Plan and under a previous plan approved by the Board in 2004 (the "2004 Plan") at an aggregate cost of $93.8 million. As of December 31, 2007, no shares remain available under the 2006 Plan or the 2004 Plan. In November 2007, the Board authorized the repurchase of up to an additional 2 million shares of the Company's outstanding common stock (the "2007 Plan"). No shares have been repurchased under the 2007 Plan. The Company may in the future make purchases of its common stock pursuant to the 2007 Plan 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.

For Equity Compensation Plan Information see Part III, Item 12 – Security Ownership of Certain Beneficial Owners and Management.

Item 6. Selected Financial Data

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

	Years Ended December 31,				
	2007	2006	2005	2004	2003
Operating revenues	$ 877,427	$ 816,455	$ 803,913	$ 708,628	$ 664,362
Operating income	$ 128,321	$ 115,562	$ 107,883	$ 93,071	$ 79,370
Income before extraordinary item and cumulative effect of accounting change	$ 74,753	$ 61,387	$ 36,615	$ 33,369	$ 20,322
Extraordinary gain on re-application of SFAS No. 71, net of tax	$ –	$ 6,063	$ –	$ 1,802	$ –
Cumulative effect of accounting change, net of tax	$ –	$ –	$ (1,093)	$ –	$ 39,635
Net income	$ 74,753	$ 67,450	$ 35,522	$ 35,171	$ 59,957
Basic earnings per share:					
Income before extraordinary item and cumulative effect of accounting change	$ 1.64	$ 1.29	$ 0.77	$ 0.70	$ 0.42
Extraordinary gain on re-application of SFAS No. 71, net of tax	$ –	$ 0.13	$ –	$ 0.04	$ –
Cumulative effect of accounting change, net of tax	$ –	$ –	$ (0.02)	$ –	$ 0.82
Net income	$ 1.64	$ 1.42	$ 0.75	$ 0.74	$ 1.24
Weighted average number of shares outstanding	45,563,858	47,663,890	47,711,894	47,426,813	48,424,212
Diluted earnings per share:					
Income before extraordinary item and cumulative effect of accounting change	$ 1.63	$ 1.27	$ 0.76	$ 0.69	$ 0.42
Extraordinary gain on re-application of SFAS No. 71, net of tax	$ –	$ 0.13	$ –	$ 0.04	$ –
Cumulative effect of accounting change, net of tax	$ –	$ –	$ (0.02)	$ –	$ 0.81
Net income	$ 1.63	$ 1.40	$ 0.74	$ 0.73	$ 1.23
Weighted average number of shares and dilutive potential shares outstanding	45,928,478	48,164,067	48,307,910	48,019,721	48,814,761
Cash additions to utility property, plant and equipment	$ 144,588	$ 103,182	$ 88,263	$ 72,092	$ 77,679
Total assets	$ 1,853,888	$ 1,714,654	$ 1,665,449	$ 1,580,835	$ 1,596,614
Long-term debt and financing and capital lease obligations, net of current portion	$ 655,111	$ 616,130	$ 611,018	$ 379,636	$ 608,722
Common stock equity	$ 666,459	$ 579,675	$ 556,439	$ 532,147	$ 495,768

Certain amounts presented for prior years have been reclassified to conform to the 2007 presentation.

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

As you read this Management's Discussion and Analysis, please refer to our Consolidated Financial Statements and the accompanying notes, which contain our operating results.

Summary of Critical Accounting Policies and Estimates

Note A to the Consolidated Financial Statements contains a summary of significant accounting policies. 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 include the following:

- Application of SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation"
- Collection of fuel expense
- Decommissioning costs and estimated asset retirement obligations
- Future pension and other postretirement benefit obligations
- Tax accruals

Application of SFAS No. 71

The Company applies the provisions of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," ("SFAS No. 71") to its regulated operations in Texas and New Mexico. SFAS No. 71 requires a rate regulated enterprise to reflect the economic impact of regulatory decisions in its financial statements. As a result, we record certain costs or obligations as either assets or liabilities on our balance sheet and amortize them in subsequent periods. The deferral of costs as regulatory assets is appropriate only when the future recovery of such costs is probable. The application of SFAS No. 71 requires our management to make assumptions and estimates as to the amount of costs that regulatory authorities will ultimately permit us to recover. In the event we determine that we can no longer apply SFAS No. 71 to all or a portion of our operations, either as (i) a result of the establishment of retail competition in our service territory; (ii) a change in the regulatory approach for setting rates from cost-based ratemaking to another form of ratemaking; or (iii) other regulatory actions that restrict cost recovery to a level insufficient to recover costs, we could be required to record a charge against income in the amount of the remaining unamortized net regulatory assets. Such an action could materially reduce our shareholders' equity.

As of December 31, 2006, we determined that we met the criteria to re-apply SFAS No. 71 to our Texas jurisdiction, and we recorded regulatory assets of $9.6 million and associated accumulated deferred tax liabilities of $3.5 million, representing costs currently being recovered through the Texas fuel factor, which resulted in an extraordinary gain of $6.1 million, net of tax. We determined it was not appropriate at this time to recognize other potential regulatory assets and liabilities, such as the costs associated with refinancing our first mortgage bonds in 2005, because in our judgment they have not yet been included in our recoverable cost of service. We had previously made a determination to re-apply SFAS No. 71 to our New Mexico jurisdiction beginning July 1, 2004. At December 31, 2007, we had $27.8 million of regulatory assets, net of regulatory liabilities. We may record additional regulatory assets and regulatory liabilities in the future based on our judgment as to whether sufficient evidence exists that our regulators will include them in our rate base and or cost of service. Thus, the amount of our net regulatory assets could increase materially in the future. In addition, we include an allowance for equity and borrowed funds used during construction as a cost of construction of electric plant in service. The allowance for equity funds used during construction is recognized as other income and the allowance for borrowed funds used during construction is shown as capitalized interest in our statement of operations. Under this treatment, we report higher other income and lower capitalized interest expense than we would have reported prior to the re-application of SFAS No. 71, and the difference may be material if our construction program continues at current levels or should increase relative to current levels. The factors that supported our decision are set forth in Note A to the consolidated financial statements.

Collection of Fuel Expense

In general, by law and regulation, our fuel and purchased power expenses are recovered from our customers. In times of rising fuel prices, we experience a lag in recovery of higher fuel costs. These costs are subject to reconciliation by the Texas Commission and the NMPRC. Prior to the completion of a reconciliation, we record fuel transactions such that fuel revenues equal fuel expense except for the fixed portion in New Mexico prior to July 2007. In the event that a disallowance occurs during a reconciliation proceeding, the amounts recorded for fuel and purchased power expenses could differ from the amounts we are allowed to collect from our customers, and we could incur a loss to the extent of the disallowance.

Decommissioning Costs and Estimated Asset Retirement Obligation

Pursuant to the ANPP Participation Agreement and federal law, we must fund our share of the estimated costs to decommission Palo Verde Units 1, 2 and 3 and associated common areas. We recorded a liability and a corresponding asset for the fair value of our decommissioning obligation upon implementation of SFAS No. 143, "Accounting for Asset Retirement Obligations." We will adjust the liability to its present value periodically over time, and the corresponding asset will be depreciated over its useful life. The determination of the estimated liability requires the use of various assumptions pertaining to decommissioning costs, escalation and discount rates.

We and other Palo Verde Participants rely upon decommissioning cost studies and make discount rate, rate of return and inflation projections to determine funding requirements and estimate liabilities related to decommissioning. Every third year outside engineers perform a study to estimate decommissioning costs associated with Palo Verde Units 1, 2 and 3 and associated common areas. We determine how we will fund our share of those estimated costs by making assumptions about future investment returns and future decommissioning cost escalations. The funds are invested in professionally managed investment trust accounts. We are required to establish a minimum accumulation and a minimum funding level in our decommissioning trust accounts at the end of each annual reporting period in accordance with the ANPP Participation Agreement. If actual decommissioning costs exceed our estimates, we would incur additional costs related to decommissioning. Further, if the rates of return earned by the trusts fail to meet expectations, we will be required to increase our funding to the decommissioning trust accounts. Although we cannot predict the results of future studies, we believe that the liability we have recorded for our decommissioning costs will be adequate to fund our share of the costs, assuming that Palo Verde Units 1, 2 and 3 operate over their remaining lives (which includes an assessment of the probability of a license extension) and that the DOE assumes responsibility for permanent disposal of spent fuel at plant shut down. We believe that our current annual funding levels of the decommissioning trust will adequately provide for the cash requirements associated with decommissioning. Historically, regulated utilities like us have been permitted to collect in rates in Texas and New Mexico the costs of nuclear decommissioning. Should we become subject to the Texas Restructuring Law, we will be able to collect from regulated transmission and distribution customers the costs of decommissioning. Reference is made to Note D, "Accounting for Asset Retirement Obligations" to the Notes to Consolidated Financial Statements.

Future Pension and Other Postretirement Obligations

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

In developing the assumptions, management makes judgments based on the advice of financial and actuarial advisors and our review of third-party and market-based data. These sources include life expectancy tables, surveys of compensation and health care cost trends, and historical and expected return data on various categories of plan assets. The assumed discount rate applied to future plan obligations is based at each measuring date on prevailing market interest rates inherent in high quality (AA and better) corporate bonds that would provide future cash flow needed to pay the benefits as they become due, as well as on publicly available bond issues. We regularly review our assumptions and conduct a reassessment at least once a year. We do not expect that any such change in assumptions will have a material effect on net income for 2008.

Tax Accruals

Our federal tax returns for the years 1999 through 2004 have been examined by the IRS. On June 12, 2007, we received from the IRS a notice of proposed deficiency for the tax years 1999 through 2004. A previous IRS notice of proposed deficiency had been received in 2005 for the years 1999 through 2002. The primary audit adjustments proposed by the IRS related to (i) whether we were entitled to currently deduct payments related to the repair of the Palo Verde Unit 2 steam generators or whether these payments should be capitalized and depreciated and (ii) whether we were entitled to currently deduct payments related to the dry cask storage facilities for spent nuclear fuel or whether these payments should be capitalized and depreciated. A tax deficiency was also received proposing to include in taxable income capital costs paid by third parties for construction of a switchyard. The third parties have indemnified the Company against any tax liability associated with the switchyard. The proposed IRS adjustments would affect the timing of these deductions, not their ultimate deductibility for federal tax purposes. We have protested the audit adjustments through administrative appeals. We believe that our treatment of the payments is supported by substantial legal authority. The IRS is currently performing an examination of the 2005 income tax return. We review our accruals for future liabilities under the provisions of the FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," ("FIN 48"). FIN 48 provides a recognition threshold and measurement attribute for the financial statement measurement of tax positions. We have evaluated our tax positions under these provisions including the recognition of interest and penalties on tax benefits that have not been recognized. Although the ultimate outcome of the appeals and current examination cannot be predicted with certainty, we believe that, as of December 31, 2007, we have adequately recognized our expected tax liabilities.

Overview

The following is an overview of our results of operations for the years ended December 31, 2007, 2006 and 2005. Income for the years ended December 31, 2007, 2006 and 2005 is shown below:

	Years Ended December 31,		
	2007	2006	2005
Net income before extraordinary item and cumulative effect of accounting change (in thousands)	$ 74,753	$ 61,387	$ 36,615
Basic earnings per share before extraordinary item and cumulative effect of accounting change	1.64	1.29	0.77

The following table and accompanying explanations show the primary factors affecting the after-tax change in income before extraordinary items and cumulative effect of accounting change between the calendar years ended 2007 and 2006, 2006 and 2005, and 2005 and 2004 (in thousands):

	2007	2006	2005
Prior year December 31 income before extraordinary item and cumulative effect of accounting change	$ 61,387	$ 36,615	$ 33,369
Change in (net of tax):			
Increased retail base revenues	11,698 (a)	5,874 (a)	4,985 (a)
Increased (decreased) AFUDC and capitalized interest	6,189 (b)	(533)	1,681
Decreased (increased) administrative and general expense	3,471 (c)	(229)	715
Decreased (increased) maintenance at coal and gas-fired generating plants	3,516	(2,440)	147
Increased investment and interest income	1,983	516	1,377
Decreased (increased) taxes other than income taxes	846	(3,427) (d)	(1,514) (d)
Decreased (increased) transmission and distribution operations and maintenance expense	706	(4,230) (e)	(1,710)
Net fuel recoveries	173	3,635 (f)	(624)
Increased Palo Verde operations and maintenance expense	(7,114) (g)	(8,050) (h)	(2,189) (i)
Income tax adjustment	(6,174) (j)	6,174 (j)	–
Increased (decreased) off-system sales margins	(1,731)	2,797	456
Increased (decreased) wheeling revenues	(1,512)	3,665	1,485
Decreased (increased) interest charges on long-term debt	(751)	3,168 (k)	5,212 (k)
Decreased (increased) depreciation and amortization expense	(599)	8,694 (l)	6,760 (l)
Decreased (increased) loss on extinguishments of debt	–	12,128 (m)	(8,807) (m)
2004 IRS settlement	–	–	(6,200) (n)
Other	2,665	(2,970)	1,472
Current year December 31 net income before extraordinary item and cumulative effect of accounting change	$ 74,753	$ 61,387	$ 36,615

(a) Retail base revenues excludes fuel recovered through New Mexico base rates. Retail base revenues increased primarily due to increased kWh sales reflecting growth in the number of customers served in all periods presented above.

(b) Increased capitalized interest and AFUDC (allowance for funds used during construction) in 2007 are due to the reapplication of SFAS No. 71 to our Texas jurisdiction at December 31, 2006 and higher balances of construction work in progress and nuclear fuel subject to AFUDC and capitalized interest in 2007.

(c) Administrative and general expenses decreased due to an increase in capitalized employee salaries and benefits, decreased workers compensation insurance expense, and a sales tax refund in 2007.

(d) Taxes other than income taxes increased in 2006 compared to 2005 and 2005 compared to 2004 due to an increase in the El Paso city franchise fee rate which took effect in August 2005.

(e) Transmission and distribution operations and maintenance expense increased primarily due to increased wheeling expenses due to the expiration of an exchange contract and increased distribution expenses.

(f) Net fuel recoveries increased in 2006 compared to 2005 primarily due to the recovery of purchased power capacity payments in New Mexico in 2006 and increased recovery of transmission expenses in Texas.

(g) Palo Verde operations and maintenance expense increased in 2007 when compared to 2006 due to increased operations costs at all three units and increased maintenance costs at Unit 3 associated with the planned replacement of steam generators.

(h) Palo Verde operations and maintenance expense increased in 2006 when compared to 2005 due to the repairs and modification at Unit 1 and scheduled maintenance and refueling outages at Unit 2 and Unit 3 in 2006.

(i) Palo Verde operations and maintenance expense increased in 2005 when compared to 2004 due to increased operations and maintenance expense at Unit 1 during the planned replacement of steam generators and refueling outage in 2005, and increased administrative and general expenses.

(j) A reduction in income tax expense was recorded in 2006 to recognize the change in tax rates resulting from changes in the Texas franchise (income) tax law in May 2006 with no comparable activity in 2007 or 2005.

(k) Interest charges decreased in 2006 compared to 2005 and in 2005 compared to 2004 due to lower interest expense on long-term debt and financing obligations resulting from the refinancing of first mortgage bonds with long-term senior notes in May 2005 and the August 2005 reissuance and remarketing of pollution control bonds at lower interest rates.

(l) Depreciation and amortization decreased in 2006 compared to 2005 and 2005 compared to 2004 due to completing the recovery of certain fresh-start accounting related assets over the term of a rate stipulation in Texas Docket No. 12700 which ended in July 2005.

(m) Loss on extinguishments of debt in 2006 decreased compared to 2005 and increased in 2005 compared to 2004 reflecting the refinancing of all of our first mortgage bonds in May 2005.

(n) A benefit was recorded in the third quarter of 2004 from a settlement of an IRS audit of our 1996-1998 tax returns.

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. Under the terms of our rate agreements in Texas and New Mexico, we share 25% of our off-system sales margins with customers in Texas and New Mexico (effective July 1, 2005 and July 1, 2007, respectively). We also share 25% of transmission wheeling revenues in Texas. (See Note B of the Notes to Consolidated Financial Statements).

Revenues from the sale of electricity include the recovery of fuel costs, which are recovered from our customers through fuel adjustment mechanisms in Texas and New Mexico and a portion through base rates in New Mexico. We record deferred fuel revenues for the difference between fuel costs and 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:

	Twelve Months Ended December 31,		
	2007	**2006**	**2005**
Residential	40%	39%	40%
Commercial and industrial, small	36	36	36
Commercial and industrial, large	8	9	9
Sales to public authorities	16	16	15
Total retail non-fuel base revenues	100%	100%	100%

No retail customer accounted for more than 2% of our non-fuel base revenues during such periods. As shown in the table above, residential and small commercial customers comprise approximately 76% 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. The following table sets forth the percentage of our revenues derived during each quarter for the periods presented:

	Years Ended December 31,		
	2007	2006	2005
January 1 to March 31	22%	22%	21%
April 1 to June 30	24	26	25
July 1 to September 30	30	29	30
October 1 to December 31	24	23	24
Total	100%	100%	100%

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 for 2007, 2006 and 2005.

	2007	2006	2005	10-year Average
Heating degree days	2,286	2,020	2,176	2,329
Cooling degree days	2,512	2,457	2,549	2,525

Customer growth is a primary driver in our retail sales growth. The average number of retail customers grew 2.4% and 2.7% in 2007 and 2006, respectively. See the tables presented on pages 43 and 44 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 $18.6 million or 4.2% for the twelve months ended December 31, 2007 when compared to the same period in 2006 largely due to increased kWh sales associated with a 2.4% increase in the average number of retail customers served and colder winter weather in the first quarter of 2007 compared to the same period in 2006. Non-fuel base revenues to residential customers increased $8.9 million or 5.1% due to increased kWh sales. KWh sales to residential customers increased 5.6% in the twelve-month period compared to the same period last year largely as a result of a 2.1% increase in the average number of residential customers served and the colder winter weather in the first quarter of 2007. Heating degree days increased 13.2% while cooling degree days increased 2.2% for the twelve-month period in 2007 compared to the same period last year. Small commercial and industrial non-fuel base revenues increased $6.7 million or 4.2% in the twelve-month period ended December 31, 2007 reflecting an increase in kWh sales of 2.6% and a small increase in non-fuel base rates in New Mexico effective in July 2007. Other public authorities' non-fuel base revenues increased $4.3 million or 6.3% due to a 3.1% increase in kWh sales and a small increase in non-fuel base rates in New Mexico. Large commercial and industrial non-fuel base revenues decreased $1.4 million or 3.5% primarily due to customers migrating to the small commercial and industrial class.

Retail non-fuel base revenues increased by $9.5 million or 2.2% for the twelve months ended December 31, 2006 when compared to the same period in 2005. Retail kWh sales in the twelve month period ended December 31, 2006 were 2.5% higher than the twelve month period ended December 31, 2005. Growth of 2.7% in the average number of retail customers served in 2006 accounted for most of the increase in sales. The mild weather in the first quarter of 2006 was largely offset by warmer summer weather in the second quarter of 2006. Cooling and heating degree days for the twelve months ended

December 31, 2006 were approximately 3.6% and 7.2% below 2005, respectively. As a result, retail non-fuel base revenues for the residential, small commercial and industrial and other public authorities' customer classes increased primarily due to customer growth. Retail base revenues for large commercial and industrial increased primarily as a result of increased kWh sales to large industrial customers.

Fuel revenues. Fuel revenues consists of: (i) revenues collected from customers under fuel recovery mechanisms approved by the state commissions, (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, the fuel adjustment clause allows us to reflect current fuel costs above the amount recovered in base rates and to recover under-recoveries or refund over-recoveries with a two-month lag. Until terminated on July 1, 2007, a fixed amount of fuel costs was reflected in the fuel adjustment clause for 10% of kWh sales. In Texas, fuel costs are recovered through a fixed fuel factor that may be adjusted two times per year. 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.

In September 2007, we completed the recovery of $53.6 million of fuel under-recoveries through a fuel surcharge from our Texas customers which began in October 2005. We completed the recovery in January 2007 of $34 million of fuel under-recoveries, including interest through the surcharge period, through a fuel surcharge which began in February 2006. In 2007, 2006 and 2005, we collected $22.9 million, $56.9 million and $6.0 million of deferred fuel revenues in Texas through surcharges, respectively.

We under-collected current fuel costs and deferred for future recovery from our Texas and New Mexico customers by $17.8 million and $79.5 million in 2007 and 2005, respectively, compared to an over-collection of fuel costs of $3.7 million in 2006. At December 31, 2007, we had an under-recovered fuel balance of $29.2 million from our Texas customers and an over-recovery balance of $1.5 million from our New Mexico customers. At December 31, 2006, we had under-recovered fuel balances of $29.8 million from our Texas customers and $2.8 million from our New Mexico customers.

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 between 40% and 50% 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 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 MWhs, sales revenue, fuel cost, total margins and retained margins made on off-system sales for the twelve months ended December 31, 2007, 2006 and 2005:

	Twelve Months Ended December 31,		
	2007	2006	2005
MWh sales	2,201,294	1,635,407	1,420,778
Sales revenues (in thousands)	$ 125,974	$ 95,932	$ 78,209
Fuel cost (in thousands)	$ 106,393	$ 73,332	$ 57,942
Total margins (in thousands)	$ 19,581	$ 22,600	$ 20,267
Retained margins (in thousands)	$ 15,514	$ 18,261	$ 13,750

Off-system sales increased $30.0 million or 31.3% for the twelve months ended December 31, 2007 when compared to 2006 primarily due to increased off-system kWh sales of 34.6%. We had increased energy available for sale in the twelve months of 2007 compared to the same period in 2006 primarily due to the increased energy generated at Palo Verde in the first six months of 2007 compared to the same period in 2006. This increase was partially offset by lower average market prices. Customers receive 25% of off-system sales margins in Texas and New Mexico pursuant to rate settlements. Prior to July 1, 2007, we retained 100% of off-system sales margins in New Mexico.

Off-system sales increased $17.7 million or 22.7% for the twelve months ended December 31, 2006 when compared to 2005 primarily due to increased off-system kWh sales of 15.1% and higher average market prices.

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

Years Ended December 31:	2007	2006	Increase (Decrease) Amount	Increase (Decrease) Percent
kWh sales:				
Retail:				
Residential	2,232,668	2,113,733	118,935	5.6%
Commercial and industrial, small	2,216,428	2,159,599	56,829	2.6
Commercial and industrial, large	1,195,038	1,204,707	(9,669)	(0.8)
Sales to public authorities	1,384,380	1,343,129	41,251	3.1
Total retail sales	7,028,514	6,821,168	207,346	3.0
Wholesale:				
Sales for resale	48,290	45,397	2,893	6.4
Off-system sales	2,201,294	1,635,407	565,887	34.6
Total wholesale sales	2,249,584	1,680,804	568,780	33.8
Total kWh sales	9,278,098	8,501,972	776,126	9.1
Operating revenues:				
Non-fuel base revenues:				
Retail:				
Residential	$ 184,562	$ 175,641	$ 8,921	5.1%
Commercial and industrial, small	168,091	161,359	6,732	4.2
Commercial and industrial, large	39,092	40,502	(1,410)	(3.5)
Sales to public authorities	72,763	68,438	4,325	6.3
Total retail non-fuel base revenues	464,508	445,940	18,568	4.2
Wholesale:				
Sales for resale	1,919	1,794	125	7.0
Total non-fuel base revenues	466,427	447,734	18,693	4.2
Fuel revenues:				
Recovered from customers during the period	197,383	225,441	(28,058)	(12.4) (1)
Under (over) collection of fuel	17,828	(3,655)	21,483	-
New Mexico fuel in base rates	51,487	30,033	21,454	71.4
Total fuel revenues	266,698	251,819	14,879	5.9
Off-system sales	125,974	95,932	30,042	31.3
Other	18,328	20,970	(2,642)	(12.6) (2)
Total operating revenues	$ 877,427	$ 816,455	$ 60,972	7.5
Average number of retail customers:				
Residential	315,114	308,483	6,631	2.1
Commercial and industrial, small	34,199	32,591	1,608	4.9
Commercial and industrial, large	56	58	(2)	(3.4)
Sales to public authorities	4,834	4,797	37	0.8
Total	354,203	345,929	8,274	2.4

(1) Excludes $22.9 million and $56.9 million of deferred fuel revenues recovered through Texas fuel surcharges in 2007 and 2006, respectively.

(2) Represents revenues with no related kWh sales.

Years Ended December 31:	2006	2005	Increase (Decrease) Amount	Percent	
kWh sales:					
Retail:					
Residential	2,113,733	2,090,098	23,635	1.1%	
Commercial and industrial, small	2,159,599	2,126,918	32,681	1.5	
Commercial and industrial, large	1,204,707	1,165,506	39,201	3.4	
Sales to public authorities	1,343,129	1,270,116	73,013	5.7	
Total retail sales	6,821,168	6,652,638	168,530	2.5	
Wholesale:					
Sales for resale	45,397	41,883	3,514	8.4	
Off-system sales	1,635,407	1,420,778	214,629	15.1	
Total wholesale sales	1,680,804	1,462,661	218,143	14.9	
Total kWh sales	8,501,972	8,115,299	386,673	4.8	
Operating revenues:					
Non-fuel base revenues:					
Retail:					
Residential	$ 175,641	$ 173,007	$ 2,634	1.5%	
Commercial and industrial, small	161,359	158,406	2,953	1.9	
Commercial and industrial, large	40,502	39,192	1,310	3.3	
Sales to public authorities	68,438	65,861	2,577	3.9	
Total retail non-fuel base revenues	445,940	436,466	9,474	2.2	
Wholesale:					
Sales for resale	1,794	1,687	107	6.3	
Total non-fuel base revenues	447,734	438,153	9,581	2.2	
Fuel revenues:					
Recovered from customers during the period	225,441	164,500	60,941	37.0	(1)(2)
Under (over) collection of fuel	(3,655)	79,539	(83,194)	-	(2)
New Mexico fuel in base rates	30,033	29,440	593	2.0	
Total fuel revenues	251,819	273,479	(21,660)	(7.9)	
Off-system sales	95,932	78,209	17,723	22.7	
Other	20,970	14,072	6,898	49.0	(3)(4)
Total operating revenues	$ 816,455	$ 803,913	$ 12,542	1.6	
Average number of retail customers:					
Residential	308,483	300,581	7,902	2.6	
Commercial and industrial, small	32,591	31,573	1,018	3.2	
Commercial and industrial, large	58	59	(1)	(1.7)	
Sales to public authorities	4,797	4,658	139	3.0	
Total	345,929	336,871	9,058	2.7	

(1) Excludes $56.9 million and $6.0 million of deferred fuel revenues recovered through Texas fuel surcharges in 2006 and 2005, respectively.
(2) Reflects increases in Texas fixed fuel factors in October 2005 and February 2006.
(3) Primarily due to increased transmission revenue.
(4) Represents revenues with no related kWh sales.

Energy expenses

Our sources of energy include electricity generated from our nuclear, natural gas and coal generating plants and purchased power. Palo Verde represented approximately 42% of our available net generating capability and approximately 43% of our available energy for the twelve months ended December 31, 2007.

Our energy expenses increased $47.3 million for the twelve months ended December 31, 2007 when compared to 2006 primarily due to (i) increased natural gas costs of $37.7 million due to increased natural gas-fired generation, (ii) increased costs of purchased power of $9.8 million due to higher market prices for power, and (iii) increased nuclear fuel costs of $2.8 million due to increased generation. These increases were partially offset in 2007 by a $2.7 million refund related to a gas pipeline reservation fee and a $0.4 million decrease to our coal expense due to a decrease in the amount of coal burned.

Energy expenses decreased $12.6 million for the twelve months ended December 31, 2006 when compared to 2005 due to decreased natural gas generation and lower natural gas prices. During 2006, we were able to displace gas-fired generation with increased purchases of economy energy in the wholesale power market. The average cost of purchased power in 2006 was $52.97 per megawatt-hour compared to our cost of generating power at our gas-fired generating plants of $78.91 per megawatt-hour. In addition, the average cost of purchased power in 2006 was approximately 17% lower than in 2005. As a result, we purchased 76% more energy in 2006 compared to 2005 which resulted in increased costs of purchased power of $37.0 million.

	2007			2006		
Fuel Type	Cost (in thousands)	MWh	Cost per MWh	Cost (in thousands)	MWh	Cost per MWh
Natural Gas	$ 218,165 (a)	2,763,016	$ 78.96	$ 180,485	2,287,097	$ 78.91
Coal	11,343	714,164	15.88	11,698	827,181	14.14
Nuclear	23,993	4,229,915	5.67	21,173	3,793,728	5.58
Total	253,501	7,707,095	32.89	213,356	6,908,006	30.89
Purchased power	126,833	2,189,697	57.92	116,989	2,208,661	52.97
Total energy	$ 380,334	9,896,792	38.43	$ 330,345	9,116,667	36.24

	2005		
Fuel Type	Cost (in thousands)	MWh	Cost per MWh
Natural Gas	$ 230,900	2,643,584	$ 87.34
Coal	11,003 (b)	779,002	14.12
Nuclear	21,619	4,077,558	5.30
Total	263,522	7,500,144	35.14
Purchased power	80,040	1,255,626	63.75
Total energy	$ 343,562	8,755,770	39.24

(a) Excludes a reservation charge refund of $2.7 million recorded in 2007.
(b) Excludes a reduction of $0.7 million to our coal reclamation liability recorded in 2005.

Other operations expense

Other operations expense increased $4.4 million, or 2.3% in 2007 compared to 2006 primarily due to increased Palo Verde operations expense of $9.0 million. This increase was partially offset by decreased administrative and general expenses of $5.6 million related to a decrease in workers compensation insurance costs, an increase in capitalized employee salaries and benefits, and a decrease in legal expenses related to regulatory matters.

Other operations expense increased $13.2 million, or 7.4% in 2006 compared to 2005 primarily due to (i) increased Palo Verde operation expense of $5.1 million; (ii) increased transmission expense of $2.7 million primarily as the result of new wheeling contracts; (iii) increased customer accounts expense of $1.8 million due to increased bad debt expense; (iv) increased accruals for employee incentive payments of $2.9 million; and (v) increased consulting fees of $1.8 million.

Maintenance expense

Maintenance expense decreased $3.1 million, or 5.1% in 2007 compared to 2006 due to decreased maintenance expense at our gas-fired generating plants of $5.6 million as a result of the timing of planned maintenance, partially offset by increased maintenance expense at Palo Verde of $2.3 million.

Maintenance expense increased $12.7 million, or 26.8% in 2006 compared to 2005 primarily due to increased maintenance expense at Palo Verde of $7.9 million and our gas-fired generating plants of $3.9 million.

Depreciation and amortization expense

Depreciation and amortization expense increased $1.0 million in 2007 compared to 2006 primarily due to increased depreciable plant balances. Depreciation and amortization expense decreased $14.0 million in 2006 compared to 2005 primarily due to completing the recovery of certain fresh-start accounting related assets over the term of a rate stipulation in Texas Docket No. 12700 which ended in July 2005. The decrease was partially offset by increases in the depreciable plant balances, primarily related to the replacement of Palo Verde Unit 1 steam generators in December 2005.

Taxes other than income taxes

Taxes other than income taxes decreased $1.3 million in 2007 compared to 2006 primarily due to a decrease in property taxes and the change in the Texas franchise (income) tax law in 2006 which took effect in 2007. These decreases were partially offset by an increase in payroll taxes. Taxes other than income taxes increased $5.5 million in 2006 compared to 2005 primarily due to an increase in the El Paso city franchise fees which took effect in August 2005 and higher taxable revenues due to increased kWh sales and increases in fuel recoveries including fuel surcharges. We incur city franchise taxes as revenues are billed to customers.

Other income (deductions)

Other income (deductions) increased $7.7 million for the twelve months ended December 31, 2007 compared to the same period last year primarily due to (i) increased allowance for equity funds used during construction ("AEFUDC") due to the re-application of SFAS No. 71 to our Texas jurisdiction beginning December 31, 2006 and increased construction work in progress subject to AEFUDC in 2007 and (ii) increased investment and interest income due to increased interest income on larger cash and decommissioning trust fund balances.

Other income (deductions) increased $20.8 million in 2006 compared to 2005 primarily due to a decrease in the loss on extinguishment of debt of $19.6 million, resulting from the retirement of our first mortgage bonds in the second quarter of 2005.

Interest charges (credits)

Interest charges (credits) decreased $1.3 million for the twelve months ended December 31, 2007 compared to the same period last year primarily due to an increase in allowance for borrowed funds used during construction as a result of the re-application of SFAS No. 71 to our Texas jurisdiction beginning December 31, 2006 and increased construction work in progress and nuclear fuel subject to AFUDC and capitalized interest. This decrease was partially offset by a $1.2 million increase in interest related to our nuclear fuel trust and our pollution control bonds.

Interest charges (credits) decreased $3.8 million in 2006 compared to 2005 due to a $5.1 million decrease in interest on long-term debt and financing obligations resulting from (i) the repurchase and retirement of our first mortgage bonds in May 2005; (ii) the May 2005 issuance of unsecured senior notes at a lower interest rate than the first mortgage bonds; and (iii) the reissuance and remarketing of our pollution control bonds in August 2005 with lower interest rates. This decrease was partially offset by a $0.2 million reduction in allowance for borrowed funds used during construction as a result of completing construction of new Palo Verde Unit 1 steam generators in December 2005.

Income tax expense

Income tax expense, before extraordinary item and the cumulative effect of an accounting change, increased $8.4 million and $7.5 million, respectively, for the twelve months ended December 31, 2007 compared to the same period in 2006 and the twelve months ended December 31, 2006 compared to the same period in 2005, due to increases in pretax income and certain permanent tax differences. The increase in 2007 compared to 2006 was partially offset by adjustments to income tax accruals related to prior years including an adjustment to deferred taxes associated with the accrual of other post-retirement benefits. The increase in income tax expense in 2006 compared to 2005 was partially offset by a reduction in state income taxes resulting from a change in the Texas franchise (income) tax law in 2006 as discussed below.

In May 2006, legislation was approved in Texas revamping the state franchise (income) tax. The tax legislation changes the franchise tax from a tax based upon either taxable capital or taxable income to a 1% tax on taxable margins. The revised franchise tax is effective for tax payments in 2008 based upon 2007 taxable margin. Our taxable margin is based upon revenues taxable for federal income tax purposes less cost of goods sold which includes all costs of producing electricity, but does not include post-production costs. Even with the lower tax rate, the expansion of the tax base resulted in higher franchise tax expense beginning in 2007.

For accounting purposes, the revised franchise tax is an income tax subject to the requirements of SFAS No. 109, "Accounting for Income Taxes". SFAS No. 109 requires that deferred tax assets and liabilities be adjusted for changes in tax law in the period of change. As a result, we recorded a $6.2 million reduction in our net deferred tax liability in the second quarter of 2006 and a corresponding reduction in income tax expense. The adjustment to the net deferred income tax liability included: (i) a reduction of $2.7 million in net Texas deferred income tax liabilities associated with temporary differences that will not reverse in the future under the revised franchise tax calculation; (ii) a reduction of $6.8 million in net Texas deferred income tax liabilities for the change in tax rate from 4.5% to 1% effective in 2007; and (iii) an increase of $3.3 million in deferred federal income tax liabilities to reflect the change in deferred federal income taxes associated with deferred Texas franchise taxes.

Extraordinary gain

The extraordinary gain on re-application of SFAS No. 71 for 2006 relates to our determination that we met the criteria necessary to re-apply SFAS No. 71 to our Texas jurisdiction at December 31, 2006. The re-application of SFAS No. 71 to our Texas jurisdiction resulted in a $6.1 million extraordinary gain, net of tax, at December 31, 2006. For a full discussion on the re-application of SFAS No. 71 to our Texas jurisdiction, see Note A of Notes to Consolidated Financial Statements.

Cumulative effect of accounting change

The cumulative effect of accounting change for 2005 of a $1.1 million charge, net of tax, relates to the adoption of FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," ("FIN 47") in December 2005. FIN 47 provides guidance on the recognition and measurement of liabilities associated with the retirement and disposal obligations of tangible long-lived assets not already accounted for under SFAS No. 143. FIN 47 affected the accounting for the disposal obligations of our fuel oil storage tanks, water wells, evaporative ponds and asbestos at our gas-fired generating stations.

Implementation of SFAS No. 71

Regulated electric utilities typically prepare their financial statements in accordance with SFAS No. 71. Under this accounting standard, certain recoverable costs are shown as either assets or liabilities on a utility's balance sheet if the regulator provides assurance that these costs will be charged to and collected from the utility's customers (or has already permitted such cost recovery). The resulting regulatory assets or liabilities are amortized in subsequent periods based upon their respective amortization periods in a utility's cost of service.

Prior to December 31, 2006 we did not prepare our financial statements in accordance with SFAS No. 71 for our Texas jurisdiction which had been operating under a rate freeze which expired on July 31, 2005. In July 2005, we entered into agreements ("Texas Rate Agreements") with El Paso, Texas Commission Staff and other parties in Texas that provide for most retail base rates to remain at their current level through June 30, 2010. During the rate freeze period, if our return on equity falls below the bottom of a defined range, we have the right to initiate a rate case and seek an adjustment to base rates. If our return on equity exceeds the top of the range, we will refund an amount equal to 50% of the pre-tax return in excess of the ceiling. The Texas Rate Agreements required the approval of the Texas Commission to implement the fuel related provisions of the agreements including the sharing of 25% of off-system sales margins with customers through our fixed fuel factor.

On December 8, 2006, the Texas Commission issued a final order approving the fuel related provisions of the Texas Rate Agreements and extending the rate freeze and earnings sharing provisions of the agreements to all customers in Texas based upon settlements with parties to the proceeding. Based upon the Texas Rate Agreements and order of the Texas Commission extending the agreement to all customers in Texas, we determined that our Texas jurisdiction met the criteria for the re-application of SFAS No. 71 to our Texas jurisdiction as of December 31, 2006.

The re-application of SFAS No. 71 to our Texas jurisdiction recognizes that our rates are based upon our cost of providing service, and the earnings sharing provisions of the rate agreements provide for continued recovery of our costs of providing service during the rate freeze period. In addition, the adoption of a rule by the Texas Commission in October 2004 results in an indefinite delay in retail competition in our Texas service territory and the continued regulation of our retail rates by El Paso and the Texas Commission.

As a result of the re-application of SFAS No. 71 to our Texas jurisdiction at December 31, 2006, we recorded regulatory assets of $9.6 million and recognized an extraordinary gain of $6.1 million, net of tax. Regulatory assets recorded as of December 31, 2006 are currently being recovered through the Texas fixed fuel factor. Other regulatory assets and liabilities will be recorded when recognized in Texas rates. Effective with the re-application of SFAS No. 71 and in accordance with regulatory accounting requirements, we now recognize an allowance for equity and borrowed funds used during construction as a cost of construction of electric plant in service for Texas operations. The allowance for equity funds used during construction is recognized as income and the allowance for borrowed funds used during construction is shown as capitalized interest in our statement of operations. Prior to the re-application of SFAS No. 71, we capitalized interest costs in accordance with SFAS No. 34, "Capitalization of Interest Costs."

New accounting standards

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 modifies other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS No. 157 will not have a significant impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value at specified election dates without having to apply complex hedge accounting provisions. Unrealized gains and losses on items for which the fair value option has been elected should be reported in earnings at each subsequent reporting date. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. We have determined that we will continue to recognize the fair value of our financial instruments under current elections and will not change the elections for the fair value measurement of any existing financial instruments under SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" which replaces SFAS No. 141, "Business Combinations." SFAS No. 141 (revised 2007) applies the acquisition method of accounting to all transactions and other events in which one entity obtains control over one or more businesses and, therefore, improves the comparability of the information about business combinations provided in financial reports. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51." SFAS No. 160 applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 amends Accounting Research Bulletin No. 51 ("ARB No. 51") to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We currently do not own a non-controlling interest in any subsidiaries the accounting for which would be impacted by SFAS No. 160.

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

Liquidity and Capital Resources

Our principal liquidity requirements in the near-term are expected to consist of interest payments on our indebtedness, capital expenditures to expand and support electric service obligations, expenditures for nuclear fuel inventory and operating expenses including fuel costs and taxes. Cash flow from operations funded all of our capital requirements except nuclear fuel inventory for the year ended December 31, 2007 and we expect that cash flows from operations will continue to fund a significant portion of capital requirements. As of December 31, 2007, we had approximately $25.0 million in cash and short-term debt securities, a decrease of $15.1 million from the balance of $40.1 million on December 31, 2006.

Capital Requirements. Revenues from the sale of electricity include a recovery of fuel costs, which are essentially recovered from customers through fuel adjustment mechanisms in Texas and New Mexico and a portion through base rates in New Mexico. In Texas, fuel costs are recovered through a fixed fuel factor which may be adjusted twice a year. We record deferred fuel revenues for the under-recovery of fuel costs until they can be recovered from Texas customers. In September 2007, we completed the recovery in Texas of $53.6 million of fuel under-recoveries through a fuel surcharge which began in October 2005 and in January 2007 we completed the recovery in Texas of $34 million of fuel under-recoveries, including interest through the surcharge period, through a fuel surcharge which began in February 2006. The collection of $22.9 million of deferred fuel revenue through surcharges was largely offset by the under-collection of current fuel costs deferred for future recovery from our Texas customers of $22.4 million during 2007. As of December 31, 2007, we had a fuel under-recovery balance of $29.2 million from our Texas customers and an over-recovery balance of $1.5 million from our New Mexico customers. On January 8, 2008, we filed a petition ("PUC Docket No. 35204") with the Texas Commission to surcharge $30.1 million of under-recovered fuel costs and interest to our Texas customers. We anticipate beginning to collect this surcharge from our Texas customers in April 2008.

Our long-term liquidity requirements consist primarily of construction of electric utility plant and the payment of interest on debt. Capital requirements for new electric plant were $144.6 million for the year ended December 31, 2007 which were financed with cash flows from operations. Projected utility construction expenditures will consist primarily of expanding and updating the transmission and distribution systems, adding new generation, and making capital improvements and replacements at Palo Verde and other generating facilities. See Part I, Item 1, "Business – Construction Program." We expect that a significant portion of our construction expenditures will be financed with internal sources of funds through 2008 and the remainder financed with debt.

Our capital requirements for nuclear fuel increased substantially in 2007 as a result of increases in prices for uranium concentrates and increases in our inventory of nuclear fuel feedstock. We finance our nuclear fuel inventory through a trust that borrows under our $200 million credit facility to acquire and process the nuclear fuel. In 2007, borrowings under the credit facility for nuclear fuel increased $36.8 million to $83.0 million as of December 31, 2007 compared to an increase of $4.3 million in 2006 to $46.2 million as of December 31, 2006.

Our cash requirements for federal and state income taxes increased $20.6 million in 2007 as tax loss carryforwards were fully utilized in previous years. Future cash flow requirements for federal income taxes are expected to increase as the Texas fuel under-recovery balance is collected and becomes subject to income tax.

We continually evaluate our funding requirements related to our retirement plans, other postretirement benefit plans, and decommissioning trust funds. We contributed $13.6 million and $13.7 million to our retirement plans during the twelve months ended December 31, 2007 and 2006, respectively. We also contributed $3.4 million to our other postretirement benefit plan for both 2007 and 2006 and $7.0 million and $6.7 million to our decommissioning trust funds during the twelve months ended December 31, 2007 and 2006, respectively.

The Company does not pay dividends on common stock. Since 1999, we have repurchased approximately 19.3 million shares of common stock at an aggregate cost of $269.4 million, including commissions. During 2007, we repurchased 1,344,338 shares of common stock at an aggregate cost of $31.4 million. In November 2007, the Board authorized the repurchase of up to an additional 2 million shares of our outstanding common stock. No shares have been repurchased under the 2007 authorization. We financed capital requirements for common stock repurchases with cash flows from operations. We may make purchases of our stock in the future pursuant to our 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. Common stock equity as a percentage of capitalization, including the current portion of long-term debt and financing obligations, was 49.7% as of December 31, 2007.

Capital Sources. We maintain the ability to issue long-term debt, if needed, to finance capital requirements and for other corporate purposes including the repurchase of common stock. Our Senior Notes are rated "Baa2" by Moody's and "BBB" by Standard & Poors. Construction expenditures are expected to increase as we plan to add new generation capacity in 2009 and subsequent years. Due to the increased volatility in the natural gas and nuclear fuel markets, we expanded our existing credit facility in July 2007 from $150 million to $200 million and increased the maximum authorized amount of the credit facility which is available for nuclear fuel borrowings from $70 million to $120 million. We expect to initially fund most of our construction expenditures with internally generated funds and, when appropriate, borrow from our $200 million credit facility or issue long-term debt, consistent with maintaining a capital structure typical of an investment grade regulated electric utility.

Pollution Control Bonds Interest Rates. We currently have approximately $100.6 million of Pollution Control Bonds (the "PCBs") for which the interest rate is reset on a weekly "dutch auction" basis. The PCBs are insured by Financial Guaranty Insurance Company ("FGIC"). FGIC's bond ratings have recently been downgraded by all of the major rating agencies thereby calling into question FGIC's claims paying ability in the event of default by the Company. As a result, we have experienced increased yields and resulting interest expense for the PCBs. Although there has not yet been a failed auction of the PCBs, if one were to occur we would be required to pay a default interest rate of 15%. We are currently reviewing our alternatives as it relates to the PCBs and although a definitive decision has not yet been made, we may remarket or refinance the PCBs to fix the interest rates for these bonds for a yet undecided term.

Contractual Obligations. Our contractual obligations as of December 31, 2007 are as follows (in thousands):

	Payments due by period				
	Total	2008	2009 and 2010	2011 and 2012	2013 and Beyond
Long-Term Debt (including interest):					
Senior notes	$ 1,058,000	$ 24,000	$ 48,000	$ 48,000	$ 938,000
Pollution control bonds (1)	461,192	9,394	18,788	51,533	381,477
Financing Obligations (including interest):					
Nuclear fuel (2)	87,652	19,848	67,804	–	–
Purchase Obligations:					
Capacity contract with SPS (3)	241,993	11,688	23,918	24,700	181,687
Other power contracts	10,149	10,149	–	–	–
Fuel contracts:					
Coal (4)	80,360	9,440	18,881	18,881	33,158
Gas (4)	232,195	76,840	23,218	22,324	109,813
Nuclear fuel (5)	58,303	15,417	29,922	12,964	–
Retirement Plans and Other Postretirement benefits (6)	5,004	5,004	–	–	–
Decommissioning trust funds (7)	252,407	7,226	16,100	17,950	211,131
Operating leases (8)	2,025	1,069	791	136	29
Executive and administrative offices lease (9)	17,397	1,670	3,340	3,340	9,047
Total	$ 2,506,677	$ 191,745	$ 250,762	$ 199,828	$ 1,864,342

(1) Two series of pollution control bonds are remarketed and the interest rates are set weekly. The remaining two series of pollution control bonds are scheduled for remarketing and/or mandatory tender in 2012 and 2040.

(2) This reflects current obligations outstanding under the $200 million credit facility used to finance nuclear fuel including interest based on actual interest rates at the end of 2007.

(3) Amount includes $7.1 million contractual obligation for nine months in 2009. On January 29, 2008, we entered into an amendment to the original 20-year contract with SPS and agreed that the contract will terminate on September 30, 2009.

(4) Amount is based on the minimum volumes per the contract and market price at the end of 2007. Gas obligation includes a gas storage contract and a gas transportation contract.

(5) Some of the nuclear fuel contracts are based on a fixed price adjusted for an index. The index used is the current index at the end of 2007.
(6) These obligations include our minimum contractual funding requirements for the non-qualified retirement income plan and the other postretirement benefits for 2008. We have no minimum contractual funding requirement related to our retirement income plan for 2008. However, we may decide to fund at higher levels and expect to contribute $13.6 million and $3.4 million to our retirement plans and postretirement benefit plan in 2008, as disclosed in Part II, Item 8, Notes to Consolidated Financial Statements, Note K, Employee Benefits. Minimum contractual funding requirements for 2009 and beyond are not included due to the uncertainty of interest rates and the related return on assets.
(7) These obligations represent funding requirements under the ANPP Participation Agreement based on the current rate of return on investments.
(8) We lease certain warehouse facilities in El Paso, Texas under a lease which expires in December 2009 with three concurrent renewal options of one year each. We also have several other leases for office and parking facilities which expire within the next six years.
(9) In July 2007, we entered into an agreement to lease executive and administrative offices in El Paso, Texas under a lease which expires in May 2018 with three concurrent renewal options of five years each. On February 8, 2008, we exercised our right of first refusal in the lease agreement to purchase this office building. All obligations previously incurred relating to this lease were terminated.

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 7A. Quantitative and Qualitative Disclosures About Market Risk

The following discussion regarding our market-risk sensitive instruments contains forward-looking information involving risks and uncertainties. The statements regarding potential gains and losses are only estimates of what could occur in the future. Actual future results may differ materially from those estimates presented due to the characteristics of the risks and uncertainties involved.

We are exposed to market risk due to changes in interest rates, equity prices and commodity prices. Substantially all financial instruments and positions we hold are for purposes other than trading and are described below.

Interest Rate Risk

Our long-term debt obligations are all fixed-rate obligations with varying maturities, except for two of our pollution control bond series which are repriced weekly and our revolving credit facility, which provides for nuclear fuel financing and working capital and which is based on floating rates.

We have issued two series of pollution control bonds in the amounts of \$63.5 million and \$37.1 million with a variable rate that is repriced weekly until they mature in 2040. These pollution control bonds are carried on the balance sheet at their face value. At December 31, 2007, the variable interest rates were 5.35% and 4.91% for the \$63.5 million and the \$37.1 million pollution control bond series, respectively. A hypothetical 10% increase in interest rates, annualized from the December 31, 2007 rate, would cause an approximate \$0.5 million increase in interest expense. The weekly auction rate market is experiencing higher interest rates and higher rates of failure particularly in issuances such as ours which are backed by monoline insurance carriers. Although a failed auction has not yet been experienced, the default interest rates on the weekly auction rate securities we have outstanding is 15%. We are currently reviewing our alternatives as it relates to the PCBs and although a definitive decision has not yet been made, we may remarket or refinance the PCBs to fix the interest rates for these bonds for a yet undecided term.

To the extent the revolving credit facility is solely utilized for nuclear fuel purchases, interest rate risk, if any, related to the revolving credit facility is substantially mitigated through the operation of the Texas Commission and NMPRC rules which establish energy cost recovery clauses ("fuel clauses"). Under these rules and fuel clauses, energy costs, including interest expense on nuclear fuel financing, are recovered from our customers.

Our decommissioning trust funds consist of equity securities and fixed income instruments and are carried at market value. We face interest rate risk on the fixed income instruments, which consist primarily of municipal, federal and corporate bonds and which were valued at \$54.1 million and \$45.6 million as of December 31, 2007 and 2006, respectively. A hypothetical 10% increase in interest rates would reduce the fair values of these funds by \$0.7 million and \$0.7 million based on their fair values at December 31, 2007 and 2006, respectively.

Equity Price Risk

Our decommissioning trust funds include marketable equity securities of approximately \$76.6 million and \$69.1 million at December 31, 2007 and 2006, respectively. A hypothetical 20% decrease in equity prices would reduce the fair values of these funds by \$15.3 million and \$13.8 million based on their fair values at December 31, 2007 and 2006, respectively.

Commodity Price Risk

We utilize contracts of various durations for the purchase of natural gas, uranium concentrates and coal to effectively manage our available fuel portfolio. These agreements contain variable pricing provisions and are settled by physical delivery. The fuel contracts with variable pricing provisions, as well as substantially all of our purchased power requirements, are exposed to fluctuations in prices due to unpredictable factors, including weather and various other worldwide events, which impact supply and demand. However, our exposure to fuel and purchased power price risk is substantially mitigated through the operation of the Texas Commission and NMPRC rules and our fuel clauses, as discussed previously.

In the normal course of business, we enter into contracts of various durations for the forward sales and purchases of electricity to effectively manage our available generating capacity and supply needs. Such contracts include forward contracts for the sale of generating capacity and energy during periods when our available power resources are expected to exceed the requirements of our retail native load and sales for resale. They also include forward contracts for the purchase of wholesale capacity and energy during periods when the market price of electricity is below our expected incremental power production costs or to supplement our generating capacity when demand is anticipated to exceed such capacity. As of January 31, 2008, we had entered into forward sales and purchase contracts for energy as discussed in Part I, Item 1, "Business – Energy Sources – Purchased Power" and "Regulation – Power Sales Contracts." These agreements are generally fixed-priced contracts which qualify for the "normal purchases and normal sales" exception provided in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," including any effective implementation guidance discussed by the FASB Derivatives Implementation Group and are not recorded at their fair value in our financial statements. Because of the operation of the Texas Commission and NMPRC rules and our fuel clauses, these contracts do not expose us to significant commodity price risk.

Management Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and affected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and the receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, the Company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control-Integrated Framework.

Based on its assessment, management believes that, as of December 31, 2007, the Company's internal control over financial reporting is effective based on those criteria.

The Company's independent registered public accounting firm, KPMG LLP, has issued an audit report on the Company's internal control over financial reporting. This report appears on page 58 of this report.

Item 8. Financial Statements and Supplementary Data

INDEX TO FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
El Paso Electric Company:

We have audited the accompanying consolidated balance sheets of El Paso Electric Company and subsidiary as of December 31, 2007 and 2006, and the related consolidated statements of operations, comprehensive operations, changes in common stock equity, and cash flows for each of the years in the three-year period ended December 31, 2007. We also have audited El Paso Electric Company's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). El Paso Electric Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As discussed in Notes D, A, K, and H to the consolidated financial statements, the Company changed its accounting for conditional asset retirement obligations in 2005, share-based payments and defined benefit pension and other postretirement plans in 2006, and uncertainty in income taxes in 2007.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of El Paso Electric Company and subsidiary as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, El Paso Electric Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

KPMG LLP

Houston, Texas
February 28, 2008

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

ASSETS (In thousands)	December 31, 2007	December 31, 2006
Utility plant:		
Electric plant in service	$ 2,047,673	$ 1,958,787
Less accumulated depreciation and amortization	(858,426)	(799,579)
Net plant in service	1,189,247	1,159,208
Construction work in progress	185,122	134,470
Nuclear fuel; includes fuel in process of $47,256 and $8,632, respectively	113,330	66,261
Less accumulated amortization	(37,114)	(27,745)
Net nuclear fuel	76,216	38,516
Net utility plant	1,450,585	1,332,194
Current assets:		
Cash and cash equivalents	4,976	40,101
Investment in debt securities	20,000	–
Accounts receivable, principally trade, net of allowance for doubtful accounts of $2,873 and $2,999, respectively	84,578	86,730
Accumulated deferred income taxes	14,486	6,109
Inventories, at cost	34,234	31,390
Undercollection of fuel revenues	29,156	32,582
Prepayments and other	14,175	7,264
Total current assets	201,605	204,176
Deferred charges and other assets:		
Decommissioning trust funds	130,654	114,716
Regulatory assets	42,667	35,013
Other	28,377	28,555
Total deferred charges and other assets	201,698	178,284
Total assets	$ 1,853,888	$ 1,714,654

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS (Continued)

CAPITALIZATION AND LIABILITIES (In thousands)	December 31, 2007	December 31, 2006
Capitalization:		
Common stock, stated value $1 per share, 100,000,000 shares authorized, 64,400,522 and 63,909,974 shares issued, and 119,403 and 110,854 restricted shares, respectively	$ 64,520	$ 64,021
Capital in excess of stated value	292,614	283,356
Retained earnings	565,701	489,082
Accumulated other comprehensive income (loss), net of tax	13,540	(18,316)
	936,375	818,143
Treasury stock, 19,370,266 and 18,025,928 shares, respectively, at cost	(269,916)	(238,468)
Common stock equity	666,459	579,675
Long-term debt, net of current portion	590,894	590,865
Financing obligations, net of current portion	64,217	25,265
Total capitalization	1,321,570	1,195,805
Current liabilities:		
Current portion of long-term debt and financing obligations	18,798	20,975
Accounts payable, principally trade	58,013	42,892
Taxes accrued	20,500	19,323
Interest accrued	4,347	4,390
Other	24,359	23,478
Total current liabilities	126,017	111,058
Deferred credits and other liabilities:		
Accumulated deferred income taxes	183,349	149,981
Accrued postretirement benefit liability	67,385	85,435
Asset retirement obligation	79,709	73,267
Accrued pension liability	30,088	56,260
Regulatory liabilities	14,876	15,079
Other	30,894	27,769
Total deferred credits and other liabilities	406,301	407,791
Commitments and contingencies		
Total capitalization and liabilities	$ 1,853,888	$ 1,714,654

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands except for share data)

	Years Ended December 31, 2007	2006	2005
Operating revenues	$ 877,427	$ 816,455	$ 803,913
Energy expenses:			
Fuel	250,789	213,356	262,870
Purchased and interchanged power	126,833	116,989	80,040
	377,622	330,345	342,910
Operating revenues net of energy expenses	499,805	486,110	461,003
Other operating expenses:			
Other operations	195,901	191,504	178,287
Maintenance	56,974	60,044	47,338
Depreciation and amortization	69,397	68,446	82,468
Taxes other than income taxes	49,212	50,554	45,027
	371,484	370,548	353,120
Operating income	128,321	115,562	107,883
Other income (deductions):			
Allowance for equity funds used during construction	5,708	882	856
Investment and interest income, net	9,605	6,456	5,625
Loss on extinguishments of debt	–	–	(19,561)
Miscellaneous non-operating income	1,431	861	1,121
Miscellaneous non-operating deductions	(4,386)	(3,589)	(4,186)
	12,358	4,610	(16,145)
Interest charges (credits):			
Interest on long-term debt and financing obligations	36,844	35,652	40,762
Other interest	804	1,092	699
Capitalized interest	(3,235)	(3,580)	(4,306)
Allowance for borrowed funds used during construction	(2,954)	(445)	(621)
	31,459	32,719	36,534
Income before income taxes, extraordinary item and cumulative effect of accounting change	109,220	87,453	55,204
Income tax expense	34,467	26,066	18,589
Income before extraordinary item and cumulative effect of accounting change	74,753	61,387	36,615
Extraordinary gain on re-application of SFAS No. 71, net of tax	–	6,063	–
Cumulative effect of accounting change, net of tax	–	–	(1,093)
Net income	$ 74,753	$ 67,450	$ 35,522
Basic earnings (losses) per share:			
Income before extraordinary item and cumulative effect of accounting change	$ 1.64	$ 1.29	$ 0.77
Extraordinary gain on re-application of SFAS No. 71, net of tax	–	0.13	–
Cumulative effect of accounting change, net of tax	–	–	(0.02)
Net income	$ 1.64	$ 1.42	$ 0.75
Diluted earnings (losses) per share:			
Income before extraordinary item and cumulative effect of accounting change	$ 1.63	$ 1.27	$ 0.76
Extraordinary gain on re-application of SFAS No. 71, net of tax	–	0.13	–
Cumulative effect of accounting change, net of tax	–	–	(0.02)
Net income	$ 1.63	$ 1.40	$ 0.74
Weighted average number of shares outstanding	45,563,858	47,663,890	47,711,894
Weighted average number of shares and dilutive potential shares outstanding	45,928,478	48,164,067	48,307,910

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS
(In thousands)

	Years Ended December 31,		
	2007	2006	2005
Net income	$ 74,753	$ 67,450	$ 35,522
Other comprehensive income (loss):			
Unrecognized pension and postretirement benefit costs:			
Net gain arising during period	40,625	–	–
Reclassification adjustments included in net income for amortization of:			
Prior service cost	(2,754)	–	–
Net loss	3,385	–	–
Minimum pension liability adjustment	–	16,923	(6,128)
Net unrealized gains (losses) on marketable securities:			
Net holding gains (losses) arising during period	5,835	8,805	(1,693)
Reclassification adjustments for net (gains) losses included in net income	(1,683)	661	(666)
Net gains (losses) on cash flow hedges:			
Gains (losses) arising during period	–	–	(22,439)
Reclassification adjustment for interest expense included in net income	278	263	143
Total other comprehensive income (loss) before income taxes	45,686	26,652	(30,783)
Income tax benefit (expense) related to items of other comprehensive income (loss):			
Unrecognized pension and postretirement benefit costs	(18,037)	–	–
Minimum pension liability adjustment	–	(6,348)	2,299
Net unrealized gains (losses) on marketable securities	(830)	(1,893)	472
Gains (losses) on cash flow hedges	(104)	(99)	8,398
Total income tax benefit (expense)	(18,971)	(8,340)	11,169
Other comprehensive income (loss), net of tax	26,715	18,312	(19,614)
Comprehensive income	$ 101,468	$ 85,762	$ 15,908

See accompanying notes to consolidated financial statements.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN COMMON STOCK EQUITY
(In thousands except for share data)

	Common Stock Shares	Common Stock Amount	Capital in Excess of Stated Value	Deferred and Unearned Compensation	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Treasury Stock Shares	Treasury Stock Amount	Total Common Stock Equity
Balances at December 31, 2004	62,768,180	$ 62,768	$ 268,771	$ 1,127	$ 386,110	$ (10,553)	15,365,108	$ (176,076)	$ 532,147
Grants of restricted common stock	104,907	105	1,870	(1,975)					–
Deferred compensation-restricted stock and performance shares				2,926					2,926
Stock awards withheld for taxes	(7,907)	(8)	(144)						(152)
Forfeitures of restricted common stock	(4,251)	(4)	(68)	72					–
Deferred taxes on stock incentive plan			170						170
Stock options exercised	646,500	646	4,794						5,440
Net income					35,522				35,522
Other comprehensive loss						(19,614)			(19,614)
Balances at December 31, 2005	63,507,429	63,507	275,393	2,150	421,632	(30,167)	15,365,108	(176,076)	556,439
Reclassification adjustment upon adoption of SFAS No. 123r			2,150	(2,150)					–
Restricted common stock grants and deferred compensation	77,054	77	1,317						1,394
Performance share awards	68,425	69	1,371						1,440
Stock awards withheld for taxes	(28,640)	(29)	(573)						(602)
Deferred taxes on stock incentive plan			955						955
Stock options exercised	396,560	397	2,743						3,140
Net income					67,450				67,450
Other comprehensive income						18,312			18,312
SFAS No. 158 adoption, net of tax of $3,879						(6,461)			(6,461)
Treasury stock acquired, at cost							2,660,820	(62,392)	(62,392)
Balances at December 31, 2006	64,020,828	64,021	283,356	–	489,082	(18,316)	18,025,928	(238,468)	579,675
Restricted common stock grants and deferred compensation	109,318	109	1,348						1,457
Performance share awards	58,650	59	660						719
Stock awards withheld for taxes	(28,492)	(28)	(669)						(697)
Forfeitures and lapsed restricted common stock	(24,379)	(25)	(4)						(29)
Deferred taxes on stock incentive plan			3,992						3,992
Stock options exercised	384,000	384	3,931						4,315
Net income					74,753				74,753
FIN 48 adoption					1,866				1,866
Other comprehensive income						26,715			26,715
Adjustment for tax effect of SFAS No. 158						5,141			5,141
Treasury stock acquired, at cost							1,344,338	(31,448)	(31,448)
Balances at December 31, 2007	64,519,925	$ 64,520	$ 292,614	$ –	$ 565,701	$ 13,540	19,370,266	$ (269,916)	$ 666,459

See accompanying notes to consolidated financial statements.

0082

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended December 31,		
	2007	2006	2005
Cash Flows From Operating Activities:			
Net income	$ 74,753	$ 67,450	$ 35,522
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of electric plant in service	69,397	68,446	82,468
Amortization of nuclear fuel	18,166	15,387	15,575
Extraordinary gain on the re-application of SFAS No. 71, net of tax	–	(6,063)	–
Cumulative effect of accounting change, net of tax	–	–	1,093
Deferred income taxes, net	10,392	19,751	25,286
Allowance for equity funds used during construction	(5,708)	(882)	(856)
Loss on extinguishments of debt	–	–	19,561
Other amortization and accretion	12,173	12,945	11,961
Gain on sale of assets	(195)	(766)	(422)
Other operating activities	(561)	(941)	(110)
Change in:			
Accounts receivable	2,152	(10,724)	(5,296)
Inventories	(3,438)	(2,792)	(758)
Net recovery (deferral) of fuel revenues	4,886	59,749	(73,549)
Prepayments and other	(1,177)	(8,676)	(1,765)
Accounts payable	12,508	(3,858)	13,513
Taxes accrued	4,204	3,781	456
Interest accrued	(43)	(94)	(9,125)
Other current liabilities	(513)	720	(715)
Deferred charges and credits	(14,686)	4,565	(6,249)
Net cash provided by operating activities	182,310	217,998	106,590
Cash Flows From Investing Activities:			
Cash additions to utility property, plant and equipment	(144,588)	(103,182)	(88,263)
Cash additions to nuclear fuel	(52,400)	(17,602)	(15,888)
Proceeds from sale of assets	5,305	992	1,992
Capitalized interest and AFUDC:			
Utility property, plant and equipment	(8,662)	(4,238)	(5,330)
Nuclear fuel	(3,235)	(669)	(453)
Allowance for equity funds used during construction	5,708	882	856
Decommissioning trust funds:			
Purchases, including funding of $7.0 million, $6.7 million and $6.2 million, respectively	(116,165)	(106,403)	(42,381)
Sales and maturities	105,201	98,085	33,451
Purchases of debt securities	(20,000)	–	–
Other investing activities	192	867	(1,671)
Net cash used for investing activities	(228,644)	(131,268)	(117,687)
Cash Flows From Financing Activities:			
Proceeds from exercise of stock options	4,315	3,140	5,440
Acquisition of treasury stock	(31,448)	(62,392)	–
Settlement on derivative instruments classified as cash flow hedges	–	–	(22,439)
Proceeds from issuance of long-term notes payable	–	–	397,688
Repurchases of and payments on first mortgage bonds	–	–	(381,847)
Pollution control bonds:			
Proceeds	–	–	193,135
Payments	–	–	(193,135)
Financing obligations:			
Proceeds	56,083	20,373	18,138
Payments	(19,308)	(16,040)	(17,427)
Excess tax benefits from long-term incentive plans	2,395	1,417	–
Other financing activities	(828)	(1,083)	(9,901)
Net cash provided by (used for) financing activities	11,209	(54,585)	(10,348)
Net increase (decrease) in cash and temporary investments	(35,125)	32,145	(21,445)
Cash and temporary investments at beginning of period	40,101	7,956	29,401
Cash and temporary investments at end of period	$ 4,976	$ 40,101	$ 7,956

See accompanying notes to consolidated financial statements.

INDEX TO NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. Summary of Significant Accounting Policies

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

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

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

Basis of Presentation. The Company maintains its accounts in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (the "FERC").

Application of SFAS No. 71. Regulated electric utilities typically prepare their financial statements in accordance with SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." Under this accounting standard, certain recoverable costs are shown as either assets or liabilities on a utility's balance sheet if the regulator provides assurance that these costs will be charged to and collected from the utility's customers (or has already permitted such cost recovery). The resulting regulatory assets or liabilities are amortized in subsequent periods based upon their respective amortization periods in a utility's cost of service. Prior to December 31, 2006, the Company did not apply SFAS No. 71 to the Company's Texas jurisdictional operations. The Company's Texas jurisdiction had been operating under a rate freeze which expired on July 31, 2005. In July 2005, the Company entered into agreements ("Texas Rate Agreements") with El Paso, Texas Commission Staff and other parties in Texas that provide 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 falls below the bottom of a defined range, the Company has the right to initiate a rate case and seek an adjustment to base rates. If the Company's return on equity exceeds the top of the range, the Company will refund an amount equal to 50% of the pre-tax return in excess of the ceiling. The Texas Rate Agreements required the approval of the Texas Commission to implement the fuel related provisions of the agreements including the sharing of 25% of off-system sales margins with customers through the Company's fixed fuel factor. On December 8, 2006, the Texas Commission issued a final order approving the fuel related provisions of the Texas Rate Agreements and extending the rate freeze and earnings sharing provisions of the agreements to all customers in Texas based upon settlements with parties to the proceeding. Based upon the Texas Rate Agreements and order of the Texas Commission extending the agreements to all customers in Texas, the Company determined that the Company's Texas jurisdiction meets the criteria for the re-application of SFAS No. 71 to the Company's Texas jurisdiction as of December 31, 2006.

The re-application of SFAS No. 71 to the Company's Texas jurisdiction recognizes that the Company's rates are based upon the Company's cost of providing service, and the margin sharing provisions of the rate agreements provide for continued recovery of the Company's costs of providing service during the rate freeze period. In addition, the adoption of a rule by the Texas Commission in October 2004 results in an indefinite delay in retail competition in the Company's Texas service territory and the continued regulation of the Company's retail rates by El Paso and the Texas Commission.

As a result of the re-application of SFAS No. 71 to the Company's Texas jurisdiction at December 31, 2006, the Company recorded regulatory assets of $9.6 million, related accumulated deferred income tax liability of $3.5 million, and recognized an extraordinary gain of $6.1 million, net of tax. Regulatory assets recorded as of December 31, 2006 are currently being recovered through the Texas fixed fuel factor. Other regulatory assets and liabilities will be recorded when recognized in Texas rates. Effective with the re-application of SFAS No. 71 and in accordance with regulatory accounting requirements, the Company includes an allowance for equity and borrowed funds used during construction as a cost of construction of electric plant in service. The allowance for equity funds used during construction is recognized as income and the allowance for borrowed funds used during construction is shown as capitalized interest charges in the Company's statement of operations. Prior to the re-application of SFAS No. 71, the Company capitalized interest costs in accordance with SFAS No. 34, "Capitalization of Interest Costs."

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

Utility Plant. Depreciation is provided on a straight-line basis over the estimated remaining lives of the assets (ranging from 3 to 31 years), except for approximately $298 million of reorganization value allocated primarily to net transmission, distribution and general plant in service. This amount was depreciated on a straight-line basis over a ten-year period which ended in July 2005. For all other utility plant, Texas and New Mexico depreciation lives are the same.

The Company charges the cost of repairs and minor replacements to the appropriate operating expense accounts and capitalizes the cost of renewals and betterments. When property subject to composite depreciation is retired or otherwise disposed of in the normal course of business, its original cost – together with the cost of removal, less salvage – is charged to accumulated depreciation. For other property dispositions, the applicable cost and accumulated depreciation is removed from the balance sheet accounts and a gain or loss is recognized.

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

Impairment of Long-Lived Assets. In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," long-lived assets, such as property, plant, and equipment and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset.

AFUDC and Capitalized Interest. The Company capitalizes interest (ABFUDC) and common equity (AEFUDC) costs to construction work in progress and nuclear fuel in process in accordance with the FERC Uniform System of Accounts as provided for in SFAS No. 71. AFUDC is a non-cash component of income and is calculated monthly and charged to all new eligible construction and capital improvement projects. The AFUDC rate utilized in 2007 was 8.43%. Prior to December 31, 2006, the Company capitalized interest cost to construction work in progress and nuclear fuel in process in accordance with SFAS No. 34, "Capitalization of Interest Cost" for its Texas jurisdictional operations. The AFUDC rates applied for the New Mexico jurisdiction for 2006 and 2005 were 8.73% and 10.20%, respectively.

Asset Retirement Obligation. The Company complies with SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 sets forth accounting requirements for the recognition and measurement of liabilities associated with the retirement of tangible long-lived assets. An asset retirement obligation ("ARO") associated with long-lived assets included within the scope of SFAS No. 143 is that for which a legal obligation exists under enacted laws, statutes, written or oral contracts, including obligations arising under the doctrine of promissory estoppel. Under the statement, these liabilities are recognized as incurred if a reasonable estimate of fair value can be established and are capitalized as part of the cost of the related tangible long-lived assets. The Company records the increase in the ARO due to the passage of time as an operating expense (accretion expense). Effective December 31, 2005, the Company adopted FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," ("FIN 47"). FIN 47 clarifies that the term "conditional" as used in SFAS

No. 143, refers to a legal obligation to perform an asset retirement activity even if the timing and/or settlement are conditional on a future event that may or may not be within the control of an entity. See Note D.

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

Investment in Debt Securities. The Company has invested excess cash for short periods of time in auction rate securities with contract maturity dates that extend beyond three months. These securities provide for interest rates to be reset on a short-term basis which typically provides a liquid market to sell the securities to meet cash requirements. The Company classifies the investments in auction rate securities in current assets as investment in debt securities in the consolidated balance sheets.

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

Derivative Accounting. The Company complies with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," including any effective implementation guidance discussed by the FASB Derivatives Implementation Group. This standard requires the recognition of derivatives as either assets or liabilities in the balance sheet with measurement of those instruments at fair value. Any changes in the fair value of these instruments are recorded in earnings or other comprehensive income. See Note M.

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

Operating Revenues Net of Energy Expenses. The Company accrues revenues for services rendered, including unbilled electric service revenues. Energy expenses are stated at actual cost incurred. The Company's Texas retail customers are presently being billed under a fixed fuel factor approved by the Public Utility Commission of Texas ("Texas Commission"). The Company's New Mexico retail customers are being billed under base rates and a fuel adjustment clause which is adjusted monthly, as approved by the New Mexico Public Regulation Commission ("NMPRC"). The

Company's recovery of energy expenses in these jurisdictions is subject to periodic reconciliations of actual energy expenses incurred to actual fuel revenues collected. The difference between energy expenses incurred and fuel revenues charged to the Company's Texas and New Mexico customers, as determined under Texas Commission and NMPRC rules, is reflected as over/undercollection of fuel revenues in the consolidated balance sheets. See Note B.

Revenues. Accounts receivable include accrued unbilled revenues of $17.9 million and $18.0 million at December 31, 2007 and 2006, respectively. The Company presents sales net of sales taxes in its consolidated statements of operations.

Allowance for Doubtful Accounts. Additions, deductions and balances for allowance for doubtful accounts for 2007, 2006 and 2005 are as follows (in thousands):

	2007	2006	2005
Balance at beginning of year	$ 2,999	$ 2,474	$ 3,071
Additions:			
Charged to costs and expense	2,875	3,454	2,527
Recovery of previous write-offs	1,152	1,062	1,195
Uncollectible receivables written off	4,153	3,991	4,319
Balance at end of year	$ 2,873	$ 2,999	$ 2,474

Income Taxes. The Company accounts for federal and state income taxes under the asset and liability method of accounting for income taxes under the provisions of SFAS No. 109, Accounting for Income Taxes ("SFAS No. 109"). Under this method, deferred income taxes are recognized for the estimated future tax consequences of "temporary differences" by applying enacted statutory tax rates for each taxable jurisdiction applicable to future years to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the enactment date. The Company recognizes tax assets and liabilities for uncertain tax positions in accordance with the recognition and measurement criteria of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"). A tax liability has been established to recognize interest and penalties on tax benefits that have not been recognized. See Note H.

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

Stock-Based Compensation. The Company has a stock-based long-term incentive plan. Effective January 1, 2006, the Company adopted SFAS No. 123 (revised) "Accounting for Stock – Based

Compensation," which requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with some limited exceptions). Such cost will be recognized over the period during which an employee is required to provide service in exchange for the award (the "requisite service period") which typically will be the vesting period. Compensation cost is not recognized for anticipated forfeitures prior to vesting of equity instruments. SFAS No. 123 (revised) applies to all awards granted after January 1, 2006 and to awards modified, repurchased or cancelled after that date. Additionally, compensation cost for outstanding awards for which the requisite service has not been rendered as of January 1, 2006 shall be expensed as the requisite service is rendered on or after such date. The compensation cost for that portion of awards shall be based on the grant-date fair value of those awards as calculated for pro forma disclosure under SFAS No. 123. SFAS No. 123 (revised) replaces SFAS No. 123, "Accounting for Stock – Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. See Note E.

If compensation expense for the incentive plans had been amortized on a straight-line basis over the vesting period, consistent with the provisions of SFAS No. 123 (revised), the Company's net earnings and earnings per share for 2005 would have been reduced to the proforma amounts presented below (in thousands, except for per share data):

	Years Ended December 31, 2005
Net income, as reported	$ 35,522
Deduct: Compensation expense, net of tax	806
Pro forma net income	$ 34,716
Basic earnings per share:	
As reported	$ 0.75
Pro forma	0.73
Diluted earnings per share:	
As reported	0.74
Pro forma	0.72

Prior to the adoption of SFAS No. 123 (revised), the Company presented all tax benefits for deductions resulting from the exercise of share-based compensation as operating cash flows in the Condensed Consolidated Statement of Cash Flows. SFAS No. 123 (revised) requires the benefits of tax deductions in excess of the taxes expensed on recognized compensation cost to be reported as financing cash flows.

Other New Accounting Standards. In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 modifies other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS No. 157 will not have a significant impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value at specified election dates without having to apply complex hedge accounting provisions. Unrealized gains and losses on items for which the fair value option has been elected should be reported in earnings at each subsequent reporting date. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company has determined that it will continue to recognize the fair value of its financial instruments under current elections and will not change the elections for the fair value measurement of any existing financial instruments under SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" which replaces SFAS No. 141, "Business Combinations." SFAS No. 141 (revised 2007) applies the acquisition method of accounting to all transactions and other events in which one entity obtains control over one or more businesses and, therefore, improves the comparability of the information about business combinations provided in financial reports. This statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51." SFAS No. 160 applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. SFAS No. 160 amends Accounting Research Bulletin No. 51 ("ARB No. 51") to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company currently does not own a non-controlling interest in any subsidiaries the accounting for which would be impacted by SFAS No. 160.

Pension and Postretirement Benefit Accounting. For a full discussion of the Company's accounting policies for its employee benefits. See Note K.

Reclassification. Certain amounts in the consolidated financial statements for 2006 and 2005 have been reclassified to conform with the 2007 presentation.

B. Regulation

General

The rates and services of the Company are regulated by incorporated municipalities in Texas, the Texas Commission, the NMPRC, and the FERC. The Texas Commission 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. The decisions of the Texas Commission, NMPRC and the FERC are subject to judicial review.

Texas Regulatory Matters

Texas Rate Agreements. The Company has entered into agreements ("Texas Rate Agreements") with El Paso, Commission Staff and other parties in Texas that provide 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 falls below the bottom of a defined range, the Company has the right to initiate a rate case and seek an adjustment to base rates. If the Company's return on equity exceeds the top of the range, the Company will refund an amount equal to 50% of the pretax return in excess of the ceiling. The range is based upon a risk premium above a twelve month average of comparable credit quality bond yields, and at a twelve month average of such bond yields the range would be approximately 8.3% to 12.3%. During 2007 the Company's return on equity fell within this range.

Pursuant to a rate agreement with El Paso in July 2005, the Company agreed to share with its Texas customers 25% of off-system sales margins and wheeling revenues among other provisions. Under the prior rate agreement, the Company shared 50% of off-system sales margins and wheeling revenues with Texas customers. A request for approval of the off-system sales and wheeling revenue sharing provision was filed with the Texas Commission in January 2006 ("PUC Docket No. 32289").

In PUC Docket No. 32289, the Company entered into settlement agreements with the Texas Commission Staff, a large industrial customer, El Paso, Texas Ratepayers Organization to Save Energy, and the Office of the Attorney General of the State of Texas (the "State") which (i) extended the rate freeze to all customers in Texas; (ii) extended the earnings sharing provisions to all customers in Texas; (iii) expanded the Company's support of low-income energy efficiency programs; and (iv) provided that after the expiration of the Texas Rate Agreements, the Company will treat wheeling revenues and expenses associated with non-native load in a manner consistent with then-existing Texas Commission rules and other substantive and procedural law. In addition, the agreement with the State provides for the Company to share 90% of off-system sales margins with customers after June 30, 2010 through June 30, 2015. This provision is not binding on the Texas Commission or other settling parties. In addition, the Company agreed that upon the expiration of the rate freeze, it would file a full base rate case with the Texas Commission and the applicable cities having original jurisdiction if requested to do so by the Texas Commission staff, El Paso, the State or the Texas Office of Public Utility Counsel. The

Company also retained the right to voluntarily file a full base rate case. On December 8, 2006, the Texas Commission approved the margin sharing provisions of the Texas Rate Agreements in PUC Docket No. 32289 pursuant to the settlement agreements.

Fuel and Purchased Power Costs. Although the Company's base rates are frozen under the Texas Rate Agreements, pursuant to Texas Commission rules and the Texas Rate Agreements, the Company's fuel costs including purchased power energy costs are recoverable from its customers. In January and July of each year, the Company can request adjustments to its fixed fuel factor to more accurately reflect projected energy costs associated with providing electricity, seek recovery of past undercollections of fuel revenues, and refund past overcollections of fuel revenues. All such fuel revenue and expense activities are subject to periodic final review by the Texas Commission in fuel reconciliation proceedings.

On August 31, 2007, the Company filed for authority to reconcile its eligible fuel expenses and revenues for the period of March 1, 2004 through February 28, 2007 ("Reconciliation Period"), which was assigned PUC Docket No. 34695. The Company is seeking to reconcile a total of $548.4 million in eligible fuel, fuel-related, and purchased power expenses to generate and purchase electric energy for its Texas retail customers. At the conclusion of the Reconciliation Period, the Company had a cumulative under-recovery of such expenses of $18.2 million of which $17.6 million was subject to an existing fuel surcharge. The Company is seeking to carry over the cumulative Reconciliation Period fuel under-recovery balance into the subsequent reconciliation period beginning March 2007. Hearings on the fuel reconciliation are scheduled in May 2008. A final order is not expected to be issued until the third quarter of 2008.

On January 8, 2008, the Company filed a request with the Texas Commission to surcharge approximately $30.1 million of under-recovered fuel and purchased power costs and interest over a twelve month period beginning in March 2008. The fuel under-recoveries were incurred during the period December 2005 through November 2007. A decision from the Texas Commission is expected in the first quarter of 2008.

On January 5, 2006, the Company filed a petition ("PUC Docket No. 32240") with the Texas Commission to increase its fixed fuel factors and to surcharge under-recovered fuel costs. The Company requested an increase in its Texas jurisdiction fixed fuel factors of $30.8 million or 16% annually to reflect an average cost of natural gas of $9.35 per MMBtu. The Company also requested a fuel surcharge to recover over a twelve-month period approximately $34 million of fuel undercollections, including interest, for under-recoveries for the period September 2005 through November 2005. The requested fuel factor and fuel surcharge were placed into effect on an interim basis subject to refund effective with February 2006 bills to customers. This proceeding was abated pending the Texas Commission's decision in the margin sharing proceeding, PUC Docket No. 32289, which was approved December 8, 2006. The Company filed a unanimous settlement with the Texas Commission to resolve all issues in this docket on January 24, 2007. The settlement provided for approval of the fuel surcharge and fuel factor for the period February 2006 through January 2007, the end of the surcharge period. In addition, the Company agreed to reduce its fixed fuel factors by 10% effective February 1, 2007 reducing annual fuel recoveries by approximately $20.0 million per year. The revised fixed fuel factors reflect natural gas prices of approximately $7.80 per MMBtu. A final order approving the settlement in PUC Docket No. 32240 was issued by the Texas Commission on March 15, 2007.

Generation CCN Filing. On July 6, 2007, the Company filed a petition with the Texas Commission requesting a Certificate of Convenience and Necessity ("CCN") for two generating facilities in PUC Docket No. 34494. The first such facility is a natural-gas fueled power generating unit to be located at an existing plant site in El Paso. This facility is known as Newman Unit 5. The Newman Unit 5 project consists of 280 to 290 MW of natural gas-fired combined cycle generating capacity that the Company presently plans to construct in two phases. The first phase includes two 70 MW gas turbines to be installed by the peak of 2009. The second phase converts the unit into a combined cycle combustion turbine with a total capacity of 280 to 290 MW and is expected to be completed by late 2010 or early 2011.

The Newman Unit 5 will operate mostly in a baseload manner, but can also be used in a load following manner. It will be the most efficient gas-fired unit on the Company's system when operated in combined cycle.

The Company also requested a CCN for two renewable energy wind turbines currently operating at the Hueco Mountains Wind Ranch, the acquisition of which the Texas Commission had previously found to be consistent with the public interest.

On December 17, 2007, the parties to PUC Docket No. 34494 filed a Stipulation, signed by all parties, which recommended approval of the Company's requests. On January 31, 2008, the Texas Commission issued an order approving the requested CCNs. The costs of the project have not been approved.

Palo Verde Performance Standards. The Texas Commission established performance standards for the operation of Palo Verde pursuant to which each Palo Verde unit is evaluated annually to determine whether its three-year rolling average capacity factor entitles the Company to a reward or subjects it to a penalty. The capacity factor is calculated as the ratio of actual generation to maximum possible generation. If the capacity factor, as measured on a station-wide basis for any consecutive 36-month period, should fall below 52.5%, the parties to the Texas Rate Agreements can seek different rate treatment for Palo Verde. The removal of Palo Verde from rate base could have a significant negative impact on the Company's revenues and financial condition. The Company has calculated the performance rewards for the reporting periods ending in 2007 and 2006 to be approximately $0.6 million and $0.4 million, respectively. The 2006 reward was included along with energy costs incurred and fuel revenue billed as part of the Texas Commission's review during the 2007 fuel reconciliation proceeding as discussed above. Under the performance standards the Company did not earn a performance reward nor incur a penalty for the 2005 reporting period. Performance rewards are not recorded on the Company's books until the Texas Commission has ordered a final determination in a fuel proceeding or comparable evidence of collectibility is obtained. Performance penalties would be recorded when assessed as probable by the Company.

In a prior fuel reconciliation proceeding ("PUC Docket No. 20450"), the Company agreed to contribute any Palo Verde rewards in its next fuel reconciliation to assist low-income customers in paying their utility bills. In compliance with the Texas Commission's order, the Company sought and received approval by the El Paso City Council in January 2006 to remit to El Paso approximately \$5.8 million in Palo Verde performance reward funds to fund demand side management programs such as weatherization with a focus on programs to assist small business and commercial customers. As of December 31, 2007 \$5.6 million, including accrued interest, remains to be paid under these agreements and is recorded as a liability on the Company's balance sheet.

Deregulation. The Texas Restructuring Law required certain investor-owned electric utilities to separate power generation activities and retail service activities from transmission and distribution activities by January 1, 2002, and on that date, retail competition for generation services was instituted in some parts of Texas. However, the Texas Commission has delayed retail competition in the Company's Texas service territory by approving a rule which identifies various milestones for the Company to reach before competition can begin. The first milestone calls for the development, approval by the FERC, and commencement of independent operation of a regional transmission organization (RTO) in the area that includes the Company's service territory, including the development of retail market protocols to facilitate retail competition (see "FERC Regulatory Matters – RTO" below). The complete transition to retail competition would occur upon the completion of the last milestone, which would be the Texas Commission's final evaluation of the market's readiness to offer fair competition and reliable service to all retail customers. The Company believes this rule delays retail competition in El Paso indefinitely. There is substantial uncertainty about both the regulatory framework and market conditions that will exist if and when retail competition is implemented in the Company's service territory, and the Company may incur substantial preparatory, restructuring and other costs that may not ultimately be recoverable. There can be no assurance that deregulation would not adversely affect the future operations, cash flows and financial condition of the Company.

Renewable Energy Requirements. Notwithstanding the Texas Commission's approval of a rule further delaying competition in the Company's Texas service territory, the Company became subject to the renewable energy and energy efficiency requirements of the Texas Restructuring Law on January 1, 2006. Under the renewable energy requirements, the Company is required to annually obtain its pro rata share of renewable energy credits as determined by the Program Administrator (the Electric Reliability Council of Texas). The Company's ultimate obligation to obtain renewable energy credits will not be known until January 31 of the year following the compliance year, and it will have until March 31 to obtain, if necessary, and submit to the Program Administrator, sufficient credits. The Company obtained the required renewable energy credits to meet its expected obligations through 2007.

2007 Energy Efficiency Legislation. New energy efficiency legislation was approved in Texas in June 2007. The new legislation establishes new and increased goals for additional cost-effective energy efficiency for residential and commercial customers equivalent to at least (i) 10% of the annual growth in peak demand for residential and commercial customers by December 31, 2007; (ii) 15% of the annual growth in demand by December 31, 2008; and (iii) 20% of the annual growth in demand by December 31, 2009. Among other things, the new legislation requires the Texas Commission to establish an energy efficiency cost recovery factor for ensuring cost recovery for utility expenditures made to satisfy the energy efficiency goal. The legislation provides that utilities that are unable to establish an energy efficiency cost recovery factor in a timely manner due to a rate freeze will be allowed to defer the costs of complying with the energy efficiency goal and recover such deferred costs at the end of the rate freeze period.

New Mexico Regulatory Matters

2007 New Mexico Stipulation. On July 3, 2007, the NMPRC issued a final order approving a stipulation ("2007 New Mexico Stipulation") addressing all issues in the 2006 rate filing in Case No. 06-00258-UT. On July 26, 2007, the NMPRC modified its final order to clarify that its approval of the Stipulation did not preclude the NMPRC from examining the Company's rates upon its own motion at any time prior to the date stipulated for the Company's next rate filing. The 2007 New Mexico Stipulation provides for a $5.8 million non-fuel base rate increase and a $0.3 million fuel and purchased power decrease relative to test year rates. The 2007 New Mexico Stipulation reflects average natural gas costs of $7.20 per MMBtu for the June 2007 through May 2008 forecast period. Most of the Company's fuel and purchased power costs during the period of the 2007 New Mexico Stipulation are expected to be recovered through base rates. Any difference between actual fuel and purchased power costs and the amount included in base rates will be recovered or refunded through the Fuel and Purchased Power Cost Adjustment Clause ("FPPCAC"). Rates will continue in effect until changed by the NMPRC after the Company's next rate case. The 2007 New Mexico Stipulation requires the Company to file its next general rate case no later than May 30, 2009 using a base period of the twelve months ending December 31, 2008. Under NMPRC statutes, new rates would become effective no later than June 2010.

The 2007 New Mexico Stipulation provides for energy from the deregulated Palo Verde Unit 3 to be recovered through fuel and purchased power costs based upon the contract cost of capacity and fuel for power purchased under the existing SPS purchased power contract. The 2007 New Mexico Stipulation eliminates the fixed fuel and purchased power cost of $0.021 per kWh for 10% of New Mexico kWh sales and requires 25% of jurisdictional off-system sales margins to be credited to customers through the FPPCAC. Consistent with the Texas settlement in PUC Docket No. 32289, beginning in July 2010 through June 2015, the Company will credit 90% of the New Mexico jurisdictional portion of off-system sales margins to New Mexico customers through the FPPCAC. No later than two years after implementation, the 2007 New Mexico Stipulation requires the Company to file to continue its FPPCAC according to NMPRC rules, at which time any party may propose to change the price of capacity and related energy from Palo Verde Unit 3 since the SPS purchased power contract will terminate in September 2009. The 2007 New Mexico Stipulation results in final reconciliation of fuel and purchased power costs for the period May 31, 2004 through December 31, 2005. The Company will continue to file annual reconciliation statements for fuel and purchased power costs in accordance with NMPRC rules. The Company filed a reconciliation statement for the period June 1, 2006 through May 31, 2007 on August 31, 2007.

Fuel and Purchased Power Costs. The Company currently recovers fuel and purchased power costs in base rates in an average amount of $0.04288 per kWh and recovers the remaining fuel and purchased power costs through its FPPCAC. See discussion of 2007 New Mexico Stipulation above.

Notice of Investigation of Rates. On August 3, 2007, the Company received by mail a "Notice of Investigation of Rates of El Paso Electric Company" from the NMPRC in Case No. 07-00317-UT (the "Notice"). On August 21, 2007, the NMPRC requested the Company to file a response to the issues, including the reasonableness of fuel and purchased power costs. On September 7, 2007, the Company filed its response and requested that the NMPRC suspend its investigation and close the docket. No further action has been taken by the Commission. The Company is unable at this time to predict any potential negative financial impact from this docket.

Renewables. The New Mexico Renewable Energy Act of 2004 as amended by the 2007 New Mexico legislature requires that, by January 1, 2006, renewable energy comprise no less than 5% of the Company's total retail sales to New Mexico customers. This requirement has been fixed at 6% until January 1, 2011, when the renewable portfolio standard increases to 10% of the Company's total retail sales to New Mexico customers. After 2011, the renewable portfolio standard, as a percentage of total retail sales to New Mexico customers, increases to 15% by 2015 and 20% by 2020. The Company has met all requirements to date.

The NMPRC approved the Company's 2006 annual procurement plan ("Procurement Plan") in December 2006, including the purchase of renewable energy certificates ("RECs") and the issuance of a diversity RFP for renewable resources to meet future requirements. In addition, the NMPRC authorized the Company to enter into two 20-year purchased power agreements to purchase energy from an 8 MW low-emissions biomass generating facility and from a 6 kW solar energy generating facility. Both generating facilities would have been located within the Company's New Mexico service area. The biomass renewable supplier defaulted on its contract obligations. In the Order approving the 2006 Plan, the NMPRC approved recovery of REC costs, without associated energy, through the FPPCAC. The NMPRC's decision to allow recovery of REC costs, without associated energy, through the FPPCAC was appealed to the New Mexico Supreme Court (the "Court") by the New Mexico Industrial Energy Consumers. The Court issued a decision on August 28, 2007, ordering that RECs without associated energy could not be recovered through the FPPCAC, but the costs would be recovered through the ratemaking process. The Company filed a request to create a deferral as provided under New Mexico law, with carrying costs, to recover these costs and refunded to customers the previously-collected REC costs recovered through the FPPCAC. NMPRC action to approve the deferral, with carrying costs, is pending.

The Company filed its 2007 annual Procurement Plan on August 31, 2007. The Company has proposed procurement of Texas RECs to complete its 2008 and 2009 renewable obligations. The Company also requested funding to conduct a proposal process in 2008 to attempt to procure diverse renewable energy resources to meet NMPRC requirements. The Company is seeking a deferral of the costs associated with renewable compliance, including carrying costs. Hearings were held on November 29, 2007. The Hearing Examiner issued the Recommended Decision on December 5, 2007 recommending that the Company's request to replace the biomass project with Texas RECs be rejected and that the Company include a plan to replace these RECs with New Mexico RECs in its next procurement plan filing. The Company filed exceptions to the Recommended Decision on December 14, 2007. A NMPRC order adopting the Recommended Decision was issued on February 27, 2008.

New Mexico Energy Efficiency Plan Filing. On November 5, 2007, the Company filed its Application for Approval of Energy Efficiency and Load Management Programs. This case has been designated as NMPRC Case No. 07-00411-UT. In this filing, the Company requests approval of a number of energy efficiency programs. The Company also proposed a methodology to address disincentives and barriers to utility-provided energy efficiency and proposed to recover the costs of energy efficiency programs through a cost recovery factor. The hearing is scheduled to begin March 19, 2008. The final order is expected in June 2008.

New Mexico Energy Efficiency Legislation. On February 12, 2008, the New Mexico legislature passed House Bill 305, the Utility Customer Load Management bill. This bill modifies the 2005 Efficient Use of Energy Act and requires that electric utilities provide cost-effective energy efficiency programs that will produce savings of 5% of 2005 total retail kWh sales to New Mexico customers in calendar year 2014 and 10% of 2005 retail kWh sales to New Mexico customers in 2020. This legislation is expected to be signed by the governor.

2007 Long-Term Incentive Plan. On May 18, 2007, the Company filed for NMPRC approval for issuance of common stock for purposes of incentives and compensation. After the filing of supplemental testimony, the Hearing Examiner issued a Recommended Decision in July 2007 recommending that the securities transactions related to issuance of new stock be approved. The NMPRC requested additional supplemental testimony on the reasonableness of executive compensation and the effect on capital structure and rates to be set in the next general rate case. The Company filed supplemental testimony addressing these issues on October 31, 2007. Hearings on this matter were held on November 9, 2007. The Company is awaiting a final decision by the NMPRC.

New Mexico Investigation into Executive Compensation. In December 2007, the NMPRC initiated an investigation into executive compensation of investor-owned gas and electric public utilities. In its order initiating the investigation, the NMPRC required each utility to provide information on compensation of executive officers and directors for the period 1977-2006. The Company has provided the requested information. No further action has been taken by the NMPRC.

Generation CCN Filing. On July 18, 2007, the Company filed its application for issuance of a CCN to construct and operate Newman Unit 5. This case has been designated as NMPRC Case No. 07-00301-UT. The hearing was held on January 24, 2008. The Hearing Examiner issued a Recommended Decision on January 29, 2008 recommending Commission approval of the CCN. Pursuant to a request by the NMPRC, the Commission Staff and the Company provided additional information on February 26, 2008. A final order is expected in April 2008.

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 a new generating station (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 the 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. The October 4 order granted a hearing to examine the disputed evidence, and a hearing before an administrative law judge on the dispute was held on May 22 through May 24, 2007 and June 20, 2007.

The initial decision of the administrative law judge was issued September 6, 2007. The Presiding Judge generally found that the Transmission Agreement allows TEP to transmit power from the Deming Plant 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 briefs on exceptions and replies to briefs on exceptions to the Initial Decision. In its brief on exceptions, TEP argued that it is entitled to a refund of the revenues the Company has received from TEP for transmission service to the Deming Plant during the pendency of these proceedings. In its response, the Company vigorously contested TEP's request for refunds. The Commission will issue a decision on the merits after review of the Initial Decision and the briefs on exceptions and replies to exceptions. While the Company believes that it will prevail on all points, the Company cannot predict the outcome of this case. During 2006 and 2007, TEP paid the Company $6.6 million for transmission service relating to the LEF. The Company has established a reserve for rate refund for $3.5 million related to this issue. If the FERC were to rule in TEP's favor, the Company may be required to refund all of the $6.6 million it has received from TEP for transmission service relating to the LEF and may lose the opportunity to