

EL PASO ELECTRIC CO /TX/

Form 10-Q/A

November 22, 2004

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q/A**  
**Amendment No. 1**

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(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2004

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

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# El Paso Electric Company

(Exact name of registrant as specified in its charter)

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**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**

(Registrant's telephone number, including area code)

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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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES  NO

As of August 2, 2004, there were 47,591,765 shares of the Company's no par value common stock outstanding.

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**EL PASO ELECTRIC COMPANY**

**FORM 10-Q/A INTRODUCTORY**

**NOTE**

This Amendment No. 1 to quarterly report on Form 10-Q/A ( Form 10-Q/A ) is being filed to amend the Company's quarterly report on Form 10-Q for the quarter ended June 30, 2004, which was originally filed on August 9, 2004 ( Original Form 10-Q ). Accordingly, pursuant to rule 12b-15 under the Securities Exchange Act of 1934, as amended, this Form 10-Q/A contains the complete text of Items 1, 2 and 4 of Part I and Item 6 of Part II, as amended, as well as certain currently dated certifications. Unaffected items have not been repeated in the Amendment No. 1.

During the quarter ended September 30, 2004, the Company determined that Alternative Minimum Tax ( AMT ) credit carryforward assets pertaining to the pre-reorganization time period were overstated by \$4.5 million and reorganization-related transmission and distribution assets were understated by \$4.5 million. To correct this error, the Company has restated its consolidated balance sheets as of December 31, 2003 and June 30, 2004, the consolidated statements of operations for the three, six and twelve months ended June 30, 2003 and 2004, the consolidated statements of comprehensive operations for the three, six and twelve months ended June 30, 2003 and 2004, and the consolidated statements of cash flows for the six months ended June 30, 2003 and 2004. The Company has also restated the notes to consolidated financial statements as necessary to reflect the adjustments. The adjustments to the consolidated balance sheet as of December 31, 2003, include the elimination of \$4.5 million of AMT credit carryforward assets, the related increase of \$4.5 million in reorganization-related transmission and distribution assets, an increase of \$3.8 million in accumulated depreciation, an increase of \$0.3 million in deferred tax liabilities, and a decrease of \$4.1 million in retained earnings. The statements of operations and comprehensive operations were adjusted by a quarterly increase of \$0.1 million and an annual increase of \$0.5 million in depreciation and amortization expense. Net income and comprehensive income were reduced by \$0.1 million, \$0.2 million and \$0.3 million for the three, six and twelve months ended June 30, 2003 and 2004, respectively, as a result of the aforementioned adjustments. Please read Note H to the accompanying consolidated financial statements for a discussion of the adjustments.

This amendment does not reflect events occurring after the filing of the Original Form 10-Q, which was filed on August 9, 2004. Such events include, among others, the events described in the Company's quarterly report on Form 10-Q for the quarter ended September 30, 2004, and the events described in the Company's current reports on Form 8-K filed after the filing of the Original Form 10-Q. Certain other items have been revised or added in response to comments from the SEC in its letter to the Company dated May 28, 2004.

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

	June 30, 2004 (Unaudited)	December 31, 2003
	(Restated)	
<b>ASSETS</b> (In thousands)		
<b>Utility plant:</b>		
Electric plant in service	\$ 1,809,569	\$ 1,788,652
Less accumulated depreciation and amortization	633,942	595,371
	<u>1,175,627</u>	<u>1,193,281</u>
Net plant in service	1,175,627	1,193,281
Construction work in progress	74,681	69,175
Nuclear fuel; includes fuel in process of \$6,580 and \$6,878, respectively	69,385	70,198
Less accumulated amortization	33,633	33,888
	<u>35,752</u>	<u>36,310</u>
Net nuclear fuel	35,752	36,310
	<u>1,286,060</u>	<u>1,298,766</u>
Net utility plant	1,286,060	1,298,766
<b>Current assets:</b>		
Cash and temporary investments	26,928	34,426
Accounts receivable, principally trade, net of allowance for doubtful accounts of \$3,547 and \$3,470, respectively	71,436	66,589
Accumulated deferred income taxes	23,386	36,248
Inventories, at cost	25,162	25,321
Undercollection of fuel revenues	11,591	12,399
Prepayments and other	29,725	27,190
	<u>188,228</u>	<u>202,173</u>
Total current assets	188,228	202,173
<b>Deferred charges and other assets:</b>		
Decommissioning trust funds	83,470	80,475
Other	12,976	15,200
	<u>96,446</u>	<u>95,675</u>
Total deferred charges and other assets	96,446	95,675
<b>Total assets</b>	<u>\$ 1,570,734</u>	<u>\$ 1,596,614</u>

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See accompanying notes to consolidated financial statements.

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

(In thousands except for share data)

	June 30, 2004	December 31, 2003
	(Unaudited)	(Restated)
<b>Capitalization:</b>		
Common stock, stated value \$1 per share, 100,000,000 shares authorized, 62,606,097 and 62,487,263 shares issued, and 104,920 and 146,489 restricted shares, respectively	\$ 62,711	\$ 62,633
Capital in excess of stated value	265,283	264,235
Unearned compensation restricted stock awards	(1,102)	(878)
Retained earnings	361,553	350,939
Accumulated other comprehensive loss, net of tax	(10,515)	(9,613)
	<u>677,930</u>	<u>667,316</u>
Treasury stock, 15,120,266 and 15,070,266 shares respectively; at cost	(172,294)	(171,548)
	<u>505,636</u>	<u>495,768</u>
Common stock equity	505,636	495,768
Long-term debt, net of current portion	563,071	588,536
Financing obligations, net of current portion		20,186
	<u>1,068,707</u>	<u>1,104,490</u>
<b>Total capitalization</b>	<b>1,068,707</b>	<b>1,104,490</b>
<b>Current liabilities:</b>		
Current portion of long-term debt and financing obligations	42,003	22,106
Accounts payable, principally trade	30,301	19,197
Taxes accrued other than federal income taxes	13,919	15,167
Interest accrued	14,088	14,706
Overcollection of fuel revenues	851	10,070
Other	18,818	20,781
	<u>119,980</u>	<u>102,027</u>
<b>Total current liabilities</b>	<b>119,980</b>	<b>102,027</b>
<b>Deferred credits and other liabilities:</b>		
Accumulated deferred income taxes	130,014	144,419
Accrued postretirement benefit liability	98,007	94,510
Asset retirement obligation	57,768	55,149
Accrued pension liability	54,225	53,000
Other	42,033	43,019
	<u>382,047</u>	<u>390,097</u>
<b>Total deferred credits and other liabilities</b>	<b>382,047</b>	<b>390,097</b>
<b>Commitments and contingencies</b>		

<b>Total capitalization and liabilities</b>	<b>\$ 1,570,734</b>	<b>\$ 1,596,614</b>
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See accompanying notes to consolidated financial statements.



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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
	<b>(Restated)</b>		<b>(Restated)</b>	
<b>Operating revenues</b>	\$ 182,206	\$ 162,498	\$ 338,058	\$ 309,984
<b>Energy expenses:</b>				
Fuel	47,804	37,901	86,853	70,252
Purchased and interchanged power	21,742	13,855	34,594	26,631
	69,546	51,756	121,447	96,883
<b>Operating revenues net of energy expenses</b>	112,660	110,742	216,611	213,101
<b>Other operating expenses:</b>				
Other operations	41,369	42,988	82,581	82,305
Maintenance	10,751	15,707	19,954	30,770
Depreciation and amortization	23,247	21,855	46,426	43,337
Taxes other than income taxes	10,956	11,017	22,493	22,100
	86,323	91,567	171,454	178,512
<b>Operating income</b>	26,337	19,175	45,157	34,589
<b>Other income (deductions):</b>				
Investment and interest income, net	441	397	712	527
Loss on extinguishments of debt	(1,732)		(3,838)	(1)
Miscellaneous other income	233	183	298	211
Miscellaneous income deductions	(1,020)	(355)	(1,984)	(1,144)
	(2,078)	225	(4,812)	(407)
<b>Interest charges (credits):</b>				
Interest on long-term debt and financing obligations	12,306	12,795	24,979	25,891
Other interest	139	90	287	189
Interest capitalized	(821)	(1,349)	(1,591)	(2,665)
	11,624	11,536	23,675	23,415
	12,635	7,864	16,670	10,767

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<b>Income before income taxes and cumulative effect of accounting change</b>				
<b>Income tax expense</b>	4,936	2,942	6,057	3,802
<b>Income before cumulative effect of accounting change</b>	7,699	4,922	10,613	6,965
<b>Cumulative effect of accounting change, net of tax</b>				39,635
<b>Net income</b>	\$ 7,699	\$ 4,922	\$ 10,613	\$ 46,600
<b>Basic earnings per share:</b>				
Income before cumulative effect of accounting change	\$ 0.16	\$ 0.10	\$ 0.22	\$ 0.15
Cumulative effect of accounting change, net of tax				0.80
<b>Net income</b>	\$ 0.16	\$ 0.10	\$ 0.22	\$ 0.95
<b>Diluted earnings per share:</b>				
Income before cumulative effect of accounting change	\$ 0.16	\$ 0.10	\$ 0.22	\$ 0.14
Cumulative effect of accounting change, net of tax				0.80
<b>Net income</b>	\$ 0.16	\$ 0.10	\$ 0.22	\$ 0.94
<b>Weighted average number of shares outstanding</b>	47,500,257	48,659,155	47,475,778	48,981,211
<b>Weighted average number of shares and dilutive potential shares outstanding</b>	47,966,465	49,037,673	47,933,383	49,327,186

See accompanying notes to consolidated financial statements.

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## EL PASO ELECTRIC COMPANY AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands except for share data)

	Twelve Months Ended	
	June 30,	
	2004	2003
	(Restated)	
<b>Operating revenues</b>	\$ 692,436	\$ 669,850
<b>Energy expenses:</b>		
Fuel	181,968	140,267
Purchased and interchanged power	63,555	79,231
	245,523	219,498
<b>Operating revenues net of energy expenses</b>	446,913	450,352
<b>Other operating expenses:</b>		
Other operations	167,773	164,480
FERC settlements		15,500
Impairment loss on CIS project	17,576	
Maintenance	37,430	56,308
Depreciation and amortization	90,710	88,150
Taxes other than income taxes	43,121	43,473
	356,610	367,911
<b>Operating income</b>	90,303	82,441
<b>Other income (deductions):</b>		
Investment and interest income (loss), net	2,025	(640)
Loss on extinguishments of debt	(3,838)	(1)
Miscellaneous other income	475	698
Miscellaneous income deductions	(2,724)	(2,892)
	(4,062)	(2,835)
<b>Interest charges (credits):</b>		
Interest on long-term debt and financing obligations	50,488	53,167
Other interest	793	4,647
Interest capitalized	(4,498)	(5,347)
	46,783	52,467

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<b>Income before income taxes and cumulative effect of accounting change</b>	39,458	27,139
<b>Income tax expense</b>	15,488	9,522
	<u>          </u>	<u>          </u>
<b>Income before cumulative effect of accounting change</b>	23,970	17,617
<b>Cumulative effect of accounting change, net of tax</b>		39,635
	<u>          </u>	<u>          </u>
<b>Net income</b>	\$ 23,970	\$ 57,252
	<u>          </u>	<u>          </u>
<b>Basic earnings per share:</b>		
Income before cumulative effect of accounting change	\$ 0.50	\$ 0.35
Cumulative effect of accounting change, net of tax		0.81
	<u>          </u>	<u>          </u>
Net income	\$ 0.50	\$ 1.16
	<u>          </u>	<u>          </u>
<b>Diluted earnings per share:</b>		
Income before cumulative effect of accounting change	\$ 0.50	\$ 0.35
Cumulative effect of accounting change, net of tax		0.80
	<u>          </u>	<u>          </u>
Net income	\$ 0.50	\$ 1.15
	<u>          </u>	<u>          </u>
<b>Weighted average number of shares outstanding</b>	47,677,134	49,335,156
	<u>          </u>	<u>          </u>
<b>Weighted average number of shares and dilutive potential shares outstanding</b>	48,123,497	49,727,209
	<u>          </u>	<u>          </u>

See accompanying notes to consolidated financial statements.

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## EL PASO ELECTRIC COMPANY AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS

(Unaudited)

(In thousands)

	Three Months		Six Months		Twelve Months	
	Ended		Ended		Ended	
	June 30,		June 30,		June 30,	
	2004	2003	2004	2003	2004	2003
	(Restated)		(Restated)		(Restated)	
<b>Net income</b>	\$ 7,699	\$ 4,922	\$ 10,613	\$ 46,600	\$ 23,970	\$ 57,252
<b>Other comprehensive income (loss):</b>						
Minimum pension liability adjustment					(4,234)	(21,148)
Net unrealized gains (losses) on marketable securities:						
Net holding gains (losses) arising during period	(1,066)	5,322	(779)	4,137	3,848	1,204
Reclassification adjustments for net (gains) losses included in net income	(115)	130	(348)	796	(422)	3,617
<b>Total other comprehensive income (loss) before income taxes</b>	<b>(1,181)</b>	<b>5,452</b>	<b>(1,127)</b>	<b>4,933</b>	<b>(808)</b>	<b>(16,327)</b>
Income tax benefit (expense) related to items of other comprehensive income (loss):						
Minimum pension liability adjustment					1,673	8,216
Net unrealized gains (losses) on marketable securities	236	(1,908)	225	(1,727)	(165)	(1,687)
<b>Total income tax benefit (expense)</b>	<b>236</b>	<b>(1,908)</b>	<b>225</b>	<b>(1,727)</b>	<b>1,508</b>	<b>6,529</b>
<b>Other comprehensive income (loss), net of tax</b>	<b>(945)</b>	<b>3,544</b>	<b>(902)</b>	<b>3,206</b>	<b>700</b>	<b>(9,798)</b>
<b>Comprehensive income</b>	<b>\$ 6,754</b>	<b>\$ 8,466</b>	<b>\$ 9,711</b>	<b>\$ 49,806</b>	<b>\$ 24,670</b>	<b>\$ 47,454</b>

See accompanying notes to consolidated financial statements.

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	Six Months Ended	
	June 30,	
	2004	2003
		(Restated)
<b>Cash flows from operating activities:</b>		
Net income	\$ 10,613	\$ 46,600
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of electric plant in service	46,426	43,337
Amortization of nuclear fuel	8,193	8,470
Cumulative effect of accounting change, net of tax		(39,635)
Deferred income taxes, net	(1,084)	(2,995)
Loss on extinguishments of debt	3,838	1
Other amortization and accretion	4,456	3,929
Other operating activities	1	1,422
Change in:		
Accounts receivable	(4,847)	(7,261)
Inventories	71	621
Net (under)/overcollection of fuel revenues	(8,411)	9,381
Prepayments and other	(3,573)	(136)
Accounts payable	11,104	710
Taxes accrued other than federal income taxes	(1,248)	(2,504)
Interest accrued	(618)	(1,302)
Other current liabilities	(1,963)	1,688
Deferred charges and credits	4,653	2,835
<b>Net cash provided by operating activities</b>	<b>67,611</b>	<b>65,161</b>
<b>Cash flows from investing activities:</b>		
Cash additions to utility property, plant and equipment	(30,010)	(32,735)
Cash additions to nuclear fuel	(7,602)	(6,660)
Interest capitalized:		
Utility property, plant and equipment	(1,476)	(2,523)
Nuclear fuel	(115)	(142)
Decommissioning trust funds:		
Purchases, includes funding of \$3.0 million and \$7.6 million, respectively	(9,392)	(11,501)
Sales and maturities	5,272	3,469
Other investing activities	(1,755)	1,238
<b>Net cash used for investing activities</b>	<b>(45,078)</b>	<b>(48,854)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options	305	

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Repurchases of common stock	(746)	(16,728)
Repurchases of and payments on first mortgage bonds	(29,067)	(39,360)
Nuclear fuel financing obligations:		
Proceeds	8,198	7,367
Payments	(8,465)	(9,704)
Other financing activities	(256)	(309)
<b>Net cash used for financing activities</b>	<b>(30,031)</b>	<b>(58,734)</b>
<b>Net decrease in cash and temporary investments</b>	<b>(7,498)</b>	<b>(42,427)</b>
<b>Cash and temporary investments at beginning of period</b>	<b>34,426</b>	<b>75,142</b>
<b>Cash and temporary investments at end of period</b>	<b>\$ 26,928</b>	<b>\$ 32,715</b>

See accompanying notes to consolidated financial statements.

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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(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/A for the year ended December 31, 2003 (the 2003 Form 10-K/A ). Capitalized terms used in this report and not defined herein have the meaning ascribed for such terms in the 2003 Form 10-K/A. In the opinion of management of the Company, the accompanying consolidated financial statements contain all adjustments necessary to present fairly the financial position of the Company at June 30, 2004 (restated) and December 31, 2003 (restated); the results of its operations and comprehensive operations for the three, six and twelve months ended June 30, 2004 (restated) and 2003 (restated); and its cash flows for the six months ended June 30, 2004 (restated) and 2003 (restated). The results of operations and comprehensive operations for the three and six months ended June 30, 2004 (restated) and the cash flows for the six months ended June 30, 2004 (restated) 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 annual financial statements prepared in accordance with generally accepted accounting principles. Certain prior period amounts primarily related to the presentation of energy service operation revenues and expenses have been reclassified to conform with the current period presentation.

At January 1, 2004, the Company adopted FASB Interpretation No. 46 ( FIN 46R ), Consolidation of Variable Interest Entities, which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. As of June 30, 2004, the Company has had no transactions that have established a variable interest entity and the implementation of this standard did not have an impact on the Company's financial position or results of operations.

*SFAS No. 71.* The Company discontinued the application of SFAS No. 71, Accounting for the Effects of Certain Types of Regulation, to its financial statements in 1991 and is currently evaluating whether it meets the criteria for reapplication of SFAS No. 71 to some or all of its business.

*Stock Options and Restricted Stock.* The Company has two stock-based long-term incentive plans and accounts for them under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Stock options have typically been granted with an exercise price equal to fair market value on the date of grant and, accordingly, no compensation expense is recorded by the Company. Restricted stock has been granted at fair market value. Accordingly, the Company recognizes compensation expense by ratably amortizing the fair market value of the grant of restricted stock over the restriction period. If compensation expense for the option portion of the plans had been determined based on the fair value of the option at the grant date and amortized on a straight-line basis over the vesting period, consistent with the provisions of SFAS





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No. 123, Accounting for Stock-Based Compensation, the Company's net earnings and earnings per share would have been reduced to the pro forma amounts presented below:

	<b>Three Months</b>		<b>Six Months</b>	
	<b>Ended June 30,</b>		<b>Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(Restated)</b>		<b>(Restated)</b>	
Net income, as reported	\$ 7,699	\$ 4,922	\$ 10,613	\$ 46,600
Deduct: Compensation expense, net of tax	229	228	458	459
<b>Pro forma net income</b>	<b>\$ 7,470</b>	<b>\$ 4,694</b>	<b>\$ 10,155</b>	<b>\$ 46,141</b>
<b>Basic earnings per share:</b>				
As reported	\$ 0.16	\$ 0.10	\$ 0.22	\$ 0.95
Pro forma	0.16	0.10	0.21	0.94
<b>Diluted earnings per share:</b>				
As reported	0.16	0.10	0.22	0.94
Pro forma	0.16	0.10	0.21	0.94

	<b>Twelve Months</b>	
	<b>Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Restated)</b>	
Net income, as reported	\$ 23,970	\$ 57,252
Deduct: Compensation expense, net of tax	916	1,184
<b>Pro forma net income</b>	<b>\$ 23,054</b>	<b>\$ 56,068</b>
<b>Basic earnings per share:</b>		
As reported	\$ 0.50	\$ 1.16
Pro forma	0.48	1.14

Diluted earnings per share:

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As reported	0.50	1.15
Pro forma	0.48	1.13

Compensation expense for the restricted stock awards is recognized on a fair value basis and is measured by referencing the quoted market price of the shares at the grant date, amortized ratably over the restriction period. Unearned compensation related to restricted stock awards is shown as a reduction of common stock equity and is the remaining unamortized portion of the restricted stock awards.

*Unbilled Revenues.* Accounts receivable include accrued unbilled revenues of \$18.2 million and \$16.5 million at June 30, 2004 and December 31, 2003, respectively.

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

*Restatement of Previously Issued Financial Statements.* During the third quarter ended September 30, 2004, the Company determined that certain pre-organization AMT credit carryforward assets were overstated and corresponding reorganization-related transmission and distribution assets were understated. To correct this error certain financial and other information contained herein has been restated to reflect the adjustments. See Note H for a discussion of the adjustments.

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

	<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
Cash paid for:		
Interest on long-term debt and financing obligations	\$ 25,001	\$ 26,659
Income taxes	7,150	2,100
Non-cash financing activities:		
Grants of restricted shares of common stock	776	669

**B. Regulation**

For a full discussion of the Company's regulatory matters, see Note B of Notes to Consolidated Financial Statements in the 2003 Form 10-K/A.

**General**

In 1999, both the Texas and New Mexico legislatures enacted electric utility industry restructuring laws requiring competition in certain functions of the industry and ultimately in the Company's service area. In Texas, the Company is exempt from the requirements of the Texas Restructuring Law, including utility restructuring and retail competition, at least until the expiration of the Freeze Period in August 2005. In April 2003, the New Mexico Restructuring Act was repealed and as a result, the Company's operations in New Mexico will continue to be fully regulated. The Company cannot predict at this time the full effects the repeal of the New Mexico Restructuring Act will have on the Company as it prepares for retail competition in Texas.

**Federal Regulatory Matters**

*Federal Energy Regulatory Commission.* The FERC has been conducting an investigation into potential manipulation of electricity prices in the western United States during 2000 and 2001. On August 13, 2002, the FERC initiated a Federal Power Act ( FPA ) investigation into the Company s wholesale power trading in the western United States during 2000 and 2001 to determine whether the Company and Enron engaged in misconduct and, if so, to determine potential remedies. The Company reached settlements with the FERC and other parties in 2002 and 2003. Under the terms of the

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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

settlements, the Company agreed to refund a total of \$15.5 million of revenues it earned on wholesale power transactions. In July 2003, the FERC approved the settlements and on August 5, 2003, the Company deposited the \$15.5 million into an interest bearing escrow account to consummate the settlements. The Company believes the FERC's order resolved all issues between the FERC and the other parties to this investigation. Under the settlements, the Company has agreed to make wholesale sales pursuant to its cost of service rate authority rather than its market-based rate authority for the period December 1, 2002 through December 31, 2004. This agreement allows the Company to sell power into wholesale markets at its incremental cost plus \$21.11 per MWh. To the extent that wholesale market prices exceed these agreed upon amounts, the Company will forego the opportunity to realize these additional revenues. Although this provision has not had a significant impact on the Company's revenues through June 30, 2004, the Company is unable to predict the effect, if any, this will have on the Company's revenues for the remainder of 2004.

**Texas Regulatory Matters**

The rates and services of the Company are regulated in Texas by municipalities and by the Texas Commission. The largest municipality in the Company's service area is the City of El Paso. The Texas Commission has exclusive appellate jurisdiction to review municipal orders and ordinances regarding rates and services within municipalities in Texas and original jurisdiction over certain other activities of the Company. The decisions of the Texas Commission are subject to judicial review.

*Deregulation.* The Texas Restructuring Law required certain investor-owned electric utilities to separate power generation activities from transmission and distribution activities by January 1, 2002, and on that date, retail competition was instituted in some parts of Texas. The Texas Restructuring Law, however, specifically recognized and preserved the Company's Texas Rate Stipulation and Texas Settlement Agreement by, among other things, exempting the Company's Texas service area from retail competition until the end of the Freeze Period. The Texas Commission opened a project (Project No. 28971) to evaluate the readiness of the Company's service area in Texas for retail competition. In this project, the Texas Commission may specify in advance the factors that are important in deciding when and how to open the Company's service area in Texas to customer choice. The Texas Commission has published and taken comments from interested parties on a proposed rule. The proposed rule sets forth a process and sequence of events for the introduction of retail competition in the Company's service territory. The proposed sequence of events is based upon completion of the specific items in each stage before the next stage is initiated. Based on the Texas Commission's proposed rule, the first event that must occur before the introduction of competition in the Company's service territory is the creation of an operating regional transmission organization. If the proposed rule is adopted in its present form, the Company believes that retail competition in the El Paso area would likely not begin for several years. The Texas Commission is expected to issue its final rule before the end of 2004. There is substantial uncertainty about both the regulatory framework and market conditions that will exist if and when retail competition is implemented in the Company's service territory and the Company may incur substantial preparatory, restructuring and other costs that may not ultimately be recoverable. There can

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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

be no assurance that deregulation will not adversely affect the future operations, cash flows and financial condition of the Company.

*Fuel.* Although the Company's base rates are frozen in Texas pursuant to Texas Commission rules and the Texas Rate Stipulation, the Company can request adjustments to its fuel factor to more accurately reflect projected energy costs associated with providing electricity and seek recovery of past undercollections of fuel revenues, subject to periodic final review by the Texas Commission in fuel reconciliation proceedings.

The Company reconciled its Texas jurisdictional fuel costs for the period January 1, 1999 through December 31, 2001 in PUC Docket No. 26194, and on May 5, 2004, the Texas Commission issued its final order. At issue was the Company's request to recover an additional \$15.8 million, before interest, from its Texas customers as a surcharge because of fuel undercollections from January 1999 through December 2001. The Texas Commission disallowed approximately \$4.5 million of Texas jurisdictional expenses, before interest, consisting primarily of (i) approximately \$4.2 million of purchased power expenses which the Texas Commission characterized as imputed capacity charges, and (ii) approximately \$0.3 million in fees which were deemed to be administrative costs, not recoverable as fuel. In Texas, capacity charges are not eligible for recovery as fuel expenses, but are to be recovered through the Company's base rates. As the Company's base rates were frozen during the time period in which the imputed capacity charges were deemed to have been incurred, the \$4.2 million of imputed capacity charges would be permanently disallowed, and not recoverable from its Texas customers. The Texas Commission's decision has been appealed by two parties and the Company, and the Company is unable to predict the ultimate outcome of the appeals.

The Company has incurred similar purchased power costs for the fuel reconciliation period beginning January 1, 2002. The Company believes that it has accounted for its purchased power costs during the reconciliation period beginning January 2002 in a manner consistent with the Texas Commission's decision in PUC Docket No. 26194. However, the Texas Commission has indicated its desire to conduct a generic rulemaking proceeding to determine a statewide policy for the appropriate pricing of capacity in purchased power contracts. There can be no assurance as to the outcome of such rulemaking and its potential impact on the Company with respect to fuel recovery in future reconciliation periods.

**New Mexico Regulatory Matters**

The New Mexico Commission has jurisdiction over the Company's rates and services in New Mexico and over certain other activities of the Company, including prior approval of the issuance, assumption or guarantee of securities. The New Mexico Commission's decisions are subject to judicial review. The largest city in the Company's New Mexico service territory is Las Cruces.

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*Deregulation.* In April 2003, the New Mexico Restructuring Act was repealed and as a result the Company's operations in New Mexico will continue to be fully regulated. The Company cannot predict



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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

at this time the full effects the repeal of the New Mexico Restructuring Act will have on the Company if it ultimately transitions to retail competition in Texas.

*New Mexico Rate Stipulation.* On June 1, 2004, the Company implemented new rates according to the New Mexico Stipulation whereby, among other things, the Company agreed for a period of three years beginning June 1, 2004 to (i) freeze base rates after an initial non-fuel base rate reduction of 1%; (ii) fix fuel and purchased power cost associated with 10% of the Company's jurisdictional retail sales in New Mexico at \$0.021 per kWh; (iii) leave subject to reconciliation the remaining 90% of the Company's New Mexico jurisdictional fuel and purchased power costs not collected in base rates; (iv) continue the collection of a portion of fuel and purchased power costs in base rates as presently collected in the amount of \$0.01949 per kWh; (v) price power provided from Palo Verde Unit 3 to the extent of its availability at an 80% nuclear, 20% gas fuel mix (previously such power was priced at 75% nuclear, 25% gas fuel mix); and (vi) deem reconciled, for the period June 15, 2001 through May 31, 2004, the Company's fuel and purchased power costs for the New Mexico jurisdiction.

*Fuel.* In April 2004, the New Mexico Commission, as part of the New Mexico Stipulation, approved a fuel and purchased power cost adjustment clause. The Company will continue to recover fuel and purchased power costs in base rates in the amount of \$0.01949 per kWh and continue the fuel and purchased power cost adjustment to recover 90% of the remaining fuel and purchased power costs. Fuel and purchased power costs associated with the remaining 10% of the Company's jurisdictional retail sales in New Mexico is fixed at \$0.021 per kWh. The Company and all intervenors entered into the New Mexico Stipulation on the Company's compliance filing.

**C. Common Stock**

**Common Stock Repurchase Program**

In February 2004, the Board of Directors authorized a new stock repurchase program permitting the repurchase of up to 2 million shares of its outstanding common stock. During the second quarter of 2004, the Company repurchased 50,000 shares of common stock. Since the inception of the stock repurchase programs in 1999, the Company has repurchased a total of 15,050,000 shares of common stock at an aggregate cost of \$171.8 million, including commissions. The Company may continue making purchases of its stock 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 option plans, or may be retired.

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## EL PASO ELECTRIC COMPANY AND SUBSIDIARY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)

(Unaudited)

## Reconciliation of Basic and Diluted Earnings Per Share

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

	Three Months Ended June 30,					
	2004			2003		
			Per			Per
	Income (Restated)	Shares	Share (Restated)	Income (Restated)	Shares	Share (Restated)
(In thousands)			(In thousands)			
Basic earnings per share:						
Net Income	\$ 7,699	47,500,257	\$ 0.16	\$ 4,922	48,659,155	\$ 0.10
Effect of dilutive securities:						
Unvested restricted stock		17,505			41,707	
Stock options		448,703			336,811	
Diluted earnings per share:						
Net Income	\$ 7,699	47,966,465	\$ 0.16	\$ 4,922	49,037,673	\$ 0.10
Six Months Ended June 30,						
2004			2003			
		Per			Per	
Income (Restated)	Shares	Share (Restated)	Income (Restated)	Shares	Share (Restated)	
(In thousands)			(In thousands)			
Basic earnings per share:						
Income before cumulative effect of accounting change	\$ 10,613	47,475,778	\$ 0.22	\$ 6,965	48,981,211	\$ 0.15

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<b>Effect of dilutive securities:</b>					
Unvested restricted stock		20,431		23,826	
Stock options		437,174		322,149	

<b>Diluted earnings per share:</b>						
Income before cumulative effect of accounting change	\$ 10,613	47,933,383	\$ 0.22	\$ 6,965	49,327,186	\$ 0.15

**Twelve Months Ended June 30,**

	<b>2004</b>		<b>2003</b>			
		<b>Per</b>		<b>Per</b>		
	<b>Income</b>	<b>Share</b>	<b>Income</b>	<b>Share</b>		
	<b>(Restated)</b>	<b>(Restated)</b>	<b>(Restated)</b>	<b>(Restated)</b>		
	<b>Shares</b>	<b>Share</b>	<b>Shares</b>	<b>Share</b>		
	<b>(Restated)</b>	<b>(Restated)</b>	<b>(Restated)</b>	<b>(Restated)</b>		
	<b>(In thousands)</b>	<b>(In thousands)</b>	<b>(In thousands)</b>	<b>(In thousands)</b>		
<b>Basic earnings per share:</b>						
Income before cumulative effect of accounting change	\$ 23,970	47,677,134	\$ 0.50	\$ 17,617	49,335,156	\$ 0.35
<b>Effect of dilutive securities:</b>						
Unvested restricted stock		50,111		61,880		
Stock options		396,252		330,173		
<b>Diluted earnings per share:</b>						
Income before cumulative effect of accounting change	\$ 23,970	48,123,497	\$ 0.50	\$ 17,617	49,727,209	\$ 0.35

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Options excluded from the computation of diluted earnings per share because the exercise price was greater than the average market price for the periods presented are as follows:

	Three Months		Six Months		Twelve Months	
	Ended June 30,		Ended June 30,		Ended June 30,	
	2004	2003	2004	2003	2004	2003
Options excluded	154,449	966,041	356,597	1,120,580	686,054	1,120,580
Exercise price range	\$ 14.50 - \$15.99	\$ 11.88 - \$15.99	\$ 13.77 - \$15.99	\$ 11.00 - \$15.99	\$ 11.88 - \$15.99	\$ 11.00 - \$15.99

**D. Commitments, Contingencies and Uncertainties**

For a full discussion of commitments and contingencies, see Note I of Notes to Consolidated Financial Statements in the 2003 Form 10-K/A. In addition, see Note B above and Notes B and C of Notes to Consolidated Financial Statements in the 2003 Form 10-K/A regarding matters related to regulation and Palo Verde, including decommissioning, spent fuel storage, disposal of low-level radioactive waste, steam generators and liability and insurance matters.

**Power Contracts**

In addition to the contracts disclosed in the Company's 2003 Form 10-K/A, the Company has entered into a 20-year contract for the purchase of up to 133 MW of capacity and associated energy from Southwestern Public Service Company beginning in 2006. This contract includes a demand charge, energy charge and a transmission charge.

**Environmental Matters**

The Company is subject to regulation with respect to air, soil and water quality, solid waste disposal and other environmental matters by federal, state, tribal and local authorities. Those authorities govern current facility operations and have continuing jurisdiction over facility modifications. Failure to comply with these environmental regulatory requirements can result in actions by regulatory agencies or other authorities that might

seek to impose on the Company administrative, civil, and/or criminal penalties. In addition, unauthorized releases of pollutants or contaminants into the environment can result in costly cleanup obligations that are subject to enforcement by the regulatory agencies. Environmental regulations can change rapidly and are often difficult to predict. While the Company strives to prepare for and implement changes necessary to comply with changing environmental regulations, substantial expenditures may be required for the Company to comply with such regulations in the future.

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The Company analyzes the costs of its obligations arising from environmental matters on an ongoing basis, and believes it has made adequate provision in its financial statements to meet such obligations. As a result of this analysis, the Company has a provision for environmental remediation obligations of approximately \$0.8 million as of June 30, 2004, which is related to compliance with federal and state environmental standards. However, unforeseen expenses associated with compliance could have a material adverse effect on the future operations and financial condition of the Company.

The Company incurred the following expenditures (the majority of which are non-remediation) during the three, six and twelve months ended June 30, 2004 and 2003 to comply with federal environmental statutes (in thousands):

	<b>Three Months</b>		<b>Six Months</b>		<b>Twelve Months</b>	
	<b>Ended June 30,</b>		<b>Ended June 30,</b>		<b>Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Clean Air Act	\$ 424	\$ 453	\$ 634	\$ 558	\$ 1,136	\$ 883
Clean Water Act	130	235	356	382	623	2,155

The Company is not aware of any active investigation of its compliance with environmental requirements by the Environmental Protection Agency, the Texas Commission on Environmental Quality or the New Mexico Environment Department. Furthermore, the Company is not aware of any unresolved, potentially material liability it would face pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980, also known as the Superfund law.

**Tax Matters**

The IRS has disputed whether the Company was entitled to deduct certain payments made in 1996 related to Palo Verde and its treatment of a litigation settlement in 1997 related to a terminated merger agreement. The Company has reached a tentative agreement, subject to final IRS approval, to settle these and all other issues relative to its 1996 through 1998 federal income tax returns. The Company expects the IRS will make a final decision regarding the proposed settlement before the end of 2004. Should the proposed settlement be rejected by the IRS, the Company cannot predict the eventual outcome of this matter. Also, the IRS is currently performing an examination of the 1999 through 2002 income tax returns. The Company has established, and periodically reviews and re-evaluates, an estimated contingent tax liability on its consolidated balance sheet to provide for the possibility of adverse outcomes in tax proceedings. Although the ultimate outcome of the settlement or the ongoing examination cannot be predicted with certainty, and while the contingent tax reserve may not in fact be sufficient, the Company believes that the amount of contingent tax reserve recorded as of June 30, 2004 is a reasonable estimate of any additional tax that may be due.



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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

**Union Matters**

On October 2 and 3, 2003, employees in the Company's meter reading and collections areas, comprised of 68 employees, voted in favor of representation by the International Brotherhood of Electrical Workers, Local 960 ( Local 960 ). This vote was certified by the National Labor Relations Board ( NLRB ) on October 14, 2003. In addition, employees in the Company's facilities services area, comprised of seven employees, voted in favor of representation by Local 960 on October 16, 2003. This vote was certified by the NLRB on October 24, 2003. The Company has begun negotiations with Local 960 on behalf of these employees.

On April 2, 2004, Local 960 filed a petition with the NLRB seeking an election to determine union representation for employees in the customer service area. The Company challenged the appropriateness of the employee unit petitioned by Local 960. On June 10, 2004, the NLRB decided the appropriate group eligible to vote consisted of 65 hourly, customer service employees in the Company's phone center, outlying areas and customer resource unit. The election is scheduled for August 20, 2004.

**E. 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, the Company believes that, except as described below, none of these claims will have a material adverse effect on the financial position, results of operations and cash flows of the Company.

On January 16, 2003, the Company was served with a complaint on behalf of a purported class of shareholders alleging violations of the federal securities laws (*Roth v. El Paso Electric Company, et al.*, No. EP-03-CA-0004). The complaint was filed in the El Paso Division of the United States District Court for the Western District of Texas. The suit seeks undisclosed compensatory damages for the class as well as costs and attorneys' fees. The lead plaintiff, Carpenters Pension Fund of Illinois, filed a consolidated amended complaint on July 2, 2003, alleging, among other things, that the Company and certain of its current and former directors and officers violated securities laws by failing to disclose that some of the Company's revenues and income were derived from an allegedly unlawful relationship with Enron. The allegations arise out of the FERC investigation of the power markets in the western United States during 2000 and 2001, which the Company previously settled with the FERC Trial Staff and certain intervening parties. On August 15, 2003, the Company and the individual defendants filed a motion to dismiss the complaint for failure to state a claim upon which relief can be granted. On November 26, 2003, the Court denied the motion to dismiss as to the Company and three of the individual defendants and granted the motion to dismiss as to two individual defendants. On April 13, 2004, the Court granted a motion of the Company and the remaining individual defendants requesting permission to file an interlocutory appeal to the U. S. Court of Appeals for the Fifth Circuit regarding certain legal questions relating to the Court's denial of the motion to dismiss the complaint as to those defendants. On April 27, 2004, the Court entered an order staying the district court proceedings until the





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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

Fifth Circuit completed its review. On June 7, 2004, the U. S. Court of Appeals denied the appeal which automatically lifted the stay in the district court. This matter is presently set for trial on March 28, 2005, but such date may be extended. While the Company believes the lawsuit is without merit and intends to defend itself vigorously, the Company is unable to predict the outcome.

On May 21, 2003, the Company was served with a complaint by the Port of Seattle seeking civil damages under the Sherman Act, the Racketeer Influenced and Corrupt Organization Act, and state anti-trust laws, as well as for fraud (*Port of Seattle v. Avista Corporation, et al.*, No. CV03-117OP). The complaint was filed in the United States District Court for the Western District of Washington. The complaint alleges that the Company, indirectly through its dealings with Enron, conspired with the other named defendants to manipulate the California energy market, which had the effect of artificially inflating the price that the Port of Seattle paid for electricity. The Company, together with several other defendants, filed a motion to dismiss. On May 12, 2004, the Court granted the Company's motion, and the suit was dismissed. The Port of Seattle has filed an appeal of the Court's decision with the U. S. Court of Appeals for the Ninth Circuit.

On May 5, 2004, Wah Chang, a specialty metals manufacturer which operates a plant in Oregon, filed suit against the Company and other defendants in the United States District Court for the District of Oregon. (*Wah Chang v. Avista Corporation, et al.*, No. 04-619AS). The complaint makes substantially the same allegations as were made in *Port of Seattle* and seeks the same types of damages. In addition, on June 7, 2004, the City of Tacoma filed suit against the Company and other defendants in the United States District Court for the Western District of Washington (*City of Tacoma v. American Electric Power Service Corp., et al.*, C04-5325RBL). This complaint also makes substantially the same allegations as were made in *Port of Seattle* and seeks civil damages (including treble damages) from the Company and the other defendants for violations of certain antitrust provisions under the Sherman Act. Based on court rulings in *Port of Seattle*, the Company anticipates that both of these matters will be transferred to the same court that heard and dismissed the *Port of Seattle* lawsuit. While the Company believes that these matters are without merit and intends to defend itself vigorously, the Company is unable to predict the outcome.

On November 3, 2003, TNP filed a complaint against the Company with the FERC, asking the FERC to make a determination that TNP has certain rollover rights to network-type transmission service over the Company's transmission system as a result of a power sales agreement between it and the Company which expired at the end of 2002. TNP asserts that it has such rights under the rollover provisions of FERC Order No. 888. The Company has responded to TNP's complaint by contesting TNP's assertion of rollover rights on several grounds. Due to existing transmission constraints, a FERC ruling granting TNP's complaint could adversely impact the Company's ability to import lower cost power from Palo Verde and Four Corners to serve its retail customers, which could result in higher rates for the Company's retail electric customers. A hearing on this matter before an administrative law judge was held on July 19 and 20, 2004, and the Company is awaiting a decision. The Company cannot predict the outcome of this matter or the effect that an adverse ruling by the FERC might have on the Company or its retail customers.

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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

On June 29, 2004, the Company filed suit against TNP in the Third Judicial District Court of New Mexico, claiming that TNP acted in bad faith by claiming such transmission rights and seeking to obtain use of more transmission rights than originally allocated to TNP under its original contract with the Company. The Company seeks both actual and exemplary damages from TNP as well as a declaration that TNP breached its agreements with the Company, acted in bad faith and violated New Mexico law prohibiting such actions.

On February 9, 2004, Enron North America Corp. ( ENA ) filed suit against the Company seeking payment of approximately \$5.4 million, plus interest and costs, relating to certain natural gas supply contracts (*Enron North America Corp. v. El Paso Electric Co.*, Case No. 01-16034, United States Bankruptcy Court, Southern District of New York). The complaint alleges that ENA entered into two natural gas supply contracts with the Company which automatically terminated as a result of ENA's bankruptcy. ENA contends that, under the terms of the contracts, the Company owes ENA termination payments because the market price of natural gas at the date of termination was lower than the contract price. While ENA acknowledges that the contracts contain a provision (the One-Way Payment Provision ) under which the termination payment would be calculated to be zero, ENA seeks a ruling from the court that the One-Way Payment Provision is unenforceable and that the Company should be required to pay termination payments in the amount of approximately \$5.4 million, plus interest and costs. The first of these two contracts covers gas to be supplied by ENA during the months of November and December of 2001 (the 2001 Contract ). The Company estimates that the value of the termination payment claimed by ENA under the 2001 Contract is approximately \$1.8 million. The second of these two contracts covers gas to be supplied by ENA during the months of January through December of 2002 (the 2002 Contract ). The Company estimates that the value of the termination payment claimed by ENA under the 2002 Contract is approximately \$3.6 million. Based upon the Company's assessment of the probability of an adverse outcome, the Company expensed \$1.5 million, pre-tax, in 2003 for this matter. On April 19, 2004, the Bankruptcy Court approved a confidential settlement agreement and mutual release by and between ENA and the Company, resolving all issues in the suit. The Company does not expect any further charge to earnings as a result of this settlement.

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**EL PASO ELECTRIC COMPANY AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Restated)**

**(Unaudited)**

**F. Employee Benefits**

**Retirement Plans**

The net periodic benefit cost recognized for the three, six and twelve months ended June 30, 2004 and 2003 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>Components of net periodic benefit cost:</b>				
Service cost	\$ 1,113	\$ 953	\$ 2,226	\$ 1,906
Interest cost	2,522	2,403	5,044	4,806
Expected return on plan assets	(1,927)	(1,884)	(3,854)	(3,768)
Amortization of:				
Unrecognized loss	843	434	1,686	868
Unrecognized prior service cost	5	5	10	10
<b>Net periodic benefit cost</b>	<b>\$ 2,556</b>	<b>\$ 1,911</b>	<b>\$ 5,112</b>	<b>\$ 3,822</b>

  

	<b>Twelve Months Ended</b>	
	<b>June 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Components of net periodic benefit cost:</b>		
Service cost	\$ 4,132	\$ 3,585
Interest cost	9,848	9,368
Expected return on plan assets	(7,622)	(7,649)
Amortization of:		
Unrecognized loss	2,554	868
Unrecognized prior service cost	21	21

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Net periodic benefit cost	<u>\$ 8,933</u>	<u>\$ 6,193</u>
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During the six months ended June 30, 2004, the Company contributed \$3.8 million to its retirement plans. By September 15, 2004, the Company anticipates it will contribute, at a minimum, an additional \$7.9 million. This additional contribution will increase total contributions to \$15.5 million in 2004.

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

The net periodic benefit cost recognized for the three, six and twelve months ended June 30, 2004 and 2003 is made up of the components listed below (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>Components of net periodic benefit cost:</b>				
Service cost	\$ 1,159	\$ 979	\$ 2,318	\$ 1,958
Interest cost	1,756	1,617	3,512	3,234
Expected return on plan assets	(315)	(255)	(630)	(510)
Amortization of unrecognized gain				
<b>Net periodic benefit cost</b>	<b>\$ 2,600</b>	<b>\$ 2,341</b>	<b>\$ 5,200</b>	<b>\$ 4,682</b>

	<b>Twelve Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Components of net periodic benefit cost:</b>		
Service cost	\$ 4,275	\$ 3,516
Interest cost	6,746	6,080
Expected return on plan assets	(1,140)	(1,009)
Amortization of unrecognized gain		(396)
<b>Net periodic benefit cost</b>	<b>\$ 9,881</b>	<b>\$ 8,191</b>

During the six months ended June 30, 2004, the Company contributed \$1.7 million to its other postretirement benefits plan.

In December 2003, the Company elected to defer recognition of the potential effect of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (the Act ) until authoritative guidance on the accounting for the federal subsidy is issued. In May 2004, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. 106-2 ( FSP 106-2 ) which requires measurement of the accumulated post-retirement benefit obligation and the net periodic post-retirement benefit cost to reflect the effects of the subsidy for interim or annual periods beginning after June 15, 2004. The Company has not yet determined the effects of the Act on its results of operations, financial condition or liquidity.

#### **G. Franchises and Significant Customers**

##### **City of El Paso Franchise**

The Company s franchise agreement with the City of El Paso, Texas ( City ) includes an option to acquire all of the non-cash assets of the Company at the end of the franchise on August 1, 2005. To

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

exercise the option, the City was required to deliver written notice to the Company one year prior to the expiration of the franchise term. The option expired on August 1, 2004 without being exercised by the City.

**H. Restatement of Previously Issued Financial Statements**

During the quarter ended September 30, 2004, the Company determined that AMT credit carryforward assets pertaining to the pre-reorganization time period were overstated by \$4.5 million and reorganization-related transmission and distribution assets were understated by \$4.5 million. To correct this error, the Company has restated its consolidated balance sheets as of December 31, 2003 and June 30, 2004, the consolidated statements of operations for the three, six and twelve months ended June 30, 2003 and 2004, the consolidated statements of comprehensive operations for the three, six and twelve months ended June 30, 2003 and 2004, and the consolidated statements of cash flows for the six months ended June 30, 2003 and 2004. The Company has also restated the notes to consolidated financial statements as necessary to reflect the adjustments.

The effects of the revisions on the consolidated balance sheets as of June 30, 2004 and December 31, 2003 are summarized in the following table (in thousands):

	Previously Reported		As Restated	
	June 30, 2004	December 31, 2003	June 30, 2004	December 31, 2003
<b>Utility Plant:</b>				
Electric plant in service	\$ 1,805,052	\$ 1,784,134	\$ 1,809,569	\$ 1,788,652
Less accumulated depreciation and amortization	629,944	591,613	633,942	595,371
Net plant in service	1,175,108	1,192,521	1,175,627	1,193,281
Net utility plant	1,285,541	1,298,006	1,286,060	1,298,766
Total assets	\$ 1,570,215	\$ 1,595,854	\$ 1,570,734	\$ 1,596,614
<b>Capitalization:</b>				
Retained earnings	\$ 365,753	\$ 354,993	\$ 361,553	\$ 350,939
Common stock equity	509,836	499,822	505,636	495,768
Total capitalization	1,072,907	1,108,544	1,068,707	1,104,490



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Deferred credits and other liabilities:				
Accumulated deferred income taxes	125,295	139,605	130,014	144,419
Total deferred credits and other liabilities	377,328	385,283	382,047	390,097
Total capitalization and liabilities	\$ 1,570,215	\$ 1,595,854	\$ 1,570,734	\$ 1,596,614

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

The consolidated statements of operations and comprehensive operations were adjusted by a quarterly increase of \$0.1 million and an annual increase of \$0.5 million in depreciation and amortization expense. Net income and comprehensive income were reduced by \$0.1 million, \$0.2 million and \$0.3 million for the three, six and twelve months ended June 30, 2004 and 2003, respectively.

The effects of the revisions on the consolidated statements of operations for the three, six and twelve month periods ended June 30, 2004 and 2003 are summarized in the following table (in thousands, except for share data):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2004		2003		2004		2003	
	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated	Previously Reported	As Restated
<b>Other operating expenses:</b>								
Depreciation and amortization	\$ 23,127	\$ 23,247	\$ 21,735	\$ 21,855	\$ 46,186	\$ 46,426	\$ 43,097	\$ 43,337
Total other operating expenses	86,203	86,323	91,447	91,567	171,214	171,454	178,272	178,512
Operating income	26,457	26,337	19,295	19,175	45,397	45,157	34,829	34,589
<b>Income before income taxes and cumulative effect of accounting change</b>								
	12,755	12,635	7,984	7,864	16,910	16,670	11,007	10,767
Income tax expense	4,982	4,936	2,989	2,942	6,150	6,057	3,896	3,802
Income before cumulative effect of accounting change	7,773	7,699	4,995	4,922	10,760	10,613	7,111	6,965
Net income	\$ 7,773	\$ 7,699	\$ 4,995	\$ 4,922	\$ 10,760	\$ 10,613	\$ 46,746	\$ 46,600
<b>Basic earnings per share:</b>								
Income before cumulative effect of accounting change	\$ 0.16	\$ 0.16	\$ 0.10	\$ 0.10	\$ 0.23	\$ 0.22	\$ 0.15	\$ 0.15
Cumulative effect of accounting change, net of tax							0.80	0.80
Net income	\$ 0.16	\$ 0.16	\$ 0.10	\$ 0.10	\$ 0.23	\$ 0.22	\$ 0.95	\$ 0.95
<b>Diluted earnings per share:</b>								
Income before cumulative effect of accounting change	\$ 0.16	\$ 0.16	\$ 0.10	\$ 0.10	\$ 0.22	\$ 0.22	\$ 0.15	\$ 0.14
Cumulative effect of accounting change, net of tax							0.80	0.80

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Net income	\$ 0.16	\$ 0.16	\$ 0.10	\$ 0.10	\$ 0.22	\$ 0.22	\$ 0.95	\$ 0.94
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	Twelve Months Ended June 30,			
	2004		2003	
	Previously Reported	As Restated	Previously Reported	As Restated
	_____	_____	_____	_____
Other operating expenses:				
Depreciation and amortization	\$ 90,230	\$ 90,710	\$ 87,670	\$ 88,150
Total other operating expenses	356,130	356,610	367,431	367,911
Operating income	90,783	90,303	82,921	82,441
Income before income taxes and cumulative effect of accounting change	39,938	39,458	27,619	27,139
Income tax expense	15,673	15,488	9,710	9,522
Income before cumulative effect of accounting change	24,265	23,970	17,909	17,617
Net income	\$ 24,265	\$ 23,970	\$ 57,544	\$ 57,252
	_____	_____	_____	_____
Basic earnings per share:				
Income before cumulative effect of accounting change	\$ 0.51	\$ 0.50	\$ 0.36	\$ 0.35
Cumulative effect of accounting change, net of tax			0.81	0.81
	_____	_____	_____	_____
Net income	\$ 0.51	\$ 0.50	\$ 1.17	\$ 1.16
	_____	_____	_____	_____
Diluted earnings per share:				
Income before cumulative effect of accounting change	\$ 0.50	\$ 0.50	\$ 0.36	\$ 0.35
Cumulative effect of accounting change, net of tax			0.80	0.80
	_____	_____	_____	_____
Net income	\$ 0.50	\$ 0.50	\$ 1.16	\$ 1.15
	_____	_____	_____	_____

The effects of the revisions on the consolidated statements of comprehensive operations for the three, six and twelve month periods ended June 30, 2004 and 2003 are summarized in the following table (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	_____	_____	_____	_____
	As Restated	As Restated	As Restated	As Restated

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	<u>Previously Reported</u>	<u>          </u>	<u>Previously Reported</u>	<u>          </u>	<u>Previously Reported</u>	<u>          </u>	<u>Previously Reported</u>	<u>          </u>
Net income	\$ 7,773	\$ 7,699	\$ 4,995	\$ 4,922	\$ 10,760	\$ 10,613	\$ 46,746	\$ 46,600
Comprehensive income	6,828	6,754	8,539	8,466	9,858	9,711	49,952	49,806

	<u>Twelve Months Ended June 30,</u>			
	<u>2004</u>		<u>2003</u>	
	<u>Previously Reported</u>	<u>As Restated</u>	<u>Previously Reported</u>	<u>As Restated</u>
Net income	\$ 24,265	\$ 23,970	\$ 57,544	\$ 57,252
Comprehensive income	24,965	24,670	47,746	47,454

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

The effects of the revisions on the consolidated statements of cash flows for the six months ended June 30, 2004 and 2003 are summarized in the following table (in thousands):

	Six Months Ended June 30,			
	2004		2003	
	Previously Reported	As Restated	Previously Reported	As Restated
Net income	\$ 10,760	\$ 10,613	\$ 46,746	\$ 46,600
Adjustment to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization of electric plant in service	46,186	46,426	43,097	43,337
Deferred income taxes	(991)	(1,084)	(2,901)	(2,995)
Other operating activities and cash flow items	11,656	11,656	(21,781)	(21,781)
<b>Net cash flow provided by operating activities</b>	<b>\$ 67,611</b>	<b>\$ 67,611</b>	<b>\$ 65,161</b>	<b>\$ 65,161</b>

There was no net impact on net cash provided by operating activities, net cash used for investing activities, and net cash used for financing activities on the consolidated statements of cash flows for the six months ended June 30, 2004 and 2003 due to the restatement.

The following Notes to Consolidated Financial Statements have been restated to reflect the correction of the AMT credit carryforward asset overstatement and the reorganization-related transmission and distribution asset understatement: (i) the Stock Options and Restricted Stock disclosure in Note A and (ii) the Reconciliation of Basic and Diluted Earnings Per Share disclosure in Note C.

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**Report of Independent Registered Public Accounting Firm**

The Shareholders and Board of Directors

El Paso Electric Company:

We have reviewed the condensed consolidated balance sheet of El Paso Electric Company and subsidiary as of June 30, 2004, the related condensed consolidated statements of operations and comprehensive operations for the three-month, six-month, and twelve-month periods ended June 30, 2004 and 2003, and the related condensed consolidated statements of cash flows for the six-month periods ended June 30, 2004 and 2003. These condensed 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 condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

As discussed in Note H, the Company has restated the condensed consolidated balance sheet as of June 30, 2004, and the related condensed consolidated statements of operations and comprehensive operations for the three-month, six-month, and twelve-month periods ended June 30, 2004 and 2003, and the related condensed consolidated statements of cash flows for the six-month periods ended June 30, 2004 and 2003.

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, 2003 (restated), and the related consolidated statements of operations (restated), comprehensive operations (restated), changes in common stock equity (restated), and cash flows (restated) for the year then ended (not presented herein); and in our report dated March 10, 2004, except as to Note P, which is as of November 8, 2004, we expressed an unqualified opinion on those consolidated financial statements. Our report referred to a change in the Company's method of accounting for asset retirement obligations in 2003. Our report also referred to the Company's restatement of its 2003 and 2002 financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2003 (restated), is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

KPMG LLP

El Paso, Texas

August 5, 2004, except as to Note H,

which is as of November 8, 2004



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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 the Company's 2003 Form 10-K/A.

Statements in this document, other than statements of historical information, are forward-looking statements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements, as well as other oral and written forward-looking statements made by or on behalf of the Company from time to time, including statements contained in the Company's filings with the Securities and Exchange Commission and its reports to shareholders, involve known and unknown risks and other factors which may cause the Company's actual results in future periods to differ materially from those expressed in any forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to: (i) increased prices for fuel and purchased power and determinations by regulators that may adversely affect the Company's ability to recover incurred fuel costs in rates; (ii) fluctuations in economy sales and margins due to uncertainty in the economy power market; (iii) unanticipated increased costs associated with scheduled and unscheduled outages; (iv) the cost of replacing steam generators for Palo Verde Units 1 and 3 and other costs at Palo Verde; (v) the costs of legal defense and possible judgments which may accrue as the result of litigation arising out of the FERC investigation or any other regulatory proceeding; (vi) deregulation of the electric utility industry; and (vii) other factors discussed below under the headings Summary of Critical Accounting Policies and Estimates, Overview and Liquidity and Capital Resources. The Company's filings are available from the Securities and Exchange Commission or may be obtained through the Company's website, [www.epelectric.com](http://www.epelectric.com). Any such forward-looking statement is qualified by reference to these risks and factors. The Company cautions that these risks and factors are not exclusive. The Company does not undertake to update any forward-looking statement that may be made from time to time by or on behalf of the Company except as required by law.

### **Summary of Critical Accounting Policies and Estimates**

The preparation of the Company's 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. In addition to the discussion on reapplication of SFAS No. 71, Accounting for the Effects of Certain Types of Regulation, presented below, critical accounting policies and estimates, which are both important to the portrayal of the Company's financial condition and results of operations and which require complex, subjective judgments are more fully described in the Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's 2003 Form 10-K/A.

#### *SFAS No. 71*

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

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are amortized in subsequent periods based upon their respective amortization periods in a utility's cost of service.

Beginning in 1991, the Company discontinued the application of SFAS No. 71 to its financial statements. This decision was based on the Company's determination that its rates were no longer designed to recover its costs of providing service to customers. Upon emerging from bankruptcy in 1996, the Company again concluded that it did not meet the criteria for applying SFAS No. 71 because of the 10-year rate freeze in Texas and its ongoing intention not to seek changes in its New Mexico rates, which had been established in 1990.

The Company regularly analyzes whether it meets the criteria for reapplication of SFAS No. 71 to some or all of its business. Recently, the Company settled a cost of service-based rate case in New Mexico. In August 2005, the Texas Freeze Period will terminate and at some point the Company's generation business in Texas could be deregulated. These or other factors may lead the Company to conclude that the financial results for some or all of its business should in the future be prepared in accordance with SFAS No. 71. This change would generally require that certain costs (e.g. OPEB transition obligations or accumulated deferred investment tax credits) be recorded as regulatory assets or regulatory liabilities, and that a corresponding charge or credit to income be recorded during the period. There would be no change in the Company's present method of accounting for fuel expense under-recoveries and over-recoveries which are recorded as assets or liabilities until collected or repaid in accordance with generally accepted accounting principles, as required by statutes in both Texas and New Mexico.

The Company expects to complete its current evaluation during the third quarter of 2004.

## **Overview**

El Paso Electric Company is an investor owned electric utility that serves retail customers in west Texas and southern New Mexico and wholesale customers in Texas. The Company also periodically sells power to the CFE. The Company owns or has substantial ownership interests in six electrical generating facilities providing it with a total capacity of approximately 1,500 MW. The Company's energy sources consist of nuclear fuel, natural gas, coal, wind powered resources and purchased power. The Company owns or has significant ownership interests in four major 345 kV transmission lines and three 500 kV transmission lines utilized to transfer power from Palo Verde and Four Corners, and owns the transmission and distribution network within its retail service territory. The Company is subject to regulation by the Texas and New Mexico Commissions and, with respect to wholesale power sales, transmission of electric power and the issuance of securities, the FERC.

The Company faces a number of risks and challenges that could negatively impact its operations and financial results. The most significant of these risks and challenges are the deregulation of the electric utility industry and the possibility of increased costs especially from Palo Verde.

The electric utility industry in general and the Company in particular are facing significant challenges and increased competition as a result of changes in federal provisions relating to third-party transmission services and independent power production, as well as changes in state laws and regulatory provisions relating to wholesale and retail service. In 1999, both Texas and New Mexico passed industry deregulation legislation requiring the Company to separate its transmission and distribution

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functions, which would remain regulated, from its power generation and energy services businesses, which would operate in a competitive market in the future. New Mexico repealed the New Mexico Restructuring Act in April 2003, and the Company's operations in New Mexico will remain fully regulated. In Texas, the Company's service territory has not yet been deregulated, but the Company is preparing for retail competition. If the Company does not enter retail competition for generating services at the end of the Freeze Period, the Company's generating services will continue to be regulated by the Texas Commission. The Texas Commission opened a project (Project No. 28971) to evaluate the readiness of the Company's service area in Texas for retail competition. In this project, the Texas Commission may specify in advance the factors that are important in deciding when and how to open the Company's service area in Texas to customer choice. The Texas Commission has published and taken comments from interested parties on a proposed rule. The proposed rule sets forth a process and sequence of events for the introduction of retail competition in the Company's service territory. The proposed sequence of events is based upon completion of the specific items in each stage before the next stage is initiated. Based on the Texas Commission's proposed rule, the first event that must occur before the introduction of competition in the Company's service territory is the creation of an operating regional transmission organization. If the proposed rule is adopted in its present form, retail competition in the El Paso area would not begin for several years. The Texas Commission is expected to issue its final rule before the end of 2004. There is substantial uncertainty about both the regulatory framework and market conditions that will exist if and when retail competition is implemented in the Company's Texas service territory and the Company may incur substantial preparatory, restructuring and other costs that may not ultimately be recoverable. There can be no assurance that deregulation would not adversely affect the future operations, cash flows and financial condition of the Company.

The changing regulatory environment and the potential for unregulated power production have created a substantial risk that the Company will lose important customers. The Company's wholesale and large retail customers already have, in varying degrees, alternate sources of economical power, including co-generation of electric power. If the Company loses a significant portion of its retail customer base, the Company may not be able to replace such revenues through either the addition of new customers, an increase in rates to remaining customers, or sales in the economy market.

Another risk to the Company is potential increased costs, including the risk of additional or unanticipated costs at Palo Verde resulting from (i) increases in operation and maintenance expenses; (ii) the replacement of steam generators in Palo Verde Units 1 and 3; (iii) an extended outage of any of the Palo Verde units; (iv) increases in estimates of decommissioning costs; (v) the storage of radioactive waste, including spent nuclear fuel; (vi) insolvency of other Palo Verde Participants; and (vii) compliance with the various requirements and regulations governing commercial nuclear generating stations. At the same time, the Company's retail base rates in Texas are effectively capped through a rate freeze ending in August 2005. As a result, the Company cannot raise its base rates in Texas in the event of increases in non-fuel costs or loss of revenue. Additionally, upon initiation of competition, there may be competitive pressure on the Company's power generation rates which could reduce its profitability. The Company cannot assure that its revenues will be sufficient to recover any increased costs, including any increased costs in connection with Palo Verde or other operations, whether as a result of inflation, changes in tax laws or regulatory requirements, or other causes.

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**Liquidity and Capital Resources**

The Company's principal liquidity requirements in the near-term are expected to consist of interest payments on the Company's indebtedness, operating and capital expenditures related to the Company's generating facilities and transmission and distribution systems, income and other taxes, and reorganization costs related to deregulation in Texas, if and when deregulation occurs. The Company expects that cash flows from operations will be sufficient for such purposes. As of June 30, 2004, the Company had approximately \$26.9 million in cash and cash equivalents, a decrease of \$7.5 million from the balance of \$34.4 million on December 31, 2003.

In addition to the contractual obligations disclosed in the Company's 2003 Form 10-K/A, in July 2004 the Company entered into a 20-year power contract beginning in 2006. The contractual obligation related to this contract will be \$11.3 million, \$11.5 million and \$11.7 million for 2006, 2007 and 2008, respectively, and \$230.3 million for 2009 and later.

Pollution control bonds of \$193.1 million are subject to remarketing in 2005, and first mortgage bonds of \$175.8 million are scheduled to mature in 2006. The Company expects that these obligations and the \$100 million revolving credit facility, which matures in January 2005 (against which approximately \$41.9 million had been drawn for nuclear fuel purchases as of June 30, 2004) will be refinanced through the capital and credit markets. Additionally, the Company has \$194.1 million of first mortgage bonds which become callable in 2006. The Company's ability to access capital and credit markets may be adversely affected by uncertainties related to operating in a competitive energy market, tight credit markets and debt rating agency actions.

Long-term capital requirements of the Company will consist primarily of construction of electric utility plant and the payment of interest on and retirement and refinancing of debt. Utility construction expenditures will consist primarily of expanding and updating the transmission and distribution systems, possible addition of new generation, and the cost of capital improvements and replacements at Palo Verde and other generating facilities, including the replacement of steam generators in Palo Verde Units 1 and 3.

During the twelve months ended June 30, 2004 and 2003, the Company utilized \$2.5 million and \$70.9 million, respectively, of federal tax loss carryforwards. The Company anticipates that existing federal tax loss carryforwards will be fully utilized in 2004, should the IRS settlement for the tax years 1996 through 1998 be approved by the IRS, and that the Company's cash flow requirements for income taxes are expected to increase over that required in recent years.

The Company is continually evaluating its funding requirements related to its retirement plans, other postretirement benefit plans, and decommissioning trust funds. By September 15, 2004, the Company anticipates it will contribute, at a minimum, an additional \$7.9 million to its pension plan. The Company contributed an additional \$3.2 million to one of its retirement plans in September 2003. The Company also contributed an additional \$4.7 million to the decommissioning trust funds in January 2003 in order to meet its funding requirement as of December 31, 2002.

Since inception of its deleveraging program in 1996, the Company has repurchased or retired with internally generated cash \$575.9 million of first mortgage bonds. First mortgage bonds totaling \$25.4 million were repurchased in the six month period ended June 30, 2004. Common stock equity as a

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percentage of capitalization, including current portion of long-term debt and financing obligations, was 46% as of June 30, 2004.

Although the Company is currently at industry averages, the degree to which the Company is leveraged could have important consequences for the Company's liquidity, including (i) limiting the Company's ability to obtain additional financing for working capital, capital expenditures, acquisitions, general corporate or other purposes in the future; and (ii) placing the Company at a competitive disadvantage by limiting its financial flexibility to respond to the demands of the competitive market and making it more vulnerable to adverse economic or business changes.

Since the inception of the stock repurchase programs in 1999, the Company has repurchased 15.1 million shares in total at an aggregate cost of \$171.8 million, including commissions. In February 2004, the Board of Directors authorized a new stock repurchase program permitting the repurchase of up to 2 million shares of its outstanding common stock. During the second quarter of 2004, the Company repurchased approximately 50,000 shares of common stock in the open market. The Company may continue making purchases of its stock 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 option plans, or may be retired.

**Historical Results of Operations**

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2004	2003	2004	2003
	(Restated)		(Restated)	
Income before cumulative effect of accounting change (in thousands)	\$ 7,699	\$ 4,922	\$ 10,613	\$ 6,965
Diluted earnings per share before cumulative effect of accounting change	0.16	0.10	0.22	0.15
	<b>Twelve Months</b>			
	Ended June 30,			
	2004	2003		
	Actual	Actual	Pro forma	
	(Restated)		(Restated)	
Income before cumulative effect of accounting change (in thousands)	\$ 23,970	\$ 17,617	\$ 19,929	
Diluted earnings per share before cumulative effect of accounting change	0.50	0.35	0.40	

Income before the cumulative effect of accounting change for the three months ended June 30, 2004 (restated) increased \$2.8 million, or \$0.06 diluted earnings per share, compared to the results for the same period a year ago (restated). This after-tax increase resulted primarily from decreased non-Palo Verde maintenance expense of \$2.4 million, increased retail sales of \$1.4 million and decreased Palo Verde operation and maintenance expense of \$0.7 million. These increases were partially offset by



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the loss on extinguishment of debt of \$1.1 million, after-tax and increased depreciation and amortization expense of \$0.8 million, after-tax.

Income before the cumulative effect of accounting change for the six months ended June 30, 2004 (restated) increased \$3.6 million, or \$0.08 diluted earnings per share, compared to the results for the same period a year ago (restated). This after-tax increase resulted primarily from decreased non-Palo Verde maintenance expense of \$5.8 million and increased retail sales of \$4.0 million. These increases were partially offset by the following items, which are all presented on an after-tax basis (i) an increase in the loss on extinguishment of debt of \$2.3 million; (ii) increased depreciation and amortization expense of \$1.9 million; (iii) decreased economy sales and margins of \$0.8 million; and (iv) increased pension and benefits expense of \$0.8 million.

Income before the cumulative effect of accounting change for the twelve months ended June 30, 2004 (restated) increased \$4.0 million or \$0.10 diluted earnings per share, compared to the pro forma results for the same period a year ago (restated). The pro forma net income and earnings per share amounts shown above assume SFAS No. 143 had been applied on a retroactive basis. This after-tax increase was primarily due to the following items, which are all presented on an after-tax basis (i) the 2002 accrual for the FERC settlements of \$9.5 million; (ii) decreased non-Palo Verde maintenance expense of \$9.1 million; and (iii) increased retail sales of \$8.9 million. These increases were partially offset by (i) the impairment loss on the CIS project of \$10.7 million; (ii) decreased wholesale sales revenue of \$6.4 million primarily related to the expiration of two long-term contracts; (iii) the Texas fuel disallowance of \$2.7 million; (iv) increased pension and benefits expenses of \$2.9 million; and (v) an increase in the loss on extinguishment of debt of \$2.3 million.

Operating revenues net of energy expenses increased \$1.9 million and \$3.5 million for the three and six months ended June 30, 2004, respectively, compared to the same periods last year, primarily due to increased retail sales of \$2.3 million and \$6.6 million, respectively. The increase for the six month period ended June 30, 2004 was partially offset by (i) decreased sales and/or margins on economy sales of \$1.3 million; (ii) \$0.6 million of various fuel expense items; and (iii) 2003 CFE margins of \$0.4 million with no comparable activity in 2004.

Operating revenues net of energy expenses decreased \$3.4 million for the twelve months ended June 30, 2004 compared to the same period last year, primarily due to (i) decreased wholesale sales revenues of \$10.5 million primarily related to the expiration of two long-term contracts; (ii) the Texas fuel disallowance of \$4.5 million; (iii) a \$1.8 million decrease in revenue from the energy service operation; and (iv) the \$1.6 million expense which related to the settlement agreement with ENA. This decrease was partially offset by an increase in retail sales of \$14.6 million.

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

<u>Quarter Ended June 30:</u>	<u>2004</u>	<u>2003</u>	<u>Increase (Decrease)</u>	
			<u>Amount</u>	<u>Percent</u>
<b>kWh sales:</b>				
<b>Retail:</b>				
Residential	468,486	447,248	21,238	4.7%
Commercial and industrial, small	556,515	535,141	21,374	4.0
Commercial and industrial, large	315,445	301,785	13,660	4.5
Sales to public authorities	323,768	315,943	7,825	2.5
<b>Total retail sales</b>	<b>1,664,214</b>	<b>1,600,117</b>	<b>64,097</b>	<b>4.0</b>
<b>Wholesale:</b>				
Sales for resale	13,486	29,313	(15,827)	(54.0)(1)
Economy sales	431,354	417,896	13,458	3.2
<b>Total wholesale sales</b>	<b>444,840</b>	<b>447,209</b>	<b>(2,369)</b>	<b>(0.5)</b>
<b>Total kWh sales</b>	<b>2,109,054</b>	<b>2,047,326</b>	<b>61,728</b>	<b>3.0</b>
<b>Operating revenues:</b>				
<b>Base revenues:</b>				
<b>Retail:</b>				
Residential	\$ 41,981	\$ 40,437	\$ 1,544	3.8%
Commercial and industrial, small	43,346	42,418	928	2.2
Commercial and industrial, large	11,013	11,023	(10)	(0.1)
Sales to public authorities	19,045	19,174	(129)	(0.7)
<b>Total retail base revenues</b>	<b>115,385</b>	<b>113,052</b>	<b>2,333</b>	<b>2.1</b>
<b>Wholesale:</b>				
Sales for resale	520	1,557	(1,037)	(66.6)(1)
<b>Total base revenues</b>	<b>115,905</b>	<b>114,609</b>	<b>1,296</b>	<b>1.1</b>
Fuel revenues	45,070	30,470	14,600	47.9(2)
Economy sales	18,527	15,639	2,888	18.5(3)
Other	2,704	1,780	924	51.9(4)(5)
<b>Total operating revenues</b>	<b>\$ 182,206</b>	<b>\$ 162,498</b>	<b>\$ 19,708</b>	<b>12.1</b>



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<b>Six Months Ended June 30:</b>	<b>2004</b>	<b>2003</b>	<b>Increase (Decrease)</b>	
			<b>Amount</b>	<b>Percent</b>
<b>kWh sales:</b>				
<b>Retail:</b>				
Residential	936,803	878,450	58,353	6.6%
Commercial and industrial, small	1,011,363	972,704	38,659	4.0
Commercial and industrial, large	618,835	566,526	52,309	9.2
Sales to public authorities	602,672	573,448	29,224	5.1
<b>Total retail sales</b>	<b>3,169,673</b>	<b>2,991,128</b>	<b>178,545</b>	<b>6.0</b>
<b>Wholesale:</b>				
Sales for resale	22,753	39,206	(16,453)	(42.0)(1)
Economy sales	917,974	1,033,584	(115,610)	(11.2)(6)
<b>Total wholesale sales</b>	<b>940,727</b>	<b>1,072,790</b>	<b>(132,063)</b>	<b>(12.3)</b>
<b>Total kWh sales</b>	<b>4,110,400</b>	<b>4,063,918</b>	<b>46,482</b>	<b>1.1</b>
<b>Operating revenues:</b>				
<b>Base revenues:</b>				
<b>Retail:</b>				
Residential	\$ 82,152	\$ 77,819	\$ 4,333	5.6%
Commercial and industrial, small	79,447	78,123	1,324	1.7
Commercial and industrial, large	21,303	20,910	393	1.9
Sales to public authorities	35,603	35,063	540	1.5
<b>Total retail base revenues</b>	<b>218,505</b>	<b>211,915</b>	<b>6,590</b>	<b>3.1</b>
<b>Wholesale:</b>				
Sales for resale	912	1,947	(1,035)	(53.2)(1)
<b>Total base revenues</b>	<b>219,417</b>	<b>213,862</b>	<b>5,555</b>	<b>2.6</b>
Fuel revenues	76,344	51,967	24,377	46.9(2)
Economy sales	37,491	40,670	(3,179)	(7.8)(6)
Other	4,806	3,485	1,321	37.9(4)(5)
<b>Total operating revenues</b>	<b>\$ 338,058</b>	<b>\$ 309,984</b>	<b>\$ 28,074</b>	<b>9.1</b>

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Twelve Months Ended June 30:	2004	2003	Increase (Decrease)	
			Amount	Percent
<b>kWh sales:</b>				
<b>Retail:</b>				
Residential	1,990,524	1,878,726	111,798	6.0%
Commercial and industrial, small	2,135,519	2,063,254	72,265	3.5
Commercial and industrial, large	1,249,374	1,158,565	90,809	7.8
Sales to public authorities	1,253,573	1,203,875	49,698	4.1
<b>Total retail sales</b>	<b>6,628,990</b>	<b>6,304,420</b>	<b>324,570</b>	<b>5.1</b>
<b>Wholesale:</b>				
Sales for resale	51,301	419,427	(368,126)	(87.8)(7)
Economy sales	1,805,272	1,904,830	(99,558)	(5.2)
<b>Total wholesale sales</b>	<b>1,856,573</b>	<b>2,324,257</b>	<b>(467,684)</b>	<b>(20.1)</b>
<b>Total kWh sales</b>	<b>8,485,563</b>	<b>8,628,677</b>	<b>(143,114)</b>	<b>(1.7)</b>
<b>Operating revenues:</b>				
<b>Base revenues:</b>				
<b>Retail:</b>				
Residential	\$ 175,792	\$ 166,970	\$ 8,822	5.3%
Commercial and industrial, small	166,758	163,456	3,302	2.0
Commercial and industrial, large	43,687	43,304	383	0.9
Sales to public authorities	73,676	71,577	2,099	2.9
<b>Total retail base revenues</b>	<b>459,913</b>	<b>445,307</b>	<b>14,606</b>	<b>3.3</b>
<b>Wholesale:</b>				
Sales for resale	2,188	13,501	(11,313)	(83.8)(7)
<b>Total base revenues</b>	<b>462,101</b>	<b>458,808</b>	<b>3,293</b>	<b>0.7</b>
Fuel revenues	147,138	134,022	13,116	9.8
Economy sales	73,357	68,343	5,014	7.3
Other	9,840	8,677	1,163	13.4(4)(8)
<b>Total operating revenues</b>	<b>\$ 692,436</b>	<b>\$ 669,850</b>	<b>\$ 22,586</b>	<b>3.4</b>

- (1) Primarily due to a 2003 CFE wholesale power contract with no comparable contract in 2004.
- (2) Primarily due to an increase in recoverable fuel expense as a result of an increase in the price and volume of natural gas burned and an increase in purchased power costs.
- (3) Primarily due to higher prices in the economy market.
- (4) Represents revenues with no related kWh sales.
- (5) Primarily due to increased transmission revenues.
- (6) Primarily due to decreased available power as a result of outages at Palo Verde and increased retail sales.
- (7) Primarily due to the expiration of a wholesale power contract with TNP on December 31, 2002 and a 2003 CFE wholesale power contract with no comparable contract in 2004.
- (8) Primarily due to increased transmission revenues partially offset by decreased revenues from the energy service operation.

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Other operations expense decreased \$1.6 million for the three months ended June 30, 2004 compared to the same period last year primarily due to (i) decreased Palo Verde expense of \$0.7 million;

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(ii) decreased customer accounts expense of \$0.4 million; and (iii) decreased legal and consulting fees of \$0.4 million.

Other operations expense increased \$0.3 million for the six months ended June 30, 2004 compared to the same period last year primarily due to (i) increased pension and benefits expense of \$1.3 million resulting from plan asset performance and decreasing discount rates; and (ii) increased legal and consulting fees of \$0.8 million primarily related to implementing Sarbanes-Oxley Section 404. These increases were partially offset by (i) decreased regulatory expense of \$0.8 million; (ii) decreased customer accounts expense of \$0.5 million; and (iii) decreased Palo Verde expense of \$0.3 million.

Other operations expense increased \$3.3 million for the twelve months ended June 30, 2004 compared to the same period last year primarily due to (i) increased pension and benefits expense of \$4.7 million resulting from plan asset performance and decreasing discount rates; (ii) increased consulting and legal fees of \$2.6 million; (iii) increased accretion expense of \$2.6 million related to the implementation of SFAS No. 143; and (iv) increased insurance related expenses of \$1.8 million. These increases were partially offset by (i) decreased energy services operations expense of \$4.7 million primarily due to a warranty reserve recorded in the third quarter of 2002 and the cessation of additional marketing activities by the energy service operation in 2002; and (ii) decreased regulatory expense of \$2.9 million.

The FERC settlements relate to the settlements with the FERC Trial Staff and principal California parties pursuant to which the Company agreed to refund \$15.5 million of revenues it earned on wholesale power transactions in 2000 and 2001. These settlements were recorded in December 2002.

The Company abandoned a CIS project and recognized an asset impairment loss of \$17.6 million in September 2003. The Company is now analyzing various options to meet its current and projected CIS needs.

Maintenance expense decreased \$5.0 million, \$10.8 million and \$18.9 million, respectively, for the three, six and twelve months ended June 30, 2004 compared to the same periods last year primarily due to (i) reduced maintenance outages at non-Palo Verde generating stations of \$3.9 million, \$10.0 million and \$15.0 million, respectively; and (ii) the timing of refueling and maintenance outages at Palo Verde of \$0.5 million, \$0.4 million and \$2.3 million, respectively.

Depreciation and amortization expense increased \$1.4 million, \$3.1 million and \$2.6 million for the three, six and twelve months ended June 30, 2004 (restated), respectively, compared to the same periods last year (restated). The increases for the three, six and twelve month periods were primarily due to (i) an increase in other depreciable plant balances resulting in increased depreciation of \$0.7 million, \$1.6 million, and \$1.1 million, respectively; (ii) depreciation of the new Palo Verde Unit 2 steam generators of \$0.5 million, \$1.0 million, and \$1.0 million, respectively; and (iii) the implementation of new depreciation rates based on an updated depreciation study resulting in an increase of \$0.2 million, \$0.5 million, and \$0.5 million, respectively.

Taxes other than income taxes remained relatively unchanged for the three, six and twelve months ended June 30, 2004 compared to the same periods last year.

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Other income (deductions) decreased \$2.3 million for the three months ended June 30, 2004 compared to the same period last year primarily due to losses on extinguishments of debt recorded in 2004 with no comparable amount in the prior period. Other income (deductions) decreased \$4.4 million for the six months ended June 30, 2004 compared to the same period last year primarily due to (i) losses on extinguishments of debt of \$3.8 million; (ii) \$1.0 million related to an adjustment of interest income associated with the resolution of the Texas fuel reconciliation in PUC Docket No. 26194; and (iii) \$0.4 million related to certain tax refunds received in 2003 with no comparable amount in the current period. These decreases were partially offset by an increase of \$0.6 million on investment income related to the decommissioning trust funds. Other income (deductions) decreased \$1.2 million for the twelve months ended June 30, 2004 compared to the same period last year due to (i) losses on extinguishments of debt of \$3.8 million; and (ii) \$1.0 million related to an adjustment of interest income associated with the resolution of the Texas fuel reconciliation in PUC Docket No. 26194. These decreases were partially offset by (i) an increase of \$2.2 million on investment income related to the decommissioning trust funds; and (ii) \$0.3 million related to certain sales tax refunds.

Interest charges (credits) increased \$0.1 million and \$0.3 million, respectively, for the three and six months ended June 30, 2004 compared to the same period last year primarily due to reduced capitalized interest of \$0.5 million and \$1.0 million for the three and six month periods, respectively, as a result of transferring Palo Verde Unit 2 steam generators to plant in service. These increases were partially offset by decreased interest expense of \$0.4 million and \$0.8 million for the three and six month periods, respectively, due to a reduction of outstanding debt as a result of open market purchases of the Company's first mortgage bonds. Interest charges (credits) decreased \$5.7 million for the twelve months ended June 30, 2004 compared to the same period last year primarily due to (i) a \$4.1 million decrease resulting from the adoption of SFAS No. 143; and (ii) a \$2.4 million decrease resulting from a reduction of outstanding debt as a result of open market purchases of the Company's first mortgage bonds.

Income tax expense, excluding the tax effect of a cumulative effect of accounting change, increased \$2.0 million, \$2.3 million and \$6.0 million for the three, six and twelve months ended June 30, 2004 (restated), respectively, compared to the same periods last year (restated) primarily due to changes in pretax income and certain permanent differences and adjustments.

**Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures.* During the period covered by this report, the Company's chief executive officer and chief financial officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) as of June 30, 2004, (the Evaluation Date), concluded that as of the Evaluation Date, the Company's disclosure controls and procedures (as required by paragraph (b) of the Securities Exchange Act of 1934 Rules 13a-15 or 15d-15) were adequate and designed to ensure that material information relating to the Company and the Company's consolidated subsidiary would be made known to them by others within those entities. Subsequent to the Evaluation Date, it was determined that there was a material weakness in the Company's internal controls over financial reporting, as more fully described below. This weakness pertained to the discovery of a mathematical error made in the 1996 financial statements that carried through to the current period. Upon discovery, this error was immediately reported by the Company's financial staff to its senior management, its audit committee and its independent accountants, and the Company's financial statements were thereafter promptly restated. Subsequent to these actions, the Company's CEO and CFO, following consultation with the Audit Committee and outside corporate counsel, have concluded that the Company's disclosure controls and procedures were not effective as the Company's failure over several years to discover and correct an error in the AMT credit carryforward asset account constituted a material weakness in internal controls over financial reporting.

*Changes in internal control over financial reporting.* There were no changes in the Company's 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 June 30, 2004, that materially affected, or that were reasonably likely to materially affect, the Company's internal control over financial reporting.



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In the third quarter of 2004, the Company discovered an error in its consolidated balance sheets. The error, which was caused by a mathematical miscalculation in a tax return schedule that was reflected in the Company's 1996 financial statements, resulted in a \$4.5 million overstatement of AMT credit carryforward assets and a \$4.5 million understatement of transmission and distribution assets. Because the Company had no procedure for the periodic reconciliation of this account, the error has remained in the Company's financial statements until it was found in connection with its recent IRS settlement. Management promptly brought these matters to the attention of its Audit Committee and independent accountants and determined that it would restate its consolidated balance sheets as of December 31, 2002 and 2003 and March 31 and June 30, 2004, and its consolidated statements of operations, statements of comprehensive operations, changes in common stock equity and cash flows for each annual, quarterly and twelve month period ending on the above dates. Management and the Company's independent accountants have determined that the deficiency in reconciliation procedures constituted a material weakness in the Company's internal controls over financial reporting. The Company's management has implemented new procedures for reconciling and analyzing AMT credit carryforward assets on a timely basis and believes that the controls now in place are adequate to assure that similar errors will not recur.

**Item 6. Exhibits and Reports on Form 8-K**

- (a) Exhibits: See Index to Exhibits incorporated herein by reference.
- (b) Reports on Form 8-K:

<u>Date of Reports</u>	<u>Item Numbers</u>	<u>Financial Statements Required to be Filed</u>
July 27, 2004	7 and 12	None

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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/ TERRY BASSHAM

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Terry Bassham  
Executive Vice President,  
Chief Financial and  
Administrative Officer  
(Duly Authorized Officer and  
Principal Financial Officer)

Dated: November 18, 2004



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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)
10.02	Form of Directors Stock Option Agreement between the Company and certain directors of the Company. (Identical in all material respects to Exhibit 99.17 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997)
15	Letter re Unaudited Interim Financial Information
31.01	Rule 13a-14(a)/15d-14(a) Certifications
32.01	Section 1350 Certifications

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In lieu of non-employee director cash compensation, three agreements, dated as of April 1, 2004, substantially identical in all material respects to this Exhibit, have been entered into with Kenneth R. Heitz; Patricia Z. Holland-Branch; and Charles A. Yamarone; directors of the Company.

Eleven agreements, dated as of May 5, 2004, substantially identical in all material respects to this Exhibit, were entered into with George W. Edwards, Jr.; Ramiro Guzman; James W. Harris; Kenneth R. Heitz; James W. Cicconi; Patricia Z. Holland-Branch; Michael K. Parks; Eric B. Siegel; Stephen N. Wertheimer; Charles A. Yamarone; and J. Robert Brown; directors of the Company.

In lieu of non-employee director cash compensation, one agreement, dated as of April 1, 2004, substantially identical in all material respects to this Exhibit, has been entered into with Wilson K. Cadman; director of the Company.