	28,396	45,390	45,066
Income tax expense	16,078	4,458	16,583	10,515

Income before extraordinary item	28,012	23,938	28,807	34,551
Extraordinary gain on re-application of SFAS No. 71, net of tax		1,802		1,802
Net income	$ 28,012	$ 25,740	$ 28,807	$ 36,353
Basic earnings per share:				
Income before extraordinary item	$ 0.59	$ 0.50	$ 0.60	$ 0.73
Extraordinary gain on re-application of SFAS No. 71, net of tax		0.04		0.04
Net income	$ 0.59	$ 0.54	$ 0.60	$ 0.77
Diluted earnings per share:				
Income before extraordinary item	$ 0.58	$ 0.50	$ 0.60	$ 0.72
Extraordinary gain on re-application of SFAS No. 71, net of tax		0.04		0.04
Net income	$ 0.58	$ 0.54	$ 0.60	$ 0.76
Weighted average number of shares outstanding	47,826,500	47,456,759	47,646,788	47,469,393
Weighted average number of shares and dilutive potential shares outstanding	48,590,859	48,092,572	48,183,301	47,991,751

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands except for share data)

	Twelve Months Ended September 30,	
	2005	**2004**
Operating revenues	$ 756,145	$ 699,952
Energy expenses:		
Fuel	230,708	187,374
Purchased and interchanged power	68,965	67,815
	299,673	255,189
Operating revenues net of energy expenses	456,472	444,763
Other operating expenses:		
Other operations	179,160	169,370
Maintenance	46,811	37,877
Depreciation and amortization	89,725	92,036
Taxes other than income taxes	40,925	43,323
	356,621	342,606
Operating income	99,851	102,157
Other income (deductions):		
Investment and interest income, net	5,347	2,240
Loss on extinguishments of debt	(20,112)	(4,692)
Miscellaneous non-operating income	1,345	504
Miscellaneous non-operating deductions	(3,683)	(3,107)
	(17,103)	(5,055)
Interest charges (credits):		
Interest on long-term debt and financing obligations	44,297	49,899
Other interest	564	829
Interest capitalized and AFUDC	(5,004)	(3,834)
	39,857	46,894
Income before income taxes and extraordinary item	42,891	50,208
Income tax expense	15,266	13,471

Income before extraordinary item	27,625	36,737
Extraordinary gain on re-application of SFAS No. 71, net of tax		1,802
Net income	$ 27,625	$ 38,539
Basic earnings per share:		
Income before extraordinary item	$ 0.58	$ 0.77
Extraordinary gain on re-application of SFAS No. 71, net of tax		0.04
Net income	$ 0.58	$ 0.81
Diluted earnings per share:		
Income before extraordinary item	$ 0.57	$ 0.76
Extraordinary gain on re-application of SFAS No. 71, net of tax		0.04
Net income	$ 0.57	$ 0.80
Weighted average number of shares outstanding	47,559,379	47,531,797
Weighted average number of shares and dilutive potential shares outstanding	48,162,904	48,039,553

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(Unaudited)

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2005	**2004**	**2005**	**2004**	**2005**	**2004**
Net income	$ 28,012	$ 25,740	$ 28,807	$ 36,353	$ 27,625	$ 38,539
Other comprehensive income (loss):						
Minimum pension liability adjustment					(1,413)	(4,234)
Net unrealized gains (losses) on marketable securities:						
Net holding gains (losses) arising during period	153	(1,251)	(1,760)	(2,030)	621	2,323
Reclassification adjustments for net (gains) losses included in net income	89	68	244	(280)	99	(346)
Net losses on cash flow hedges:						
Net holding losses arising during period			(22,439)		(22,439)	
Reclassification adjustment for interest expense included in net income	84		104		104	
Total other comprehensive income (loss) before income taxes	326	(1,183)	(23,851)	(2,310)	(23,028)	(2,257)
Income tax benefit (expense) related to items of other comprehensive income (loss):						
Minimum pension liability adjustment					532	1,673
Net unrealized gains (losses) on marketable securities	(48)	237	304	462	(143)	165
Net unrealized (gains) losses on cash flow hedges	(33)		8,412		8,412	
Total income tax benefit (expense)	(81)	237	8,716	462	8,801	1,838
Other comprehensive income (loss), net of tax	245	(946)	(15,135)	(1,848)	(14,227)	(419)
Comprehensive income	$ 28,257	$ 24,794	$ 13,672	$ 34,505	$ 13,398	$ 38,120

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine Months Ended September 30,	
	2005	**2004**
Cash flows from operating activities:		
Net income	$ 28,807	$ 36,353
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of electric plant in service	66,175	69,822
Amortization of nuclear fuel	12,258	13,235
Extraordinary gain on the re-application of SFAS No. 71, net of tax		(1,802)
Deferred income taxes, net	22,983	(7,892)
Loss on extinguishments of debt	19,448	4,692
Other amortization and accretion	8,836	6,701
Gain on sale of asset	(374)	
Other operating activities		619
Change in:		
Accounts receivable	(16,117)	(9,839)
Inventories	(527)	(56)
Net undercollection of fuel revenues	(44,481)	(12,298)
Prepayments and other	(9,628)	718
Accounts payable	6,599	5,805
Taxes accrued other than federal income taxes	1,129	3,260
Interest accrued	(3,712)	(1,007)
Other current liabilities	(701)	1,448
Deferred charges and credits	(7,975)	(1,498)
Net cash provided by operating activities	82,720	108,261
Cash flows from investing activities:		
Cash additions to utility property, plant and equipment	(58,352)	(46,535)
Cash additions to nuclear fuel	(9,888)	(9,499)
Proceeds from sale of asset	1,944	
Capitalized interest and AFUDC:		
Utility property, plant and equipment	(3,671)	(2,169)
Nuclear fuel	(254)	(179)
Decommissioning trust funds:		
Purchases, including funding of $4.6 and $4.5 million, respectively	(19,004)	(14,112)
Sales and maturities	12,969	8,061
Other investing activities	1,906	(1,754)
Net cash used for investing activities	(74,350)	(66,187)
Cash flows from financing activities:		
Proceeds from exercise of stock options	4,218	877

Repurchases of treasury stock		(4,528)
Proceeds from issuance of long-term notes payable	397,688	
Repurchases of and payments on first mortgage bonds	(381,847)	(35,729)
Settlement on derivative instruments classified as cash flow hedges	(22,439)	
Pollution Control Bonds:		
Proceeds	193,135	
Payments	(193,135)	
Financing obligations:		
Proceeds	11,585	10,429
Payments	(12,849)	(12,683)
Other financing activities	(9,966)	(288)
Net cash used for financing activities	(13,610)	(41,922)
Net increase (decrease) in cash and temporary investments	(5,240)	152
Cash and temporary investments at beginning of period	29,401	34,426
Cash and temporary investments at end of period	$ 24,161	$ 34,578

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

A. Principles of Preparation

These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Annual Report of El Paso Electric Company on Form 10-K for the year ended December 31, 2004 (the 2004 Form 10-K). Capitalized terms used in this report and not defined herein have the meaning ascribed for such terms in the 2004 Form 10-K. In the opinion of management of the Company, the accompanying consolidated financial statements contain all adjustments necessary to present fairly the financial position of the Company at September 30, 2005 and December 31, 2004; the results of its operations and comprehensive operations for the three, nine and twelve months ended September 30, 2005 and 2004; and its cash flows for the nine months ended September 30, 2005 and 2004. The results of operations and comprehensive operations for the three and nine months ended September 30, 2005 and the cash flows for the nine months ended September 30, 2005 are not necessarily indicative of the results to be expected for the full calendar year.

Pursuant to the rules and regulations of the Securities and Exchange Commission (SEC), certain financial information has been condensed and certain footnote disclosures have been omitted. Such information and disclosures are normally included in financial statements prepared in accordance with generally accepted accounting principles. Certain prior period amounts have been reclassified to conform with the current period presentation.

Stock Options. The Company has stock-based long-term incentive plans and accounts for them under the recognition and measurement principles of APB Opinion No. 25, 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, for restricted stock the Company recognizes compensation expense by ratably amortizing the fair market value of the restricted stock determined at the date of grant over the restriction period of the grant. 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 (in thousands, except for per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income as reported	$ 28,012	$ 25,740	$ 28,807	$ 36,353
Deduct: Compensation expense, net of tax	202	223	626	682
Pro forma net income	$ 27,810	$ 25,517	$ 28,181	$ 35,671

Basic earnings per share:								
As reported	$	0.59	$	0.54	$	0.60	$	0.77
Pro forma		0.58		0.54		0.59		0.75
Diluted earnings per share:								
As reported		0.58		0.54		0.60		0.76
Pro forma		0.57		0.53		0.58		0.75

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	Twelve Months Ended September 30,	
	2005	**2004**
Net income, as reported	$ 27,625	$ 38,539
Deduct: Compensation expense, net of tax	854	911
Pro forma net income	$ 26,771	$ 37,628
Basic earnings per share:		
As reported	$ 0.58	$ 0.81
Pro forma	0.56	0.79
Diluted earnings per share:		
As reported	0.57	0.80
Pro forma	0.56	0.79

Unbilled Revenues. Accounts receivable include accrued unbilled revenues of $17.4 million and $18.0 million at September 30, 2005 and December 31, 2004, respectively.

Supplemental Cash Flow Disclosures (in thousands)

	Nine Months Ended September 30,	
	2005	**2004**
Cash paid for:		
Interest on long-term debt and financing obligations	$ 35,034	$ 37,310
Income taxes	1,195	7,300
Non-cash financing activities:		
Grants of restricted shares of common stock	1,953	792
Changes in federal deferred tax valuation allowance credited to capital in excess of stated value		(6,053)

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

B. Regulation

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 (City). 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.

Extension of Rate Freeze and Franchise Agreement. On July 21, 2005, the Company entered into an agreement with the City to extend its existing freeze period for an additional five years expiring June 30, 2010. Under the new rate agreement which became effective as of July 1, 2005, most retail base rates will remain at their current level for the next five years. If, during the term of the agreement, the Company s return on equity falls below the bottom of a defined range, the Company has the right to initiate a rate case and seek an adjustment to base rates. If the Company s return on equity exceeds the top of the range, the Company will refund, at the City s direction, an amount equal to 50% of the pre-tax return in excess of the ceiling. The range is market-based, and at current rates, would be a range of approximately 8% to 12%.

The Company will share with its Texas customers 25% of off-system sales margins and wheeling revenues. Under the prior rate agreement, the Company shared 50% of off-system sales margins and wheeling revenues with Texas customers. Since the agreement requires a variance to the substantive rules of the Texas Commission regarding the sharing of margins, the Company will seek Texas Commission approval of the margin sharing provisions of the agreement. If the Texas Commission does not approve the margin sharing, the Company and the City have agreed to negotiate in good faith to amend the rate agreement to achieve a similar economic result to the parties. The Company is unable to predict when or if the Texas Commission will approve such provisions.

In addition, the Company has committed to spend at least 0.3% of its El Paso revenues on civic and charitable causes within the City. The Company and the City have agreed to engage the services of an independent consultant to review the reasonableness of certain operating expenses of the Company. If the consultant finds such expenses to be unreasonable, the parties will seek to negotiate an appropriate remedy. If the parties are unable to agree on a remedy, the agreement will terminate at the end of one year, and thereafter the Company would be subject to traditional rate regulation. Consistent with the prior rate agreement, the new rate agreement may also be reopened by the City in the event of a merger or change in control of the Company to seek rate reductions based on post-merger synergy savings.

The City also granted to the Company a new 25-year franchise which became effective August 2, 2005. The franchise governs the Company s usage of City-owned property and the payment of franchise fees. See Note G.

Fuel and Purchased Power Costs. Although the Company s base rates are frozen in El Paso, pursuant to Texas Commission rules and the Texas Rate Stipulation, the Company s fuel costs are passed

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

through to its customers. In January and July of each year, the Company can request adjustments to its fuel factor to more accurately reflect projected energy costs associated with providing electricity, seek recovery of past undercollections of fuel revenues, and refund past overcollections of fuel revenues. All such fuel revenue and expense activities are subject to periodic final review by the Texas Commission in fuel reconciliation proceedings.

The Company reconciled its Texas jurisdictional fuel costs for the period January 1, 1999 through December 31, 2001 in PUC Docket No. 26194, and on May 5, 2004, the Texas Commission issued its final order. At issue was the Company s request to recover an additional $15.8 million, before interest, from its Texas customers as a surcharge due to 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. This disallowance was recorded as a reduction of fuel revenue during the fourth quarter of 2003. 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 period in which the imputed capacity charges were deemed to have been incurred, the $4.2 million of imputed capacity charges were therefore permanently disallowed and not recoverable from its Texas customers. The Texas Commission s decision has been appealed by two parties and the Company, and the Company is unable to predict the ultimate outcome of the appeals.

On August 31, 2004, the Company filed an application to reconcile Texas jurisdictional fuel costs for the period January 1, 2002 through February 29, 2004 in PUC Docket No. 30143. The Company has incurred purchased power costs similar to those that were at issue in PUC Docket No. 26194 during the period covered by this current fuel reconciliation case. The Company believes that it has accounted for its purchased power costs during the reconciliation period covered by PUC Docket No. 30143 in a manner consistent with the Texas Commission s decision in PUC Docket No. 26194. However, the Texas Commission is currently conducting a generic rulemaking proceeding to determine a statewide policy for the appropriate recovery mechanism for capacity in purchased power contracts. There can be no assurance as to the outcome of the rulemaking and its potential impact on the Company with respect to fuel recovery in future reconciliation periods, including that in PUC Docket No. 30143. Additionally, intervenors in PUC Docket No. 30143 have filed testimony disputing as much as $44 million of the requested fuel and purchased power costs. A settlement in principle was reached with all parties on November 4, 2005 pending approval by the El Paso city council. A motion to abate the procedural schedule was also filed with the Texas Commission pending the completion and filing of a formal settlement agreement. The Company has recorded a reserve including $1.5 million in the third quarter of 2005 sufficient to provide for $9.0 million in fuel disallowances in PUC Docket No. 30143 which fully recognizes the impact of the settlement in principle. Although the ultimate outcome of the proceeding cannot be predicted with certainty, the Company believes the amount of under/overcollection of fuel revenues recorded as of September 30, 2005 is appropriate. An adverse ruling by the Texas Commission in an amount in excess of the reserved amount could, however, have a material adverse effect on the Company s results of operations.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

On July 8, 2005, the Company filed a petition (PUC Docket No. 31332) with the Texas Commission to increase its fixed fuel factors and to surcharge under-recovered fuel costs as a result of higher natural gas prices. The Company requested an increase in its Texas jurisdiction fixed fuel factors of $30.6 million or 23% annually to reflect higher natural gas costs. The Company also requested a fuel surcharge to recover over a twelve month period $28.2 million of fuel undercollections through the end of May 2005. On September 13, 2005, the Company amended its petition to seek additional fuel under-recoveries through August 2005 and requested that the total fuel under-recoveries of $53.6 million be surcharged over a 24-month period. On September 14, 2005, the Company filed a unanimous stipulation to approve the requested fixed fuel factor and amended fuel surcharge. The stipulation also requested that the fixed fuel factors and fuel surcharge be implemented on an interim basis effective with billings in October 2005. The Administrative Law Judge issued an order approving the fixed fuel factors and fuel surcharge on an interim basis on September 16, 2005. The interim rates are subject to final approval by the Texas Commission which is expected by the end of 2005. The interim rates were implemented effective with the first billing cycle in October 2005.

New Mexico Regulatory Matters

Fuel and Purchased Power Costs. On August 29, 2005 the Company filed the annual reconciliation of its Fuel and Purchased Power Cost Adjustment Clause FPPCAC for the period June 1, 2004 through May 31, 2005 in compliance with the requirements of the New Mexico Public Regulation Commission s (NMPRC) Final Order in NMPRC Case No. 03-00302-UT. The Company requested reconciliation of all its fuel and purchased power costs for this period, and requested recovery of $1.3 million for the New Mexico jurisdictional portion of purchased power capacity costs consistent with its interpretation of NMPRC rules. However, the Company has not recognized deferred fuel revenue through September 2005 to reflect recovery of these costs. A hearing date has not been established for this proceeding. While the Company believes that it has fully supported the recovery of all of its applicable fuel and purchased power costs, the Company cannot predict when or how the NMPRC will rule on this case. An adverse ruling by the NMPRC could have a material negative effect on the Company s results of operations.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

C. Common Stock

Common Stock Repurchase Program

Since the inception of the stock repurchase programs in 1999, the Company has repurchased a total of approximately 15.3 million shares of its common stock at an aggregate cost of $175.6 million, including commissions. Approximately 1.7 million shares remain authorized to be repurchased under the currently authorized program. No shares were repurchased during 2005. The Company may continue making purchases of its stock pursuant to its stock repurchase plan 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.

Reconciliation of Basic and Diluted Earnings Per Share

The reconciliation of basic and diluted earnings per share before extraordinary item is presented below:

	Three Months Ended September 30,					
	2005			2004		
	Income	Shares	Per Share	Income	Shares	Per Share
	(In thousands)			(In thousands)		
Basic earnings per share:						
Income before extraordinary item	$ 28,012	47,826,500	$ 0.59	$ 23,938	47,456,759	$ 0.50
Effect of dilutive securities:						
Unvested restricted stock		181,868			122,546	
Stock options		582,491			513,267	
Diluted earnings per share:						
Income before extraordinary item	$ 28,012	48,590,859	$ 0.58	$ 23,938	48,092,572	$ 0.50

	Nine Months Ended September 30,					
	2005			2004		
	Income	Shares	Per Share	Income	Shares	Per Share
	(In thousands)			(In thousands)		
Basic earnings per share:						
Income before extraordinary item	$ 28,807	47,646,788	$ 0.60	$ 34,551	47,469,393	$ 0.73
Effect of dilutive securities:						
Unvested restricted stock		106,264			59,820	
Stock options		430,249			462,538	
Diluted earnings per share:						
Income before extraordinary item	$ 28,807	48,183,301	$ 0.60	$ 34,551	47,991,751	$ 0.72

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	Twelve Months Ended September 30,					
	2005			2004		
	Income	Shares	Per Share	Income	Shares	Per Share
	(In thousands)			(In thousands)		
Basic earnings per share:						
Income before extraordinary item	$ 27,625	47,559,379	$ 0.58	$ 36,737	47,531,797	$ 0.77
Effect of dilutive securities:						
Unvested restricted stock		119,766			67,929	
Stock options		483,759			439,827	
Diluted earnings per share:						
Income before extraordinary item	$ 27,625	48,162,904	$ 0.57	$ 36,737	48,039,553	$ 0.76

Options excluded from the computation of diluted earnings per share because the exercise price was greater than the average market price for the periods presented are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2005	2004	2005	2004	2005	2004
Options excluded		2,184		238,459		444,645
Exercise price range	$	$ 15.65 - $15.99	$	$ 13.77 - $15.99	$	$ 12.78 - $15.99

D. Commitments, Contingencies and Uncertainties

For a full discussion of commitments and contingencies, see Note I of Notes to Consolidated Financial Statements in the 2004 Form 10-K. In addition, see Note B above and Notes B and C of Notes to Consolidated Financial Statements in the 2004 Form 10-K regarding matters related to regulation and Palo Verde, including decommissioning, spent fuel storage, disposal of low-level radioactive waste, steam generators and liability and insurance matters.

Environmental Matters

The Company is subject to regulation with respect to air, soil and water quality, solid waste disposal and other environmental matters by federal, state, tribal and local authorities. Those authorities govern current facility operations and have continuing jurisdiction over facility modifications. Failure to comply with these environmental regulatory requirements can result in actions by regulatory agencies or other authorities that might seek to impose on the Company administrative, civil, and/or criminal penalties. If the United States regulates greenhouse gas emissions, the Company s fossil fuel generation assets will be faced with the additional cost of monitoring, controlling and reporting these emissions, although, given the Company s significant nuclear and gas fired portfolio, the Company does not believe such regulations would impose greater burdens on the Company than on most other electric utilities. In

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addition, unauthorized releases of pollutants or contaminants into the environment can result in costly cleanup obligations that are subject to enforcement by regulatory agencies. Environmental regulations can change rapidly and are often difficult to predict. While the Company strives to prepare for and implement changes necessary to comply with changing environmental regulations, substantial expenditures may be required for the Company to comply with such regulations in the future.

The Company analyzes the costs of its obligations arising from environmental matters on an ongoing basis, and believes it has made adequate provision in its financial statements to meet such obligations. As a result of this analysis, the Company has a provision for environmental remediation obligations of approximately $1.1 million as of September 30, 2005, which is related to compliance with federal and state environmental standards. However, unforeseen expenses associated with compliance could have a material adverse effect on the future operations and financial condition of the Company.

The Company incurred the following expenditures during the three, nine and twelve months ended September 30, 2005 and 2004 to comply with federal environmental statutes (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2005	2004	2005	2004	2005	2004
Clean Air Act	$ 300	$ 59	$ 875	$ 693	$ 944	$ 1,024
Clean Water Act (1)	213	104	549	460	1,295	410

(1) Includes $0.6 million in remediation costs for the twelve months ended September 30, 2005.

Along with many other companies, the Company received from the Texas Commission on Environmental Quality (TCEQ) a request for information dated October 15, 2003 in connection with environmental conditions at a facility in San Angelo, Texas that has been owned and operated by the San Angelo Electric Service Company (SESCO). The Company s written response to TCEQ notes that SESCO performed repair services for certain Company electrical equipment between 1981 and 1991, prior to the Company s bankruptcy. Although the SESCO site has not been designated as a state or federal Superfund site and the Company has not been named as a responsible party or a potentially responsible party at that site, the Company received in October 2004 an invitation to participate in site cleanup activities from a group of private companies that are conducting certain cleanup activities at the SESCO site. At this time, the Company has not agreed to participate in the cleanup of the SESCO site and is unable to predict the outcome of this matter, although the Company has no reason at present to believe that it will incur material liabilities in connection with the SESCO site.

Except as described herein, the Company is not aware of any other active investigation of its compliance with environmental requirements by the Environmental Protection Agency, the TCEQ or the New Mexico Environment Department which is expected to result in any material liability. Furthermore, except as described herein, the Company is not aware of any unresolved, potentially

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material liability it would face pursuant to the Comprehensive Environmental Response, Comprehensive Liability Act of 1980, also known as the Superfund law.

Tax Matters

The Company s federal income tax returns for the years 1999 through 2002 have been examined by the IRS. On May 9, 2005, the Company received the IRS notice of proposed deficiency. The primary audit adjustments proposed by the IRS related to (i) whether the Company was entitled to currently deduct payments related to the repair of the Palo Verde Unit 2 steam generators or whether these payments should be capitalized and depreciated and (ii) whether the Company was entitled to currently deduct payments related to the dry cask storage facilities for spent nuclear fuel or whether these payments should be capitalized and depreciated. The Company has protested the audit adjustments through administrative appeals and believes that its treatment of the payments is supported by substantial legal authority. In the event that the IRS prevails, the resulting income tax and interest payments could be material to the Company s cash flows. The Company believes that the audit adjustments can be resolved through administrative appeals and that, as of September 30, 2005, adequate provision has been made for any additional tax that may be due.

E. Litigation

The Company is a party to various legal actions. In many of these matters, the Company has excess casualty liability insurance that covers the various claims, actions and complaints. Based upon a review of these claims and applicable insurance coverage, to the extent that the Company has been able to reach a conclusion as to its ultimate liability, it believes that none of these claims will have a material adverse effect on the financial position, results of operations or cash flows of the Company.

On January 16, 2003, the Company was served with a complaint on behalf of a purported class of shareholders alleging violations of the federal securities laws (*Roth v. El Paso Electric Company, et al.,* No. EP-03-CA-0004). The complaint was filed in the El Paso Division of the United States District Court for the Western District of Texas. The suit seeks undisclosed compensatory damages for the class as well as costs and attorneys fees. The lead plaintiff, Carpenters Pension Fund of Illinois, filed a consolidated amended complaint on July 2, 2003, alleging, among other things, that the Company and certain of its current and former directors and officers violated securities laws by failing to disclose that some of the Company s revenues and income were derived from an allegedly unlawful relationship with Enron. The allegations arise out of the FERC investigation of the power markets in the western United States during 2000 and 2001, which the Company previously settled with the FERC Trial Staff and certain intervening parties. On August 15, 2003, the Company and the individual defendants filed a motion to dismiss the complaint for failure to state a claim upon which relief can be granted. On November 26, 2003, the Court denied the motion to dismiss as to the Company and three of the individual defendants and granted the motion to dismiss as to two individual defendants. On April 13, 2004, the Court granted a motion of the Company and the remaining individual defendants requesting permission to file an interlocutory appeal to the U. S. Court of Appeals for the Fifth Circuit regarding certain legal questions relating to the Court s denial of the motion to dismiss the complaint as to those

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defendants. On April 27, 2004, the Court entered an order staying the district court proceedings until the Fifth Circuit completed its review. On June 7, 2004, the U. S. Court of Appeals denied the appeal which automatically lifted the stay in the district court. While the Company believed the lawsuit was without merit, the parties reached a settlement to resolve this case. The parties filed a Stipulation of Settlement with the Court on June 2, 2005, and the Court issued a final order approving the settlement on September 15, 2005. The settlement was paid by the Company s insurance carrier since the deductible had been met and did not require any further charge to the Company s earnings.

On May 21, 2003, the Company was served with a complaint by the Port of Seattle seeking civil damages under the Sherman Act, the Racketeer Influenced and Corrupt Organization Act, and state antitrust laws, as well as for fraud (*Port of Seattle v. Avista Corporation, et al.*, No. CV03-117OP). The complaint was filed in the United States District Court for the Western District of Washington. The complaint alleges that the Company, indirectly through its dealings with Enron, conspired with the other named defendants to manipulate the California energy market, which had the effect of artificially inflating the price that the Port of Seattle paid for electricity. The Company, together with several other defendants, filed a motion to dismiss. On May 12, 2004, the Court granted the Company s motion, and the suit was dismissed. The Port of Seattle has filed an appeal of the Court s decision with the U. S. Court of Appeals for the Ninth Circuit. The Company and the other defendants filed a motion for summary affirmance on July 19, 2005 based on recent U.S. Supreme Court action in a similar case which the defendants contend supports the Court s dismissal of this case. The motion for summary affirmance was denied on October 17, 2005. The parties are awaiting a hearing and decision on that appeal. While the Company believes that these matters are without merit, the Company is unable to predict the outcome or range of any possible loss.

On May 5, 2004, Wah Chang, a specialty metals manufacturer which operates a plant in Oregon, filed suit against the Company and other defendants in the United States District Court for the District of Oregon. (*Wah Chang v. Avista Corporation, et al.,* No. 04-619AS). The complaint makes substantially the same allegations as were made in *Port of Seattle* and seeks the same types of damages. In addition, on June 7, 2004, the City of Tacoma filed suit against the Company and other defendants in the United States District Court for the Western District of Washington (*City of Tacoma v. American Electric Power Service Corp., et al.,* C04-5325RBL). This complaint also makes substantially the same allegations as were made in *Port of Seattle* and seeks civil damages (including treble damages) from the Company and the other defendants for violations of certain antitrust provisions under the Sherman Act. Both of these matters were transferred to the same court that heard and dismissed the *Port of Seattle* lawsuit and on February 11, 2005, the Court granted the Company s motion to dismiss both cases. Wah Chang and the City of Tacoma have both filed notices of appeal with the U.S. Court of Appeals for the Ninth Circuit. The parties have filed briefs in both cases and are awaiting a hearing and decision. In addition, the Company and the other defendants filed a motion for summary affirmance in the *City of Tacoma* lawsuit on August 9, 2005, similar to the motion filed in the *Port of Seattle* lawsuit. The motion for summary affirmance was denied on October 17, 2005. While the Company believes that these matters are without merit and intends to defend itself vigorously, the Company is unable to predict the outcome or range of possible loss.

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F. Employee Benefits

Retirement Plans

The net periodic benefit cost recognized for the three, nine and twelve months ended September 30, 2005 and 2004 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Components of net periodic benefit cost:				
Service cost	$ 1,291	$ 1,113	$ 3,873	$ 3,339
Interest cost	2,658	2,522	7,974	7,566
Expected return on plan assets	(2,359)	(1,927)	(7,077)	(5,781)
Amortization of:				
Net loss	1,049	843	3,146	2,529
Prior service cost	29	5	87	15
Net periodic benefit cost	$ 2,668	$ 2,556	$ 8,003	$ 7,668

	Twelve Months Ended September 30,	
	2005	2004
Components of net periodic benefit cost:		
Service cost	$ 4,975	$ 4,292
Interest cost	10,526	9,967
Expected return on plan assets	(9,222)	(7,665)
Amortization of:		
Net loss	4,040	2,963
Prior service cost	187	21

Net periodic benefit cost	$ 10,506	$ 9,578

During the nine months ended September 30, 2005, the Company contributed $15.3 million of its projected $18.5 million 2005 annual contribution to its retirement plans.

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Other Postretirement Benefits

The net periodic benefit cost recognized for the three, nine and twelve months ended September 30, 2005 and 2004 is made up of the components listed below (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Components of net periodic benefit cost:				
Service cost	$ 1,187	$ 1,159	$ 3,561	$ 3,477
Interest cost	1,667	1,756	5,001	5,268
Expected return on plan assets	(345)	(315)	(1,036)	(945)
Amortization of:				
Net gain				
Prior service cost	(89)		(267)	
Net periodic benefit cost	$ 2,420	$ 2,600	$ 7,259	$ 7,800

	Twelve Months Ended September 30,	
	2005	2004
Components of net periodic benefit cost:		
Service cost	$ 3,880	$ 4,455
Interest cost	5,572	6,885
Expected return on plan assets	(1,349)	(1,200)
Amortization of:		
Net gain	(387)	
Prior service cost	(518)	
Net periodic benefit cost	$ 7,198	$ 10,140

During the nine months ended September 30, 2005, the Company contributed $2.6 million of its projected $3.4 million 2005 annual contribution to its postretirement plan.

G. Franchises and Significant Customers

City of El Paso Franchise

On July 21, 2005, the Company entered into a new 25-year franchise with the City which became effective August 2, 2005. Under the new agreement, the franchise fee payable to the City increased from 2% to 3.25% of revenues from customers within the City, and, subject to regulatory approvals, the Company agreed to construct its next power generating plant within the city limits of El Paso. The

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agreement further provides that the franchise cannot be assigned by the Company to a third party without the consent of the City. In August 2005, a dispute arose over the timing and characterization of past and future franchise fee payments to the City. Management is seeking a resolution of this issue and does not believe that it will have a material impact on the Company s results of operations or financial condition.

Military Installations

The Company s retail service contract with Holloman Air Force Base expires December 2005. The Company is currently negotiating with Holloman Air Force Base and is seeking to enter into a new contract with this customer.

H. Long-Term Debt

The Company filed a shelf registration statement on Form S-3 with the Securities and Exchange Commission which became effective in May 2005. The shelf registration statement enables the Company to offer and issue debt securities, first mortgage bonds, shares of stock and certain other securities from time to time in one or more offerings of up to $1.0 billion.

In May 2005, the Company commenced a cash tender offer for any and all of its 8.90% Series D First Mortgage Bonds due February 1, 2006 and its 9.40% Series E First Mortgage Bonds due May 1, 2011, which were callable by the Company beginning on February 1, 2006 (collectively, the Bonds). The total outstanding principal amount of the Bonds subject to the offer was approximately $359.4 million. On June 3, 2005, the Company completed the cash tender offer, and paid approximately $289.9 million for principal, premium and accrued and unpaid interest for all Bonds tendered and accepted for payment. On June 7, 2005, the Company exercised its right to defease all Bonds which were not tendered by the expiration date of the tender offer by depositing approximately $95.7 million with a trustee for payment of principal, premium and accrued interest through February 1, 2006. As a result of the cash tender offer and legal defeasance, the Company has concluded that the liabilities associated with the Bonds have been extinguished in accordance with SFAS No. 140, Accounting for Transfers and Services of Financial Assets and Extinguishments of Liabilities.

In May 2005, the Company issued $400.0 million aggregate principal amount of its 6% Senior Notes due May 15, 2035 (the Notes) under its shelf registration statement. The proceeds from the issuance of the Notes of $397.7 million (net of a $2.3 million discount) were used to fund the retirement of the Bonds.

During the first quarter of 2005, the Company entered into treasury rate lock agreements to hedge against potential movements in the treasury reference interest rate pending the issuance of the Notes. These treasury rate locks were terminated on May 11, 2005. The treasury rate lock agreements met the criteria for hedge accounting and were designated as a cash flow hedge. In accordance with cash flow hedge accounting, the Company recorded the loss associated with the fair value of the cash flow hedge of approximately $14.0 million, net of tax, as a component of accumulated other comprehensive loss. In

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May 2005, the Company began to recognize in earnings (as additional interest expense) the accumulated other comprehensive loss associated with the cash flow hedge. During the next twelve month period, approximately $0.3 million of this accumulated other comprehensive loss item will be reclassified to interest expense.

On August 1, 2005, the Company issued three series of pollution control bonds in the amounts of $63.5 million, $59.2 million and $37.1 million. The $59.2 million bonds, which mature in 2040, were issued with a fixed interest rate of 4.80% and an effective interest rate of 4.91% after considering related insurance and issuance costs. The $63.5 million and $37.1 million bonds, which also mature in 2040, were issued with a variable rate that is repriced weekly. The Company also remarketed $33.3 million of pollution control bonds which bear a fixed interest rate of 4% until August 1, 2012 which is the date the bonds are due to be remarketed. The effective interest rate for these bonds is 4.47% after considering related insurance and issuance costs. The issuance and remarketing replace four series of bonds which were subject to mandatory tender or remarketing as of August 1, 2005.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

El Paso Electric Company:

We have reviewed the condensed consolidated balance sheet of El Paso Electric Company and subsidiary as of September 30, 2005, the related condensed consolidated statements of operations and comprehensive operations for the three-month, nine-month, and twelve-month periods ended September 30, 2005 and 2004, and the related condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2005 and 2004. These condensed consolidated financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of El Paso Electric Company and subsidiary as of December 31, 2004, and the related consolidated statements of operations, comprehensive operations, changes in common stock equity, and cash flows for the year then ended (not presented herein); and in our report dated March 11, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2004, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

KPMG LLP

El Paso, Texas

November 4, 2005

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The information contained in this Item 2 updates, and should be read in conjunction with, the information set forth in Part II, Item 7 of our 2004 Form 10-K.

Forward-Looking Statements

Certain matters discussed in this Quarterly Report on Form 10-Q other than statements of historical information are forward-looking statements. The Private Securities Litigation Reform Act of 1995 has established that these statements qualify for safe harbors from liability. Forward-looking statements may include words like we believe , anticipate , target , expect , pro forma , estimate , intend and words of sir meaning. Forward-looking statements describe our future plans, objectives, expectations or goals. Such statements address future events and conditions concerning and include, but are not limited to such things as:

- capital expenditures,
- earnings,
- liquidity and capital resources,
- litigation,
- accounting matters,
- possible corporate restructurings, acquisitions and dispositions,
- compliance with debt and other restrictive covenants,
- interest rates and dividends,
- environmental matters,
- nuclear operations, and
- the overall economy of our service area.

These forward-looking statements involve known and unknown risks that may cause our actual results in future periods to differ materially from those expressed in any forward-looking statement. Factors that would cause or contribute to such differences include, but are not limited to, such things as:

- our rates following the end of the Texas freeze period ending August 1, 2010 and the New Mexico Stipulation,
- loss of margins on off-system sales,
- increased costs at Palo Verde,
- unscheduled outages,
- electric utility deregulation or re-regulation,
- regulated and competitive markets,
- ongoing municipal, state and federal activities,
- economic and capital market conditions,
- changes in accounting requirements and other accounting matters,
- changing weather trends,
- rates, cost recoveries and other regulatory matters,
- the impact of changes and downturns in the energy industry and the market for trading wholesale electricity,
- the City of El Paso s review of operating expenses pursuant to the rate stipulation,
- timing of fuel costs recoveries,

political, legislative, judicial and regulatory developments,

the impact of lawsuits filed against us,

the impact of changes in interest rates,

changes in, and the assumptions used for, pension and other post-retirement and post-employment benefit liability calculations, as well as actual and assumed investment returns on pension plan assets,

the impact of changing cost and cost escalation and other assumptions on our nuclear decommissioning liability for the Palo Verde Nuclear Generating Station,

Texas, New Mexico and electric industry utility service reliability standards,

homeland security considerations,

coal, natural gas, oil and wholesale electricity prices, and

other circumstances affecting anticipated operations, sales and costs.

These lists are not all-inclusive because it is not possible to predict all factors. A discussion of some of these factors is included in this document under the headings Risk Factors and in the 2004 Form 10-K under the headings Management s Discussion and Analysis Summary of Critical Accounting Policies and Estimates and Liquidity and Capital Resources. This report should be read in its entirety. No one section of this report deals with all aspects of the subject matter. Any forward-looking statement speaks only as of the date such statement was made, and we are not obligated to update any forward-looking statement to reflect events or circumstances after the date on which such statement was made except as required by applicable laws or regulations.

Summary of Critical Accounting Policies and Estimates

The preparation of our financial 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 policies and estimates are both important to the portrayal of our financial condition and results of operations and require complex, subjective judgments and are more fully described in the Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2004 Form 10-K.

Decommissioning. Recently the Palo Verde Participants approved the 2004 Palo Verde decommissioning study. Some changes in the cost calculations occurred between the prior 2001 study and the 2004 study. The 2004 study estimated that we must fund approximately $335.7 million (stated in 2004 dollars) to cover our share of decommissioning costs. The previous cost estimate from the 2001 study estimated that we needed to fund approximately $311.6 million (stated in 2001 dollars). Had an equivalent estimate been calculated for the 2001 study in 2004 dollars, based upon the same 3.6% escalation rate utilized in the 2001 study, the previous estimate would have been $346.5 million stated in 2004 dollars. The estimated liability under the 2004 study differs from the ARO liability of $62.9 million we recorded as of September 30, 2005. This difference can be attributed to how SFAS No. 143 measures the ARO liability, relative to current cost estimates, and the inherent assumption in SFAS No. 143 that Palo Verde will operate until the end of its useful life (which includes an assessment of the probability of a license extension). The ARO liability calculation begins with the same current cost estimate referenced above, then escalates that cost over the remaining life of the plant, finally discounting the resulting cost at a credit-risk adjusted discount rate. Since we assumed an escalation rate of 3.6% and a credit-risk adjusted discount rate of 9.5% in the calculation of the ARO liability, the ARO liability is significantly less than our share of the current estimated cost to decommission Palo Verde in 2001 dollars. As Palo Verde approaches the end of its estimated useful life, the difference between the

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ARO liability and future current cost estimates will narrow over time due to the accretion of the ARO liability.

Paragraph A26 of SFAS No. 143, Accounting for Asset Retirement Obligations requires us to revise our previously recorded asset retirement obligation (ARO) for any changes in estimated cash flows. Any changes that result in an upward revision to estimated cash flows shall be treated as a new liability. Any downward revisions to the estimated cash flows results in a reduction to the previously recorded ARO. Since the 2004 study reflects a downward revision in the estimated cash flows for decommissioning costs from the 2001 study, we recorded a $1.8 million reduction to our ARO asset and liability in the third quarter of 2005. Accretion and depreciation expense related to the ARO will decrease approximately $0.3 million annually as a result of this adjustment.

The decommissioning study is updated every three years. The 2007 study is expected to be completed in the second quarter of 2008. Any changes in the estimated cash flows resulting from the 2007 study will be analyzed to determine the impacts to the ARO.

Overview

The following is an overview of our results of operations for the three, nine, and twelve month periods ended September 30, 2005. Income during the three, nine and twelve month periods ended September 30, 2005 and 2004 are shown below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income before extraordinary item (in thousands)	$ 28,012	$ 23,938	$ 28,807	$ 34,551
Basic earnings per share before extraordinary item	0.59	0.50	0.60	0.73

	Twelve Months Ended September 30,	
	2005	2004
Net income before extraordinary item (in thousands)	$ 27,625	$ 36,737
Basic earnings per share before extraordinary item	0.58	0.77

The primary factors affecting our results of operations are revenues from the sale of power to retail customers and economy sales as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2005	2004	2005	2004	2005	2004

Retail sales	88%	87%	88%	87%	88%	87%
Economy sales	10	12	11	11	11	12

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Revenues from the sale of electricity include fuel costs, which are substantially passed through to customers through fuel adjustment mechanisms in Texas and New Mexico, and base revenues. Base revenues refers to our revenues from the sale of electricity excluding such fuel costs. Economy sales are wholesale sales into markets outside our service territory. Sales for resale (which are wholesale sales within our service territory) accounted for less than 1% of base revenues.

Retail base revenue percentages by customer class are presented below:

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2005	2004	2005	2004	2005	2004
Residential	43%	40%	40%	39%	39%	38%
Commercial and industrial, small	34	36	35	36	36	36
Commercial and industrial, large	8	9	9	9	9	10
Sales to public authorities	15	15	16	16	16	16
Total base revenues	100%	100%	100%	100%	100%	100%

No retail customer accounted for more than 2% of our base revenues during such periods.

Our results of operations are also significantly impacted by the operation of Palo Verde, which represents approximately 40% of our available net generating capacity and approximately 46%, 48% and 48% of our kWh generation for the three, nine and twelve months ended September 30, 2005, respectively. Palo Verde comprises 41% of our total net plant-in-service and Palo Verde expenses comprise a significant portion of operation and maintenance expenses. In addition, plant operations are subject to performance standards in Texas. If such performance standards are not met, we are subject to a penalty. We have met the Texas performance standards during the 2004 and 2005 periods. See Part I, Business Regulation Texas Regulatory Matters Palo Verde Performance Standards of the 2004 Form 10-K.

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The following table and accompanying explanation show the primary factors affecting the after-tax change in income before extraordinary item between the 2005 and 2004 periods presented (in thousands):

	Three Months Ended	Nine Months Ended	Twelve Months Ended
September 30, 2004 net income before extraordinary item	$ 23,938	$ 34,551	$ 36,737
Change in:			
Increase in retail base revenues (a)	5,797	4,787	4,469
Decreased depreciation and amortization expense (b)	2,881	2,261	1,433
Decreased interest charges on long-term debt (c)	2,052	3,020	3,473
Sales tax refund (d)	770	770	770
Decreased (increased) loss on extinguishment of debt (e)	511	(9,149)	(9,560)
Increased investment and interest income (f)	445	1,205	1,926
Palo Verde operations and maintenance expense (g)	253	(1,011)	(4,011)
2004 IRS settlement (h)	(6,200)	(6,200)	(6,200)
Increased incentive compensation (i)	(1,371)	(2,368)	(4,550)
Accrual for Texas fuel cases (j)	(904)	(904)	1,884
Taxes other than income taxes (k)	(239)	1,029	1,487
Other	79	816	(233)
September 30, 2005 net income	$ 28,012	$ 28,807	$ 27,625

(a) Retail base revenues increased in 2005 compared to the same periods last year primarily due to increased kWh sales to our residential customers reflecting growth in the number of customers served and favorable weather conditions.

(b) Depreciation and amortization decreased due to completing the recovery of certain fresh-start accounting related assets over the term of the Texas Rate Stipulation which ended July 2005.

(c) Interest charges decreased due to decreased interest expense on long-term debt and financing obligations resulting from the refinancing of first mortgage bonds with long-term senior notes and the August 2005 reissuance and remarketing of pollution control bonds at lower interest rates.

(d) The sales tax refund pertains to a 2005 refund of Texas sales and use tax estimated payments made in prior periods with no comparable amount in 2004.

(e) Loss on extinguishment of debt for the three month period ended September 30, 2005 compared to the same period last year decreased due to losses incurred with the repurchases of first mortgage bonds in 2004 with no comparable amount in the current quarter. Loss on extinguishment of debt for the nine and twelve month periods ended September 30, 2005 increased compared to the same periods in 2004 and reflect the refinancing of all of our first mortgage bonds in June 2005.

(f) Investment and interest income increased in 2005 compared to the same periods last year due to the receipt of interest on the sales tax refund referred to above and an adjustment to interest income on a Texas fuel under-recovery balance in 2004.

(g) Palo Verde operations and maintenance expense increased for the nine months ended September 30, 2005 when compared to the same period last year due to increased operations expense. The twelve months ended September 30, 2005 increased when compared to the same period last year due to increased maintenance expense and the accrual of an employee bonus in the fourth quarter of 2004 with no comparable amount in 2003.

(h) A benefit was recorded in the third quarter of 2004 from a settlement of an IRS audit of our 1996-1998 tax returns with no comparable amount in 2005.

(i) Increased incentive compensation relates to the increased accrual for our short-term incentive plan in 2005.

(j) Accrual for Texas fuel cases for the three and nine month periods ended September 30, 2005 reflect an accrual for a potential fuel disallowance related to the Texas Commission s review of fuel costs for the period January 1, 2001 through February 28, 2004. The decrease in the accrual for Texas fuel cases for the twelve month period ended September 30, 2005 compared to the same period last year is primarily due to a fuel disallowance in PUC Docket No. 26194 of $2.8 million, after-tax, recorded in the fourth quarter of 2003 offset by the accrual in the current quarter.

(k) Taxes other than income taxes increased for the three month period ended September 30, 2005 compared to September 30, 2004 due to an increase in the El Paso city franchise fee rate which took effect August 2, 2005, partially offset by a decrease in property taxes. For the nine and twelve month periods other taxes decreased due to lower property taxes. In addition, pursuant to a June 2004 change in New Mexico law, the occupation street rental tax on retail sales of electricity is now collected directly from retail customers and not recorded as an expense.

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Historical Results of Operations

The following discussion includes detailed descriptions of factors affecting individual line items in the results of operations. The amounts presented below are presented on a pre-tax basis.

Operating revenues

Operating revenues net of energy expenses increased $8.8 million for the three months ended September 30, 2005 compared to the same period last year primarily due to increased retail base revenues of $9.3 million partially offset by an additional accrual of $1.5 million for a potential Texas fuel disallowance related to PUC Docket No. 30143.

Operating revenues net of energy expenses increased $8.7 million for the nine months ended September 30, 2005 compared to the same period last year primarily due to (i) increased retail base revenues of $7.7 million; (ii) increased economy sales of $1.7 million; and (iii) increases in wheeling and other revenues of $0.8 million. These increases were partially offset by an additional $1.5 million accrual for a potential Texas fuel disallowance related to PUC Docket No. 30143.

Operating revenues net of energy expenses increased $11.7 million for the twelve months ended September 30, 2005 compared to the same period last year primarily due to (i) increased retail base revenues of $7.2 million; (ii) the Texas fuel disallowance of $4.5 million recorded in the fourth quarter of 2003 related to PUC Docket No. 26194 compared to an additional $1.5 million accrual for a potential Texas fuel disallowance related to PUC Docket No. 30143 recorded in the current period; and (iii) increased 2005 economy sales revenue of $2.3 million primarily due to higher prices. These increases were partially offset by the $1.8 million increase in the current period coal reclamation liability.

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

			Increase (Decrease)	
Quarter Ended September 30:	**2005**	**2004**	**Amount**	**Percent**
kWh sales:				
Retail:				
Residential	673,092	586,905	86,187	14.7%(1)
Commercial and industrial, small	642,342	618,039	24,303	3.9
Commercial and industrial, large	309,002	311,814	(2,812)	(0.9)
Sales to public authorities	374,459	346,887	27,572	7.9
Total retail sales	1,998,895	1,863,645	135,250	7.3
Wholesale:				
Sales for resale	12,800	11,163	1,637	14.7
Economy sales	360,157	536,151	(175,994)	(32.8)(2)
Total wholesale sales	372,957	547,314	(174,357)	(31.9)
Total kWh sales	2,371,852	2,410,959	(39,107)	(1.6)
Operating revenues:				
Base revenues:				
Retail:				
Residential	$ 59,599	$ 52,420	$ 7,179	13.7%(1)
Commercial and industrial, small	48,030	47,036	994	2.1
Commercial and industrial, large	11,161	11,237	(76)	(0.7)
Sales to public authorities	20,747	19,495	1,252	6.4
Total retail base revenues	139,537	130,188	9,349	7.2
Wholesale:				
Sales for resale	508	481	27	5.6
Total base revenues	140,045	130,669	9,376	7.2
Fuel revenues:				
Recovered from customers during the period	47,852	43,621	4,231	9.7(3)(4)
Change in deferred fuel revenues	26,408	3,878	22,530	581.0(5)
Total fuel revenues	74,260	47,499	26,761	56.3
Economy sales	23,640	23,382	258	1.1
Other	4,086	3,391	695	20.5(6)(7)
Total operating revenues	$ 242,031	$ 204,941	$ 37,090	18.1
Average number of residential and small commercial and industrial customers	336	325	11	3.4%

(1) Primarily due to favorable weather conditions and increased customer growth.

(2) Primarily due to decreased sales as a result of higher retail load and decreased availability of Palo Verde generation.

(3) Approximately $0.02 per kWh of fuel revenues is collected in base revenues from our New Mexico customers.

(4) Primarily due to increased kWh sales and recovery of increased fuel costs in New Mexico.

(5) Primarily due to increased natural gas prices which were not reflected in our Texas fixed fuel factor.

(6) Primarily due to increased transmission revenues.

(7) Represents revenues with no related kWh sales.

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Nine Months Ended September 30:	2005	2004	Increase (Decrease) Amount	Increase (Decrease) Percent
kWh sales:				
Retail:				
Residential	1,608,976	1,523,708	85,268	5.6%(1)
Commercial and industrial, small	1,631,809	1,629,402	2,407	0.1
Commercial and industrial, large	883,862	930,649	(46,787)	(5.0)(2)
Sales to public authorities	977,947	949,559	28,388	3.0
Total retail sales	5,102,594	5,033,318	69,276	1.4