

EL PASO ELECTRIC CO /TX/  
Form 10-Q  
May 06, 2011  
Table of Contents

**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 March 31, 2011

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 April 29, 2011, there were 42,107,716 shares of the Company's no par value common stock outstanding.

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**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**INDEX TO FORM 10-Q**

	<b>Page No.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets March 31, 2011 and December 31, 2010</u>	1
<u>Consolidated Statements of Operations Three Months and Twelve Months Ended March 31, 2011 and 2010</u>	3
<u>Consolidated Statements of Comprehensive Operations Three Months and Twelve Months Ended March 31, 2011 and 2010</u>	4
<u>Consolidated Statements of Cash Flows Three Months Ended March 31, 2011 and 2010</u>	5
<u>Notes to Consolidated Financial Statements</u>	6
<u>Report of Independent Registered Public Accounting Firm</u>	28
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	29
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	44
Item 4. <u>Controls and Procedures</u>	44
<b><u>PART II. OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	45
Item 1A. <u>Risk Factors</u>	45
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	45
Item 6. <u>Exhibits</u>	45

(i)

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

	<b>March 31, 2011 (Unaudited)</b>	<b>December 31, 2010</b>
<b>ASSETS</b>		
<b>(In thousands)</b>		
<b>Utility plant:</b>		
Electric plant in service	\$ 2,547,135	\$ 2,522,862
Less accumulated depreciation and amortization	(1,068,322)	(1,047,498)
Net plant in service	1,478,813	1,475,364
Construction work in progress	311,118	285,086
Nuclear fuel; includes fuel in process of \$42,858 and \$47,746, respectively	165,444	150,774
Less accumulated amortization	(54,324)	(45,471)
Net nuclear fuel	111,120	105,303
Net utility plant	1,901,051	1,865,753
<b>Current assets:</b>		
Cash and cash equivalents	26,905	79,184
Accounts receivable, principally trade, net of allowance for doubtful accounts of \$2,251 and \$2,885, respectively	69,809	71,685
Accumulated deferred income taxes	19,955	25,818
Inventories, at cost	38,020	36,132
Income taxes receivable	16,767	12,656
Prepayments and other	6,682	4,543
Total current assets	178,138	230,018
<b>Deferred charges and other assets:</b>		
Decommissioning trust funds	159,286	153,878
Regulatory assets	85,828	88,557
Other	28,146	26,560
Total deferred charges and other assets	273,260	268,995
<b>Total assets</b>	<b>\$ 2,352,449</b>	<b>\$ 2,364,766</b>

See accompanying notes to consolidated financial statements.



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

	March 31, 2011 (Unaudited)	December 31, 2010
<b>CAPITALIZATION AND LIABILITIES</b>		
(In thousands except for share data)		
<b>Capitalization:</b>		
Common stock, stated value \$1 per share, 100,000,000 shares authorized, 65,189,444 and 65,121,689 shares issued, and 214,926 and 143,371 restricted shares, respectively	\$ 65,404	\$ 65,265
Capital in excess of stated value	306,015	305,068
Retained earnings	817,633	810,858
Accumulated other comprehensive loss, net of tax	(31,501)	(33,177)
	1,157,551	1,148,014
Treasury stock, 23,297,375 and 22,693,995 shares, respectively, at cost	(354,813)	(337,639)
Common stock equity	802,738	810,375
Long-term debt, net of current portion	849,758	849,745
Total capitalization	1,652,496	1,660,120
<b>Current liabilities:</b>		
Current portion of long-term debt and financing obligations	12,951	4,704
Accounts payable, principally trade	35,913	41,795
Taxes accrued	25,020	29,172
Interest accrued	13,174	12,099
Overcollection of fuel revenues	17,783	18,976
Other	24,254	24,207
Total current liabilities	129,095	130,953
<b>Deferred credits and other liabilities:</b>		
Accumulated deferred income taxes	293,758	286,730
Asset retirement obligation	95,003	92,911
Accrued pension liability	82,707	93,471
Accrued postretirement benefit liability	60,999	61,594
Regulatory liabilities	13,885	14,489
Other	24,506	24,498
Total deferred credits and other liabilities	570,858	573,693
<b>Commitments and contingencies</b>		
<b>Total capitalization and liabilities</b>	<b>\$ 2,352,449</b>	<b>\$ 2,364,766</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 March 31,		Twelve Months Ended March 31,	
	2011	2010	2011	2010
<b>Operating revenues</b>	\$ 176,112	\$ 204,168	\$ 849,195	\$ 841,728
<b>Energy expenses:</b>				
Fuel	42,759	49,093	193,495	192,637
Purchased and interchanged power	18,474	28,847	81,543	108,052
	61,233	77,940	275,038	300,689
<b>Operating revenues net of energy expenses</b>	114,879	126,228	574,157	541,039
<b>Other operating expenses:</b>				
Other operations	54,107	50,098	228,230	216,635
Maintenance	12,236	14,500	54,559	60,735
Depreciation and amortization	20,936	19,284	82,663	76,551
Taxes other than income taxes	13,127	11,743	55,873	49,224
	100,406	95,625	421,325	403,145
<b>Operating income</b>	14,473	30,603	152,832	137,894
<b>Other income (deductions):</b>				
Allowance for equity funds used during construction	3,051	2,540	11,327	9,262
Investment and interest income, net	2,385	1,098	6,602	5,397
Miscellaneous non-operating income	270	2	1,636	897
Miscellaneous non-operating deductions	(715)	(359)	(3,562)	(2,527)
	4,991	3,281	16,003	13,029
<b>Interest charges (credits):</b>				
Interest on long-term debt and financing obligations	13,498	12,201	52,123	48,789
Other interest	297	40	511	266
Capitalized interest	(1,256)	(228)	(3,515)	(921)
Allowance for borrowed funds used during construction	(1,849)	(1,567)	(6,953)	(5,914)
	10,690	10,446	42,166	42,220
<b>Income before income taxes and extraordinary item</b>	8,774	23,438	126,669	108,703
<b>Income tax expense</b>	1,999	11,989	41,026	39,930
<b>Income before extraordinary item</b>	6,775	11,449	85,643	68,773
	0	0	10,286	0



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**Extraordinary gain related to Texas regulatory assets, net of tax**

<b>Net income</b>	\$	6,775	\$	11,449	\$	95,929	\$	68,773
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**Basic earnings per share:**

Income before extraordinary item	\$	0.16	\$	0.26	\$	1.99	\$	1.55
Extraordinary gain related to Texas regulatory assets, net of tax		0.00		0.00		0.24		0.00

Net income	\$	0.16	\$	0.26	\$	2.23	\$	1.55
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**Diluted earnings per share:**

Income before extraordinary item	\$	0.16	\$	0.26	\$	1.98	\$	1.54
Extraordinary gain related to Texas regulatory assets, net of tax		0.00		0.00		0.24		0.00

Net income	\$	0.16	\$	0.26	\$	2.22	\$	1.54
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<b>Weighted average number of shares outstanding</b>		42,308,097		43,738,947		42,776,922		44,273,168
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<b>Weighted average number of shares and dilutive potential shares outstanding</b>		42,523,285		43,863,802		42,964,190		44,366,933
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See accompanying notes to consolidated financial statements.

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

	<b>Three Months Ended March 31,</b>		<b>Twelve Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
<b>Net income</b>	\$ 6,775	\$ 11,449	\$ 95,929	\$ 68,773
<b>Other comprehensive income (loss):</b>				
Unrecognized pension and postretirement benefit costs:				
Net loss arising during period	0	0	(9,874)	(48,580)
Prior service benefit	0	0	26,605	0
Reclassification adjustments included in net income for amortization of:				
Prior service benefit	(1,455)	(700)	(3,509)	(2,754)
Net loss	1,475	900	3,949	2,125
Net unrealized losses on marketable securities:				
Net holding gains arising during period	2,173	2,423	6,415	20,630
Reclassification adjustments for net (gains) losses included in net income	(205)	31	(114)	(224)
Net losses on cash flow hedges:				
Reclassification adjustment for interest expense included in net income	88	83	343	323
<b>Total other comprehensive income (loss) before income taxes</b>	<b>2,076</b>	<b>2,737</b>	<b>23,815</b>	<b>(28,480)</b>
<b>Income tax benefit (expense) related to items of other comprehensive income (loss):</b>				
Unrecognized pension and postretirement benefit costs	(7)	(73)	(6,221)	16,775
Net unrealized losses on marketable securities	(360)	(491)	(1,226)	(4,082)
Losses on cash flow hedges	(33)	(30)	(126)	(117)
<b>Total income tax benefit (expense)</b>	<b>(400)</b>	<b>(594)</b>	<b>(7,573)</b>	<b>12,576</b>
<b>Other comprehensive income (loss), net of tax</b>	<b>1,676</b>	<b>2,143</b>	<b>16,242</b>	<b>(15,904)</b>
<b>Comprehensive income</b>	<b>\$ 8,451</b>	<b>\$ 13,592</b>	<b>\$ 112,171</b>	<b>\$ 52,869</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>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 6,775	\$ 11,449
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of electric plant in service	20,936	19,284
Amortization of nuclear fuel	9,243	6,985
Allowance for equity funds used during construction	(3,051)	(2,540)
Deferred income taxes, net	12,291	11,059
Other amortization and accretion	7,405	4,041
Other operating activities	(132)	(308)
Change in:		
Accounts receivable	1,876	(3,678)
Inventories	(1,888)	953
Net overcollection (undercollection) of fuel revenues	(1,193)	(6,000)
Prepayments and other	(2,303)	411
Accounts payable	(6,569)	(15,360)
Taxes accrued	(8,263)	(2,737)
Interest accrued	1,075	2,325
Other current liabilities	47	925
Deferred charges and credits	(13,891)	(1,274)
<b>Net cash provided by operating activities</b>	<b>22,358</b>	<b>25,535</b>
<b>Cash flows from investing activities:</b>		
Cash additions to utility property, plant and equipment	(45,388)	(47,145)
Cash additions to nuclear fuel	(14,228)	(15,739)
Capitalized interest and AFUDC:		
Utility property, plant and equipment	(4,900)	(4,107)
Nuclear fuel	(1,256)	(228)
Allowance for equity funds used during construction	3,051	2,540
Decommissioning trust funds:		
Purchases, including funding of \$2.1 and \$2.1 million, respectively	(17,466)	(22,354)
Sales and maturities	14,231	19,504
Other investing activities	47	(378)
<b>Net cash used for investing activities</b>	<b>(65,909)</b>	<b>(67,907)</b>
<b>Cash flows from financing activities:</b>		
Repurchases of common stock	(16,675)	(4,089)
Financing obligations:		
Proceeds	16,778	15,972
Payments	(8,531)	(4,858)
Other financing activities	(300)	(78)

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<b>Net cash provided by (used for) financing activities</b>	(8,728)	6,947
<b>Net decrease in cash and cash equivalents</b>	(52,279)	(35,425)
<b>Cash and cash equivalents at beginning of period</b>	79,184	91,790
<b>Cash and cash equivalents at end of period</b>	\$ 26,905	\$ 56,365

See accompanying notes to consolidated financial statements.

**Table of Contents**

**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, 2010 (the 2010 Form 10-K). Capitalized terms used in this report and not defined herein have the meaning ascribed for such terms in the 2010 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 March 31, 2011 and December 31, 2010; the results of its operations and comprehensive operations for the three and twelve months ended March 31, 2011 and 2010; and its cash flows for the three months ended March 31, 2011 and 2010. The results of operations and comprehensive operations and the cash flows for the three months ended March 31, 2011 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.* Revenues related to the sale of electricity are generally recorded when service is rendered or electricity is delivered to customers. The billing of electricity sales to retail customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. Unbilled revenues are estimated based on monthly generation volumes and by applying an average revenue/kWh to the number of estimated kWhs delivered but not billed. Accounts receivable include accrued unbilled revenues of \$12.7 million and \$16.6 million at March 31, 2011 and December 31, 2010, respectively. The Company presents revenues net of sales taxes in its consolidated statements of operations.

*Extraordinary Item.* As a regulated electric utility, the Company prepares its financial statements in accordance with the FASB guidance for regulated operations. FASB guidance for regulated operations requires the Company to show certain items as assets or liabilities on its balance sheet when the regulator provides assurance that these items will be charged to and collected from its customers or refunded to its customers. In the final order for PUCT Docket No. 37690, the Company was allowed to include the previously expensed loss on reacquired debt associated with the refinancing of first mortgage bonds in 2005 in its calculation of the weighted cost of debt to be recovered from its customers. The Company recorded the impacts of the re-application of FASB guidance for regulated operations to its Texas jurisdiction in 2006 as an extraordinary item. In order to establish this regulatory asset, the Company recorded an extraordinary gain of \$10.3 million, net of income tax expense of

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

\$5.8 million, in its statements of operations for the quarter ended September 30, 2010. This item was recorded as a regulatory asset at September 30, 2010 pursuant to the final order received from the PUCT and will be amortized over the remaining life of the Company's 6% Senior Notes due in 2035.

*New accounting standards.* 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 was adopted during the first quarter of 2011. During the three and twelve months ended March 31, 2011, the Company had no purchases, sales, issuances or settlements in the Level 3 category. This guidance requires additional disclosure on fair value measurements but does not impact the Company's consolidated financial statements.

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

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Cash paid for:		
Interest on long-term debt and financing obligations	\$ 9,763	\$ 9,610
Income taxes paid (refund)	(5,586)	1,133
Non-cash financing activities:		
Grants of restricted shares of common stock	1,989	779
Issuance of performance shares	565	662
Acquisition of treasury stock for options exercised	500	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

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**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

transactions and compliance with federally-mandated reliability standards. The decisions of the PUCT, NMPRC and the FERC are subject to judicial review.

**Texas Regulatory Matters**

*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 called for an annual non-fuel base rate increase of \$17.15 million effective for usage beginning July 1, 2010. This increase was partially offset by the provision that, consistent with a prior rate agreement, effective July 1, 2010, the Company shares 90% of off-system sales margins with customers and retains 10% of such margins. Previously, the Company retained 75% of off-system sales margins. Interim rates went into 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. 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 Four Corners coal mine reclamation costs. The fuel reconciliation (Docket No. 38361, discussed below) was bifurcated from the rate case to allow for litigation of the final coal mine 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 Reconciliation Case (Severed from 2009 Rate Case).* Pursuant to the stipulation in Docket No. 37690, a fuel reconciliation component of the rate case was severed and a separate docket, PUCT Docket No. 38361, was established to address one fuel reconciliation issue not settled by the parties. That single issue was a determination of the proper amount of the Four Corners coal mine final reclamation costs to be recovered from the Company's Texas retail customers. The hearing on the merits of the case was held on August 11, 2010. On November 23, 2010 the Administrative Law Judge (the ALJ) issued the Proposal for Decision which approved the Company's request. The PUCT issued a final order approving the Proposal for Decision on January 27, 2011.

*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 fuel cost recovery rule ( Texas Fuel Rule ) that allows the Company to seek periodic adjustments to its fixed fuel factor. The Company received approval on July 30, 2010 in PUCT Docket No. 37690 (discussed above), to implement a formula to determine its fuel factor. The Company can seek to revise its fixed fuel factor

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

based upon the approved formula at least four months after its last revision except in the month of December. The Texas Fuel 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 fuel costs 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 fuel cost recovery 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 December 17, 2009, the Company filed a petition with the PUCT in 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 ALJ 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 was \$11.1 million. On June 16, 2010, the ALJ 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.

On October 20, 2010, the Company filed a petition with the PUCT which was assigned Docket No. 38802 to refund \$12.8 million in fuel cost over-recoveries, including interest, for the period April 2010 through September 2010. In its filing, the Company requested the refund be made to customers in the single billing month of December 2010. On November 22, 2010, a stipulation was filed that resolved all issues in this case and requested that an order be issued that would allow the interim refund in December 2010 consistent with the Company's filing. The ALJ issued an order approving the implementation of interim rates to allow the requested refund to be made in December. On December 16, 2010, the PUCT issued a final order approving the stipulation.

On November 23, 2010, the Company filed a petition with the PUCT which was assigned Docket No. 38895 to revise its fixed fuel factor pursuant to the fuel factor formula authorized in PUCT Docket No. 37690 for determining the Company's fuel factor. The Company's request was to decrease its fixed fuel factor by 14.7%. On December 2, 2010, the State Office of Administrative Hearings (SOAH) ALJ issued Order No. 1, establishing interim rates as requested, as well as a deadline of



**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

December 3, 2010, for the purpose of requesting a hearing, and absent such a request, implementation of the revised fuel factor would become final by its own terms and without further PUCT order. No request was received; therefore, the revised fuel factor became final. On January 6, 2011, the SOAH ALJ dismissed the proceeding from the SOAH docket, the case was dismissed from the PUCT's docket on that same date, and the case was closed.

On February 18, 2011, the Company filed a petition with the PUCT which was assigned Docket No. 39159 to refund \$11.8 million in fuel cost over-recoveries, including interest, for the period October 2010 through December 2010. In its filing, the Company requested the refund be made to customers in the single billing month of April 2011. On March 25, 2011, the ALJ approved the implementation of the interim fuel refund in April 2011. The PUCT approved the fuel refund on April 29, 2011.

*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 ( EECRF ), which was assigned PUCT Docket No. 38226. The Company requested that its revised EECRF become effective beginning with the first billing cycle of its January 2011 billing month. In its application, the Company requested authority to increase its 2011 EECRF to a total of \$6.6 million 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 PUCT's final order in Docket No. 35612. A final order approving the Company's application was issued on October 4, 2010.

*Application for a Certificate of Convenience and Necessity ( CCN ) for Rio Grande Unit 9.* On September 30, 2010, the Company filed a petition seeking a CCN to construct an 87 MW natural gas-fired combustion turbine unit at the Company's existing Rio Grande Generating Station in the City of Sunland Park in southeast New Mexico. This case was assigned PUCT Docket No. 38717. A unanimous settlement to approve the CCN was filed on March 2, 2011 and a final order granting the CCN was approved on April 8, 2011.

*Project to Investigate Early February 2011 Outages and Curtailments.* On February 8, 2011, the PUCT opened Project No. 39134, *Investigation into Power Outages in El Paso Electric's Service Territory*. In this project, the PUCT is investigating the Company's power plant outages and customer curtailments that occurred February 2-4, 2011, as a result of the extreme cold weather in the El Paso area. There was no accompanying PUCT order for the opening of this project. The PUCT Staff has conducted discovery in the investigation. On February 14, 2011, the Company also filed a report on this weather event.

On February 15, 2011, the City Council of El Paso adopted a motion that when the results of hearings and investigations concerning the extreme cold weather event are concluded, the Mayor will call for Special City Council meetings or public hearings, on utility issue topics, at a time accessible to the public, inviting the public and the utility representatives to review the findings.

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**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 a revision of depreciation rates for other plant in 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 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, and the stipulated rates went into effect with January 2010 bills.

*2010 Energy Efficiency Program Approval.* On January 19, 2010, the Company filed its Application for Approval of its 2010 Energy Efficiency Programs pursuant to the New Mexico Efficient Use of Energy Act. The filing included changes and additions to the Company's previously approved programs and sought revisions to the associated rate rider through which program costs are recovered. The parties to the proceeding entered into an uncontested stipulation to implement program changes and expansions as well as the rate rider to recover related costs. The NMPRC approved the stipulation in its final order issued August 12, 2010.

*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 the Company's RPS requirements, including three purchased power agreements for solar energy. In addition, the Company requested a variance from the solar diversity requirements in 2011 to be made up in later years from the new purchased power agreements for solar energy. Hearings were held on October 21, 2010. A final order was issued on December 16, 2010 that approved the Company's 2010 Renewable Procurement plan, including granting the requested variance from the solar diversity requirements in 2011. However, the NMPRC maintained the 2010 rates and contract terms for energy produced by customer-owned renewable distributed generation facilities.

*Application for Approval to Recover Regulatory Disincentives and Incentives.* On August 31, 2010, the Company filed an application for approval of its proposed rate design methodology to recover regulatory disincentives and incentives associated with the Company's energy efficiency and load management programs in New Mexico. On March 18, 2011, the Company entered into an uncontested stipulation which would provide for a rate per kWh of energy efficiency savings that would be

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

recovered through the efficient use of energy rider. A hearing on the uncontested stipulation was held on April 26, 2011 and a final order is expected before July 2011.

*Application for a CCN for Rio Grande Unit 9.* On September 30, 2010, the Company filed a petition seeking a CCN to construct an 87 MW natural gas-fired combustion turbine unit at the Company's existing Rio Grande Generating Station in the City of Sunland Park in southeast New Mexico. This case was assigned NMPRC Case No. 10-00301-UT. On March 4, 2011, NMPRC Staff filed testimony in support of the Company's application and no party filed testimony or a position statement opposing the application. On April 13, 2011 an unopposed stipulation was filed in this case seeking approval of a CCN for the Company to construct, own and operate the 87 MW generating unit. A public hearing on this matter is scheduled for May 18, 2011 before the NMPRC.

**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

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

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 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 Court of Appeals) and on August 18, 2010, TEP filed a motion to intervene in the proceeding. On January 14, 2011, the Company and TEP filed a joint consent motion, asking the Court to hold the proceedings in abeyance while the parties engaged in settlement discussions. The Court granted the motion on January 19, 2011.

On April 26, 2011, TEP and the Company entered into a proposed settlement (subject to FERC approval) to resolve this dispute. The proposed settlement would reduce TEP's transmission rights under the Transmission Agreement from 200 MW to 170 MW and would require TEP to pay the Company a lump sum of \$5 million, equivalent to the amount TEP would have paid the Company for 30 MW of transmission from February 1, 2006 through the settlement date, plus interest. Additionally, TEP and the Company will enter into two new firm transmission capacity agreements at applicable tariff rates for a total of 40 MW. The settlement agreement will be filed with the FERC and will become effective after (i) the FERC issues a final non-appealable order approving the settlement, and (ii) the FERC issues a final non-appealable order approving a settlement between the Company and Macho Springs Power I, LLC regarding the reimbursement of certain network upgrade costs associated with the interconnection of a wind generating facility to the Company's transmission system. The Company will withdraw its appeal before the Court of Appeals when the settlement agreement becomes effective.

Under the terms of the proposed settlement, the Company would record approximately \$4.3 million in transmission revenues for the period February 1, 2006 through March 31, 2011, and \$0.7 million in interest income. The Company would share with its customers 25% of the transmission revenues earned before July 1, 2010, or approximately \$0.7 million, through a credit to Texas fuel recoveries. The Company estimates that the proposed settlement will add approximately \$0.6 million to its transmission revenues for the remaining nine months of 2011. If the settlement agreement does not become effective and if the Company is unsuccessful in its petition for review at the Court of Appeals, the Company will lose the opportunity to receive compensation from TEP for the disputed transmission service.

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. If the settlement agreement described in the preceding paragraph becomes effective, TEP has agreed to withdraw this complaint.

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Inquiry into Early February 2011 Outages and Curtailments.* On February 14, 2011, FERC directed its staff to initiate an inquiry into power plant outages and customer curtailments by power generators and gas suppliers in the Southwestern United States, including the Company, in early February 2011, as a result of the extreme cold weather. The inquiry has been assigned Docket No. AD11-9-000. FERC specifically stated that its inquiry is not an enforcement investigation. The agency encouraged its staff to identify the causes of the outages and to determine appropriate responses to prevent such outages in the future. There has been no staff report posted in the docket, and FERC has not taken any additional action on the matter.

**C. Palo Verde**

*License Extension.* On April 21, 2011, the Company, along with the other Palo Verde Participants, was notified that the NRC had renewed the operating licenses for all three units at Palo Verde. The renewed licenses for the nuclear power plants will now expire on June 1, 2045 for Unit 1, April 24, 2046 for Unit 2, and November 25, 2047 for Unit 3.

*Oversight of the Nuclear Energy Industry in the Wake of the Earthquake and Tsunami in Japan.* On March 11, 2011, a 9.0 magnitude earthquake occurred off the north-eastern coast of Japan. The earthquake produced a tsunami that caused significant damage to the Fukushima Daiichi Nuclear Power Station in Japan. Preliminary data available from the Fukushima Daiichi plant operator and Japanese government have each indicated that the earthquake and tsunami were beyond the plant's required licensing and design parameters. Validation of that data will continue as more information becomes available.

The Nuclear Energy Institute ( NEI ) and the Institute of Nuclear Power Operations ( INPO ) are working closely to analyze the situation in Japan and develop action plans for U.S. nuclear power plants. APS, which operates Palo Verde, is actively engaged with NEI and INPO in these efforts. Additionally, the NRC is performing its own independent review of the events at Fukushima Daiichi. On March 23, 2011, the NRC Commissioners voted to launch a two-pronged review of U.S. nuclear power plant safety. The NRC announced that it supports the establishment of an agency task force that will conduct both a short- and long-term analysis of the lessons that can be learned from the situation in Japan. The NRC expects the task force to begin its long-term evaluations within 90 days and anticipates that a report with any recommended actions will be available within six months after the evaluations begin.

**D. Common Stock**

*Repurchase Program.* Since the inception of the stock repurchase program in 1999, the Company has repurchased approximately 23.2 million shares of common stock at an aggregate cost of \$353.8 million, including commissions. During the first quarter of 2011, the Company repurchased 586,911 shares of common stock in the open market at an aggregate cost of \$16.7 million under the Company's 2010 Plan. On March 21, 2011, the Board of Directors authorized an additional repurchase

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

of up to 2.5 million shares of the Company's outstanding common stock (the 2011 Plan). As of March 31, 2011, 2,589,360 shares remain available for repurchase under the Company's authorized programs. The Company may in the future make purchases of its common stock pursuant to its authorized programs in open market transactions at prevailing 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.

*Dividend Policy.* On April 28, 2011 the Board of Directors declared a quarterly cash dividend of \$0.22 per share payable on June 30, 2011 to shareholders of record on June 15, 2011. This is the first quarterly cash dividend declared by the Company since 1991.

*Basic and Diluted Earnings Per Share.* The basic and diluted earnings per share are presented below:

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2011	2010	2011	2010
<b>Weighted average number of common shares outstanding:</b>				
Basic number of common shares outstanding	42,308,097	43,738,947	42,776,922	44,273,168
Dilutive effect of unvested performance awards	169,426	72,343	126,051	45,961
Dilutive effect of stock options	45,762	52,512	61,217	47,804
Diluted number of common shares outstanding	42,523,285	43,863,802	42,964,190	44,366,933
<b>Basic net income per common share:</b>				
Net income	\$ 6,775	\$ 11,449	\$ 95,929	\$ 68,773
Income allocated to participating restricted stock	(28)	(44)	(391)	(255)
Net income available to common shareholders	\$ 6,747	\$ 11,405	\$ 95,538	\$ 68,518
<b>Diluted net income per common share:</b>				
Net income	\$ 6,775	\$ 11,449	\$ 95,929	\$ 68,773
Income reallocated to participating restricted stock	(28)	(44)	(390)	(255)
Net income available to common shareholders	\$ 6,747	\$ 11,405	\$ 95,539	\$ 68,518
Basic net income per common share	\$ 0.16	\$ 0.26	\$ 2.23	\$ 1.55
Diluted net income per common share	\$ 0.16	\$ 0.26	\$ 2.22	\$ 1.54

The calculation of the diluted number of common shares outstanding for the three months ended March 31, 2011 and 2010, excludes 94,076 and 79,990 shares, respectively, of restricted stock awards because their effect was antidilutive. The calculation of the diluted number of common shares outstanding for the twelve months ended March 31, 2011 and 2010, excludes 78,792 and 66,534 shares, respectively, of restricted stock awards because their effect was antidilutive.

No performance shares were excluded from the computation of diluted earnings per share for the three months ended March 31, 2011 and 2010. Performance shares of 24,225 and 87,382 were excluded from the computation of diluted earnings per share for the twelve months ended March 31, 2011 and 2010,



**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

respectively, as no payouts would be required based upon current performance. These amounts assume a 100% performance level payout.

No stock options were excluded from the computation of diluted earnings per share for the three and twelve months ended March 31, 2011 and 2010.

**E. 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 the taxing authorities in the federal jurisdiction 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.

For the three months ended March 31, 2011 and 2010, the Company's consolidated effective tax rate was 22.8% and 51.2%, respectively. For the twelve months ended March 31, 2011 and 2010 the Company's consolidated effective tax rate was 32.8% and 36.7%, respectively. The Company's consolidated effective tax rate for the three and twelve months ended March 31, 2011 differs from the federal statutory tax rate of 35% primarily due to the allowance for equity funds used during construction ( AEFUDC ) and state income taxes. AEFUDC in the first quarter of 2011 as compared to 2010 was larger due to larger balances of construction work in progress which accrues AEFUDC. In March 2010, the Patient Protection and Affordable Care Act ( PPACA ) was signed into law which contained a provision that the cost of providing certain prescription drug coverage will be reduced by the amount of the Medicare Part D subsidies received. The Company was required to recognize the impacts of the tax law change at the time of enactment. The Company's consolidated effective tax rate without the effect of the enactment of the PPACA for the three and twelve months ended March 31, 2010, was 30.7% and 32.3%, respectively. The Company's 2010 effective tax rates without the effect of the enactment of the PPACA differ from the federal statutory tax rate of 35% primarily due to state income taxes, AEFUDC, the tax rate on qualified decommissioning trust investment, and various permanent tax differences.

**F. Commitments, Contingencies and Uncertainties**

For a full discussion of commitments and contingencies, see Note J of Notes to Consolidated Financial Statements in the 2010 Form 10-K. In addition, see Note B above and Notes B and D of Notes to Consolidated Financial Statements in the 2010 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, and liability and insurance matters.



**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Power Purchase and Sale Contracts**

To supplement its own generation and operating reserves, the Company engages in firm power purchase arrangements which may vary in duration and amount based on evaluation of the Company's resource needs and the economics of the transactions. For a full discussion of power purchase and sale contracts that the Company has entered into with various counterparties, see Note J of Notes to Consolidated Financial Statements in the 2010 Form 10-K.

**Environmental Matters**

*General.* The Company is subject to laws and regulations with respect to air, soil and water quality, waste disposal and other environmental matters by federal, state, regional, tribal and local authorities. Those authorities govern 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 or other sanctions. In addition, releases of pollutants or contaminants into the environment can result in costly cleanup obligations. 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. Certain key environmental issues, laws and regulations facing the Company are described further below.

*Air Emissions.* The U.S. Clean Air Act (CAA) and comparable state laws and regulations relating to air emissions impose, among other obligations, limitations on pollutants generated during the Company's operations, including sulfur dioxide (SO<sub>2</sub>), particulate matter, nitrogen oxides (NO<sub>x</sub>) and mercury.

*Clean Air Interstate Rule.* The U.S. Environmental Protection Agency's (EPA) Clean Air Interstate Rule (CAIR) as applied to the Company, involves requirements to limit emissions of NO<sub>x</sub> from the Company's power plants in Texas and/or purchase allowances representing other parties' emissions reductions starting in 2009. Although the U.S. Court of Appeals for the District of Columbia voided CAIR in 2008, the Company must comply with CAIR until the EPA rewrites the rule as required by the Court's final opinion. The 2010 reconciliation to comply with CAIR was filed before the March 2011 deadline and the Company purchased and expensed \$0.3 million of allowances during 2010 to meet its estimated requirement.

*Clean Air Transport Rule.* In July 2010, the EPA proposed as a replacement to CAIR, the Clean Air Transport Rule (CATR). CATR would require 31 states, including Texas, and the District of Columbia to issue regulations and develop a scheme by which power plants in their respective jurisdictions will further reduce emissions of SO<sub>2</sub> and NO<sub>x</sub>. Reductions would be required beginning in 2012, with further reductions likely to be required in 2014. The EPA expects CATR to be finalized in July 2011, but it is unclear when the states would issue implementing regulations. There are a number of other uncertainties relating to this proposed rule, including whether it will be ultimately finalized and how the states will implement the requirements. As a result, the ultimate impact of this rule on the Company's operations cannot currently be determined, but it could be material.

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

*Ozone.* NOx emissions can lead to the formation of ozone. Ozone levels are limited by the National Ambient Air Quality Standards established by the EPA. The EPA is in the process of revising these standards. If these revisions result in more stringent standards, the Company could be required to place additional NOx pollution control measures on certain of its generating facilities. Without knowing the new ozone standards, the ultimate impact on the Company's facilities cannot be determined. However the impact of these regulations and associated costs could be material.

*Climate Change.* A significant portion of the Company's generation assets are nuclear or gas-fired, and as a result, the Company believes that its greenhouse gas (GHG) emissions are low relative to electric power companies who rely on more coal-fired generation. However, regulations governing the emission of GHGs, such as carbon dioxide, could impose significant costs or limitations on the Company. In recent years, the U.S. Congress has considered new legislation to restrict or regulate GHG emissions, although federal efforts directed at enacting comprehensive climate change legislation stalled in 2010 and appear highly unlikely to recommence in 2011. Nonetheless, it is possible that federal legislation related to GHG emissions will be considered in Congress in the future. The EPA has also proposed using the CAA to limit carbon dioxide and other GHG emissions, and GHG emissions regulations have been adopted by EPA in recent years, with additional regulations proposed or in development.

Significant GHG emissions regulations have been adopted by EPA in recent years with additional regulations proposed or in development. In September 2009, the EPA adopted a rule requiring approximately 10,000 facilities comprising a substantial percentage of annual U.S. GHG 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 also has inventoried and implemented procedures for electrical equipment containing sodium hexafluoride (SF6), another GHG. The Company is tracking these GHG emissions pursuant to EPA's new SF6 reporting rule that was finalized in late 2010 and became effective January 1, 2011. The first report to EPA under this rule is due March 31, 2012.

EPA has also proposed and finalized other rulemakings on GHG emissions that affect electric utilities. Under EPA regulations finalized in May 2010 (referred to as the Tailoring Rule), the EPA began regulating GHG emissions from certain stationary sources in January 2011. The regulations are being implemented pursuant to two CAA programs: the Title V Operating Permit program and the program requiring a permit if undergoing construction or major modifications (referred to as the PSD program). Obligations relating to Title V permits will include recordkeeping and monitoring requirements. With respect to PSD permits, projects that cause a significant increase in GHG emissions (currently defined to be more than 75,000 tons or more per year or 100,000 tons or more per year, depending on various factors), will be required to implement best available control technology, or BACT. The EPA has issued guidance on what BACT entails for the control of GHGs and individual states are now required to determine what controls are required for facilities within their jurisdiction on a case-by-case basis. The ultimate impact of these new regulations on the Company's operations cannot be determined at this time, but the cost of compliance with new regulations could be material. Also, on December 23, 2010, EPA announced a settlement agreement with states and environmental groups regarding setting new source performance standards for GHG emissions from new and existing coal-, gas- and oil-based power plants. Pursuant to this agreement, EPA will propose standards for both new

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

or modified boilers and for existing facilities in August 2011, and finalize those standards by May 26, 2012. The impact of these rules on the Company is unknown at this time, but they could result in material costs.

In addition, almost half of the states, either individually or through multi state regional initiatives, have begun to consider how to address GHG emissions and are actively considering the development of emission inventories or regional GHG cap and trade programs. 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 GHG emissions in the state. The New Mexico Environmental Improvement Board approved two separate rulemakings in November and December 2010 to limit GHG emissions from certain stationary sources. Under the November 2010 regulation, stationary sources that emit 25,000 metric tons or more of carbon dioxide a year would be required to reduce their GHG emissions by 2% per year from 2012 through 2020. The December 2010 regulation establishes a cap-and-trade system which would require certain industrial and electric generating facilities with carbon dioxide emissions in excess of 25,000 metric tons per year to reduce their emissions by 3% per year below 2010 levels. There are various uncertainties relating to these regulations, including whether current legal challenges to them will be successful, but as drafted, the Company does not expect these regulations to result in significant costs to the Company.

It is not currently possible to predict with confidence how any pending, proposed or future GHG legislation by Congress, the states, or multi-state regions or regulations adopted by EPA or the state environmental agencies will impact the Company's business. However, any such legislation or regulation of GHG emissions or any future related litigation could result in increased compliance costs or additional operating restrictions or reduced demand for the power the Company generates, could require the Company to purchase rights to emit GHG, and could have a material adverse effect on the Company's business, financial condition, reputation or results of operations.

Climate change also has potential physical effects that could be relevant to the Company's business. In particular, some studies suggest that climate change could affect our service area by causing higher temperatures, less winter precipitation and less spring runoff, as well as by causing more extreme weather events. Such developments could change the demand for power in the region and could also impact the price or ready availability of water supplies or affect maintenance needs and the reliability of Company equipment.

The Company believes that material effects on the Company's business or operations may result from the physical consequences of climate change, the regulatory approach to climate change ultimately selected and implemented by governmental authorities, or both. 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. Given the very significant remaining uncertainties regarding whether and how these issues will be regulated, as well as the timing and severity of any physical effects of climate change, the Company believes it is impossible at present to meaningfully quantify the costs of these potential impacts.

*Contamination Matters.* The Company has a provision for environmental remediation obligations of approximately \$0.4 million at March 31, 2011, related to compliance with federal and state environmental standards. However, unforeseen expenses associated with environmental

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

compliance or remediation may occur and could have a material adverse effect on the future operations and financial condition of the Company.

The Company incurred the following expenditures during the three and twelve months ended March 31, 2011 and 2010 to comply with federal environmental statutes (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2011	2010	2011	2010
Clean Air Act	\$ 58	\$ 217	\$ 456	\$ 677
Clean Water Act	56	34	200	572

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 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 EPA and a former property owner to resolve this matter and in 2011, the Company is expected to enter into a consent decree with the EPA at a cost to the Company of less than \$0.1 million (which amount is included in the \$0.4 million accrued at March 31, 2011).

*Environmental Litigation and Investigations.* 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. If the agencies certify impairment, the EPA is required to evaluate and, if necessary, determine best available retrofit technology (BART) for Four Corners. On January 19, 2011, a similar group of environmental organizations filed a lawsuit against the Departments of Interior and Agriculture, alleging, among other things, that the agencies failed to act on the February 2010 petition without unreasonable delay and requesting the court to order the agencies to act on the petition within 30 days. 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.

**G. 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.

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

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

**H. Employee Benefits****Retirement Plans**

The net periodic benefit cost recognized for the three and twelve months ended March 31, 2011 and 2010 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2011	2010	2011	2010
<b>Components of net periodic benefit cost:</b>				
Service cost	\$ 1,743	\$ 1,500	\$ 6,307	\$ 5,634
Interest cost	3,495	3,425	13,699	13,333
Amendments	0	0	838	0
Expected return on plan assets	(3,533)	(3,500)	(13,900)	(15,064)
Amortization of:				
Net loss	1,583	900	4,232	2,125
Prior service cost	27	25	117	115
<b>Net periodic benefit cost</b>	<b>\$ 3,315</b>	<b>\$ 2,350</b>	<b>\$ 11,293</b>	<b>\$ 6,143</b>

During the three months ended March 31, 2011, the Company contributed \$12.5 million of its projected \$13.9 million 2011 annual contribution to its retirement plans.

**Other Postretirement Benefits**

The net periodic benefit cost recognized for the three and twelve months ended March 31, 2011 and 2010 is made up of the components listed below (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2011	2010	2011	2010
<b>Components of net periodic benefit cost:</b>				
Service cost	\$ 738	\$ 925	\$ 3,371	\$ 3,395
Interest cost	1,290	1,725	6,229	6,567
Expected return on plan assets	(458)	(375)	(1,612)	(1,499)
Amortization of:				
Prior service benefit	(1,482)	(725)	(3,626)	(2,869)
Net gain	(108)	0	(283)	0

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Net periodic benefit cost	\$	(20)	\$ 1,550	\$ 4,079	\$ 5,594
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**Table of Contents****EL PASO ELECTRIC COMPANY AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)**

During the three months ended March 31, 2011, the Company contributed \$2.2 million to fund its entire annual contribution to its postretirement plan for 2011.

**I. 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.

*Long-Term Debt and Financing Obligations.* 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):

	March 31, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Pollution Control Bonds	\$ 193,135	\$ 191,445	\$ 193,135	\$ 192,924
Senior Notes	546,623	581,129	546,610	574,700
Nuclear Fuel Financing (1):				
RGRT Senior Notes	110,000	110,900	110,000	110,371
RCF	12,951	12,951	4,704	4,704
Total	\$ 862,709	\$ 896,425	\$ 854,449	\$ 882,699

- (1) Nuclear fuel financing as of March 31, 2011 is funded through the \$110 million RGRT Senior Notes and the RCF. The interest rate on the Company's nuclear fuel financing through the RCF 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 \$159.3 million and \$153.9 million at March 31, 2011 and December 31, 2010, 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

**Table of Contents**

**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

time that individual securities have been in a continuous unrealized loss position, at March 31, 2011 and December 31, 2010 (in thousands):

Description of Securities (1):	Less than 12 Months		March 31, 2011 12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Federal Agency Mortgage Backed Securities	\$ 4,864	\$ (76)	\$ 436	\$ (32)	\$ 5,300	\$ (108)
U.S. Government Bonds	12,779	(213)	0	0	12,779	(213)
Municipal Obligations	12,653	(340)	5,440	(219)	18,093	(559)
Corporate Obligations	1,381	(21)	0	0	1,381	(21)
Total debt securities	31,677	(650)	5,876	(251)	37,553	(901)
Common stock	9,719	(1,074)	1,191	(288)	10,910	(1,362)
<b>Total temporarily impaired securities</b>	<b>\$ 41,396</b>	<b>\$ (1,724)</b>	<b>\$ 7,067</b>	<b>\$ (539)</b>	<b>\$ 48,463</b>	<b>\$ (2,263)</b>

(1) Includes approximately 108 securities.

Description of Securities (2):	Less than 12 Months		December 31, 2010 12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Federal Agency Mortgage Backed Securities	\$ 2,290	\$ (51)	\$ 441	\$ (27)	\$ 2,731	\$ (78)
U.S. Government Bonds	9,583	(124)	0	0	9,583	(124)
Municipal Obligations	13,145	(278)	3,763	(145)	16,908	(423)
Corporate Obligations	1,855	(18)	0	0	1,855	(18)
Total debt securities	26,873	(471)	4,204	(172)	31,077	(643)
Common stock	6,943	(774)	4,303	(420)	11,246	(1,194)
<b>Total temporarily impaired securities</b>	<b>\$ 33,816</b>	<b>\$ (1,245)</b>	<b>\$ 8,507</b>	<b>\$ (592)</b>	<b>\$ 42,323</b>	<b>\$ (1,837)</b>

(2) Includes approximately 96 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 2044 or a later period when the Company begins to decommission Palo Verde.





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

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):

	March 31, 2011		December 31, 2010	
	Fair Value	Unrealized Gains	Fair Value	Unrealized Gains
<b>Description of Securities:</b>				
Federal Agency Mortgage Backed Securities	\$ 16,770	\$ 685	\$ 18,472	\$ 793
U.S. Government Bonds	6,193	98	10,450	183
Municipal Obligations	15,005	583	15,633	592
Corporate Obligations	8,361	332	7,223	362
Total debt securities	46,329	1,698	51,778	1,930
Common stock	60,493	16,768	56,770	14,142
Temporary investments	4,001	0	3,007	0
<b>Total</b>	<b>\$ 110,823</b>	<b>\$ 18,466</b>	<b>\$ 111,555</b>	<b>\$ 16,072</b>

The Company's marketable securities include investments in municipal, corporate and federal debt obligations. Substantially all of the Company's mortgage backed securities, based on contractual maturity, are due in 10 years or more. The mortgage backed securities have an estimated weighted average maturity which generally range from 3 to 7 years and reflects anticipated future prepayments. The contractual year for maturity for all other available-for-sale securities as of March 31, 2011 is as follows (in thousands):

	Total	2011	2012 through 2015	2016 through 2020	2021 and Beyond
Municipal Debt Obligations	\$ 33,098	\$ 2,292	\$ 11,281	\$ 11,721	\$ 7,804
Corporate Debt Obligations	9,742	0	4,479	3,305	1,958
U.S. Government Bonds	18,972	2,105	7,788	5,887	3,192

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 and twelve months ended March 31, 2011 and 2010 the Company recognized other than temporary impairment losses on its available-for-sale securities as follows (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2011	2010	2011	2010
Gross unrealized holding losses included in pre-tax income	\$ 0	\$ 0	\$ (263)	\$ (3,092)



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

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</b>		<b>Twelve Months Ended</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>	<b>2011</b>	<b>2010</b>
Proceeds from sales of available-for-sale securities	\$ 14,231	\$ 19,504	\$ 56,383	\$ 87,023
Gross realized gains included in pre-tax income	\$ 264	\$ 397	\$ 897	\$ 3,809
Gross realized losses included in pre-tax income	(59)	(428)	(520)	(493)
Gross unrealized losses included in pre-tax income	0	0	(263)	(3,092)
Net gains (losses) in pre-tax income	\$ 205	\$ (31)	\$ 114	\$ 224
Net unrealized holding gains included in accumulated other comprehensive income	\$ 2,173	\$ 2,423	\$ 6,415	\$ 20,630
Net gains (losses) reclassified out of other accumulated comprehensive income	(205)	31	(114)	(224)
Net gains (losses) in other comprehensive income	\$ 1,968	\$ 2,454	\$ 6,301	\$ 20,406

*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 other fixed income 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.

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

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.

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.

The fair value of the Company's decommissioning trust funds and investments in debt securities, at March 31, 2011 and December 31, 2010, 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 March 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Trading Securities:</b>				
Investments in Debt Securities	\$ 2,837	\$ 0	\$ 0	\$ 2,837