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receive compensation from TEP for such transmission service in the future. An adverse ruling by the FERC could have a negative effect on the Company's results of operations.

RTOs. FERC's rule on RTOs ("Order 2000") strongly encourages, but does not require, public utilities to form and join RTOs. The Company is an active participant in the development of WestConnect. The Company has entered into a Memorandum of Understanding ("MOU") with ten other transmission owners that obligates the parties to participate in and commit resources to ongoing joint efforts, including involvement with stakeholders, customers, local, state and federal regulatory personnel, and other Western Grid transmission providers to identify, develop and implement cost-effective wholesale market enhancements on a voluntary, phased-in basis to add value in transmission accessibility, wholesale market efficiency and reliability for wholesale users of the Western Grid. These enhancements may ultimately include formation of an RTO. WestConnect will continue to work with the FERC and two other proposed RTOs in the west to achieve a seamless market structure. The Company comprises approximately 7% of WestConnect and cannot control the terms or timing of its development. WestConnect as an RTO will not be operational for several years.

Department of Energy. The DOE regulates the Company's exports of power to the CFE in Mexico pursuant to a license granted by the DOE and a presidential permit. The DOE has determined that all such exports over international transmission lines shall be made in accordance with Order No. 888, which established the FERC rules for open access.

The DOE is authorized to assess operators of nuclear generating facilities a share of the costs of decommissioning the DOE's uranium enrichment facilities and for the ultimate costs of disposal of spent nuclear fuel. See "Note C – Palo Verde – Spent Fuel Storage" for discussion of spent fuel storage and disposal costs.

Nuclear Regulatory Commission. The NRC has jurisdiction over the Company's licenses for Palo Verde and regulates the operation of nuclear generating stations to protect the health and safety of the public from radiation hazards. The NRC also has the authority to grant license extensions pursuant to the Atomic Energy Act of 1954, as amended.

Sales for Resale

The Company entered into a contract to sell up to 100 MW firm energy and 50 MW of contingent energy to Imperial Irrigation District ("IID") which began May 1, 2007 and continues through April 30, 2009. The contract also provides for the Company to sell up to 100 MW firm energy and 40 MW of contingent energy beginning May 1, 2009 through April 30, 2010. To ensure that power is available to meet the IID contract demand, the Company entered into a contract effective May 1, 2007 to purchase up to 100 MW of firm energy from CreditSuisse Energy, LLC. This contract provides for up to 100 MW of firm energy to be delivered at Palo Verde through April 30, 2010 and 50 MW of energy

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delivered at Four Corners in the months of July through September 2007 and May through September for the years 2008 through 2010.

The Company provides up to 10 MW of firm capacity, associated energy, and transmission service to the Rio Grande Electric Cooperative pursuant to an ongoing contract which requires a two-year notice to terminate. In 2006 the Company provided RGEC with a notice of termination. Such termination will be effective as of March 31, 2008. The Company is discussing the provision of future electric service with RGEC.

C. Utility Plant, Palo Verde and Other Jointly-Owned Utility Plant

The table below presents the balance of each major class of depreciable assets at December 31, 2007 (in thousands):

	<u>Gross Plant</u>	<u>Accumulated Depreciation</u>	<u>Net Plant</u>
Nuclear production	\$ 660,342	\$ (174,024)	\$ 486,318
Steam and other	<u>279,930</u>	<u>(165,146)</u>	<u>114,784</u>
Total production	940,272	(339,170)	601,102
Transmission.....	342,332	(217,024)	125,308
Distribution.....	647,516	(243,008)	404,508
General.....	91,690	(49,235)	42,455
Intangible	<u>25,863</u>	<u>(9,989)</u>	<u>15,874</u>
Total.....	<u>\$ 2,047,673</u>	<u>\$ (858,426)</u>	<u>\$ 1,189,247</u>

Amortization of intangible plant (software) is provided on a straight-line basis over the estimated useful life of the asset (ranging from 3 to 10 years). The amortization expense for intangible plant was \$3.3 million, \$2.8 million and \$1.9 million for 2007, 2006 and 2005, respectively. The table below presents the estimated amortization expense for the next five years (in thousands):

2008	\$ 3,874
2009	3,502
2010	3,235
2011	1,654
2012	719

The Company owns a 15.8% interest in each of the three nuclear generating units and Common Facilities at Palo Verde, in Wintersburg, Arizona. The Palo Verde Participants include the Company and six other utilities: Arizona Public Service Company ("APS"), Southern California Edison Company ("SCE"), Public Service Company of New Mexico ("PNM"), Southern California Public Power

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Authority, Salt River Project Agricultural Improvement and Power District ("SRP") and the Los Angeles Department of Water and Power.

Other jointly-owned utility plant includes a 7% interest in Units 4 and 5 at Four Corners Generating Station ("Four Corners") and certain other transmission facilities. A summary of the Company's investment in jointly-owned utility plant, excluding fuel inventories, at December 31, 2007 and 2006 is as follows (in thousands):

	<u>December 31, 2007</u>		<u>December 31, 2006</u>	
	<u>Palo Verde</u>	<u>Other</u>	<u>Palo Verde</u>	<u>Other</u>
Electric plant in service	\$ 660,342	\$ 193,574	\$ 655,679	\$ 190,200
Accumulated depreciation	(174,024)	(147,203)	(154,029)	(140,373)
Construction work in progress.....	<u>75,035</u>	<u>5,051</u>	<u>33,222</u>	<u>3,181</u>
Total	<u>\$ 561,353</u>	<u>\$ 51,422</u>	<u>\$ 534,872</u>	<u>\$ 53,008</u>

Palo Verde

The operation of Palo Verde and the relationship among the Palo Verde Participants is governed by the Arizona Nuclear Power Project Participation Agreement (the "ANPP Participation Agreement"). APS serves as operating agent for Palo Verde, and under the ANPP Participation Agreement, the Company has limited ability to influence operations and costs at Palo Verde. Pursuant to the ANPP Participation Agreement, the Palo Verde Participants share costs and generating entitlements in the same proportion as their percentage interests in the generating units, and each participant is required to fund its share of fuel, other operations, maintenance and capital costs. The Company's share of direct expenses in Palo Verde and other jointly-owned utility plants is reflected in fuel expense, other operations expense, maintenance expense, miscellaneous other deductions, and taxes other than income taxes in the Company's consolidated statements of operations. The ANPP Participation Agreement provides that if a participant fails to meet its payment obligations, each non-defaulting participant shall pay its proportionate share of the payments owed by the defaulting participant. Because it is impracticable to predict defaulting participants, the Company cannot estimate the maximum potential amount of future payment, if any, which could be required under this provision.

NRC. The NRC regulates the operation of all commercial nuclear power reactors in the United States, including Palo Verde. The NRC periodically conducts inspections of nuclear facilities and monitors performance indicators to enable the agency to arrive at objective conclusions about a licensee's safety performance. Based on this assessment information and using a cornerstone evaluation system, the NRC determines the appropriate level of agency response and oversight, including supplemental inspections and pertinent regulatory actions as necessary.

In October 2006, the NRC conducted an inspection of the Palo Verde emergency diesel generators after a Palo Verde Unit 3 emergency diesel generator did not activate during routine

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inspections in July and September 2006. On February 22, 2007, the NRC issued a "white" finding (low to moderate safety significance) for this matter. Based upon this finding, coupled with a previous NRC "yellow" finding (substantial safety significance) relating to a 2004 matter involving Palo Verde's safety injection systems, the NRC placed Palo Verde Unit 3 in the "multiple/repetitive degraded cornerstone" column of the NRC's action matrix which has resulted in an enhanced NRC inspection regimen. This enhanced inspection regimen and resulting corrective actions has resulted in increased operating costs at the plant. Of the 104 commercial nuclear reactors in the United States regulated by the NRC, only Palo Verde Unit 3 was listed in the "multiple/repetitive degraded cornerstone" category as of the end of 2007. The Company is currently unable to predict the impact that the NRC's increased oversight may have on Palo Verde's operations and the cost of operations.

Decommissioning. Pursuant to the ANPP Participation Agreement and federal law, the Company must fund its share of the estimated costs to decommission Palo Verde Units 1, 2 and 3, including the Common Facilities, through the term of their respective operating licenses. The Company is required to maintain a minimum accumulation and a minimum funding level in its decommissioning account at the end of each annual reporting period during the life of the plant. The Company has established external trusts with an independent trustee which enable the Company to record a current deduction for federal income tax purposes of a portion of amounts funded. At December 31, 2007, the Company's decommissioning trust fund had a balance of \$130.7 million and the Company was above its minimum funding level. The Company will continue to monitor the status of its decommissioning funds and adjust its deposits, if necessary, to remain at or above its minimum accumulation requirements in the future.

Decommissioning costs are estimated every three years based upon engineering cost studies performed by outside engineers retained by APS. In 2005, the Palo Verde Participants approved the 2004 Palo Verde decommissioning study ("2004 Study"). The 2004 Study estimated that the Company must fund approximately \$335.7 million (stated in 2004 dollars) to cover its share of decommissioning costs. Although the 2004 Study was based on the latest available information, there can be no assurance that decommissioning cost estimates will not increase in the future or that regulatory requirements will not change. In addition, until a new low-level radioactive waste repository opens and operates for a number of years, estimates of the cost to dispose of low-level radioactive waste are subject to significant uncertainty. A study of decommissioning costs was performed in 2007 ("2007 Study"). Preliminary results of the 2007 Study indicate a reduction in decommissioning costs from the 2004 Study which, if adopted, will result in lower asset retirement obligations and lower expenses in the future. The 2007 Study is expected to be approved in the second quarter of 2008. See "Spent Fuel Storage" and "Disposal of Low-Level Radioactive Waste" below.

Spent Fuel Storage. The original spent fuel storage facilities at Palo Verde had sufficient capacity to store all fuel discharged from normal operation of all three Palo Verde units through 2003. Alternative on-site storage facilities and casks have been constructed to supplement the original facilities. In March 2003, APS began removing spent fuel from the original facilities as necessary, and placing it in special storage casks which will be stored at the new facilities until accepted by the DOE for

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permanent disposal. The 2004 Study assumed that costs to store fuel on-site will become the responsibility of the DOE after 2037. APS believes that spent fuel storage or disposal methods will be available to allow each Palo Verde unit to continue to operate through the term of its operating license.

Pursuant to the Nuclear Waste Policy Act of 1982, as amended in 1987 (the "Waste Act"), the DOE is legally obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive waste generated by all domestic power reactors. In accordance with the Waste Act, the DOE entered into a spent nuclear fuel contract with the Company and all other Palo Verde Participants. The DOE has previously reported that its spent nuclear fuel disposal facilities would not be in operation in the near future. Subsequent judicial decisions required the DOE to start accepting spent nuclear fuel by January 31, 1998. The DOE did not meet that deadline, and the Company cannot currently predict when spent fuel shipments to the DOE's permanent disposal site will commence.

The Company expects to incur significant costs for on-site spent fuel storage during the life of Palo Verde that the Company believes are the responsibility of the DOE. These costs are assigned to fuel requiring the additional on-site storage and amortized as that fuel is burned until an agreement is reached with the DOE for recovery of these costs. In December 2003, APS, in conjunction with other nuclear plant operators, filed suit against the DOE on behalf of the Palo Verde Participants to recover monetary damages associated with the delay in the DOE's acceptance of spent fuel. On February 28, 2007, APS served on the U.S. Department of Justice its "Initial Disclosure of Claimed Damages" of \$93.4 million (the Company's portion being \$14.8 million). This amount includes expenses associated with design, construction, loading, and operation of the Palo Verde independent spent fuel storage installation through December 2006. This amount represents costs incurred to ensure sufficient storage capacity for Palo Verde spent fuel that would not have been incurred had the DOE complied with its standard contract obligation to begin accepting spent fuel from the commercial nuclear power industry beginning in 1998. The Company is unable to predict the outcome of this matter at this time.

Disposal of Low-Level Radioactive Waste. Congress has established requirements for the disposal by each state of low-level radioactive waste generated within its borders. Arizona, California, North Dakota and South Dakota have entered into a compact (the "Southwestern Compact") for the disposal of low-level radioactive waste. California will act as the first host state of the Southwestern Compact, and Arizona will serve as the second host state. The construction and opening of the California low-level radioactive waste disposal site in Ward Valley has been delayed due to extensive public hearings, disputes over environmental issues and review of technical issues related to the proposed site. Palo Verde is projected to undergo decommissioning during the period in which Arizona will act as host for the Southwestern Compact. The opposition, delays, uncertainty and costs experienced in California demonstrate possible roadblocks that may be encountered when Arizona seeks to open its own waste repository. APS currently believes that interim low-level waste storage methods are or will be available to allow each Palo Verde unit to continue to operate and to store safely low-level waste until a permanent disposal facility is available.

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Reactor Vessel Heads. In accordance with applicable NRC requirements, APS conducts regular inspections of reactor vessel heads at Palo Verde Units 1, 2 and 3. In an effort to reduce long-term operating costs at the station related to inspection of the reactor heads, related equipment, and possible repair costs, APS plans to replace reactor vessel heads at Palo Verde. Reactor vessel head replacement is scheduled to occur at Units 1, 2 and 3 in 2010, 2009 and 2009, respectively.

Liability and Insurance Matters. The Palo Verde participants have insurance for public liability resulting from nuclear energy hazards to the full limit of liability under federal law currently at \$10.8 billion. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of \$300 million and the balance by an industry-wide retrospective assessment program. If a loss at a nuclear power plant covered by the programs exceeds the accumulated funds in the primary level of protection, the Company could be assessed retrospective premium adjustments on a per incident basis. Under federal law, the maximum assessment per reactor under the program for each nuclear incident is approximately \$100.6 million, subject to an annual limit of \$15 million. Based upon the Company's 15.8% interest in the three Palo Verde units, the Company's maximum potential assessment per incident for all three units is approximately \$47.7 million, with an annual payment limitation of approximately \$7.1 million.

The Palo Verde Participants maintain "all risk" (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of \$2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. The Company has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen outage of any of the three units. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions. A mutual insurance company whose members are utilities with nuclear facilities issues these policies. If losses at any nuclear facility covered by this mutual insurance company were to exceed the accumulated funds for these insurance programs, the Company could be assessed retrospective premium adjustments of up to \$11.5 million for the current policy period.

D. Accounting for Asset Retirement Obligations

The Company complies with SFAS No. 143, "Accounting for Asset Retirement Obligations" which primarily affects the accounting for the decommissioning of the Company's Palo Verde and Four Corners Stations and the method used to report the decommissioning obligation. The Company records the increase in the ARO due to the passage of time as an operating expense (accretion expense). As the DOE assumes responsibility for the permanent disposal of spent fuel, spent fuel costs have not been included in the ARO calculation. The Company has six external trust funds with an independent trustee which are legally restricted to settling its ARO at Palo Verde. The fair value of the funds at December 31, 2007 is \$130.7 million.

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A reconciliation of the Company's ARO liability recorded is as follows (in thousands):

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
ARO liability at beginning of year	\$ 73,267	\$ 66,997	\$ 60,388
Liabilities incurred	—	—	2,719 (1)
Liabilities settled	(418)	—	—
Revisions to estimate	—	—	(1,767)
Accretion expense	6,860	6,270	5,657
ARO liability at end of year	<u>\$ 79,709</u>	<u>\$ 73,267</u>	<u>\$ 66,997</u>

(1) Results from the implementation of FIN 47 (see discussion below).

The Company has transmission and distribution lines which are operated under various property easement agreements. If the easements were to be released, the Company may have a legal obligation to remove the lines; however, the Company has assessed the likelihood of this occurring as remote. The majority of these easements include renewal options which the Company routinely exercises.

The ARO liability for Palo Verde is based upon the estimated cost of decommissioning the plant from the 2004 Palo Verde decommissioning study. See Note C. The ARO liability is calculated by adjusting the estimated decommissioning costs for spent fuel storage and a profit margin and market-risk premium factor. The resulting costs are escalated over the remaining life of the plant and finally discounted using a credit-risk adjusted discount rate. Since the Company assumed an escalation rate of 3.6% and a credit-risk adjusted discount rate of 9.5% in the original calculation of the ARO liability, the ARO liability is less than the Company's share of the current estimated cost to decommission Palo Verde in 2004 dollars. As Palo Verde approaches the end of its estimated useful life, the difference between the ARO liability and future current cost estimates will narrow over time due to the accretion of the ARO liability.

SFAS No. 143 requires the Company to revise its previously recorded ARO for any changes in estimated cash flows. Any changes that result in an upward revision to estimated cash flows shall be treated as a new liability. Any downward revisions to the estimated cash flows result in a reduction to the previously recorded ARO. Since the 2004 study reflected a downward revision in the estimated cash flows for decommissioning costs from the 2001 study, the Company recorded a \$1.8 million reduction to its ARO asset and liability in the third quarter of 2005. Accretion and depreciation expense related to the ARO decreased approximately \$0.3 million annually as a result of this adjustment. An updated decommissioning study was performed in 2007 subject to approval of the Palo Verde Participants. Upon approval the ARO asset and liability will be adjusted to reflect the results of the 2007 study.

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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. Accordingly, the entity must record a liability for the conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. The adoption of FIN 47 primarily affected the accounting for the disposal obligations of the Company's fuel oil storage tanks, water wells, evaporative ponds and asbestos found at the Company's gas-fired generating plants. With the adoption of FIN 47 at December 31, 2005, the Company recognized an increase in its ARO of \$2.7 million, an increase in net plant in service of \$0.9 million, and a cumulative effect of accounting change resulting in a loss of \$1.1 million, net of related taxes.

Amounts recorded under SFAS No. 143, including those under FIN 47, are subject to various assumptions and determinations such as (i) whether a legal obligation exists to remove assets; (ii) estimation of the fair value of the costs of removal; (iii) when final removal will occur; (iv) future changes in decommissioning cost escalation rates; and (v) the credit-adjusted interest rates to be utilized in discounting future liabilities. Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as an expense for AROs. If the Company incurs or assumes any liability in retiring any asset at the end of its useful life without a legal obligation to do so, it will record such retirement costs as incurred.

E. Common Stock

Overview

The Company's common stock has a stated value of \$1 per share, with no cumulative voting rights or preemptive rights. Holders of the common stock have the right to elect the Company's directors and to vote on other matters.

Long-Term Incentive Plans

On May 2, 2007, the Company's shareholders approved a stock-based long-term incentive plan (the "2007 Plan") and authorized the issuance of up to one million shares of common stock for the benefit of directors and employees. Under the plan, common stock may be issued through the award or grant of non-statutory stock options, incentive stock options, stock appreciation rights, restricted stock, bonus stock, performance stock, cash-based awards and other stock-based awards. Subject to applicable regulatory approvals, the Company may issue new shares, purchase shares on the open market, or issue shares from shares the Company has repurchased to meet the share requirements of these plans.

As discussed in Note A, the Company adopted SFAS No. 123 (revised) effective January 1, 2006. The Company adopted the "modified prospective application method" as provided for in SFAS No. 123 (revised) which provides for compensation expense related to unvested stock awards to be recognized prospectively. Under the modified prospective application method, the cumulative change in

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compensation expense vested in prior periods is recognized in the period the new accounting standard was adopted.

Stock Options. Stock options have been granted at exercise prices equal to or greater than the market value of the underlying shares at the date of grant. The fair value for these options was estimated at the grant date using the Black-Scholes option pricing model. The options expire ten years from the date of grant unless terminated earlier by the Board of Directors (the "Board"). Stock options have not been granted since 2003.

The following table summarizes the transactions in the Company's stock options for 2007:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u> (In thousands)
Options outstanding at December 31, 2006.....	957,888	\$ 12.45		
Options exercised	(384,000)	11.24		
Options outstanding at December 31, 2007.....	<u>573,888</u>	13.26	3.72	\$ 7,063
Exercisable at December 31, 2007	<u>553,888</u>	13.28	3.64	6,807

The Company received approximately \$4.3 million in cash for the 384,000 stock options exercised in 2007. During 2007, the Company realized \$1.8 million in current tax benefits from the exercise of stock options. The intrinsic value of stock options exercised in 2007, 2006 and 2005 was \$5.2 million, \$5.6 million and \$7.8 million, respectively. The fair value at grant date of options vested during 2007, 2006 and 2005 was \$0.8 million, \$1.2 million and \$1.5 million, respectively. No options were forfeited or expired during 2007.

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested options at December 31, 2006	140,000	\$ 6.14
Options vested	<u>(120,000)</u>	6.37
Nonvested options at December 31, 2007	<u>20,000</u>	4.82

The Company recorded compensation cost of less than \$0.1 million and \$0.8 million in 2007 and 2006, respectively, related to the outstanding unvested stock option awards and the tax benefit and capitalized costs related to these compensation costs were less than \$0.1 million and \$0.3 million, respectively. On January 2, 2008, the remaining 20,000 stock options vested for which compensation expense was recognized by December 31, 2007. There is no remaining unrecognized compensation cost related to stock options. The weighted average aggregate fair value at grant date of these unvested stock options is \$0.1 million.

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Restricted Stock. The Company has awarded restricted stock under its long-term incentive plans. Restrictions from resale generally lapse and awards vest over periods of one to three years. The market value of vested restricted stock awards is expensed at the time of grant. The market value of the unvested restricted stock at the date of grant is amortized to expense over the restriction period. Compensation cost is not recognized for anticipated forfeitures prior to vesting. On May 18, 2007, the Company entered into an employment separation agreement with Gary Hedrick, the Company's former chief executive officer. As part of this separation agreement, Mr. Hedrick forfeited 100% of his unvested restricted shares. As a result, the Company revised its estimated forfeiture rates and reduced its compensation costs accordingly.

Approximately \$1.7 million, \$1.6 million and \$1.4 million was charged to expense related to restricted stock awards in 2007, 2006 and 2005, respectively. The deferred tax benefit related to these expenses was \$0.7 million, \$0.6 million and \$0.6 million for 2007, 2006 and 2005, respectively. The Company realized \$0.2 million and \$0.1 million of current tax benefits from the issuance of restricted stock in 2007 and 2006, respectively. No current tax benefits were realized for the tax deduction from restricted stock issuances in 2005 because the Company was in a tax net operating loss position. Any capitalized costs related to these expenses would be less than \$0.1 million for all years.

The aggregate intrinsic value for restricted stock vested during 2007, 2006 and 2005 was \$2.0 million, \$1.9 million and \$1.5 million, respectively. The fair value at grant date for restricted stock vested in 2007, 2006 and 2005 was \$1.4 million, \$1.6 million and \$1.1 million, respectively. The outstanding restricted stock has remaining \$1.3 million of unrecognized expense at December 31, 2007 that is expected to be recognized over the weighted average remaining contractual term of the outstanding restricted stock of approximately one year. The aggregate intrinsic value of the 119,403 outstanding restricted shares at December 31, 2007 was \$3.1 million.

The following table summarizes the unvested restricted stock transactions for 2007:

	<u>Total Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Restricted shares outstanding at December 31, 2006.....	110,854	\$ 19.32
Restricted stock awards	109,318	26.39
Lapsed restrictions and vesting.....	(77,019)	18.82
Forfeitures.....	<u>(23,750)</u>	21.33
Restricted shares outstanding at December 31, 2007.....	<u>119,403</u>	25.71

The weighted average fair values at grant date for restricted stock awarded during 2007, 2006 and 2005 are \$26.39, \$19.85 and \$18.82, respectively.

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The holder of a restricted stock award has rights as a shareholder of the Company, including the right to vote and, if applicable, receive cash dividends on restricted stock, except that certain restricted stock awards require any cash dividend on restricted stock to be delivered to the Company in exchange for additional shares of restricted stock of equivalent market value.

Performance Shares. The Company has granted performance share awards to certain officers under the Company's existing long-term incentive plans, which provide for issuance of Company stock based on the achievement of certain performance criteria over a three-year period. The payout varies between 0% to 200% of performance shares. On January 1, 2007, 58,650 performance shares were issued at the 150% performance level with a total cost of \$0.7 million which had been expensed ratably between 2004 and 2006. The Company realized \$0.3 million of current tax benefits from the issuance of performance shares in 2007. The requisite service period for these shares ended December 31, 2006, and the shares had an aggregate intrinsic value of \$1.4 million. On January 1, 2008, 2009 and 2010, subject to meeting certain performance criteria, additional performance shares will be awarded. In accordance with SFAS No. 123 (revised), the Company will recognize the related compensation expense by ratably amortizing the grant date fair market value of awards over the requisite service period and the compensation expense will only be adjusted for forfeitures. The actual number of shares issued can range from zero to 292,682 shares.

The fair market value at the date of each separate grant of performance shares was based upon a Monte Carlo simulation. The Monte Carlo simulation reflected the structure of the performance plan which calculates the share payout on performance of the Company relative to a defined peer group over a three-year performance period based upon total return to shareholders. The fair market value was determined as the average payout of one million simulation paths discounted to the grant date using a risk-free interest rate based upon the constant maturity treasury rate yield curve at the grant date. The expected volatility of total return to shareholders is calculated in accordance with the plan's term structure and includes the volatilities of all members of the defined peer group.

The following table summarizes the outstanding performance share awards at the 100% performance level:

	<u>Number Outstanding</u>	<u>Weighted Average Grant Date Fair Value</u>
Performance shares outstanding at December 31, 2006	174,100	\$ 19.92
Performance share awards	94,480	22.78
Performance shares lapsed and issued	(41,239)	18.46
Performance shares forfeited	(81,000)	20.69
Performance shares outstanding at December 31, 2007	<u>146,341</u>	21.75

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The outstanding performance awards have remaining \$1.1 million of unrecognized expense at December 31, 2007 that is expected to be recognized over the weighted average remaining contractual term of the awards of approximately 1.3 years. The aggregate intrinsic value of the 146,341 outstanding awards (based on 100% performance level) at December 31, 2007 was \$3.7 million. The weighted average grant date fair value of performance shares awarded during the years 2007, 2006 and 2005 was \$22.78, \$18.37, and \$22.55, respectively. The fair value of performance shares which vested in 2007 and 2006 was \$0.7 million and \$0.8 million, respectively, with an intrinsic value of \$1.0 million and \$0.8 million, respectively. No performance shares vested in 2005.

The Company recorded compensation expense related to performance shares of \$0.4 million in 2007 and 2006, respectively. The compensation expense for 2007 and 2006 included cumulative adjustments. On May 18, 2007, the Company entered into an employment separation agreement with Gary Hedrick, the Company's former chief executive officer. As part of this separation agreement, Mr. Hedrick forfeited 100% of his unvested performance shares. As a result, the Company revised its forfeiture rates related to performance shares which resulted in a cumulative adjustment which reduced operating expense by \$0.7 million pretax and \$0.4 million after-tax. During the first quarter of 2006, the Company recorded a cumulative adjustment to operating expense related to 2004 and 2005 performance stock awards to reflect the implementation of SFAS No. 123 (revised) which reduced expense by \$0.7 million pretax and \$0.4 million after-tax. Deferred tax expense related to compensation expense in 2007 and 2006 was \$0.1 million and less than \$0.1 million, respectively.

Prior to implementing SFAS No. 123 (revised) the Company recognized compensation expense for performance share awards by ratably amortizing their fair market value at the end of the reporting period based on the Company's performance at that time over the performance cycles. The Company recorded compensation expense related to performance share awards of \$1.5 million in 2005. The deferred tax related to these expenses was \$0.6 million.

Common Stock Repurchase Program

Since the inception of the stock repurchase program in 1999, the Company has repurchased a total of approximately 19.3 million shares of its common stock at an aggregate cost of \$269.4 million, including commissions. In September 2006, the Board authorized the repurchase of up to 2.3 million shares of the Company's outstanding common stock (the "2006 Plan"). During 2006 and 2007, the Company repurchased 4,055,158 shares of common stock under the 2006 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Reconciliation of Basic and Diluted Earnings Per Share

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

Year Ended December 31, 2007			
	<u>Income</u>	<u>Shares</u>	<u>Per Share</u>
	(In thousands)		
Basic earnings per share:			
Income before extraordinary item and cumulative effect of accounting change.....	\$ 74,753	45,563,858	\$ <u>1.64</u>
Effect of dilutive securities:			
Unvested restricted stock.....	—	55,460	
Unvested performance awards.....	—	69,426	
Stock options	—	<u>239,734</u>	
Diluted earnings per share:			
Income before extraordinary item and cumulative effect of accounting change.....	\$ <u>74,753</u>	<u>45,928,478</u>	\$ <u>1.63</u>
 Year Ended December 31, 2006			
	<u>Income</u>	<u>Shares</u>	<u>Per Share</u>
	(In thousands)		
Basic earnings per share:			
Income before extraordinary item and cumulative effect of accounting change.....	\$ 61,387	47,663,890	\$ <u>1.29</u>
Effect of dilutive securities:			
Unvested restricted stock.....	—	57,459	
Unvested performance awards.....	—	87,147	
Stock options	—	<u>355,571</u>	
Diluted earnings per share:			
Income before extraordinary item and cumulative effect of accounting change.....	\$ <u>61,387</u>	<u>48,164,067</u>	\$ <u>1.27</u>

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	Year Ended December 31, 2005		
	Income	Shares	Per Share
	(In thousands)		
Basic earnings per share:			
Income before extraordinary item and cumulative effect of accounting change.....	\$ 36,615	47,711,894	\$ 0.77
Effect of dilutive securities:			
Unvested restricted stock.....	—	46,284	
Unvested performance awards.....	—	90,295	
Stock options	—	459,437	
Diluted earnings per share:			
Income before extraordinary item and cumulative effect of accounting change.....	\$ 36,615	48,307,910	\$ 0.76

No options were excluded from the computation of diluted earnings per share because the exercise price was greater than the average market price for the years ended December 31, 2007, 2006 and 2005.

F. Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) consists of the following components (in thousands):

	Net Unrealized Gains (Losses) on Marketable Securities	Unrecognized Pension and Postretirement Benefit Costs	Net Losses on Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2004	\$ 6,355	\$ (16,908)	\$ —	\$ (10,553)
Other comprehensive loss.....	(2,359)	(6,128)	(22,296)	(30,783)
Income tax benefit.....	472	2,299	8,398	11,169
Balance at December 31, 2005	4,468	(20,737)	(13,898)	(30,167)
Other comprehensive income	9,466	16,923	263	26,652
Income tax expense	(1,893)	(6,348)	(99)	(8,340)
SFAS No. 158 adoption, net of tax of \$3,879	—	(6,461)	—	(6,461)
Balance at December 31, 2006	12,041	(16,623)	(13,734)	(18,316)
Other comprehensive income	4,152	41,256	278	45,686
Income tax expense	(830)	(18,037)	(104)	(18,971)
Adjustment for tax effect of SFAS No. 158.....	—	5,141	—	5,141
Balance at December 31, 2007	\$ 15,363	\$ 11,737	\$ (13,560)	\$ 13,540

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G. Long-Term Debt and Financing Obligations

Outstanding long-term debt and financing obligations are as follows:

	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
	(In thousands)	
Long-Term Debt:		
Pollution Control Bonds (1):		
2005 Series B refunding bonds, due 2040	\$ 63,500	\$ 63,500
4.80% 2005 Series A refunding bonds, due 2040.....	59,235	59,235
2005 Series C refunding bonds, due 2040	37,100	37,100
4.00% 2002 Series A refunding bonds, due 2032.....	33,300	33,300
Senior Notes (2):		
Senior Notes, net of discount, due 2035	397,759	397,730
Total long-term debt.....	590,894	590,865
Financing Obligations:		
Nuclear fuel (\$18,798 due in 2008) (3)	83,015	46,240
Total long-term debt and financing obligations.....	673,909	637,105
Current Portion (amount due within one year).....	(18,798)	(20,975)
	<u>\$ 655,111</u>	<u>\$ 616,130</u>

(1) Pollution Control Bonds

The Company has four series of tax exempt Pollution Control Bonds in an aggregate principal amount of approximately \$193.1 million. On August 1, 2005, the Company reissued three series of pollution control bonds which were the 2005 Series B bonds for \$63.5 million, the 2005 Series A bonds for \$59.2 million and the 2005 Series C bonds for \$37.1 million. The 2005 Series A \$59.2 million bonds which mature in 2040, were reissued with a fixed interest rate of 4.80% and an effective interest rate of 5.27% after considering related insurance and issuance costs. The 2005 Series B \$63.5 million and 2005 Series C \$37.1 million bonds, which also mature in 2040, were reissued with a variable rate that is repriced weekly, 5.35% and 4.91% at December 31, 2007, respectively. These bonds are insured by FGIC whose bond ratings have recently been downgraded by all the major rating agencies thereby calling into question FGIC's claims paying ability in the event of default by the Company. As a result, the Company has 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 the Company would be required to pay a default interest rate of 15%. The Company also remarketed the 2002 Series A \$33.3 million of pollution control bonds which bear a fixed interest rate of 4.00% until August 1, 2012 which is the date the bonds are due to be remarketed. The effective interest rate for these bonds is 4.70% after considering related insurance and issuance costs. The interest rate will remain at its current fixed interest rate until remarketing in August 2012.

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(2) Senior Notes

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

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

(3) Nuclear Fuel and Working Capital Financing

The Company has available a \$200 million credit facility for a five-year term ending April 2011. The credit facility was expanded under terms of the facility from \$150 million to \$200 million in July 2007 due to increased volatility in the nuclear fuel market. The credit facility provides for up to \$120 million for the financing of nuclear fuel, which is accomplished through a trust that borrows under the facility to acquire and process the nuclear fuel. The Company is obligated to repay the trust's borrowings with interest. In the Company's financial statements, the assets and liabilities of the trust are reported as assets and liabilities of the Company. Any amounts not borrowed by the trust may be borrowed by the Company for working capital needs. The weighted average interest rate on the credit facility was 5.59% as of December 31, 2007.

The \$200 million credit facility requires compliance with certain total debt and interest coverage ratios. The Company was in compliance with these requirements throughout 2007. No amounts are currently outstanding on this facility for working capital needs.

As of December 31, 2007, the scheduled maturities for the next five years of long-term debt and financing obligations are as follows (in thousands):

2008	\$	—
2009		—
2010		—
2011		—
2012		33,300

The table above does not reflect future obligations and maturities related to nuclear fuel financing obligations.

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H. Income Taxes

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 2007 and 2006 are presented below (in thousands):

	December 31,	
	2007	2006
Deferred tax assets:		
Alternative minimum tax credit carryforward	\$ 42,495	\$ 50,172
Pensions and benefits.....	40,860	53,962
Asset retirement obligation.....	27,898	25,644
Other	19,244	20,094
Total gross deferred tax assets	<u>130,497</u>	<u>149,872</u>
Deferred tax liabilities:		
Plant, principally due to depreciation and basis differences.....	(240,721)	(232,905)
Decommissioning	(33,896)	(31,118)
Deferred fuel.....	(9,694)	(16,554)
Other	(15,049)	(13,167)
Total gross deferred tax liabilities	<u>(299,360)</u>	<u>(293,744)</u>
Net accumulated deferred income taxes.....	<u>\$ (168,863)</u>	<u>\$ (143,872)</u>

Based on the average annual book income before taxes for the prior three years, excluding the effects of extraordinary and unusual or infrequent items, the Company believes that the net deferred tax assets will be fully realized at current levels of book and taxable income.

The Company recognized income taxes as follows (in thousands):

	Years Ended December 31,		
	2007	2006	2005
Income tax expense:			
Federal:			
Current	\$ 19,579	\$ 7,973	\$ (4,909)
Deferred	10,499	27,496	23,046
Total federal income tax.....	<u>30,078</u>	<u>35,469</u>	<u>18,137</u>
State:			
Current	4,496	1,007	(1,788)
Deferred	(107)	(6,845)	1,583
Total state income tax	<u>4,389</u>	<u>(5,838)</u>	<u>(205)</u>
Total income tax expense.....	<u>34,467</u>	<u>29,631</u>	<u>17,932</u>
Tax expense classified as extraordinary gain on re-application of SFAS No. 71.....	—	(3,565)	—
Tax benefit (expense) classified as cumulative effect of accounting change	—	—	657
Total income tax expense before extraordinary item and cumulative effect of accounting change	<u>\$ 34,467</u>	<u>\$ 26,066</u>	<u>\$ 18,589</u>

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The current federal income tax expense for 2007 results primarily from increased pretax income and certain permanent differences. The current federal income tax expense for 2006 results primarily from the accrual of alternative minimum tax ("AMT"). The current income tax expense for 2005 results primarily from a reversal of AMT for prior years as a result of increased tax deductions due to several method changes primarily related to tax depreciation and repair allowances. Deferred federal income tax for 2007 includes an offsetting AMT benefit of \$7.1 million. Deferred federal income tax includes an offsetting AMT expense of \$8.4 million and \$6.7 million for 2006 and 2005 respectively. The reduction in deferred state income taxes in 2006 is a result of legislation 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. The Company's 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, the Company recorded a \$6.2 million reduction in its 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 includes: (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.

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Income tax provisions differ from amounts computed by applying the statutory federal income tax rate of 35% to book income before federal income tax as follows (in thousands):

	Years Ended December 31,		
	2007	2006	2005
Federal income tax expense computed on income at statutory rate	\$ 38,227	\$ 33,938	\$ 18,709
Difference due to:			
State taxes, net of federal benefit	2,852	2,184	(133)
Deferred tax adjustment for change in Texas franchise (income) tax	—	(6,174)	—
Allowance for equity funds used during construction	(2,398)	—	—
Permanent tax differences	(4,091)	(1,670)	323
Other	(123)	1,353	(967)
Total income tax expense	34,467	29,631	17,932
Tax expense classified as extraordinary gain on re-application of SFAS No. 71	—	(3,565)	—
Tax benefit (expense) classified as cumulative effect of accounting change	—	—	657
Total income tax expense before extraordinary item and cumulative effect of accounting change	\$ 34,467	\$ 26,066	\$ 18,589
Effective income tax rate	31.6%	31.0%	33.5%

As of December 31, 2007, the Company had \$42.5 million of AMT credit carryforwards that have an unlimited life.

The Company files income tax returns in the U.S. federal jurisdiction and in the states of Texas, New Mexico and Arizona. The Company is no longer subject to tax examination by the taxing authorities in the federal or state jurisdictions for years prior to 1998. The Company's federal tax returns for the years 1999 through 2004 have been examined by the IRS. The Company is currently under audit for 2005. On June 12, 2007, the Company received the IRS notice of proposed deficiency for the tax years 1999 through 2004. A previous IRS notice of proposed deficiency had been received for the years 1999 through 2002 in 2004. The primary audit adjustments proposed by the IRS related to (i) whether the Company was entitled to currently deduct payments related to the repair of the Palo Verde Unit 2 steam generators or whether these payments should be capitalized and depreciated and (ii) whether the Company was entitled to currently deduct payments related to the dry cask storage facilities for spent nuclear fuel or whether these payments should be capitalized and depreciated. 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. The Company protested the audit adjustments through

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administrative appeals. The Company believes that its treatment of the payments is supported by substantial legal authority.

A deficiency notice relating to the Company's 1998 through 2003 income tax returns in Arizona contests a pollution control credit and the payroll apportionment factor. The Company is contesting these adjustments.

The Company adopted FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," ("FIN 48") on January 1, 2007. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. As a result of the implementation of FIN 48, the Company recognized a \$1.9 million decrease in the liability for unrecognized tax benefits, which was accounted for as an increase to the January 1, 2007, balance of retained earnings. A reconciliation of the December 31, 2006 and December 31, 2007 amount of unrecognized tax benefits is as follows:

	Year Ended <u>December 31, 2007</u> (In millions)
Balance at December 31, 2006	\$ 6.8
Additions based on tax positions related to the current year	2.0
Additions for tax positions of prior years	0.1
Reductions for tax positions of prior years	(0.4)
Balance at December 31, 2007	<u>\$ 8.5</u>

The Company has determined that the ultimate deductibility of the federal tax positions as of December 31, 2007 are "highly certain", as such term is defined in FIN 48, but the timing of such deductibility is uncertain. Because of the impact of deferred tax accounting, the disallowance of the shorter deductibility period does not change the amount of tax expense other than associated interest and penalties. However, the timing of cash payments to the federal taxing authority would be affected. An unrecognized tax position of \$0.2 million associated with state income taxes has been recognized as a reduction in income tax expense.

The Company recognizes in tax expense interest and penalties related to tax benefits that have not been recognized. During the years ended December 31, 2007 and December 31, 2006, the Company recognized approximately \$0.7 million and \$0.1 million, respectively, in interest. The Company had approximately \$2.5 million and \$3.6 million for the payment of interest and penalties accrued at December 31, 2007 and December 31, 2006, respectively.

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I. Commitments, Contingencies and Uncertainties

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 receive compensation from TEP for such transmission service in the future. An adverse ruling by the FERC could have a negative effect on the Company's results of operations.

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Power Contracts

The Company had entered into the following significant agreements with various counterparties for forward firm purchases and sales of electricity:

<u>Type of Contract</u>	<u>Quantity</u>	<u>Term</u>
Power Purchase and Sale Agreement	100 MW	2006 through 2021
Purchase Capacity	133 MW	2006 through September 2009
Purchase On-peak Energy	100 MW	2008
Sale On-peak Energy	100 MW	2008
Power Sale Agreement	100 MW	May 2007 through April 2010
Power Purchase Agreement	100 MW	May 2007 through April 2010

In addition to the above transactions, the Company has also entered into several agreements with various counterparties for the forward firm purchases and sales of electricity during the first quarter of 2008:

<u>Type of Contract</u>	<u>Quantity</u>	<u>Term</u>
Purchase Off-Peak Energy	225 MW	1st Quarter 2008
Sale Off-Peak Energy	225 MW	1st Quarter 2008

To supplement its own generation and operating reserves, the Company engages in firm and non-firm power purchase arrangements which may vary in duration and amount based on evaluation of the Company's resource needs and the economics of the transactions. In 2004, the Company entered into a 20-year contract, beginning in 2006, for the purchase of up to 133 MW of capacity and associated energy from SPS. This contract includes a demand charge, fuel charge, variable operations and maintenance charge, and a transmission charge. The contract provides that, in the event the transactions thereunder are subject to adverse regulatory action, the affected party may initiate discussions with the other party to assess whether modifications to the agreement may be appropriate. If the parties are unable to reach a mutually satisfactory resolution within six months, either party may terminate the contract by providing not less than two years' prior written notice to the other party.

The Company previously received notice from SPS that SPS had been subject to adverse regulatory action by the Texas Commission regarding transactions under the contract and that SPS wished to exercise its right to terminate the contract early. As a result, on January 29, 2008, the Company and SPS entered into an amendment to the contract and agreed that the contract will terminate on September 30, 2009.

In June 2006, the Company began exchanging up to 100 MW of capacity and associated energy with Phelps Dodge Energy. The contract provides for Phelps Dodge to deliver energy to the Company from its ownership interest in the Luna Energy Facility, an approximate 570 MW natural gas fired combined cycle generation facility located in Luna County, New Mexico and for the Company to deliver

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a like amount of energy at the Greenlee delivery point. The Company may purchase up to 100 MW at a specified price at times when energy is not exchanged. The agreement was approved by the FERC and continues through December 31, 2021.

The Company entered into a contract to sell up to 100 MW of firm energy and 50 MW of contingent energy to Imperial Irrigation District ("IID") which began May 1, 2007 and continues through April 30, 2009. The contract also provides for the Company to sell up to 100 MW of firm energy and 40 MW of contingent energy beginning May 1, 2009 through April 30, 2010. To ensure that power is available to meet the IID contract demand, the Company entered into a contract effective May 1, 2007 to purchase up to 100 MW of firm energy from CreditSuisse Energy, LLC. This contract provides for up to 100 MW of firm energy to be delivered at Palo Verde through April 30, 2010 and 50 MW of energy delivered at Four Corners in the months of July through September in 2007 and May through September for the years 2008 through 2010.

Environmental Matters

The Company is subject to regulation with respect to air, soil and water quality, solid waste disposal and other environmental matters by federal, state, tribal and local authorities. Those authorities govern current facility operations and have continuing jurisdiction over facility modifications. Failure to comply with these environmental regulatory requirements can result in actions by regulatory agencies or other authorities that might seek to impose on the Company administrative, civil, and/or criminal penalties. In addition, unauthorized releases of pollutants or contaminants into the environment can result in costly cleanup obligations that are subject to enforcement by regulatory agencies.

These laws and regulations are subject to change and, as a result of those changes, the Company may face additional capital and operating costs to comply. For example, recent developments suggest a growing likelihood of future regulation relating to climate change and greenhouse gas emissions. At the federal level, Congress continues to hold many hearings relating to climate change issues and many bills have been introduced to impose regulation through regulatory schemes including a "cap and trade" program. The United States Supreme Court has found carbon dioxide, one of the principal greenhouse gases, to be a "pollutant" under the Clean Air Act, increasing the possibility that the U.S. Environmental Protection Agency will begin to regulate these emissions even in the absence of further action by Congress. In addition, the State of New Mexico, where the Company operates one facility and has an interest in another facility, has joined with California and several other states in the Western Regional Climate Action Initiative and is pursuing initiatives to reduce greenhouse gas emissions in the state. The Company is monitoring these developments and how regulation may affect it. If the United States or individual states in which the Company operates were to regulate greenhouse gas emissions, the Company's fossil fuel generation assets are likely to face additional costs for monitoring, reporting, controlling, or offsetting these emissions.

Another way in which environmental matters may impact the Company's operations and business is the implementation of the U.S. Environmental Protection Agency's Clean Air Interstate Rule which, as applied to the Company, may result in a requirement that it substantially reduce emissions of nitrogen oxides from its power plants in Texas and/or purchase allowances representing other parties' emissions

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reductions starting in 2009. These requirements become more stringent in 2015, and are anticipated to require even further emissions reductions or additional allowance purchases.

The Company takes these regulatory matters seriously and is monitoring these issues so that the Company is best able to effectively adapt to any such changes. Because the Company's generating portfolio has a carbon footprint that compares favorably with other power generating companies, the Company believes such regulations would not impose greater relative burdens on the Company than on most other electric utilities. Environmental regulations like these can change rapidly and those changes are often difficult to predict. While the Company strives to prepare for and implement actions necessary to comply with changing environmental regulations, substantial expenditures may be required for the Company to comply with such regulations in the future and, in some instances, those expenditures may be material. The Company believes it is impossible at present to meaningfully quantify the costs of these potential impacts.

The Company analyzes the costs of its obligations arising from environmental matters on an ongoing basis and believes it has made adequate provision in its financial statements to meet such obligations. As a result of this analysis, the Company has a provision for environmental remediation obligations of approximately \$1.4 million as of December 31, 2007, which amounts are related to compliance with federal and state environmental standards. However, unforeseen expenses associated with environmental compliance or remediation may occur and could have a material adverse effect on the future operations and financial condition of the Company.

The Company incurred the following expenditures to comply with federal environmental statutes (in thousands):

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Clean Air Act	\$ 1,808	\$ 1,203	\$ 1,106
Clean Water Act (1)	1,293	2,004	1,708

(1) Includes a \$0.5 million adjustment reducing the estimated costs of remediation at the Rio Grande and Copper generating stations and \$1.1 million in remediation costs for the twelve months ended December 31, 2007 and 2005, respectively.

Along with many other companies, the Company received from the Texas Commission on Environmental Quality ("TCEQ") a request for information in 2003 in connection with environmental conditions at a facility in San Angelo, Texas that was operated by the San Angelo Electric Service Company ("SESCO"). In November 2005, TCEQ proposed the SESCO site for listing on the registry of Texas state superfund sites and mailed notice to more than five hundred entities, including the Company, indicating that TCEQ considers each of them to be "potentially responsible parties" at the SESCO site. The Company received from the SESCO working group of potentially responsible parties a settlement offer in May 2006 for remediation and other expenses expected to be incurred in connection with the SESCO site. The Company's position is that any liability it may have related to the SESCO site was discharged in the

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Company's bankruptcy. At this time, the Company has not agreed to a settlement or to otherwise participate in the cleanup of the SESCO site and is unable to predict the outcome of this matter. While the Company has no reason at present to believe that it will incur material liabilities in connection with the SESCO site, it has accrued \$0.3 million for potential costs related to this matter.

On September 26, 2006, the Secretary of the New Mexico Environment Department issued a Compliance Order concerning the Company's Rio Grande Generating Station, located in Dona Ana County, New Mexico. The Compliance Order alleges that, on approximately 650 occasions between May 2000 and September 2005, the Rio Grande Generating Station emitted sulfur dioxide, nitrogen oxides or carbon monoxide in excess of its permitted emission rates and failed to properly report these allegedly excess emissions. The Compliance Order asserts a statutory authority to seek a civil penalty of up to \$15,000 per violation for each of the violations alleged. The Company disputes the allegations made and has requested a hearing before the New Mexico Environment Department on the matter. While the Company cannot predict the outcome of this matter, it believes these emissions did not violate applicable legal standards and that penalties, if any, should not involve a material liability.

On April 4, 2007, the Company submitted its application for a New Source Review Air Quality Permit/Prevention of Significant Deterioration ("PSD") permit to the TCEQ for the new natural-gas electric generating units to be located at its existing Newman plant site in the City of El Paso ("Newman Unit 5"). The Company expects to receive approval of its PSD application in the second quarter of 2008. Additional environmental permits other than the PSD are not required to begin construction of these new generating units because Newman Unit 5 will be constructed at an existing plant site and other permits are currently in place which will encompass Newman Unit 5.

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

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

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

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MiraSol Warranty Obligations

MiraSol is an energy services subsidiary which offered a variety of services to reduce energy use and/or lower energy costs. MiraSol was not a power marketer. 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. As of December 31, 2007, the Company has a reserve for warranty claims in the amount of approximately \$1.0 million. Accruals, charges and balances for the reserve for warranty claims are as follows:

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Balance at beginning of year	\$ 1,785	\$ 1,288	\$ 1,305
Accrual of warranty costs.....	—	500	—
Charges for work performed	—	(3)	(17)
Liabilities settled	(800)	—	—
Balance at end of year	<u>\$ 985</u>	<u>\$ 1,785</u>	<u>\$ 1,288</u>

While no other probable warranty liabilities have been identified at this time, if it is determined at a future date that MiraSol has further obligations to any customer, and contributions from MiraSol, its subcontractors or any other third party are insufficient to honor the warranty obligations, the Company intends to honor any such warranty obligations after making appropriate regulatory filings, if any.

Lease Agreements

The Company has operating leases for administrative offices and certain warehouse facilities. The administrative offices lease has an 11-year term ending May 31, 2018. The fixed minimum lease payments are \$1.7 million annually. On February 8, 2008, the Company exercised its right of first refusal in the lease agreement to purchase this office building. All obligations previously incurred relating to this lease were terminated. The warehouse facilities lease expires in December 2009 and has three concurrent renewal options of one year each. The lease payments are \$0.3 million annually. The lease agreements do not impose any restrictions relating to issuance of additional debt, payment of dividends or entering into other lease arrangements. The Company has no significant capital lease agreements.

The Company's total annual rental expense related to operating leases was \$2.0 million, \$1.7 million and \$1.1 million for 2007, 2006 and 2005, respectively. As of December 31, 2007, the Company's minimum future rental payments for the next five years are as follows (in thousands):

2008.....	\$ 2,739
2009.....	2,301
2010.....	1,830
2011.....	1,762
2012.....	1,714

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J. Litigation

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

On June 7, 2004, the City of Tacoma filed suit against the Company and other defendants in the United States District Court for the Western District of Washington (*City of Tacoma v. American Electric Power Service Corp., et al.*, C04-5325RBL). This complaint sought civil damages (including treble damages) from the Company and the other defendants for violations of certain antitrust provisions under the Sherman Act. This matter was filed in the United States District Court for the Western District of Washington and on February 11, 2005, the Court granted the Company's motion to dismiss the case. The City of Tacoma filed a notice of appeal with the U.S. Court of Appeals for the Ninth Circuit. On March 20, 2007, the Ninth Circuit entered an order dismissing the appeal pursuant to a stipulation of the parties. The dismissal is final and no further appeal may be filed.

On May 5, 2004, Wah Chang, a specialty metals manufacturer which operates a plant in Oregon, filed suit against the Company and other defendants in the United States District Court for the District of Oregon. (*Wah Chang v. Avista Corporation, et al.*, No. 04-619AS). The complaint also makes substantially the same allegations as were made in *City of Tacoma* and seeks the same types of damages. This matter was transferred to the same court that heard and dismissed the *City of Tacoma* lawsuit and on February 11, 2005, the Court granted the Company's motion to dismiss the case. Wah Chang filed notice of appeal with the U.S. Court of Appeals for the Ninth Circuit, and in November 2007, the Ninth Circuit upheld the dismissal of the suit. Wah Chang filed a motion for rehearing of the appeal, and on January 15, 2008, the Ninth Circuit denied Wah Chang's motion. While the Company believes that this matter is without merit and intends to defend itself vigorously in any further appeal by Wah Chang to the U.S. Supreme Court, the Company is unable to predict the outcome or range of possible loss.

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

K. Employee Benefits

Retirement Plans

The Company's Retirement Income Plan (the "Retirement Plan") covers employees who have completed one year of service with the Company and work at least a minimum number of hours each year. The Retirement Plan is a qualified noncontributory defined benefit plan. Upon retirement or death of a vested plan participant, assets of the Retirement Plan are used to pay benefit obligations under the

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

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Retirement Plan. Contributions from the Company are at least the minimum funding amounts required by the IRS under provisions of the Retirement Plan, as actuarially calculated. The assets of the Retirement Plan are invested in equity securities, debt securities and cash equivalents and are managed by professional investment managers appointed by the Company.

The Company has two non-qualified retirement income plans that are non-funded defined benefit plans. One plan covers certain former employees of the Company, and the other plan, an excess benefit plan adopted during 2004, covers certain active and former employees of the Company. The benefit cost for the non-qualified retirement income plans are based on substantially the same actuarial methods and economic assumptions as those used for the Retirement Plan. On December 31, 2006, the Company adopted SFAS No. 158 "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans", which amended SFAS No. 87 and SFAS No. 132R. The Company uses a measurement date of December 31 for its retirement plans; therefore, there were no adjustments related to a change in measurement date as a result of the adoption of SFAS No. 158.

The obligations and funded status of the plans are presented below (in thousands):

	December 31,			
	2007		2006	
	Retirement Income Plan	Non- Qualified Retirement Income Plans	Retirement Income Plan	Non- Qualified Retirement Income Plans
Change in projected benefit obligation:				
Benefit obligation at end of prior year	\$ 182,222	\$ 22,112	\$ 181,191	\$ 23,523
Service cost	5,455	179	5,466	141
Interest cost	10,794	1,263	9,892	1,236
Actuarial gain	(12,153)	(1,534)	(9,043)	(1,085)
Benefits paid	(6,017)	(1,623)	(5,284)	(1,703)
Benefit obligation at end of year	<u>180,301</u>	<u>20,397</u>	<u>182,222</u>	<u>22,112</u>
Change in plan assets:				
Fair value of plan assets at end of prior year	146,425	-	123,492	-
Actual return on plan assets	16,620	-	16,217	-
Employer contribution	12,000	1,623	12,000	1,703
Benefits paid	(6,017)	(1,623)	(5,284)	(1,703)
Fair value of plan assets at end of year	<u>169,028</u>	<u>-</u>	<u>146,425</u>	<u>-</u>
Funded status at end of year	<u>\$ (11,273)</u>	<u>\$ (20,397)</u>	<u>\$ (35,797)</u>	<u>\$ (22,112)</u>

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Amounts recognized in the Company's consolidated balance sheets consist of the following (in thousands):

	December 31,			
	2007		2006	
	Retirement Income Plan	Non- Qualified Retirement Income Plans	Retirement Income Plan	Non- Qualified Retirement Income Plans
Current liabilities.....	\$ -	\$ (1,582)	\$ -	\$ (1,649)
Noncurrent liabilities.....	(11,273)	(18,815)	(35,797)	(20,463)
Total.....	<u>\$ (11,273)</u>	<u>\$ (20,397)</u>	<u>\$ (35,797)</u>	<u>\$ (22,112)</u>

The accumulated benefit obligation for all retirement plans was \$164.7 million and \$172.7 million at December 31, 2007 and 2006, respectively. The accumulated benefit obligation in excess of plan assets is as follows (in thousands):

	December 31,			
	2007		2006	
	Retirement Income Plan	Non- Qualified Retirement Income Plans	Retirement Income Plan	Non- Qualified Retirement Income Plans
Projected benefit obligation.....	\$ (180,301)	\$ (20,397)	\$ (182,222)	\$ (22,112)
Accumulated benefit obligation.....	(149,308)	(15,352)	(151,569)	(21,101)
Fair value of plan assets.....	169,028	-	146,425	-

Amounts recognized in accumulated other comprehensive income consist of the following (in thousands):

	Years Ended December 31,			
	2007		2006	
	Retirement Income Plan	Non- Qualified Retirement Income Plans	Retirement Income Plan	Non- Qualified Retirement Income Plans
Net loss.....	\$ 24,603	\$ 2,589	\$ 44,000	\$ 4,379
Prior service cost.....	110	785	132	879
Total.....	<u>\$ 24,713</u>	<u>\$ 3,374</u>	<u>\$ 44,132</u>	<u>\$ 5,258</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following are the weighted-average actuarial assumptions used to determine the benefit obligations:

	December 31,					
	2007			2006		
	Retirement Income Plan	Non-Qualified Retirement Income Plan	Excess Benefit Plan	Retirement Income Plan	Non-Qualified Retirement Income Plan	Excess Benefit Plan
Discount rate.....	6.40%	6.10%	6.40%	5.90%	5.70%	5.90%
Rate of compensation increase	5.00%	N/A	5.00%	5.00%	N/A	5.00%

The components of net periodic benefit cost are presented below (in thousands):

	Years Ended December 31,					
	2007		2006		2005	
	Retirement Income Plan	Non-Qualified Retirement Income Plans	Retirement Income Plan	Non-Qualified Retirement Income Plans	Retirement Income Plan	Non-Qualified Retirement Income Plans
Service cost	\$ 5,455	\$ 179	\$ 5,466	\$ 141	\$ 5,021	\$ 143
Interest cost	10,794	1,263	9,892	1,236	9,351	1,281
Expected return on plan assets	(12,537)	—	(11,029)	—	(9,426)	—
Amortization of:						
Net loss	3,161	257	4,202	299	3,938	291
Prior service cost	21	94	22	94	21	94
Net periodic benefit cost	<u>\$ 6,894</u>	<u>\$ 1,793</u>	<u>\$ 8,553</u>	<u>\$ 1,770</u>	<u>\$ 8,905</u>	<u>\$ 1,809</u>

The changes in benefit obligations recognized in other comprehensive income are presented below (in thousands):

	Years Ended December 31,					
	2007		2006		2005	
	Retirement Income Plan	Non-Qualified Retirement Income Plans	Retirement Income Plan	Non-Qualified Retirement Income Plans	Retirement Income Plan	Non-Qualified Retirement Income Plans
Net gain	\$ (16,236)	\$ (1,533)				
Amortization of:						
Net loss	(3,161)	(257)				
Prior service cost	(21)	(94)				
Increase (decrease) in minimum liability included in other comprehensive income before adoption of SFAS No. 158	—	—	\$ (16,363)	\$ (560)	\$ 5,757	\$ 371
Increase (decrease) in accumulated other comprehensive income due to adoption of SFAS No. 158	—	—	30,785	1,781	—	—
Total expense (income) recognized in other comprehensive income	<u>\$ (19,418)</u>	<u>\$ (1,884)</u>	<u>\$ 14,422</u>	<u>\$ 1,221</u>	<u>\$ 5,757</u>	<u>\$ 371</u>

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The total amount recognized in net periodic benefit costs and other comprehensive income are presented below (in thousands):

	Years Ended December 31,					
	2007		2006		2005	
	Retirement Income Plan	Non- Qualified Retirement Income Plans	Retirement Income Plan	Non- Qualified Retirement Income Plans	Retirement Income Plan	Non- Qualified Retirement Income Plans
Total recognized in net periodic benefit cost and other comprehensive income.....	\$ (12,524)	\$ (91)	\$ 22,975	\$ 2,991	\$ 14,662	\$ 2,180

The following are amounts in accumulated other comprehensive income that are expected to be recognized as components of net periodic benefit cost during 2008 (in thousands):

	Retirement Income Plan	Non-Qualified Retirement Income Plans
Net loss	\$ 660	\$ 55
Prior service cost	21	94

The following are the weighted-average actuarial assumptions used to determine the net periodic benefit cost at December 31:

	2007			2006			2005		
	Retirement Income Plan	Non-Qualified Retirement Income Plan	Excess Benefit Plan	Retirement Income Plan	Non-Qualified Retirement Income Plan	Excess Benefit Plan	Retirement Income Plan	Non-Qualified Retirement Income Plan	Excess Benefit Plan
Discount rate	5.90%	5.70%	5.90%	5.50%	5.50%	5.50%	5.75%	5.75%	5.75%
Expected long-term return on plan assets	8.50%	N/A	N/A	8.50%	N/A	N/A	8.50%	N/A	N/A
Rate of compensation increase	5.00%	N/A	5.00%	5.00%	N/A	5.00%	5.00%	N/A	5.00%

The Company reassesses various actuarial assumptions at least on an annual basis. The discount rate is changed at each measurement date based on prevailing market interest rates inherent in high-quality (AA and better) corporate bonds that would provide the future cash flow needed to pay the benefits included in the benefit obligation as they become due, as well as on publicly available bond indices. The Company changed its discount rate to determine the benefit obligations for the retirement income plan and the excess benefit plan from 5.90% to 6.40% and the non-qualified retirement income

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plan from 5.70% to 6.10% at December 31, 2007. For determining 2008 benefit costs, the Company changed its discount rate for the retirement income plan and the excess benefit plan from 5.50% to 5.90% and the non-qualified retirement income plan from 5.50% to 5.70%. A 1.0% decrease in the discount rate would increase the 2007 retirement plans' projected benefit obligation by 14.7%. A 1.0% increase in the discount rate would decrease the 2007 retirement plans' projected benefit obligation by 12.0%.

The Company's overall expected long-term rate of return on assets is 8.50%, which is both a pre-tax and after-tax rate as pension funds are generally not subject to income tax. The expected long-term rate of return is based on the weighted average of the expected returns on investments based upon the target asset allocation of the pension fund. The Retirement Plan fund includes a diversified portfolio of mutual funds investing in equity securities including large and small capital funds, international funds, and an energy industry specific fund. In addition, the Retirement Plan fund includes mutual funds that invest in commodities and emerging market debt. The Retirement Plan fund also invests in fixed income securities. The target long-term asset allocation provides for investments in real estate. The expected returns for mutual fund investments are based on historical risk premiums above the current fixed income rate, while the expected returns for the fixed income securities are based on the portfolio's yield to maturity.

The Company's Retirement Plan fund actual and target long-term asset allocations are as follows:

<u>Asset Category</u>	<u>December 31,</u>			
	<u>2007</u>		<u>2006</u>	
	<u>Actual</u>	<u>Target</u>	<u>Actual</u>	<u>Target</u>
Equity funds.....	60%	60%	54%	55%
Fixed income.....	40	35	37	35
Alternative investments	—	5	9	10
Total.....	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

The Company adheres to the traditional capital market pricing theory which maintains that over the long term, the risk of owning equities should be rewarded with a greater return than available from fixed income investments. The Company seeks to minimize the risk of owning equity securities by investing in mutual funds that pursue risk minimization strategies and by diversifying its investments to limit its risks during falling markets. The investment managers have full discretionary authority to direct the investment of plan assets held in trust within the guidelines prescribed by the Company through the plan's investment policy statement including the ability to hold cash equivalents. The investment guidelines of the investment policy statement are in accordance with the Employee Retirement Income Security Act of 1974 (ERISA) and Department of Labor (DOL) regulations.

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The contributions for the Retirement Plan, as actuarially calculated, are at least the minimum funding amounts required by the IRS. The Company expects to contribute \$13.6 million to its retirement plans in 2008, although the Company has no 2008 minimum funding requirements for the Retirement Plan.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands):

	<u>Retirement Income Plan</u>	<u>Non- Qualified Retirement Income Plans</u>
2008	\$ 6,247	\$ 1,582
2009	6,829	1,563
2010	7,465	1,623
2011	8,178	1,596
2012	9,002	1,574
2013-2017	60,383	9,145

Other Postretirement Benefits

The Company provides certain health care benefits for retired employees and their eligible dependents and life insurance benefits for retired employees only. Substantially all of the Company's employees may become eligible for those benefits if they retire while working for the Company. Contributions from the Company are based on the funding amounts established in Texas Commission Docket No. 12700. The assets of the plan are invested in equity securities, debt securities, and cash equivalents and are managed by professional investment managers appointed by the Company.

The Company determined that the prescription drug benefits of its plan were actuarially equivalent to the Medicare Part D benefit provided for in the Medicare Prescription Drug, Improvement, and Modernization Act of 2003. FASB Staff Position No. 106-2 "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" requires measurement of the postretirement benefit obligation, the plan assets, and the net periodic postretirement benefit cost to reflect the effects of the subsidy.

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The following table contains a reconciliation of the change in the benefit obligation, the fair value of plan assets, and the funded status of the plans (in thousands):

	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
Change in benefit obligation:		
Benefit obligation at end of prior year	\$ 113,933	\$ 112,769
Service cost	3,870	4,584
Interest cost	6,053	5,762
Actuarial gain	(22,801)	(6,863)
Benefits paid	(2,810)	(2,658)
Retiree contributions	367	339
Benefit obligation at end of year	<u>98,612</u>	<u>113,933</u>
Change in plan assets:		
Fair value of plan assets at end of prior year	28,498	24,717
Actual return on plan assets	1,750	2,678
Employer contribution	3,422	3,422
Benefits paid	(2,810)	(2,658)
Retiree contributions	367	339
Fair value of plan assets at end of year	<u>31,227</u>	<u>28,498</u>
Funded status	<u>\$ (67,385)</u>	<u>\$ (85,435)</u>

Amounts recognized in the Company's consolidated balance sheets as a non-current liability consist of accrued postretirement costs of \$67.4 million and \$85.4 million for 2007 and 2006, respectively.

On December 31, 2006, the Company adopted SFAS No. 158 "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans", which amended SFAS No. 106 and SFAS No. 132R. The Company uses a measurement date of December 31 for its other postretirement benefits plan, therefore there were no adjustments related to a change in measurement date as a result of the adoption of SFAS No. 158.

Amounts recognized in accumulated other comprehensive income that have not been recognized as a component of net periodic cost in accordance with SFAS No. 158 consist of the following (in thousands):

	<u>Years Ended December 31,</u>	
	<u>2007</u>	<u>2006</u>
Net gain	\$ (23,604)	\$ (780)
Prior service credit	<u>(18,577)</u>	<u>(21,446)</u>
	<u>\$ (42,181)</u>	<u>\$ (22,226)</u>

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The following are the weighted-average actuarial assumptions used to determine the accrued postretirement costs:

	<u>2007</u>	<u>2006</u>
Discount rate at end of year	6.50%	5.90%
Trend rates:		
Initial	9.50%	9.60%
Ultimate	5.00%	6.00%
Years ultimate reached	10	4

Net periodic benefit cost is made up of the components listed below (in thousands):

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Service cost.....	\$ 3,870	\$ 4,584	\$ 4,749
Interest cost.....	6,053	5,762	6,667
Expected return on plan assets	(1,695)	(1,478)	(1,382)
Amortization of:			
Prior service benefit	(2,869)	(2,869)	(355)
Net gain	(32)	—	—
Net periodic benefit cost.....	<u>\$ 5,327</u>	<u>\$ 5,999</u>	<u>\$ 9,679</u>

The changes in benefit obligations recognized in accumulated other comprehensive income are presented below (in thousands):

	<u>Years Ended December 31,</u>	
	<u>2007</u>	<u>2006</u>
Net gain	\$ (22,856)	
Amortization of:		
Prior service benefit	2,869	
Net gain	32	
Increase (decrease) in accumulated other comprehensive income due to adoption of SFAS No. 158	—	\$ (22,226)
Total recognized in other comprehensive income.....	<u>\$ (19,955)</u>	<u>\$ (22,226)</u>

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The total recognized in net periodic benefit cost and other comprehensive income are presented below (in thousands):

	<u>Years Ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Total recognized in net periodic benefit cost and other comprehensive income.....	\$ <u>(14,628)</u>	\$ <u>(16,227)</u>	\$ <u>9,679</u>

The following are amounts in accumulated other comprehensive income that are expected to be recognized as components of net periodic benefit cost during 2008 (in thousands):

Prior service benefit.....	\$ (2,869)
Net gain.....	(1,127)

The following are the weighted-average actuarial assumptions used to determine the net periodic benefit cost:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Discount rate at beginning of year.....	5.90%	5.50%	5.75%
Expected long-term return on plan assets.....	5.90%	5.90%	5.90%
Trend rates:			
Initial	9.60%	9.60%	9.60%
Ultimate	6.00%	6.00%	6.00%
Years ultimate reached	4	4	4

The Company reassesses various actuarial assumptions at least on an annual basis. The discount rate is evaluated at each measurement date based on prevailing market interest rates inherent in high-quality (AA and better) corporate bonds that would provide the future cash flow needed to pay the benefits included in the benefit obligation as they become due, as well as on publicly available bond indices. At December 31, 2007, the Company changed its discount rate from 5.90% to 6.50% for the other postretirement benefits plan. For determining 2008 benefit cost, the Company changed its discount rate from 5.50% to 5.90%. A 1.0% decrease in the discount rate would increase the 2007 accumulated postretirement benefit obligation by 16.7%. A 1.0% increase in the discount rate would decrease the 2007 accumulated postretirement benefit obligation by 17.5%.

For measurement purposes, a 9.5% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2008; the rate was assumed to decrease gradually to 5% for 2017 and remain at that level thereafter. Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plan. The effect of a 1% change in these assumed health care cost

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trend rates would increase or decrease the benefit obligation by \$15.5 million or \$12.6 million, respectively. In addition, such a 1% change would increase or decrease the aggregate service and interest cost components of the net periodic benefit cost by \$1.9 million or \$1.5 million, respectively.

The Company's overall expected long-term rate of return on assets, on an after-tax basis, is 5.90%. The expected long-term rate of return is based on the after-tax weighted average of the expected returns on investments based upon the target asset allocation. The asset portfolio includes a diversified mix of mutual funds investing in equity securities including large and small capital funds, international funds, and an energy industry specific fund. In addition, the asset portfolio includes mutual funds that invest in commodities and emerging market debt. The asset portfolio also includes fixed income securities and cash equivalents. The target long-term asset allocation provides for investments in real estate. The expected returns for mutual fund investments are based on historical risk premiums above the current fixed income rate, while the expected returns for the fixed income securities are based on the portfolio's yield to maturity. The Company's asset portfolio actual and target long-term asset allocations are as follows:

<u>Asset Category</u>	<u>December 31,</u>			
	<u>2007</u>		<u>2006</u>	
	<u>Actual</u>	<u>Target</u>	<u>Actual</u>	<u>Target</u>
Equity funds.....	70%	65%	62%	60%
Fixed income.....	30	30	29	30
Alternative investments	—	5	9	10
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

The Company adheres to the traditional capital market pricing theory which maintains that over the long term, the risk of owning equities should be rewarded with a greater return than available from fixed income investments. The Company seeks to minimize the risk of owning equity securities by investing in mutual funds that pursue risk minimization strategies and by diversifying its investments to limit its risks during falling markets. The investment managers have full discretionary authority to direct the investment of plan assets held in trust within the guidelines prescribed by the Company through the plan's investment policy statement including the ability to hold cash equivalents. The investment guidelines of the investment policy statement are in accordance with the ERISA and DOL regulations.

The Company expects to contribute \$3.4 million to its other postretirement benefits plan in 2008.

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The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid (in thousands):

	Including Medicare Part D Subsidy	Excluding Medicare Part D Subsidy	Reduction due to the Medicare Part D Subsidy
2008	\$ 2,946	\$ 3,220	\$ (274)
2009	3,355	3,666	(311)
2010	3,877	4,223	(346)
2011	4,434	4,825	(391)
2012	5,030	5,468	(438)
2013-2017	34,602	37,815	(3,213)

401(k) Defined Contribution Plans

The Company sponsors 401(k) defined contribution plans covering substantially all employees. Historically, the Company has provided a 50 percent matching contribution up to 6 percent of the employee's compensation subject to certain other limits and exclusions. Total matching contributions made to the savings plans for the years 2007, 2006 and 2005 were \$1.6 million, \$1.5 million and \$1.5 million, respectively.

Annual Short-Term Bonus Plan

The Annual Short-Term Bonus Plan (the "Bonus Plan") provides for the payment of cash awards to eligible Company employees, including each of its named executive officers. Payment of awards is based on the achievement of performance measures reviewed and approved by the Company's Board of Directors Compensation Committee. Generally, these performance measures are based on meeting certain financial, operational and individual performance criteria. The financial performance goals are based on earnings per share and the operational performance goals are based on safety and customer satisfaction. If a certain level of earnings per share is not attained, no bonuses will be paid under the Bonus Plan. The Company reached the required levels of improvements in the earnings per share, customer satisfaction, safety goals to pay a bonus of \$7.0 million, \$6.1 million and \$3.5 million for 2007, 2006 and 2005, respectively. The Company has renewed the Bonus Plan in 2008 with similar goals.

L. Franchises and Significant Customers

El Paso Franchise

The Company has a franchise agreement with El Paso, the largest city it serves, through July 31, 2030. The franchise agreement includes a franchise fee of 3.25% of revenues and allows the Company to utilize public rights-of-way necessary to serve its retail customers within El Paso.

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Las Cruces Franchise

In February 2000, the Company and Las Cruces entered into a seven-year franchise agreement with a franchise fee of 2% of revenues (approximately \$1.5 million per year) for the provision of electric distribution service. Las Cruces exercised its right to extend the franchise for an additional two-year term ending April 30, 2009 and waived its option to purchase the Company's distribution system pursuant to the terms of the February 2000 settlement agreement.

Military Installations

The Company currently serves Holloman Air Force Base ("Holloman"), White Sands Missile Range ("White Sands") and the United States Army Air Defense Center at Fort Bliss ("Ft. Bliss"). The Company's sales to the military bases represent approximately 2% of annual operating revenues. The Company signed a contract with Ft. Bliss in December 1998 under which Ft. Bliss will take retail electric service from the Company through December 2008. In May 1999, the Army and the Company entered into a ten-year contract to provide retail electric service to White Sands. In March 2006, the Company signed a contract with Holloman that provides for the Company to provide retail electric service and limited wheeling services to Holloman for a ten-year term which expires in January 2016.

M. Financial Instruments and Investments

SFAS No. 107, "Disclosure about Fair Value of Financial Instruments," requires the Company to disclose estimated fair values for its financial instruments. The Company has determined that cash and temporary investments, investment in debt securities, accounts receivable, decommissioning trust funds, long-term debt and financing obligations, accounts payable and customer deposits meet the definition of financial instruments. The carrying amounts of cash and temporary investments, accounts receivable, accounts payable and customer deposits approximate fair value because of the short maturity of these items. Decommissioning trust funds are carried at market value.

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

	December 31,			
	2007		2006	
	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>	<u>Carrying Amount</u>	<u>Estimated Fair Value</u>
Pollution Control Bonds	\$ 193,135	\$ 192,820	\$ 193,135	\$ 193,539
Senior Notes.....	397,759	376,150	397,730	384,920
Nuclear Fuel Financing (1).....	<u>83,015</u>	<u>83,015</u>	<u>46,240</u>	<u>46,240</u>
Total	<u>\$ 673,909</u>	<u>\$ 651,985</u>	<u>\$ 637,105</u>	<u>\$ 624,699</u>

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

EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Treasury Rate Locks. During the first quarter of 2005, the Company entered into treasury rate lock agreements to hedge against potential movements in the treasury reference interest rate pending the issuance of the Notes. These treasury rate locks were terminated on May 11, 2005. The treasury rate lock agreements met the criteria for hedge accounting and were designated as a cash flow hedge. In accordance with cash flow hedge accounting, the Company recorded the loss associated with the fair value of the cash flow hedge of approximately \$14.0 million, net of tax, as a component of accumulated other comprehensive loss. In May 2005, the Company began to recognize in earnings (as additional interest expense) the accumulated other comprehensive loss associated with the cash flow hedge. During the next twelve month period, approximately \$0.3 million of this accumulated other comprehensive loss item will be reclassified to interest expense.

Contracts and Derivative Accounting. The Company uses commodity contracts to manage its exposure to price and availability risks for fuel purchases and power sales and purchases and these contracts generally have the characteristics of derivatives. The Company does not trade or use these instruments with the objective of earning financial gains on the commodity price fluctuations. The Company has determined that all such contracts outstanding at December 31, 2007, except for certain natural gas commodity contracts with optionality features, that had the characteristics of derivatives met the "normal purchases and normal sales" exception provided in SFAS No. 133, and, as such, were not required to be accounted for as derivatives pursuant to SFAS No. 133 and other guidance.

The Company determined that certain of its natural gas commodity contracts with optionality features are not eligible for the normal purchases exception and, therefore, are required to be accounted for as derivative instruments pursuant to SFAS No. 133. However, as of December 31, 2007, the variable, market-based pricing provisions of existing gas contracts are such that these derivative instruments have no significant fair value.

Marketable Securities. The Company's marketable securities, included in decommissioning trust funds in the balance sheets, are reported at fair value which was \$130.7 million and \$114.7 million at December 31, 2007 and 2006, respectively. Gross unrealized losses on marketable securities and the fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2007 and 2006, were as follows (in thousands):

	December 31, 2007					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Description of Securities:						
Federal Agency Mortgage						
Backed Securities	\$ 944	\$ (2)	\$ 2,253	\$ (34)	\$ 3,197	\$ (36)
Municipal Obligations	3,072	(11)	6,995	(54)	10,067	(65)
Corporate Obligations	1,119	(24)	880	(10)	1,999	(34)
Total debt securities	5,135	(37)	10,128	(98)	15,263	(135)
Common stock	9,031	(1,464)	-	-	9,031	(1,464)
Total temporarily impaired securities	\$ 14,166	\$ (1,501)	\$ 10,128	\$ (98)	\$ 24,294	\$ (1,599)

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Description of Securities:	December 31, 2006					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury Obligations and Direct Obligations of U.S. Government Agencies	\$ 4,223	\$ (21)	\$ 5,532	\$ (184)	\$ 9,755	\$ (205)
Federal Agency Mortgage Backed Securities	250	(2)	590	(30)	840	(32)
Municipal Obligations	12,336	(56)	1,517	(65)	13,853	(121)
Corporate Obligations	612	(7)	841	(27)	1,453	(34)
Total debt securities	17,421	(86)	8,480	(306)	25,901	(392)
Common stock	4,510	(161)	662	(199)	5,172	(360)
Total temporarily impaired securities	\$ 21,931	\$ (247)	\$ 9,142	\$ (505)	\$ 31,073	\$ (752)

The total impaired securities are comprised of approximately 80 investments that are in an unrealized loss position. The Company monitors the length of time the investment trades below its cost basis along with the amount and percentage of the unrealized loss in determining if a decline in fair value of marketable securities below original cost is considered to be other than temporary. In addition, the Company will research the future prospects of individual securities as necessary. As a result of these factors, as well as the Company's intent and ability to hold these investments until their market price recovers, these investments are not considered other-than-temporarily impaired. The Company will not have a requirement to expend monies held in trust before 2024 or a later period when the Company begins to decommission Palo Verde. For 2007, the Company realized a \$0.8 million gain on the sale of investments that were previously considered impaired. During the year ended December 31, 2006, the Company recognized other than temporary impairment losses of marketable securities of \$0.5 million. The Company did not recognize any impairment losses for 2007 or 2005.

N. Supplemental Statements of Cash Flows Disclosures

	Years Ended December 31,		
	2007	2006	2005
	(In thousands)		
Cash paid for:			
Interest on long-term debt and financing obligations	\$ 34,146	\$ 33,302	\$ 48,407
Income taxes	26,312	5,666	1,195
Non-cash financing activities:			
Grants of restricted shares of common stock	3,502	1,529	1,975
Deferred tax benefit on long-term incentive plans	3,993	954	—

EL PASO ELECTRIC COMPANY AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

O. Selected Quarterly Financial Data (Unaudited)

	2007 Quarters				2006 Quarters			
	4th	3rd	2nd	1st	4th	3rd	2nd	1st
(In thousands except for share data)								
Operating revenues (1).....	\$ 211,194	\$ 258,525	\$ 219,291	\$ 188,417	\$ 193,281	\$ 228,949	\$ 211,796	\$ 182,429
Operating income.....	15,971	60,990	21,451	29,909	19,968	51,055	22,192	22,347
Income before extraordinary item (2).....	13,947	36,088	9,599	15,119	9,758	27,076	15,249	9,304
Extraordinary gain on re-application of SFAS No. 71, net of tax.....	—	—	—	—	6,063	—	—	—
Net income.....	13,947	36,088	9,599	15,119	15,821	27,076	15,249	9,304
Basic earnings per share:								
Income before extraordinary item.....	0.31	0.79	0.21	0.33	0.21	0.57	0.32	0.19
Extraordinary gain on re-application of SFAS No. 71, net of tax.....	—	—	—	—	0.13	—	—	—
Net income.....	0.31	0.79	0.21	0.33	0.34	0.57	0.32	0.19
Diluted earnings per share:								
Income before extraordinary item.....	0.30	0.79	0.21	0.33	0.21	0.56	0.31	0.19
Extraordinary gain on re-application of SFAS No. 71, net of tax.....	—	—	—	—	0.13	—	—	—
Net income.....	0.30	0.79	0.21	0.33	0.34	0.56	0.31	0.19

- (1) Operating revenues are seasonal in nature, with the peak sales periods generally occurring during the summer months. Comparisons among quarters of a year may not represent overall trends and changes in operations.
- (2) During the fourth quarter of 2007, net income was positively affected by \$4.0 million of deferred income tax adjustments related to earlier quarters and the reversal of a \$1.7 million reserve for rate refund upon completion of contract negotiations with a large Texas customer.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of disclosure controls and procedures. During the period covered by this report, our chief executive officer and chief financial officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of December 31, 2007, (the "Evaluation Date"), concluded that as of the Evaluation Date, our disclosure controls and procedures (as required by paragraph (b) of the Securities Exchange Act of 1934 Rules 13a-15 or 15d-15) were adequate and designed to ensure that material information relating to us and our consolidated subsidiary would be made known to them by others within those entities.

Management's Annual Report on Internal Control Over Financial Reporting. Included herein under the caption "Management Report on Internal Control Over Financial Reporting" on page 56 of this report.

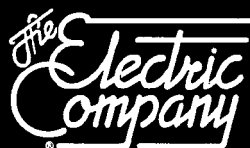
Changes in internal control over financial reporting. There were no changes in our internal control over financial reporting in connection with the evaluation required by paragraph (d) of the Securities Exchange Act of 1934 Rules 13a-15 or 15d-15, that occurred during the quarter ended December 31, 2007, that materially affected, or that were reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

PART III and PART IV

The information set forth in Part III and Part IV has been omitted from this Annual Report to Shareholders.



El Paso Electric