

EL PASO ELECTRIC CO /TX/  
Form 10-Q  
August 06, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 30, 2010

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 001-14206

**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)

(915) 543-5711

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(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  NO

Indicate by check mark whether the registrant submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

As of July 30, 2010, there were 43,520,513 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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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

|   | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|---|--|------------------------------|
| <b>ASSETS</b>   |  |                              |
| <b>(In thousands)</b>   |  |                              |
| <b>Utility plant:</b>   |  |                              |
| Electric plant in service   | \$ 2,469,953                             | \$ 2,392,850                 |
| Less accumulated depreciation and amortization  | (1,011,182)                              | (981,314)                    |
| Net plant in service  | 1,458,771                                | 1,411,536                    |
| Construction work in progress   | 251,760                                  | 244,166                      |
| Nuclear fuel; includes fuel in process of \$39,605 and \$50,929, respectively                                       | 152,601                                  | 135,021                      |
| Less accumulated amortization   | (38,465)                                 | (34,737)                     |
| Net nuclear fuel  | 114,136                                  | 100,284                      |
| Net utility plant   | 1,824,667                                | 1,755,986                    |
| <b>Current assets:</b>  |  |                              |
| Cash and cash equivalents   | 29,410                                   | 91,790                       |
| Accounts receivable, principally trade, net of allowance for doubtful accounts of \$2,733 and \$1,191, respectively | 96,557                                   | 70,382                       |
| Accumulated deferred income taxes   | 22,092                                   | 20,445                       |
| Inventories, at cost  | 36,161                                   | 37,935                       |
| Income taxes receivable   | 16,277                                   | 24,162                       |
| Undercollection of fuel revenues  | 68                                       | 0                            |
| Prepayments and other   | 6,351                                    | 4,837                        |
| Total current assets  | 206,916                                  | 249,551                      |
| <b>Deferred charges and other assets:</b>   |  |                              |
| Decommissioning trust funds   | 137,328                                  | 135,372                      |
| Regulatory assets   | 66,250                                   | 60,708                       |
| Other   | 24,598                                   | 24,535                       |
| Total deferred charges and other assets   | 228,176                                  | 220,615                      |
| <b>Total assets</b>   | <b>\$ 2,259,759</b>                      | <b>\$ 2,226,152</b>          |

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See accompanying notes to consolidated financial statements.

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS (Continued)**

|   | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|---|--|------------------------------|
| <b>CAPITALIZATION AND LIABILITIES</b>   |  |                              |
| <b>(In thousands except for share data)</b>   |  |                              |
| <b>Capitalization:</b>  |  |                              |
| Common stock, stated value \$1 per share, 100,000,000 shares authorized, 64,995,314 and 64,946,729 shares issued, and 191,772 and 147,427 restricted shares, respectively | \$ 65,187                                | \$ 65,094                    |
| Capital in excess of stated value   | 302,104                                  | 301,180                      |
| Retained earnings   | 743,211                                  | 710,255                      |
| Accumulated other comprehensive loss, net of tax  | (52,438)                                 | (49,887)                     |
|   | 1,058,064                                | 1,026,642                    |
| Treasury stock, 21,671,776 and 21,169,284 shares, respectively, at cost   | (313,901)                                | (303,913)                    |
| Common stock equity   | 744,163                                  | 722,729                      |
| Long-term debt, net of current portion  | 739,721                                  | 739,697                      |
| Financing obligations, net of current portion   | 0  | 65,278                       |
| Total capitalization  | 1,483,884                                | 1,527,704                    |
| <b>Current liabilities:</b>   |  |                              |
| Current portion of long-term debt and financing obligations   | 122,826                                  | 41,720                       |
| Accounts payable, principally trade   | 33,176                                   | 54,702                       |
| Taxes accrued   | 17,353                                   | 22,157                       |
| Interest accrued  | 10,276                                   | 10,283                       |
| Overcollection of fuel revenues   | 18,506                                   | 18,018                       |
| Other   | 24,241                                   | 24,896                       |
| Total current liabilities   | 226,378                                  | 171,776                      |
| <b>Deferred credits and other liabilities:</b>  |  |                              |
| Accumulated deferred income taxes   | 251,968                                  | 233,424                      |
| Accrued postretirement benefit liability  | 91,070                                   | 88,919                       |
| Asset retirement obligation   | 88,972                                   | 85,358                       |
| Accrued pension liability   | 79,745                                   | 80,940                       |
| Regulatory liabilities  | 13,925                                   | 14,127                       |
| Other   | 23,817                                   | 23,904                       |
| Total deferred credits and other liabilities  | 549,497                                  | 526,672                      |
| <b>Commitments and contingencies</b>  |  |                              |
| <b>Total capitalization and liabilities</b>   | <b>\$ 2,259,759</b>                      | <b>\$ 2,226,152</b>          |

See accompanying notes to consolidated financial statements.



**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(In thousands except for share data)**

|   | Three Months Ended |            | Six Months Ended |            |
|---|--------------------|------------|------------------|------------|
|   | 2010               | 2009       | 2010             | 2009       |
|   | June 30,           |            | June 30,         |            |
| <b>Operating revenues</b>                             | \$ 211,397         | \$ 203,649 | \$ 415,565       | \$ 394,085 |
| <b>Energy expenses:</b>                               |                    |            |                  |            |
| Fuel  | 50,752             | 43,883     | 99,845           | 86,176     |
| Purchased and interchanged power                      | 19,552             | 28,295     | 48,399           | 57,693     |
|   | 70,304             | 72,178     | 148,244          | 143,869    |
| <b>Operating revenues net of energy expenses</b>      | 141,093            | 131,471    | 267,321          | 250,216    |
| <b>Other operating expenses:</b>                      |                    |            |                  |            |
| Other operations                                      | 51,544             | 50,634     | 101,642          | 99,938     |
| Maintenance   | 15,735             | 16,404     | 30,235           | 29,775     |
| Depreciation and amortization                         | 20,167             | 18,706     | 39,451           | 36,385     |
| Taxes other than income taxes                         | 13,170             | 12,511     | 24,913           | 25,028     |
|   | 100,616            | 98,255     | 196,241          | 191,126    |
| <b>Operating income</b>                               | 40,477             | 33,216     | 71,080           | 59,090     |
| <b>Other income (deductions):</b>                     |                    |            |                  |            |
| Allowance for equity funds used during construction   | 2,707              | 2,623      | 5,247            | 5,212      |
| Investment and interest income, net                   | 840                | (1,150)    | 1,938            | (1,636)    |
| Miscellaneous non-operating income                    | 151                | 549        | 153              | 761        |
| Miscellaneous non-operating deductions                | (529)              | (726)      | (888)            | (2,041)    |
|   | 3,169              | 1,296      | 6,450            | 2,296      |
| <b>Interest charges (credits):</b>                    |                    |            |                  |            |
| Interest on long-term debt and financing obligations  | 12,241             | 12,196     | 24,442           | 26,120     |
| Other interest  | 25                 | 82         | 65               | 252        |
| Capitalized interest                                  | (258)              | (246)      | (486)            | (496)      |
| Allowance for borrowed funds used during construction | (1,534)            | (1,691)    | (3,101)          | (3,373)    |
|   | 10,474             | 10,341     | 20,920           | 22,503     |
| <b>Income before income taxes</b>                     | 33,172             | 24,171     | 56,610           | 38,883     |
| <b>Income tax expense</b>                             | 11,665             | 8,740      | 23,654           | 13,843     |
| <b>Net income</b>                                     | \$ 21,507          | \$ 15,431  | \$ 32,956        | \$ 25,040  |



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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| <b>Basic earnings per share</b>  | \$ 0.49    | \$ 0.34    | \$ 0.75    | \$ 0.56    |
| <b>Diluted earnings per share</b>  | \$ 0.49    | \$ 0.34    | \$ 0.75    | \$ 0.56    |
| <b>Weighted average number of shares outstanding</b>                               | 43,460,458 | 44,782,749 | 43,598,933 | 44,769,843 |
| <b>Weighted average number of shares and dilutive potential shares outstanding</b> | 43,557,788 | 44,792,345 | 43,710,026 | 44,791,380 |

See accompanying notes to consolidated financial statements.

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(In thousands except for share data)**

|   | <b>Twelve Months Ended<br/>June 30,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
| <b>Operating revenues</b>                             | \$ 849,476                              | \$ 908,370  |
| <b>Energy expenses:</b>                               |   |             |
| Fuel  | 199,506                                 | 228,257     |
| Purchased and interchanged power                      | 99,309                                  | 151,600     |
|   | 298,815                                 | 379,857     |
| <b>Operating revenues net of energy expenses</b>      | 550,661                                 | 528,513     |
| <b>Other operating expenses:</b>                      |   |             |
| Other operations                                      | 217,545                                 | 203,607     |
| Maintenance   | 60,066                                  | 58,815      |
| Depreciation and amortization                         | 78,012                                  | 74,565      |
| Taxes other than income taxes                         | 49,883                                  | 50,735      |
|   | 405,506                                 | 387,722     |
| <b>Operating income</b>                               | 145,155                                 | 140,791     |
| <b>Other income (deductions):</b>                     |   |             |
| Allowance for equity funds used during construction   | 9,346                                   | 9,833       |
| Investment and interest income, net                   | 7,387                                   | 127         |
| Miscellaneous non-operating income                    | 499                                     | 2,887       |
| Miscellaneous non-operating deductions                | (2,330)                                 | (3,434)     |
|   | 14,902                                  | 9,413       |
| <b>Interest charges (credits):</b>                    |   |             |
| Interest on long-term debt and financing obligations  | 48,834                                  | 53,043      |
| Other interest  | 209                                     | 903         |
| Capitalized interest                                  | (933)                                   | (1,988)     |
| Allowance for borrowed funds used during construction | (5,757)                                 | (5,596)     |
|   | 42,353                                  | 46,362      |
| <b>Income before income taxes</b>                     | 117,704                                 | 103,842     |
| <b>Income tax expense</b>                             | 42,855                                  | 34,903      |
| <b>Net income</b>                                     | \$ 74,849                               | \$ 68,939   |

|  |            |            |
|--|------------|------------|
| <b>Basic earnings per share</b>  | \$ 1.70    | \$ 1.54    |
| <b>Diluted earnings per share</b>  | \$ 1.69    | \$ 1.53    |
| <b>Weighted average number of shares outstanding</b>                               | 43,943,503 | 44,751,020 |
| <b>Weighted average number of shares and dilutive potential shares outstanding</b> | 44,059,201 | 44,819,062 |

See accompanying notes to consolidated financial statements.

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS****(Unaudited)****(In thousands)**

|   | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  | Twelve Months Ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|---------------------------------|------------------|
|   | 2010                           | 2009             | 2010                         | 2009             | 2010                            | 2009             |
| <b>Net income</b>   | \$ 21,507                      | \$ 15,431        | \$ 32,956                    | \$ 25,040        | \$ 74,849                       | \$ 68,939        |
| <b>Other comprehensive income (loss):</b>   |                                |                  |                              |                  |                                 |                  |
| Unrecognized pension and postretirement benefit costs:                              |                                |                  |                              |                  |                                 |                  |
| Net loss arising during period  | 0                              | 0                | 0                            | 0                | (48,580)                        | (30,587)         |
| Reclassification adjustments included in net income for amortization of:            |                                |                  |                              |                  |                                 |                  |
| Prior service benefit   | (677)                          | (677)            | (1,377)                      | (1,377)          | (2,754)                         | (2,754)          |
| Net loss  | 787                            | 412              | 1,687                        | 812              | 2,500                           | 735              |
| Net unrealized gains (losses) on marketable securities:                             |                                |                  |                              |                  |                                 |                  |
| Net holding gains (losses) arising during period                                    | (6,401)                        | 7,749            | (3,978)                      | 2,358            | 6,480                           | (19,398)         |
| Reclassification adjustments for net (gains) losses included in net income          | 378                            | 2,798            | 409                          | 5,271            | (2,644)                         | 7,472            |
| Net losses on cash flow hedges:   |                                |                  |                              |                  |                                 |                  |
| Reclassification adjustment for interest expense included in net income             | 83                             | 79               | 166                          | 156              | 327                             | 307              |
| <b>Total other comprehensive income (loss) before income taxes</b>                  | <b>(5,830)</b>                 | <b>10,361</b>    | <b>(3,093)</b>               | <b>7,220</b>     | <b>(44,671)</b>                 | <b>(44,225)</b>  |
| Income tax benefit (expense) related to items of other comprehensive income (loss): |                                |                  |                              |                  |                                 |                  |
| Unrecognized pension and postretirement benefit costs                               | (39)                           | 96               | (112)                        | 205              | 16,640                          | 11,715           |
| Net unrealized gains (losses) on marketable securities                              | 1,205                          | (2,110)          | 714                          | (1,526)          | (767)                           | 2,386            |
| Losses on cash flow hedges  | (30)                           | (29)             | (60)                         | (57)             | (118)                           | (112)            |
| <b>Total income tax benefit (expense)</b>   | <b>1,136</b>                   | <b>(2,043)</b>   | <b>542</b>                   | <b>(1,378)</b>   | <b>15,755</b>                   | <b>13,989</b>    |
| <b>Other comprehensive income (loss), net of tax</b>                                | <b>(4,694)</b>                 | <b>8,318</b>     | <b>(2,551)</b>               | <b>5,842</b>     | <b>(28,916)</b>                 | <b>(30,236)</b>  |
| <b>Comprehensive income</b>   | <b>\$ 16,813</b>               | <b>\$ 23,749</b> | <b>\$ 30,405</b>             | <b>\$ 30,882</b> | <b>\$ 45,933</b>                | <b>\$ 38,703</b> |

See accompanying notes to consolidated financial statements.

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)****(In thousands)**

|   | <b>Six Months Ended<br/>June 30,</b> |                  |
|---|--------------------------------------|------------------|
|   | <b>2010</b>                          | <b>2009</b>      |
| <b>Cash flows from operating activities:</b>                                      |                                      |                  |
| Net income  | \$ 32,956                            | \$ 25,040        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                      |                  |
| Depreciation and amortization of electric plant in service                        | 39,451                               | 36,385           |
| Amortization of nuclear fuel  | 13,758                               | 11,001           |
| Deferred income taxes, net  | 14,206                               | (4,186)          |
| Allowance for equity funds used during construction                               | (5,247)                              | (5,212)          |
| Other amortization and accretion  | 7,260                                | 7,247            |
| Other operating activities  | 44                                   | 3,599            |
| Change in:  |                                      |                  |
| Accounts receivable   | (26,175)                             | 3,499            |
| Inventories   | 1,148                                | 1,764            |
| Net overcollection of fuel revenues   | 420                                  | 51,618           |
| Prepayments and other   | (2,266)                              | (2,837)          |
| Accounts payable  | (15,880)                             | (13,687)         |
| Taxes accrued   | 3,220                                | 2,344            |
| Interest accrued  | (7)                                  | 2,152            |
| Other current liabilities   | (655)                                | 153              |
| Deferred charges and credits  | (2,708)                              | (7,569)          |
| <b>Net cash provided by operating activities</b>                                  | <b>59,525</b>                        | <b>111,311</b>   |
| <b>Cash flows from investing activities:</b>                                      |                                      |                  |
| Cash additions to utility property, plant and equipment                           | (90,603)                             | (99,795)         |
| Cash additions to nuclear fuel  | (26,981)                             | (20,199)         |
| Proceeds from sale of assets  | 0                                    | 466              |
| Capitalized interest and AFUDC:   |                                      |                  |
| Utility property, plant and equipment   | (8,348)                              | (8,585)          |
| Nuclear fuel  | (486)                                | (496)            |
| Allowance for equity funds used during construction                               | 5,247                                | 5,212            |
| Decommissioning trust funds:  |                                      |                  |
| Purchases, including funding of \$4.1 and \$3.9 million, respectively             | (39,809)                             | (24,715)         |
| Sales and maturities  | 34,205                               | 20,812           |
| Other investing activities  | (867)                                | (2)              |
| <b>Net cash used for investing activities</b>                                     | <b>(127,642)</b>                     | <b>(127,302)</b> |
| <b>Cash flows from financing activities:</b>                                      |                                      |                  |
| Repurchases of common stock   | (9,988)                              | 0                |
| Financing obligations:  |                                      |                  |
| Proceeds  | 25,092                               | 171,305          |
| Payments  | (9,264)                              | (161,465)        |
| Other financing activities  | (103)                                | (1,782)          |

|   |           |           |
|---|-----------|-----------|
| <b>Net cash provided by financing activities</b>        | 5,737     | 8,058     |
| <b>Net decrease in cash and cash equivalents</b>        | (62,380)  | (7,933)   |
| <b>Cash and cash equivalents at beginning of period</b> | 91,790    | 91,642    |
| <b>Cash and cash equivalents at end of period</b>       | \$ 29,410 | \$ 83,709 |

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, 2009 (the 2009 Form 10-K). Capitalized terms used in this report and not defined herein have the meaning ascribed for such terms in the 2009 Form 10-K. In the opinion of the Company's management, the accompanying consolidated financial statements contain all adjustments necessary to present fairly the financial position of the Company at June 30, 2010 and December 31, 2009; the results of its operations and comprehensive operations for the three, six and twelve months ended June 30, 2010 and 2009; and its cash flows for the six months ended June 30, 2010 and 2009. The results of operations and comprehensive operations for the three and six months ended June 30, 2010 and the cash flows for the six months ended June 30, 2010 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.

*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.

*Revenues.* Accounts receivable include accrued unbilled revenues of \$23.7 million and \$18.2 million at June 30, 2010 and December 31, 2009, respectively. The Company presents sales net of sales taxes in its consolidated statements of operations.

*New Accounting Standards.* In December 2009, the FASB issued revised guidance related to financial reporting by enterprises involved with variable interest entities. This guidance became effective for reporting periods beginning after November 15, 2009. The guidance requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. The Company has performed the required analysis and has determined that it does not have any purchase power agreements that qualify as a variable interest entity.

Effective April 1, 2009, the Company adopted FASB guidance which establishes general standards of accounting and disclosure of events that occur after the balance sheet date, but before financial statements are issued. In February 2010, the Company adopted an amendment to FASB guidance removing the requirement for an SEC filer to disclose a date through which subsequent events have been evaluated. This new guidance changed disclosure requirement but does not impact the Company's financial statements.

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

In January 2010, the FASB issued new guidance to improve disclosure requirements related to fair value measurements and disclosures. The new requirements include (i) disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers; and (ii) disclosure in the reconciliation for Level 3 fair value measurements should include information about purchases, sales, issuances, and settlements on a gross basis. The new guidance also clarifies existing disclosures and requires (i) an entity to provide fair value measurement disclosures for each class of assets and liabilities and (ii) disclosures about inputs and valuation techniques. The provisions of this new guidance were adopted in the first quarter of 2010 except for the reconciliation for the Level 3 fair value measurements on a gross basis which will be adopted during the first quarter of 2011. During the three and six months ended June 30, 2010, there were no transfers in or out of Level 1 or Level 2 categories. This guidance requires additional disclosure on fair value measurements, but does not impact the Company's consolidated financial statements. See Note H.

**Supplemental Cash Flow Disclosures (in thousands)**

|  | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2010</b>                          | <b>2009</b> |
| Cash paid for:                                       |                                      |             |
| Interest on long-term debt and financing obligations | \$ 23,825                            | \$ 23,522   |
| Other interest                                       | 0                                    | 4           |
| Income taxes paid                                    | 5,291                                | 12,938      |
| Non-cash financing activities:                       |                                      |             |
| Grants of restricted shares of common stock          | 1,823                                | 1,230       |
| Issuance of performance shares                       | 662                                  | 0           |

**B. Regulation****General**

The rates and services of the Company are regulated by incorporated municipalities in Texas, the PUCT, the NMPRC, and the FERC. The PUCT and the NMPRC have jurisdiction to review municipal orders, ordinances, and utility agreements regarding rates and services within their respective states and over certain other activities of the Company. The FERC has jurisdiction over the Company's wholesale transactions and compliance with federally-mandated reliability standards. The decisions of the PUCT, NMPRC and the FERC are subject to judicial review.



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**Texas Regulatory Matters**

*Texas Freeze Period.* The Company entered into agreements ( Texas Rate Agreements ) with El Paso, PUCT staff and other parties in Texas that provided for most retail base rates to remain at their current level through June 30, 2010. During the rate freeze period, if the Company's return on equity fell below the bottom of a defined range, the Company had the right to initiate a rate case and seek an adjustment to base rates. If the Company's return on equity exceeded the top of the range, the Company would refund an amount equal to 50% of the Texas jurisdictional pretax return in excess of the ceiling. The Company's return on equity fell within the then prevailing range during the last reporting period. Also pursuant to the Texas Rate Agreements, the Company agreed to share with its Texas customers 25% of off-system sales margins increasing to 90% after June 30, 2010.

*2009 Texas Retail Rate Case.* On December 9, 2009, the Company filed an application with the PUCT for authority to change rates, to reconcile fuel costs, to establish formula-based fuel factors, and to establish an energy efficiency cost-recovery factor. This case was assigned PUCT Docket No. 37690. The filing included a base rate increase which was based upon an adjusted test year ended June 30, 2009.

On July 30, 2010, the PUCT approved a settlement in the 2009 Texas retail rate case in PUCT Docket No. 37690. The settlement calls for an annual non-fuel base rate increase of \$17.15 million effective for usage beginning July 1, 2010. This increase is offset by the provision that consistent with a prior rate agreement, effective July 1, 2010, the Company will share 90% of off-system sales margins with customers and retain 10% of such margins. Previously, the Company retained 75% of off-system sales margins. Interim rates were placed in effect July 1, 2010 pending final approval by the PUCT. All additions to electric plant in service since June 30, 1993 through June 30, 2009 were deemed to be reasonable and necessary with the exception of one small addition. In addition, the Company's new customer information system completed in April 2010 was also included in base rates with a ten-year amortization. The settlement provides for the reconciliation of fuel costs incurred through June 30, 2009 except for the recovery of final coal reclamation costs which will be litigated separately. The fuel reconciliation was bifurcated from the rate case (Docket No. 38361) to allow for litigation of the final coal reclamation costs. The PUCT also approved the use of a formula-based fuel factor which provides for more timely recovery of fuel costs. The PUCT approved a \$19.7 million or 11% reduction in the Company's fixed fuel factor as the initial rate under the approved fuel factor formula. The PUCT also approved an energy efficiency cost-recovery factor that includes the recovery of deferred energy efficiency costs over a three-year period.

*Fuel and Purchased Power Costs.* The Company's actual fuel costs, including purchased power energy costs, are recoverable from its customers. The PUCT has adopted a rule establishing the recovery of fuel costs ( Texas Fuel Rule ) that allows the Company to seek periodic adjustments to its fixed fuel factor. The Company received approval on July 30, 2010, to implement a formula to determine its fuel factor. The Company can seek to revise its fixed fuel factor based upon the approved formula at least four months after its last revision except in the month of December. The Texas Fuel

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Rule requires the Company to request to refund fuel costs in any month when the over-recovery balance exceeds a threshold material amount and it expects to continue to be materially over-recovered. The Texas Fuel Rule also permits the Company to seek to surcharge fuel under-recoveries in any month the balance exceeds a threshold material amount and it expects to continue to be materially under-recovered. Fuel over and under recoveries are considered material when they exceed 4% of the previous twelve months fuel costs. All such fuel revenue and expense activities are subject to periodic final review by the PUCT in fuel reconciliation proceedings.

On January 8, 2008, the Company filed a request with the PUCT in Docket No. 35204 to surcharge approximately \$30.1 million, including interest, of under-recovered fuel and purchased power costs to be collected over a twelve-month period. The fuel under-recoveries were incurred during the period December 2005 through November 2007. On April 11, 2008, the PUCT issued a final order approving the fuel surcharge to be collected over a twelve-month period beginning in May 2008.

On July 8, 2008, the Company filed a petition in Docket No. 35856 with the PUCT to increase its fixed fuel factors and to surcharge \$39.5 million of under-recovered fuel and purchased power costs including interest. The surcharge was based upon actual under-recoveries for the period December 2007 through May 2008 and expected under-recoveries for June and July 2008. On September 25, 2008, the PUCT issued a final order approving an increase in the Company's Texas jurisdictional fixed fuel factors of \$38.8 million or 21.5% annually beginning with customer bills rendered in October 2008. In addition, the PUCT approved the recovery of \$39.5 million in fuel under-recoveries over an 18-month period beginning in October 2008.

On April 1, 2009, the Company filed a petition with the PUCT in Docket No. 36864 to terminate the interim fuel surcharge which had been authorized in Docket No. 35856. The Company's request was a result of the over-recovery of fuel costs under the Company's fixed fuel factor effective in October 2008 which largely offset the remaining balance of the fuel surcharge. The fuel over-recoveries were the result of the significant drop in natural gas prices since the fixed fuel factor went into effect in October 2008. On April 23, 2009, the Company received approval from the PUCT to terminate the fuel surcharge effective for customer bills rendered in May 2009 and thereafter.

On June 5, 2009, the Company filed a petition with the PUCT in Docket No. 37086 to decrease its fixed fuel factor by 13.1%, or \$27.9 million. On July 30, 2009, the PUCT approved the new factors effective for customer bills rendered beginning in August 2009.

On September 1, 2009, the Company filed a petition in Docket No. 37433 to refund \$12.0 million in fuel cost over-recoveries, including interest, for the period of July 2008 through July 2009. The Company entered into a stipulation in October 2009 that included the August 2009 over-recovery in the refund for a total of \$16.8 million, including interest, and provided for the refund to be paid in November and December, 2009. On October 23, 2009, the PUCT issued an order approving the stipulation.

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On December 17, 2009, the Company filed a petition with the PUCT Docket No. 37788 to refund \$11.8 million in fuel cost over-recoveries, including interest, for the period September through November 2009. On January 20, 2010, a stipulation was filed that resolved all of the issues in this proceeding. The stipulation provided for the Company to implement a fuel refund for the net over-recovery of \$11.8 million, including interest, in the month of February 2010. On January 21, 2010, the administrative law judge assigned to the docket issued an order approving the implementation of interim rates to allow the requested refund to be made. The PUCT issued a final order on February 11, 2010 approving the stipulation.

On May 12, 2010, the Company filed a petition with the PUCT which was assigned Docket No. 38253 to refund \$10.5 million in fuel cost over-recoveries, including interest, for the period December 2009 through March 2010. On June 14, 2010, the Company and all other parties filed a stipulation that resolved all of the issues in this case. In the stipulation, the Company and the other parties agreed to increase the refund by \$0.6 million to remove costs for the purchase of renewable energy credits from the Company's fuel cost, and as a result of that adjustment and the associated recalculation of interest, the total refund will be \$11.1 million. On June 16, 2010, the administrative law judge assigned to the docket issued an order approving the implementation of interim rates to allow the requested refund to be made in July and August 2010. The PUCT issued a final order on July 15, 2010 approving the stipulation.

*Application for Approval to Revise Energy Efficiency Cost Recovery Factor for 2011.* On June 1, 2010, the Company filed with the PUCT an application for approval to revise its energy efficiency cost recovery factor, which was assigned PUCT Docket No. 38226. The Company requested that its revised energy efficiency cost recovery factor ( EECRF ) become effective beginning with the first billing cycle of its January 2011 billing month. In its application, the Company requests authority to revise its 2011 EECRF to recover \$4.2 million in energy efficiency costs projected to be incurred in 2011, a performance bonus of \$0.1 million for the Company's 2009 program performance, and \$2.3 million in annual amortization of the energy efficiency costs that were deferred pursuant to the final order in Docket No. 35612. The total amount that the Company requested to be included in its 2011 EECRF is \$6.6 million. A final order should be issued in August or early September 2010.

**New Mexico Regulatory Matters**

*2009 New Mexico Stipulation.* On May 29, 2009, the Company filed a general rate case using a test year ended December 31, 2008. The 2009 rate case was docketed as NMPRC Case No. 09-00171-UT.

A comprehensive unopposed stipulation (the 2009 New Mexico Stipulation ) was reached in this general rate case and filed on October 8, 2009. The 2009 New Mexico Stipulation provided for an increase in New Mexico jurisdictional non-fuel and purchased power base rate revenues of \$5.5 million. The 2009 New Mexico Stipulation provided for the revision of depreciation rates for the Palo Verde nuclear generating plant to reflect a 20-year life extension and depreciation rates for other plant in

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service. The 2009 New Mexico Stipulation also provided for the continuation of the Company's Fuel and Purchased Power Cost Adjustment Clause ( FPPCAC ) without conditions or variance. In addition, it modified the market pricing of capacity and energy provided by Palo Verde Unit 3 to include such capacity and energy in the FPPCAC using a methodology based upon a previous purchased power contract with Credit Suisse Energy, LLC.

On December 10, 2009, the NMPRC issued a final order conditionally approving and clarifying the unopposed stipulation. The stipulated rates approved in the final order went into effect with January 2010 bills.

*Investigation into Recovering County Franchise Fees.* On December 10, 2009, the NMPRC issued an order in NMPRC Case No. 09-00421-UT, requiring the Company to show cause why it should collect franchise fees from its customers on behalf of Doña Ana and Otero Counties (the Counties ). The Company responded to the order on January 5, 2010. On January 26, 2010, the NMPRC issued a final order concluding that the imposition of franchise fees by New Mexico counties is not authorized under New Mexico law and, therefore, the Company may not pass through to its customers some past and all ongoing franchise fees imposed by the Counties. The order concluded that only home rule municipalities, who had adopted a charter under the state constitution, could impose franchise fees or taxes, provided the residents so voted.

As a result of its findings, the NMPRC directed the Company to immediately cease passing through to its customers any franchise fees paid by the Company to the Counties. The NMPRC also directed the Company to refund to its customers in the Counties the amount of franchise fees charged to those customers since June 1, 2004, plus interest. The Company estimates that its refund obligation under the order would be approximately \$6.2 million, plus accrued interest of approximately \$1.3 million through June 30, 2010. The order stated that the Company was required to refund these franchise fees to customers over a three-year period through a credit on customer bills and file tariffs for refunding within three days. On January 29, 2010, the NMPRC granted the Company's request to extend its deadline for compliance with the order until February 12, 2010. Interest will continue to accrue on the unamortized balance until fully refunded. The order does not relieve the Company of its obligation to pay franchise fees to the Counties but states that this issue must be addressed by the New Mexico courts.

The Company filed a Notice of Appeal with the New Mexico Supreme Court on January 27, 2010 (the Appeal ), seeking to set aside the order on legal and jurisdictional grounds. The Company followed with a motion for Emergency Stay on January 29, 2010, asking the New Mexico Supreme Court to stay the order pending the Appeal. The Company also asked the NMPRC, on February 12, 2010, to delay implementation of its order pending the Appeal. The Counties moved to intervene in the Appeal on February 10, 2010. The Company had placed pending franchise payments to the Counties in separate accounts pending resolution of the proceedings. However, beginning in April 2010 the Company began paying franchise payments to the Counties in accordance with the current franchise agreements. On February 22, 2010, the New Mexico Supreme Court granted the Company's motion for

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Emergency Stay pending the outcome of the Appeal and granted the Counties' motion to intervene in the Appeal. In February 2010, the New Mexico legislature passed legislation that confirmed the legality of the Company's existing franchise agreements with the Counties. The NMPRC, however, did not withdraw its order after this legislation was enacted, and the Company is proceeding with the Appeal. The parties have filed their initial briefs in the Appeal, and the Company has requested oral argument before the New Mexico Supreme Court. The Company cannot predict the outcome of the proceedings.

The Company will also review its legal options to terminate any future obligation to pay franchise fees to the Counties and to seek reimbursement from the Counties if refunds are ultimately required. The Company cannot predict the outcome of these legal reviews or any legal proceedings that may follow.

*Investigation into the Service Quality of the Company.* On October 22, 2009, NMPRC Staff filed a petition requesting an investigation into the quality of service of the Company's power distribution system in the Santa Teresa Industrial Park, based upon a report prepared for customers in that area by the Los Alamos National Laboratory. On October 27, 2009, the NMPRC decided to initiate an investigation and ordered the Company to respond no later than November 16, 2009. The Company filed an initial response on November 16, 2009 and a supplemental response on January 8, 2010 after obtaining data on which the report was based. The Company responses provided evidence that the reliability and power quality performance for the Company's service territory as a whole and on the Santa Teresa circuits in particular meet all applicable reliability standards and comport with good utility practices. On January 28, 2010, the NMPRC Staff filed a reply stating that it found no factual basis to conclude that the Company had violated NMPRC rules and recommended the NMPRC dismiss this proceeding.

On June 8, 2010, the Hearing Examiner issued a Recommended Decision concluding that there is no substantial evidence that would support the allegations in this case regarding the Company's quality of service. The Hearing Examiner found there is good cause to dismiss the investigation, and close the docket without further proceedings. The Company is unable at this time to predict the ultimate outcome of this docket.

*2010 Renewable Procurement Plan Pursuant to the Renewable Energy Act.* On July 1, 2010, the Company filed its Application for Approval of its 2010 Renewable Procurement Plan, which was assigned NMPRC Case No. 10-00200-UT. The filing included renewable resources intended to meet the Company's Renewable Portfolio Standard (RPS) requirements in 2011 and future years. The 2010 Renewable Procurement Plan included a number of projects to meet its RPS requirements, including three solar purchased power agreements discussed in Note E below. In addition, the Company is also requesting a variance from solar diversity requirements in 2011 to be made up in later years from additional solar procurement.

*Replacement of Revolving Credit Facility and Guarantee of Debt.* On June 22, 2010, the Company received final approval from the NMPRC in Case No. 10-00145-UT to refinance the

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Company's revolving credit facility and issue in a private placement up to \$110 million of senior notes from the Rio Grande Resources Trust II (the RGRT), guaranteed by the Company, to finance nuclear fuel. The Company currently expects to complete the notes financing by RGRT during the third quarter and to use the proceeds to repay amounts borrowed under the revolving credit facility for nuclear fuel. This would enable the future nuclear fuel financing requirements by RGRT to be met with the senior notes with any additional amounts borrowed from the revolving credit facility. The Company also anticipates completing the refinancing of the revolving credit facility prior to its maturity in April 2011.

**Federal Regulatory Matters**

*Transmission Dispute with Tucson Electric Power Company (TEP)*. In January 2006, the Company filed a complaint with the FERC to interpret the terms of a Power Exchange and Transmission Agreement (the Transmission Agreement) entered into with TEP in 1982. TEP filed a complaint with the FERC one day later raising virtually identical issues. TEP claimed that, under the Transmission Agreement, it was entitled to up to 400 MW of firm transmission rights on the Company's transmission system that would enable it to transmit power from the Luna Energy Facility (LEF) located near Deming, New Mexico to Springerville or Greenlee in Arizona. The Company asserted that TEP's rights under the Transmission Agreement do not include transmission rights necessary to transmit such power as contemplated by TEP and that TEP must acquire any such rights in the open market from the Company at applicable tariff rates or from other transmission providers. On April 24, 2006, the FERC ruled in the Company's favor, finding that TEP does not have transmission rights under the Transmission Agreement to transmit power from the LEF to Arizona. The ruling was based on written evidence presented and without an evidentiary hearing. TEP's request for a rehearing of the FERC's decision was granted in part and denied in part in an order issued October 4, 2006, and hearings on the disputed issues were held before an administrative law judge. In the initial decision dated September 6, 2007, the administrative law judge found that the Transmission Agreement allows TEP to transmit power from the LEF to Arizona but limits that transmission to 200 MW on any segment of the circuit and to non-firm service on the segment from Luna to Greenlee. The Company and TEP filed exceptions to the initial decision.

On November 13, 2008, the FERC issued an order on the initial decision finding that the transmission rights given to TEP in the Transmission Agreement are firm and are not restricted for transmission of power from Springerville as the receipt point to Greenlee as the delivery point. Therefore, pursuant to the order, TEP can use its transmission rights granted under the Transmission Agreement to transmit power from the LEF to either Springerville or Greenlee so long as it transmits no more than 200 MW over all segments at any one time.

The FERC also ordered that the Company refund to TEP all sums with interest that TEP had paid it for transmission under the applicable transmission service agreements since February 2006 for service relating to the LEF. On December 3, 2008, the Company refunded \$9.7 million to TEP. The Company had established a reserve for the rate refund of approximately \$7.2 million as of September 30, 2008, resulting in a pre-tax charge to earnings of approximately \$2.5 million in 2008. The Company also paid TEP interest on the refunded balance of approximately \$0.9 million, which was

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also charged to earnings in 2008. The Company filed a request for rehearing of the FERC's decision on December 15, 2008, seeking reversal of the order on the merits and a return of any refunds made in the interim, as well as compensation for all service that the Company may provide to TEP from the LEF over the Company's transmission system on a going forward basis. On July 7, 2010, the FERC denied the Company's request for rehearing. On July 23, 2010, the Company filed a Petition for Review in the United States Court of Appeals for the District of Columbia Circuit. The Company cannot predict the outcome of that appeal. If the order is not reversed, the Company will lose the opportunity to receive compensation from TEP for such transmission service in the future.

In an ancillary proceeding, TEP filed a lawsuit in the United States District Court for the District of Arizona in December 2008, seeking reimbursement for amounts TEP paid a third party transmission provider for purchases of transmission capacity between April 2006 and May 2007, allegedly totaling approximately \$1.5 million, plus accrued interest. TEP alleges that the Company was obligated to provide TEP with that transmission capacity without charge under the Transmission Agreement. In September 2009, the Court granted a stay in this suit pending a resolution of the underlying FERC proceeding and any appeal thereof. The Company cannot predict the outcome of this matter.

*Replacement of Revolving Credit Facility and Guarantee of Debt.* On June 29, 2010, the Company received approval from the FERC in Docket No. ES10-43-000 to refinance the Company's revolving credit facility and issue in a private placement up to \$110 million of senior notes from the RGRT, guaranteed by the Company, to finance nuclear fuel. The Company currently expects to complete the notes financing by RGRT during the third quarter and to use the proceeds to repay amounts borrowed under the revolving credit facility for nuclear fuel. This would enable the future nuclear fuel financing requirements by RGRT to be met with the senior notes with any additional amounts borrowed from the revolving credit facility. The Company also anticipates completing the refinancing of the revolving credit facility prior to its maturity in April 2011.

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**C. Common Stock****Common Stock Repurchase Program**

Since 1999, the Company has repurchased approximately 21.6 million shares of common stock at an aggregate cost of \$313.4 million, including commissions. As of December 31, 2009, 200,982 shares remained available for repurchase under its authorized program. On February 19, 2010, the Board of Directors authorized the repurchase of up to 2 million additional shares of the Company's outstanding common stock. During the first six months of 2010, the Company repurchased 502,492 shares of common stock in the open market at an aggregate cost of \$10.0 million under both the previously authorized program and under the recently authorized program. As of June 30, 2010, 1,698,490 shares remain available for repurchase under the current program. The Company may make purchases of its stock in the future 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 incentive plans, or may be retired.

**Basic and Diluted Earnings Per Share**

The basic and diluted earnings per share are presented below:

|  | <b>Three Months Ended June 30,</b> |                   |
|--|------------------------------------|-------------------|
|  | <b>2010</b>                        | <b>2009</b>       |
| <b>Weighted average number of common shares outstanding:</b> |                                    |                   |
| Basic number of common shares outstanding                    | 43,460,458                         | 44,782,749        |
| Dilutive effect of unvested performance awards               | 40,740                             | 0                 |
| Dilutive effect of stock options                             | 56,590                             | 9,596             |
| <b>Diluted number of common shares outstanding</b>           | <b>43,557,788</b>                  | <b>44,792,345</b> |
| <b>Basic net income per common share:</b>                    |                                    |                   |
| Net income   | \$ 21,507                          | \$ 15,431         |
| Income allocated to participating restricted stock           | (91)                               | (58)              |
| <b>Net income available to common shareholders</b>           | <b>\$ 21,416</b>                   | <b>\$ 15,373</b>  |
| <b>Diluted net income per common share:</b>                  |                                    |                   |
| Net income   | \$ 21,507                          | \$ 15,431         |
| Income reallocated to participating restricted stock         | (90)                               | (58)              |
| <b>Net income available to common shareholders</b>           | <b>\$ 21,417</b>                   | <b>\$ 15,373</b>  |
| <b>Basic net income per common share</b>                     | <b>\$ 0.49</b>                     | <b>\$ 0.34</b>    |
| <b>Diluted net income per common share</b>                   | <b>\$ 0.49</b>                     | <b>\$ 0.34</b>    |



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The calculation of the weighted average number of common shares and dilutive potential shares outstanding for the three months ended June 30, 2010 and 2009, excludes 64,840 and 44,363 shares, respectively, of restricted stock awards because their effect was antidilutive.

Performance shares of 96,900 and 222,267 were excluded from the computation of diluted earnings per share for the three months ended June 30, 2010 and 2009, respectively, as no payouts

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would be required based upon performance at the end of each corresponding period. These amounts assume a 100% performance level payout.

No stock options were excluded from the computation of diluted earnings per share for the three months ended June 30, 2010. Options of 214,440 were excluded from the computation of diluted earnings per share for the three months ended June 30, 2009 as the exercise price was greater than the average stock price for that period.

|  | <b>Six Months Ended June 30,</b> |                   |
|--|----------------------------------|-------------------|
|  | <b>2010</b>                      | <b>2009</b>       |
| <b>Weighted average number of common shares outstanding:</b> |                                  |                   |
| Basic number of common shares outstanding                    | 43,598,933                       | 44,769,843        |
| Dilutive effect of unvested performance awards               | 56,542                           | 0                 |
| Dilutive effect of stock options                             | 54,551                           | 21,537            |
| <b>Diluted number of common shares outstanding</b>           | <b>43,710,026</b>                | <b>44,791,380</b> |
| <b>Basic net income per common share:</b>                    |                                  |                   |
| Net income   | \$ 32,956                        | \$ 25,040         |
| Income allocated to participating restricted stock           | (132)                            | (88)              |
| <b>Net income available to common shareholders</b>           | <b>\$ 32,824</b>                 | <b>\$ 24,952</b>  |
| <b>Diluted net income per common share:</b>                  |                                  |                   |
| Net income   | \$ 32,956                        | \$ 25,040         |
| Income reallocated to participating restricted stock         | (132)                            | (88)              |
| <b>Net income available to common shareholders</b>           | <b>\$ 32,824</b>                 | <b>\$ 24,952</b>  |
| <b>Basic net income per common share</b>                     | <b>\$ 0.75</b>                   | <b>\$ 0.56</b>    |
| <b>Diluted net income per common share</b>                   | <b>\$ 0.75</b>                   | <b>\$ 0.56</b>    |

The calculation of the weighted average number of common shares and dilutive potential shares outstanding for the six months ended June 30, 2010 and 2009, excludes 72,415 and 62,365 shares, respectively, of restricted stock awards because their effect was antidilutive.

Performance shares of 48,450 and 224,734 were excluded from the computation of diluted earnings per share for the six months ended June 30, 2010 and 2009, respectively, as no payouts would be required based upon performance at the end of each corresponding period. These amounts assume a 100% performance level payout.

No stock options were excluded from the computation of diluted earnings per share for the six months ended June 30, 2010. Options of 107,220 were excluded from the computation of diluted earnings per share for the six months ended June 30, 2009 as the exercise price was greater than the average stock price for that period.



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|  | <b>Twelve Months Ended June 30,</b> |                   |
|--|-------------------------------------|-------------------|
|  | <b>2010</b>                         | <b>2009</b>       |
| <b>Weighted average number of common shares outstanding:</b> |                                     |                   |
| Basic number of common shares outstanding                    | 43,943,503                          | 44,751,020        |
| Dilutive effect of unvested performance awards               | 56,146                              | 3,180             |
| Dilutive effect of stock options                             | 59,552                              | 64,862            |
| <b>Diluted number of common shares outstanding</b>           | <b>44,059,201</b>                   | <b>44,819,062</b> |
| <b>Basic net income per common share:</b>                    |                                     |                   |
| Net income   | \$ 74,849                           | \$ 68,939         |
| Income allocated to participating restricted stock           | (287)                               | (205)             |
| <b>Net income available to common shareholders</b>           | <b>\$ 74,562</b>                    | <b>\$ 68,734</b>  |
| <b>Diluted net income per common share:</b>                  |                                     |                   |
| Net income   | \$ 74,849                           | \$ 68,939         |
| Income reallocated to participating restricted stock         | (286)                               | (205)             |
| <b>Net income available to common shareholders</b>           | <b>\$ 74,563</b>                    | <b>\$ 68,734</b>  |
| <b>Basic net income per common share</b>                     | <b>\$ 1.70</b>                      | <b>\$ 1.54</b>    |
| <b>Diluted net income per common share</b>                   | <b>\$ 1.69</b>                      | <b>\$ 1.53</b>    |

The calculation of the weighted average number of common shares and dilutive potential shares outstanding for the twelve months ended June 30, 2010 and 2009, excludes 71,653 and 56,045 shares, respectively, of restricted stock awards because their effect was antidilutive.

Performance shares of 65,763 and 153,039 were excluded from the computation of diluted earnings per share for the twelve months ended June 30, 2010 and 2009, respectively, as no payouts would be required based upon performance at the end of each corresponding period. These amounts assume a 100% performance level payout.

No stock options were excluded from the computation of diluted earnings per share for the six months ended June 30, 2010. Options of 53,160 were excluded from the computation of diluted earnings per share for the twelve months ended June 30, 2009 as the exercise price was greater than the average stock price for that period.

**D. Income Taxes**

The Company files income tax returns in the U.S. federal jurisdiction and in the states of Texas, New Mexico and Arizona. The Company is no longer subject to tax examination by federal taxing authorities for years prior to 2007 and in the state jurisdictions for years prior to 1998. A deficiency notice relating to the Company's 1998 through 2003 income tax returns in Arizona contests a pollution control credit, a research and development credit, and the sales and property apportionment factors. The Company is contesting these adjustments.

On March 23, 2010, the Patient Protection and Affordable Care Act ( PPACA ) was signed into law. A major provision of the law is that, beginning in 2013, the income tax deductions for the cost of providing certain prescription drug coverage will be reduced by the amount of the Medicare Part D



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subsidies received. The Company was required to recognize the impacts of the tax law change at the time of enactment and recorded a one-time non-cash charge to income tax expense of approximately \$4.8 million in the first quarter of 2010.

For the three months ended June 30, 2010 and 2009, the Company's consolidated effective tax rate was 35.2% and 36.2%, respectively. For the six months ended June 30, 2010 and 2009, the Company's consolidated effective tax rate was 41.8% and 35.6%, respectively. For the twelve months ended June 30, 2010 and 2009 the Company's consolidated effective tax rate was 36.4% and 33.6%, respectively. For the six and twelve months ended June 30, 2010, the Company's effective tax rates differ from the federal statutory tax rate of 35% primarily due to the enactment of the PPACA discussed above. The Company's consolidated effective tax rate without the effect of the enactment of the PPACA for the six and twelve months ended June 30, 2010, was 32.6% and 32.0%, respectively. The Company's 2010 effective tax rates without the effect of the enactment of the PPACA and 2009 effective tax rates differ from the federal statutory tax rate of 35% primarily due to state income taxes, the allowance for equity funds used during construction, the tax rate on income or losses on investments in the Company's qualified decommissioning trust fund, and various permanent tax differences.

**E. Commitments, Contingencies and Uncertainties**

For a full discussion of commitments and contingencies, see Note J of Notes to Consolidated Financial Statements in the 2009 Form 10-K. In addition, see Note B above and Notes B and D of Notes to Consolidated Financial Statements in the 2009 Form 10-K regarding matters related to wholesale power sales contracts and transmission contracts subject to regulation and Palo Verde, including decommissioning, spent fuel storage, disposal of low-level radioactive waste, reactor vessel heads and liability and insurance matters.

**Power Purchase and Sale Contracts**

In addition to the contracts disclosed in the related table of the Company's 2009 Form 10-K, the Company has entered into several agreements with various counterparties for forward firm purchases of electricity:

| <b>Type of Contract</b>  | <b>Quantity</b> | <b>Term</b>                               |
|--------------------------|-----------------|---|
| Power Purchase Agreement | 20 MW           | 20 years after operational start date (1) |
| Power Purchase Agreement | Up to 40 MW     | 2010                                      |
| Power Purchase Agreement | Up to 40 MW     | 2011 through September 2014               |

- (1) This contract is a power purchase agreement for the full capacity of a 20 MW solar photovoltaic plant to be built in Southern New Mexico. The plant is scheduled for commercial operation no sooner than December 31, 2011.

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The Company entered into a 20-year contract (the Agreement) with New Mexico SunTower, LLC (NM SunTower) in 2008 for the purchase of the output of a 92-MW concentrated solar plant which was expected to begin commercial operation in 2011. NM SunTower is an affiliate of NRG Energy, Inc. NM SunTower failed to meet its financial commitment milestone, and, on May 3, 2010, the Company delivered to NM SunTower a notice of default as provided under the terms of the Agreement. The Company presented testimony to the NMPRC at a hearing June 8, 2010, seeking approval for NM SunTower's request to (i) change the technology from concentrated solar to photovoltaic, (ii) downsize the solar project from 92 MW to 20 MW, and (iii) delay the date for commercial operation to December 31, 2011, at the earliest. The Company also requested deferral of its 2011 solar diversity requirements to the 2012-2015 period and approval to meet its 2011 RPS with purchases of renewable energy credits (RECs) from a third party. On June 24, 2010, the NMPRC approved changes to the Agreement with NM SunTower and requested that the Company submit the other items requested in its annual Renewable Energy Procurement Plan (Plan) filing.

On July 1, 2010, the Company made its annual Plan filing requesting approval for a 20-year purchase from two solar photovoltaic projects totaling 24 MW consisting of two 12 MW projects located in Southern New Mexico expected to be operational by December 31, 2011. The Company also requested approval for a 20-year purchase from a 5 MW photovoltaic project also located in Southern New Mexico expected to be operational by March 31, 2011. Contracts for these projects are currently being negotiated. In addition, approval for the purchase of RECs to assist in meeting the Company's RPS requirements for the 2011 to 2015 period was requested. The Company expects NMPRC approval of its Plan by December 2010. See Note B.

**Environmental Matters**

*Environmental Regulation.* 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. In addition, unauthorized releases of pollutants or contaminants into the environment can result in costly cleanup obligations that are subject to enforcement by regulatory agencies. These laws and regulations are subject to change and, as a result of those changes, the Company may face additional capital and operating costs to comply.

Another way in which environmental matters may impact the Company's operations and business is the implementation of the U.S. Environmental Protection Agency's (EPA) Clean Air Interstate Rule (CAIR) which, as applied to the Company, may result in a requirement that it substantially reduce emissions of nitrogen oxides from its power plants in Texas and/or purchase allowances representing other parties emissions reductions starting in 2009. These requirements become more stringent in 2015, and are anticipated to require even further emissions reductions or additional allowance purchases. On July 11, 2008, the U.S. Court of Appeals for the District of Columbia vacated CAIR in its entirety. On December 23, 2008 the DC Circuit Panel granted rehearing and instead remanded CAIR without vacating the original regulation. As a result, the Company must comply with CAIR as written until the EPA rewrites the CAIR as required by the Court's final opinion.

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The Company's 2009 reconciliation was filed and all required allowances were purchased by the due date of March 1, 2010.

Regulations governing the emission of greenhouse gases, such as carbon dioxide, could also impact the Company. The U.S. Congress is considering new legislation to restrict or regulate greenhouse gas emissions. The American Clean Energy and Security Act of 2009, which was passed by the U.S. House of Representatives in 2009, could, if enacted by the full Congress, require greenhouse gas emissions reductions by covered sources of as much as 17% from 2005 levels by 2020 and by as much as 83% by 2050. The State of New Mexico, where the Company operates one facility and has an interest in another facility, has joined with California and several other states in the Western Climate Initiative and is pursuing initiatives to reduce greenhouse gas emissions in the state.

Also, as a result of the U.S. Supreme Court's decision on April 2, 2007 in *Massachusetts, et al. v. EPA*, on December 15, 2009, the EPA officially published its finalized determination that emissions of carbon dioxide, methane and other greenhouse gases present an endangerment to human health and welfare because emissions of such gases are, according to the EPA, contributing to warming of the earth's atmosphere and other climatic changes. Following that determination, the EPA has said it will finalize regulations under its existing Clean Air Act (CAA) authority governing greenhouse gas emissions, including regulating emissions from large stationary sources, such as the fossil fuel-fired power plants operated by the Company, even if Congress does not adopt new legislation specifically addressing emissions of greenhouse gases. In addition, in September 2009, the EPA adopted a new rule requiring approximately 10,000 facilities comprising a substantial percentage of annual U.S. greenhouse gas emissions to inventory their emissions starting in 2010 and to report those emissions to the EPA beginning in 2011. The Company's fossil fuel-fired power generating assets are subject to this rule.

The Company will continue to monitor laws and regulations seeking to limit greenhouse gas emissions. Such laws and regulations have not imposed specific requirements on the Company to date and, as a result, no accrual has been made for potential compliance costs. While the Company strives to prepare for and implement actions necessary to comply with changing environmental regulations, substantial expenditures may be required for the Company to comply with such regulations in the future and, in some instances, those expenditures may be material.

*Ongoing Regulatory Compliance.* The Company analyzes the costs of its current obligations arising from environmental matters on an ongoing basis and believes it has made adequate provision in its financial statements to meet the obligations which can be meaningfully quantified. As a result of this analysis, the Company has a provision for environmental remediation obligations of approximately \$0.9 million as of June 30, 2010, related to compliance with federal and state environmental standards. However, unforeseen expenses associated with environmental compliance or remediation may occur and could have a material adverse effect on the future operations and financial condition of the Company.



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The Company incurred the following expenditures during the three, six and twelve months ended June 30, 2010 and 2009 to comply with federal environmental statutes (in thousands):

|                     | Three Months Ended |                  | Six Months Ended |                  | Twelve Months Ended |                  |
|---------------------|--------------------|------------------|------------------|------------------|---------------------|------------------|
|                     | June 30,<br>2010   | June 30,<br>2009 | June 30,<br>2010 | June 30,<br>2009 | June 30,<br>2010    | June 30,<br>2009 |
| Clean Air Act (1)   | \$ 71              | \$ 243           | \$ 288           | \$ 593           | \$ 505              | \$ 922           |
| Clean Water Act (2) | 69                 | 72               | 103              | 131              | 569                 | 553              |

- (1) Includes a \$0.3 million reserve related to excess emissions at the Rio Grande generating station for the six and twelve months ended June 30, 2009.
- (2) Includes a \$0.2 million reserve for remediation costs for the Gila River Boundary Site for the twelve months ended June 30, 2009. Excludes a \$0.6 million adjustment reducing estimated remediation costs for a property previously owned by the Company for the three, six and twelve months ended June 30, 2009. The twelve months ended June 30, 2010, includes a \$0.3 million reserve for remediation costs related to the oil discharge at its Rio Grande Power Station discussed below.

Along with many other companies, the Company received from the Texas Commission on Environmental Quality ( TCEQ ) a request for information in 2003 in connection with environmental conditions at a facility in San Angelo, Texas that was operated by the San Angelo Electric Service Company ( SESCO ). In November 2005, TCEQ proposed the SESCO site for listing on the registry of Texas state superfund sites and mailed notice to more than five hundred entities, including the Company, indicating that TCEQ considers each of them to be a potentially responsible party at the SESCO site. The Company received from the SESCO working group of potentially responsible parties a settlement offer in May 2006 for remediation and other expenses expected to be incurred in connection with the SESCO site. The Company's position is that any liability it may have related to the SESCO site was discharged in the Company's bankruptcy. In July 2010, the Company made a revised offer to the SESCO working group to settle this matter. At this time, the Company has not agreed to a settlement or to otherwise participate in the cleanup of the SESCO site and is unable to predict the outcome of this matter. While the Company has no reason at present to believe that it will incur material liabilities in connection with the SESCO site, it had accrued \$0.3 million for potential costs related to this matter.

The EPA has investigated releases or potential releases of hazardous substances, pollutants or contaminants at the Gila River Boundary Site, on the Gila River Indian Community ( GRIC ) reservation in Arizona and designated it as a Superfund Site. The Company currently owns 16.29% of the site and will share in the cost of cleanup of this site. The Company has a tentative agreement with the former property owner and the EPA to settle this matter for less than \$0.1 million and the Company has accrued \$0.2 million for potential costs related to this matter.

In 2006, the Company experienced an oil discharge at the Rio Grande Power Station. The Company remediated the site by removing the contaminated soil and installing monitoring wells to monitor for the presence of hydrocarbons in the ground water. A monitoring well showed signs of contamination at levels exceeding New Mexico ground water standards. The Company notified the NMED of its findings and submitted an abatement plan to the NMED addressing the soil and ground

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water impacts. The abatement plan was approved by the NMED, and the Company further assessed and remediated the site in accordance to the plan in 2010. The Company has incurred \$0.3 million in costs related to this matter. Four of the five oil tanks at the Rio Grande Power Station have recently been dismantled and removed. The Company does not expect any significant additional costs to be incurred related to the 2006 discharge.

In May 2007, the EPA finalized a new federal implementation plan which addresses emissions at the Four Corners Station in northwestern New Mexico of which the Company owns a 7% interest in Units 4 and 5. APS, the Four Corners operating agent, has filed suit against the EPA relating to this new federal implementation plan in order to resolve issues involving operating flexibility for emission opacity standards. The Company cannot predict the outcome of the suit filed against the EPA or whether compliance with the new requirements could have an adverse effect on its capital and operating costs.

On April 6, 2009, APS received a request from the EPA under Section 114 of the CAA seeking detailed information regarding projects and operations at Four Corners. APS has responded to this request. The Company is unable to predict the timing or content of EPA's response or any resulting actions.

On February 16, 2010, a group of environmental organizations filed a petition with the United States Departments of Interior and Agriculture requesting that the agencies certify to the EPA that emissions from Four Corners are causing reasonably attributable visibility impairment under the CAA. APS is currently reviewing the petition and has indicated that it will likely file a response in opposition to the petition. The Company cannot predict the outcome of the petition or whether any resulting actions could have an adverse effect on its capital or operating costs.

Except as described herein, the Company is not aware of any other active investigation of its compliance with environmental requirements by the EPA, the TCEQ or the NMED which is expected to result in any material liability. Furthermore, except as described herein, the Company is not aware of any unresolved, potentially material liability it would face pursuant to the Comprehensive Environmental Response, Comprehensive Liability Act of 1980, also known as the Superfund law.

**Union Matters**

The Company has approximately 1,000 employees, 42% of whom are covered by a collective bargaining agreement which expires in September 2010. The Company is currently in negotiations on a new collective bargaining agreement. The Company is unable at this time to predict the ultimate outcome of these negotiations.

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**F. 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.

See Note B for discussion of the effects of government legislation and regulation on the Company.

**G. Employee Benefits****Retirement Plans**

The net periodic benefit cost recognized for the three, six and twelve months ended June 30, 2010 and 2009 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

|   | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          | Twelve Months Ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|---------------------------------|----------|
|   | 2010                           | 2009     | 2010                         | 2009     | 2010                            | 2009     |
| <b>Components of net periodic benefit cost:</b> |                                |          |                              |          |                                 |          |
| Service cost                                    | \$ 1,532                       | \$ 1,367 | \$ 3,032                     | \$ 2,767 | \$ 5,799                        | \$ 5,304 |
| Interest cost                                   | 3,390                          | 3,317    | 6,815                        | 6,592    | 13,406                          | 12,892   |
| Expected return on plan assets                  | (3,433)                        | (3,845)  | (6,933)                      | (7,720)  | (14,652)                        | (14,815) |
| Amortization of:                                |                                |          |                              |          |                                 |          |
| Net loss  | 874                            | 412      | 1,774                        | 812      | 2,587                           | 1,398    |
| Prior service cost                              | 33                             | 33       | 58                           | 58       | 115                             | 115      |
| Net periodic benefit cost                       | \$ 2,396                       | \$ 1,284 | \$ 4,746                     | \$ 2,509 | \$ 7,255                        | \$ 4,894 |

During the six months ended June 30, 2010, the Company contributed \$4.1 million of its projected \$8.4 million 2010 annual contribution to its retirement plans.

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The net periodic benefit cost recognized for the three, six and twelve months ended June 30, 2010 and 2009 is made up of the components listed below (in thousands):

|   | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          | Twelve Months Ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|---------------------------------|----------|
|   | 2010                           | 2009     | 2010                         | 2009     | 2010                            | 2009     |
| <b>Components of net periodic benefit cost:</b> |                                |          |                              |          |                                 |          |
| Service cost                                    | \$ 854                         | \$ 773   | \$ 1,779                     | \$ 1,698 | \$ 3,476                        | \$ 3,278 |
| Interest cost                                   | 1,607                          | 1,596    | 3,332                        | 3,246    | 6,578                           | 6,345    |
| Expected return on plan assets                  | (390)                          | (375)    | (765)                        | (750)    | (1,514)                         | (1,676)  |
| Amortization of:                                |                                |          |                              |          |                                 |          |
| Prior service benefit                           | (710)                          | (710)    | (1,435)                      | (1,435)  | (2,869)                         | (2,869)  |
| Net gain  | (87)                           | 0        | (87)                         | 0        | (87)                            | (663)    |
| Net periodic benefit cost                       | \$ 1,274                       | \$ 1,284 | \$ 2,824                     | \$ 2,759 | \$ 5,584                        | \$ 4,415 |

During the six months ended June 30, 2010, the Company contributed \$2.2 million of its projected \$4.6 million 2010 annual contribution to its postretirement plan.

In March of 2010, the President signed into law comprehensive health care reform legislation under the Patient Protection and Affordable Care Act and the Health Care Education and Affordability Reconciliation Act (the Acts). The Acts contain provisions which could impact the Company's accounting for retiree medical benefits in future periods. However, the extent of any additional impact cannot be completely determined until regulations are promulgated under the Acts and those regulations become available. The Company will continue to assess the accounting implications of the Acts as related regulations and interpretations of the Acts become available. Based on the analysis to date of the provisions in the Acts, the impact of which are reasonably determinable, a re-measurement of the Company's retiree plan liabilities is not required at this time.

**H. Financial Instruments and Investments**

FASB guidance requires the Company to disclose estimated fair values for its financial instruments. The Company has determined that cash and temporary investments, investment in debt securities, accounts receivable, decommissioning trust funds, long-term debt and financing obligations, accounts payable and customer deposits meet the definition of financial instruments. The carrying amounts of cash and temporary investments, accounts receivable, accounts payable and customer deposits approximate fair value because of the short maturity of these items. Investments in debt securities and decommissioning trust funds are carried at fair value.

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The fair values of the Company's long-term debt and financing obligations, including the current portion thereof, are based on estimated market prices for similar issues and are presented below (in thousands):

|                            | June 30, 2010   |                      | December 31, 2009 |                      |
|----------------------------|-----------------|----------------------|-------------------|----------------------|
|                            | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| Pollution Control Bonds    | \$ 193,135      | \$ 200,084           | \$ 193,135        | \$ 197,680           |
| Senior Notes               | 546,586         | 568,830              | 546,562           | 545,475              |
| Nuclear Fuel Financing (1) | 122,826         | 122,826              | 106,998           | 106,998              |
| Total                      | \$ 862,547      | \$ 891,740           | \$ 846,695        | \$ 850,153           |

(1) The interest rate on the Company's financing for nuclear fuel purchases is reset every quarter to reflect current market rates. Consequently, the carrying value approximates fair value.

*Marketable Securities.* The Company's marketable securities, included in decommissioning trust funds in the balance sheets, are reported at fair value which was \$137.3 million and \$135.4 million at June 30, 2010 and December 31, 2009, respectively. These securities are classified as available for sale under FASB guidance for certain investments in debt and equity securities and are valued using prices and other relevant information generated by market transactions involving identical or comparable securities. The reported fair values include gross unrealized losses on marketable securities whose impairment the Company has deemed to be temporary. The tables below present the gross unrealized losses and the fair value of these securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

| Description of Securities (1):               | Less than 12 Months |                   | June 30, 2010<br>12 Months or<br>Longer |                   | Total            |                   |
|--|---------------------|-------------------|---|-------------------|------------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value                              | Unrealized Losses | Fair Value       | Unrealized Losses |
| Federal Agency Mortgage Backed Securities    | \$ 0                | \$ 0              | \$ 451                                  | \$ (17)           | \$ 451           | \$ (17)           |
| U.S. Government Bonds                        | 1,844               | (1)               | 330                                     | 0                 | 2,174            | (1)               |
| Municipal Obligations                        | 5,404               | (88)              | 4,344                                   | (207)             | 9,748            | (295)             |
| Corporate Obligations                        | 502                 | (4)               | 0                                       | 0                 | 502              | (4)               |
| Total debt securities                        | 7,750               | (93)              | 5,125                                   | (224)             | 12,875           | (317)             |
| Common stock                                 | 22,759              | (3,304)           | 2,770                                   | (781)             | 25,529           | (4,085)           |
| <b>Total temporarily impaired securities</b> | <b>\$ 30,509</b>    | <b>\$ (3,397)</b> | <b>\$ 7,895</b>                         | <b>\$ (1,005)</b> | <b>\$ 38,404</b> | <b>\$ (4,402)</b> |

- (1) Includes approximately 81 securities.

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| Description of Securities (1):               | December 31, 2009   |                   |                     |                   |                  |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------------|-------------------|
|  | Less than 12 Months |                   | 12 Months or Longer |                   | Total            |                   |
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value       | Unrealized Losses |
| Federal Agency Mortgage Backed Securities    | \$ 6,975            | \$ (70)           | \$ 38               | \$ (2)            | \$ 7,013         | \$ (72)           |
| U.S. Government Bonds                        | 9,355               | (248)             | 0                   | 0                 | 9,355            | (248)             |
| Municipal Obligations                        | 3,235               | (53)              | 5,067               | (159)             | 8,302            | (212)             |
| Corporate Obligations                        | 2,039               | (20)              | 856                 | (27)              | 2,895            | (47)              |
| Total debt securities                        | 21,604              | (391)             | 5,961               | (188)             | 27,565           | (579)             |
| Common stock                                 | 11,735              | (790)             | 3,718               | (686)             | 15,453           | (1,476)           |
| <b>Total temporarily impaired securities</b> | <b>\$ 33,339</b>    | <b>\$ (1,181)</b> | <b>\$ 9,679</b>     | <b>\$ (874)</b>   | <b>\$ 43,018</b> | <b>\$ (2,055)</b> |

(1) Includes approximately 106 securities.

The Company monitors the length of time the security trades below its cost basis along with the amount and percentage of the unrealized loss in determining if a decline in fair value of marketable securities below original cost is considered to be other than temporary. In addition, the Company will research the future prospects of individual securities as necessary. As a result of these factors, as well as the Company's intent and ability to hold these securities until their market price recovers, these securities are considered temporarily impaired. The Company will not have a requirement to expend monies held in trust before 2024 or a later period when the Company begins to decommission Palo Verde.

The reported fair values also include gross unrealized gains on marketable securities which have not been recognized in the Company's net income. The table below presents the unrecognized gross unrealized gains and the fair value of these securities, aggregated by investment category (in thousands):

| Description of Securities:                | June 30, 2010    |                  | December 31, 2009 |                  |
|---|------------------|------------------|-------------------|------------------|
|   | Fair Value       | Unrealized Gains | Fair Value        | Unrealized Gains |
| Federal Agency Mortgage Backed Securities | \$ 23,547        | \$ 1,046         | \$ 13,050         | \$ 567           |
| U.S. Government Bonds                     | 13,116           | 429              | 4,537             | 58               |
| Municipal Obligations                     | 20,262           | 948              | 21,121            | 852              |
| Corporate Obligations                     | 8,075            | 378              | 4,313             | 222              |
| Total debt securities                     | 65,000           | 2,801            | 43,021            | 1,699            |
| Common stock                              | 30,615           | 5,484            | 45,317            | 7,808            |
| Temporary investments                     | 3,309            | 0                | 4,016             | 0                |
| <b>Total</b>                              | <b>\$ 98,924</b> | <b>\$ 8,285</b>  | <b>\$ 92,354</b>  | <b>\$ 9,507</b>  |





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The Company's marketable securities include investments in municipal, corporate and federal debt obligations. The contractual year for maturity of these available-for-sale securities as of June 30, 2010 is as follows (in thousands):

|   | <b>Total</b> | <b>2010</b> | <b>2011<br/>through<br/>2014</b> | <b>2015<br/>through<br/>2019</b> | <b>2020<br/>and<br/>Beyond</b> |
|---|--------------|-------------|----------------------------------|----------------------------------|--------------------------------|
| Municipal Debt Obligations                | \$ 30,010    | \$ 1,823    | \$ 10,804                        | \$ 12,407                        | \$ 4,976                       |
| Corporate Debt Obligations                | 8,577        | 0           | 2,801                            | 3,882                            | 1,894                          |
| Federal Agency Mortgage Backed Securities | 23,998       | 0           | 1,462                            | 2,379                            | 20,157                         |
| U.S. Government Bonds                     | 15,290       | 0           | 8,632                            | 4,617                            | 2,041                          |

The Company recognizes impairment losses on certain of its securities deemed to be other than temporary. In accordance with FASB guidance, these impairment losses are recognized in net income, and a lower cost basis is established for these securities. For the three, six and twelve months ended June 30, 2010, \$0.3 million, \$0.3 million and \$0.7 million of gross impairments deemed to be other than temporary were recognized in the consolidated statement of operations. For the three, six and twelve months ended June 30, 2009, \$2.6 million, \$5.2 million and \$11.6 million of gross impairments were deemed to be other than temporary and recognized in the consolidated statements of operations.

The Company's marketable securities in its decommissioning trust funds are sold from time to time and the Company uses the specific identification basis to determine the amount to reclassify out of accumulated other comprehensive income and into net income. The proceeds from the sale of these securities and the related effects on pre-tax income are as follows (in thousands):

|  | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             | <b>Twelve Months Ended<br/>June 30,</b> |             |
|--|--|-------------|--------------------------------------|-------------|---|-------------|
|  | <b>2010</b>                            | <b>2009</b> | <b>2010</b>                          | <b>2009</b> | <b>2010</b>                             | <b>2009</b> |
| Proceeds from sales of available-for-sale securities                         | \$ 14,701                              | \$ 8,396    | \$ 34,205                            | \$ 20,812   | \$ 93,328                               | \$ 57,446   |
| Gross realized gains included in pre-tax income                              | \$ 129                                 | \$ 87       | \$ 526                               | \$ 289      | \$ 3,851                                | 4,990       |
| Gross realized losses included in pre-tax income                             | (244)                                  | (236)       | (672)                                | (409)       | (502)                                   | (888)       |
| Gross unrealized losses included in pre-tax income                           | (263)                                  | (2,649)     | (263)                                | (5,151)     | (705)                                   | (11,574)    |
| Net gains (losses) in pre-tax income   | \$ (378)                               | \$ (2,798)  | \$ (409)                             | \$ (5,271)  | \$ 2,644                                | \$ (7,472)  |
| Net unrealized holding gains (losses) included in other comprehensive income | \$ (6,401)                             | \$ 7,749    | \$ (3,978)                           | \$ 2,358    | \$ 6,480                                | \$ (19,398) |
| Net gains (losses) reclassified out of other comprehensive income            | 378                                    | 2,798       | 409                                  | 5,271       | (2,644)                                 | 7,472       |
| Net gains (losses) in other comprehensive income                             | \$ (6,023)                             | \$ 10,547   | \$ (3,569)                           | \$ 7,629    | \$ 3,836                                | \$ (11,926) |

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*Fair Value Measurements.* FASB guidance requires the Company to provide expanded quantitative disclosures for financial assets and liabilities recorded on the balance sheet at fair value. Financial assets carried at fair value include the Company's decommissioning trust investments and investments in debt securities. The Company has no liabilities that are measured at fair value on a recurring basis. The FASB guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels as follows:

Level 1 Observable inputs that reflect quoted market prices for identical assets and liabilities in active markets. Financial assets utilizing Level 1 inputs include the nuclear decommissioning trust investments in active exchange-traded equity securities and U.S. treasury securities that are in a highly liquid and active market.

Level 2 Inputs other than quoted market prices included in Level 1 that are observable for the asset or liability either directly or indirectly. Financial assets utilizing Level 2 inputs include the nuclear decommissioning trust investments in fixed income securities other than U.S. Treasury securities. The fair value of these financial instruments is based on evaluated prices that reflect observable market information, such as actual trade information of similar securities, adjusted for observable differences.

Level 3 Unobservable inputs using data that is not corroborated by market data and primarily based on internal Company analysis using models and various other analyses. Financial assets utilizing Level 3 inputs include the Company's investments in debt securities.

As of June 30, 2010, the Company had \$4.0 million invested in debt securities which consisted of two \$2.0 million investments in auction rate securities maturing in 2042 and 2044. The Company classifies these securities as trading securities which are included in deferred charges and other assets on the Company's consolidated balance sheets. These auction rate securities are collateralized with student loans which are re-insured by the Department of Education as part of the Federal Family Education Loan Program (FFELP) and have credit ratings of A by Standard & Poors and A2 by Moody's. The principal on the securities can be realized at maturity, sold in a successful auction, or sold in the secondary market. Interest rates on the auction rate securities are reset every 28 days. At June 30, 2010 upon a failed auction, the maximum interest rates for \$2.0 million of the debt securities were based upon the lesser of the interest paid on the student loan portfolio, less service costs or one-month LIBOR plus 2.5%. At June 30, 2010, the default interest rate was 2.85% based on one-month LIBOR plus 2.5%. The maximum interest rate for the remaining \$2.0 million of debt securities were based upon the lesser of (i) the net loan rate (the interest paid on the student loan portfolio less service costs); (ii) 91-day Treasury bills plus 1.5%; (iii) one-month LIBOR plus 1.5%; (iv) 18%; or (v) highest rate legally payable. At June 30, 2010, the default interest rate was 1.553% based on the net loan rate.

The auction process historically provided a liquid market to sell the securities to meet cash requirements. These auction rate securities had successful auctions through January 2008. However, since February 2008, auctions for these securities have not been successful, resulting in the inability to liquidate these investments. The Company's valuation as of June 30, 2010 is based upon the average of a discounted cash flow model valuation and a market comparables method.

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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The discounted cash flow model valuation is based on expected cash flows using the maximum expected interest rates discounted by an expected yield reflecting illiquidity and credit risk. In order to more accurately forecast cash flows, Treasury and LIBOR yield curves were created using swap rates and data provided on the U.S. Department of the Treasury website and the British Bankers' Association website. After thorough analysis, future cash flows were projected based on interest rate models over a term, which was based on an estimate of the weighted average life of the student loan portfolio within the issuing trusts. The applied discount yield was based on the applicable forward LIBOR rate and yield spreads of 470 and 570 basis points based on each security's (i) credit risk, (ii) illiquidity, (iii) subordinated status, (iv) interest rate limitations, and (v) FFELP guarantees.

The market comparables method is based upon sales and purchases of auction rate securities in secondary market transactions. The secondary market discounts of 33% to 37% are based on discounts indicated in secondary market transactions involving comparable student loan auction rate securities. The average of the values provided by the discounted cash flow calculation and the market comparables method are used to arrive at the concluded value of the securities.

The securities in the Company's decommissioning trust funds are valued using prices and other relevant information generated by market transactions involving identical or comparable securities. FASB guidance identifies this valuation technique as the market approach with observable inputs. The Company analyzes available-for-sale securities to determine if losses are other than temporary.

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

The fair value of the Company's decommissioning trust funds and investments in debt securities, at June 30, 2010 and December 31, 2009, and the level within the three levels of the fair value hierarchy defined by FASB guidance are presented in the table below (in thousands):

| Description of Securities                 | Fair Value as of<br>June 30,<br>2010 | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|--------------------------------------|--|---|--|
| <b>Trading Securities:</b>                |                                      |  |   |  |
| Investments in Debt Securities            | \$ 2,546                             | \$ 0   | \$ 0  | \$ 2,546   |
| <b>Available for sale:</b>                |                                      |  |   |  |
| U.S. Government Bonds                     | \$ 15,290                            | \$ 15,290  | \$ 0  | \$ 0   |
| Federal Agency Mortgage Backed Securities | 23,998                               | 0  | 23,998  | 0  |
| Municipal Bonds                           | 30,010                               | 0  | 30,010  | 0  |
| Corporate Asset Backed Obligations        | 8,577                                | 0  | 8,577   | 0  |
| Subtotal Debt Securities                  | 77,875                               | 15,290   | 62,585  | 0  |
| <b>Common Stock:</b>                      |                                      |  |   |  |
| U.S. companies                            | 47,387                               | 47,387   | 0   | 0  |
| International companies                   | 8,757                                | 8,757  | 0   | 0  |
| Cash and Cash Equivalents                 | 3,309                                | 3,309  | 0   | 0  |
| Total available for sale                  | \$ 137,328                           | \$ 74,743  | \$ 62,585   | \$ 0   |

| Description of Securities                 | Fair Value as of<br>December 31,<br>2009 | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|--|--|---|--|
| <b>Trading Securities:</b>                |  |  |   |  |
| Investments in Debt Securities            | \$ 2,510                                 | \$ 0   | \$ 0  | \$ 2,510   |
| <b>Available for sale:</b>                |  |  |   |  |
| U.S. Government Bonds                     | \$ 13,892                                | \$ 13,892  | \$ 0  | \$ 0   |
| Federal Agency Mortgage Backed Securities | 20,063                                   | 0  | 20,063  | 0  |
| Municipal Bonds                           | 29,424                                   | 0  | 29,424  | 0  |
| Corporate Asset Backed Obligations        | 7,207                                    | 0  | 7,207   | 0  |
| Subtotal Debt Securities                  | 70,586                                   | 13,892   | 56,694  | 0  |
| <b>Common Stock:</b>                      |  |  |   |  |

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|                                 |                   |                  |                  |             |
|---------------------------------|-------------------|------------------|------------------|-------------|
| U.S. companies                  | 51,759            | 51,759           | 0                | 0           |
| International companies         | 9,011             | 9,011            | 0                | 0           |
| Cash and Cash Equivalents       | 4,016             | 4,016            | 0                | 0           |
| <b>Total available for sale</b> | <b>\$ 135,372</b> | <b>\$ 78,678</b> | <b>\$ 56,694</b> | <b>\$ 0</b> |

The change in the fair value of the investments in debt securities resulted in a charge to income of less than \$0.1 million for the three months ended June 30, 2010, and a credit to income of less than \$0.1 million and \$0.1 million for the six and twelve months ended June 30, 2010, respectively. The change

**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

in the fair value of the investments in debt securities resulted in a credit to income of \$0.2 million for the three and six months ended June 30, 2009, and a charge to income of \$0.6 million for the twelve months ended June 30, 2009. These amounts are reflected in the Company's consolidated statement of operations as an adjustment to investment and interest income. Below is a reconciliation of the beginning and ending balances of the investments in debt securities (in thousands):

|   | <b>2010</b> | <b>2009</b> |
|---|-------------|-------------|
| Balance at January 1                                      | \$ 2,510    | \$ 2,264    |
| Unrealized gain (loss) in fair value recognized in income | 62          | (52)        |
| Balance at March 31                                       | 2,572       | 2,212       |
| Unrealized gain (loss) in fair value recognized in income | (26)        | 213         |
| Balance at June 30  | \$ 2,546    | \$ 2,425    |

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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 consolidated balance sheet of El Paso Electric Company and subsidiary as of June 30, 2010, the related consolidated statements of operations and comprehensive operations for the three-month, six-month and twelve-month periods ended June 30, 2010 and 2009, and the related consolidated statements of cash flows for the six-month periods ended June 30, 2010 and 2009. These 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 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, 2009, 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 February 25, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2009, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Houston, Texas  
August 5, 2010

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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 2009 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 similar meaning. Forward-looking statements describe our future plans, objectives, expectations or goals. Such statements address future events and conditions concerning and including, 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:



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ability of our operating partners to maintain plant operations and manage operation and maintenance costs at the Palo Verde and Four Corners plants,

reductions in output at generation plants operated by the Company,

unscheduled outages including outages at Palo Verde,

the size of our construction program and our ability to complete construction on budget and on a timely basis,

the recovery of capital investments through rates,

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 including the ability to recover fuel costs on a timely basis,

changes in environmental regulations, including those related to greenhouse gas emissions,

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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 recent U.S. health care reform legislation,

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

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

homeland security considerations,

coal, uranium, natural gas, oil and wholesale electricity prices and availability, 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 2009 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 2009 Form 10-K.

**Summary**

The following is an overview of our results of operations for the three, six and twelve month periods ended June 30, 2010 and 2009. Income for the three, six and twelve month periods ended June 30, 2010 and 2009 is shown below:

| <b>Three Months Ended<br/>June 30,</b> | <b>Six Months Ended<br/>June 30,</b> | <b>Twelve Months Ended<br/>June 30,</b> |
|--|--------------------------------------|---|
|--|--------------------------------------|---|

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|                           | 2010      | 2009      | 2010      | 2009      | 2010      | 2009      |
|---------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Net income (in thousands) | \$ 21,507 | \$ 15,431 | \$ 32,956 | \$ 25,040 | \$ 74,849 | \$ 68,939 |
| Basic earnings per share  | 0.49      | 0.34      | 0.75      | 0.56      | 1.70      | 1.54      |

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The following table and accompanying explanations show the primary factors affecting the after-tax change in income between the 2010 and 2009 periods presented (in thousands):

|   | Three Months<br>Ended | Six Months<br>Ended | Twelve Months<br>Ended |
|---|-----------------------|---------------------|------------------------|
| June 30, 2009 net income  | \$ 15,431             | \$ 25,040           | \$ 68,939              |
| Change in (net of tax):   |                       |                     |                        |
| Increased retail non-fuel base revenues (a)                         | 4,235                 | 9,353               | 18,305                 |
| Increased (decreased) deregulated Palo Verde Unit 3 revenues (b)    | 1,808                 | 1,484               | (3,228)                |
| Increased interest and investment income (c)                        | 1,665                 | 3,079               | 6,294                  |
| Decreased (increased) Palo Verde operations and maintenance expense | 1,007                 | 585                 | (2,391)                |
| Increased depreciation and amortization (d)                         | (921)                 | (1,932)             | (2,172)                |
| Increased pension and benefits expense (e)                          | (752)                 | (847)               | (2,542)                |
| Decreased off-system sales margins retained (f)                     | (44)                  | (460)               | (3,186)                |
| Decreased (increased) interest on long-term debt (g)                | (28)                  | 1,058               | 2,652                  |
| Elimination of Medicare Part D tax benefit (h)                      | 0                     | (4,787)             | (4,787)                |
| Other   | (894)                 | 383                 | (3,035)                |
| June 30, 2010 net income  | \$ 21,507             | \$ 32,956           | \$ 74,849              |

- (a) Non-fuel retail base revenues increased for the three month period ending June 30, 2010 compared to the same period last year primarily due to a 4.2% increase in kWh sales to retail customers as a result of a 1.7% growth in customers served and increased sales to large commercial and industrial customers. Non-fuel retail base revenues increased for the six month period ending June 30, 2010 compared to the same period last year primarily due to a 5.3% increase in kWh sales to retail customers as a result of colder winter weather, increased sales to large commercial and industrial customers, and a 1.8% growth in customers served. Non-fuel retail base revenues increased for the twelve month period ending June 30, 2010 compared to the same period last year primarily due to a 5.3% increase in kWh sales to retail customers and increased sales to large and industrial customers. The increases in all three periods were also due to new rates effective in New Mexico beginning January 2010. Non-fuel retail base revenues exclude fuel recovered through New Mexico base rates.
- (b) Revenues from retail sales of deregulated Palo Verde Unit 3 power increased for the three and six month periods ended June 30, 2010 compared to the same periods last year as the unit did not operate for most of April and May 2009 due to a refueling outage. Decreased revenues from sales of deregulated Palo Verde Unit 3 power for the twelve months ended June 30, 2010 reflects lower proxy market prices in the 2010 period partially offset by increased Unit 3 power sold to retail customers.
- (c) Investment and interest income increased primarily due to reduced impairments of equity investments in our Palo Verde decommissioning trust funds for the three and six months ended June 30, 2010 of \$2.4 million and \$4.9 million, respectively, when compared to the same periods last year. Investment and interest income increased for the twelve months ended June 30, 2010 primarily due to impairments in the prior period with no comparable impairment in the current period.
- (d) Depreciation and amortization expense increased for all three periods due to increased depreciable plant balances.
- (e) Pension and benefits expense increased for all three periods primarily due to changes in actuarial assumptions used to calculate expenses for our pension plan.
- (f) Off-system sales margins retained decreased for the three, six, and twelve months ended June 30, 2010 compared to the same periods last year as a result of a decline in MWh sales.
- (g) Interest expense on long-term debt decreased for the six and twelve months ended June 30, 2010 primarily as a result of lower interest rates on pollution control bonds. Two series of pollution control bonds were refunded in March 2009 at a fixed 7.25% interest rate which is lower than the variable interest rates applied to these bonds before refunding.
- (h) Tax expense increased for the six and twelve months ended June 30, 2010 due to a change in the tax law enacted in the Patient Protection and Affordable Care Act to eliminate the tax benefit related to the Medicare Part D subsidies.

**Table of Contents****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*

We realize revenue from the sale of electricity to retail customers at regulated rates and the sale of energy in the wholesale power market generally at market based prices. Sales for resale (which are wholesale sales within our service territory) accounted for less than 1% of revenues. Off-system sales are wholesale sales into markets outside our service territory. Off-system sales are primarily made in off-peak periods when we have competitive generation capacity available after meeting our regulated service obligations. We shared 25% of our off-system sales margins with our customers in Texas, New Mexico, and FERC and retained 75% of off-system margins through June 30, 2010 pursuant to rate agreements in prior years. In July 2010, off-system sales margins shared with customers in Texas and New Mexico increased to 90%.

Revenues from the sale of electricity include fuel costs that are recovered from our customers through fuel adjustment mechanisms. A significant portion of fuel costs are also recovered through base rates in New Mexico. We record deferred fuel revenues for the difference between actual fuel costs and recoverable fuel revenues until such amounts are collected from or refunded to customers. Non-fuel base revenues refers to our revenues from the sale of electricity excluding such fuel costs.

Retail non-fuel base revenue percentages by customer class are presented below:

|  | Three Months Ended<br>June 30, |             | Six Months Ended<br>June 30, |             | Twelve Months Ended<br>June 30, |             |
|--|--------------------------------|-------------|------------------------------|-------------|---------------------------------|-------------|
|  | 2010                           | 2009        | 2010                         | 2009        | 2010                            | 2009        |
| Residential                                | 39%                            | 39%         | 39%                          | 39%         | 40%                             | 40%         |
| Commercial and industrial, small           | 36                             | 37          | 36                           | 37          | 36                              | 37          |
| Commercial and industrial, large           | 9                              | 7           | 9                            | 7           | 8                               | 7           |
| Sales to public authorities                | 16                             | 17          | 16                           | 17          | 16                              | 16          |
| <b>Total retail non-fuel base revenues</b> | <b>100%</b>                    | <b>100%</b> | <b>100%</b>                  | <b>100%</b> | <b>100%</b>                     | <b>100%</b> |

No retail customer accounted for more than 3% of our base revenues during such periods. As shown in the table above, residential and small commercial customers comprise approximately 75% of our revenues. While this customer base is more stable, it is also more sensitive to changes in weather conditions. As a result, our business is seasonal, with higher kWh sales and revenues during the summer cooling season.

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Weather significantly impacts our residential, small commercial and industrial customers, and to a lesser extent, our sales to public authorities. Heating and cooling degree days can be used to evaluate the effect of weather on energy use. For each degree the average outdoor temperature varies from a standard of 65 degrees Fahrenheit a degree day is recorded. The table below shows heating and cooling degree days compared to a 10-year average.

|                     | Three Months Ended |       |         | Six Months Ended |       |         | Twelve Months Ended |       |          |
|---------------------|--------------------|-------|---------|------------------|-------|---------|---------------------|-------|----------|
|                     | June 30,           |       | 10-Year | June 30,         |       | 10-Year | June 30,            |       | 10-Year  |
|                     | 2010               | 2009  | Average | 2010             | 2009  | Average | 2010                | 2009  | Average* |
| Heating degree days | 82                 | 82    | 69      | 1,478            | 1,112 | 1,306   | 2,510               | 2,026 | 2,290    |
| Cooling degree days | 995                | 1,013 | 988     | 1,004            | 1,050 | 1,006   | 2,722               | 2,290 | 2,556    |

\* Calendar year basis.

Customer growth is a primary driver of the growth of retail sales. The average number of retail customers grew 1.7% for the three months ended June 30, 2010 and 1.8% for both the six and twelve months ended June 30, 2010 when compared to the same period last year. See the tables presented on pages 41, 42 and 43 which provide detail on the average number of retail customers and the related revenues and kWh sales.

*Retail non-fuel base revenues.* Retail non-fuel base revenues increased by \$6.7 million or 5.4% for the three months ended June 30, 2010 when compared to the same period last year primarily due to (i) a 32.5% increase in retail non-fuel base revenues received from large commercial and industrial customers reflecting an increase of 13.3% in kWh sales and the implementation of higher rates in new contracts with several large customers whose contracts had expired; (ii) a 2.5% increase in kWh sales to residential customers reflecting a 1.7% growth in the average number of customers served; and (iii) a 2.6% increase in kWh sales to small commercial and industrial customers primarily as a result of a 2.4% increase in the average number of small commercial and industrial customers served. Retail non-fuel base revenues to public authorities increased 2.1% primarily reflecting increased kWh sales of 2.9% largely due to increased sales to military bases. Revenues in all customer classes also reflect increased non-fuel base rates in New Mexico which were effective beginning January 2010.

For the six months ended June 30, 2010, retail non-fuel base revenues increased by \$14.8 million, or 6.6% compared to the same period in 2009 primarily due to a 7.6% increase in kWh sales to residential customers reflecting colder winter weather in 2010 and 1.8% growth in the average number of customers served. During the six months ended June 30, 2010, heating degree days were 33% above the same period in 2009 and 13% above the 10-year average. Retail non-fuel base revenues received from large commercial and industrial customers increased 25.7% due to an increase of 9.9% in kWh sales and the implementation of higher rates in new contracts with several large customers whose contracts had expired. Retail non-fuel base revenues also increased due to a 2.5% increase in kWh sales to small commercial and industrial customers primarily as a result of a 2.2% increase in the average number of small commercial and industrial customers served. Retail non-fuel base revenues to public authorities increased 2.7% primarily reflecting increased kWh sales of 3.1% largely due to increased sales to military bases. Revenues in all customer classes also reflect increased non-fuel base rates in New Mexico which were effective beginning January 2010.

Retail non-fuel base revenues for the twelve months ended June 30, 2010 increased by \$29.1 million, or 6.2%, compared to the same period in 2009 primarily due to a 9.2% increase in kWh sales to residential customers reflecting colder winter weather in the first quarter of 2010 and hotter

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summer weather in the third quarter of 2009 and a 1.8% growth in the average number of customers served. During the twelve months ended June 30, 2010, heating degree days were 24% above the same period in 2009 and 10% above the 10-year average. Retail non-fuel base revenues from large commercial and industrial customers increased \$4.5 million, or 13.1% primarily due to a 7.0% increase in kWh sales and the implementation of higher rates in new contracts with several large customers whose contracts had expired. Retail non-fuel base revenues from small commercial and industrial customers increased 2.4% reflecting a 1.6% growth in the average number of small commercial and industrial customers served. Retail non-fuel base revenues from public authorities increased 5.2% due to a 3.6% increase in kWh sales including increased sales to military bases. Revenues in all customer classes also reflect increased non-fuel base rates in New Mexico which were effective beginning January 2010.

*Fuel revenues.* Fuel revenues consist of: (i) revenues collected from customers under fuel recovery mechanisms approved by the state commissions and the FERC, (ii) deferred fuel revenues which are comprised of the difference between fuel costs and fuel revenues collected from customers and (iii) fuel costs recovered in base rates in New Mexico. In New Mexico and with our sales for resale customer, the fuel adjustment clause allows us to recover under-recoveries or refund over-recoveries of current fuel costs above the amount recovered in base rates with a two-month lag. In Texas, fuel costs are recovered through a fixed fuel factor. Effective July 1, 2010, we can seek to revise our fixed fuel factor based upon our approved formula at least four months after our last revision except in the month of December. In addition, if we materially over-recover fuel costs, we must seek to refund the over-recovery, and if we materially under-recover fuel costs, we may seek a surcharge to recover those costs.

We over-recovered our fuel costs by \$6.4 million, \$12.1 million and \$42.1 million for the three, six and twelve months ended June 30, 2010, respectively, compared to fuel over-recoveries of \$13.3 million, \$36.6 million, and \$36.7 million in the same periods last year. In August 2009, we implemented a reduced fixed fuel factor in Texas, and in February 2010, we refunded \$11.8 million of fuel over-recoveries incurred through November 2009 to our Texas customers. During the six months ended June 30, 2009, we recovered \$16.3 million of fuel under-recoveries from Texas customers through a surcharge. Refunds of \$28.5 million were returned to our Texas customers in the twelve-months ended June 30, 2010 compared to recovery of \$37.4 million of fuel under-recoveries through fuel surcharges, including interest, in the twelve months ended June 30, 2009. Over-recoveries or under-recoveries in New Mexico and from our FERC customer are refunded through fuel adjustment clauses with a two-month lag. At June 30, 2010, we had a net fuel over-recovery balance of \$18.4 million, including a \$17.9 million over-recovery in Texas, a \$0.6 million over-recovery in New Mexico, and \$0.1 million under-recovery from our FERC customer. At June 30, 2009, we had a fuel over-recovery balance of \$4.8 million, including a \$5.8 million over-recovery in Texas, a \$1.2 million under-recovery in New Mexico, and a \$0.2 million over-recovery from our FERC customer.

*Off-system sales.* Off-system sales are primarily made in off-peak periods when we have competitive generation capacity available after meeting our regulated service obligations. Typically, we realize a significant portion of our off-system sales margins in the first quarter of each calendar year when our native load is lower than at other times of the year allowing for the sale in the wholesale

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market of relatively larger amounts of off-system energy generated from lower cost generating resources. Palo Verde's availability is an important factor in realizing these off-system sales margins. The table below shows the MWhs, sales revenue, fuel costs, total margins, and retained margins made on off-system sales for the three, six, and twelve month periods (in thousands except for MWhs).

|                 | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           | Twelve Months Ended<br>June 30, |            |
|-----------------|--------------------------------|-----------|------------------------------|-----------|---------------------------------|------------|
|                 | 2010                           | 2009      | 2010                         | 2009      | 2010                            | 2009       |
| MWh sales       | 511,470                        | 634,078   | 1,359,208                    | 1,692,481 | 2,662,711                       | 3,522,446  |
| Sales revenues  | \$ 17,710                      | \$ 22,464 | \$ 56,413                    | \$ 61,081 | \$ 111,396                      | \$ 169,982 |
| Fuel cost       | \$ 16,661                      | \$ 21,321 | \$ 49,523                    | \$ 53,216 | \$ 97,971                       | \$ 149,813 |
| Total margin    | \$ 1,049                       | \$ 1,143  | \$ 6,890                     | \$ 7,865  | \$ 13,425                       | \$ 20,169  |
| Retained margin | \$ 787                         | \$ 857    | \$ 5,169                     | \$ 5,900  | \$ 10,073                       | \$ 15,130  |

Off-system sales revenues decreased in the three, six, and twelve month periods ended June 30, 2010 when compared to the same periods last year as a result of lower MWh sales. Customers were credited 25% of the off-system sales margins through fuel recovery mechanisms through June 30, 2010, pursuant to rate agreements then in effect. In July 2010, off-system sales margins shared with customers in Texas and New Mexico increased to 90%.



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

| Quarter Ended June 30:                     | 2010              | 2009              | Increase (Decrease) |               |
|--|-------------------|-------------------|---------------------|---------------|
|  |                   |                   | Amount              | Percent       |
| <b>kWh sales:</b>                          |                   |                   |                     |               |
| <b>Retail:</b>                             |                   |                   |                     |               |
| Residential                                | 583,096           | 569,004           | 14,092              | 2.5%          |
| Commercial and industrial, small           | 601,048           | 585,678           | 15,370              | 2.6           |
| Commercial and industrial, large           | 289,095           | 255,178           | 33,917              | 13.3          |
| Sales to public authorities                | 403,770           | 392,328           | 11,442              | 2.9           |
| <b>Total retail sales</b>                  | <b>1,877,009</b>  | <b>1,802,188</b>  | <b>74,821</b>       | <b>4.2</b>    |
| <b>Wholesale:</b>                          |                   |                   |                     |               |
| Sales for resale                           | 17,335            | 18,564            | (1,229)             | (6.6)         |
| Off-system sales                           | 511,470           | 634,078           | (122,608)           | (19.3)        |
| <b>Total wholesale sales</b>               | <b>528,805</b>    | <b>652,642</b>    | <b>(123,837)</b>    | <b>(19.0)</b> |
| <b>Total kWh sales</b>                     | <b>2,405,814</b>  | <b>2,454,830</b>  | <b>(49,016)</b>     | <b>(2.0)</b>  |
| <b>Operating revenues:</b>                 |                   |                   |                     |               |
| <b>Non-fuel base revenues:</b>             |                   |                   |                     |               |
| <b>Retail:</b>                             |                   |                   |                     |               |
| Residential                                | \$ 50,153         | \$ 48,073         | \$ 2,080            | 4.3%          |
| Commercial and industrial, small           | 47,238            | 45,888            | 1,350               | 2.9           |
| Commercial and industrial, large           | 11,608            | 8,762             | 2,846               | 32.5          |
| Sales to public authorities                | 21,186            | 20,741            | 445                 | 2.1           |
| <b>Total retail non-fuel base revenues</b> | <b>130,185</b>    | <b>123,464</b>    | <b>6,721</b>        | <b>5.4</b>    |
| <b>Wholesale:</b>                          |                   |                   |                     |               |
| Sales for resale                           | 567               | 575               | (8)                 | (1.4)         |
| <b>Total non-fuel base revenues</b>        | <b>130,752</b>    | <b>124,039</b>    | <b>6,713</b>        | <b>5.4</b>    |
| <b>Fuel revenues:</b>                      |                   |                   |                     |               |
| Recovered from customers during the period | 45,248            | 47,447            | (2,199)             | (4.6)(1)      |
| Under (over) collection of fuel            | (6,402)           | (13,285)          | 6,883               | (51.8)        |
| New Mexico fuel in base rates              | 17,753            | 16,444            | 1,309               | 8.0           |
| <b>Total fuel revenues</b>                 | <b>56,599</b>     | <b>50,606</b>     | <b>5,993</b>        | <b>11.8</b>   |
| Off-system sales                           | 17,710            | 22,464            | (4,754)             | (21.2)        |
| Other                                      | 6,336             | 6,540             | (204)               | (3.1)(2)      |
| <b>Total operating revenues</b>            | <b>\$ 211,397</b> | <b>\$ 203,649</b> | <b>\$ 7,748</b>     | <b>3.8</b>    |
| <b>Average number of retail customers:</b> |                   |                   |                     |               |
| Residential                                | 330,976           | 325,302           | 5,674               | 1.7%          |
| Commercial and industrial, small           | 36,740            | 35,892            | 848                 | 2.4           |
| Commercial and industrial, large           | 49                | 49                | 0                   | 0.0           |
| Sales to public authorities                | 4,701             | 4,929             | (228)               | (4.6)         |

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|       |         |         |       |     |
|-------|---------|---------|-------|-----|
| Total | 372,466 | 366,172 | 6,294 | 1.7 |
|-------|---------|---------|-------|-----|

- (1) Excludes \$4.0 million in 2009 of prior periods deferred fuel revenues recovered through Texas fuel surcharges.
- (2) Represents revenues with no related kWh sales.

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| Six Months Ended June 30:                  | 2010              | 2009              | Increase (Decrease) |               |
|--|-------------------|-------------------|---------------------|---------------|
|  |                   |                   | Amount              | Percent       |
| <b>kWh sales:</b>                          |                   |                   |                     |               |
| <b>Retail:</b>                             |                   |                   |                     |               |
| Residential                                | 1,139,376         | 1,058,633         | 80,743              | 7.6%          |
| Commercial and industrial, small           | 1,085,330         | 1,058,965         | 26,365              | 2.5           |
| Commercial and industrial, large           | 525,708           | 478,175           | 47,533              | 9.9           |
| Sales to public authorities                | 729,327           | 707,377           | 21,950              | 3.1           |
| <b>Total retail sales</b>                  | <b>3,479,741</b>  | <b>3,303,150</b>  | <b>176,591</b>      | <b>5.3</b>    |
| <b>Wholesale:</b>                          |                   |                   |                     |               |
| Sales for resale                           | 26,515            | 28,958            | (2,443)             | (8.4)         |
| Off-system sales                           | 1,359,208         | 1,692,481         | (333,273)           | (19.7)        |
| <b>Total wholesale sales</b>               | <b>1,385,723</b>  | <b>1,721,439</b>  | <b>(335,716)</b>    | <b>(19.5)</b> |
| <b>Total kWh sales</b>                     | <b>4,865,464</b>  | <b>5,024,589</b>  | <b>(159,125)</b>    | <b>(3.2)</b>  |
| <b>Operating revenues:</b>                 |                   |                   |                     |               |
| <b>Non-fuel base revenues:</b>             |                   |                   |                     |               |
| <b>Retail:</b>                             |                   |                   |                     |               |
| Residential                                | \$ 94,988         | \$ 88,264         | \$ 6,724            | 7.6%          |
| Commercial and industrial, small           | 86,437            | 83,552            | 2,885               | 3.5           |
| Commercial and industrial, large           | 20,821            | 16,568            | 4,253               | 25.7          |
| Sales to public authorities                | 38,102            | 37,118            | 984                 | 2.7           |
| <b>Total retail non-fuel base revenues</b> | <b>240,348</b>    | <b>225,502</b>    | <b>14,846</b>       | <b>6.6</b>    |
| <b>Wholesale:</b>                          |                   |                   |                     |               |
| Sales for resale                           | 874               | 882               | (8)                 | (0.9)         |
| <b>Total non-fuel base revenues</b>        | <b>241,222</b>    | <b>226,384</b>    | <b>14,838</b>       | <b>6.6</b>    |
| <b>Fuel revenues:</b>                      |                   |                   |                     |               |
| Recovered from customers during the period | 83,281            | 97,908            | (14,627)            | (14.9)(1)     |
| Under (over) collection of fuel            | (12,092)          | (36,641)          | 24,549              | (67.0)        |
| New Mexico fuel in base rates              | 33,582            | 31,804            | 1,778               | 5.6           |
| <b>Total fuel revenues</b>                 | <b>104,771</b>    | <b>93,071</b>     | <b>11,700</b>       | <b>12.6</b>   |
| Off-system sales                           | 56,413            | 61,081            | (4,668)             | (7.6)         |
| Other                                      | 13,159            | 13,549            | (390)               | (2.9)(2)      |
| <b>Total operating revenues</b>            | <b>\$ 415,565</b> | <b>\$ 394,085</b> | <b>\$ 21,480</b>    | <b>5.5</b>    |
| <b>Average number of retail customers:</b> |                   |                   |                     |               |
| Residential                                | 330,356           | 324,542           | 5,814               | 1.8%          |
| Commercial and industrial, small           | 36,644            | 35,839            | 805                 | 2.2           |
| Commercial and industrial, large           | 48                | 49                | (1)                 | (2.0)         |
| Sales to public authorities                | 4,833             | 4,934             | (101)               | (2.0)         |
| <b>Total</b>                               | <b>371,881</b>    | <b>365,364</b>    | <b>6,517</b>        | <b>1.8</b>    |

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- (1) Excludes \$11.8 million refund in 2010 and a \$16.3 million surcharge in 2009 related to prior periods Texas deferred fuel revenues.
- (2) Represents revenues with no related kWh sales.

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| Twelve Months Ended June 30:               | 2010              | 2009              | Increase (Decrease) |               |
|--|-------------------|-------------------|---------------------|---------------|
|  |                   |                   | Amount              | Percent       |
| <b>kWh sales:</b>                          |                   |                   |                     |               |
| <b>Retail:</b>                             |                   |                   |                     |               |
| Residential                                | 2,442,393         | 2,236,081         | 206,312             | 9.2%          |
| Commercial and industrial, small           | 2,277,764         | 2,238,976         | 38,788              | 1.7           |
| Commercial and industrial, large           | 1,071,719         | 1,001,358         | 70,361              | 7.0           |
| Sales to public authorities                | 1,504,398         | 1,452,344         | 52,054              | 3.6           |
| <b>Total retail sales</b>                  | <b>7,296,274</b>  | <b>6,928,759</b>  | <b>367,515</b>      | <b>5.3</b>    |
| <b>Wholesale:</b>                          |                   |                   |                     |               |
| Sales for resale                           | 54,488            | 53,353            | 1,135               | 2.1           |
| Off-system sales                           | 2,662,711         | 3,522,446         | (859,735)           | (24.4)        |
| <b>Total wholesale sales</b>               | <b>2,717,199</b>  | <b>3,575,799</b>  | <b>(858,600)</b>    | <b>(24.0)</b> |
| <b>Total kWh sales</b>                     | <b>10,013,473</b> | <b>10,504,558</b> | <b>(491,085)</b>    | <b>(4.7)</b>  |
| <b>Operating revenues:</b>                 |                   |                   |                     |               |
| <b>Non-fuel base revenues:</b>             |                   |                   |                     |               |
| <b>Retail:</b>                             |                   |                   |                     |               |
| Residential                                | \$ 202,522        | \$ 186,092        | \$ 16,430           | 8.8%          |
| Commercial and industrial, small           | 178,213           | 173,972           | 4,241               | 2.4           |
| Commercial and industrial, large           | 39,057            | 34,539            | 4,518               | 13.1          |
| Sales to public authorities                | 78,354            | 74,490            | 3,864               | 5.2           |
| <b>Total retail non-fuel base revenues</b> | <b>498,146</b>    | <b>469,093</b>    | <b>29,053</b>       | <b>6.2</b>    |
| <b>Wholesale:</b>                          |                   |                   |                     |               |
| Sales for resale                           | 2,029             | 1,633             | 396                 | 24.2          |
| <b>Total non-fuel base revenues</b>        | <b>500,175</b>    | <b>470,726</b>    | <b>29,449</b>       | <b>6.3</b>    |
| <b>Fuel revenues:</b>                      |                   |                   |                     |               |
| Recovered from customers during the period | 181,454           | 210,571           | (29,117)            | (13.8)(1)     |
| Under (over) collection of fuel            | (42,059)          | (36,661)          | (5,398)             | 14.7          |
| New Mexico fuel in base rates              | 70,804            | 67,710            | 3,094               | 4.6           |
| <b>Total fuel revenues</b>                 | <b>210,199</b>    | <b>241,620</b>    | <b>(31,421)</b>     | <b>(13.0)</b> |
| Off-system sales                           | 111,396           | 169,982           | (58,586)            | (34.5)        |
| Other                                      | 27,706            | 26,042            | 1,664               | 6.4(2)        |
| <b>Total operating revenues</b>            | <b>\$ 849,476</b> | <b>\$ 908,370</b> | <b>\$ (58,894)</b>  | <b>(6.5)</b>  |
| <b>Average number of retail customers:</b> |                   |                   |                     |               |
| Residential                                | 328,908           | 323,062           | 5,846               | 1.8%          |
| Commercial and industrial, small           | 36,442            | 35,878            | 564                 | 1.6           |
| Commercial and industrial, large           | 48                | 49                | (1)                 | (2.0)         |
| Sales to public authorities                | 4,890             | 4,927             | (37)                | (0.8)         |
| <b>Total</b>                               | <b>370,288</b>    | <b>363,916</b>    | <b>6,372</b>        | <b>1.8</b>    |

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- (1) Excludes \$28.5 million refund in 2010 and a \$37.4 million surcharge in 2009 related to prior periods Texas deferred fuel revenues.
- (2) Represents revenues with no related kWh sales.

**Table of Contents***Energy expenses*

Our sources of energy include electricity generated from our nuclear, natural gas and coal generating plants and purchased power. Palo Verde represents approximately 39% of our available net generating capacity and approximately 54%, 60% and 59% of our Company-generated energy for the three, six and twelve months ended June 30, 2010, respectively. Large fluctuations in the price of natural gas which also is the primary factor influencing the price of purchased power have had a significant impact on our cost of energy.

Our energy expenses decreased \$1.9 million or 3% for the three months ended June 30, 2010 when compared to 2009 primarily due to decreased costs of purchased power of \$8.7 million due to a 25% decrease in the MWhs purchased and an 8% decrease in market prices for power. This decrease was partially offset by (i) increased natural gas costs of \$4.5 million due to a 32% increase in MWhs generated with natural gas, (ii) increased nuclear fuel costs of \$1.9 million due to a 28% increase in the average cost of nuclear fuel, and (iii) increased coal costs of \$0.5 million due to a 30% increase in the average cost of coal. The table below details the sources and costs of energy for the three months ended June 30, 2010 and 2009.

| Fuel Type       | Three Months Ended June 30, |           |                 |                        |           |                 |
|-----------------|-----------------------------|-----------|-----------------|------------------------|-----------|-----------------|
|                 | 2010                        |           |                 | 2009                   |           |                 |
|                 | Cost<br>(in thousands)      | MWh       | Cost per<br>MWh | Cost<br>(in thousands) | MWh       | Cost per<br>MWh |
| Natural gas     | \$ 38,781                   | 766,575   | \$ 50.59        | \$ 34,275              | 581,947   | \$ 58.90        |
| Coal            | 3,335                       | 167,625   | 19.90           | 2,853                  | 186,566   | 15.29           |
| Nuclear         | 8,636                       | 1,091,969 | 7.91            | 6,755                  | 1,093,069 | 6.18            |
| Total           | 50,752                      | 2,026,169 | 25.05           | 43,883                 | 1,861,582 | 23.57           |
| Purchased power | 19,552                      | 545,720   | 35.83           | 28,295                 | 729,839   | 38.77           |
| Total energy    | \$ 70,304                   | 2,571,889 | 27.34           | \$ 72,178              | 2,591,421 | 27.85           |

Our energy expenses increased \$4.4 million or 3% for the six months ended June 30, 2010 when compared to 2009 primarily due to (i) increased natural gas costs of \$11.7 million due to a 30% increase in MWhs generated with natural gas, and (ii) increased nuclear fuel costs of \$3.1 million due to a 25% increase in the average cost of nuclear fuel. These increases were partially offset by (i) decreased purchased power costs of \$9.3 million due to a 20% decrease in the MWhs purchased, and (ii) decreased coal costs of \$1.1 million due to a 25% decrease in MWhs generated with coal. The table below details the sources and costs of energy for the six months ended June 30, 2010 and 2009.

| Fuel Type       | Six Months Ended June 30, |           |                 |                        |           |                 |
|-----------------|---------------------------|-----------|-----------------|------------------------|-----------|-----------------|
|                 | 2010                      |           |                 | 2009                   |           |                 |
|                 | Cost<br>(in thousands)    | MWh       | Cost per<br>MWh | Cost<br>(in thousands) | MWh       | Cost per<br>MWh |
| Natural gas     | \$ 76,698                 | 1,319,377 | \$ 58.13        | \$ 64,991              | 1,013,471 | \$ 64.13        |
| Coal            | 5,769                     | 288,034   | 20.03           | 6,879                  | 385,956   | 17.82           |
| Nuclear         | 17,378                    | 2,372,281 | 7.33            | 14,306                 | 2,446,153 | 5.85            |
| Total           | 99,845                    | 3,979,692 | 25.09           | 86,176                 | 3,845,580 | 22.41           |
| Purchased power | 48,399                    | 1,155,743 | 41.88           | 57,693                 | 1,442,013 | 40.01           |
| Total energy    | \$ 148,244                | 5,135,435 | 28.87           | \$ 143,869             | 5,287,593 | 27.21           |

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Our energy expenses decreased \$81.0 million or 21% for the twelve months ended June 30, 2010 when compared to 2009 primarily due to (i) decreased purchased power costs of \$52.3 million due to a 19% decrease in the MWhs purchased and in the average cost of purchased power, respectively, (ii) decreased natural gas costs of \$30.4 million due to a 25% decrease in the average price of natural gas partially offset by a 12% increase in MWhs generated with natural gas, and (iii) decreased coal costs of \$2.7 million due to a 21% decrease in MWhs generated with coal. These decreases were partially offset by increased nuclear fuel costs of \$4.3 million primarily due to a 16% increase in the average cost of nuclear fuel. The table below details the sources and costs of energy for the twelve months ended June 30, 2010 and 2009.

| Fuel Type       | Twelve Months Ended June 30, |            |                 |                        |            |                 |
|-----------------|------------------------------|------------|-----------------|------------------------|------------|-----------------|
|                 | 2010                         |            |                 | 2009                   |            |                 |
|                 | Cost<br>(in thousands)       | MWh        | Cost per<br>MWh | Cost<br>(in thousands) | MWh        | Cost per<br>MWh |
| Natural gas     | \$ 155,650                   | 2,691,538  | \$ 57.83        | \$ 186,036             | 2,402,877  | \$ 77.42        |
| Coal            | 11,728                       | 646,936    | 18.13           | 14,393                 | 822,395    | 17.50           |
| Nuclear         | 32,128                       | 4,774,928  | 6.73            | 27,828                 | 4,803,706  | 5.79            |
| Total           | 199,506                      | 8,113,402  | 24.59           | 228,257                | 8,028,978  | 28.43           |
| Purchased power | 99,309                       | 2,459,230  | 40.38           | 151,600                | 3,023,783  | 50.14           |
| Total energy    | \$ 298,815                   | 10,572,632 | 28.26           | \$ 379,857             | 11,052,761 | 34.37           |

*Other operations expense*

Other operations expense increased \$0.9 million, or 1.8%, for the three months ended June 30, 2010 compared to the same period last year primarily due to (i) an increase of \$1.2 million in pension and benefits expenses reflecting a change in actuarial assumptions for our pension plan and increased costs associated with our medical and dental plans; and (ii) increased administrative and general salaries of \$0.7 million. These increases were partially offset by decreased Palo Verde operations expense of \$1.2 million.

Other operations expense increased \$1.7 million, or 1.7%, for the six months ended June 30, 2010 compared to the same period last year primarily due to (i) increased miscellaneous general expense of \$1.4 million, (ii) increased pension and benefits expenses of \$1.3 million reflecting a change in actuarial assumptions for our pension plan, and (iii) increased administrative and general salaries of \$0.5 million. These increases were partially offset by decreased outside services expense of \$1.6 million.

Other operations expense increased \$13.9 million, or 6.8%, for the twelve months ended June 30, 2010 compared to the same period last year primarily due to (i) increased administrative and general expense of \$6.8 million due primarily to increased pension and benefits expenses of \$4.0 million reflecting a change in actuarial assumptions for our pension plan and increased accruals for employee incentive compensation, and (ii) increased Palo Verde operations expense of \$3.9 million primarily due to an increase in employee pension and benefit costs.



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### *Maintenance expense*

Maintenance expense decreased \$0.7 million, or 4.1%, for the three months ended June 30, 2010 compared to the same period last year primarily due to (i) decreased maintenance expense at our fossil-fueled generating plants of \$1.3 million as a result of the timing of planned maintenance, and (ii) decreased Palo Verde maintenance expense of \$0.4 million due to decreased maintenance expenses associated with the spring refueling outages in 2010 compared to the spring refueling in 2009. These decreases were partially offset by increased general plant maintenance expense of \$1.0 million primarily due to the reversal of a reserve for environmental remediation costs in 2009 with no comparable amount in 2010.

Maintenance expense increased \$0.5 million, or 1.5%, for the six months ended June 30, 2010 compared to the same period last year primarily due to the reversal of a reserve for environmental remediation costs in 2009 with no comparable amount in 2010. The increase in maintenance expense was partially offset by decreased Palo Verde maintenance expenses associated with the spring refueling outage in 2010 compared to the spring refueling outage in 2009.

Maintenance expense increased \$1.3 million, or 2.1%, for the twelve months ended June 30, 2010 compared to the same period last year primarily due to the reversal of a reserve for environmental remediation costs in 2009 with no comparable amount in 2010.

### *Depreciation and amortization expense*

Depreciation and amortization expense increased \$1.5 million, \$3.1 million and \$3.4 million for the three, six and twelve months ended June 30, 2010 compared to the same periods last year primarily due to increases in depreciable plant balances, which include Phase I of Newman Unit 5 in June 2009 and a new customer care and billing system in April 2010.

### *Taxes other than income taxes*

Taxes other than income taxes increased \$0.7 million, or 5.3%, for the three months ended June 30, 2010, compared to the same period last year due to higher revenue-related taxes in Texas resulting from an increase in billed revenues in the current period and higher property taxes.

Taxes other than income taxes decreased \$0.1 million and \$0.9 million, or 0.5% and 1.7%, for the six and twelve months ended June 30, 2010 compared to the same periods last year primarily due to lower revenue-related taxes in Texas resulting from a decrease in billed revenues in current periods, which was partially offset by higher property and payroll taxes.

### *Other income (deductions)*

Other income (deductions) increased \$1.9 million for the three months ended June 30, 2010 compared to the same period last year due to reduced impairments of equity securities in our Palo Verde decommissioning trust funds of \$2.4 million when compared to the same period last year. This increase was partially offset by (i) a \$0.3 million decrease in interest income collected on fuel surcharges in the three months ended June 30, 2009 with no comparable amount in 2010, and (ii) a \$0.3 million gain on disposition of property in 2009 with no comparable amount in 2010.

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Other income (deductions) increased \$4.2 million for the six months ended June 30, 2010 compared to the same period last year due to reduced impairments of equity securities in our Palo Verde decommissioning trust funds of \$4.9 million when compared to the same period last year. This increase was partially offset by a \$1.4 million decrease in interest income collected on fuel surcharges in the six months ended June 30, 2009 with no comparable amount in 2010.

Other income (deductions) increased \$5.5 million for the twelve months ended June 30, 2010 compared to the same period last year due to an \$7.5 million loss for impairments of equity securities in our Palo Verde decommissioning trust funds in 2009 while in 2010 we realized \$2.6 million in gains on the trust equity securities. This increase was partially offset by (i) a \$3.1 million decrease in interest income collected on fuel surcharges in the twelve months ended June 30, 2009 with no comparable amount in 2010, and (ii) a \$1.6 million decrease in miscellaneous income primarily related to an increase in the cash surrender value of life insurance policies in the 2009 period with no comparable amount in 2010.

### *Interest charges (credits)*

Interest charges (credits) remained relatively unchanged for the three months ended June 30, 2010 compared to the same period last year.

Interest charges (credits) decreased \$1.6 million, or 7%, for the six months ended June 30, 2010 compared to the same period last year primarily due to lower interest rates on pollution control bonds. Two series of pollution control bonds were refunded in March 2009 at a fixed 7.25% interest rate which was lower than the variable interest rates applied to these bonds before the refunding.

Interest charges (credits) for the twelve month period ended June 30, 2010 decreased \$4.0 million, or 8.6%, compared to the same period last year primarily due to a \$3.2 million decrease in interest related to two series of pollution control bonds discussed above and an interest payment of \$0.9 million related to a refund of transmission revenues in November 2008.

### *Income tax expense*

Income tax expense increased \$2.9 million, or 33.4% in the three months ended June 30, 2010 compared to the three months ended June 30, 2009, primarily due to an increase in pre-tax income. In March 2010, the Patient Protection and Affordable Care Act ( PPACA ) was signed into law. A major provision of the law is that beginning in 2013 the income tax deductions for the cost of providing certain prescription drug coverage will be reduced by the amount of the Medicare Part D subsidies received. The Company is required to recognize the impacts of the tax law change at the time of enactment and recorded a one-time non-cash charge to income tax expense of approximately \$4.8 million in the first quarter of 2010. Income tax expense increased by \$9.8 million and \$8.0 million, or 70.9% and 22.8%, in the six and twelve month periods of 2010 compared to the same periods last year, respectively, primarily due to the passage of the PPACA and an increase in pre-tax income.

### *New Accounting Standards*

In December 2009, the FASB issued revised guidance related to financial reporting by enterprises involved with variable interest entities. This guidance became effective for reporting periods beginning after November 15, 2009. The guidance requires an enterprise to perform an analysis to

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determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. We have performed the required analysis and have determined that we do not have any purchase power agreements that qualify as a variable interest entity.

Effective April 1, 2009, we adopted FASB guidance which establishes general standards of accounting and disclosure of events that occur after the balance sheet date, but before financial statements are issued. In February 2010, we adopted an amendment to FASB guidance removing the requirement for an SEC filer to disclose a date through which subsequent events have been evaluated. This new guidance changed our disclosures but does not impact our financial statements.

In January 2010, the FASB issued new guidance to improve disclosure requirements related to fair value measurements and disclosures. The new requirements include (i) disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers; and (ii) disclosure in the reconciliation for Level 3 fair value measurements of information about purchases, sales, issuances, and settlements on a gross basis. The new guidance also clarifies existing disclosures and requires (i) an entity to provide fair value measurement disclosures for each class of assets and liabilities and (ii) disclosures about inputs and valuation techniques. The provisions of this new guidance were adopted in the first quarter of 2010 except for the reconciliation for the Level 3 fair value measurements on a gross basis which will be adopted during the first quarter of 2011. During the six months ended June 30, 2010, there were no transfers in or out of Level 1 or Level 2 categories. This guidance requires additional disclosure on fair value measurements, but does not impact our consolidated financial statements.

*Inflation*

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

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**Liquidity and Capital Resources**

We continue to maintain a strong capital structure which allows us the ability to access financing from the capital markets at a reasonable cost. At June 30, 2010, our capital structure, including common stock, long-term debt, and the current portion of long-term debt and financing obligations, consisted of 46.3% common stock equity and 53.7% debt. At June 30, 2010, our liquidity included \$29.4 million in cash and cash equivalents, most of which was invested in United States Treasury securities.

Our principal liquidity requirements in the near-term are expected to consist of capital expenditures to expand and support electric service obligations, expenditures for nuclear fuel inventory, interest payments on our indebtedness, and operating expenses including fuel costs, non-fuel operation and maintenance costs and taxes. In addition, we may repurchase common stock in the future.

Capital requirements and resources have been impacted by the timing of the recovery of fuel costs through fuel recovery mechanisms in Texas and New Mexico and our sales for resale customer. We recover actual fuel costs from customers through fuel adjustment mechanisms in Texas, New Mexico, and from our sales for resale customer. We record deferred fuel revenues for the under-recovery or over-recovery of fuel costs until they can be recovered from or refunded to customers. In Texas, fuel costs are recovered through a fixed fuel factor. Effective July 1, 2010, we can seek to revise our fixed fuel factor based upon our approved formula at least four months after our last revision except in the month of December.

In the six months ended June 30, 2010, we had decreased cash from operations due to \$0.4 million of fuel over-recoveries compared to the \$51.6 million of fuel over-recoveries in 2009. During the first six months of 2010, we refunded \$11.8 million of over-recoveries to Texas customers compared to recovering through a surcharge of \$16.3 million of fuel under-recoveries from Texas customers in the first six months of 2009. In addition, fuel over-recoveries in the first six months of 2009 exceeded fuel over-recoveries in the first six months of 2010 by \$24.5 million. Over-recoveries in New Mexico and from our FERC customer are refunded through fuel adjustment clauses with a two month lag. At June 30, 2010, we had a net fuel over-recovery balance of \$18.4 million, including fuel over-recoveries of \$17.9 million in Texas and \$0.6 million in New Mexico, and a fuel under-recovery of \$0.1 million from our FERC customer. On July 15, 2010, the PUCT approved our request to refund to our Texas customers \$11.1 million of over-recoveries in July and August 2010.

*Capital Requirements.* During the six months ended June 30, 2010, our capital requirements primarily consisted of expenditures for the construction and purchase of electric utility plant, purchases of nuclear fuel, and the repurchase of common stock. Projected utility construction expenditures will consist primarily of expanding and updating our transmission and distribution systems, adding new generation, and making capital improvements and replacements at Palo Verde and other generating facilities. We are constructing Newman Unit 5, a 288 MW gas-fired combined cycle combustion turbine generating unit, which will be completed in two phases at an estimated cost of approximately \$230 million, including AFUDC. The first phase of Newman Unit 5 was completed in May 2009 and the second phase is currently expected to be completed by April 2011. As of June 30, 2010, we had expended \$184.6 million, including AFUDC, on Newman Unit 5, including \$26.1 million in the first six months of 2010. Estimated construction expenditures for 2010 are approximately \$189 million, including \$68 million for Newman Unit 5. See Part I, Item 1, Business Construction Program in our 2009 Form 10-K. Capital expenditures were \$90.6 million in the six months ended June 30, 2010 compared to \$99.8 million in the six months ended June 30, 2009.

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We maintain a \$200 million revolving credit facility to provide liquidity to the Company. Up to \$120 million under the revolving credit facility is available through direct borrowings to a trust that is used to finance our nuclear fuel inventory. Nuclear fuel financing requirements exceeded the trust borrowing capacity in June 2010 and as a result, the Company itself borrowed under the facility to finance nuclear fuel that could not be financed by the trust. Amounts borrowed under the revolving credit facility by both the trust and the Company for nuclear fuel were \$122.8 million as of June 30, 2010, including accrued interest and fees. Amounts borrowed by the trust for nuclear fuel were \$103.5 million as of June 30, 2009, including accrued interest and fees. The revolving credit facility is scheduled to expire in April 2011, and has been classified as a current liability on the June 30, 2010 balance sheet.

We do not pay dividends on common stock. Since 1999, we have repurchased approximately 21.6 million shares of common stock at an aggregate cost of \$313.4 million, including commissions. On February 19, 2010, the Board of Directors authorized a repurchase of up to 2 million additional shares of the Company's outstanding common stock. During the first six months of 2010, we repurchased 502,492 shares of common stock in the open market at an aggregate cost of approximately \$10.0 million under both the previously authorized program and under the current program. As of June 30, 2010, 1,698,490 shares remain available for repurchase under the current program. We may make purchases of our stock in the future pursuant to our stock repurchase program 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 incentive plans, or may be retired.

Our cash requirements for federal and state income taxes vary from year to year based on taxable income, which is influenced by the timing of revenues and expenses recognized for income tax purposes. Due to accelerated tax deductions, tax payments are expected to be minimal in 2010.

We continually evaluate our funding requirements related to our retirement plans, other postretirement benefit plans, and decommissioning trust funds. We contributed \$4.1 million of the projected \$8.4 million 2010 annual contribution to our retirement plans during the six months ended June 30, 2010. In the six months ended June 30, 2010, we contributed \$2.2 million of the projected \$4.6 million 2010 annual contribution to our other postretirement benefit plan, and \$4.1 million of the projected \$8.2 million 2010 annual contribution to our decommissioning trust funds. We are in compliance with the funding requirements of the federal government for our benefit plans and decommissioning trust.

*Capital Resources.* Cash generated from operations decreased \$51.8 million in the six months ended June 30, 2010 compared to the same period in 2009 primarily due to a decrease in the collection of fuel revenues in 2010. We collected \$0.4 million in the six months ended June 30, 2010, compared to \$51.6 million in 2009. Cash from operations will continue to be a primary source of funds for capital expenditures for electric plant.

At June 30, 2010, we had \$77.2 million of unused credit available on our revolving credit facility. The revolving credit facility is scheduled to expire in April 2011. In June 2010, we received approval from the FERC and the NMPRC to refinance our revolving credit facility and to issue in a private placement up to \$110 million of senior notes from the Rio Grande Resource Trust II (the RGRT), guaranteed by the Company, to finance nuclear fuel. We currently expect to complete the notes financing by RGRT during the third quarter and to use the proceeds to repay amounts borrowed

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under the revolving credit facility for nuclear fuel. This would enable the future nuclear fuel financing requirements by RGRT to be met with the senior notes with any additional amounts borrowed from the revolving credit facility. We also anticipate completing the refinancing of the revolving credit facility prior to its maturity in April 2011. We believe that we will have adequate liquidity through our current cash balances, cash from operations, and our current revolving credit facility to meet all of our anticipated cash requirements through 2010 based on current projections.

### **Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to market risk due to changes in interest rates, equity prices and commodity prices. See our 2009 Form 10-K, Item 7A,

Quantitative and Qualitative Disclosures About Market Risk, for a complete discussion of the market risks we face and our market risk sensitive assets and liabilities. As of June 30, 2010, there have been no material changes in the market risks we faced or the fair values of assets and liabilities disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our 2009 Form 10-K.

### **Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our management, including our chief executive officer and our chief financial officer, we conducted an evaluation pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 of our disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934. Based on that evaluation, our chief executive officer and our chief financial officer concluded that, as of June 30, 2010, our disclosure controls and procedures are effective.

*Changes in internal control over financial reporting.* In April 2010, we implemented a new Oracle utility information system which handles our billings and maintains our customer information. We did not make this change in response to a deficiency. Rather, our new system increases efficiency and adds functionality that was not available in the previous customer billing system. Management took the necessary steps to maintain reasonable assurance that internal controls over financial reporting continued to function as designed during the conversion to the new system. In addition, management evaluated our internal controls over financial reporting after conversion to the new system to ensure that internal controls over financial reporting are and continue to operate effectively.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

We hereby incorporate by reference the information set forth in Part I of this report under Notes B and F of Notes to Consolidated Financial Statements.

**Item 1A. Risk Factors**

Our 2009 Form 10-K includes a detailed discussion of our risk factors.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****(c) Issuer Purchases of Equity Securities.**

| <b>Period</b>             | <b>Total<br/>Number<br/>of Shares<br/>Purchased</b> | <b>Average Price<br/>Paid per Share<br/>(Including<br/>Commissions)</b> | <b>Total<br/>Number of<br/>Shares<br/>Purchased as<br/>Part of a<br/>Publicly<br/>Announced<br/>Program</b> | <b>Maximum<br/>Number of<br/>Shares that May<br/>Yet Be Purchased<br/>Under the Plans<br/>or Programs<br/>(a)</b> |
|---------------------------|---|---|---|---|
| April 1 to April 30, 2010 | 0   | \$ 0  | 0   | 1,996,336   |
| May 1 to May 31, 2010     | 263,046   | 19.83   | 263,046   | 1,733,290   |
| June 1 to June 30, 2010   | 34,800  | 19.66   | 34,800  | 1,698,490   |

(a) On February 19, 2010, the Company's Board of Directors authorized a stock repurchase program permitting the repurchase of up to 2.0 million additional shares of its outstanding common stock.

**Item 6. Exhibits**

See Index to Exhibits incorporated herein by reference.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**EL PASO ELECTRIC COMPANY**

By: /s/ DAVID G. CARPENTER  
David G. Carpenter  
Senior Vice President-Chief Financial Officer  
(Duly Authorized Officer and Principal Financial  
Officer)

Dated: August 6, 2010



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**EL PASO ELECTRIC COMPANY**

**INDEX TO EXHIBITS**

| <b>Exhibit Number</b> | <b>Exhibit</b>  |
|-----------------------|---|
| 10.02                 | Form of Directors Restricted Stock Award Agreement between the Company and certain directors of the Company. (Identical in all material respects to Exhibit 10.07 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999) |
| 15                    | Letter re Unaudited Interim Financial Information   |
| 31.01                 | Certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.01                 | Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101.INS               | XBRL Instance Document  |
| 101.SCH               | XBRL Taxonomy Extension Schema Document   |
| 101.CAL               | XBRL Taxonomy Extension Calculation Linkbase Document   |
| 101.DEF               | XBRL Taxonomy Extension Definition Linkbase Document  |
| 101.LAB               | XBRL Taxonomy Extension Label Linkbase Document   |
| 101.PRE               | XBRL Taxonomy Extension Presentation Linkbase Document  |

In lieu of non-employee director cash compensation, three agreements, dated as of July 1, 2010, substantially identical in all material respects to this Exhibit, have been entered into with Catherine A. Allen; Kenneth R. Heitz; and Patricia Z. Holland-Branch; directors of the Company.

In lieu of non-employee director cash compensation, eleven agreements, dated as of May 26, 2010, substantially identical in all material respects to this Exhibit, were entered into with Catherine A. Allen; J. Robert Brown; James W. Cicconi; James W. Harris; Kenneth R. Heitz; Patricia Z. Holland-Branch; Michael K. Parks; Thomas V. Shockley, III; Eric B. Siegel; Stephen N. Wertheimer; and Charles A. Yamarone; directors of the Company.