

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

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 0-296

El Paso Electric Company

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

74-0607870
(I.R.S. Employer Identification No.)

Stanton Tower, 100 North Stanton, El Paso, Texas
(Address of principal executive offices)

79901
(Zip Code)

(915) 543-5711

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(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

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

As of April 30, 2010, there were 43,761,615 shares of the Company's no par value common stock outstanding.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

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

| | March 31, 2010 (Unaudited) | December 31, 2009 |
|---|---|------------------------------|
| ASSETS | | |
| (In thousands) | | |
| Utility plant: | | |
| Electric plant in service | \$ 2,413,451 | \$ 2,392,850 |
| Less accumulated depreciation and amortization | (991,366) | (981,314) |
| Net plant in service | 1,422,085 | 1,411,536 |
| Construction work in progress | 262,295 | 244,166 |
| Nuclear fuel; includes fuel in process of \$47,644 and \$50,929, respectively | 150,867 | 135,021 |
| Less accumulated amortization | (41,479) | (34,737) |
| Net nuclear fuel | 109,388 | 100,284 |
| Net utility plant | 1,793,768 | 1,755,986 |
| Current assets: | | |
| Cash and cash equivalents | 56,365 | 91,790 |
| Accounts receivable, principally trade, net of allowance for doubtful accounts of \$995 and \$1,191, respectively | 74,060 | 70,382 |
| Accumulated deferred income taxes | 18,000 | 20,445 |
| Inventories, at cost | 37,324 | 37,935 |
| Income taxes receivable | 22,733 | 24,162 |
| Prepayments and other | 6,238 | 6,853 |
| Total current assets | 214,720 | 251,567 |
| Deferred charges and other assets: | | |
| Decommissioning trust funds | 140,845 | 135,372 |
| Regulatory assets | 63,249 | 60,708 |
| Other | 22,590 | 22,519 |
| Total deferred charges and other assets | 226,684 | 218,599 |
| Total assets | \$ 2,235,172 | \$ 2,226,152 |

See accompanying notes to consolidated financial statements.

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

| | March 31, 2010 (Unaudited) | December 31, 2009 |
|---|----------------------------------|----------------------|
| CAPITALIZATION AND LIABILITIES | | |
| (In thousands except for share data) | | |
| Capitalization: | | |
| Common stock, stated value \$1 per share, 100,000,000 shares authorized, 64,954,649 and 64,946,729 shares issued, and 179,312 and 147,427 restricted shares, respectively | \$ 65,134 | \$ 65,094 |
| Capital in excess of stated value | 301,486 | 301,180 |
| Retained earnings | 721,704 | 710,255 |
| Accumulated other comprehensive loss, net of tax | (47,744) | (49,887) |
| | 1,040,580 | 1,026,642 |
| Treasury stock, 21,373,930 and 21,169,284 shares, respectively, at cost | (308,002) | (303,913) |
| Common stock equity | 732,578 | 722,729 |
| Long-term debt, net of current portion | 739,709 | 739,697 |
| Financing obligations, net of current portion | 78,001 | 65,278 |
| Total capitalization | 1,550,288 | 1,527,704 |
| Current liabilities: | | |
| Current portion of long-term debt and financing obligations | 40,111 | 41,720 |
| Accounts payable, principally trade | 35,971 | 54,702 |
| Taxes accrued | 17,939 | 22,157 |
| Interest accrued | 12,608 | 10,283 |
| Overcollection of fuel revenues | 12,018 | 18,018 |
| Other | 25,821 | 24,896 |
| Total current liabilities | 144,468 | 171,776 |
| Deferred credits and other liabilities: | | |
| Accumulated deferred income taxes | 244,406 | 233,424 |
| Accrued postretirement benefit liability | 90,054 | 88,919 |
| Asset retirement obligation | 87,294 | 85,358 |
| Accrued pension liability | 80,760 | 80,940 |
| Regulatory liabilities | 14,136 | 14,127 |
| Other | 23,766 | 23,904 |
| Total deferred credits and other liabilities | 540,416 | 526,672 |
| Commitments and contingencies | | |
| Total capitalization and liabilities | \$ 2,235,172 | \$ 2,226,152 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---|---------------------------------|------------|----------------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Operating revenues | \$ 204,168 | \$ 190,436 | \$ 841,728 | \$ 989,126 |
| Energy expenses: | | | | |
| Fuel | 49,093 | 42,293 | 192,637 | 271,178 |
| Purchased and interchanged power | 28,847 | 29,398 | 108,052 | 184,523 |
| | 77,940 | 71,691 | 300,689 | 455,701 |
| Operating revenues net of energy expenses | 126,228 | 118,745 | 541,039 | 533,425 |
| Other operating expenses: | | | | |
| Other operations | 50,098 | 49,304 | 216,635 | 202,878 |
| Maintenance | 14,500 | 13,371 | 60,735 | 62,985 |
| Depreciation and amortization | 19,284 | 17,679 | 76,551 | 74,633 |
| Taxes other than income taxes | 11,743 | 12,517 | 49,224 | 50,545 |
| | 95,625 | 92,871 | 403,145 | 391,041 |
| Operating income | 30,603 | 25,874 | 137,894 | 142,384 |
| Other income (deductions): | | | | |
| Allowance for equity funds used during construction | 2,540 | 2,589 | 9,262 | 9,062 |
| Investment and interest income, net | 1,098 | (486) | 5,397 | 2,683 |
| Miscellaneous non-operating income | 2 | 212 | 897 | 2,483 |
| Miscellaneous non-operating deductions | (359) | (1,315) | (2,527) | (2,957) |
| | 3,281 | 1,000 | 13,029 | 11,271 |
| Interest charges (credits): | | | | |
| Interest on long-term debt and financing obligations | 12,201 | 13,924 | 48,789 | 51,424 |
| Other interest | 40 | 170 | 266 | 1,166 |
| Capitalized interest | (228) | (250) | (921) | (2,575) |
| Allowance for borrowed funds used during construction | (1,567) | (1,682) | (5,914) | (4,793) |
| | 10,446 | 12,162 | 42,220 | 45,222 |
| Income before income taxes | 23,438 | 14,712 | 108,703 | 108,433 |
| Income tax expense | 11,989 | 5,103 | 39,930 | 35,691 |
| Net income | \$ 11,449 | \$ 9,609 | \$ 68,773 | \$ 72,742 |

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| | | | | |
|--|------------|------------|------------|------------|
| Basic earnings per share | \$ 0.26 | \$ 0.21 | \$ 1.55 | \$ 1.62 |
| Diluted earnings per share | \$ 0.26 | \$ 0.21 | \$ 1.54 | \$ 1.62 |
| Weighted average number of shares outstanding | 43,738,947 | 44,756,793 | 44,273,168 | 44,726,924 |
| Weighted average number of shares and dilutive potential shares outstanding | 43,863,802 | 44,790,271 | 44,366,933 | 44,830,110 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---|---|-----------------|--|------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income | \$ 11,449 | \$ 9,609 | \$ 68,773 | \$ 72,742 |
| Other comprehensive income (loss): | | | | |
| Unrecognized pension and postretirement benefit costs: | | | | |
| Net gain (loss) arising during period | | | (48,580) | (30,587) |
| Reclassification adjustments included in net income for amortization of: | | | | |
| Prior service benefit | (700) | (700) | (2,754) | (2,754) |
| Net loss | 900 | 400 | 2,125 | 223 |
| Net unrealized gains (losses) on marketable securities: | | | | |
| Net holding gains (losses) arising during period | 2,423 | (5,391) | 20,630 | (28,356) |
| Reclassification adjustments for net (gains) losses included in net income | 31 | 2,473 | (224) | 5,155 |
| Net losses on cash flow hedges: | | | | |
| Reclassification adjustment for interest expense included in net income | 83 | 77 | 323 | 301 |
| Total other comprehensive income (loss) before income taxes | 2,737 | (3,141) | (28,480) | (56,018) |
| Income tax benefit (expense) related to items of other comprehensive income (loss): | | | | |
| Unrecognized pension and postretirement benefit costs | (73) | 109 | 16,775 | 11,787 |
| Net unrealized gains (losses) on marketable securities | (491) | 584 | (4,082) | 4,641 |
| Losses on cash flow hedges | (30) | (28) | (117) | (109) |
| Total income tax benefit (expense) | (594) | 665 | 12,576 | 16,319 |
| Other comprehensive income (loss), net of tax | 2,143 | (2,476) | (15,904) | (39,699) |
| Comprehensive income | \$ 13,592 | \$ 7,133 | \$ 52,869 | \$ 33,043 |

See accompanying notes to consolidated financial statements.

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| | Three Months Ended March 31, | |
|---|---|-----------------|
| | 2010 | 2009 |
| Cash flows from operating activities: | | |
| Net income | \$ 11,449 | \$ 9,609 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of electric plant in service | 19,284 | 17,679 |
| Amortization of nuclear fuel | 6,985 | 5,921 |
| Allowance for equity funds used during construction | (2,540) | (2,589) |
| Deferred income taxes, net | 11,059 | (4,222) |
| Other amortization and accretion | 4,041 | 3,860 |
| Unrealized (gain) loss on investments in debt securities | (62) | 52 |
| Other operating activities | (246) | 1,473 |
| Change in: | | |
| Accounts receivable | (3,678) | 17,668 |
| Inventories | 953 | 2,168 |
| Net overcollection (undercollection) of fuel revenues | (6,000) | 34,679 |
| Prepayments and other | 189 | (1,511) |
| Accounts payable | (15,360) | (24,257) |
| Taxes accrued | (2,737) | 8,835 |
| Interest accrued | 2,325 | 3,137 |
| Other current liabilities | 925 | (89) |
| Deferred charges and credits | (1,052) | (4,788) |
| Net cash provided by operating activities | 25,535 | 67,625 |
| Cash flows from investing activities: | | |
| Cash additions to utility property, plant and equipment | (47,145) | (47,262) |
| Cash additions to nuclear fuel | (15,739) | (13,631) |
| Capitalized interest and AFUDC: | | |
| Utility property, plant and equipment | (4,107) | (4,271) |
| Nuclear fuel | (228) | (250) |
| Allowance for equity funds used during construction | 2,540 | 2,589 |
| Decommissioning trust funds: | | |
| Purchases, including funding of \$2.1 and \$2.0 million, respectively | (22,354) | (14,198) |
| Sales and maturities | 19,504 | 12,416 |
| Other investing activities | (378) | (436) |
| Net cash used for investing activities | (67,907) | (65,043) |
| Cash flows from financing activities: | | |
| Repurchases of common stock | (4,089) | |
| Financing obligations: | | |
| Proceeds | 15,972 | 164,485 |
| Payments | (4,858) | (155,466) |
| Other financing activities | (78) | (1,281) |

| | | |
|---|-----------|------------|
| Net cash provided by financing activities | 6,947 | 7,738 |
| Net increase (decrease) in cash and cash equivalents | (35,425) | 10,320 |
| Cash and cash equivalents at beginning of period | 91,790 | 91,642 |
| Cash and cash equivalents at end of period | \$ 56,365 | \$ 101,962 |

See accompanying notes to consolidated financial statements.

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

A. Principles of Preparation

These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Annual Report of El Paso Electric Company on Form 10-K for the year ended December 31, 2009 (the 2009 Form 10-K). Capitalized terms used in this report and not defined herein have the meaning ascribed for such terms in the 2009 Form 10-K. In the opinion of the Company's management, the accompanying consolidated financial statements contain all adjustments necessary to present fairly the financial position of the Company at March 31, 2010 and December 31, 2009; the results of its operations and comprehensive operations for the three and twelve months ended March 31, 2010 and 2009; and its cash flows for the three months ended March 31, 2010 and 2009. The results of operations and comprehensive operations and the cash flows for the three months ended March 31, 2010 are not necessarily indicative of the results to be expected for the full calendar year.

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

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

Revenues. Accounts receivable include accrued unbilled revenues of \$20.1 million and \$18.2 million at March 31, 2010 and December 31, 2009, respectively. The Company presents sales net of sales taxes in its consolidated statements of operations.

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

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

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In January 2010, the FASB issued new guidance to improve disclosure requirements related to fair value measurements and disclosures. The new requirements include (i) disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers; and (ii) disclosure in the reconciliation for Level 3 fair value measurements should include information about purchases, sales, issuances, and settlements on a gross basis. The new guidance also clarifies existing disclosures and requires (i) an entity to provide fair value measurement disclosures for each class of assets and liabilities and (ii) disclosures about inputs and valuation techniques. The provisions of this new guidance were adopted in the first quarter of 2010 except for the reconciliation for the Level 3 fair value measurements on a gross basis which will be adopted during the first quarter of 2011. During the three months ended March 31, 2010, there were no transfers in or out of Level 1 or Level 2 categories. This guidance requires additional disclosure on fair value measurements, but does not impact the Company's consolidated financial statements. See Note H.

Supplemental Cash Flow Disclosures (in thousands)

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2010 | 2009 |
| Cash paid for: | | |
| Interest on long-term debt and financing obligations | \$ 9,610 | \$ 10,531 |
| Other interest | | 5 |
| Income taxes paid (refund) | 1,133 | (2,063) |
| Non-cash financing activities: | | |
| Grants of restricted shares of common stock | 779 | 490 |
| Issuance of performance shares | 662 | |

B. Regulation**General**

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

Texas Regulatory Matters

Texas Freeze Period. The Company has entered into agreements (Texas Rate Agreements) with El Paso, PUCT staff and other parties in Texas that provide for most retail base rates to remain at

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(Unaudited)

their current level through June 30, 2010. During the rate freeze period, if the Company's return on equity falls below the bottom of a defined range, the Company has the right to initiate a rate case and seek an adjustment to base rates. If the Company's return on equity exceeds the top of the range, the Company will refund an amount equal to 50% of the Texas jurisdictional pretax return in excess of the ceiling. The range is based upon a risk premium analysis used in rate proceedings to establish a utility's return on equity, and as of March 31, 2010, the range would be approximately 8.64% to 12.64%. The Company's return on equity fell within the then prevailing range during the last reporting period. Also pursuant to the Texas Rate Agreements, the Company agreed to share with its Texas customers 25% of off-system sales margins increasing to 90% after June 30, 2010 through June 30, 2015.

Fuel and Purchased Power Costs. Although the Company's base rates are frozen pursuant to the Texas Rate Agreements, the Company's actual fuel costs, including purchased power energy costs, are recoverable from its customers. The PUCT has adopted a rule establishing the recovery of fuel costs (Texas Fuel Rule) that allows the Company to seek adjustments to its fixed fuel factor three times per year in February, June and October. The Texas Fuel Rule provides for the fixed fuel factor to be based upon projected fuel and purchased power costs and projected kilowatt-hour sales for a twelve-month period. The Texas Fuel Rule also allows for the Company to request a formula to determine its fuel factor. Once a formula is approved, the Company could seek to revise its fixed fuel factor based upon the approved formula at least four months after its last revision except in the month of December. The Texas Fuel Rule requires the Company to request to refund fuel costs in any month when the over-recovery balance exceeds a threshold material amount and it expects to continue to be materially over-recovered. The Texas Fuel Rule also permits the Company to seek to surcharge fuel under-recoveries in any month the balance exceeds a threshold material amount and it expects to continue to be materially under-recovered. Fuel over and under recoveries are considered material when they exceed 4% of the previous twelve months fuel costs. All such fuel revenue and expense activities are subject to periodic final review by the PUCT in fuel reconciliation proceedings.

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

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

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

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

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

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

2009 Texas Retail Rate Case. On December 9, 2009, the Company filed an application with the PUCT for authority to change rates, to reconcile fuel costs, to establish formula-based fuel factors, and to establish an energy efficiency cost-recovery factor. This case was assigned PUCT Docket No. 37690. The filing included base rate increase which was based upon an adjusted test year ended June 30, 2009. The Company's requested base rate increase is \$46.4 million which has been revised from the original request to reflect a December 2009 change in accounting for federal income taxes. The Company's filing also seeks to reconcile fuel and purchased power costs and fuel-factor revenues for the period March 1, 2007 through June 30, 2009. The Company also requested approval to implement a fuel-factor formula that would change its historically-used method of establishing fuel and purchased power costs based upon a projected test year period to a PUCT-approved, utility-specific formula pursuant to PUCT Rules. Finally, the Company requested approval to implement an energy-efficiency cost-recovery factor to recover its ongoing reasonable energy-efficiency costs in addition to the previous costs that were deferred for future recovery due to the Company's rate freeze.

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The Company has been engaged in settlement discussions with all parties in the case. On April 23, 2010, the administrative law judge issued an order approving the Company's request for an indefinite suspension of the procedural deadlines in PUCT Docket No. 37690 to facilitate further settlement discussions. On April 30, 2010, the Company filed a report with the administrative law judge discussing the status of the settlement discussions. A prehearing conference has been scheduled for May 11, 2010, to reestablish the procedural schedule, if needed.

New Mexico Regulatory Matters

2009 New Mexico Stipulation. On May 29, 2009, the Company filed with the NMPRC a petition to increase non-fuel and purchased power base rates by \$12.7 million annually. The filing reflected a projected reduction of \$21.3 million in fuel related revenues based upon the difference in revenues for the test year ended December 31, 2008 and the forecast period revenues (forecasted fuel and purchased power costs for the twelve month period beginning July 1, 2010) for a projected net decrease in New Mexico jurisdictional fuel and purchased power revenues of \$8.6 million. The filing complied with the 2007 New Mexico Stipulation Requirement in the NMPRC's Final Order in Case No. 06-00258-UT to file a general rate case by May 30, 2009 using a test year ended December 31, 2008. The 2009 rate case was docketed as NMPRC Case No. 09-00171-UT.

A unanimous settlement of all issues in the case and an unopposed, comprehensive stipulation (the 2009 New Mexico Stipulation) was filed on October 8, 2009. The 2009 New Mexico Stipulation resolved all issues and provided for an increase in New Mexico jurisdictional non-fuel and purchased power base rate revenues of \$5.5 million. The 2009 New Mexico Stipulation provided for the revision of depreciation rates for the Palo Verde nuclear generating plant to reflect a 20-year life extension and depreciation rates for other plant in service. The 2009 New Mexico Stipulation also provided for the continuation of the Company's FPPCAC without conditions or variance and established the base fuel factor at \$0.04362 per kWh. In addition, the 2009 New Mexico Stipulation modified the market pricing of capacity and energy provided by Palo Verde Unit 3 due to the termination of the SPS contract in September 2009. Pursuant to the 2009 New Mexico Stipulation, Palo Verde Unit 3 capacity and energy will be included in the FPPCAC using a methodology based upon a purchased power contract with Credit Suisse Energy, LLC.

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

Investigation into Recovering County Franchise Fees. On December 10, 2009, the NMPRC issued an order in NMPRC Case No. 09-00421-UT, requiring the Company to show cause why it should collect franchise fees from its customers on behalf of Doña Ana and Otero Counties (the Counties). The Company responded to the order on January 5, 2010. On January 26, 2010, the NMPRC issued its decision concluding that the imposition of franchise fees by New Mexico counties is not authorized

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under New Mexico law and, therefore, the Company may not pass through to its customers some past and all ongoing franchise fees imposed by the Counties. The order concluded that only home rule municipalities, who had adopted a charter under the state constitution, could impose franchise fees or taxes, provided the residents so voted.

As a result of its findings, the NMPRC directed the Company to immediately cease passing through to its customers any franchise fees paid by the Company to the Counties. The NMPRC also directed the Company to refund to its customers in the Counties the amount of franchise fees charged to those customers since June 1, 2004, plus interest. The Company estimates that its refund obligation under the order would be approximately \$5.9 million, plus accrued interest of approximately \$1.1 million through March 31, 2010. The order stated that the Company was required to refund these franchise fees to customers over a three-year period through a credit on customer bills and file tariffs for refunding within three days. On January 29, 2010, the NMPRC granted the Company's request to extend its deadline for compliance with the order until February 12, 2010. Interest will continue to accrue on the unamortized balance until fully refunded. The order does not relieve the Company of its obligation to pay franchise fees to the Counties but states that this issue must be addressed by the New Mexico courts.

The Company filed a Notice of Appeal with the New Mexico Supreme Court on January 27, 2010 (the Appeal), seeking to set aside the order on legal and jurisdictional grounds. The Company followed with a motion for Emergency Stay on January 29, 2010, asking the New Mexico Supreme Court to stay the order pending the Appeal. The Company also asked the NMPRC, on February 12, 2010, to delay implementation of its order pending the Appeal. The Counties moved to intervene in the Appeal on February 10, 2010, and have also informed the Company they intend to pursue their own legal actions opposing the order. The Company had placed pending franchise payments to the Counties in separate accounts pending resolution of the proceedings. However, beginning in April 2010 the Company began paying franchise payments to the Counties in accordance with the current franchise agreements. On February 22, 2010, the New Mexico Supreme Court granted the Company's motion for Emergency Stay pending the outcome of the Appeal and granted the Counties' motion to intervene in the Appeal. The New Mexico legislature recently passed legislation that confirmed the legality of the Company's existing franchise agreements with the Counties. However, since the NMPRC order is still in effect, the Company is continuing its Supreme Court appeal. The Company cannot predict the outcome of the proceedings.

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

Investigation into the Service Quality of El Paso Electric Company. On October 22, 2009, NMPRC Staff filed a petition requesting an investigation into the quality of service of the Company's power distribution system in the Santa Teresa Industrial Park, based upon a report prepared for customers in that area by the Los Alamos National Laboratory. On October 27, 2009, the NMPRC

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decided to initiate an investigation and ordered the Company to respond no later than November 16, 2009. The Company filed an initial response on November 16, 2009 and a supplemental response on January 8, 2010 after obtaining data on which the report was based. The Company responses provided evidence that the reliability and power quality performance for the Company's service territory as a whole and on the Santa Teresa circuits in particular meet all applicable reliability standards and comport with good utility practices. On January 28, 2010, the NMPRC Staff filed its reply stating that they found no factual basis to conclude that the Company has violated NMPRC rules by not following good utility practices regarding service quality to the customers in the Santa Teresa Industrial Park area and recommended the NMPRC dismiss this proceeding. The Company is unable at this time to predict the ultimate outcome of this docket.

Federal Regulatory Matters

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

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

The FERC also ordered that the Company refund to TEP all sums with interest that TEP had paid it for transmission under the applicable transmission service agreements since February 2006 for service relating to the LEF. On December 3, 2008 the Company refunded \$9.7 million to TEP. The

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Company had established a reserve for the rate refund of approximately \$7.2 million as of September 30, 2008, resulting in a pre-tax charge to earnings of approximately \$2.5 million in 2008. The Company also paid TEP interest on the refunded balance of approximately \$0.9 million, which was also charged to earnings in 2008. The Company filed a request for rehearing of the FERC's decision on December 15, 2008, seeking reversal of the order on the merits and a return of any refunds made in the interim, as well as compensation for all service that the Company may provide to TEP from the LEF over the Company's transmission system on a going forward basis. The FERC suspended the period for ruling on the motion for rehearing on January 14, 2009. If the FERC denies the Company's request for rehearing or again finds against the Company on rehearing, the Company will have the right to seek judicial review of the order. If the order is not reversed, the Company will lose the opportunity to receive compensation from TEP for such transmission service in the future. The Company cannot predict the outcome of such potential future proceedings.

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

C. Common Stock

Common Stock Repurchase Program

Since 1999, the Company has repurchased approximately 21.3 million shares of common stock at an aggregate cost of \$307.5 million, including commissions. On February 19, 2010, the Board of Directors authorized an additional repurchase of up to 2 million shares of the Company's outstanding common stock. During the first quarter of 2010, the Company repurchased 204,646 shares of common stock in the open market at an aggregate cost of \$4.1 million under both the previously authorized program and under the recently authorized program. As of March 31, 2010, 1,996,336 shares remain available for repurchase under the recently authorized program. The Company may make purchases of its stock in the future pursuant to its stock repurchase plan at open market prices and may engage in private transactions, where appropriate. The repurchased shares will be available for issuance under employee benefit and stock incentive plans, or may be retired.

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Basic and Diluted Earnings Per Share

The basic and diluted earnings per share are presented below:

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---|------------------------------|-------------------|-------------------------------|-------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Weighted average number of common shares outstanding: | | | | |
| Basic number of common shares outstanding | 43,738,947 | 44,756,793 | 44,273,168 | 44,726,924 |
| Dilutive effect of unvested performance awards | 72,343 | | 45,961 | 3,180 |
| Dilutive effect of stock options | 52,512 | 33,478 | 47,804 | 100,006 |
| Diluted number of common shares outstanding | 43,863,802 | 44,790,271 | 44,366,933 | 44,830,110 |
| Basic net income per common share: | | | | |
| Net income | \$ 11,449 | \$ 9,609 | \$ 68,773 | \$ 72,742 |
| Income allocated to participating restricted stock | (44) | (32) | (255) | (191) |
| Net income available to common shareholders | \$ 11,405 | \$ 9,577 | \$ 68,518 | \$ 72,551 |
| Diluted net income per common share: | | | | |
| Net income | \$ 11,449 | \$ 9,609 | \$ 68,773 | \$ 72,742 |
| Income reallocated to participating restricted stock | (44) | (32) | (255) | (191) |
| Net income available to common shareholders | \$ 11,405 | \$ 9,577 | \$ 68,518 | \$ 72,551 |
| Basic net income per common share | \$ 0.26 | \$ 0.21 | \$ 1.55 | \$ 1.62 |
| Diluted net income per common share | \$ 0.26 | \$ 0.21 | \$ 1.54 | \$ 1.62 |

The calculation of the diluted number of common shares outstanding for the three months ended March 31, 2010 and 2009, excludes 79,990 and 80,367 shares, respectively, of restricted stock awards because their effect was antidilutive. The calculation of the diluted number of common shares outstanding for the twelve months ended March 31, 2010 and 2009, excludes 66,534 and 52,673 shares, respectively, of restricted stock awards because their effect was antidilutive.

No performance shares were excluded from the computation of diluted earnings per share for the three months ended March 31, 2010. Performance shares of 227,200 were excluded from the computation of diluted earnings per share for the three months ended March 31, 2009, as no payouts would have been required based upon performance at that time. These amounts assume a 100% performance level payout. Performance shares of 87,382 were excluded from the computation of diluted earnings per share for the twelve months ended March 31, 2010 as no payouts would be required based upon current performance. These amounts assume a 100% performance level payout. Performance shares of 121,810 were excluded from the computation of diluted earnings per share for the twelve months ended March 31, 2009.

No options were excluded from the computation of diluted earnings per share for the three and twelve months ended March 31, 2010 and 2009.

D. Income Taxes

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

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On March 23, 2010, the Patient Protection and Affordable Care Act (PPACA) was signed into law. A major provision of the law is that beginning in 2013 the income tax deductions for the cost of providing certain prescription drug coverage will be reduced by the amount of the Medicare Part D subsidies received. The Company is required to recognize the impacts of the tax law change at the time of enactment and recorded a non-cash charge to income tax expense of approximately \$4.8 million in the first quarter of 2010.

For the three months ended March 31, 2010 and 2009, the Company's consolidated effective tax rate was 51.2% and 34.7%, respectively. For the twelve months ended March 31, 2010 and 2009 the Company's consolidated effective tax rate was 36.7% and 32.9%, respectively. In 2010, the Company's effective tax rates differ from the federal statutory tax rate of 35% primarily due to the enactment of the PPACA discussed above. The Company's consolidated effective tax rate without the effect of the enactment of the PPACA for the three and twelve months ended March 31, 2010, was 30.7% and 32.3%, respectively. The Company's 2010 effective tax rates without the effect of the enactment of the PPACA and 2009 effective tax rates differ from the federal statutory tax rate of 35% primarily due to state income taxes, the allowance for equity funds used during construction, the tax rate on qualified decommissioning trust investment, and various permanent tax differences.

E. Commitments, Contingencies and Uncertainties

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

Power Purchase and Sale Contracts

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

| Type of Contract | Quantity | Term |
|--------------------------|-----------------|---|
| Power Purchase Agreement | Up to 92 MW | 20 years after operational start date (1) |
| Power Purchase Agreement | Up to 40 MW | 2010 |

(1) This contract is a power purchase agreement for the full capacity of a 92 MW concentrated solar plant to be built in Southern New Mexico. The plant is scheduled for commercial operation in 2011.

The Company entered into a 20-year contract (the Agreement) with New Mexico SunTower, LLC (NM SunTower also referred to as eSolar) in 2008 for the purchase of the output of a 92-MW

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concentrated solar plant which was expected to begin commercial operation in 2011. NM SunTower is an affiliate of NRG Energy, Inc. Under the terms of the Agreement, NM SunTower is required to meet certain construction milestones, the first of which was to demonstrate to the Company by April 30, 2010 that financing for the project had been secured. NM SunTower failed to meet this milestone, and, on May 3, 2010, the Company delivered to NM SunTower a notice of default as provided under the terms of the Agreement. NM SunTower has thirty days from the date of the notice to cure this default. If NM SunTower fails to cure the default within that period, the Company has the right, at its option, to either (i) terminate the Agreement, (ii) complete construction of the facility at the expense of and for the account of NM SunTower, or (iii) negotiate changes to the Agreement with NM SunTower. The Company also has the right to draw on a security fund of approximately \$1.8 million, which is a component of current assets on the Company's balance sheet, for any amount due under the Agreement as a result of the default. NM SunTower established the security fund upon execution of the Agreement.

The Company is presently evaluating its options in the event that NM SunTower fails to cure the default as provided in the Agreement. The Company is also pursuing other alternatives to meet its renewable energy and capacity requirements in New Mexico in the event the Agreement with NM SunTower is terminated or delayed.

Environmental Matters

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

Another way in which environmental matters may impact the Company's operations and business is the implementation of the U.S. Environmental Protection Agency's (EPA) Clean Air Interstate Rule (CAIR) which, as applied to the Company, may result in a requirement that it substantially reduce emissions of nitrogen oxides from its power plants in Texas and/or purchase allowances representing other parties' emissions reductions starting in 2009. These requirements become more stringent in 2015, and are anticipated to require even further emissions reductions or additional allowance purchases. On July 11, 2008, the U.S. Court of Appeals for the District of Columbia vacated CAIR in its entirety. On December 23, 2008 the DC Circuit Panel granted rehearing and instead remanded CAIR without vacating the original regulation. As a result, the Company must comply with CAIR as written until the EPA rewrites the CAIR as required by the Court's final opinion. The 2009 reconciliation to comply with CAIR was filed by the due date of March 1, 2010 and the Company had accrued \$0.5 million at December 31, 2009 to purchase the estimated credits needed to meet its requirement.

Regulations governing the emission of greenhouse gases, such as carbon dioxide, could also impact the Company. The U.S. Congress is considering new legislation to restrict or regulate

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

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

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

Ongoing Regulatory Compliance. The Company analyzes the costs of its current obligations arising from environmental matters on an ongoing basis and believes it has made adequate provision in its financial statements to meet the obligations which can be meaningfully quantified. As a result of this analysis, the Company has a provision for environmental remediation obligations of approximately \$1.0 million as of March 31, 2010, related to compliance with federal and state environmental standards. However, unforeseen expenses associated with environmental compliance or remediation may occur and could have a material adverse effect on the future operations and financial condition of the Company.

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The Company incurred the following expenditures during the three and twelve months ended March 31, 2010 and 2009 to comply with federal environmental statutes (in thousands):

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---------------------|---------------------------------|--------|----------------------------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Clean Air Act (1) | \$ 217 | \$ 350 | \$ 677 | \$ 810 |
| Clean Water Act (2) | 34 | 59 | 572 | 799 |

- (1) Includes a \$0.3 million reserve related to excess emissions at the Rio Grande generating station for the three and twelve months ended March 31, 2009.
- (2) Includes a \$0.2 million reserve for remediation costs for the Gila River Boundary Site for the twelve months ended March 31, 2009. The twelve months ended March 31, 2010 includes a \$0.3 million reserve for remediation costs related to an oil discharge discussed below. It also excludes a \$0.6 million adjustment reducing estimated remediation costs for a property previously owned by the Company.

Along with many other companies, the Company received from the Texas Commission on Environmental Quality (TCEQ) a request for information in 2003 in connection with environmental conditions at a facility in San Angelo, Texas that was operated by the San Angelo Electric Service Company (SESCO). In November 2005, TCEQ proposed the SESCO site for listing on the registry of Texas state superfund sites and mailed notice to more than five hundred entities, including the Company, indicating that TCEQ considers each of them to be a potentially responsible party at the SESCO site. The Company received from the SESCO working group of potentially responsible parties a settlement offer in May 2006 for remediation and other expenses expected to be incurred in connection with the SESCO site. The Company's position is that any liability it may have related to the SESCO site was discharged in the Company's bankruptcy. In November 2009, the Company made an offer to the SESCO working group to settle this matter. The SESCO working group has proposed a counter offer. The Company is presently reviewing the working group's offer. At this time, the Company has not agreed to a settlement or to otherwise participate in the cleanup of the SESCO site and is unable to predict the outcome of this matter. While the Company has no reason at present to believe that it will incur material liabilities in connection with the SESCO site, it had accrued \$0.3 million for potential costs related to this matter.

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

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

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water impacts. Upon approval of the abatement plan by the NMED, the Company will begin a detailed assessment of the site and perform further remediation of the site as appropriate. The Company has accrued \$0.3 million for potential costs related to this matter.

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

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

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

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

Union Matters

The collective bargaining agreement with existing union employees expires in September 2010 and the Company anticipates entering into negotiations on a new collective bargaining agreement prior to the expiration of the current contract.

F. Litigation

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

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

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G. Employee Benefits**Retirement Plans**

The net periodic benefit cost recognized for the three and twelve months ended March 31, 2010 and 2009 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---|---------------------------------|----------|----------------------------------|----------|
| | 2010 | 2009 | 2010 | 2009 |
| Components of net periodic benefit cost: | | | | |
| Service cost | \$ 1,500 | \$ 1,400 | \$ 5,634 | \$ 5,150 |
| Interest cost | 3,425 | 3,275 | 13,333 | 12,700 |
| Expected return on plan assets | (3,500) | (3,875) | (15,064) | (14,533) |
| Amortization of: | | | | |
| Net loss | 900 | 400 | 2,125 | 1,273 |
| Prior service cost | 25 | 25 | 115 | 115 |
| Net periodic benefit cost | \$ 2,350 | \$ 1,225 | \$ 6,143 | \$ 4,705 |

During the three months ended March 31, 2010, the Company contributed \$1.6 million of its projected \$6.8 million 2010 annual contribution to its retirement plans.

Other Postretirement Benefits

The net periodic benefit cost recognized for the three and twelve months ended March 31, 2010 and 2009 is made up of the components listed below (in thousands):

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---|---------------------------------|----------|----------------------------------|----------|
| | 2010 | 2009 | 2010 | 2009 |
| Components of net periodic benefit cost: | | | | |
| Service cost | \$ 925 | \$ 925 | \$ 3,395 | \$ 3,285 |
| Interest cost | 1,725 | 1,650 | 6,567 | 6,274 |
| Expected return on plan assets | (375) | (375) | (1,499) | (1,778) |
| Amortization of: | | | | |
| Prior service benefit | (725) | (725) | (2,869) | (2,869) |
| Net gain | | | | (1,050) |
| Net periodic benefit cost | \$ 1,550 | \$ 1,475 | \$ 5,594 | \$ 3,862 |

During the three months ended March 31, 2010, the Company contributed \$1.1 million of its projected \$3.4 million 2010 annual contribution to its postretirement plan.

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

H. Financial Instruments and Investments

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

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

| | March 31, 2010 | |
|----------------------------|----------------------------|-------------------------------------|
| | Carrying Amount | Estimated Fair Value |
| Pollution Control Bonds | \$ 193,135 | \$ 198,252 |
| Senior Notes | 546,574 | 550,883 |
| Nuclear Fuel Financing (1) | 118,112 | 118,112 |
| Total | \$ 857,821 | \$ 867,247 |

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

Marketable Securities. The Company's marketable securities, included in decommissioning trust funds in the balance sheets, are reported at fair value which was \$140.8 million and \$135.4 million at March 31, 2010 and December 31, 2009, respectively. These securities are classified as available for sale under FASB guidance for certain investments in debt and equity securities and are valued using prices and other relevant information generated by market transactions involving identical or comparable securities. The reported fair values include gross unrealized losses on marketable securities

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whose impairment the Company has deemed to be temporary. The tables below present the gross unrealized losses and the fair value of these securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2010 (in thousands):

| Description of Securities (1): | March 31, 2010 | | | | | |
|--|---------------------|-------------------|---------------------|-------------------|------------------|-------------------|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Federal Agency Mortgage Backed Securities | \$ 4,650 | \$ (27) | \$ 456 | \$ (13) | \$ 5,106 | \$ (40) |
| U.S. Government Bonds | 8,697 | (153) | | | 8,697 | (153) |
| Municipal Obligations | 10,240 | (240) | 290 | (20) | 10,530 | (260) |
| Corporate Obligations | 2,039 | (7) | 236 | | 2,275 | (7) |
| Total debt securities | 25,626 | (427) | 982 | (33) | 26,608 | (460) |
| Common stock | 8,076 | (639) | 4,479 | (719) | 12,555 | (1,358) |
| Total temporarily impaired securities | \$ 33,702 | \$ (1,066) | \$ 5,461 | \$ (752) | \$ 39,163 | \$ (1,818) |

(1) Includes approximately 95 securities.

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

The reported fair values also include gross unrealized gains on marketable securities which have not been recognized in the Company's net income. The table below presents the unrecognized gross unrealized gains and the fair value of these securities, aggregated by investment category at March 31, 2010 (in thousands):

| Description of Securities: | March 31, 2010 | |
|---|----------------|------------------|
| | Fair Value | Unrealized Gains |
| Federal Agency Mortgage Backed Securities | \$ 17,883 | \$ 621 |
| U.S. Government Bonds | 4,701 | 33 |
| Municipal Obligations | 18,934 | 694 |
| Corporate Obligations | 6,432 | 205 |
| Total debt securities | 47,950 | 1,553 |

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| | | |
|-----------------------|-------------------|------------------|
| Common stock | 50,880 | 10,168 |
| Temporary investments | 2,852 | |
| Total | \$ 101,682 | \$ 11,721 |

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

The Company's marketable securities include investments in municipal, corporate and federal debt obligations. The contractual year for maturity of these available-for-sale securities as of March 31, 2010 is as follows (in thousands):

| | Total | 2010 | 2011 through 2014 | 2015 through 2019 | 2020 and Beyond |
|---|--------------|-------------|----------------------------------|----------------------------------|--------------------------------|
| Municipal Debt Obligations | \$ 29,464 | \$ 2,283 | \$ 10,815 | \$ 11,195 | \$ 5,171 |
| Corporate Debt Obligations | 8,707 | | 2,769 | 4,135 | 1,803 |
| U.S. Government Bonds and Federal Agency Mortgage Backed Securities | 36,387 | 1,715 | 8,195 | 5,411 | 21,066 |

The Company recognizes impairment losses on certain of its securities to be other than temporary and in accordance with FASB guidance, these impairment losses are recognized in net income and a lower cost basis is established for these securities. However, for the three months ended March 31, 2010, there were no impairments deemed to be other than temporary. For the twelve months ended March 31, 2010, \$3.1 million gross impairments deemed to be other than temporary were recognized in the Consolidated Statement of Operations. For the three and twelve months ended March 31, 2009, \$2.5 million and \$9.5 million of gross impairments were deemed to be other than temporary and recognized in the consolidated statements of operations.

The Company's marketable securities in its decommissioning trust funds are sold from time to time and the Company uses the specific identification basis on which to determine the amount to reclassify out of accumulated other comprehensive income and into net income. The proceeds from the sale of these securities during the three and twelve months ended March 31, 2010, and the related effects on pre-tax income are as follows (in thousands):

| | Three Months Ended | Twelve Months Ended |
|---|-----------------------------------|------------------------------------|
| Proceeds from sales of available-for-sale securities | \$ 19,504 | \$ 87,023 |
| Gross realized gains included in pre-tax income | \$ 397 | \$ 3,809 |
| Gross realized losses included in pre-tax income | (428) | (493) |
| Gross unrealized losses in pre-tax income | | (3,092) |
| Net gains (losses) in pre-tax income | \$ (31) | \$ 224 |
| Net unrealized holding gains included in accumulated other comprehensive income | \$ 2,423 | \$ 20,630 |
| Net (gains) losses reclassified out of accumulated other comprehensive income | 31 | (224) |
| Net gains in other comprehensive income | \$ 2,454 | \$ 20,406 |

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

As of March 31, 2010, the Company had \$4.0 million invested in debt securities which consisted of two \$2.0 million investments in auction rate securities maturing in 2042 and 2044. The Company classifies these securities as trading securities and are included in deferred charges and other assets on the Company's balance sheet. These auction rate securities are collateralized with student loans which are re-insured by the Department of Education as part of the Federal Family Education Loan Program (FFELP) and have credit ratings of A by Standard & Poors and A2 by Moody's. The principal on the securities can be realized at maturity, sold in a successful auction, or sold in the secondary market. Interest rates on the auction rate securities are reset every 28 days. At March 31, 2010 upon a failed auction, the maximum interest rates for \$2.0 million of the debt securities were based upon the lesser of the interest paid on the student loan portfolio, less service costs or one month LIBOR plus 2.5%. At March 31, 2010, the default interest rate was 2.737% based on one month LIBOR plus 2.5%. The maximum interest rate for the remaining \$2.0 million of debt securities were based upon the lesser of (i) the Net Loan Rate (the interest paid on the student loan portfolio less service costs); (ii) 91-day Treasury bills plus 1.5%; (iii) one month LIBOR plus 1.5%; (iv) 18%; or (v) highest rate legally payable. At March 31, 2010, the default interest rate was 1.383% based on the Net Loan Rate.

The auction process historically provided a liquid market to sell the securities to meet cash requirements. These auction rate securities had successful auctions through January 2008. However, since February 2008, auctions for these securities have not been successful, resulting in the inability to liquidate these investments. The Company's valuation as of March 31, 2010 is based upon the average of a discounted cash flow model valuation and a market comparables method.

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

The discounted cash flow model valuation is based on expected cash flows using the maximum expected interest rates discounted by an expected yield reflecting illiquidity and credit risk. In order to more accurately forecast cash flows, treasury and LIBOR yield curves were created using swap rates, data provided on the U.S. Department of the Treasury website and the British Bankers' Association website. After thorough analysis, future cash flows were projected based on interest rate models over a term, which was based on an estimate of the weighted average life of the student loan portfolio within the issuing trusts. The applied discount yield was based on the applicable forward LIBOR rate and a yield spread of 550 basis points based on the securities' (i) credit risk, (ii) illiquidity, (iii) subordinated status, (iv) interest rate limitations, and (v) FFELP guarantees.

The market comparables method is based upon sales and purchases of auction rate securities in secondary market transactions. The secondary market discounts of 32% to 35% are based on discounts indicated in secondary market transactions involving comparable Student Loan Auction Rate Securities. The average of the values provided by the discounted cash flow calculation and the market comparables method are used to arrive at the concluded value of the securities.

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

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

| Description of Securities | Fair Value as of March 31, 2010 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---------------------------------------|--|---|--|
| Trading Securities: | | | | |
| Investments in Debt Securities | \$ 2,572 | \$ | \$ | \$ 2,572 |
| Available for sale: | | | | |
| U.S. Government Bonds | \$ 13,398 | \$ 13,398 | \$ | \$ |
| Federal Agency Mortgage Backed Securities | 22,989 | | 22,989 | |
| Municipal Bonds | 29,464 | | 29,464 | |
| Corporate Asset Backed Obligations | 8,707 | | 8,707 | |
| Common Stock: | | | | |
| U.S. companies | 53,874 | 53,874 | | |
| International companies | 9,561 | 9,561 | | |
| Cash and Cash Equivalents | 2,852 | 2,852 | | |
| Total available for sale | \$ 140,845 | \$ 79,685 | \$ 61,160 | \$ |

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

The change in the fair value of the investments in debt securities resulted in a credit to income of \$0.1 million and \$0.3 million for the three and twelve months ended March 31, 2010. For the three and twelve months ended March 31, 2009, the decline in the fair value of the investments in debt securities resulted in a charge to income of \$0.1 million and \$1.3 million, respectively. The amount is reflected in the Company's consolidated statement of operations as an adjustment to investment and interest income. Below is a reconciliation of the beginning and ending balance of the fair value in investment in debt securities (in thousands):

| | 2010 | 2009 |
|---|-------------|-------------|
| Balance at January 1 | \$ 2,510 | \$ 2,264 |
| Unrealized gain (loss) in fair value recognized in income | 62 | (52) |
| Balance at March 31 | \$ 2,572 | \$ 2,212 |

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

El Paso Electric Company:

We have reviewed the consolidated balance sheet of El Paso Electric Company and subsidiary as of March 31, 2010, the related consolidated statements of operations and comprehensive operations for the three-month and twelve-month periods ended March 31, 2010 and 2009, and the related consolidated statements of cash flows for the three-month periods ended March 31, 2010 and 2009. These consolidated financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of El Paso Electric Company and subsidiary as of December 31, 2009, and the related consolidated statements of operations, comprehensive operations, changes in common stock equity, and cash flows for the year then ended (not presented herein); and in our report dated February 25, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2009, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Houston, Texas
May 5, 2010

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

The information contained in this Item 2 updates, and should be read in conjunction with, the information set forth in Part II, Item 7 of our 2009 Form 10-K.

FORWARD-LOOKING STATEMENTS

Certain matters discussed in this Quarterly Report on Form 10-Q other than statements of historical information are forward-looking statements. The Private Securities Litigation Reform Act of 1995 has established that these statements qualify for safe harbors from liability.

Forward-looking statements may include words like we believe, anticipate, target, expect, pro forma, estimate, intend and words of similar meaning. Forward-looking statements describe our future plans, objectives, expectations or goals. Such statements address future events and conditions concerning and include, but are not limited to such things as:

capital expenditures,

earnings,

liquidity and capital resources,

litigation,

accounting matters,

possible corporate restructurings, acquisitions and dispositions,

compliance with debt and other restrictive covenants,

interest rates and dividends,

environmental matters,

nuclear operations, and

the overall economy of our service area.

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

our rates in Texas following the five-year moratorium on rate increases which ends June 30, 2010,

our rates in New Mexico after January 1, 2011 following the end of the 2009 New Mexico Stipulation,

loss of margins on off-system sales due to changes in wholesale power prices or availability of competitive generation resources,

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

reductions in output at generation plants operated by the Company,

unscheduled outages including outages at Palo Verde,

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

the recovery of capital investments through rates,

electric utility deregulation or re-regulation,

regulated and competitive markets,

ongoing municipal, state and federal activities,

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economic and capital market conditions,

changes in accounting requirements and other accounting matters,

changing weather trends,

rates, cost recoveries and other regulatory matters including the ability to recover fuel costs on a timely basis,

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

political, legislative, judicial and regulatory developments,

the impact of lawsuits filed against us,

the impact of changes in interest rates,

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

the impact of recent U.S. health care reform legislation,

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

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

homeland security considerations,

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

other circumstances affecting anticipated operations, sales and costs.

These lists are not all-inclusive because it is not possible to predict all factors. A discussion of some of these factors is included in this document under the heading "Risk Factors" and in the 2009 Form 10-K under the headings "Management's Discussion and Analysis," "Summary of Critical Accounting Policies and Estimates" and "Liquidity and Capital Resources." This report should be read in its entirety. No one section of this report deals with all aspects of the subject matter. Any forward-looking statement speaks only as of the date such statement was made, and we are not obligated to update any forward-looking statement to reflect events or circumstances after the date on which such statement was made except as required by applicable laws or regulations.

Summary of Critical Accounting Policies and Estimates

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The preparation of our financial statements requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented and actual results could differ in future periods from those estimates. Critical accounting policies and estimates are both important to the portrayal of our financial condition and results of operations and require complex, subjective judgments and are more fully described in the Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2009 Form 10-K.

Table of Contents**Summary**

The following is an overview of our results of operations for the three and twelve month periods ended March 31, 2010 and 2009. Income for the three and twelve month periods ended March 31, 2010 and 2009 is shown below:

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|---------------------------|---------------------------------|----------|----------------------------------|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Net income (in thousands) | \$ 11,449 | \$ 9,609 | \$ 68,773 | \$ 72,742 |
| Basic earnings per share | 0.26 | 0.21 | 1.55 | 1.62 |

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

| | Three Months Ended | Twelve Months Ended |
|--|-----------------------|------------------------|
| March 31, 2009 net income | \$ 9,609 | \$ 72,742 |
| Change in (net of tax): | | |
| Increased retail non-fuel base revenues (a) | 5,119 | 14,528 |
| Increased investment and interest income (b) | 1,413 | 2,625 |
| Decreased interest on long-term debt (c) | 1,086 | 1,660 |
| Decreased transmission and distribution operations and maintenance | 356 | 1,011 |
| Elimination of Medicare Part D tax benefit (d) | (4,787) | (4,787) |
| Increased depreciation and amortization (e) | (1,011) | (1,208) |
| Increased operations and maintenance at coal and gas-fired generating plants | (896) | (1,130) |
| Decreased off-system sales margins retained (f) | (416) | (3,638) |
| Deregulated Palo Verde Unit 3 proxy market pricing (g) | (323) | (8,289) |
| Increased Palo Verde operations and maintenance expense (h) | (422) | (2,942) |
| Increased administrative and general expense (i) | (81) | (2,861) |
| Other | 1,802 | 1,062 |
| March 31, 2010 net income | \$ 11,449 | \$ 68,773 |

- (a) Non-fuel retail base revenues increased for the three months ending March 31, 2010 compared to the same period last year primarily due to increased kWh sales to all customer classes. Non-fuel retail base revenues increased for the twelve months ending March 31, 2010 primarily due to increased kWh sales to residential customers, public authorities, and small commercial and industrial customers. Non-fuel retail base revenues exclude fuel recovered through New Mexico base rates.
- (b) Investment and interest income increased primarily due to impairments of equity investments in our Palo Verde decommissioning trust funds for the three and twelve months ended March 31, 2009 with no comparable impairment in 2010.
- (c) Interest expense on long-term debt decreased for both periods in 2010 primarily as the result of lower interest rates on pollution control bonds. Two series of pollution control bonds were refunded in March 2009 at a fixed 7.25% interest rate which is lower than the variable interest rates applied to these bonds before refunding.
- (d) Increased tax expense to recognize a change in tax law enacted in the Patient Protection and Affordable Care Act to eliminate the tax benefit related to the Medicare Part D subsidies.

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- (e) Depreciation and amortization expense increased for the three and twelve months ended March 31, 2010 compared to the same period last year due to increased depreciable plant balances including Phase 1 of Newman Unit 5.
- (f) Off-system sales margins retained decreased for the twelve months ended March 31, 2010 compared to the same period last year as a result of a decline in MWh sales and reduced margins per MWh due to lower market prices for power.
- (g) For the twelve months ended March 31, 2010 compared to the same period last year, deregulated Palo Verde Unit 3 proxy market pricing reflects lower proxy market prices and lower sales of the deregulated portion of Palo Verde Unit 3 to retail customers due mostly to its planned refueling outage in April and May 2009.
- (h) Palo Verde non-fuel operations and maintenance expenses increased for the twelve months ended March 31, 2010 compared to the same period last year primarily due to an increase in employee pension and benefits costs.
- (i) Administrative and general expenses increased for the twelve months ended March 31, 2010 compared to the same period last year primarily due to increased accruals for employee incentive compensation and increased pension and benefits expenses reflecting a lower discount rate used to determine postretirement benefit costs.

Table of Contents**Historical Results of Operations**

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

Operating revenues

We realize revenue from the sale of electricity to retail customers at regulated rates and the sale of energy in the wholesale power market generally at market based prices. Sales for resale (which are wholesale sales within our service territory) accounted for less than 1% of revenues. Off-system sales are wholesale sales into markets outside our service territory. Off-system sales are primarily made in off-peak periods when we have competitive generation capacity available after meeting our regulated service obligations. Under the terms of our rate agreements in Texas and New Mexico, we share 25% of our off-system sales margins with our customers in Texas and New Mexico (effective July 1, 2005 and July 1, 2007, respectively). We are also sharing 25% of our off-system sales margins with our sales for resale customer under the terms of a contract which was effective April 1, 2008. In July 2010, off-system sales margins shared with customers increases to 90%.

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

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

| | Three Months Ended March 31, | | Twelve Months Ended March 31, | |
|--|---------------------------------|-------------|----------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Residential | 41% | 39% | 41% | 39% |
| Commercial and industrial, small | 36 | 37 | 36 | 37 |
| Commercial and industrial, large | 8 | 8 | 7 | 8 |
| Sales to public authorities | 15 | 16 | 16 | 16 |
| Total retail non-fuel base revenues | 100% | 100% | 100% | 100% |

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

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Weather significantly impacts our residential, small commercial and industrial customers, and to a lesser extent, our sales to public authorities. For the quarter ended March 31, 2010, retail non-fuel base revenues were positively impacted by colder winter weather when compared to the first quarter of 2009. Heating and cooling degree days can be used to evaluate the effect of weather on energy use. For each degree the average outdoor temperature varies from a standard of 65 degrees Fahrenheit a degree day is recorded. The table below shows heating and cooling degree days compared to a 10-year average.

| | Three Months Ended | | 10-Year Average | Twelve Months Ended | | 10-Year Average* |
|---------------------|--------------------|-------|--------------------|---------------------|-------|---------------------|
| | March 31, 2010 | 2009 | | March 31, 2010 | 2009 | |
| Heating degree days | 1,396 | 1,030 | 1,236 | 2,510 | 2,027 | 2,290 |
| Cooling degree days | 9 | 37 | 18 | 2,740 | 2,285 | 2,556 |

* Calendar year basis.

Customer growth is a key driver of the growth of retail sales. The average number of retail customers grew 1.8% and 1.7%, respectively, for the three and twelve months ended March 31, 2010 when compared to the same periods last year. See the tables presented on pages 36 and 37 which provide detail on the average number of retail customers and the related revenues and kWh sales.

Retail non-fuel base revenues. Retail non-fuel base revenues increased by \$8.1 million or 8.0% for the three months ended March 31, 2010 when compared to the same period last year primarily due to a 13.6% increase in kWh sales to residential customers reflecting colder winter weather in 2010 and a 1.8% growth in the average number of customers served. During the first quarter of 2010, heating degree days were 36% above the same period in 2009 and 13% above the 10-year average. Retail non-fuel base revenues also increased due to a 2.3% increase in kWh sales to small commercial and industrial customers primarily due to a 2.1% increase in the average number of small commercial and industrial customers served. Retail non-fuel base revenues from large commercial and industrial customers increased 18% due to an increase of 6.1% in kWh sales and the implementation of higher rates in new contracts with several large industrial customers whose contracts had expired. Sales and revenues to public authorities increased 3.3% primarily reflecting increased revenues from military bases.

Retail non-fuel base revenues for the twelve months ended March 31, 2010 increased by \$23.1 million, or 4.9%, compared to the same period in 2009 primarily due to a 9.8% increase in kWh sales to residential customers reflecting colder winter weather in the first quarter of 2010 and hotter summer weather in 2009 and a 1.8% growth in the average number of customers served. During the twelve months ended March 31, 2010, heating degree days were 24% above the same period in 2009 and 10% above the 10-year average. Retail non-fuel base revenues from public authorities increased 4.8% due to a 3.0% increase in kWh sales and reflect increased sales to military bases. Retail non-fuel base revenues from small commercial and industrial customers increased 1.3% reflecting a 1.0% increase in the average number of customers served. Retail non-fuel base revenues from large commercial and industrial customers increased \$0.8 million, or 2.1% reflecting the implementation of higher rates in new contracts with several large customers whose contracts had expired.

Fuel revenues. Fuel revenues consist of: (i) revenues collected from customers under fuel recovery mechanisms approved by the state commissions and the FERC, (ii) deferred fuel revenues which are comprised of the difference between fuel costs and fuel revenues collected from customers

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and (iii) fuel costs recovered in base rates in New Mexico. In New Mexico and with our sales for resale customer, the fuel adjustment clause allows us to recover under-recoveries or refund over-recoveries of current fuel costs above the amount recovered in base rates with a two-month lag. In Texas, fuel costs are recovered through a fixed fuel factor that may be adjusted up to three times per year. In addition, if we materially over-recover fuel costs, we must seek to refund the over-recovery, and if we materially under-recover fuel costs, we may seek a surcharge to recover those costs.

In the first quarter of 2010, we over-recovered our fuel costs for all three jurisdictions by \$5.7 million compared to \$23.4 million of fuel over-recoveries in the first quarter of 2009. In August 2009, we implemented a reduced fixed fuel factor in Texas and in February 2010 we refunded \$11.8 million of fuel over-recoveries incurred through November 2009 to our Texas customers. During the first quarter of 2009 we recovered \$12.3 million of fuel under-recoveries from Texas customers through a surcharge. Over-recoveries or under-recoveries in New Mexico and from our FERC customer are refunded through fuel adjustment clauses with a two month lag.

In the twelve-month period ended March 31, 2010 we over-collected fuel costs by \$48.9 million compared to an under-collection of fuel costs of \$17.4 million for the same time period in 2009. Refunds, net of fuel surcharges, of \$24.6 million were returned to our Texas customers in the twelve-months ended March 31, 2010 compared to the recovery of \$38.3 million of fuel under-recoveries through fuel surcharges, including interest, in the twelve months ended March 31, 2009. At March 31, 2010, we had a fuel over-recovery balance of \$12.0 million, including \$11.4 million in Texas, \$0.5 million in New Mexico, and a \$0.1 million from our FERC customer. At March 31, 2009, we had a fuel under-recovery balance of \$12.2 million, including \$10.5 million in Texas and \$1.7 million in New Mexico.

Off-system sales. Off-system sales are primarily made in off-peak periods when we have competitive generation capacity available after meeting our regulated service obligations. Typically, we realize a significant portion of our off-system sales margins in the first quarter of each calendar year when our native load is lower than at other times of the year allowing for the sale in the wholesale market of relatively larger amounts of off-system energy generated from lower cost generating resources. Palo Verde's availability is an important factor in realizing these off-system sales margins. The table below shows the MWhs, sales revenue, fuel costs, total margins, and retained margins made on off-system sales for the three and twelve month periods (in thousands except for MWhs).

| | Three Months Ended | | Twelve Months Ended | |
|-----------------|--------------------|-----------|---------------------|------------|
| | March 31, | | March 31, | |
| | 2010 | 2009 | 2010 | 2009 |
| MWh sales | 847,738 | 1,058,403 | 2,785,319 | 3,452,487 |
| Sales revenues | \$ 38,703 | \$ 38,617 | \$ 116,150 | \$ 197,600 |
| Fuel cost | \$ 32,862 | \$ 31,895 | \$ 102,632 | \$ 176,382 |
| Total margin | \$ 5,841 | \$ 6,722 | \$ 13,518 | \$ 21,218 |
| Retained margin | \$ 4,382 | \$ 5,043 | \$ 10,142 | \$ 15,917 |

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Off-system sales increased \$0.1 million for the three months ended March 31, 2010 when compared to the same period last year as a result of higher average market prices for power offset by a 19.9% decrease in MWh sales. Off-system sales decreased \$81.5 million for the twelve months ended March 31, 2010 compared to the same period last year as a result of lower average market prices for power and a 19.3% decrease in off-system MWh sales. We currently share 25% of the off-system sales margins with customers and retain 75% of off-system sales margins. Pursuant to rate agreements entered into in prior years, effective July 1, 2010, we will share 90% of off-system sales margins with customers and retain 10% of off-system sales margins. For the three months ended March 31, 2010 retained margins decreased \$0.7 million when compared to the same period in 2009. For the twelve months ended March 31, 2010 retained margins decreased \$5.8 million when compared to the same period in 2009.

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

| Quarter Ended March 31: | 2010 | 2009 | Increase (Decrease) Amount | Percent |
|--|-------------------|-------------------|-------------------------------|---------------|
| kWh sales: | | | | |
| Retail: | | | | |
| Residential | 556,280 | 489,629 | 66,651 | 13.6% |
| Commercial and industrial, small | 484,282 | 473,287 | 10,995 | 2.3 |
| Commercial and industrial, large | 236,613 | 222,997 | 13,616 | 6.1 |
| Sales to public authorities | 325,557 | 315,049 | 10,508 | 3.3 |
| Total retail sales | 1,602,732 | 1,500,962 | 101,770 | 6.8 |
| Wholesale: | | | | |
| Sales for resale | 9,180 | 10,394 | (1,214) | (11.7) |
| Off-system sales | 847,738 | 1,058,403 | (210,665) | (19.9) |
| Total wholesale sales | 856,918 | 1,068,797 | (211,879) | (19.8) |
| Total kWh sales | 2,459,650 | 2,569,759 | (110,109) | (4.3) |
| Operating revenues: | | | | |
| Non-fuel base revenues: | | | | |
| Retail: | | | | |
| Residential | \$ 44,835 | \$ 40,191 | \$ 4,644 | 11.6% |
| Commercial and industrial, small | 39,199 | 37,664 | 1,535 | 4.1 |
| Commercial and industrial, large | 9,213 | 7,806 | 1,407 | 18.0 |
| Sales to public authorities | 16,916 | 16,377 | 539 | 3.3 |
| Total retail non-fuel base revenues | 110,163 | 102,038 | 8,125 | 8.0 |
| Wholesale: | | | | |
| Sales for resale | 307 | 307 | | |
| Total non-fuel base revenues | 110,470 | 102,345 | 8,125 | 7.9 |
| Fuel revenues: | | | | |
| Recovered from customers during the period | 38,033 | 50,461 | (12,428) | (24.6)(1) |
| Under (over) collection of fuel | (5,690) | (23,356) | 17,666 | (75.6) |
| New Mexico fuel in base rates | 15,829 | 15,360 | 469 | 3.1 |
| Total fuel revenues | 48,172 | 42,465 | 5,707 | 13.4 |
| Off-system sales | 38,703 | 38,617 | 86 | 0.2 |
| Other | 6,823 | 7,009 | (186) | (2.7)(2) |
| Total operating revenues | \$ 204,168 | \$ 190,436 | \$ 13,732 | 7.2 |
| Average number of retail customers: | | | | |
| Residential | 329,734 | 323,781 | 5,953 | 1.8% |
| Commercial and industrial, small | 36,547 | 35,785 | 762 | 2.1 |
| Commercial and industrial, large | 48 | 48 | | |
| Sales to public authorities | 4,965 | 4,938 | 27 | 0.5 |

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| | | | | |
|-------|---------|---------|-------|-----|
| Total | 371,294 | 364,552 | 6,742 | 1.8 |
|-------|---------|---------|-------|-----|

- (1) Excludes an \$11.8 million refund in 2010 and a \$12.3 million surcharge in 2009 related to prior periods Texas deferred fuel revenues.
- (2) Represents revenues with no related kWh sales.

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| Twelve Months Ended March 31: | 2010 | 2009 | Increase (Decrease) | |
|--|-------------------|-------------------|---------------------|---------------|
| | | | Amount | Percent |
| kWh sales: | | | | |
| Retail: | | | | |
| Residential | 2,428,301 | 2,212,019 | 216,282 | 9.8% |
| Commercial and industrial, small | 2,262,394 | 2,250,613 | 11,781 | 0.5 |
| Commercial and industrial, large | 1,037,802 | 1,051,868 | (14,066) | (1.3) |
| Sales to public authorities | 1,492,956 | 1,449,229 | 43,727 | 3.0 |
| Total retail sales | 7,221,453 | 6,963,729 | 257,724 | 3.7 |
| Wholesale: | | | | |
| Sales for resale | 55,717 | 50,663 | 5,054 | 10.0 |
| Off-system sales | 2,785,319 | 3,452,487 | (667,168) | (19.3) |
| Total wholesale sales | 2,841,036 | 3,503,150 | (662,114) | (18.9) |
| Total kWh sales | 10,062,489 | 10,466,879 | (404,390) | (3.9) |
| Operating revenues: | | | | |
| Non-fuel base revenues: | | | | |
| Retail: | | | | |
| Residential | \$ 200,442 | \$ 183,881 | \$ 16,561 | 9.0% |
| Commercial and industrial, small | 176,863 | 174,653 | 2,210 | 1.3 |
| Commercial and industrial, large | 36,211 | 35,455 | 756 | 2.1 |
| Sales to public authorities | 77,909 | 74,376 | 3,533 | 4.8 |
| Total retail non-fuel base revenues | 491,425 | 468,365 | 23,060 | 4.9 |
| Wholesale: | | | | |
| Sales for resale | 2,037 | 1,559 | 478 | 30.7 |
| Total non-fuel base revenues | 493,462 | 469,924 | 23,538 | 5.0 |
| Fuel revenues: | | | | |
| Recovered from customers during the period | 183,653 | 210,139 | (26,486) | (12.6)(1) |
| Under (over) collection of fuel | (48,942) | 17,361 | (66,303) | |
| New Mexico fuel in base rates | 69,495 | 67,897 | 1,598 | 2.4 |
| Total fuel revenues | 204,206 | 295,397 | (91,191) | (30.9) |
| Off-system sales | 116,150 | 197,600 | (81,450) | (41.2) |
| Other | 27,910 | 26,205 | 1,705 | 6.5(2) |
| Total operating revenues | \$ 841,728 | \$ 989,126 | \$(147,398) | (14.9) |
| Average number of retail customers: | | | | |
| Residential | 327,490 | 321,679 | 5,811 | 1.8% |
| Commercial and industrial, small | 36,230 | 35,865 | 365 | 1.0 |
| Commercial and industrial, large | 49 | 51 | (2) | (3.9) |
| Sales to public authorities | 4,947 | 4,911 | 36 | 0.7 |
| Total | 368,716 | 362,506 | 6,210 | 1.7 |

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- (1) Excludes \$24.6 million refund, net of surcharges, in 2010 and a \$38.3 million surcharge in 2009 related to prior periods Texas deferred fuel revenues.
- (2) Represents revenues with no related kWh sales.

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Our sources of energy include electricity generated from our nuclear, natural gas and coal generating plants and purchased power. Palo Verde represents approximately 39% of our available net generating capacity and approximately 66% and 60% of our Company generated energy for the three and twelve months ended March 31, 2010, respectively. Large fluctuations in the price of natural gas which also is the primary factor influencing the price of purchased power have had a significant impact on our cost of energy in recent years.

Our energy expenses increased \$6.2 million or 8.7% for the three months ended March 31, 2010 when compared to 2009 primarily due to (i) increased natural gas costs of \$7.2 million due to a 28% increase in MWhs generated with natural gas partially offset by a 3.6% decrease in the average price of natural gas, and (ii) increased nuclear fuel costs of \$1.2 million due to a 22% increase in the average price of nuclear fuel partially offset by a 5% decrease in the MWhs generated with nuclear fuel. These increases were partially offset by (i) decreased coal costs of \$1.6 million due to a 40% decrease in MWhs generated with coal, and (ii) decreased costs of purchased power of \$0.6 million due to a 14% decrease in the MWhs purchased partially offset by a 15% increase in the market prices for power. Total MWh energy requirements decreased 0.1 million MWhs in the three months ended March 31, 2010 compared to the same period in 2009 as a result of decreased off-system sales partially offset by an increase in retail sales. The table below details the sources and costs of energy for the three months ended March 31, 2010 and 2009.

| Fuel Type | Three Months Ended March 31, | | | | | |
|-----------------|------------------------------|-----------|-----------------|------------------------|-----------|-----------------|
| | 2010 | | | 2009 | | |
| | Cost (in thousands) | MWh | Cost per MWh | Cost (in thousands) | MWh | Cost per MWh |
| Natural gas | \$ 37,917 | 552,802 | \$ 68.59 | \$ 30,716 | 431,524 | \$ 71.18 |
| Coal | 2,434 | 120,409 | 20.21 | 4,026 | 199,390 | 20.19 |
| Nuclear | 8,742 | 1,280,312 | 6.83 | 7,551 | 1,353,084 | 5.58 |
| Total | 49,093 | 1,953,523 | 25.13 | 42,293 | 1,983,998 | 21.32 |
| Purchased power | 28,847 | 610,023 | 47.29 | 29,398 | 712,174 | 41.28 |
| Total energy | \$ 77,940 | 2,563,546 | 30.40 | \$ 71,691 | 2,696,172 | 26.59 |

Our energy expenses decreased \$155.0 million or 34% for the twelve months ended March 31, 2010 when compared to 2009 primarily due to decreased natural gas costs of \$78.8 million due to a 33% decrease in the average price of natural gas, and decreased costs of purchased power of \$76.5 million due to a 12% decrease in MWhs purchased and a 33% decrease in the average price of power purchased. Total MWh energy requirements decreased 0.4 million MWhs in the twelve months ended March 31, 2010 compared to the same period in 2009 as a result of decreased off-system sales partially offset by an increase in retail sales. The table below details the sources and costs of energy for the twelve month periods ended March 31, 2010 and 2009.

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| Fuel Type | Twelve Months Ended March 31, | | | | | |
|-----------------|-------------------------------|------------|-----------------|------------------------|------------|-----------------|
| | 2010 | | | 2009 | | |
| | Cost (in thousands) | MWh | Cost per MWh | Cost (in thousands) | MWh | Cost per MWh |
| Natural gas | \$ 151,144 | 2,506,910 | \$ 60.29 | \$ 229,971 | 2,538,132 | \$ 90.61 |
| Coal | 11,246 | 665,877 | 16.89 | 14,644 | 768,358 | 19.06 |
| Nuclear | 30,247 | 4,776,028 | 6.33 | 26,563 | 4,714,396 | 5.63 |
| Total | 192,637 | 7,948,815 | 24.23 | 271,178 | 8,020,886 | 33.81 |
| Purchased power | 108,052 | 2,643,349 | 40.88 | 184,523 | 3,016,187 | 61.18 |
| Total energy | \$ 300,689 | 10,592,164 | 28.39 | \$ 455,701 | 11,037,073 | 41.29 |

Other operations expense

Other operations expense increased \$0.8 million, or 1.6%, for the three months ended March 31, 2010 compared to the same period last year due primarily to (i) increased Palo Verde operations expense of \$0.8 million, and (ii) increased operations expense at our fossil-fueled generating plants of \$0.3 million. These increases were partially offset by decreased transmission operations expense of \$0.6 million.

Other operations expense increased \$13.8 million, or 6.8%, for the twelve months ended March 31, 2010 compared to the same period last year primarily due to (i) increased administrative and general expenses of \$5.3 million due to increased accruals for employee incentive compensation and increased pension and benefits expenses reflecting a lower discount rate used to determine postretirement benefit costs, (ii) increased Palo Verde operations expense of \$5.8 million primarily due to the increase in employee pension and benefit costs, and (iii) increased operations expense at our fossil-fueled generating plants of \$1.5 million.

Maintenance expense

Maintenance expense increased \$1.1 million, or 8.4%, for the three months ended March 31, 2010 compared to the same period last year primarily due to increased maintenance expense at our fossil-fueled generating plants as a result of the timing of planned maintenance. Maintenance expense decreased \$2.3 million, or 3.6%, for the twelve months ended March 31, 2010 compared to the same period last year primarily due to (i) decreased maintenance at Palo Verde of \$1.1 million, (ii) decreased maintenance of \$0.8 million related to our general plant, and (iii) decreased distribution maintenance expense of \$0.5 million.

Depreciation and amortization expense

Depreciation and amortization expense increased \$1.6 million and \$1.9 million for the three and twelve months ended March 31, 2010 compared to the same period last year primarily due to increases in depreciable plant balances including Phase I of Newman Unit 5.

Table of Contents*Taxes other than income taxes*

Taxes other than income taxes decreased \$0.8 million and \$1.3 million, or 6% and 3%, for the three and twelve months ended March 31, 2010 compared to the same period last year primarily due to lower revenue-related taxes in Texas resulting from a decrease in billed revenues in 2010, which was partially offset by higher property taxes.

Other income (deductions)

Other income (deductions) increased \$2.3 million for the three months ended March 31, 2010 compared to the same period last year due to a \$2.5 million loss for impairments of equity securities in our Palo Verde decommissioning trust funds in 2009 with no comparable loss in 2010. Other income (deductions) increased \$1.8 million for the twelve months ended March 31, 2010 compared to the same period last year primarily due to a \$5.2 million loss for impairments of equity securities in our decommissioning trust funds in 2009 while in 2010 all impairments of equity securities were offset by realized gains. This fluctuation was partially offset by (i) a \$2.7 million decrease in interest income related to interest included in fuel surcharges in the twelve months ended March 31, 2009 with no comparable amount in 2010, and (ii) a \$1.6 million decrease in miscellaneous income primarily related to an increase in the cash surrender value of life insurance policies in the 2009 period with no comparable amount in 2010.

Interest charges (credits)

Interest charges (credits) decreased \$1.7 million, or 14%, for the three months ended March 31, 2010 compared to the same period last year primarily due to lower interest rates on pollution control bonds. Two series of pollution control bonds were refunded in March 2009 at a fixed 7.25% interest rate which was lower than the variable interest rates applied to these bonds before the refunding.

Interest charges (credits) for the twelve month period ended March 31, 2010 decreased \$3.0 million, or 6.6%, compared to the same period last year primarily due to a \$3.0 million decrease in interest related to two series of pollution control bonds discussed above and a \$1.1 million increase in AFUDC as a result of increased construction work in progress subject to AFUDC. The decrease in interest charges (credits) was partially offset by a \$2.0 million increase in interest related to the issuance of our 7.50% Senior Notes in June 2008.

Income tax expense

On March 23, 2010, the Patient Protection and Affordable Care Act (PPACA) was signed into law. A major provision of the law is that beginning in 2013 the income tax deductions for the cost of providing certain prescription drug coverage will be reduced by the amount of the Medicare Part D subsidies received. The Company is required to recognize the impacts of the tax law change at the time of enactment and recorded a non-cash charge to income tax expense of approximately \$4.8 million in the first quarter of 2010. Income tax expense increased by \$6.9 million, or 135%, in the first quarter of 2010 compared to the first quarter of 2009 primarily due to the passage of the PPACA and an increase in pretax income. Income tax expense increased \$4.2 million, or 11.9%, in the twelve months ended March 31, 2010 compared to the same period last year primarily due to the passage of PPACA in March 2010.

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New accounting standards

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

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

In January 2010, the FASB issued new guidance to improve disclosure requirements related to fair value measurements and disclosures. The new requirements include (i) disclosure of significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers; and (ii) disclosure in the reconciliation for Level 3 fair value measurements should include information about purchases, sales, issuances, and settlements on a gross basis. The new guidance also clarifies existing disclosures and requires (i) an entity to provide fair value measurement disclosures for each class of assets and liabilities and (ii) disclosures about inputs and valuation techniques. The provisions of this new guidance were adopted in the first quarter of 2010 except for the reconciliation for the Level 3 fair value measurements on a gross basis which will be adopted during the first quarter of 2011. During the three months ended March 31, 2010, there were no transfers in or out of Level 1 or Level 2 categories. This guidance requires additional disclosure on fair value measurements, but does not impact our consolidated financial statements.

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

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Liquidity and Capital Resources

We continue to maintain a strong capital structure which allows us the ability to access financing from the capital markets at a reasonable cost. At March 31, 2010, our capital structure, including common stock, long-term debt, and the current portion of long-term debt and financing obligations, consisted of 46.1% common stock equity and 53.9% debt. At March 31, 2010, our liquidity included \$56.4 million in cash and cash equivalents, most of which was in funds invested in United States Treasury securities.

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

Capital requirements and resources have been impacted by the timing of the recovery of fuel costs through fuel recovery mechanisms in Texas and New Mexico and our sales for resale customer. We recover actual fuel costs from customers through fuel adjustment mechanisms in Texas, New Mexico, and from our sales for resale customer. We record deferred fuel revenues for the under-recovery or over-recovery of fuel costs until they can be recovered from or refunded to customers. In Texas, fuel costs are recovered through a fixed fuel factor which may be adjusted three times a year.

In the three months ended March 31, 2010, we had decreased cash from operations when compared to the same period in 2009 due to a net cash outflow in 2010 of \$6.0 million from retail fuel revenues compared to the collection of retail fuel revenues of \$34.7 million in 2009. During the first quarter of 2010, we refunded \$11.8 million of over-recoveries to Texas customers compared to recovering through a surcharge \$12.3 million of fuel under-recoveries from Texas customers in the first quarter of 2009. Over-recoveries in New Mexico and from our FERC customer are refunded through fuel adjustment clauses with a two month lag. At March 31, 2010, we had a fuel over-recovery balance of \$12.0 million, including \$11.4 million in Texas, \$0.5 million in New Mexico, and \$0.1 million from our FERC customer.

Capital Requirements. During the three months ended March 31, 2010, our capital requirements primarily consisted of expenditures for the construction and purchase of electric utility plant, purchases of nuclear fuel, and the repurchase of common stock. Projected utility construction expenditures will consist primarily of expanding and updating our transmission and distribution systems, adding new generation, and making capital improvements and replacements at Palo Verde and other generating facilities. We are constructing Newman Unit 5, a 288 MW gas-fired combined cycle combustion turbine generating unit, which will be completed in two phases at an estimated cost of approximately \$230 million, including AFUDC. The first phase of Newman Unit 5 was completed in May 2009 and the second phase is currently expected to be completed before the summer of 2011. As of March 31, 2010, we had expended \$169.1 million, including AFUDC, on Newman Unit 5. Estimated construction expenditures for 2010 are approximately \$189 million. See Part I, Item 1, Business Construction Program in our 2009 Form 10-K. Capital expenditures were \$47.1 million in the three months ended March 31, 2010 compared to \$47.3 million in the three months ended March 31, 2009.

We maintain a \$200 million revolving credit facility to provide liquidity to the Company. Up to \$120 million under the revolving credit facility is available through direct borrowings to a trust that is used to finance our nuclear fuel inventory. Borrowings by the trust for nuclear fuel were \$118.1 million as of March 31, 2010 and \$102.7 million as of March 31, 2009. The Company itself may borrow under the facility to finance nuclear fuel above the \$120 million sublimit, but this reduces the amounts available for other purposes.

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The Company does not pay dividends on common stock. Since 1999, we have repurchased approximately 21.3 million shares of common stock at an aggregate cost of \$307.5 million, including commissions. On February 19, 2010, the Board of Directors authorized an additional repurchase of up to 2 million shares of the Company's outstanding common stock. During the first quarter of 2010, we repurchased 204,646 shares of common stock in the open market at an aggregate cost of \$4.1 million under both the previously authorized program and under the recently authorized program. As of March 31, 2010, 1,996,336 shares remain available for repurchase under the recently authorized program. We may make purchases of our stock in the future pursuant to our stock repurchase program at open market prices and may engage in private transactions, where appropriate. The repurchased shares will be available for issuance under employee benefit and stock incentive plans, or may be retired.

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

We continually evaluate our funding requirements related to our retirement plans, other postretirement benefit plans, and decommissioning trust funds. We contributed \$1.6 million of the projected \$6.8 million 2010 annual contribution to our retirement plans during the three months ended March 31, 2010. In the three months ended March 31, 2010, we contributed \$1.1 million of the projected \$3.4 million 2010 annual contribution to our other postretirement benefit plan, and \$2.1 million of the projected \$8.2 million 2010 annual contribution to our decommissioning trust funds. We are in compliance with the funding requirements of the federal government for our benefit plans and decommissioning trust.

Capital Resources. Cash generated from operations decreased \$42.1 million in the three months ended March 31, 2010 compared to the same period in 2009 primarily due to a net cash outflow in 2010 of \$6.0 million from retail fuel revenues compared to the collection of retail fuel revenues of \$34.7 million in 2009. Cash from operations will continue to be a primary source of funds for capital expenditures for electric plant.

We continue to maintain a \$200 million credit facility to provide funds for the purchase of nuclear fuel and to provide liquidity to meet our capital requirements before they can be financed with long-term capital sources. At March 31, 2010, we had \$81.9 million of unused credit available on our credit facility. In September 2009, we received approval from the FERC to enter into an additional \$100 million credit facility by August 2011 to supply additional liquidity. We believe that we will have adequate liquidity through our current cash balances, cash from operations, and our credit facility to meet all of our anticipated cash requirements through 2010 based on current projections. We could also seek to issue additional long-term debt or obtain funds through a new credit facility to finance capital requirements in 2010 and 2011 in addition to funds from operations.

Off-Balance Sheet Arrangements

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

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Quantitative and Qualitative Disclosures About Market Risk, for a complete discussion of the market risks we face and our market risk sensitive assets and liabilities. As of March 31, 2010, there have been no material changes in the market risks we faced or the fair values of assets and liabilities disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our 2009 Form 10-K.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our management, including our chief executive officer and our chief financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities and Exchange Act of 1934. These controls and procedures are designed to ensure that material information relating to the company and its subsidiary is communicated to the chief executive officer and the chief financial officer by others within those entities. Based on that evaluation, our chief executive officer and our chief financial officer concluded that, as of March 31, 2010, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to the chief executive officer and the chief financial officer, and recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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 March 31, 2010, that materially affected, or that were reasonably likely to materially affect, our internal control over financial reporting.

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

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

Item 1A. Risk Factors

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

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

| Period | Total Number of Shares Purchased | Average Price Paid per Share (Including Commissions) | Total Number of Shares Purchased as Part of a Publicly Announced Program | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (a) |
|---------------------------------|---|---|---|---|
| January 1 to January 31, 2010 | 0 | \$ | 0 | 200,982 |
| February 1 to February 28, 2010 | 14,058 | 19.85 | 14,058 | 2,186,924 |
| March 1 to March 31, 2010 | 190,588 | 19.99 | 190,588 | 1,996,336 |

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

Item 6. Exhibits

See Index to Exhibits incorporated herein by reference.

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SIGNATURES

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

EL PASO ELECTRIC COMPANY

By: /s/ DAVID G. CARPENTER
David G. Carpenter

Senior Vice President-Chief Financial Officer

(Duly Authorized Officer and Principal Financial
Officer)

Dated: May 6, 2010

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EL PASO ELECTRIC COMPANY

INDEX TO EXHIBITS

| Exhibit Number | Exhibit |
|---------------------------|---|
| 10.01 | Form of Directors Restricted Stock Award Agreement between the Company and certain directors of the Company. (Identical in all material respects to Exhibit 10.07 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999) |
| 15 | Letter re Unaudited Interim Financial Information |
| 31.01 | Certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.01 | Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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