MIDDLE SOUTH UTILITIES, INC.

ANNUAL REPORT

SERVICE AREA

Arkansas Power & Light Company

Mississippi Power & Light Company

Louisiana Power & Light Company

New Orleans Public Service Inc.

MIDDLE SOUTH UTILITIES, INC.

Middle South Utilities, Inc. (MSU) is one of the largest investor-owned public utility holding companies in the United States. Ranked fourth in assets among the nation's electric and gas utilities in 1987, the MSU System is the leading electric energy supplier to the Middle South, a region comprised of Arkansas, Louisiana, Mississippi, and southeastern Missouri. Gas service is provided in New Orleans and portions of Arkansas and Missouri.

The MSU System utilizes a vast, interconnected transmission and distribution network and a balanced system of fossil fuel and nuclear generating plants to meet the electric needs of 1.68 million customers in the 91,000-square-mile Middle South area, encompassing 1,300 communities with an aggregate population of five million.

At the heart of the System are five operating companies working together: Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company (MP&L), New Orleans Public Service Inc. (NOPSI), and System Energy Resources, Inc. (SERI), which is responsible for the management and operation of the Grand Gulf Nuclear Station.

Additional subsidiaries include: MSU System Services, Inc. (SSI), which provides various technical, administrative, and corporate services that benefit all of the MSU System companies in common; System Fuels, Inc. (SFI), a fuels subsidiary; and Electec, Inc. (EI), a subsidiary that markets the commercial capabilities, expertise, and resources of the System companies.

The combined companies of the MSU System are committed to providing the Middle South region economical, dependable service that can be tailored to meet specific energy requirements, and to strengthening the regional economy through economic and educational development initiatives.

PERFORMANCE HIGHLIGHTS

	1987	1986	% Increase/ (decrease)
Total operating revenues (millions)	**$3,455**	$3,486	(0.9)
Total operating expenses (millions)	**$2,445**	$2,321	5.4
Fuel, purchased power & purchased gas costs (millions)	**$ 963**	$1,111	(13.3)
Rate deferrals – net of write-off (millions)	**$ 333**	$ 786	(57.6)
Operating income (millions)	**$1,010**	$1,165	(13.3)
Net income (millions)	**$ 357**	$ 454	(21.5)
Rate of return on average common equity	**8.20%**	11.51%	(28.8)
Earnings per common share	**$ 1.74**	$ 2.22	(21.6)
Net utility plant at year-end (billions)	**$ 11.2**	$ 10.8	4.0
Construction expenditures (millions)	**$ 362**	$ 335	8.1
Retail electric customers at year-end	**1,678,284**	1,670,409	0.5
Retail electric energy sales (million kWh)	**51,411**	50,133	2.5
System peak load (megawatts)	**11,270**	11,697	(3.7)
Average number of common shares outstanding (thousands)	**204,581**	204,581	–

COVER PHOTOS:

Clouds of steam billow from twin cooling towers as the sun rises behind AP&L's Independence Steam Electric Station near Newark, Arkansas.

First recipients of the "Chairman's Award," presented in recognition of outstanding Systemwide Teamwork, are, from left: Jack King, system executive – operations, MSU; Don Meiners, SSI president and CEO; and Don Aswell, LP&L/NOPSI senior vice president, energy supply-fossil.

Just as the cover photo conveys the promise of a rising sun, the new MSU Systemark symbolizes its energy. The Systemark is the new MSU symbol for Systemwide Teamwork: our source of internal strength as a Company.

Systemwide
Teamwork

Dear Stockholders:

We are awaiting a decision from the U.S. Supreme Court on an issue of utmost importance to Middle South Utilities, Inc. (MSU), its electric system, and its stockholders. The Court's decision will determine to a large extent whether a dividend will be forthcoming in 1988.

As you know, legal and regulatory uncertainties over the past two years have prevented the MSU Board of Directors from reinstating a dividend. We hope the U.S. Supreme Court's decision will clear away some of these uncertainties and allow the System to move forward.

It was about this time last year, on February 25, that the Mississippi Supreme Court reversed and remanded to the Mississippi Public Service Commission (MPSC) the $326.5 million Grand Gulf 1 rate case of our Mississippi Power & Light (MP&L) operating company.

To briefly recap: the MPSC ordered MP&L to roll back rates to the pre-September 1985 level and file with the commission a plan to refund all Grand Gulf costs collected. MP&L appealed, and a stay from the U.S. Supreme Court kept rates in place. However, a bonding arrangement was imposed by the courts as a condition to the appeal. That bonding arrangement tied up much of the System's cash and, unfortunately, precluded the consideration of a common stock dividend payment that was imminent.

U.S. Supreme Court Hears Case

On February 22, 1988, approximately one year later, the U.S. Supreme Court heard oral arguments in the case. We asked the Court to confirm that the Federal Energy Regulatory Commission's (FERC) jurisdiction and rate-setting authority take precedence over state regulatory commissions, as set forth in the Supreme Court's earlier *Nantahala* decision. Because we believe many legal precedents and lower court rulings have been consistent with our position, we feel optimistic. A favorable ruling cannot be assured, but we are hopeful of attaining a successful resolution of this litigation.

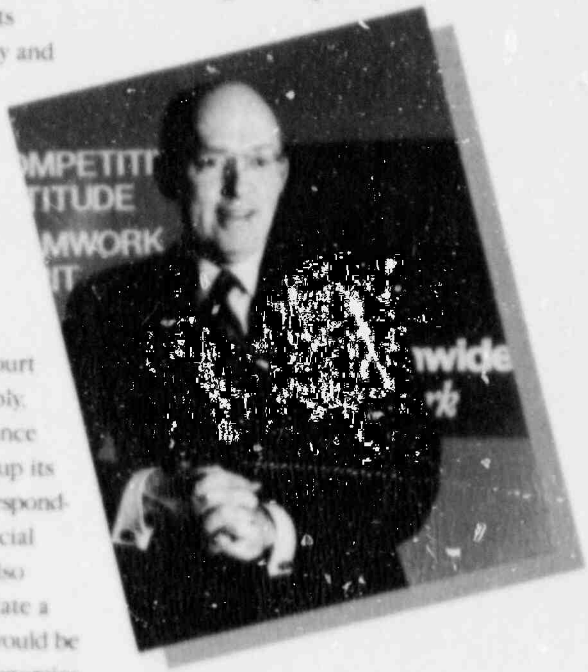
A recent decision by the Eighth Circuit Court of Appeals further fueled our optimism when it cited the *Nantahala* decision in upholding FERC's rate-setting authority in a case involving the recovery of Grand Gulf 1 costs in Missouri. And, a recent Fifth Circuit decision also recognized the *Nantahala* precedent in such cases.

Similarly, the U.S. Supreme Court, in December, refused to hear appeals challenging FERC's authority to allocate power. This action occurred shortly after FERC's decision to retain its June 1985 Grand Gulf 1 capacity and energy cost allocation after rehearing the matter at the request of the U.S. Court of Appeals for the District of Columbia Circuit. FERC's reaffirmation has again been appealed to the D.C. Circuit Court.

Should the U.S. Supreme Court decide the MP&L appeal favorably, the decision would greatly enhance the MSU System's ability to recoup its Grand Gulf investment and correspondingly improve the System's financial outlook. This outcome should also provide an opportunity to reinstate a dividend. At the same time, we would be able to turn 100 percent of our energies toward successfully competing in the changing electric utility industry.

An unfavorable decision, on the other hand, would greatly diminish dividend prospects. We would be forced to focus our energies on maintaining the solvency of our operating companies and the System. In that regard, we are currently involved in combatting an unfavorable rate decision imposed on our New Orleans Public Service Inc. (NOPSI) operating company. Alleging imprudence, the New Orleans City Council has disallowed the recovery by NOPSI of $135 million of previously deferred Grand Gulf 1 costs. As a result of the council's action, NOPSI was required to record a $135 million write-off and reflect that write-off, net of income taxes, as a loss in 1987. However, we continue to challenge the council's action in the courts and are seeking speedy reversal of this disallowance. (See page 27, Note 2 – "Rate and Regulatory Matters.")

Notwithstanding those challenges, we remain optimistic about our prospects for success in the courts and in the evolving marketplace.



1987 Viewed as Pivotal Year

I think we'll look back on 1987 as a pivotal year in our recovery. We survived vigorous legal challenges, maintained our customer energy load-ba[illegible] despite cogeneration's appeal, [illegible]ered our defense against the threat of municipalization, and we're strivi[illegible] to attain financial stability.

The challenges we've faced have forged us into a stronger, more effective organization; so much so, that I believe we're better prepared for the future and its inevitable challenges.

One of the most promising developments has been the growth and success of Systemwide teamwork. We're drawing strength from a proven ability to respond to challenges and opportunities as a smooth-functioning, efficient, Systemwide team.

For example, in June 1987, when the D.C. Circuit Court of Appeals questioned FERC's methodology in establishing the Grand Gulf 1 allocation plan, Systemwide teamwork helped sustain FERC's original allocation. Our System Energy Resources, Inc. (SERI) subsidiary filed a single brief with FERC urging the existing allocation's reaffirmation. On November 30, FERC did just that, relying heavily on arguments contained in SERI's brief.

Systemwide teamwork produced other benefits, as well. It was crucial when MP&L, SERI, and MSU worked together to secure the bonding arrangements needed to keep the MP&L Supreme Court appeal alive. And it proved beneficial as we developed standards of excellence in performance for the System's three nuclear generating stations.

We remain committed to, and continue to succeed in, controlling our cost of service. Computer-based programs at our nuclear facilities and fossil fuel plants help manage and reduce operation and maintenance costs throughout the System. (See the following section for details.)

In addition to getting more output from our plants at lower costs, we are taking steps to streamline our work force. Our Arkansas Power & Light (AP&L) operating company set the pace with an 11 percent reduction in authorized personnel. Other "belt-tightening" efforts are moving forward throughout the System.

On the financial side, we're preparing to shift gears. In 1987 we, by necessity, adopted a "damage control" strategy forced upon us by the bonding requirements associated with the MP&L appeal. We eliminated all but essential financings. We limited our borrowing to the bare minimum required. However, in the event we obtain a reasonably favorable Supreme Court decision, we will resume the more aggressive program begun in late 1986, seeking to lower our embedded capital costs through refinancing high coupon securities and other available means.

Operating Efficiencies Improved

Lowering our costs per kilowatt-hour through innovative financing and operational and organizational efficiencies is only part of the solution we are seeking. We must also continue to improve our product marketing.

To that end, the System is implementing a strategy that delineates the most effective electric power marketing methods. We are also applying, Systemwide, programs already proven successful within the individual service areas.

Externally, our New Opportunities program has achieved notable success in developing the region we serve. We have led a well-received effort to improve the literacy of, and educational and business opportunities in, the Middle South region. We believe this long-term investment in our service area will pay handsome returns in the future.

While New Opportunities enriches the region's educational and economic foundation, MSU is revamping and restructuring the System to respond to the challenges of the future. We don't intend to merely let the future happen; we are taking steps to meet it, with a game plan for being on top.

Meeting Future Challenges

Having met the challenges that 1987 posed, we know we have the wherewithal to successfully compete in this industry. We do not lack for a vision, nor are we short the enthusiasm, ambition, and know-how to achieve it. Still, for the past few years, those qualities have been encumbered by legal entanglements, regulatory recalcitrance, and a resulting investor uncertainty about the dilemmas that have shadowed us.

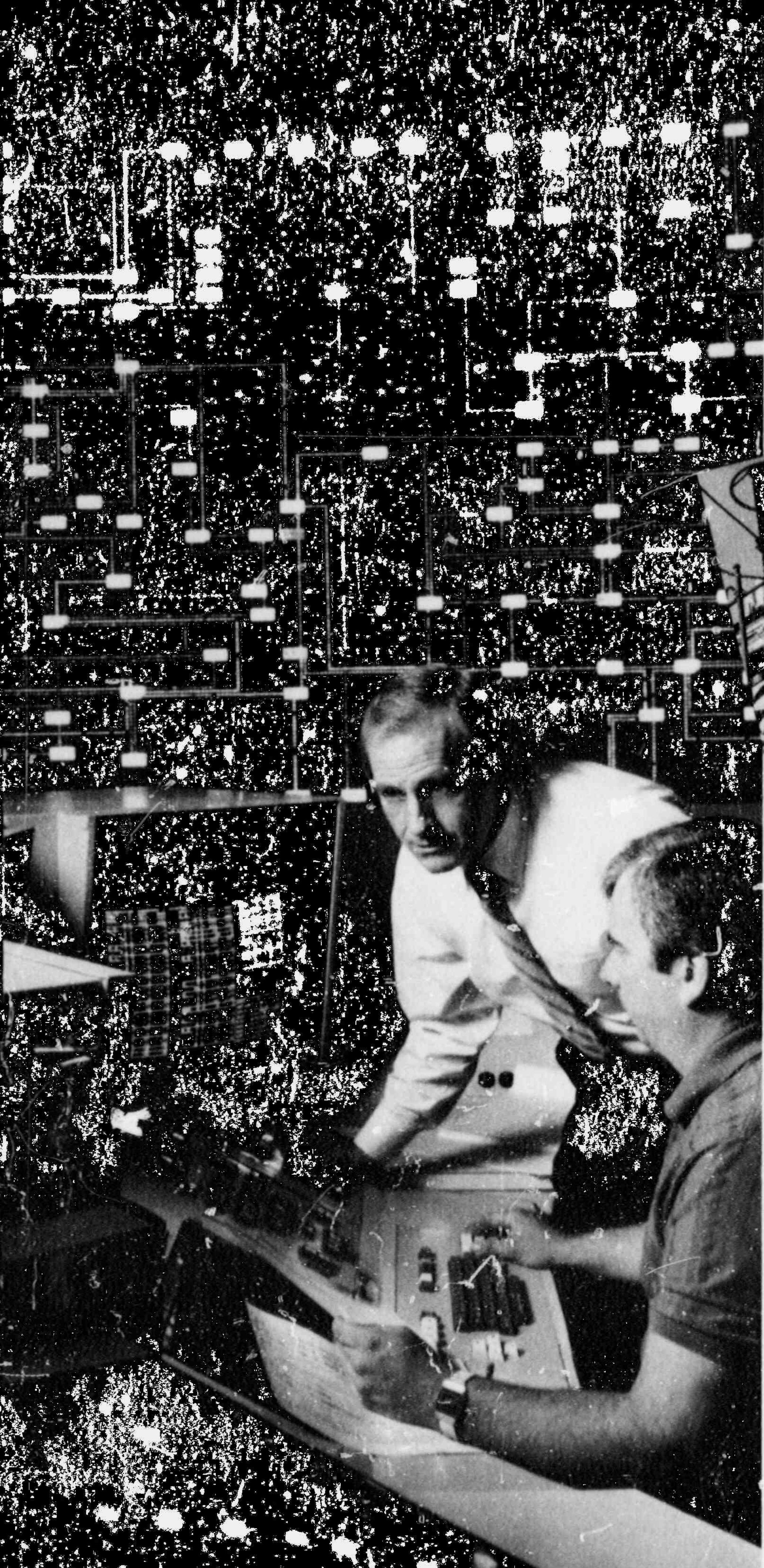
Those clouds should lift, however. The threats, constraints, and setbacks we've encountered will begin to wane if the U.S. Supreme Court renders what we hope will be a favorable decision. While not a final answer or panacea, a positive decision will afford the System an opportunity to finally move toward a resolution of its problems.

Anticipating that development, I have announced a new vision for the Company, and senior management has developed a set of sustaining priorities for bringing that vision to reality (see section that follows). As we near that reality, the Middle South Electric System can begin to perform like the thoroughbred organization we've become during this trying period.

Sincerely,

Edwin Lupberger
Chairman and President
March 22, 1988

Plant operators gather with Plant Manager Harvey Martin, third fron. right, at LP&L's Ninemile Point plant, site of a computer-based management program that has improved operating efficiency.



Jack King, system executive – operations, MSU, standing, monitors the transmission and distribution of power at the System Operations Center in Pine Bluff, Arkansas.

SYSTEM EXECUTIVES COMMITTED TO PROGRAM OF EXCELLENCE

"During the next decade, the Company will become and be widely recognized as a customer oriented, socially responsible, financially strong, successful competitor in the evolving electric energy business."
– The Vision
Edwin Lupberger

A vision statement has no power, only promise. It lists expectations, not deeds; describes goals, but not how to achieve them. it has life, but no substance until it is brought from the world of ideas to the world of accomplishments.

At Middle South Utilities, Inc. (MSU) much of the responsibility for translating the Company's vision into winning performance rests with the five System Executives, charged with responsibility for System management in the areas of operations, nuclear, legal and external affairs, finance, and human resources.

Together with the chief executive officers of MSU's principal subsidiaries, the System Executives in 1987 developed a set of sustaining priorities intended to drive the System toward its vision. Briefly stated, those sustaining priorities are to:

- become more customer oriented;
- become more cost competitive;
- energize our people;
- satisfy our internal and external constituencies;
- prepare for the future.

The MSU System Executives who have committed themselves to the accomplishment of these priorities are:

William Cavanaugh III, System Executive – Nuclear;

John L. Cowan, System Executive – Finance;

Jerry D. Jackson, System Executive – Legal and External Affairs;

Jack L. King, System Executive – Operations.

The System Executive – Human Resources position is expected to be filled during 1988.

Jack King, System Executive – Operations, understands the importance of customer orientation and cost-competitiveness in a changing business environment. In the face of such challenges as deregulation, cogeneration, and growing competition, King is working to make the Company responsive while maintaining quality service to the System's more than 1.68 million customers. "We must cultivate a commitment to innovation heretofore unheard of in the tradition-bound utility industry," King says.

"We must continue to tailor our efforts to meet every customer's needs. We must understand and anticipate the economic impact cogeneration can have on our industrial customers, develop new services for residential and commercial customers, and find ways to expand and improve existing services in every sector."

During 1987 Middle South began to see the success of its efforts. The System is successfully competing with cogeneration, an industrial alternative to utility-purchased power. In regions where electricity costs are high, utilities with similar customer profiles, i.e., similarly high percentages of chemical companies and fuel refiners, have lost significant load to cogeneration. Middle South, however, particularly through the efforts of its Louisiana Power & Light (LP&L) and New Orleans Public Service Inc. (NOPSI) subsidiaries, has increased load demand from these industrial customers.

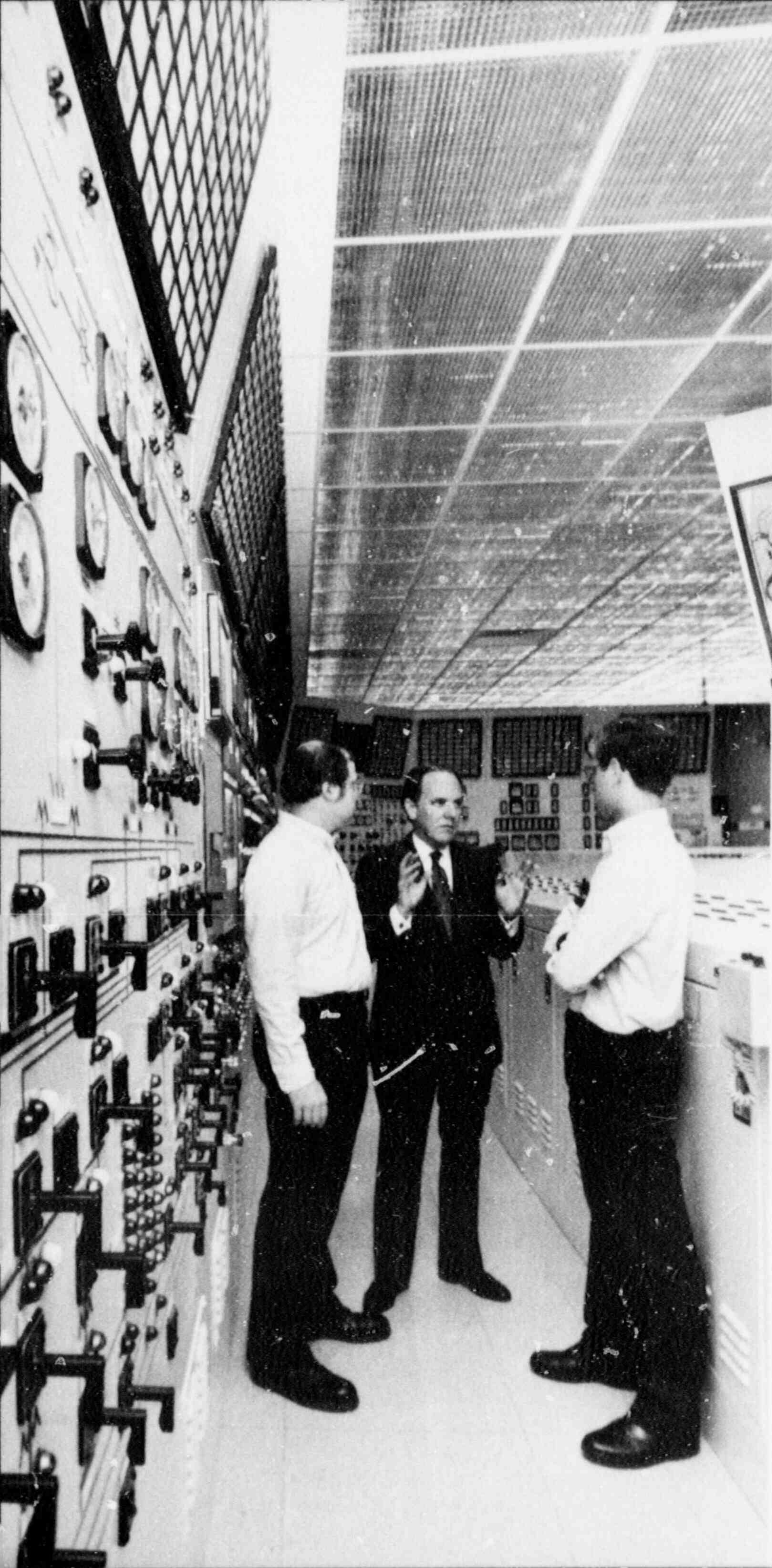
In addition, contracts securing future service commitments with many industrial customers have been successfully negotiated through a customer-tailored combination of service options and competitive pricing. King calls it a "win-win" approach.

"The industrial customer benefits from the purchase of electricity at competitive rates, without the risk of investing in an on-site power plant. Middle South benefits by keeping the industry in its customer base; and ratepayers as a whole benefit from the distribution of the utility's fixed costs among a larger customer base."

Seeking New Electric Markets

King also points out that Middle South Utilities is aggressively seeking out new markets, both within the System and beyond. Also, off-System sales, a growing sector stimulated by deregulation, are expected to contribute a larger share of Company revenues over the next few years.

Electric service is also being modified to meet special needs. As an example, King points to an Arkansas Power & Light (AP&L) program that provides "premium-grade" electricity for customers with power-sensitive equipment. "You might call it computer-grade electric power," King says about the program. "Customers with sensitive equipment can subscribe to this service and experience fewer computer interruptions and more efficient operation."



Frank Rives, SSI director of nuclear fuels, left, and Gerald Muench, SSI vice president of nuclear assurance, review emergency planning procedures.

William Cavanaugh, system executive – nuclear, MSU, center, makes a point in talking with two operators in the control room simulator at Arkansas Nuclear One.

Cost-competitiveness – the ability to achieve and retain the competitive edge afforded a "low-cost producer" – is a watchword for **William Cavanaugh, System Executive – Nuclear**, as well. Cavanaugh, who is also president and chief executive officer of Middle South's System Energy Resources, Inc. (SERI) subsidiary, sees the System's nuclear operations as critical to achieving cost-competitiveness. His track record proves he means business.

In 1987 Middle South's nuclear operations had its best year. Each nuclear unit increased the length of time it was available for full-load service, and each station (Arkansas Nuclear One, Grand Gulf, and Waterford 3) established new records for generation. Grand Gulf Unit 1 also established a new world record for continuous operation of a boiling-water reactor (BWR) during the second operating cycle, and a new record for generation in a 24-hour period by a single-unit BWR. Additionally, all the System's nuclear stations achieved full membership in the National Academy for Nuclear Training. Membership in the Academy is a prestigious honor, granted only to those nuclear stations having high-quality, effective training programs.

Meeting Standards of Excellence

"The results we're after depend largely on the effective management of our resources," says Cavanaugh. "We've set our sights on a standard of excellence. We're going to achieve that with employees who are the best, the most innovative, the most dedicated."

Meeting this standard of excellence, rather than accepting some lesser industry average as a target, "is the best assurance we have of providing a reliable supply of electricity at a reasonable cost while ensuring the protection of our investment, and the health and safety of our employees and the public," states Cavanaugh.

To obtain that goal, a structured series of initiatives was implemented in 1987 to promote Systemwide teamwork and to foster a competitive attitude toward individual, facility, and program performance. These initiatives included:

- utilization of a limited number of task forces to provide a Systemwide approach to problems common to all the nuclear units;
- formation of intercompany peer groups for the sharing of ideas and information;
- increased participation by line personnel in both the Middle South System and Institute of Nuclear Power Operations (INPO) assessment programs;
- Nuclear Management Committee meetings that focused on individual unit performance, unit problem areas, significant incidents, and current regulatory issues;
- increased emphasis on the utilization of Systemwide resources to address significant problem areas at a specific unit.

Cavanaugh is employing the Company's considerable technological resources as part of this program of excellence. The Station Information Management System (SIMS) is already operating at AP&L's Arkansas Nuclear One and LP&L's Waterford 3, and is being installed at SERI's Grand Gulf 1. SIMS is a computer-based program that enables management to better control maintenance schedules and more effectively utilize personnel and other resources at the System's nuclear facilities.

A SIMS derivative, PPPIP (Power Plant Productivity Improvement Program), accomplishes the same objectives for the System's fossil-fuel plants and is operating at LP&L's Ninemile Point plant. As with SIMS, the improved efficiency and cost savings resulting from PPPIP at Ninemile is being extended through its installation at other System plants.

These management initiatives and technological resource programs are part of a focused effort toward the establishment of standards of performance for the conduct of all System nuclear activities.

"The System's nuclear units represent either profitable opportunity or potential crisis for our System," says Cavanaugh. As a profitable opportunity, they stand – at the bottom line – as the largest contributors to the net income of our corporation. As a potential crisis – unless they are safely, cost-effectively, and successfully operated – these units represent the most significant threat to the continuing existence of Middle South Utilities," Cavanaugh says.

"That's why we cannot afford – either professionally, financially, or politically – average levels of performance within our nuclear sector. It is with the recognition of these circumstances that we are committed to one standard – the standard of excellence."

Jennifer Gary, SSI associate economic development specialist, right, observes a demonstration of the innovative computer-based literacy training program, PALS, performed by instructors at the Continuing Education Learning Center in Jackson, Mississippi.

Jerry Jackson, system executive–legal and external affairs, MSU, confers with LP&L/NOPSI attorney Tom Lind, left, and attorney Herschel Abbott, right, on the steps of the U.S. Fifth Circuit Court of Appeals in New Orleans, Louisiana.

Becoming a customer-oriented, cost-competitive electric energy producer will go a long way toward satisfying Middle South's internal and external constituencies. These constituents, including customers, regulators, stockholders, the business community, and the general public, often speak in competing voices, attempting to influence Middle South's programs and policies. The Company's vision is to satisfy all these interests – a task that requires expert management from **Jerry Jackson, System Executive – Legal and External Affairs.**

In 1987 the System made considerable progress toward resolving the judicial and regulatory conflicts that have strained its financial and managerial resources. Through effective Systemwide teamwork, the Company has been able to overcome a number of legal hurdles concerning the Mississippi Power & Light (MP&L) rate case. As Jackson says, "The fact that MP&L remains in business and continues to collect Grand Gulf costs from its customers is an example of how important Systemwide teamwork is to meeting these challenges.

"In addition," says Jackson, "we were successful in securing an order reaffirming the existing allocation of Grand Gulf 1 capacity and energy costs by the Federal Energy Regulatory Commission (FERC) following the remand by the D.C. Circuit."

The legal and regulatory battles are not over. Litigation is pending before the U.S. Supreme Court involving MP&L's right to recover the costs associated with its share of Grand Gulf, and some of the parties to the FERC proceedings filed a second appeal before the D.C. Circuit Court seeking further judicial review of the existing FERC allocation of Grand Gulf costs. Additionally, the New Orleans City Council has assessed against NOPSI a substantial disallowance of Grand Gulf 1 costs based upon alleged imprudence – an action we are challenging in the courts. "Only by working together as a System," states Jackson, "will we be able to successfully meet these challenges."

Teamwork Is Key to Success

Under Jackson's direction, teamwork efforts have resulted in successes in other related areas. Teamwork has:

- helped persuade Congress to enact legislation restricting the issuance of tax-free bonds as a means of funding a utility takeover;
- helped defeat legislation that would have given states the equivalent of "veto" power over any plan to commence operation of a nuclear generating facility;
- produced a new Systemwide strategic planning and decision-making process likely to be a model for the industry;
- helped improve the economy of the region through Systemwide efforts to promote literacy, education, and economic development.

Economic development programs, known collectively as "New Opportunities," have been designed to stimulate and foster improved long-term growth for the Middle South System service area. They are priorities that Jackson sees as essential to expanding the Company's economic base and, ultimately, increasing demand for electricity. He recognizes that an expanding business environment benefits not only the region, but the Company's customers and stockholders, as well.

"In the area of economic development, the System's New Opportunities program has recorded an enviable record," says Jackson. "Our series of entrepreneurial workshops has attracted businessmen from every corner of the region, who have been able to translate their new knowledge into better business practices." Future plans for the business community include focusing on banking's relationship to new businesses and helping minority-owned enterprises.

Similar advances have been made on the educational and literacy fronts. Because an educated, well-trained work force is essential for industrial growth today, education cannot be separated from economic development. With this in mind, the Company has embarked on a series of programs to wipe out illiteracy and improve education in the service area.

In one of the most innovative of these programs, Middle South has helped establish four adult learning centers, where a computer-based literacy training program – Principle of the Alphabet Literacy System (PALS) – enables a single tutor to simultaneously teach as many as 16 students to read. Situated in Jackson, Mississippi, New Orleans and Monroe, Louisiana, and Helena, Arkansas, the centers offer a significant advance in literacy training that has, up until now, been limited to a few students at a time.

Other educational initiatives sponsored by Middle South include student and counselor institutes, which highlight opportunities within the Middle South region for college education and professional careers. The goal is to retain the region's brightest and most promising students.

These are only a few illustrations of how teamwork helped the System in 1987 deal with the challenges and opportunities encountered in legal and

Al Wright, SSI vice president of finance, left, and Steve McNeal, SSI manager of corporate finance, examine market trends at offices of a national brokerage firm.

John Cowan, system executive – finance, MSU, standing, discusses issues presented at the System Financial Officers meeting with, clockwise, Stuart Ball, SSI; Pat Goff, MP&L; Glenn Harder, SERI; Rodney Estrada, SSI, standing; and Mal McLetchie, LP&L/NOPSI.

external affairs. As Jackson notes, "We will continue to face similar challenges in the future which, if not handled properly, could be disastrous for us and for the region. That is why teamwork will continue to be as important in the future as it has been in the past."

While Middle South is committed to developing New Opportunities for the region it serves, **John Cowan, System Executive – Finance**, is at work identifying opportunities for improving the Company's financial picture.

"Middle South has been preparing for the improved financial conditions we expect to derive from a favorable U.S. Supreme Court decision on the MP&L appeal," Cowan says. These improved conditions will include greater confidence in the strength of the System's companies among rating agencies, security analysts, and existing and potential investors in bonds and other securities. A program of refinancings to reduce the money cost of the subsidiaries would then follow.

Cowan is making contingency plans, as well. Should the Supreme Court decision not be everything anticipated, the Company will be prepared to respond quickly so the financial integrity of the System can be maintained. "We're not just going to let the future happen," Cowan emphasizes.

Before joining the System last October, Cowan was the former chief financial officer for UAL, Inc., and its United Airlines subsidiary. His experience with the deregulation of the airline industry prompts him to believe that, "The electric industry's future rests with those companies that can best adapt their total resources to meeting market realities."

Cowan believes that competition in the industry is likely to produce a major disruption in the electric power market and that those firms that are not competitive, both in terms of cost and as investment vehicles, could become casualties. Future rate increases beyond those already scheduled would definitely weaken the subsidiaries' position among their competitors.

Creating a New Competitive Edge

In order to prosper, Cowan says, the System must move now to create a competitive edge for the future. He is working to make the System capable of responding quickly to changing opportunities. These might involve innovative refinancing programs, fuel purchasing strategies, and the development of specialized services.

Because the System's high cost of capital makes it vulnerable to competition, the Company must be very aggressive in managing its money costs. "We are going to do everything we can to improve the Company's financial structure," Cowan says, "so that when some of the regulatory and legal questions are put to rest, the MSU Board of Directors will be in a position to consider reinstating a dividend at an appropriate level."

Ultimately, Middle South's success in achieving its vision as a successful competitor relies upon its people. The System's 13,700 employees are a source of energy that, working as a team, can light a road to success as surely as electricity illuminates the Middle South region. Recognizing that potential, a commitment is included in Middle South's vision to maximize human resources by "energizing" employees.

One of the priorities that has been established for the new System Executive – Human Resources is to identify and develop existing talent within the System through movement and exchange of employees among companies. Although the process of intrasystem transfers is not new to the System, a more organized and systematic approach is being emphasized for 1988 as another means of strengthening the Middle South team.

Electric utilities tend to be very specialized in terms of engineering and operating functions, and economic and financial rules and regulations, so employees with utility knowledge and skills are an invaluable asset to the Company.

Intrasystem transfers allow the Company to promote individuals who already have public utility experience, as well as experience with the System, its people, history, and operations. This creates a cadre of employees who better understand the interconnection of their jobs within the System, strengthening the teamwork concept, and furthering the Company's commitment to System-wide excellence.

Nineteen eighty-seven embodied continuing challenges to Middle South Utilities. Notwithstanding these challenges, Middle South is planning to move boldly ahead in 1988. The vision and sustaining priorities are in place. Capable System Executives are at the helm. While awaiting the U.S. Supreme Court decision, the Company's management has set its sights firmly on success, whatever the Court's ruling. A favorable decision will make success easier; but Middle South must bring its vision to fruition with or without it.

Financial Condition

During 1987, the Middle South System continued to face legal and regulatory uncertainties. Significant improvement in the Company's financial condition cannot be expected until favorable resolution or moderation of these uncertainties has been achieved. However, some progress toward firmer financial ground was accomplished during 1987 as evidenced by the following:

- The Federal Energy Regulatory Commission (FERC), on remand from the Court of Appeals for the District of Columbia Circuit, issued an order in November 1987, subject to judicial review, whereby FERC reaffirmed and reinstated the June 13, 1985, decision allocating the capacity and energy costs of Unit 1 of the Grand Gulf Nuclear Station (Grand Gulf 1) to the System operating companies on a full cost-of-service basis and providing SERI with recovery of its costs associated with the construction and operation of the unit as well as a return on its investment (June 13 Decision). (See Note 2 – "Rate and Regulatory Matters.")
- Each of the System operating companies has implemented a rate structure (in some cases pending the outcome of challenges) for the recovery, in part, of its respective allocated costs of Grand Gulf 1 and, in the case of LP&L, its costs associated with Unit 3 of the Waterford Steam Electric Generating Station (Waterford 3). Certain of the System operating companies have reduced the deferral of costs for future collections and increased their current cash collections through implementation of phase-in plans.
- SERI has, through refinancing, succeeded in reducing its bank debt from approximately $709 million at December 31, 1986, to approximately $374 million at December 31, 1987. (See Note 4 – "Lines of Credit and Related Borrowings.")
- MP&L, NOPSI, and SERI successfully accessed the capital markets in 1987, whereby a total of approximately $485 million was raised by these companies from external sources during the period, primarily to refinance existing debt and preferred stock and, in the case of MP&L and NOPSI, to also finance their rate deferrals.
- In order to increase the liquidity and financial flexibility of MSU, the System operating companies made payment of common stock dividends to MSU for the first time since the second quarter of 1985.

While the above developments represent progress, the final and favorable resolution of disputes over adequate retail rate relief for certain of the System operating companies, as discussed herein, has yet to be achieved.

On February 25, 1987, the Mississippi Public Service Commission's (MPSC) September 1985 final order on rehearing, which granted rate relief to MP&L with respect to its FERC-ordered allocation of Grand Gulf 1-related costs, was reversed by the Mississippi Supreme Court and remanded to the MPSC for further proceedings (February 25 Decision). To obtain a stay of the Mississippi Supreme Court's mandate, pending MP&L's appeal of the February 25 Decision to the U.S. Supreme Court, SERI and MSU have provided corporate guarantees (in the amount of approximately $206 million) if refunds are required of MP&L and SERI is escrowing an amount equal to MP&L's Grand Gulf 1 rate collections since June 1, 1987.

With respect to MP&L's appeal of the Mississippi Supreme Court's February 25 Decision, MP&L, based on the opinion of its counsel and assuming FERC has jurisdiction to allocate Grand Gulf 1 costs, is of the belief that the February 25 Decision should be reversed by the U.S. Supreme Court on the basis of constitutional grounds if that Court, upon further consideration of the issue of its jurisdiction, accepts the appeal or otherwise agrees to decide the case on the merits. However, no assurances can be given that MP&L's appeal will be successful. If the U.S. Supreme Court's decision is adverse to MP&L's interest, MP&L's Grand Gulf 1 rate order could be canceled which, without a commensurate reduction in costs, could render MP&L insolvent in a short period of time. In addition to the possible effects upon MP&L, if the U.S. Supreme Court renders any decision adverse to the System's position, the application of the doctrine of federal preemption could be severely undermined. The doctrine of federal preemption is necessary in order to secure implementation of SERI's federally mandated wholesale rates through the retail rate structures of the System operating companies. Under these circumstances, the continuing viability of SERI as a wholesale seller of power to the System operating companies, based upon SERI's full cost of service, would be jeopardized, and it could be difficult for one or more of the System companies to avoid a bankruptcy filing. Furthermore, the corporate structure of the Middle South System could be placed in jeopardy. (See Note 2 – "Rate and Regulatory Matters" and Note 8 – "Commitments and Contingencies – Potential Debt Acceleration, Bankruptcy, and System Viability.")

On February 4, 1988, after a lengthy prudence investigation, the New Orleans City Council adopted a resolution that required NOPSI to write off $135 million of its deferred Grand Gulf 1 costs in addition to the $51.2 million of such costs previously absorbed in connection with a March 1986 rate settlement between NOPSI and the council. The council's action has caused NOPSI to suffer immediate harm with serious consequences to the financial condition and viability of NOPSI to continue to exist in its present form. In the near term, unless the council's resolution is reversed, NOPSI will, in all probability, not be able to obtain the funds necessary to meet its ongoing obligations and could be rendered insolvent in a short period of time, perhaps as early as the second quarter of 1988. Because NOPSI has not been able to obtain an immediate stay of the council's resolution, NOPSI was required by the resolution and applicable accounting standards to write off $135 million of its previously deferred Grand Gulf 1 costs and reflect that write-off, net of income taxes, as a loss in 1987. After giving effect to the write-off, the balance of NOPSI's deferred Grand Gulf 1 costs approximated $108 million at December 31, 1987. Additionally, should the resolution stand as written, NOPSI would have its future revenues reduced by $135 million plus the carrying charges thereon (which NOPSI estimates could be as much as another $165 million). Unless the resolution is reversed, under applicable regulatory, charter, and indenture restrictions, NOPSI could be rendered unable to effect further borrowings or other financings. Moreover, there is no assurance that MSU will provide any additional funds to NOPSI under these circumstances. In addition, in the absence of a reversal, NOPSI could be required under its new general and refunding (G&R) mortgage to redeem up to $115 million of G&R bonds outstanding thereunder, which could be tendered to NOPSI for redemption. NOPSI has no real ability to obtain the funds to meet this obligation, and could thereby be rendered insolvent. Also, should NOPSI fail to maintain in effect adequate retail rates to recover its Grand Gulf 1-related costs, NOPSI would not have adequate resources to meet its contractual obligations to SERI with respect to Grand Gulf 1 and could, in a short period of time, be rendered insolvent.

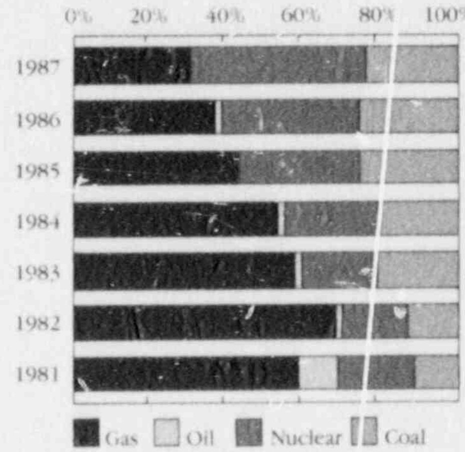
NOPSI believes that all of its actions and decisions with respect to Grand Gulf 1 were prudent and that NOPSI will ultimately be successful in defending against the council's actions. Moreover, NOPSI believes that the actions of the council are in violation of the Federal Power Act and FERC orders with respect to the allocation of Grand Gulf 1-related costs and will ultimately be so declared by the courts.

On January 30, 1987, the Louisiana Public Service Commission (LPSC) issued a permanent order for rate relief that would have allowed LP&L a base rate increase and, separately, the use of the balance of proceeds of a gas contract settlement to recover Waterford 3 deferred expenses. However, this order was subsequently modified by the LPSC through rate orders issued in April and June of 1987. LP&L appealed certain aspects of these rate orders to a state district court. In November 1987, the court issued a judgment allowing LP&L to record approximately $19 million in additional Waterford 3 deferrals, and authorizing LP&L to implement a rate increase of $40 million annually. The LPSC and LP&L have appealed the judgment to the Louisiana Supreme Court. Pending the outcome of the appeals, LP&L has not recorded the additional deferrals of approximately $19 million. LP&L has implemented such rate increase effective February 1, 1988, subject to refund. (See Note 2 – "Rate and Regulatory Matters.")

In addition to the above, several uncertainties faced the System during 1987, which had, and in certain cases continue to have, the potential to impede its financial recovery. These uncertainties included (1) the status of Unit 2 of the Grand Gulf Station (Grand Gulf 2), (2) the possible adverse effect on certain of the System operating companies of recent changes related to the accounting for phase-in plans, (3) the potentially adverse impact on SERI of certain findings stemming from a FERC audit of SERI and the Grand Gulf Station, if such findings are ultimately sustained, (4) the needs of MP&L and NOPSI to access the capital markets for external financing, (5) the continuing controversies over the Grand Gulf Station and the allocation of capacity and energy costs of Grand Gulf 1 to the System operating companies, and (6) unresolved prudence investigations of LP&L and MP&L. Certain developments with respect to these uncertainties occurred in late 1986 and 1987 and are listed below.

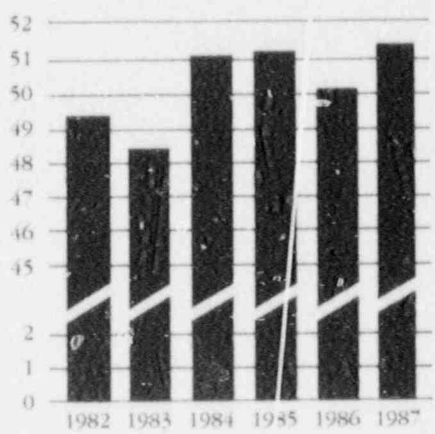
- On December 5, 1986, a recommendation was adopted by SERI's Board of Directors (with the MSU Board of Directors concurring) to continue the suspension of construction activities on Grand Gulf 2 and to make a decision by 1990 on the future status of Grand Gulf 2. This decision allows the System to maintain flexibility in meeting the energy needs of its service area. (See Note 8 – "Commitments and Contingencies – Suspended Construction Project – Grand Gulf 2.")
- In August 1987, the Financial Accounting Standards Board (FASB) issued Statement

Electricity Generation by Fuel Type
Megawatt-hours



NOTE: Percentages are for energy actually generated and not System capacity. Negligible amounts of hydroelectric generation are not plotted.

System Retail Customer Electricity Usage
Billions of Kilowatt-hours



of Financial Accounting Standards (SFAS) No. 92, Regulated Enterprises – Accounting for Phase-in Plans, an amendment of SFAS No. 71. SFAS No. 92 requires certain conditions for the deferral of costs of a newly completed plant. Certain of the System operating companies have implemented phase-in plans that do not meet the requirements of SFAS No. 92. If either AP&L or MP&L is required to ultimately write off substantial amounts of deferred costs, it could have a materially adverse effect on that company's financial condition. (See Note 8 – "Commitments and Contingencies – SFAS No. 92.")

- On June 18, 1987, FERC issued an audit report on SERI and the Grand Gulf Station. In the report, the FERC staff states, among other things, that the Grand Gulf Station's allowance for funds used during construction (AFUDC) is overstated, and that a significant portion of SERI's unrealized recorded income tax benefits should be reclassified to accounts receivable from associated companies. SERI has strongly disagreed with the staff's position, asserting that their position is in violation of the Securities and Exchange Commission's (SEC) tax allocation regulations applicable to holding company systems and contrary to FERC's accounting rules. If the staff's findings are ultimately sustained, the resulting charges against net income and refund requirements would have a materially adverse impact on SERI. (See Note 8 – "Commitments and Contingencies – FERC Audit of SERI.")
- MP&L and NOPSI will require funds from external sources to meet their capital requirements, and their ability to obtain these funds will be affected by legal and regulatory developments and other uncertainties. Any inability to obtain external funds could, particularly in NOPSI's case, produce severe liquidity problems. Due to their inability to issue significant amounts of first mortgage bonds due to lack of property additions, MP&L and NOPSI have established new G&R mortgage bond indentures to provide for future issuances of long-term debt based upon Grand Gulf 1 rate deferrals without meeting a property additions test. (See "Liquidity and Capital Resources.")
- Various parties have filed petitions for review of FERC's November 30 order whereby FERC reaffirmed and reinstated its June 13 Decision.

As a result of uncertainties facing the System, MSU has been unable to declare a common stock dividend since the second quarter of 1985. However, in order to increase the liquidity and financial flexibility of MSU to a limited extent, in the second half of 1987 and early 1988 the System operating companies paid common dividends to MSU aggregating $63 million. Resumption of MSU's common stock dividend depends, among other things, upon the favorable resolution or further moderation of these uncertainties, and improvement in the System's financial condition.

Lastly, if the New Orleans City Council's February 4, 1988, resolution as discussed herein is not reversed or if the existing retail rate structure of any other System operating company was to be revised in a manner that would cause such operating company to absorb (and not recover from customers) substantial Grand Gulf 1 and, in LP&L's case, Waterford 3 costs, the earnings, liquidity, and financial condition of the affected operating company and its ability to meet its continuing obligations could be severely impaired. Such company could be rendered insolvent and the Middle South System could be materially and adversely affected. (See Note 8 – "Commitments and Contingencies – Potential Debt Acceleration, Bankruptcy, and System Viability.")

Liquidity and Capital Resources

The capital requirements of the System noted herein assume the continued allocation of Grand Gulf 1 capacity and energy costs in accordance with the June 13 Decision and the favorable resolution of certain challenges to and modifications of retail rate relief granted with respect to Grand Gulf 1 and Waterford 3 costs, and are based on certain other assumptions and judgments with respect to, among other things, earnings, dividend policy, the outcome of regulatory and judicial proceedings, financing plans, and access to capital markets. If future events vary significantly from these assumptions, additional capital and external financing requirements could result. (See Note 8 – "Commitments and Contingencies – Capital Requirements and Financing.")

The total System construction expenditures (excluding nuclear fuel) for 1988, 1989, and 1990 are estimated to be $405.6 million, $414.7 million, and $427.3 million, respectively, and expenditures for nuclear fuel not currently owned or under lease are estimated to approximate $33.7 million during 1988-90.

In addition, significant additional capital requirements, estimated to aggregate $532.5 million during the period 1988-90, will result from the need to finance implemented and assumed rate moderation plans for the System operating companies.

Furthermore, during the period 1988-90, the Middle South System will require funds of approximately $731.9 million from internal and external sources to retire or to refinance maturing debt and to meet long-term debt and preferred stock sinking fund requirements.

Certain nuclear fuel lease arrangements are scheduled to terminate in 1988-90. It is currently anticipated that these arrangements will be extended or alternative arrangements will be secured. To the extent that this does not occur, additional financing requirements of up to an aggregate of $374 million could result. In addition, unless certain financing arrangements of SFI, in connection with its nuclear fuel procurement and services program for the Middle South System scheduled to terminate during the period 1988-89, are extended or alternative financing arranged, additional financing requirements of up to $105 million could result. Further, certain of SERI's pollution control revenue bonds may be required to be reacquired by SERI during 1988-89 in the event they cannot be remarketed. Under this circumstance, additional funds of up to approximately

$78 million may be needed to reacquire such bonds. Finally, as noted, NOPSI could be required to redeem up to $115 million aggregate principal amount of G&R bonds.

MP&L and NOPSI expect to raise capital funds from external sources through the sale of G&R bonds, common stock, borrowings, or such other methods of financing as may be appropriate. However, in NOPSI's case, unless the council's February 4, 1988, resolution is reversed, NOPSI will very likely be precluded from obtaining any additional funds from external sources and could be rendered insolvent.

AP&L, LP&L, and SERI's estimated capital requirements, including refinancing requirements, are anticipated to be met through internal cash generation, limited short-term borrowings, and, possibly, the sale of common stock, as well as the possible issuance of first mortgage bonds and preferred stock. However, many uncertainties continue to confront the Middle South System and, depending upon the ultimate resolution of such uncertainties and the effects thereof upon the Middle South System, these companies may be required to obtain additional funds from external sources, including issuances of additional first mortgage bonds, preferred stock, and such other sources as may be appropriate.

The ability of the System operating companies and SERI to obtain additional capital through the sale of common stock to MSU is limited at this time because of MSU's limited access to funds from external sources, limited dividends received by MSU from its subsidiaries, and the need for MSU to conserve cash resources. Moreover, due to the uncertainties discussed herein and in Note 8 – "Commitments and Contingencies – Capital Requirements and Financings," it cannot be predicted whether, or in what amounts and on what terms, other financing may be available to System companies. The following information with respect to sources of external financing should be read in light of the additional limitation of potential lack of access of these companies to the capital markets.

As noted, NOPSI and MP&L have established new G&R mortgage bond indentures. Under its new indenture, NOPSI is permitted, among other things, to issue G&R bonds based upon Grand Gulf 1 rate deferrals without having to satisfy a property additions test, although NOPSI would have to satisfy a two-times earnings coverage test and certain other conditions. MP&L's issuance of G&R bonds is subject to a test permitting MP&L to issue G&R bonds based upon the cumulative balance of deferred Grand Gulf 1 costs recorded as an asset on MP&L's books. MP&L would also have to satisfy certain other conditions, including a two-times earnings coverage test. These indentures constitute mortgage liens (subordinate to the liens of their respective first mortgages) on substantially all properties and assets of NOPSI and MP&L.

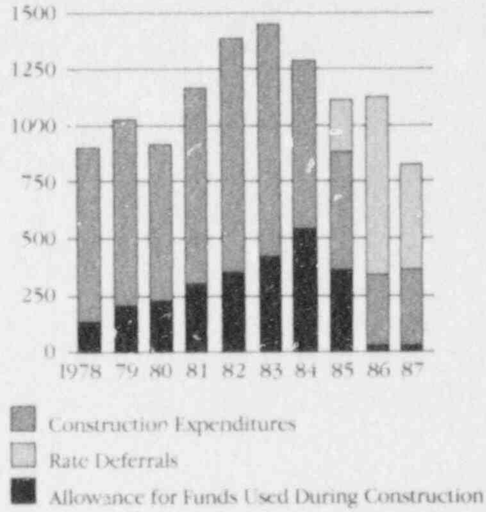
In NOPSI's case, these indentures are a first lien on certain of NOPSI's rights if the City of New Orleans purchases NOPSI's property and assets. Under these indentures, NOPSI and MP&L are essentially precluded from issuing additional first mortgage bonds under their first mortgages. NOPSI issued and sold $75 million of G&R bonds pursuant to its new indenture in 1987 and an additional $40 million of G&R bonds in January 1988. The New Orleans City Council's prudence disallowance, if not reversed, would very likely preclude NOPSI from issuing any additional G&R bonds in the foreseeable future.

MP&L, based on the most restrictive issuance test under its new indenture, could have issued $191.5 million in principal amount of G&R bonds at December 31, 1987. MP&L sold $75 million of G&R bonds in February 1988. After giving effect to this sale, MP&L could have issued $116.5 million of additional G&R bonds.

The amount of additional first mortgage bonds that AP&L, LP&L, and SERI may issue to finance their construction programs and other capital requirements is limited by the lesser of amounts based on mortgage coverage ratios or unfunded bondable property. Based upon the most restrictive test, at December 31, 1987, these companies

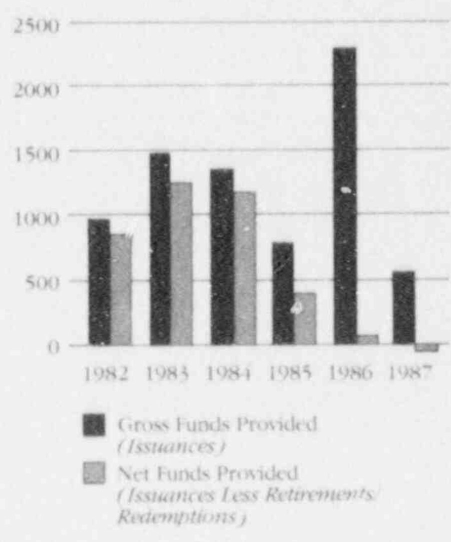
Capital Requirements Related to Construction Expenditures and Rate Deferrals

Millions of Dollars



External Financing Activity

Millions of Dollars



could have issued an aggregate of approximately $719 million of first mortgage bonds at an assumed rate of 13%.

The charter coverage ratios of the System operating companies limit the amounts of additional preferred stock that may be issued. At December 31, 1987, LP&L, MP&L, and NOPSI's earnings coverages were such that they were precluded from issuing additional preferred stock, while AP&L and SERI could have issued preferred stock in the amount of approximately $408 million, assuming a preferred dividend rate of 13%.

The amounts of additional mortgage bonds and preferred stock that can be issued by SERI and the System operating companies in the future are contingent upon earnings and the amount of unfunded bondable property or rate deferrals available to support the issuance of additional mortgage bonds. In addition, as discussed in Note 8 – "Commitments and Contingencies – SFAS No. 92," AP&L and MP&L may be required to write off substantial amounts of deferred costs in connection with the accounting for phase-in plans. Such occurrence could have a materially adverse effect on these companies' earnings and financial condition and their ability to issue preferred stock or additional mortgage bonds.

The System operating companies and SERI are currently authorized by the SEC to effect short-term borrowings in an aggregate amount outstanding at any one time of up to 10% of their respective capitalization (as defined). However, the System operating companies and SERI's abilities to borrow are subject to the availability of funds through bank lines and other credit sources. SERI is limited by certain of its credit agreements to short-term borrowings in an aggregate amount not exceeding the lesser of 5% of capitalization or $200 million. MP&L and NOPSI are subject to certain short-term borrowing constraints by provisions of their respective G&R mortgages. In addition, NOPSI is subject to an SEC order that prohibits incurrence of short-term indebtedness if common stock equity is, or would thereby become, less than 30% of the sum of total capitalization plus short-term indebtedness. As a result of the write-off of deferred Grand Gulf 1 costs and the substantial reduction of NOPSI's common stock equity caused by the council's February 4, 1988, resolution, NOPSI is currently precluded from effecting any short-term borrowings, whether through bank loans or money pool borrowings.

At December 31, 1987, the System operating companies had no existing short-term borrowings outstanding under territorial bank lines of credit aggregating approximately $131 million. In addition, LP&L had nonterritorial bank lines of credit of $90 million at December 31, 1987, none of which were utilized at year-end. In the event of certain adverse developments, the availability of certain of these bank lines could be the subject of further negotiation. Additional authorized borrowings of each System operating company and SERI can be effected through the Middle South System money pool, subject to the availability of funds, which at any particular time may be limited. The money pool provides the means whereby companies in the System with available funds can lend such funds to other participating System companies (other than MSU). At December 31, 1987, the funds available in the money pool for borrowing aggregated $190.8 million, none of which had been utilized by the System operating companies or SERI at year-end. (See Note 4 – "Lines of Credit and Related Borrowings.")

In order to help meet their interim needs for cash, MP&L and SERI have entered into arrangements for the sale of certain of their accounts receivable. For further information, see Note 4 – "Lines of Credit and Related Borrowings."

In addition, the Company is subject to contingent obligations that could expose the Company to additional demands on its cash resources and could result in potential liquidity problems. As previously noted, the Company has co-guaranteed refunds to MP&L's retail customers that could be required in the event of an adverse resolution of MP&L's pending U.S. Supreme Court appeal by providing a corporate guaranty in the amount of approximately $206 million. (See Note 2 – "Rate and Regulatory Matters.") Further, in connection with the Grand Gulf Nuclear Station, the Company has undertaken to provide or cause to be provided to SERI sufficient capital to (1) maintain SERI's equity capital at an amount at least equal to 35% of total capitalization (excluding short-term debt), (2) construct, own, and place in commercial operation the Grand Gulf Nuclear Station, (3) provide for preoperating expenses and interest charges of SERI, (4) permit the continuation of commercial operation after commencement thereof, and (5) pay in full all indebtedness for borrowed money whether at maturity, on prepayment, on acceleration, or otherwise. (See Note 8 – "Commitments and Contingencies – Potential Debt Acceleration, Bankruptcy, and System Viability.")

At December 31, 1987, the Company's cash and cash equivalents on hand totaled $143.6 million. The Company's year-end cash position has improved somewhat by the receipt of approximately $21.8 million in dividends from subsidiaries in February 1988. In addition, at December 31, 1987, the Company had a $60 million bank line of credit agreement expiring December 31, 1989, all of which was unused. However, due to uncertainties facing the Middle South System, this line of credit may not presently be available to the Company. Further, the Company's ability to obtain funds through dividend payments from its subsidiaries is currently limited. The System operating companies failed to pay dividends to the Company from mid-1985 through July 1987, and dividends since July 1987 have been in limited amounts. In addition, NOPSI is currently unable to declare further common stock dividends to the Company. SERI has never paid any dividends on its common stock and, pursuant to its bank credit agreements, will be prohibited from paying any dividends on its common stock until loans outstanding under these agreements are fully paid (presently scheduled for February 1989). The Company does not plan to effect any sales of its common stock in the near future.

Results of Operations

The following analysis of the results of operations reflects the effect of the early implementation of SFAS No. 90, which included restatement of the 1985 and 1986 financial statements. The Middle South System's net income for 1987 was $356.6 million, a decrease of approximately $97.9 million, or 21.5%, from 1986. This decrease was primarily attributable to (1) the write-off by NOPSI in 1987 of $135 million ($72.9 million net of tax) of disallowed Grand Gulf 1 costs that were previously deferred, (2) a nonrecurring accounting adjustment reported by NOPSI in 1986, and (3) the discontinuance of Waterford 3 deferrals by LP&L throughout most of 1987. The System's net income for 1986 was $454.5 million, an increase of approximately $238.9 million, or 110.8%, over 1985. This increase was due primarily to (1) the restatement of 1985 net income in connection with the write-off of disallowed Waterford 3 costs, (2) the effect of Grand Gulf 1 and Waterford 3 rate increases implemented during the latter part of 1985 and first quarter of 1986, including the rate deferral of $786 million recorded in 1986 as compared to $237 million in 1985, and (3) the recording of provisions for estimated losses as of December 1985, whereby the System operating companies expensed certain engineering and design costs and estimated liabilities associated with indefinitely delayed future fossil generating facilities and with certain investments in the System's fuel procurement program. The recording of such provisions had the net effect of reducing 1985 net income by approximately $66 million. Partially offsetting these factors were (1) the substantial reduction in the amount of AFUDC accrued in 1986 when compared to 1985, (2) the increased amounts of depreciation expense in 1986 associated with Grand Gulf 1 and Waterford 3, and (3) the recording of additional write-offs in 1986 related to the System's indefinitely delayed future fossil generating facilities (approximately $39.6 million) and SFI's uranium exploration program (approximately $19.2 million).

AFUDC for 1987 was approximately $9 million, an increase of $0.8 million, or 9.1%, over 1986, and a decrease of $356 million, or 97.7%, from 1985. AFUDC currently represents slightly over 2% of net income. The dramatic reduction in AFUDC, as compared to prior years, occurred because the System is no longer investing large sums in construction now that Grand Gulf 1 and Waterford 3 are in service and because of the suspension of construction on Grand Gulf 2 in September 1985.

Earnings per share on MSU common stock decreased to $1.74, down from the $2.22 recorded in 1986 but up from the 1985 amount of $1.08 (as restated). The 1987 decrease reflects the previously mentioned decreases in net income.

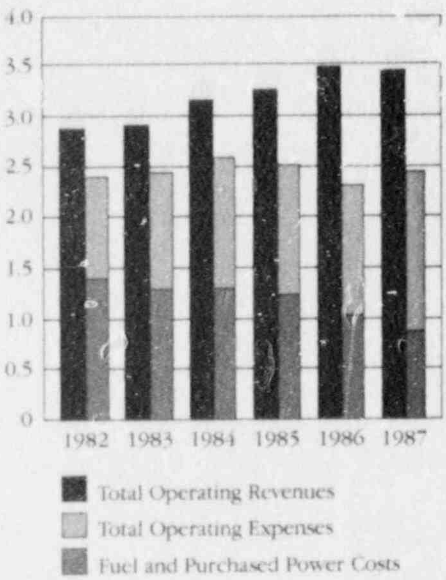
Fuel for electric generation declined $103.9 million, or 11.7%, from 1986. This decrease was due primarily to increased nuclear generation, which is at a lower average unit price than other types of generation, and to a general decline in unit prices for other fuel types.

Purchased power expenses in 1987 declined $31.8 million, or 24.8%, compared with a decrease of $102 million, or 44.3%, in 1986. Such decreases were due primarily to the use of nuclear generating capacity provided by Grand Gulf 1 and Waterford 3 (which began commercial operation in July 1985 and September 1985, respectively) rather than the purchase of power from companies outside the Middle South System.

In connection with their respective rate moderation plans, the System operating companies deferred for future recovery through rates certain operating expenses totaling $333 million, $786 million, and $237 million, respectively, in 1987, 1986, and 1985. The decrease from 1986 was primarily due to (1) NOPSI's write-off in 1987 of previously deferred Grand Gulf 1 costs, (2) LP&L's discontinuance, pursuant to orders of the LPSC, of additional Waterford 3 deferrals, and (3) NOPSI's one-time deferral in 1986 of $29.5 million of its Grand Gulf 1-related costs that had been expensed in 1985. In addition, certain of the System operating companies are currently able to recover a larger portion of their costs through increased base rates, and thereby defer a lesser amount of such costs.

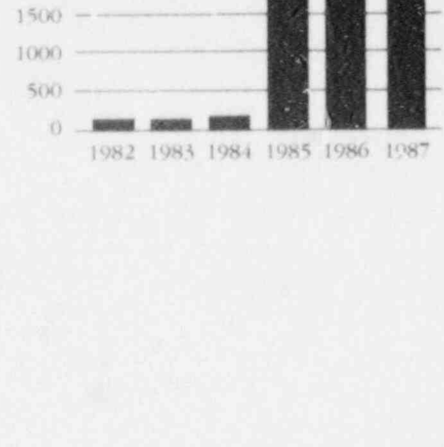
Operating Revenues and Expenses

Billions of Dollars



Wholesale Electricity Sales to Adjoining Utility Systems

Millions of Kilowatt-hours



Depreciation expense increased $44.9 million, or 13.2%, in 1987 compared with an increase of $75.8 million (as restated), or 28.8%, in 1986. Effective January 1, 1987, SERI's depreciation rate was changed from the units-of-production method to a straight-line basis. The use of the straight-line method in 1987 resulted in increased depreciation expense over the prior year due primarily to the fact that the units-of-production method was applied in a year of significantly lower generation. The 1986 increase was due primarily to the recording of additional depreciation expense in connection with the commercial operation of Grand Gulf 1 and Waterford 3.

Total income tax expense decreased $251.9 million, or 48%, in 1987 compared with an increase of $459.7 million (as restated) in 1986. The 1987 decrease is primarily attributable to a decline in pre-tax book income and the enactment of the Tax Reform Act of 1986, which effectively reduced the maximum corporate income tax rate from 46% to 34% effective July 1, 1987. The 1986 increase was due primarily to an increase in pre-tax book income recorded by LP&L and SERI as a result of the commercial operation of Waterford 3 and Grand Gulf 1, respectively.

Interest on long-term debt showed a decrease of $55.8 million, or 8.1%, in 1987 compared with a slight decrease of $4.9 million, or 0.7%, in 1986. The 1987 decrease is primarily attributable to the early retirement or refinancing of previously outstanding high-interest rate bonds. The change in long-term debt during 1986 was minimal as most of the financings effected were in connection with the refunding of outstanding indebtedness.

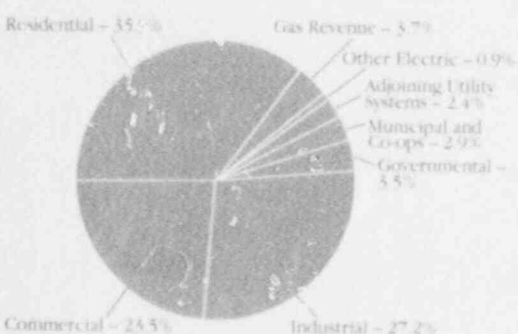
Other interest – net increased $9.5 million, or 27.4%, in 1987 compared with a decrease of $18.7 million, or 35.1%, in 1986. The increase in 1987 is due primarily to the issuance in April 1987 of $158 million of short-term notes that matured and were paid in January 1988. The 1986 decrease reflects a reduction in the amount of short-term borrowings and in interest rates on such borrowings.

Summary

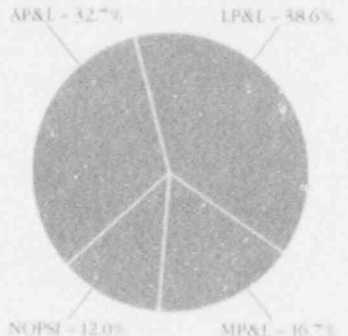
Improvement in the financial condition of the Middle South System is dependent upon the resolution of significant uncertainties that continue to face the System. These include (1) challenges to and/or reversals of rate orders and settlements, (2) the ultimate resolution of the status of Grand Gulf 2, (3) the possible adverse effect on certain of the System operating companies of recent changes related to the accounting for phase-in plans, (4) the outcome of the appeal of FERC's audit findings, (5) the ability of certain System companies to secure necessary financing in order to fund deferred Grand Gulf 1-related costs until they are collected through rates, (6) the continuing controversies over the Grand Gulf Station and the allocation of capacity and energy costs of Grand Gulf 1 to the System operating companies, and (7) unresolved prudence investigations.

The ability of the Middle South System to make progress toward its financial recovery depends primarily upon the preservation of the retail rate structures implemented in 1985 and 1986 for the recovery of costs associated with Grand Gulf 1 and Waterford 3. Certain of the retail rate structures are the subject of challenges, one having been reversed by the Mississippi Supreme Court and appealed to the U.S. Supreme Court, and another having been substantially modified by the regulator and appealed in the courts. Should one or more of these rate structures ultimately be materially modified or cease to be in effect, the Middle South System would be materially and adversely affected. (See Note 2 – "Rate and Regulatory Matters" and Note 8 – "Commitments and Contingencies – Potential Debt Acceleration, Bankruptcy, and System Viability.")

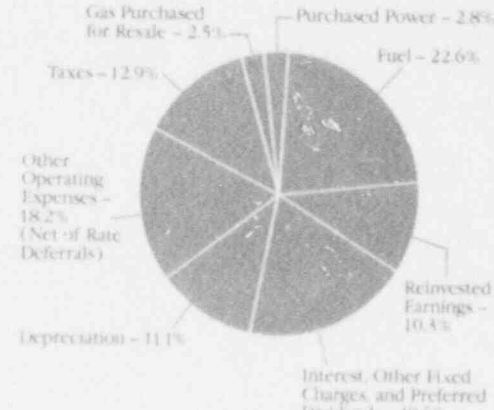
Sources of Revenue in 1987



Operating Companies' Contribution to Operating Revenues



Uses of Revenue in 1987



Report of Management

The management of Middle South Utilities, Inc. has prepared and is responsible for the financial statements and related financial information included in this annual report. The financial statements are based on generally accepted accounting principles. Financial information included elsewhere in this report is consistent with the financial statements.

To meet its responsibilities with respect to financial information, management maintains and enforces a system of internal accounting controls that is designed to provide reasonable assurance, on a cost-effective basis, as to the integrity, objectivity, and reliability of the financial records and as to the protection of assets. This system includes communication through written policies and procedures, and an organizational structure that provides for appropriate division of responsibility and the training of personnel. This system is also tested by a comprehensive internal audit program.

The independent public accountants provide an objective assessment of the degree to which management meets its responsibility for fairness of financial reporting. They regularly evaluate the system of internal accounting controls and perform such tests and other procedures as they deem necessary to reach and express an opinion on the fairness of the financial statements.

Management believes that these policies and procedures provide reasonable assurance that its operations are carried out with a high standard of business conduct.

Edwin Lupberger
Chairman and President

John L. Cowan
Senior Vice President,
System Executive – Finance

Audit Committee Chairman's Letter

The MSU Board of Directors' Audit Committee is comprised of five directors, who are not officers of the Company: Kaneaster Hodges Jr. (Chairman), W. Frank Blount, James R. Nichols, Wm. Clifford Smith, and Dr. Walter Washington. The committee held four meetings during 1987.

The Audit Committee oversees the Company's financial reporting process on behalf of the Board of Directors. In fulfilling its responsibility, the committee recommended to the Board of Directors, subject to stockholder approval, the selection of the Company's independent public accountant (Deloitte Haskins & Sells). The Audit Committee discussed with the internal auditor and the independent public accountant the overall scope and specific plans for their respective audits, as well as the Company's consolidated financial statements and the adequacy of the Company's internal controls. The committee also met with the Company's independent public accountant, without management present, to discuss the results of its examinations, its evaluations of the Company's internal controls, and the overall quality of the Company's financial reporting. The meetings were designed to facilitate any private communication with the committee desired by the internal auditor or independent public accountant.

Kaneaster Hodges Jr.
Chairman Audit Committee

Auditors' Opinion

The Stockholders and the Board of Directors of Middle South Utilities, Inc.:

We have examined the consolidated balance sheets of Middle South Utilities, Inc. as of December 31, 1987 and 1986, and the related statements of consolidated income, retained earnings and paid-in capital, and cash flows for each of the three years in the period ended December 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Notes 2 and 8 of Notes to Consolidated Financial Statements, there are challenges and/or potential reversals of certain of the System companies' rate structures, including prudence investigations and a regulatory audit; uncertainties as to the recoverability of the companies' investments in a suspended construction project and in rate deferrals; uncertainty as to the ability of one of the System operating companies to continue in existence in its present form; and, a potential for debt acceleration under certain loan agreements. The outcome of these uncertainties cannot presently be determined and no provision for any loss that may result has been made in the financial statements.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties referred to in the preceding paragraph been known, the above-mentioned consolidated financial statements present fairly the financial position of the Company and its subsidiaries at December 31, 1987 and 1986, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1987, in conformity with generally accepted accounting principles applied on a consistent basis, after restatement for the change, with which we concur, in the method of accounting for disallowed plant costs by one of the subsidiaries, as described in Note 10 of Notes to Consolidated Financial Statements.

Deloitte Haskins & Sells
New Orleans, Louisiana
March 10, 1988

CONSOLIDATED BALANCE SHEETS

Middle South Utilities, Inc. & Subsidiaries, December 31,	1987	1986
Assets	(In thousands)	
Utility Plant (Notes 1, 8, and 9):		
Electric	$12,975,581	$12,538,090
Natural gas	135,989	130,488
Construction work in progress	263,465	282,747
Nuclear fuel	580,424	241,812
Total	13,955,459	13,193,137
Less – Accumulated depreciation and amortization	2,715,314	2,386,723
Utility plant – net	11,240,145	10,806,414
Other Property and Investments:		
Letter of credit escrow (Note 4)	108,562	19,162
Other (Note 9)	103,635	54,933
Total	212,197	74,095
Current Assets:		
Cash and special deposits (Note 4)	35,473	34,972
Temporary investments – at cost, which approximates market (Note 12)	579,899	542,427
Total cash and cash equivalents (Note 1)	615,372	577,399
Funds held by first mortgage bond trustee (Note 6)	60,000	–
Escrow bonding arrangement (Notes 2 and 8)	101,202	–
Notes receivable	1,170	1,669
Accounts receivable:		
Customer (less allowance for doubtful accounts of [in thousands] $7,574 in 1987 and $7,825 in 1986) (Note 4)	136,807	174,209
Other	20,407	26,384
Accrued unbilled revenues (Note 1)	50,936	54,973
State income taxes receivable (Note 3)	8,778	20,750
Fuel inventory (Notes 1 and 4)	95,312	93,366
Materials and supplies – at average cost	110,323	90,459
Rate deferrals (Notes 1, 2, and 8)	11,765	24,398
Prepayments and other	55,910	66,999
Total	1,267,982	1,130,606
Deferred Debits		
Rate deferrals (Notes 1, 2, and 8)	1,346,090	998,909
Suspended construction project (Note 8)	889,780	908,572
Other	200,638	171,835
Total	2,436,508	2,079,316
Total	$15,156,832	$14,090,431

See Notes to Consolidated Financial Statements.

Prior Year Restated to Reflect the Adoption of SFAS No. 90.

	1987	1986
	(In thousands)	
Capitalization and Liabilities		
Capitalization:		
Common stock, $5 par value, authorized 250,000,000 shares; issued and outstanding 204,581,092 shares	$ 1,022,905	$ 1,022,905
Paid-in capital	1,565,466	1,565,889
Retained earnings (Notes 7 and 10)	1,939,757	1,583,402
Total common shareholders' equity	4,528,128	4,172,196
Subsidiaries' preferred stock (Note 5):		
Without sinking fund	330,967	330,967
With sinking fund	496,405	508,165
Long-term debt (Notes 6 and 8)	5,945,054	5,983,029
Total	11,300,554	10,994,357
Other Noncurrent Liabilities (Note 1):		
Obligations under capital leases (Note 9)	245,477	8,336
Other	50,581	51,810
Total	296,058	60,146
Current Liabilities:		
Notes payable (Notes 4 and 8):		
Commercial paper	65,000	105,000
Other	190,667	31,000
Currently maturing long-term debt (Note 6)	336,382	318,854
Accounts payable	271,293	280,191
Gas contract settlements – liability to customers (Note 12)	60,765	254,446
Deferred fuel cost	32,458	26,314
Customer deposits	67,904	64,934
Taxes accrued	76,142	66,363
Accumulated deferred income taxes (Note 3)	9,773	21,073
Interest accrued	168,896	170,542
Preferred dividends	22,192	22,220
Obligations under capital leases (Note 9)	318,460	2,483
Other	84,279	87,121
Total	1,704,211	1,450,541
Deferred Credits:		
Accumulated deferred income taxes (Note 3)	1,327,932	1,035,407
Accumulated deferred investment tax credits (Note 3)	55,332	60,577
Gas contract settlement – liability to customers (Note 12)	281,612	338,076
Other	191,133	151,327
Total	1,856,009	1,585,387
Commitments and Contingencies (Notes 1, 2, 8, and 9)		
Total	$15,156,832	$14,090,431

STATEMENTS OF CONSOLIDATED INCOME

Middle South Utilities, Inc. & Subsidiaries

For the years ended December 31,	1987	1986	1985
Operating Revenues:		(In thousands)	
Electric	**$3,327,117**	$3,339,132	$3,084,877
Natural gas	**127,703**	146,780	153,582
Total	**3,454,820**	3,485,912	3,238,459
Operating Expenses:			
Operation:			
Fuel for electric generation	**780,662**	884,560	1,001,373
Purchased power	**96,595**	128,405	230,399
Gas purchased for resale	**86,183**	98,337	120,542
Deferred fuel and other	**705,009**	703,153	593,571
Maintenance	**256,202**	242,261	176,293
Depreciation	**384,374**	339,438	263,622
Taxes other than income taxes	**169,696**	161,042	132,759
Income taxes (Note 3)	**161,817**	166,036	122,037
Rate deferrals:			
Rate deferrals (Notes 1, 2, and 8)	**(468,495)**	(785,897)	(236,676)
Write-off of previously deferred Grand Gulf 1 expenses (Notes 2 and 8)	**135,000**	–	–
Income taxes (Note 3)	**137,721**	383,180	117,245
Total	**2,444,764**	2,320,515	2,521,165
Operating Income	**1,010,056**	1,165,397	717,294
Other Income:			
Allowance for equity funds used during construction (Note 1)	**7,901**	8,830	217,734
Miscellaneous income and deductions - net	**85,849**	76,403	80,120
Income taxes - credit (Note 3)	**24,918**	22,656	82,171
Total	**118,668**	107,889	380,025
Application of SFAS No. 90 (Note 10):			
Disallowed plant costs	–	–	276,900
Related income taxes	–	–	(90,259)
Total	–	–	186,641
Interest and Other Charges:			
Interest on long-term debt	**637,139**	692,980	697,853
Other interest - net	**44,095**	34,608	53,306
Allowance for borrowed funds used during construction (Note 1)	**(1,092)**	590	(146,680)
Preferred dividend requirements of subsidiaries	**91,978**	90,643	90,601
Total	**772,120**	818,821	695,080
Net Income	**$ 356,604**	$ 454,465	$ 215,598
Earnings per Average Common Share	**$1.74**	$2.22	$1.08
Dividends Declared per Common Share (Note 8)	–	–	$0.89
Average Number of Common Shares Outstanding	**204,581,092**	204,581,092	199,496,115

See Notes to Consolidated Financial Statements.

Prior Years Restated to Reflect the Adoption of SFAS No. 90.

STATEMENTS OF CONSOLIDATED CASH FLOWS

Middle South Utilities, Inc. & Subsidiaries
For the years ended December 31,

	1987	1986	1985
		(In thousands)	
Operating Activities:			
Net income	$ 356,604	$ 454,465	$ 215,598
Noncash items included in net income:			
Rate deferrals (Notes 1, 2, and 8)	(469,548)	(780,563)	(242,744)
Write-off of previously deferred Grand Gulf 1 expenses (Notes 2 and 8)	135,000	–	–
Depreciation	384,374	339,438	263,622
Deferred income taxes	269,433	565,007	65,293
Investment tax credits – net	(5,246)	(5,019)	(4,699)
Allowance for funds used during construction (Note 1)	(8,993)	(8,240)	(364,414)
Write-off of disallowed plant costs (Note 10)	–	–	276,900
Write-off of deferred costs relating to standard coal plant design and equipment	–	31,657	16,790
Write-off of deferred costs relating to SFI's fuel acquisition program	–	19,151	–
Provisions for estimated losses	(4,551)	13,978	52,707
Changes in:			
Receivables	59,887	13,824	(65,862)
Fuel inventory	(1,946)	26,177	33,237
Accounts payable	(8,898)	(82,307)	119,906
Other working capital accounts	(11,898)	(54,373)	(47,363)
Proceeds from gas contract settlements (Note 12)	20,138	11,846	168,651
Refunds to customers – gas contract settlements (Note 12)	(252,785)	(56,374)	(62,964)
Increase in escrow bonding arrangement (Notes 2 and 8)	(101,202)	–	–
Other	26,497	(33,174)	(40,562)
Net cash flow provided by operating activities	386,866	455,488	384,096
Investing Activities:			
Construction expenditures	(351,227)	(335,289)	(876,473)
Allowance for funds used during construction (Note 1)	8,993	8,240	364,414
Nuclear fuel sales to lessors	125,053	143,998	54,045
Nuclear fuel expenditures	(65,800)	(74,718)	(64,225)
Expenditures on suspended construction project (Note 8)	(10,403)	–	–
Net cash flow used by investing activities	(293,384)	(257,769)	(522,239)
Financing Activities:			
Proceeds from issuance of:			
Common stock	–	–	208,539
Preferred stock	35,000	85,000	–
First mortgage bonds	375,000	1,750,000	130,000
General and refunding mortgage bonds	75,000	–	–
Bank notes and other long-term debt	51,377	427,846	446,684
Retirement of first mortgage bonds	(107,365)	(860,548)	(73,600)
Retirement of bank notes and other long-term debt	(406,758)	(1,352,912)	(298,070)
Redemption of preferred stock	(48,030)	(40,961)	(9,848)
Common stock dividends paid	–	–	(256,720)
Escrow payments (Note 4)	(89,400)	(19,162)	–
Funds held by first mortgage bond trustee (Note 6)	(60,000)	–	–
Changes in short-term borrowings	119,667	(162,295)	84,670
Net cash flow provided (used) by financing activities	(55,509)	(173,032)	231,655
Net increase in cash and cash equivalents	37,973	24,687	93,512
Cash and cash equivalents at beginning of year	577,399	552,712	459,200
Cash and cash equivalents at end of year	$ 615,372	$ 577,399	$ 552,712
Supplemental Disclosures of Cash Flow Information:			
Cash paid during the year for:			
Interest (net of amount capitalized)	$ 681,788	$ 722,373	$ 648,631
Income taxes (net of refunds)	$ (5,421)	$ 2,479	$ 16,546
Noncash Investing and Financing Activities:			
Capital lease obligations recorded (Note 9)	$ 555,104	$ 1,773	$ 4,021

See Notes to Consolidated Financial Statements.

Prior Years Restated to Reflect the Adoption of SFAS No. 90.

STATEMENTS OF CONSOLIDATED RETAINED EARNINGS AND PAID-IN CAPITAL

Middle South Utilities, Inc. & Subsidiaries

For the years ended December 31,	1987	1986	1985
		(In thousands)	
Retained Earnings, January 1, as previously reported	$1,765,632	$1,316,388	$1,090,839
Cumulative effect of retroactively applying SFAS No. 90 (Note 10)	(182,230)	(185,393)	-
Retained Earnings, January 1, as adjusted	1,583,402	1,130,995	1,090,839
Add – Net income	356,604	454,465	215,598
Total	1,940,006	1,585,460	1,306,437
Deduct:			
Dividends declared on common stock – $0.89 per share for 1985 (Notes 7 and 8)	–	–	175,128
Capital stock and other expenses	249	2,058	314
Total	249	2,058	175,442
Retained Earnings, December 31 (Note 7)	$1,939,757	$1,583,402	$1,130,995
Paid-in Capital, January 1	$1,565,889	$1,567,866	$1,435,570
Add:			
Excess of net proceeds over par value	–	–	131,470
Other	(423)	(1,977)	826
Paid-in Capital, December 31	$1,565,466	$1,565,889	$1,567,866

See Notes to Consolidated Financial Statements.
Prior Years Restated to Reflect the Adoption of SFAS No. 90.

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Middle South Utilities, Inc. (the Company or MSU) and its direct and indirect subsidiaries, Arkansas Power & Light Company (AP&L), Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company (MP&L), New Orleans Public Service Inc. (NOPSI), MSU System Services, Inc. (SSI), System Energy Resources, Inc. (SERI), System Fuels, Inc. (SFI), Associated Natural Gas (ANG), and Electec, Inc. The above companies, excluding Electec, Inc., are collectively referred to as the System companies or the Middle South System. All significant intercompany transactions have been eliminated except as allowed by Statement of Financial Accounting Standards (SFAS) No. 71.

Systems of Accounts

The accounts of the Company and its service subsidiary, SSI, are maintained in accordance with the Public Utility Holding Company Act of 1935 (Holding Company Act), as administered by the Securities and Exchange Commission (SEC), which has adopted a system of accounts consistent with the system prescribed by the Federal Energy Regulatory Commission (FERC).

The accounts of the System operating companies (AP&L, LP&L, MP&L, and NOPSI) are maintained in accordance with the systems of accounts prescribed by the applicable regulatory bodies, which systems of accounts substantially conform to those prescribed by FERC. The accounts of the generating subsidiary, SERI, are maintained in accordance with the system of accounts prescribed by FERC. The accounts of the non-utility subsidiary, Electec, Inc., are maintained in accordance with the system of accounts prescribed by the SEC.

Revenues and Fuel Costs

Three of the operating subsidiaries record electric and gas revenues as billed to their customers on a cycle-billing basis. Revenues are not accrued for energy delivered but not yet billed by the end of the fiscal period. LP&L accrues revenue for the non-fuel portion of estimated unbilled revenues. Unbilled revenues result from energy delivered since the period covered by the latest billings to customers. Substantially all of the rate schedules of the operating subsidiaries include adjustment clauses under which the cost of fuel used for generation and gas purchased for resale above or below specified base levels is permitted to be billed or required to be credited to customers.

MP&L has a fuel adjustment clause that allows current recovery of fuel costs. The three other operating subsidiaries utilize a deferral method of accounting for those fuel costs recoverable under fuel adjustment clauses. Under this method, such costs are deferred until related revenues are billed.

The fuel adjustment factor for AP&L contains an amount for a nuclear reserve estimated to cover the cost of replacement energy when the nuclear plant is down for scheduled maintenance and refueling. The reserve bears interest and is used to reduce fuel expense for fuel adjustment purposes during the shutdown period.

Utility Plant and Depreciation

Utility plant is stated at original cost. Partial disallowances of plant costs, as ordered by the Louisiana Public Service Commission (LPSC), have been removed from utility plant. (See Note 10 – "SFAS No. 90.") The cost of additions to utility plant includes contracted work, direct labor and materials, allocable overheads, and an allowance for the composite cost of funds used during construction. The costs of units of property retired are removed from utility plant and such costs, plus removal costs, less salvage, are charged to accumulated depreciation. Maintenance and repairs of property and replacement of items determined to be less than units of property are charged to operating expenses.

Depreciation is computed on the straight-line basis at rates based on the estimated service lives of the various classes of property. However, depreciation on Unit 1 of the Grand Gulf Station (Grand Gulf 1) was computed on the units-of-production method for the initial 12 months of commercial operation (which began July 1, 1985) and, with FERC's approval, for an additional six months thereafter. Subsequent to December 31, 1986, depreciation is being computed on a straight-line basis. SERI filed an application with FERC and FERC initiated a proceeding to determine the appropriate straight-line depreciation rate for Grand Gulf 1. On September 15, 1987, FERC approved a settlement which, among other things, established a depreciation rate of 2.85% under the Unit Power Sales Agreement effective January 1, 1987. Depreciation provisions on average depreciable property approximated 3.0%, 2.7%, and 2.9% in 1987, 1986, and 1985, respectively.

Substantially all of the System's utility plant is subject to the liens of the subsidiaries' mortgage bond indentures.

Rate Deferrals

The System operating companies have in effect (or have filed for approval of) various rate moderation or phase-in plans in order to reduce the immediate effect on ratepayers of the inclusion of Grand Gulf 1 and Waterford 3 costs in rates. Under these plans, certain costs are either permanently retained (and not recovered from ratepayers), deferred in the early years of commercial operation and collected in the later years, or recovered currently from customers. These plans vary both in the proportions of costs that each company retains, defers, or recovers and in the length of the deferral/recovery periods. By deferring costs associated with the rate moderation plans to the future when they will be collected through increased rates billed to customers, the impact of the deferral aspect of these plans on the income statement has been removed. Only those costs permanently retained and not recovered through rates or through sales to third parties result in a reduction of net income. Because the actual collection of revenues to recover the deferred amounts will not occur until the future, each company records a deferred asset representing the amount of the deferrals and, at the same time, incurs additional capital requirements to finance these deferrals. In most cases, the carrying charges associated with the financing of the deferrals are recovered currently from customers. (See Note 2 – "Rate and Regulatory Matters.")

The recording of such deferred costs as assets is governed by specific requirements as set forth in the new accounting standard, SFAS No. 92, Regulated Enterprises – Accounting for Phase-in Plans. (See Note 8 – "Commitments and Contingencies – SFAS No. 92.")

Postretirement Benefits

The Company and its subsidiaries have various defined postretirement benefit plans covering substantially all of their employees. The policy of the Company and its subsidiaries is to fund pension costs in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974 and to fund other postretirement plan costs as incurred.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. Income taxes are allocated to all subsidiaries based on their contributions to the consolidated taxable income. Deferred income taxes are provided for differences between book and taxable income to the extent permitted by the regulatory bodies for ratemaking purposes. Investment tax credits utilized are deferred and amortized based upon the average useful life of the related property.

Allowance for Funds Used During Construction

To the extent that the Company's operating subsidiaries are not permitted by their regulatory bodies to recover in current rates the carrying costs of funds used for construction, they capitalize, as an appropriate cost of utility plant, an allowance for funds used during construction (AFUDC) that is calculated and recorded as provided by the regulatory systems of accounts. Under this utility industry practice, construction work in progress on the balance sheet is charged and the income statement is credited for the approximate net composite interest cost of borrowed funds and for a reasonable return on the equity funds used for construction. This procedure is intended to remove from the income statement the effect of the cost of financing the construction program. It effectively results in treating the AFUDC charges in the same manner as construction labor and material costs in that each is capitalized rather than expensed. As non-cash items, these credits to the income statement have no effect on current cash earnings. After the property is placed in service, the AFUDC charged to construction costs is recoverable from customers through depreciation provisions included in rates for utility service.

Effective March 2, 1984, LP&L used an accrual rate for AFUDC of 3.5% on its investment in Waterford 3 up to an investment of $1.7 billion. During the first half of 1985, SERI used an accrual rate for AFUDC based on a return on average common equity of 14%, plus actual interest costs net of related income taxes. As a result of FERC's June 13, 1985, Decision, SERI's 14% accrual rate for the equity component of AFUDC was increased to 16%, effective July 1, 1985. On September 15, 1987, FERC approved a settlement that, among other things, reduced the rate of return on common equity from 16% to 14%, effective retroactively to July 1, 1987. SERI's effective composite AFUDC rate was 6% for 1987. The effective composite rates of the operating subsidiaries for the balance of AFUDC were 9.0%, 9.2%, and 9.7% for 1987, 1986, and 1985, respectively.

On September 18, 1985, the Mississippi Public Service Commission (MPSC) ordered SERI and MP&L to suspend construction of Grand Gulf 2 as of that date. Concurrent with the suspension of construction, SERI ceased accruing AFUDC on the unit effective September 18, 1985. (See Note 8 – "Commitments and Contingencies – Suspended Construction Project – Grand Gulf 2.")

Other Noncurrent Liabilities

It is the policy of AP&L, LP&L, and NOPSI to provide for uninsured property risks and claims for injuries and damages through charges to operating expenses on an accrual basis. Accruals for these provisions, classified as other noncurrent liabilities, have been allowed for ratemaking purposes. Prior to January 1, 1985, MP&L had a similar policy regarding such provisions. However, to comply with a regulatory agreement, MP&L, effective January 1, 1985, suspended provisions for its uninsured property risks and claims for injuries and damages. Effective July 1, 1985, MP&L implemented a procedure to amortize, over a three-year period, the accumulated balances of such provisions as of June 30, 1985.

Inventories

Prior to January 1, 1986, all fuel inventories of the System were valued at average cost. In July 1986, SFI adopted, retroactive to January 1, 1986, the last-in, first-out (LIFO) valuation method for its fuel oil inventory in order to achieve a better matching of current market conditions with the cost of fuel oil it charges the System operating companies. This change in valuation method did not have a material effect on the amounts charged to such companies.

Statement of Cash Flows

The Company has adopted SFAS No. 95, Statement of Cash Flows, and has presented statements of cash flows for the years 1987, 1986, and 1985. For purposes of this statement, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

2 RATE AND REGULATORY MATTERS

U.S. Supreme Court Litigation

On February 25, 1987, the Mississippi Supreme Court reversed and remanded the September 1985 order of the MPSC (February 25 Decision) that granted permanent rate relief of $326.5 million to MP&L with respect to its recovery of Grand Gulf 1 costs. Subsequently, MP&L filed an appeal of the February 25 Decision with the U.S. Supreme Court and also filed an application asking that Court to stay the mandate of the February 25 Decision pending final disposition of the appeal. On June 1, 1987, the U.S. Supreme Court entered an order granting MP&L's application for a stay conditioned upon the posting of a good and sufficient bond in a manner and amount to be determined by the Mississippi Supreme Court.

On June 10, 1987, the Mississippi Supreme Court entered an order setting bond with respect to the possible refunding to customers of amounts collected by MP&L pursuant to its Grand Gulf 1 rate order (approximately $280 million as of December 31, 1987). The requirements of the Mississippi Supreme Court's order setting bond have been, and are currently being, satisfied. These bonding requirements provide that, among other things, SERI shall make monthly deposits into an escrow account equal to MP&L's Grand Gulf 1 rate collections from June 1, 1987, until final resolution of MP&L's appeal to the U.S. Supreme Court. Through December 31, 1987, SERI had deposited approximately $99.4 million under this requirement, and such deposits are estimated to average approximately $14 million per month through June 1988, at which time it is expected that a decision shall have been rendered by the U.S. Supreme Court in MP&L's appeal. Further, SERI and MSU have provided, as required, corporate guarantees (in the amount of approximately $206 million) of MP&L's refund obligations for Grand Gulf 1 collections from September 1985 through June 1987 if refunds are required. To the extent that either MSU or SERI makes payments to discharge MP&L's obligations to make refunds to its customers as a result of an adverse final judicial determination in MP&L's appeal of the February 25 Decision, MSU and/or SERI, as the case may be, would have immediate right of reimbursement from MP&L. SERI has agreed, at the request of its creditor banks, to demand immediate reimbursement from MP&L on account of all amounts paid by SERI (whether directly or from monies placed in trust) on behalf of MP&L and to take promptly all reasonable actions necessary to collect such amounts from MP&L.

On October 5, 1987, the U.S. Supreme Court decided to hear full argument of MP&L's appeal of the Mississippi Supreme Court's February 25 Decision, but postponed further consideration of the U.S. Supreme Court's jurisdiction to the hearing of the case on the merits. The stay granted by the U.S. Supreme Court on June 1, 1987, remains in effect. Accordingly, MP&L is continuing to collect its Grand Gulf 1 rates, subject to refund, pending the Court's decision. Oral arguments were heard on February 22, 1988. MP&L, based on the opinion of its counsel, and assuming FERC has jurisdiction to allocate Grand Gulf 1 costs, is of the belief that the Mississippi Supreme Court's February 25 Decision should be reversed by the U.S. Supreme Court on the basis of constitutional grounds if that Court, upon further consideration of the issue of its jurisdiction, accepts the appeal or otherwise agrees to decide the case on the merits. No assurances can be given that MP&L's appeal before the U.S. Supreme Court will be successful. It is expected that the case will be decided by the end of June 1988. If the ultimate judicial resolution is adverse to MP&L's interest, MP&L's Grand Gulf 1 rate order could be canceled. If MP&L's Grand Gulf 1 rates are canceled, in addition to the substantial refund obligations of MP&L with respect to previously collected amounts as well as MP&L's ceasing to collect and to defer for future collection its Grand Gulf 1-related costs, MP&L would, under generally accepted accounting principles, be required to write off previously deferred costs (approximately $548 million at December 31, 1987). A cancellation of Grand Gulf 1 rates without a commensurate reduction in costs would render MP&L insolvent in a short period of time.

Prudence Investigations

Prudence investigations have been conducted with respect to NOPSI's Grand Gulf 1 cost recovery and have been initiated with respect to MP&L's Grand Gulf 1 cost recovery. In addition, the LPSC has conducted prudence investigations into Grand Gulf 1, Waterford 3, and LP&L's management but has not indicated its conclusions on these matters.

With respect to NOPSI, on February 4, 1988, after a lengthy prudence investigation, the New Orleans City Council adopted a resolution that required NOPSI to write off as a prudence disallowance and not recover from its retail electric customers $135 million of its Grand Gulf 1 costs in addition to the $51.2 million of such costs previously agreed to be absorbed by NOPSI in connection with the March 1986 settlement agreement between NOPSI and the council. The council's action has caused NOPSI to suffer immediate harm with serious consequences to the financial condition and viability of NOPSI to continue to exist in its present form. In the near term, unless the council's resolution is reversed, NOPSI will, in all probability, not be able to obtain the funds necessary to meet its ongoing obligations and could be rendered insolvent in a short period of time, perhaps as early as the second quarter of 1988. Because NOPSI has not been able to obtain an immediate stay of the council's resolution, NOPSI was required by the resolution and applicable accounting standards to write off $135 million of its previously deferred Grand Gulf 1 costs and reflect that write-off, net of income taxes, as a loss in 1987. After giving effect to the write-off, the balance of NOPSI's deferred Grand Gulf 1 costs approximated $108 million at December 31, 1987. Additionally, should the resolution stand as written, NOPSI would have its future revenues reduced by $135 million plus the carrying charges thereon (which NOPSI estimates could be as much as another $165 million). Unless the resolution is reversed, under applicable regulatory, charter, and indenture restrictions, NOPSI could be rendered unable to effect further borrowings or other financings. Moreover, there is no assurance that MSU will provide any additional funds to NOPSI under these circumstances. In addition, in the absence of a reversal, NOPSI could be required under its new general and refunding (G&R) mortgage to redeem up to $115 million of G&R bonds outstanding thereunder, which could be tendered to NOPSI for redemption. NOPSI has no real ability to obtain the funds to meet this obligation, and could thereby be rendered insolvent. Also, should NOPSI fail to maintain in effect adequate retail rates to recover its Grand Gulf 1-related costs, NOPSI would not have adequate resources to meet its contractual obligations to SERI with respect to Grand Gulf 1 and could, in a short period of time, be rendered insolvent.

NOPSI believes that all of its actions and decisions with respect to Grand Gulf 1 were prudent and that NOPSI will ultimately be successful in defending against the council's actions. Moreover, NOPSI believes that the actions of the council are in violation of the Federal Power Act and FERC orders with respect to the allocation of Grand Gulf 1-related costs and will ultimately be so declared by the courts.

With respect to MP&L, on September 16, 1986, the MPSC issued an initial order establishing a docket for the stated purposes, among other things, of examining the prudence of actions of MP&L and/or SERI relating to the construction and operation of the Grand Gulf Nuclear Station and the appropriate regulatory treatment of the associated costs, and of inquiring generally into the appropriateness of MP&L's general rate structure. MP&L and SERI have asserted that the MPSC does not have the jurisdiction to conduct such a prudence review. MP&L cannot predict the ultimate outcome of any such proceedings.

Waterford 3 Rate Orders

During 1987, the LPSC issued several rate orders with respect to a Waterford 3 rate increase for LP&L. The net effect of such orders resulted in, among other things, (1) a $48 million annual rate increase, and (2) the adequate assurance of future recovery of approximately $247 million of deferred Waterford 3 costs accumulated as of January 31, 1987. LP&L appealed certain aspects of the LPSC's orders to a state district court. In November 1987, the court issued a judgment allowing LP&L to record approximately $19 million in additional Waterford 3 deferrals and authorizing LP&L to implement an additional rate increase of $40 million annually, effective February 1, 1988. LP&L and the LPSC have appealed the judgment to the Louisiana Supreme Court. Pending the outcome of the appeal, LP&L has not recorded the additional Waterford 3 deferrals of approximately $19 million. The additional authorized rate increase of $40 million annually was implemented on February 1, 1988, subject to refund.

In February 1988, LP&L filed an application with the LPSC requesting a net annual rate increase of approximately

$38 million, subject to the outcome of the appeals mentioned above. Should the judgment of the state district court be overturned, the amount of net annual rate increase requested would increase to approximately $78 million. As part of this application, LP&L has submitted a formal phase-in plan for the recovery of approximately $266 million of deferred Waterford 3 costs. Such phase-in plan, if approved, would comply with SFAS No. 92.

FERC's June 13 Decision

FERC's June 13, 1985, Decision allocating the capacity and energy costs of Grand Gulf 1 among the System operating companies (June 13 Decision) was appealed by various parties to the U.S. Court of Appeals for the District of Columbia Circuit. On January 6, 1987, the court of appeals affirmed the June 13 Decision, holding, among other things, that FERC had authority to review and modify the allocation of power from Grand Gulf 1 and to establish an allocation of such power that FERC found to be just and reasonable under the Federal Power Act. Subsequently, the court of appeals on June 24, 1987, reversed, in part, the June 13 Decision and remanded the June 13 Decision to FERC (the June 24 Remand) for reconsideration of its decision to equalize the capacity and costs of all Middle South System nuclear plants and for an explanation of the criteria used to determine what constitutes "undue discrimination" under the Federal Power Act and why the June 13 Decision is not unduly discriminatory. In reversing, in part, the June 13 Decision, the court of appeals did not change that part of its January 6, 1987, decision upholding FERC's authority to review and modify the allocation of power from Grand Gulf 1. Various parties filed petitions for certiorari with the U.S. Supreme Court seeking review of the principle underlying that portion of the court of appeals' decision that affirmed FERC's jurisdiction to allocate Grand Gulf 1 costs. On December 14, 1987, the U.S. Supreme Court denied, without comment, these petitions, thereby leaving in place that part of the court of appeals' decision upholding FERC's jurisdiction to allocate Grand Gulf 1 costs.

On November 30, 1987, FERC issued an order in response to the June 24 Remand whereby FERC reaffirmed and reinstated the June 13 Decision, thus maintaining the previous allocation of Grand Gulf 1 capacity and energy costs among the System operating companies. In issuing the November 30 order, FERC found that the allocation in the June 13 Decision was not unduly discriminatory. Various parties filed requests for rehearing of FERC's November 30 order. On January 29, 1988, FERC denied these requests. Petitions for review of FERC's November 30, 1987, and January 29, 1988, orders have been filed with the court of appeals by various parties.

It is not possible at this time to predict the ultimate outcome of these matters, including possible reallocation, if any, or the effect thereof upon SERI and the System operating companies, including possible refunds, if any. Any material modification of the allocation established by the June 13 Decision could give rise to additional litigation, disputes, and challenges in the affected jurisdictions.

In addition, the System operating companies have initiated a study, currently scheduled to be completed in the near future, to determine whether a more equitable method of allocating costs, including those relating to Grand Gulf 1, would be appropriate in the future.

Municipalization

The New Orleans City Council, in connection with controversies surrounding the allocation of capacity and energy costs of the Grand Gulf Station, is considering the acquisition by the City of New Orleans of the electric utility properties of NOPSI and those of LP&L in the 15th Ward of the City. The ordinances under which NOPSI operates state, among other things, that the City has a continuing option to purchase NOPSI's properties. On March 7, 1985, the council established a public power authority for the purposes, among others, of acquiring and operating electric power utilities in the City of New Orleans. On October 16, 1987, the council's consultants their conclusion that municipalization holds the potential for providing significant savings for electric customers of NOPSI and asserting that the "better view" is that the City would not be required to assume NOPSI's Grand Gulf 1 obligations. The council's consultants made no recommendation as to whether the City should go forward with municipalization. NOPSI, on the basis of its ongoing studies and on the advice of its legal and engineering consultants, continues to believe that the conclusions of the updated report are based on legal, financial, and engineering assumptions that are unfounded, unproven, or so subject to a variety of future contingencies, and that the report is otherwise so internally flawed that such conclusions should not be relied upon.

NOPSI further believes that any attempt by the City to municipalize NOPSI's electric utility facilities in order to enable electric customers in the City to avoid paying their federally allocated share of Grand Gulf 1-related costs would result in extensive and complex proceedings before various regulatory authorities and the courts, all of which could take many years to resolve.

Any acquisition of NOPSI's assets by the City would presumably be accomplished at least in part by the use of tax-exempt financing. Recently enacted federal legislation has significantly limited the availability of tax-exempt financing for such an acquisition. The council has sought and received permission from the State of Louisiana to have a portion of the state's available tax-exempt bonding authority set aside for possible use in financing a portion of the potential purchase of NOPSI's assets. In light of the council's own estimate of the total cost to municipalize, this allocation of tax-exempt bonding authority constitutes a relatively small portion of the required external financing. NOPSI cannot predict the ultimate impact, if any, these financing limitations may have on a potential municipalization.

The council held a public hearing on the municipalization issue on October 29, 1987. The matter is pending.

3 INCOME TAXES

Income tax expense (credit) consists of the following:	1987	1986	1985
		(In thousands)	
Current:			
Federal	$ 10,138	–	–
State	295	$(33,423)	$ 6,258
Total	10,433	(33,423)	6,258
Deferred – Net:			
Liberalized depreciation	166,272	274,790	141,741
Unbilled revenue	(12,530)	730	7,598
Rate deferrals	137,721	383,180	117,245
Other deferred purchased power costs	17,396	11,091	11,238
Nuclear refueling and maintenance	(9,328)	2,178	(3,879)
Amortization of excess deferred income taxes	(15,368)	(3,954)	–
Disallowed plant costs	–	3,760	(89,629)
Deferred revenue and related interest	(8,660)	12,585	–
Gas contract settlement	1,037	81,096	(82,133)
Loss on sale of fuel oil and nuclear fuel to third parties	5,355	3,171	17,779
Adjustment of prior years' tax provisions	5,758	(1,022)	(19,410)
Provision for estimated losses	(3,401)	1,040	(43,415)
Alternative minimum tax	(32,302)	–	–
Reduction due to tax loss carryforwards	–	(209,799)	(1,461)
Reinstatement due to net operating loss utilization	32,078	–	–
Other	(14,5[illegible]5)	6,156	9,619
Total	269,433	565,002	65,293
Investment tax credit adjustments – net	(5,246)	(5,019)	(4,699)
Recorded income tax expense	$274,620	$526,560	$ 66,852
Charged to operations	$299,538	$549,216	$239,282
Credited to other income	(24,918)	(22,656)	(82,171)
Charged to disallowed plant costs	–	–	(90,259)
Recorded income tax expense	274,620	526,560	66,852
Income taxes applied against the debt component of AFUDC	(2,545)	(3,157)	133,478
Total income taxes	$272,075	$523,403	$200,330

Total income taxes differ from the amounts computed by applying the statutory federal income tax rate to income before taxes. The reasons for the differences are as follows (dollars in thousands):

	1987		1986		1985	
	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income
Computed at statutory rate	$289,281	40.0	$492,967	46.0	$ 171,604	46.0
Increases (reductions) in tax resulting from:						
AFUDC – equity	(2,022)	(0.3)	(2,142)	(0.2)	(164,999)	(44.2)
State income taxes net of federal income tax effect	16,251	2.2	28,185	2.6	18,687	5.0
Write-off of LP&L's state deferred taxes related to depreciation timing differences	(23,828)	(3.3)	–	–	–	–
Amortization of excess deferred income taxes	(23,468)	(3.2)	(3,954)	(0.3)	–	–
Disallowed plant costs	–	–	–	–	36,881	9.9
Investment tax credit amortization	(5,157)	(0.7)	(5,044)	(0.5)	(4,699)	(1.3)
Depreciation	25,659	3.5	21,536	2.0	3,970	1.1
Other – net	(2,096)	(0.2)	(4,988)	(0.5)	5,408	1.4
Recorded income tax expense	274,620	38.0	526,560	49.1	66,852	17.9
Income taxes applied against the debt component of AFUDC	(2,545)	(0.4)	(3,157)	(0.3)	133,478	35.8
Total income taxes	$272,075	37.6	$523,403	48.8	$ 200,330	53.7

The tax effects of the consolidated 1985 and 1986 federal tax losses have been recorded as reductions of deferred income taxes. The remaining federal tax loss carryforwards at December 31, 1987, amounted to $896.5 million and are available to offset taxable income in future years. If not used, they will expire in 1994 through 2001. Unused investment tax credits at December 31, 1987, amounted to $477.1 million after the 35% reduction required by the Tax Reform Act of 1986. These credits may be applied against federal income tax liabilities in future years. If not used, they will expire in 1992 through 2002.

The alternative minimum tax (AMT) credit at December 31, 1987, was $10.1 million. This AMT credit can be carried forward indefinitely and will reduce regular income tax in the future.

Cumulative income tax timing differences for which deferred income tax expenses have not been provided are $427.5 million, $431.6 million, and $431.7 million in 1987, 1986, and 1985, respectively.

In December 1987, the Financial Accounting Standards Board (FASB) issued SFAS No. 96, Accounting for Income Taxes, which is effective for years beginning after December 15, 1988. Under the liability method adopted by SFAS No. 96, deferred tax balances will be based on enacted tax laws at tax rates that are expected to be in effect when the temporary differences reverse. SFAS No. 96 expands the requirement to record deferred income taxes for all temporary differences that are reported in one year for financial reporting purposes and a different year for tax purposes. This will require the recognition of deferred tax balances for certain items not previously reflected in the financial statements, such as a deferred tax liability relating to AFUDC.

It is expected that reductions in deferred taxes resulting from the lower corporate federal tax rates will be reflected as liabilities to customers since the System companies' regulators may require any such savings to be passed on to the ratepayers.

The impact of SFAS No. 96 on the financial position or results of operations of the System companies has not been determined.

4 LINES OF CREDIT AND RELATED BORROWINGS

The Company has a revolving credit agreement with a group of banks, which provides for borrowings of up to $60 million and, by its terms, terminates December 31, 1989. No borrowings were outstanding under this agreement at December 31, 1987. Due to the uncertainties facing the Middle South System, the Company may not be able to effect borrowings under this line of credit at the present time.

Prior to June 28, 1985, SERI had two revolving credit agreements with various banks providing for borrowings totaling $2,089 million. One agreement, for $1,711 million, was with U.S. banks; the other agreement, with foreign banks, was for $378 million. On August 2, 1985, and August 9, 1985, respectively, the foreign and U.S. bank loan agreements were amended, effective as of June 28, 1985 to convert the borrowings thereunder to term loans. At December 31, 1987, SERI had outstanding borrowings of $247.6 million and $126.7 million, respectively, under the U.S. and foreign bank loan agreements. The loans with U.S. banks have a maturity date of February 5, 1989, subject to mandatory semiannual payments of $125 million, due on the first day of each March and September, with the unpaid balance due on the maturity date. A portion of these semiannual payments will be applied to an escrow account for the benefit of certain banks participating in the U.S. bank loan agreement that provided a letter of credit in connection with SERI's Series C Pollution Control Revenue Bonds (Series C Letter of Credit Banks). The uncollateralized amount needed to fund the escrow account was approximately $126 million at December 31, 1987. The maturity date for the loans with foreign banks is February 5, 1989, subject to mandatory semiannual payments of $47.25 million to be made on February 5 and August 5 of each year.

In January 1987, SERI prepaid $52.82 million of bank notes under the U.S. bank loan agreement and $15 million under the foreign bank loan agreement. In addition, SERI paid, in February 1987, the $47.25 million semiannual payment due under the foreign bank loan agreement. On March 2, 1987, SERI paid the scheduled semiannual installment due under the U.S. bank loan agreement.

With the consent of the foreign and U.S. banks, SERI deferred the August 1987 semiannual payment to the foreign banks and the September 1987 semiannual payment to the U.S. banks, which were subsequently paid in November 1987. In connection with these deferrals, SERI agreed, among other things, not to pay any dividends on its common stock to MSU until all loans outstanding under the U.S. and foreign bank loan agreements are fully paid, the final maturities being in February 1989. SERI is presently current with respect to the scheduled semiannual payments under these agreements.

SERI has separate "interest rate swap" agreements, each with a bank, through February 1989 for $78.7 million and $63 million, respectively, (as of December 31, 1987) under the foreign bank loan agreement. SERI has agreed to make semiannual interest payments based upon an 11.5% and an 11.16% fixed rate, respectively, in exchange for semiannual interest payments by the banks based upon the London Interbank Offered Rate (LIBOR). These agreements serve to offset fluctuations in variable rates to be paid under SERI's foreign bank loan agreement. They do not change SERI's obligations to the foreign banks for interest payments of LIBOR plus 2%.

On April 30, 1987, SERI issued and sold $158 million of unsecured promissory notes

The years 1986 and 1985 have been restated to reflect the adoption of SFAS No. 90. (See Note 10 – "SFAS No. 90.")

to a group of domestic and foreign institutional investors. Such notes, which matured and were paid January 25, 1988, bore interest at 9.5% per annum through October 27, 1987, when the rate was reset to 9.6875% per annum for the remainder of the term.

The System operating companies and SERI are currently authorized by the SEC to effect short-term unsecured borrowings in an aggregate amount outstanding at any one time of up to 10% of their respective capitalizations (as defined). However, the System operating companies and SERI's abilities to borrow are subject to the availability of funds through bank lines and other credit sources. SERI is limited by terms of its bank loan agreements to short-term borrowings in an aggregate amount not exceeding the lesser of 5% of capitalization or $200 million. SERI does not have any bank lines of credit currently available. MP&L and NOPSI are limited by the terms of their G&R mortgages to short-term borrowings in an aggregate amount not exceeding, in general, the greater of 10% of capitalization or 50% of rate deferrals available to support the issuance of G&R bonds. In addition, NOPSI is subject to an SEC order that prohibits incurrence of short-term indebtedness if common stock equity is, or would thereby become, less than 30% of the sum of total capitalization plus short-term indebtedness. As a result of NOPSI's write-off of $135 million of previously deferred Grand Gulf 1 costs and the substantial reduction of its common stock equity caused by the New Orleans City Council's February 4, 1988, resolution, NOPSI is currently precluded from effecting short-term borrowings (including either bank loans or money pool borrowings as described herein).

The operating subsidiaries have lines of credit, not requiring commitment fees, providing for short-term borrowings of $130.8 million through loans from banks within their service territory. In the event of certain adverse developments, the availability of certain of these bank lines could be the subject of further negotiation.

At December 31, 1987, LP&L had available and unused bank lines of credit of $90 million with banks located outside of the Middle South System service area. Compensating balances (approximately 5% of the commitment amount) or equivalent fees are required by certain of these lending banks. These compensating balances are not restricted as to withdrawal.

Additionally, the four System operating companies, together with MSU, SERI, SSI, and SFI, are authorized to participate in a System money pool, whereby those companies in the System with available funds can invest in the pool while other companies in the System (except MSU) having short-term needs can borrow from the pool, thereby reducing the System's dependence on external short-term borrowings. The maximum borrowing and average

The short-term borrowings (excluding money pool borrowings) and the interest rates (determined by dividing applicable interest expense by the average amount borrowed) for the Middle South System were as follows:

For the years ended December 31,	1987	1986	1985
	(Dollars in thousands)		
Average borrowing:			
Bank loans	$ 12,665	$ 96,270	$118,095
Commercial paper	$ 72,738	$121,603	$131,978
Other	$173,558	$ 32,542	$ 51,702
Maximum borrowing:			
Bank loans	$ 26,000	$125,160	$199,695
Commercial paper	$ 85,000	$125,000	$135,000
Other	$210,667	$ 49,135	$ 54,600
Year-end borrowing:			
Bank loans	–	–	$124,160
Commercial paper	$ 65,000	$105,000	$125,000
Other	$190,667	$ 31,000	$ 49,135
Average interest rate:			
During period –			
Bank loans	8.1%	8.9%	9.7%
Commercial paper	7.8%	8.1%	9.4%
Other	9.4%	9.2%	9.6%
At end of period –			
Bank loans	–	–	10.1%
Commercial paper	7.8%	7.4%	9.5%
Other	9.7%	8.6%	10.7%

Credit facilities (excluding the money pool) at December 31, 1987, 1986, and 1985, and borrowings thereunder of the System companies were as follows:

	December 31, 1987		December 31, 1986		December 31, 1985	
	Credit Facilities	Borrowings	Credit Facilities	Borrowings	Credit Facilities	Borrowings
			(In thousands)			
Short-term:						
Company	–	–	–	–	$ 71,500	$ 25,000
SERI	$158,000	$158,000	–	–	–	–
SFI	$105,000	$ 97,000	$170,000	$131,000	$ 195,000	$ 174,135
Operating subsidiaries	$220,800	–	$270,485	$ 5,000	$ 158,160	$ 99,160
Long-term:						
Company	$ 60,000	–	$ 60,000	–	–	–
SERI	$374,349	$374,349	$709,450	$709,450	$1,807,167	$1,807,167
SFI	$ 50,000	–	$ 50,000	$ 18,000	$ 65,000	$ 42,800

5 PREFERRED STOCK

borrowing by participants from the System money pool during 1987 were $188.1 million and $73.9 million, respectively. At December 31, 1987, the funds available in the money pool for borrowing aggregated $190.8 million, with System money pool borrowings of $19.4 million outstanding at that date. In addition, SSI has a line of credit with MSU for $30 million through December 31, 1989.

At December 31, 1987, SFI had a fuel oil financing arrangement allowing for borrowings of up to $40 million subject to a limit equivalent to the lower of the cost or the fair market value of SFI's fuel oil inventory and certain related receivables. SFI's borrowings under this fuel oil financing arrangement were $32 million at year-end. This agreement is scheduled to terminate in July 1988. In addition, at December 31, 1987, SFI had an arrangement to borrow up to $65 million (all of which was utilized at year-end) in the aggregate through the sale of commercial paper for use in financing its nuclear fuel inventory. Borrowings under these short-term arrangements are restricted as to use and are secured by SFI's fuel oil inventory and a portion of its nuclear fuel inventory, respectively, and certain accounts receivable arising from the sale of these inventories. SFI also has a secured revolving credit agreement, to finance in part its nuclear fuel inventory, which allows for borrowings of up to $50 million through April 10, 1989. There were no borrowings outstanding under this arrangement at December 31, 1987, and SFI has agreed not to use this facility while fuel is leased under a SERI nuclear fuel financing entered into in February 1988. It is currently contemplated that the above financing arrangements, which are scheduled to terminate during the period 1988-89, will be extended if necessary or alternative financing arrangements will be secured.

In October 1987, MP&L entered into an agreement for the sale of its billed customer accounts receivable. Proceeds from the initial sale approximated $59 million. SERI has also entered into an agreement for the sale of certain of its customer accounts receivable. Proceeds from SERI's initial sale in February 1988 approximated $50 million.

Changes in the number of shares of preferred stock of the operating subsidiaries, all of which were with sinking fund, during the last three years were as follows:

	Number of Shares		
	1987	1986	1985
Sales:			
AP&L			
8.52%, $100 par	–	500,000	–
MP&L			
[illegible]%, $100 par	–	350,000	–
9.76%, $100 par	350,000	–	–
Retirements:			
AP&L			
9.92%, $25 par	(111,000)	(18,000)	(58,100)
10.60%, $100 par	(13,880)	–	(6,105)
11.04%, $100 par	(24,675)	(37,572)	(9,245)
13.28%, $25 par	(280,325)	–	(14,000)
LP&L			
10.72%, $25 par	(480,000)	(119,750)	(120,400)
12.64%, $25 par	(134,500)	–	–
13.12%, $25 par	(202,489)	(85,000)	(80,000)
14.72%, $25 par	(366,684)	–	–
15.20%, $25 par	(119,960)	(65,000)	(60,000)
MP&L			
14.75%, $100 par	–	(100,000)	–
17.00%, $100 par	–	(200,000)	–
NOPSI			
15.44%, $100 par	(18,000)	(100)	–
Total	(1,401,513)	224,578	(347,850)

The amounts of preferred stock of the operating subsidiaries as of the end of the last two years were as follows:

	December 31,	
	1987	1986
	(In thousands)	
Without sinking fund:		
Stated at $100 a share	$304,511	$304,511
Stated at $25 a share	25,000	25,000
Premium	1,456	1,456
Total without sinking fund	$330,967	$330,967
With sinking fund:		
Stated at $100 a share	$189,834	$160,488
Stated at $25 a share	323,250	365,625
Premium	645	728
Issuance and discount expense	(17,324)	(18,676)
Total with sinking fund	$496,405	$508,165

Cash sinking fund requirements for the ensuing five years for preferred stock outstanding at December 31, 1987, are as follows (in thousands): 1988, $10,825; 1989, $22,250; 1990, $32,250; 1991, $41,750; and 1992, $41,750.

All of the System operating companies were current with respect to their quarterly preferred stock dividend payments through January 1, 1988. However, if the New Orleans City Council's February 4, 1988, resolution that required NOPSI to record a $135 million write-off is not reversed, assuming NOPSI is able to remain solvent, NOPSI estimates that it will be in arrears with respect to future preferred stock dividends until at least 1990. If and when dividends payable on any outstanding shares of NOPSI's preferred stock shall be in arrears in an amount equal to four quarterly dividends, and thereafter until all dividends in arrears on any such preferred stock shall have been paid, the holders of NOPSI's 4¾% preferred stock, voting separately as a single class, shall be entitled to elect the smallest number of directors necessary to constitute a majority of NOPSI's full Board of Directors, and the holder of NOPSI's common stock, MSU, shall be entitled to elect the remaining directors. NOPSI will be precluded from making sinking fund payments on its preferred stock until arrearages in preferred stock dividends have been paid. Further, NOPSI cannot declare dividends on its common stock until arrearages in preferred stock dividend payments and preferred stock sinking fund payments have been eliminated, and NOPSI estimates that the council's February 4, 1988, resolution will preclude it from paying future dividends on common stock for a number of years.

The number of shares of preferred stock of the operating subsidiaries as of the end of the last two years was as follows:

	Shares Authorized at December 31, 1987	Shares Outstanding at December 31, 1987	1986	Call Price Per Share
Cumulative, $100 par value				
Without sinking fund:				
4.16% - 5.56%	1,070,774	1,070,106	1,070,106	$102.50 to $107.00
6.08% - 8.56%	1,180,000	1,180,000	1,180,000	$102.80 to $105.28
9.16% - 11.48%	795,000	795,000	795,000	$104.06 to $111.11
Total	3,045,774	3,045,106	3,045,106	
With sinking fund:				
8.52% - 9.76%	1,200,000	1,200,000	850,000	$108.52 to $109.76
10.60% - 12.00%	431,337	431,337	469,892	$106.74 to $112.00
14.75% - 17.00%	266,995	266,995	284,995	$111.58 to $116.16
Total	1,898,332	1,898,332	1,604,887	
Unissued	5,306,500			
Total	10,250,606			
Cumulative, $25 par value				
Without sinking fund:				
8.84%	400,000	400,000	400,000	$27.11
10.40%	600,000	600,000	600,000	$27.95
Total	1,000,000	1,000,000	1,000,000	
With sinking fund:				
9.92% - 12.64%	5,671,871	5,671,871	6,397,371	$27.01 to $28.16
13.12% - 15.20%	5,258,168	5,258,168	6,227,626	$27.46 to $29.05
19.20%	2,000,000	2,000,000	2,000,000	$28.20
Total	12,930,039	12,930,039	14,624,997	
Unissued	15,200,000			
Total	29,130,039			

6 LONG-TERM DEBT

The long-term debt of the Company and its subsidiaries as of the end of the last two years was as follows:

	December 31, 1987	1986
	(In thousands)	
First mortgage bonds	$4,809,293	$4,541,658
General and refunding bonds - due 1997, 10.95% Series	75,000	-
Bank notes:		
Due:		
1988, at negotiated money market rate	-	18,000
1988-89, at 110% of the sum of prime and 1.3% (Note 4)	247,599	473,200
1988-89, at LIBOR plus 2% (Note 4)	126,750	236,250
Total bank notes	374,349	727,450
Other:		
Long-term obligation - Department of Energy (Note 8)	71,106	66,729
Municipal revenue bonds - due serially through 2004, 1¼%-8%	26,344	29,118
Pollution control revenue bonds and installment purchase contracts:		
Due serially through 2014, 6.4%-11.5%	60,870	61,805
Due 1995-2016, 5¼%-12½%	896,225	896,225
Purchase obligations under inventory supply agreement	25,110	28,058
Total other	1,079,655	1,081,935
Unamortized premium and discount - net	(56,861)	(49,160)
Total long-term debt	6,281,436	6,301,883
Less - amount due within one year	336,382	318,854
Long-term debt excluding amount due within one year	$5,945,054	$5,983,029

Maturities and sinking fund requirements for the ensuing five years on long-term debt outstanding at December 31, 1987, are as follows:

	Maturities	Sinking Fund Requirements	
		Cash	Other**
		(In thousands)	
1988	$335,962*	$ 1,320	$23,523
1989	$163,263*	$54,820	$23,606
1990	$ 54,777	$54,890	$23,156
1991	$330,822	$69,790	$22,686
1992	$276,558	$69,790	$22,606

**Excludes requirements aggregating $126.0 million for escrow payments by SERI for the benefit of the Series C Letter of Credit Banks and excludes potential obligation of NOPSI to redeem up to $115 million of G&R bonds (see Note 2 - "Rate and Regulatory Matters").*

***Sinking fund requirements may be met by certification of property additions at the rate of 167% of the required amount.*

In December 1987, MP&L issued $75 million of first mortgage bonds and deposited with the first mortgage bond trustee $60 million of the proceeds thereof for the redemption and retirement of $60 million of first mortgage bonds maturing in 1988. Subsequent to December 31, 1987, MP&L sold $55 million of 14.65% General and Refunding Bonds due in 1993 and $20 million of 14.95% General and Refunding Bonds due in 1995. NOPSI sold $1.4 million of 13.2% General and Refunding Bonds due in 1991, $29.4 million of 13.6% General and Refunding bonds due in 1993, and $9.2 million of 13.9% General and Refunding Bonds due in 1995. In addition, MP&L redeemed its $45 million of 11¼% Series First Mortgage Bonds due June 1, 1988.

The outstanding first mortgage bonds of the Company's subsidiaries as of December 31, 1987 and 1986, were:

Maturity	4⅛% – 5⅞%	6% – 8⅞%	9% – 11⅞%	12% – 14⅞%	15% – 17⅜%	Total
			(In thousands)			
1987						
1988	$ 15,283	–	$ 45,000	–	–	$ 60,283
1989	–	–	$ 45,000	–	–	45,000
1990	$ 20,700	–	–	–	$ 30,000	50,700
1991	$ 27,000	–	$300,000	–	–	327,000
1992	$ 8,000	–	–	$265,000	–	273,000
1993-2002	$251,250	$287,160	$914,900	$315,000	$500,000	2,268,310
2003-2012	–	$260,000	$450,000	$ 75,000	–	785,000
2013-2016	–	–	$600,000	$365,000	$ 35,000	1,000,000
Total first mortgage bonds						$4,809,293
1986						
1987	$ 26,000	–	–	–	–	$ 26,000
1988	$ 15,328	–	$ 45,000	–	–	60,328
1989	–	–	$ 45,000	–	–	45,000
1990	$ 20,800	–	–	–	$ 30,000	50,800
1991	$ 27,000	–	$300,000	–	$ 80,000	407,000
1992-2001	$259,250	$172,760	$915,520	$205,000	$500,000	2,052,530
2002-2011	–	$375,000	$450,000	–	–	825,000
2012-2016	–	–	$600,000	$440,000	$ 35,000	1,075,000
Total first mortgage bonds						$4,541,658

7 RETAINED EARNINGS

The Holding Company Act of 1935 prohibits the Company's subsidiaries from making loans or advances to MSU. The indenture and charter provisions relating to the operating subsidiaries' long-term debt and preferred stock, respectively, and the provisions of certain of SERI's financing agreements and indenture restrict the amount of consolidated retained earnings available for cash dividends on common stock of the subsidiaries. In addition, transfers by the operating subsidiaries from retained earnings to the stated value of common stock impose similar restrictions on the amount of consolidated retained earnings available for cash dividends on common stock of the subsidiaries. At December 31, 1987, the restricted retained earnings of the Company's consolidated subsidiaries aggregated $1,637.4 million.

As of December 31, 1987, $302.4 million of consolidated retained earnings were free from such restrictions, including $259.3 million of unrestricted, undistributed retained earnings of the Company's subsidiaries. The unrestricted, undistributed retained earnings of any subsidiary of MSU are not available for distribution to the common stockholders of MSU until such earnings are made available to the Company through the declaration of dividends by such subsidiary. (See Note 8 – "Commitments and Contingencies – Common Stock Dividend.")

SERI, in connection with the deferral of scheduled payments under the foreign and U.S. bank loan agreements, has agreed not to declare or pay any dividends on common stock until all loans outstanding under these agreements are fully paid, the final maturities scheduled for February 1989. After these final maturities are paid, SERI would continue to be limited in the payment of cash dividends on common stock by provisions of the reimbursement agreements for its pollution control revenue bonds. Under these agreements, SERI is presently limited in the amount of dividends it may pay on its capital stock (other than dividends payable solely in shares of common stock and dividends payable in cash where, concurrently, SERI receives a capital contribution or sells shares of its common stock) in an amount equal to its accumulated net income for the period July 1, 1985, to the date of the payment. Such amount was approximately $498.4 million as of December 31, 1987. SERI has paid no dividends on its capital stock to date. In the event SERI experienced a loss that exceeded such accumulated net income, less the sum of certain dividends paid since July 1, 1985, dividends could not be paid until such a deficit was restored by subsequently earned net income, except where concurrently SERI receives a capital contribution or sells shares of its common stock.

See Note 5 – "Preferred Stock" for additional information regarding limitations on NOPSI's ability to declare dividends on common stock.

8 COMMITMENTS AND CONTINGENCIES

Overview

At December 31, 1987, the Middle South System's most significant commitments and contingencies related to (1) the final resolution of certain retail rate structures implemented by the System operating companies that have either been challenged, reversed by judicial decisions, or have been or currently are subject to prudence investigations or disallowances, (2) the needs of MP&L and NOPSI to access the capital markets for external financing, (3) the possible adverse effect on certain System operating companies as a result of recent changes related to the accounting for phase-in plans (see "SFAS No. 92"), (4) the ultimate resolution of the status of Grand Gulf 2 (see "Suspended Construction Project – Grand Gulf 2"), (5) the potentially adverse impact on SERI if certain findings stemming from a FERC audit of SERI and the Grand Gulf Station are ultimately sustained (see "FERC Audit of SERI"), and (6) the continuing controversies over the Grand Gulf Station and the allocation of capacity and energy costs from Grand Gulf 1 to the System operating companies. As discussed in more detail herein, adverse resolutions of certain of these matters could have a material adverse effect on the affected company and, in some cases, could render the affected company insolvent and threaten the viability of the Middle South System as a whole. (See "Potential Debt Acceleration, Bankruptcy, and System Viability.")

As mentioned in (1) above, final and favorable resolution of disputes over adequate retail rate relief for certain of the System operating companies has yet to be achieved, and some of the rate structures, as initially implemented, have changed, are in litigation, or have been or currently are the subject of prudence investigations or disallowances. Further changes to or reversals of existing rate structures could occur, depending upon further actions of regulatory bodies or the courts. In this connection, the following developments are presented.

- On February 25, 1987, the Mississippi Supreme Court reversed and remanded the September 1985 order of the MPSC granting permanent rate relief to MP&L with respect to its recovery of Grand Gulf 1 costs. Subsequently, MP&L filed an appeal of the February 25 Decision with the U.S. Supreme Court and also filed an application asking that Court to stay the mandate of the February 25 Decision pending final disposition of the appeal. On June 1, 1987, the U.S. Supreme Court entered an order granting MP&L's application for a stay conditioned upon the posting of a good and sufficient bond in a manner and amount to be determined by the Mississippi Supreme Court. On June 10, 1987, the Mississippi Supreme Court entered its order setting bond. The requirements of the Mississippi Supreme Court's order setting bond have been and are currently being satisfied. On October 5, 1987, the U.S. Supreme Court decided to hear full argument of MP&L's appeal of the Mississippi Supreme Court's February 25 Decision, but postponed further consideration of the U.S. Supreme Court's jurisdiction to the hearing of the case on the merits. Oral arguments were heard on February 22, 1988. It is expected that the case will be decided by the end of June 1988.
- On February 4, 1988, after a lengthy prudence investigation, the New Orleans City Council adopted a resolution that required NOPSI to write off, and not recover from its retail electric customers, $135 million of its Grand Gulf 1 costs in addition to the $51.2 million of such costs that NOPSI had agreed to absorb in the March 1986 rate settlement. NOPSI is seeking relief in the courts against this finding of alleged imprudence by the council. The council's action has caused NOPSI to suffer immediate harm with serious consequences to the financial condition and viability of NOPSI to continue to exist in its present form. In the near term, unless the council's resolution is reversed, NOPSI will, in all probability, not be able to obtain the funds necessary to meet its ongoing obligations and could be rendered insolvent in a short period of time, perhaps as early as the second quarter of 1988. (Also, certain prudence issues involving MP&L's Grand Gulf 1 cost recovery and LP&L's expenditures on Waterford 3 remain unresolved.)

For further information regarding these rate issues and the potential financial implications to MP&L, NOPSI, and the Middle South System, see "Potential Debt Acceleration, Bankruptcy, and System Viability" and Note 2 – "Rate and Regulatory Matters."

Capital Requirements and Financing

Capital requirements of the Middle South System during the period 1988-90 include funds needed for (1) construction expenditures, (2) financing by AP&L, MP&L, and NOPSI of cost deferrals associated with Grand Gulf 1 and, in LP&L's case, Waterford 3, and (3) costs of nuclear fuel in addition to amounts that may be leased under existing nuclear fuel leases. In addition, the System will require capital funds to refinance maturing long-term debt and to meet sinking fund requirements. Estimated financing requirements assume the continued allocation of Grand Gulf 1 capacity and energy in accordance with the June 13 Decision and the favorable resolution of certain challenges to and modifications of retail rate relief granted with respect to Grand Gulf 1 and Waterford 3 costs, and are based on certain other assumptions and judgments with respect to, among other things, pending regulatory and judicial proceedings, earnings, dividend policy, financing plans, and access to capital markets. If future events vary significantly from these assumptions, additional capital and external financing requirements could result. Among the assumptions with potential significant future impact on capital requirements are:

(1) In NOPSI's case, the council determined in February 1988 to reduce its previously granted Grand Gulf 1 rate relief by $135 million because of alleged imprudence. The following assumes that ultimately a reversal of such determination is obtained from the courts. (2) In MP&L's case, its Grand Gulf 1 rate relief, including its phase-in plan, has been reversed by the Mississippi Supreme Court. As a result of stays obtained by MP&L from the U.S. Supreme Court, such relief will remain in effect, subject to refund, during the appeal of this decision and the following assumes that such appeal is successful. (3) In LP&L's case, it is assumed that a rate moderation plan is ultimately implemented for LP&L's service territory in Algiers, and that the current recovery of $40 million on an annual basis, implemented February 1, 1988, for its LPSC jurisdictional customers pursuant to a November 1987 court order, will remain in effect after resolution of appeals of such order. (4) It is assumed that no adjustments to the implemented or filed and pending phase-in plans of the System operating companies are required as a result of SFAS No. 92. (5) In SERI's case, 1988 estimated external financing requirements reflect SERI's bonding commitments to the Mississippi Supreme Court and assume that MP&L's appeal to the U.S. Supreme Court will be resolved on or before June 30, 1988, and that cash deposited by SERI (estimated to be $177.5 million by June 30, 1988) will be returned to SERI upon successful completion of the appeal. (6) It is assumed that the issues raised by the FERC staff in an audit of SERI will be resolved in SERI's favor. In the event that any of the existing rate structures were abrogated or rescinded, or future recovery by any System operating company under its phase-in plan of deferred costs were disallowed in any material respect or, in NOPSI's case, the council's recent prudence disallowance is not reversed, the capital requirements of the affected System operating company could be significantly altered, and the earnings, liquidity, and/or financial condition of the particular System operating company, and its ability to effect external financing to meet its continuing obligations (including those with respect to Grand Gulf 1) could be severely impaired.

The estimated capital requirements for the years 1988, 1989, and 1990 approximate $715.0 million, $636.3 million, and $462.5 million, respectively. These estimates are net of financing to repay maturing long-term debt and sinking fund requirements and exclude the refinancing of nuclear fuel leases and changes in short-term debt.

Construction expenditures (excluding nuclear fuel) for the Middle South System during the years 1988, 1989, and 1990 are estimated to be approximately $405.6 million, $414.7 million, and $427.3 million, respectively. No significant costs in connection with generating facilities are expected to be incurred, except for certain post-commercial operation work on various nuclear units. The construction expenditures assume no activities at Grand Gulf 2 except for demobilization and suspension. It is also estimated that approximately $33.7 million will be required during the period to acquire nuclear fuel in addition to that currently owned or under lease.

The System operating companies will incur additional capital requirements of approximately $332.8 million, $155.9 million, and $45.8 million for the years 1988, 1989, and 1990, respectively, in connection with implemented and assumed rate moderation plans.

In addition to the total capital requirements shown above, the System operating companies and SERI will require funds of approximately $731.9 million during the period 1988-90 to refinance maturing long-term debt and to meet sinking fund requirements with respect to first mortgage bonds and preferred stock. Of this amount, $481.4 million represents SERI's payment obligations under its various borrowing arrangements. In addition, certain of SERI's pollution control revenue bonds may be required to be reacquired by SERI during 1988-89 in the event they cannot be remarketed. Under this circumstance, additional funds of up to $78 million may be required to reacquire such bonds. Also, unless extended, the expiration of certain fuel inventory financing arrangements of SFI and nuclear fuel leasing arrangements of the System operating companies and SERI during 1988-90 could result in additional financing requirements of approximately $105 million and $374 million, respectively. Further, unless the council's February 4, 1988, resolution is reversed, NOPSI could be required to redeem up to $115 million of G&R bonds outstanding, which could be tendered to NOPSI for redemption under circumstances where NOPSI has no real ability to obtain funds necessary to meet this obligation.

In addition, the System operating companies and SERI may choose to refinance or retire, through the use of internally or externally generated funds, high-cost debt, and preferred stock in amounts that cannot presently be determined. Further, certain System companies may enter into arrangements for the sale and leaseback of property in which the proceeds from such transactions could be used to retire debt at par.

The System's capital requirements, including refinancing requirements, will be met through a combination of internally and externally generated funds. Due, however, to the uncertainties inherent in, among other things, MP&L and NOPSI's retail rate situations, and the adverse impact thereof on individual companies and the Middle South System as a whole, it cannot be predicted whether, or in what amounts and on what terms, such financing may be available to System companies. In particular, in the event that the council's recent action is not reversed, NOPSI will very likely be precluded from raising any additional funds from external sources and will suffer severe liquidity problems.

Potential Debt Acceleration, Bankruptcy, and System Viability

Adverse regulatory or judicial decisions involving the System operating companies' retail rate structures relating to their recovery of Grand Gulf 1 costs could produce varying consequences that could jeopardize the Middle South System, including those set forth below.

- If the U.S. Supreme Court, on the appeal of the February 25 Decision, renders any decision adverse to the Middle South System's position, the application of the doctrine of federal preemption could be severely undermined. The doctrine of federal preemption is necessary in order to secure implementation of SERI's federally mandated wholesale rates through the retail rate structures of the System operating companies.
- Without adequate rates to recover Grand Gulf 1 charges, MP&L and NOPSI could suffer such liquidity constraints that they would, in a short period of time, be unable to meet their contractual obligations to SERI with respect to the Grand Gulf Station and could be rendered insolvent.
- Failure of any System operating company to maintain its current rate structure or to meet its contractual obligations to SERI with respect to the Grand Gulf Station could, under certain agreements relating to SERI's indebtedness (but only upon further action by the requisite percentage of SERI's creditors), lead to acceleration of such indebtedness unless (1) waivers were obtained, (2) the debt was restructured, or (3) other arrangements could be negotiated. In addition, in the absence of such waivers, debt restructuring or other negotiated arrangements, acceleration of such indebtedness could occur if a System operating company were rendered insolvent as a result of a reduction in rates. Given the substantial amount of SERI's debt, it would not be able to meet its obligations, if accelerated. Under SERI's financing agreements, the System operating companies would not be responsible for the payment of SERI's accelerated obligations if SERI could not meet them. MSU, with its financial resources currently limited, would not at this time be in a position to satisfy SERI's obligations, if accelerated.
- Certain of SFI's financing agreements and leases may require payments by the System operating companies, MSU, or SERI in the event SFI's obligations under such agreements are accelerated as a result of the insolvency of a System operating company and SFI is unable to meet these obligations or otherwise satisfy these obligations through the sale of the collateral securing such obligations. In addition, insolvency of a System operating company would affect terms of financing, including an increase in cost of financing, or could preclude financing for other Middle South System companies.

In the event of any of the foregoing adverse developments, the continuing viability of the Middle South System would be placed in jeopardy, and it could be difficult to avoid a bankruptcy filing by one or more of the affected Middle South System companies. In this connection, MSU, MP&L, and SERI have each retained independent special counsel experienced in bankruptcy matters and have been studying the relief and protection that might be available to them under Chapter 11 of the United States Bankruptcy Code. While no decisions with regard to bankruptcy filings have yet been made, it must be recognized, in light of the risks discussed herein, that future events, either singly or in combination, may result in such adverse changes in business circumstances or such a decrease in liquidity as to make it prudent for one or more of the affected Middle South System companies to file a petition for reorganization under Chapter 11. Many of these future events are beyond the control of the Middle South System.

The effects of a bankruptcy proceeding involving one or more Middle South System companies and the extent of jurisdiction of the SEC under the Holding Company Act and of other federal and state regulatory bodies over the bankrupt entity or entities and over any other Middle South System companies not in bankruptcy cannot be predicted. In any event, security holders and creditors of the company or companies involved in bankruptcy proceedings could be significantly affected by such proceedings. The proceedings could last for years, and there are many uncertainties as to how provisions of the law would be applied. Rights and remedies of security holders and creditors may be altered, denied, or limited under such laws. The obligations of MSU and the System operating companies under the Capital Funds Agreement and the Availability Agreement, respectively, and the assignments thereof, could also be litigated and possibly reduced or eliminated. See "Capital Funds, Availability, and Reallocation Agreements" for a discussion of MSU and the System operating companies' respective obligations to make payments or otherwise support SERI under the Capital Funds Agreement, the Availability Agreement, and the Reallocation Agreement. There could be no assurance that any creditors would be able to recover the full amount of their claims, and securities and stock with inferior rights could be substituted for those with priorities. Further, holders of equity securities may not be able to recover any substantial amount of their investments. Moreover, it is uncertain as to whether the bankrupt entity or entities could be successfully reorganized in their present form, whether the current relationships between and among various Middle South System companies would be significantly altered, or whether the Middle South System would continue to exist in its present form after bankruptcy of one or more Middle South System companies.

SFAS No. 92

In August 1987, the FASB issued SFAS No. 92, Regulated Enterprises – Accounting for Phase-in Plans, an amendment of SFAS No. 71. SFAS No. 92 requires, among other things, the following conditions for deferral of costs: (1) the costs are deferred pursuant to a formal plan that has been agreed to by the regulator, (2) the plan specifies when recovery of costs will occur, (3) the costs deferred are scheduled for recovery within 10 years of the date when deferrals begin, and (4) the percentage increase in rates for each future year is no greater than the percentage increase in rates for each immediately preceding year. The new statement is effective for fiscal years beginning after December 15, 1987, and requires that amounts deferred under plans that do not meet the requirements of the statement be written off. SFAS No. 92 has transition rules designed to allow any affected company to delay application of the new statement and to continue deferral of costs under its existing phase-in plan provided that both of the following conditions are met: (1) the company has filed a rate application to have the plan amended to meet the requirements of the statement or it intends to do so as soon as practical, and (2) it is reasonably possible that the regulator will change the terms of the phase-in plan so that it will meet the requirements of the statement.

AP&L's deferrals of cost under the phase-in plan embodied in its settlement agreement with the Arkansas Public Service Commission (APSC) and other parties do not meet the criteria for deferral established by SFAS No. 92. However, AP&L believes that costs it has deferred in accordance with the Arkansas settlement agreement are probable of future recovery and should continue to be deferred. In this connection, AP&L has requested and obtained the approval of FERC to continue deferrals of costs for purposes of financial reporting to FERC. In February 1988, AP&L filed with the SEC an application for an order that would permit AP&L to continue deferrals of such costs in its financial statements filed with the SEC. Under the transition provisions of SFAS No. 92, application of that statement may be delayed if AP&L has filed or intends to file, as soon as practical, an application to amend its phase-in plan and it is reasonably possible the regulator will amend the phase-in plan so that it will comply with the deferral criteria of SFAS No. 92. If AP&L is ultimately required to comply with the provisions of SFAS No. 92, it may seek, under terms of the Arkansas settlement agreement, to negotiate a mutually acceptable amendment to modify the provisions of the Arkansas settlement agreement so that deferrals of cost would comply with provisions of SFAS No. 92. However, if AP&L were to seek such modifying amendment and not succeed in obtaining such modifications to its phase-in plan, the agreement would terminate, a write-off of previously deferred costs would be required for financial reporting purposes, further deferrals would not be permitted, and AP&L's financial position and results of operations would be materially and adversely affected. The Arkansas settlement agreement provides that all costs associated with Grand Gulf 1, which have been deferred by AP&L prior to any such termination of the Arkansas settlement agreement, would be recovered in accordance with its provisions. AP&L is presently unable to predict the ultimate outcome of these matters.

The terms of MP&L's Grand Gulf 1 rate order provide for the recovery of significant amounts of deferred costs beyond the 10-year recovery cap required in SFAS No. 92. MP&L intends to attempt to restructure its rate phase-in plan, as soon as practical, following the decision of the U.S. Supreme Court on MP&L's appeal of the February 25 Decision. The rate order contains provisions that permit MP&L to make application to amend its phase-in plan if MP&L establishes the existence of an inability to finance on reasonable terms and also permits MP&L to make application to the MPSC to consider the effect of a change in SFAS No. 71. During the pendency of MP&L's appeal to the U.S. Supreme Court, MP&L intends to continue to record its deferred Grand Gulf 1 costs as assets on its books in accordance with the transition provisions of SFAS No. 92. If the effort to modify its rate phase-in plan is not successful and the terms of SFAS No. 92 are applied, MP&L will be required to cease deferring Grand Gulf 1 costs on its books and instead to record these costs as current operating expenses. In addition, certain previously deferred costs (up to approximately \$548 million at December 31, 1987) will be required to be written off, which will have an immediate and materially adverse effect on the financial condition of MP&L, particularly in light of its already weakened financial condition.

In February 1988, LP&L filed a rate increase application with the LPSC, which included a formal phase-in plan for the recovery of approximately \$266 million of deferred Waterford 3 costs. Such phase-in plan, if approved, would comply with SFAS No. 92.

NOPSI believes that its phase-in for the recovery of deferred Grand Gulf 1 costs satisfies the requirements of SFAS No. 92. NOPSI cannot predict what effect, if any, the outcome of the litigation relating to the council's February 4, 1988, resolution will have on its phase-in plan.

Common Stock Dividends

In August 1987, November 1987, and February 1988, the System operating companies paid dividends to MSU aggregating approximately \$18.8 million, \$22.8 million, and \$21.8 million, respectively. The declaration and payment of common stock dividends by the System operating companies has, to a limited extent because of the limited size of the dividends, increased the liquidity and financial flexibility of MSU. Prior to July 1987, the System operating companies last declared dividends on their common stock in the second quarter of 1985. SERI has never declared any common dividends and, pursuant to recent amendments to the U.S. and foreign bank loan agreements, will be prohibited from paying any dividends on its common stock until loans outstanding under these agreements are fully paid. The council's February 4, 1988, resolution, if not reversed, will have the effect of precluding the further declaration and payment by NOPSI of dividends on its common stock for a number of years. To the extent MSU's receipt of dividends from its subsidiaries is limited or precluded, MSU's financial resources will be strained and MSU could be without the requisite funds to invest in or otherwise make available to the System operating companies and SERI. As a result of uncertainties facing the Middle South System, MSU has been unable to declare a dividend on its common stock since the second quarter of 1985.

Resumption of MSU's common stock dividend remains dependent, among other things, upon the resolution or moderation of various uncertainties facing the Middle South System, as discussed, and improvement in the System's financial condition. In addition, SERI's agreement not to pay dividends on its common stock until all amounts outstanding under the U.S. and foreign bank loan agreements are fully paid and the recent impairment of NOPSI's ability to declare common dividends could adversely affect MSU's ability to declare dividends on its common stock, or the amount thereof, as MSU's ability to declare dividends in excess of dividends received from its subsidiaries is limited. Further, the requirement that MSU, in conjunction with MP&L's obtaining a stay of the February 25 Decision, co-guarantee refunds to retail customers that may ultimately be required of MP&L upon an adverse resolution of MP&L's pending appeal, has necessitated that MSU conserve available cash resources and, pending outcome of the appeal, will further restrict MSU's ability to resume common stock dividends.

Suspended Construction Project – Grand Gulf 2

As of December 31, 1987, SERI had invested approximately $890 million in Grand Gulf 2 (including approximately $392 million of AFUDC), which was approximately 34% complete based on the estimated man-hours needed to complete the unit. Effective September 18, 1985, SERI suspended construction activities and ceased accruing AFUDC on Grand Gulf 2 following an order of the MPSC.

Since September 1985, SERI has continued suspension of construction on Grand Gulf 2 and has limited expenditures to only those activities that are absolutely necessary for demobilization and suspension of the unit. In November 1986, a special study team formed by management, which included Middle South System officials and outside consultants, completed a comprehensive year-long study that analyzed in-depth the various alternatives regarding Grand Gulf 2 and the complex issues concerning its future status. After considering the various alternatives, SERI's Board of Directors (with the MSU Board of Directors concurring), in December 1986, adopted the recommendation of the study team that suspension of construction be continued and that a further decision be made by 1990 on the future status of Grand Gulf 2, in light of alternatives available at that time. During the period of suspension, the energy needs of the region served by the System, as well as some of the uncertainties surrounding the costs of constructing nuclear power plants, should be further clarified.

During the period of continuation of suspension, SERI's expenditures on Grand Gulf 2 will be limited, and it will continue not to accrue AFUDC on its investment in the unit. Consequently, during the suspension period, the increase in SERI's investment in Grand Gulf 2 will be limited and SERI will forego any return on this investment.

SERI will continue during the suspension period to evaluate various alternatives for the future of Grand Gulf 2 and will also continue to assess whether certain equipment or facilities should continue to be carried at their full cost. Any determination that the value of SERI's investment should be reduced and the amount of any such reduction written off could adversely affect various companies in the Middle South System. SERI believes, however, that it is justified in carrying Grand Gulf 2 at its full value because the property currently comprising Grand Gulf 2 is of the same design as that of Grand Gulf 1 and is being properly maintained and is therefore suitable for its intended purpose. Certain issues relating to the value of SERI's investment in Grand Gulf 2 also exist in connection with an audit by FERC, as discussed in "FERC Audit of SERI."

As a result of the decision of SERI's Board of Directors with respect to continuation of suspension of construction, SERI does not intend to make an application to FERC during the period of suspension with respect to the recovery through rates of SERI's investment in Grand Gulf 2.

While SERI believes that all of its investment to date in Grand Gulf 2 has been prudent, in connection with any subsequent decision as to the value of Grand Gulf 2 or the ultimate decision with respect to the future of Grand Gulf 2, SERI will, at an appropriate time, make a determination as to the appropriate recovery of its investment. In making such determination, SERI would consider, among other things, the regulatory environment generally, and legal standards then applicable. Any action to seek recovery of Grand Gulf 2 costs would likely involve a filing by SERI with FERC requesting such recovery, over a period of years, through charges to the System operating companies, and related filings by the System operating companies before state or local regulatory authorities to recognize FERC-allowed charges in retail rates. In view of the controversies over the Grand Gulf Station, including the adverse reaction of various rate regulatory bodies to allocation of costs and regulatory uncertainties, including ratemaking, attendant to a delay in the decision as to the future of Grand Gulf 2, there can be no assurance that the full cost of Grand Gulf 2 will be recovered or as to the timing of any recovery. Proceedings before FERC and, with respect to recognition in retail rates of FERC-approved rates, before state or local regulatory authorities could be protracted and strongly contested on various grounds, including imprudence. If costs associated with Grand Gulf 2 were allocated to the System operating companies and they were unable to recover these costs from their customers, the System operating companies' financial condition could be materially and adversely affected. Any nonrecovery of SERI's investment in Grand Gulf 2 would result in a charge against earnings for any unrecoverable investment when that event becomes probable. In the event such a charge were substantial, the financial condition of SERI could be materially and adversely affected (although its cash position would not be adversely affected), and SERI's ability to pay dividends on its capital stock could be impaired. For information concerning an accounting standard that addresses the accounting treatment of the issues discussed herein, see Note 10 – "SFAS No. 90."

During the period to 1990, certain issues, including those described above, could cause a decrease in the valuation of the investment in Grand Gulf 2. Failure to obtain rate relief for all or a substantial portion of the cost of Grand Gulf 2 could have a material and adverse effect upon the financial condition of SERI, MSU, and possibly the System operating companies, depending upon, among other things, the timing of the realization of any such loss.

In January 1988, FERC issued an order that modified its policy regarding recovery of canceled or abandoned plant costs by utilities subject to its jurisdiction. The revised policy provides for a "50/50 sharing" of prudently incurred costs of a canceled plant between the owner and the ratepayers, whereby 50% of the prudently incurred costs of the canceled plant would be amortized and recovered from ratepayers over the expected life of the plant as if it had been completed. The currently unamortized portion of such amount would also be included in rate base thereby allowing for a return thereon. The remaining 50% of prudently incurred costs would be written off.

FERC Audit of SERI

FERC has performed an audit of SERI and the Grand Gulf Station as part of its regulatory function in auditing utilities subject to its jurisdiction. The audit report, which pertains to the period from SERI's inception through December 31, 1985, was issued on June 18, 1987. In the report, the FERC staff states, among other things, that the Grand Gulf Station's AFUDC is overstated by $152.8 million ($120.7 million relating to Grand Gulf 1 and $32.1 million relating to Grand Gulf 2) because the "AFUDC calculation failed to take into account all cost-free capital generated by SERI expenditures and claimed on consolidated income tax returns." The FERC staff recommends that SERI record an accounting entry to charge the alleged AFUDC overstatement against net income, recompute billings to customers since July 1, 1985, reflecting adjusted plant and equity balances, and refund, with interest, the difference between the recomputed billings and amounts previously charged customers. Further, the FERC staff recommends that $345.6 million of "recoverable taxes," representing a significant portion of SERI's unrealized recorded income tax benefits, should be reclassified to "accounts receivable from associated companies," the net effect of which would be a $270 million reduction of Grand Gulf 1's rate base. The staff recommends that SERI refund, with interest, the change in billings since July 1, 1985, due to this rate base reduction.

SERI has strongly disagreed with the staff's position, asserting that the staff's position is in violation of the SEC's tax allocation regulations applicable to holding company systems and contrary to FERC's own accounting rules. A hearing has been set for May 16, 1988. Various parties, including the APSC, LPSC, MPSC, and the New Orleans City Council, have intervened in this proceeding.

If the staff's findings are ultimately sustained, the resulting charges against net income and refund requirements would have a material adverse impact on SERI. SERI estimates that as of December 31, 1987, the impact on net income could be as high as approximately $290 million (net of tax effect), and SERI could be obligated to refund approximately $250 million, including interest, to its customers. In addition, the staff's proposed adjustments would adversely impact SERI's prospective net income, earnings coverages, and cash flow. SERI cannot predict the ultimate outcome of the examination.

Capital Funds, Availability, and Reallocation Agreements

Under the Capital Funds Agreement, as supplemented, the Company has agreed to supply or cause to be supplied to SERI (1) such amounts of capital as may be required in order to maintain equity capital at an amount equal to at least 35% of SERI's total capitalization (excluding short-term debt), and (2) such amounts of capital as shall be required in order (a) for SERI to construct, own, and place in commercial operation the Grand Gulf Station, (b) to provide for preoperating expenses and interest charges of SERI, (c) to permit the continuation of such commercial operation after commencement thereof, and (d) to pay in full all indebtedness for borrowed money whether at maturity, on prepayment, on acceleration, or otherwise. In addition, the Company has agreed to make cash capital contributions to enable SERI to make payments when due on its long-term debt

The System operating companies are severally obligated under the Availability Agreement in accordance with stated percentages (AP&L 17.1%, LP&L 26.9%, MP&L 31.3%, NOPSI 24.7%) to make payments or subordinated advances adequate to cover all of the operating expenses, including depreciation and interest charges, of SERI. SERI has, with the consent of the System operating companies, assigned its rights to payments and advances from the System operating companies under the Availability Agreement to the holders of its long-term debt.

In November 1981, the System operating companies entered into the Reallocation Agreement, which would have allocated the capacity and energy available to SERI from the Grand Gulf Station and the related costs to LP&L, MP&L, and NOPSI. These companies thus agreed to assume all the responsibilities and obligations of AP&L with respect to the Grand Gulf Station under the Availability Agreement with AP&L relinquishing its rights to capacity and energy costs from the Grand Gulf Station. Each of the System operating companies, including AP&L, would have remained primarily liable to SERI and its assignees for payments or advances under this agreement. AP&L was obligated to make its share of the payments or advances only if the other System operating companies were unable to meet their contractual obligations. However, FERC's June 13 Decision allocating a portion of Grand Gulf 1 capacity and energy costs to AP&L supercedes the Reallocation Agreement insofar as it relates to Grand Gulf 1. (See Note 2 – "Rate and Regulatory Matters" for further information.)

Stockholder Litigation

In 1985, MSU, certain other Middle South System companies, and individuals became defendants in a purported consolidated class action suit. The initial complaint was filed in August 1985 by an MSU stockholder (purporting to represent a class that purchased MSU common stock) followed by four similar complaints filed by MSU stockholders in August and September 1985. The five actions were consolidated in the U.S. District Court for the Eastern District of Louisiana. The consolidated, amended, and supplemental complaint alleged violations of the disclosure requirements of the Securities Exchange Act of 1934 and the Securities Act of 1933, common law fraud and common law negligent misrepresentation in connection with the financial condition of MSU and prayed for compensatory and punitive damages, legal costs and fees, and other proper relief against MSU, various other System companies, and certain officers (and former officers) and directors of MSU, the Company's outside auditors, and certain underwriters of MSU common stock. In April 1986, MSU and the other defendants filed a motion to dismiss or, in the alternative, a motion for summary judgment. On January 12, 1987, the district court entered a judgment granting defendants' motions for summary judgment and dismissed the suit. On February 6, 1987, the plaintiffs in the consolidated action filed a Notice of Appeal in the U.S. Court of Appeals for the Fifth Circuit. Oral arguments were heard on November 5, 1987. The defendants intend to vigorously oppose the appeal of the district court's decision. In the event the dismissal is reversed on appeal, the eventual outcome and impact on the Middle South System's financial condition cannot be predicted.

Fuel Contracts

SFI has a number of contracts for the purchase of fuels for use at various generating stations within the Middle South System. Among the contracts is one for an estimated 100 million tons of coal for LP&L's proposed Wilton Station. Another contract expected to provide for at least 30 years of the projected coal requirements of the Independence Station in Arkansas was assigned by SFI to AP&L, effective December 31, 1987. In addition, SFI has a long-term oil supply agreement with a major oil company providing for the purchase of 25,000 barrels of oil per day through 1996 with an option to reduce, within certain limits, the contract quantity either temporarily or permanently. An agreement was reached, effective January 1, 1988, temporarily reducing SFI's obligation to purchase fuel oil to 12,500 barrels per day. AP&L is currently purchasing coal for the White Bluff Station under an agreement that will provide approximately 100 million tons of coal over a 20-year period.

LP&L, by separate agreement, guaranteed SFI's performance under the coal contract for the Wilton Station and agreed to purchase the coal from SFI. SFI, after having kept the coal supplier advised of possible delays, advised the supplier, in August 1985, that, based on its latest appraisal, for planning purposes, the System's requirement for additional coal capacity is now forecast to be in a time frame that makes the existing contract in fact nonviable. Upon receipt of the August 1985 notification, the supplier filed a Demand For Arbitration under the coal supply agreement to establish that the agreement remains in full force and effect and that SFI is not excused from performing its obligations and, alternatively, that SFI's actions constitute anticipatory repudiation of the coal supply agreement. The parties have agreed to a postponement of the arbitration on the basis that it can be restarted by either party on 10-days notice. LP&L has filed an application with the LPSC for a certificate authorizing the construction of the Wilton plant within a time frame of 1995 or earlier, and hearings were held on April 18, 1986, and November 12, 1987. In view of the reduction in projected load requirements within LP&L's service area since the time the coal supply agreement was entered into and in view of other factors relating to LP&L, the LPSC may not grant such a certificate. On October 30, 1987, consultants to the LPSC filed a report concluding that such certificate should be denied. It is SFI's counsel's opinion that a refusal by the LPSC to grant a certificate on a reasonable basis will constitute the existence of a force majeure, which would relieve LP&L and SFI of a substantial part, if not all, of their obligation under the coal supply agreement. In an effort to resolve the dispute, SFI, LP&L, and the coal supplier entered into settlement discussions; as a result thereof, LP&L and the coal supplier have agreed in principle to a 25-year natural gas supply arrangement. The definitive agreement is expected to be completed in the first half of 1988. Unsatisfactory resolution of this matter could expose SFI and LP&L to claims for significant damages in the event SFI is unable to negotiate a new arrangement with the coal supplier, SFI does not ultimately prevail in asserting that events of force majeure have excused performance, or other efforts to mitigate any possible significant damages are unsuccessful.

Nuclear Insurance

As of December 31, 1987, the Price-Anderson Act (Act) limited the public liability of a licensee of a nuclear power plant to $720 million for a single nuclear incident. The Act in its present form provides that this limit increases by $5 million for each additional operating license issued by the Nuclear Regulatory Commission (NRC). Insurance for this exposure is provided by private insurance and an indemnity agreement with the NRC. Every licensee of a nuclear power plant is obligated, in the event of a nuclear incident involving any commercial nuclear facility in the United States that results in damages in excess of the private insurance, to pay retrospective assessments of up to $5 million per incident for each licensed reactor it operates or up to a maximum per reactor owned of $10 million in any calendar year. The Middle South System has four licensed reactors.

Certain provisions of the Act expired on August 1, 1987, and Congress is considering several proposals to amend and extend the Act. In this connection, the U.S. House of Representatives, on July 29, 1987, passed a bill that would raise the public liability limit associated with any nuclear incident to approximately $7 billion. The bill further provides that each reactor licensee is responsible to share in this maximum liability (therefore, licensees are required to share in the assessment). Each reactor licensee would be liable for approximately $66 million per incident, provided that not more than $10 million would be required to be paid per incident per year. The U.S. Senate has under consideration a similar bill relating to the extension of the Act. Until a bill is adopted by both the Senate and House of Representatives and signed into law by the President, the provisions of the Act, which expired August 1, 1987, will continue to apply to all currently licensed reactors (including all Middle South System reactors). The Middle South System is unable to predict what action Congress might ultimately take regarding the Act and what effect such actions might have on the Middle South System.

AP&L, LP&L, MP&L, and NOPSI are member-insureds of Nuclear Electric Insurance Limited (NEIL), an industry mutual insurer that provides its members with insurance coverage for certain costs of replacement power incurred due to certain prolonged outages of nuclear units (NEIL I). In addition, AP&L, LP&L, and SERI are member-insureds under an excess property insurance program that provides $775 million of coverage for property damage sustained by the insured in excess of $500 million caused by radioactive contamination or other specified damage (NEIL II). AP&L, LP&L, and SERI each have an additional $120 million of excess property and decontamination insurance with American Nuclear Insurers (ANI) and Mutual Atomic Energy Liability Underwriter, a pool of private insurance carriers, thus giving AP&L, LP&L, and SERI each a total of $895 million excess property and decontamination insurance above the $500 million primary amount. SERI is a member-insured under a primary property damage insurance program provided by Nuclear Mutual Limited, another industry mutual insurer, providing $500 million of coverage. AP&L and LP&L's primary property and decontamination damage insurance is provided by ANI. As member-insureds with these industry mutual insurers, AP&L, LP&L, MP&L, NOPSI, and SERI are subject to assessments if losses exceed the accumulated funds available to the insurer. At December 31, 1987, the proposed maximum assessment for incidents occurring during a policy year was approximately $11 million, $10 million, $0.5 million, $0.2 million, and $37 million for AP&L, LP&L, MP&L, NOPSI, and SERI, respectively.

Effective October 5, 1987, the NRC amended its regulations to require nuclear power plant licensees to obtain property insurance coverage in the minimum amount of $1.06 billion. The regulations further provide that the proceeds of this insurance shall be used to first ensure that the licensed reactor is in a safe and stable condition and can be maintained in that condition so as to prevent any significant risk to the public health and safety. Within 30 days of stabilization, the licensee is required to prepare and submit to the NRC a cleanup plan for approval. The plan is required to identify all cleanup operations necessary to decontaminate the reactor sufficiently to permit the resumption of operations or to commence decommissioning. Any property insurance proceeds not already expended to place the reactor in a safe and stable condition must be used first to complete those decontamination operations that are ordered by the NRC. Property insurance proceeds subject to the decontamination priority must be payable to a separate trust established for the sole purpose of paying for costs incurred in decontaminating the reactor and removing radioactive debris. The NRC further requires that the decontamination priority and trust requirements set forth in the regulation be incorporated in on-site property damage insurance policies not later than October 4, 1988, and apply uniformly to all required on site property damage insurance policies for nuclear power plants.

Effective January 1, 1988, the aggregate amount of property and decontamination expense insurance available for nuclear generating plants increased to $1.525 billion. With this increase, the coverage available above the amount required by the NRC to be set aside for reactor stabilization and cleanup is $465 million. However, the Middle South System is unable to predict what effect the NRC's new regulation may have at the time when insurance proceeds would be made available to any affected System company or the trustee for the bondholders of such affected System company.

Spent Nuclear Fuel and Decommissioning Costs

Under the terms of their nuclear fuel leases, AP&L, LP&L, and SERI are responsible for the disposal of spent nuclear fuel. These companies consider all costs incurred or to be incurred in the use and disposal of nuclear fuel to be proper components of nuclear fuel expense and provisions to recover such costs have been or will be made in applications to regulatory commissions. The affected Middle South System companies have executed contracts with the Department of Energy (DOE) whereby the DOE will furnish disposal service for the companies' spent nuclear fuel at a cost of one mill per kilowatt-hour of gross generation on or after April 7, 1983, plus (in AP&L's case) one-time fees for previously discharged fuel and in-core burned fuel prior to that date. AP&L has selected an option made available by the DOE to pay the one-time fee, plus interest accrued until date of payment, no earlier than 1998. AP&L has recorded the approximately $71 million including accrued interest at December 31, 1987, necessary for payment to the DOE for the disposal of all spent nuclear fuel on hand at April 6, 1983. In addition to the recovery of costs associated with the disposal of spent nuclear fuel, AP&L is recovering a total of approximately $160 million for decommissioning costs for its two nuclear units. Based upon a study performed by AP&L, nuclear plant decommissioning costs are projected to be in excess of this amount. AP&L is requesting recovery of estimated increased costs and authorization to fund in external trusts in an application to its regulatory commission. LP&L and SERI are presently recovering annually a total of approximately $2.1 million and $1.1 million, respectively, for decommissioning costs for their respective nuclear units.

Disposition of Subsidiary

AP&L has entered into a contract with Southwestern Energy Company and its subsidiary, Arkansas Western Gas Company (Arkansas Western), for the disposition of AP&L's interest in its wholly-owned subsidiary, Associated Natural Gas (ANG), by means of a cash merger of ANG into Arkansas Western. The cash merger consideration will be $27.1 million, with Arkansas Western assuming approximately $4.2 million of outstanding long-term debt of ANG. The transaction, which is subject to approval by various regulatory bodies, is expected to be completed in the second quarter of 1988.

LP&L and NOPSI Consolidation

In the interest of increased economic efficiency, LP&L and NOPSI have developed a long-term plan to consolidate the two companies and their operations. Under the proposed arrangement, subject to the receipt of necessary regulatory and other approvals, the two companies would be consolidated into a new company to be called Louisiana Power & Light Company. MSU, which currently owns all the outstanding common stock of LP&L and NOPSI, would own all the common stock of the new company. While functional consolidation, in terms of management and personnel, has already been achieved in a number of areas, legal consummation of the consolidation is not expected to be achieved in the near future.

9 LEASES

Prior to 1987, the Company's operating subsidiaries accounted for leases entered into before 1983 as operating leases, consistent with the basis used in the ratemaking process. The Company's operating subsidiaries account for capital leases entered into subsequent to 1982 in accordance with SFAS No. 13 and SFAS No. 71.

Beginning in 1987, compliance with SFAS No. 71 for pre-1983 capital leases required the recording of assets and liabilities on the balance sheet with respect to such leases. The recording of these capital leases did not affect the amounts reported as either expenses or net income. The assets and liabilities associated with these leases at December 31, 1987, are presented below. Also shown are those amounts which would have been included on the balance sheet at December 31, 1986, had earlier compliance with SFAS No. 71 been adopted.

	1987	1986
	(In thousands)	
Assets:		
Utility plant	$134,518	$142,911
Accumulated amortization	(36,393)	(40,012)
Net	$ 98,125	$102,899
Other property and investments – net	$ 45,237	$ 47,151
Liabilities:		
Noncurrent obligations under capital leases	$135,799	$141,224
Current obligations under capital leases	$ 7,563	$ 13,702

Excluded from the preceding amounts at December 31, 1987, is approximately $397.9 million recorded in connection with nuclear fuel leases.

At December 31, 1987, the System companies had noncancelable leases (excluding nuclear fuel leases) with minimum rental commitments as follows:

	Capital Leases	Operating Leases
	(In thousands)	
1988	$ 29,793	$ 54,121
1989	30,302	48,227
1990	28,846	37,394
1991	26,387	31,037
1992	22,345	29,821
Years thereafter	173,391	189,358
Minimum rental commitments	311,064	$389,958
Less: Amount representing interest	147,708	
Present value of net minimum lease payments	$163,356	

Rental expense for capital and operating leases (excluding nuclear fuel leases) amounted to approximately $77.6 million, $76.6 million, and $70.5 million in 1987, 1986, and 1985, respectively.

Three subsidiaries have entered into nuclear fuel leases aggregating $423.7 million as of December 31, 1987. Credit lines supporting two of these nuclear fuel leases terminated in 1987 and the affected subsidiaries are in the process of attempting to obtain new lines of credit. While fuel presently under these two leases may continue to be leased until September 1, 1990, and June 1, 1991, respectively, no new fuel may be leased unless new lines of credit are obtained. The credit lines supporting the remaining nuclear fuel leases are currently scheduled to terminate in 1988. It is currently assumed that such credit lines will either be extended pursuant to agreements subsequently negotiated or that alternative new lines will be secured. In February 1988, SERI entered into a new nuclear fuel lease for up to $50 million. The lease extends for one year with monthly extensions thereafter until notice is given by one of the parties thereto. Lease payments are based on nuclear fuel use. Nuclear fuel lease expense of $190.8 million, $161.4 million, and $111.8 million was charged to operations in 1987, 1986, and 1985, respectively. The unrecovered cost base of the leases was $397.9 million, $410.8 million, and $400.1 million at December 31, 1987, 1986, and 1985, respectively.

10 SFAS NO. 90

In December 1986, the FASB issued SFAS No. 90, Regulated Enterprises – Accounting for Abandonments and Disallowances of Plant Costs, an amendment of SFAS No. 71. SFAS No. 90 provides that, when an abandonment of a plant or a disallowance of costs with respect to a newly completed plant becomes probable, the following amounts, net of related tax benefits, would be reported either by restating the appropriate prior years' financial statements or by charging them against current income: (1) the cost of an abandoned plant in excess of the present value of estimated recoveries; or (2) the amount of a partial disallowance by regulators of a recently completed plant for ratemaking purposes. The new statement is effective for fiscal years beginning after December 15, 1987, with retroactive application for prior transactions.

SFAS No. 90 will not have any current effect upon SERI in light of the decision to continue suspension of Grand Gulf 2. The provisions of SFAS No. 90 would apply should SERI decide to abandon Grand Gulf 2 and would result in SERI recording a loss for any unrecovered amount.

In November 1985, the LPSC granted LP&L a rate increase subject to LP&L agreeing to permanently absorb and not recover from its retail customers $284 million (of which the LPSC's jurisdictional portion is approximately $276.9 million) of its Waterford 3 costs. LP&L has chosen to adopt the provisions of SFAS No. 90 in 1987 and has restated prior years' financial statements to reflect application of the new statement.

The following table illustrates the effects of adoption of SFAS No. 90:
For the years ended December 31,

	1986	1985
Net income reported before application of SFAS No. 90	(In thousands) $451,302	$400,991
Adjustments to operating income:		
Depreciation previously taken	6,923	1,878
Related income taxes (net)*	(3,771)	(635)
Total	3,152	1,243
Adjustments to other income:		
Related income taxes (net)*	11	5
Disallowed costs:		
Direct disallowance	–	(276,900)
Related income taxes*	–	90,259
Total	–	(186,641)
Change in net income	3,163	(185,393)
Net income (as restated)**	$454,465	$215,598
Earnings per average common share:		
Before application of SFAS No. 90	$2.21	$2.01
Effects of SFAS No. 90	0.01	(0.93)
After application of SFAS No. 90	$2.22	$1.08

**Deferred taxes related to the Waterford 3 disallowance have been provided at rates that, under current tax law, are effective when the tax basis of the plant is depreciated (46% in 1985 and 1986, 40% in 1987 and 34% thereafter) to determine the net realizable value of the tax benefit.*

***Changes in net income resulted in a cumulative adjustment to December 31, 1986, retained earnings of $182.2 million.*

11 POSTRETIREMENT BENEFITS

The companies of the Middle South System have various postretirement benefit plans covering substantially all of their employees. The pension plans are noncontributory and provide pension benefits that are based on the employees' credited service and average compensation, generally during the last five years before retirement. The policy of the Company and its subsidiaries is to fund pension costs in accordance with contribution guidelines established by the Employee Retirement Income Security Act of 1974.

Pension plans are administered by a trustee who is responsible for pension payments to retirees. Various investment managers have responsibility for management of the plans' assets. In addition, an independent actuary performs the necessary actuarial valuation for the individual company plans.

Total pension cost of the Company and its subsidiaries for 1987, 1986, and 1985 was $1 million (includes miscellaneous immaterial adjustments not reflected in the table that follows), $13.4 million, and $17.1 million, respectively.

The Company and its subsidiaries adopted SFAS No. 87, Employers' Accounting for Pensions, effective January 1, 1987. Adoption of SFAS No. 87 reduced 1987 pension cost by approximately $9.3 million. Total 1987 pension cost of the Company and its subsidiaries, including amounts capitalized, included the following components:

	(In thousands)
Service cost – benefits earned during the period	$ 18,501
Interest cost on projected benefit obligation	38,280
Actual return on plan assets	(19,554)
Net amortization and deferral	(38,713)
Net pension cost (income)	$ (1,486)

The assets of the plans consist primarily of common and preferred stocks, fixed income securities, interest in a money market fund, and insurance contracts.

The funded status of the Company's various pension plans at December 31, 1987, is as follows:

	(In thousands)
Actuarial present value of accumulated pension plan benefits:	
Vested	$ 349,437
Nonvested	26,680
Accumulated benefit obligation	$ 376,117
Projected benefit obligation	$ 469,141
Plan assets at fair value	589,959
Plan assets in excess of projected benefit obligation	120,818
Unrecognized prior service cost	2,206
Unrecognized transition asset	(126,440)
Unrecognized net gain	(30,546)
Accrued pension liability	$ (33,962)

The weighted average discount rate and rate of increase in future compensation used in determining the actuarial present value of the projected benefit obligation were generally 9.0% and 5.6%, respectively. The expected long-term rate of return on plan assets was 8.5%. Transition assets are being amortized over the greater of the remaining service period of active participants or 15 years. The actuarial present value of the accumulated plan benefits at January 1, 1986, was $322.5 million (of which $17.5 million was nonvested), compared with net assets available for pension benefits of $534.2 million. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits at that date was 9%.

The System companies also provide certain health care and life insurance benefits for retired employees. Substantially all employees may become eligible for these benefits if they reach retirement age while still working for the System companies. These benefits and similar benefits for active employees are provided through various means including payments of premiums to insurance companies and/or accruals for self-insurance policies managed by insurance companies. The cost of providing these benefits for retirees is not separable from the cost of providing benefits for active employees. The total cost of providing these benefits and the number of active employees and retirees for the last three years were:

	1987	1986	1985
Total cost of health care and life insurance (in thousands)	$32,133	$25,718	$19,771
Number of active employees	13,560	13,307	13,214
Number of retirees	3,098	2,983	2,577

12 SETTLEMENT AGREEMENTS WITH GAS SUPPLIERS

A dispute between a gas supplier and LP&L arising from the gas supplier's claimed inability to deliver full quantities of fuel gas due LP&L under several natural gas contracts was settled by the execution of a settlement agreement on June 4, 1982. The settlement agreement provides for the payment of $1.087 billion in cash (of which $587 million, $250 million, and $250 million were received by LP&L in June 1982, January 1983, and January 1984, respectively) plus a guaranty of savings of at least $585 million in certain gas acquisition costs between 1982 and 1996. In March 1983, the LPSC ordered that the refunds be made as follows: the $587 million received by LP&L on June 4, 1982, plus interest, or a total of $637 million, be refunded in 1983; the $250 million received in January 1983 be refunded in 10 equal annual installments beginning in 1984; and the $250 million received in January 1984 be refunded in nine equal annual installments beginning in 1985. In addition, in February 1984 the LPSC ordered LP&L to refund $32.6 million, representing interest not already covered in its March 1983 refund order, to customers in equal annual installments over a nine-year period beginning with the 1985 refund. As a result of the LPSC orders, LP&L accrued in 1985 net interest expense in the amount of $0.2 million. No accruals were required for 1987 and 1986. Through December 31, 1987, LP&L had refunded a total of approximately $826 million to its customers.

A settlement has been negotiated between NOPSI and a gas supplier in long-standing litigation stemming from the gas supplier's failure to deliver obligated quantities of natural gas for power plant use during the period 1973-75. A civil district court approved the settlement on August 18, 1987, which will result in the refund of approximately $73 million to electric customers served by NOPSI in that time frame. The court's judgment is final and no longer subject to appeal. Announcement of the settlement was made in February 1987. It is expected that this refund will be made during 1988.

Two lawsuits between MP&L and a gas supplier arising from MP&L's claim that the gas supplier breached the terms of a gas sales agreement were settled by the execution of a settlement agreement between the parties on September 25, 1985. In connection with this settlement, MP&L received $165 million in September 1985 and an additional $17.5 million in September 1987 from the gas supplier. In 1987, pursuant to a plan of distribution previously established by the MPSC, MP&L refunded, including interest, approximately $196.3 million to former wholesale and current retail customers.

13 QUARTERLY RESULTS (UNAUDITED)

Consolidated operating results for the four quarters of 1987 and 1986 were as follows:

Quarter Ended	Operating Revenues	Operating Income*	Net Income*	Earnings Per Share*
	(In thousands, except per share amounts)			
1987:				
March	$ 769,650	$268,414	$100,707	$ 0.49
June	$ 831,617	$258,753	$ 94,454	$ 0.46
September	$1,075,049	$350,086	$186,391	$ 0.91
December	$ 778,504	$132,803**	$(24,948)**	$(0.12)**
1986:				
March	$ 804,809	$297,487	$115,378	$0.56
June	$ 810,795	$283,451	$104,184	$0.51
September	$1,073,400	$350,731	$172,286	$0.84
December	$ 796,908	$233,728***	$ 62,617***	$0.31***

** Restated to reflect the adoption of SFAS No. 90.*

*** Includes the net effect of (1) the write-off of NOPSI's prudence disallowance of approximately $72.9 million, and (2) the discontinuance of Waterford 3 rate deferrals of approximately $24.4 million.*

**** Includes the net effect of certain write-offs recorded in the quarter ended December 31, 1986, of approximately $19.6 million or $0.10 per share.*

The business of the Middle South System is subject to seasonal fluctuations with the peak period occurring during the summer months. Accordingly, earnings information for any three-month period should not be considered as a basis for estimating results of operations for a full year.

Selected Financial Data – Five-Year Comparison
(In thousands, except per share amounts)

	1987	1986	1985	1984	1983
Net operating revenues	**$ 3,454,820**	$ 3,485,912	$ 3,238,459	$ 3,146,035	$ 2,909,657
Net income	**$ 356,604**	$ 454,465	$ 215,598	$ 508,437	$ 378,050
Earnings per share	**$ 1.74**	$ 2.22	$ 1.08	$ 2.86	$ 2.46
Dividends declared per share	**—**	–	$ 0.89	$ 1.75	$ 1.71
Total assets	**$15,156,832**	$14,090,431	$13,390,015	$12,565,546	$11,107,166
Long-term debt (excluding current maturities)	**$ 5,945,054**	$ 5,983,029	$ 5,680,590	$ 5,865,304	$ 5,032,175
Preferred stock with sinking fund	**$ 496,405**	$ 508,165	$ 467,293	$ 476,928	$ 429,601

MSU DIRECTORS

William C. Battle
Retired President and Chief Executive Officer of Fieldcrest Mills, Inc., Ivy, Virginia; Chairman of the Board of W. Alton Jones Cell Science Center. Finance and Public Affairs Committees.

W. Frank Blount
President, Network Operations Group, AT&T Company, Basking Ridge, New Jersey. Audit, Nuclear, and Personnel Committees.

John A. Cooper Jr.
President of Cooper Communities, Inc., Bentonville, Arkansas. Executive, Finance (Chairman), and Nuclear Committees.

Brooke H. Duncan
President of Foster Company, Inc., New Orleans, Louisiana. Executive, Finance, and Public Affairs (Chairman) Committees.

Kaneaster Hodges Jr.
Attorney, Newport, Arkansas. Audit (Chairman), Nuclear, and Public Affairs Committees.

Edwin Lupberger
Chairman and President of Middle South Utilities, Inc., New Orleans, Louisiana. Executive (Chairman), Nuclear, and Personnel Committees.

James R. Nichols
Partner of Nichols and Pratt (Family Trustees) and Attorney, Boston, Massachusetts. Audit and Finance Committees.

LeRoy P. Percy
Cotton farmer; Chairman of the Boards of Mississippi Chemical Company and First Mississippi Corporation; President of Greenville Compress Co., Greenville, Mississippi. Executive, Nuclear (Chairman), and Personnel Committees.

Robert D. Pugh
Chairman of the Board of Portland Gin Company (agricultural and agribusiness), Portland Bank, and Portland Agri-Credit Corporation, Portland, Arkansas. Executive, Finance, and Personnel (Chairman) Committees.

H. Duke Shackelford
President of Shackelford Co., Inc., Shackelford Gin, Inc., and Louisiana Cotton Warehouse Co. Inc.; Chairman of Union Oil Mill, Inc. (all agricultural and agribusinesses), Bonita, Louisiana. Personnel and Public Affairs Committees.

Wm. Clifford Smith
President of T. Baker Smith & Son, Inc., and Energy Helicopters, Inc., Houma, Louisiana. Audit, Nuclear, and Public Affairs Committees.

Dr. Walter Washington
President of Alcorn State University, Lorman, Mississippi. Audit and Public Affairs Committees.

MSU OFFICERS

Edwin Lupberger
Chairman and President. Age 51. Joined the MSU System in 1979. Sixteen years prior utility industry service.

William Cavanaugh III
Senior Vice President, System Executive – Nuclear. Age 49. Joined the MSU System in 1969.

John L. Cowan
Senior Vice President, System Executive – Finance. Age 60. Joined the MSU System in 1987. Twenty years prior experience in financial executive positions with several major companies.

Jerry D. Jackson
Senior Vice President, System Executive – Legal and External Affairs. Age 43. First joined the MSU System in 1979.

Jack L. King
Senior Vice President, System Executive – Operations. Age 48. Joined the MSU System in 1966.

H. Stuart Ball
Treasurer. Age 44. Joined the MSU System in 1985.

Dan E. Stapp
Secretary. Age 53. Joined the MSU System in 1958.

Dorothy M. Antoine
Assistant Secretary. Age 55. Joined the MSU System in 1952.

INVESTOR INFORMATION

Annual Meeting

The 1988 Annual Meeting of Stockholders will be held at 10 a.m. (CDT) on May 20, 1988, at the Hilton Hotel, New Orleans, Louisiana. A notice of the meeting and proxy material will be mailed on or about April 15, 1988, to stockholders of record as of the close of business on April 11, 1988. A badge for admission may be obtained at the meeting registration desk. Stockholders whose shares are held in "street name," i.e., in the name of their broker, must present a letter from their broker indicating ownership of the Company's common stock as of April 11, 1988.

Stockholders of Record

At the close of 1987, there were 104,226 stockholders of record of Middle South Utilities, Inc. A total of 204,581,092 shares were outstanding.

Dividends

Declaration of a quarterly dividend has been omitted since the second quarter of 1985. The Directors and management of Middle South Utilities are committed to reinstating a dividend as soon as prudently possible, as stated in the Chairman's Letter of this report.

Stockholder Inquiries

All correspondence concerning stockholder records should be directed to:

Middle South Utilities, Inc.
Stockholder Services
P.O. Box 61236
New Orleans, Louisiana 70161

Transfer Agent and Registrar

Morgan Shareholder Services Trust Company is the transfer agent and registrar for MSU. All correspondence concerning the issuance or transfer of common stock certificates should be directed to:

Morgan Shareholder Services
Trust Company
Stock Transfer
30 West Broadway
New York, New York 10007-2192

Form 10-K

The Middle South Utilities System 1987 Annual Report to the Securities and Exchange Commission on Form 10-K (including financial statement schedules) is available to stockholders upon request. To receive a copy without charge, call or write to:

Dan E. Stapp, Secretary
Middle South Utilities, Inc.
P.O. Box 61005
New Orleans, Louisiana 70161
(504) 529-5262

Financial and Statistical Review

Historical statistics and financial information supplemental to the 1987 Annual Report and Form 10-K are available in the Company's 1987 Financial and Statistical Review, which will be available for distribution in June. Copies of the Review may be obtained by contacting System Investor Relations at the address given in the following section.

Investor Relations

The MSU System conducts an active investor relations program to communicate the System's performance to institutional investors, security analysts, registered representatives, and individual investors. System Investor Relations may be contacted by writing or calling:

Middle South Utilities, Inc.
System Investor Relations
P.O. Box 61005
New Orleans, Louisiana 70161
(504) 529-5262

Exchange Listings

The common stock of Middle South Utilities, Inc. is listed and traded on the New York, Midwest, and Pacific stock exchanges. The ticker symbol for the Company is MSU. Newspaper stock table listing is MidSUt.

Composite Common Stock Prices by Quarters

1987 Price Range	First	Second	Third	Fourth
High-Low	\$16¼-13	\$14⅝-10	\$11⅛-9¼	\$11⅝-7¾
1986 Price Range				
High-Low	\$13¾-10½	\$14⅝-12⅛	\$15-12	\$14⅛-12¼

Middle South Utilities, Inc.
Post Office Box 61005
New Orleans, Louisiana 70161