1987 ANNUAL REPORT

DUQUESNE LIGHT COMPANY

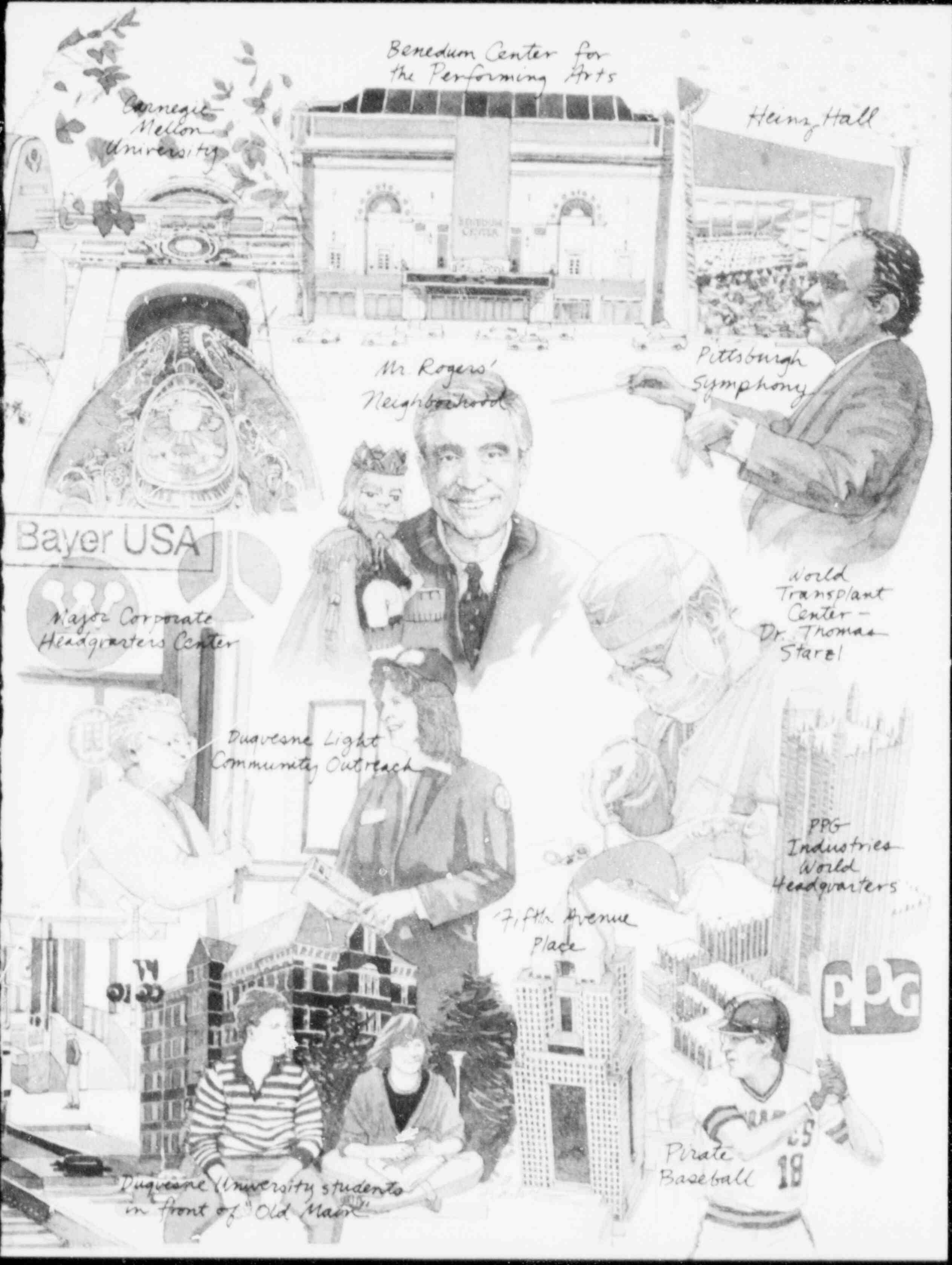
Duquesne Light Company is engaged in the production, transmission, distribution and sale of electric energy. The Company serves an area of approximately 800 square miles in Allegheny and Beaver counties. This area, which includes the City of Pittsburgh, is located in Southwestern Pennsylvania and has a population of 1,500,000. The cover illustration captures the growing diversity of our service territory and offers a glimpse of promising plans for the immediate future.

Mission Statement

Our first responsibility is to our residential, commercial, and industrial customers. In meeting their needs, we must always maintain quality and professional standards. Our efforts must be directed toward the satisfaction of new and existing customers. As well, we must constantly strive to reduce our costs so that we may offer reasonable electric rates. The success of the Company is directly dependent upon the productive contributions of all employees. Each employee must be considered as an individual. The dignity of all employees must be respected and their merit recognized. Compensation must be fair and adequate, and working conditions must be clean, orderly, and safe. Employees should be free to make suggestions and to voice their opinions. There must be equal opportunity for employment, development, and advancement. We are responsible to our stockholders. We must be innovative in our approach, entrepreneurial in our style, and willing to take calculated, reasonable business risks. By operating in this manner, we will be dedicated to earning an adequate profit and, in turn, realizing a fair and competitive return for the Company's owners for the use of their capital. We are responsible to the communities in which we live and work. We must be good corporate citizens, offering assistance and doing our part to help improve the general quality of life in our service territory. We must maintain the property we are privileged to use, comply with environmental regulations, and protect our natural resources.

Local illustrator Frederick H. Carlson composed our cover piece. Suitable-for-framing copies of the 12" x 38" illustration are available for a charge of $3 to cover postage and handling. Please send a check or money order, payable to "DLCo. Illustration," c/o Duquesne Light Company, One Oxford Centre (30-5), Pittsburgh, PA 15279.


Pittsburgh Technology Center
Metal tech - representative of the new manufacturing sector
Pittsburgh Technology Center - Monongahela River (1996)
Duquesne Light Nuclear Training Center
One Mellon Bank Center
Children's Hospital
Natural Habitat Environments - Pittsburgh Zoo
Software Engineering Institute - first major U.S. computer-software research center


Benedum Center for the Performing Arts
Carnegie Mellon University
Heinz Hall
Pittsburgh Symphony
Mr Rogers' Neighborhood
Bayer USA
Major Corporate Headquarters Center
World Transplant Center - Dr. Thomas Starzl
Duquesne Light Community Outreach
PPG Industries World Headquarters
Fifth Avenue Place
PPG
Pirate Baseball
Duquesne University students in front of "Old Main"

To Our Shareholders

Today's Pittsburgh region is growing...regaining measurable strength as it continues a transformation and diversification from an economy based primarily on heavy industry to an increasingly knowledge oriented economy.

This year's annual report cover illustration shows just some of the exciting new developments throughout the 800 square mile territory we serve—the installation of one of the largest supercomputers in the nation, pioneer work in medical transplant procedures, robotics, biotechnology, and computer software. Each typifies a region forging a new future.

Likewise, 1987 retail demand for our product increased with the improving local economy. Our annual system peak load was seven percent higher than the previous year's, and sales to retail customers increased 4.4 percent, to almost 11 billion kilowatt-hours.

Consistent growth in demand from our commercial segment reflects the changing nature of our region's economy. In 1981, commercial sales represented 30 percent of our retail sales total; in 1987, that share was 45 percent. Meanwhile, sales to other utilities reached a new high of 2.5 billion kilowatt-hours, a 16 percent increase over the previous year, resulting in overall sales of 13.5 billion kilowatt-hours.

Our DUQUESNE PLAN business strategy, initiated in 1986 to help revitalize our Company and the communities we serve, provided the foundation for our achievements in 1987. Highlights of the year include:

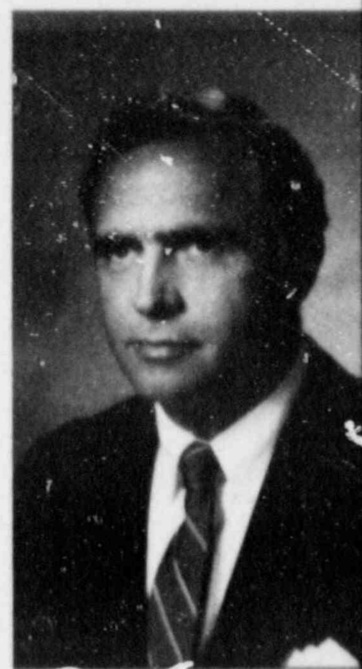
- the completion and start up of Beaver Valley Unit 2 and Perry Unit 1;

- the innovative sale and leaseback arrangement for our 13.74 percent interest in Beaver Valley Unit 2, which will help us strengthen our financial position by enabling us to buy back a portion of our common stock and to repurchase certain high coupon debt securities;
- Beaver Valley Unit 1's new continuous operation record—185 days...its high availability and employee emphasis on safety and excellence make it one of the better plants in the nation;
- the quality service we provided all year, particularly last summer when we set our highest annual retail peak in six years;
- the continued strong performance in off system sales, which set a new all time high and registered a 1,100 percent increase since 1981;
- the creative sale of 400,000 tons of fly ash from our coal-fired power plants for use in the largest of its kind road embankment in the United States...resulting in savings of up to $1 million in disposal costs;
- three consumer advisory panels created to give us the benefit of additional customer feedback;
- our new marketing emphasis to meet the challenge of increasing competition;
- our expanded use of economic development rates;
- further downsizing of our work force—approximately 13 percent fewer employees since 1984; and
- continuation of cost cutting measures, begun in 1985, which so far have realized more than $100 million in savings.

The cover of last year's annual report summarized Duquesne Light's business strategy: to become more efficient, more competitive, more market driven, more customer oriented, and more profitable. I am pleased to report we are making excellent progress in positioning ourselves to meet our objective.

1988 marks the first year in more than two decades Duquesne Light Company will not be involved in power plant construction. With this construction program complete, capital expenditures and the need for outside financings have been greatly reduced. In addition, the Public Utility Commission has formally recognized our "de facto" abandonment of the Perry Unit 2 project by allowing us to recover our investment over a 10 year period. We have no intention of voting to resume construction of that plant.

Still left unresolved as I write this letter is whether we will receive fair treatment on our investment in Beaver Valley Unit 2 and Perry Unit 1. My letter to you last year discussed the effects of the uncertain political and regulatory environment in Pennsylvania on our Company. I noted the inherent unfairness of one particular product of that environment, the so-called "excess capacity" legislation.



Wesley W. von Schack
Chairman of the Board,
President and Chief
Executive Officer

Since that time, we have been working closely with state legislators and regulators, seeking a more balanced public energy policy and regulatory incentives which would encourage the Company to effectively use its resources and give investors an opportunity to earn a fair return on their capital.

Cost reduction and organizational and financial restructuring will continue to be our top priorities as we meet the objectives of providing competitively priced energy and strengthening the financial health of our Company. Looking ahead, there will be market and revenue opportunities both within and outside our service territory which we intend to pursue aggressively.

On behalf of the Board of Directors, I wish to thank our shareholders for their support, and my fellow employees for their hard work and continuing commitment. We confidently look forward to the opportunities that lie ahead.

Wesley W von Schack

March 9, 1988

Financial And Operating Highlights

Financial	1987	1986	Percent Change
Revenues from Customers (000)	**$835,986**	$850,744	− 1.7
Revenues from Other Utilities (000)	**$52,018**	$45,519	+14.3
Total Operating Revenues (000)	**$888,004**	$896,263	− 0.9
Net Income (000)	**$151,316**	$151,426	− 0.1
Earnings Available for Common Stock	**$131,528**	$130,879	+ 0.5
Earnings Per Share of Common Stock	**$1.81**	$1.79	+ 1.1
Dividends Declared Per Share of Common Stock	**$1.20**	$1.415	−15.2
Book Value Per Share of Common Stock at Year End	**$17.61**	$16.75	+ 5.1
Shares of Common Stock Outstanding at Year End (000)	**70,096**	73,119	− 4.1
Allowance for Funds Used During Construction as a Percent of Earnings for Common Stock	**79%**	85%	−7.1
Operating			
Electric Plant (000)	**$4,007,551**	$4,312,047	− 7.1
MWH Sales to Customers	**10,980,028**	10,514,121	+ 4.4
MWH Sales to Other Utilities	**2,485,711**	2,135,834	+16.4
Total MWH Sales	**13,465,739**	12,649,955	+ 6.4
Peak Load Megawatts	**2,280**	2,132	+ 6.9
Cost of Fuel Per Million BTU	**151.0¢**	165.3¢	− 8.7
Average BTU Per KWH Output	**10,449**	10,624	− 1.6
Annual System Generation MWH	**14,033,842**	13,275,877	+ 5.7

Contents

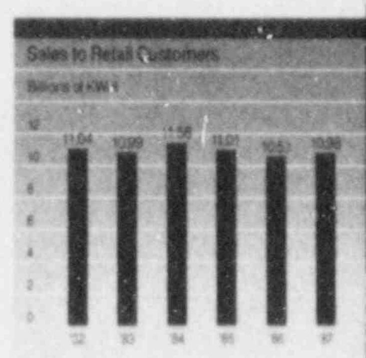
Perspective On 1987

Major Events of the Year

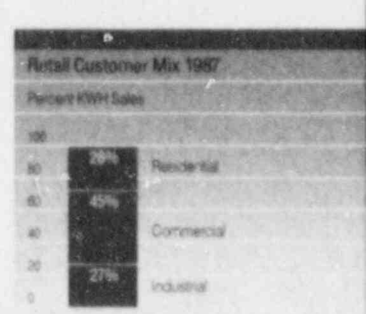
Earnings, Sales, Revenues

Earnings per share were $1.81, a two cent increase from the previous year. 1987 earnings reflect three nonrecurring events.

- The innovative sale and leaseback of our interest in Beaver Valley Unit 2 improved the Company's cash flow and enabled us to reduce our current rate increase request. However, the sale resulted in a one time, 33 cents per share loss due to the difference between Unit 2's cost at completion and its appraised value.
- In a separate matter, earnings were reduced 26 cents per share because the Pennsylvania Supreme Court reversed earlier rulings which had allowed us to recover costs associated with four plants cancelled in 1980.
- In addition, a $16 million rate reduction ordered by the Public Utility Commission lowered earnings by seven cents per share.



Sales to retail customers in 1987 increased 4.4 percent compared to the previous year, to almost 11 billion kilowatt-hours. Industrial sales were up 6.7 percent as USX Corporation steel mills rebounded from an extended 1986 strike. Both residential and commercial sales posted gains of almost four percent. Off system sales were strong, increasing 16.4 percent over 1986's record level, to 2.5 billion kilowatt-hours. Our total 1987 sales increased 6.4 percent, to 13.5 billion kilowatt-hours.



Growth in the commercial segment has been particularly encouraging. Traditional growth in this expanding market sector—office developments, restaurants, shopping complexes—

has been bolstered by the emergence of a wide range of advanced technology businesses and industries. Membership in the Pittsburgh High Technology Council has grown to about 600 firms since 1983, representing both individual entrepreneurs and Fortune 500 companies. The illustration on the cover of this report includes two of the latest developments in this rapidly growing field—the Software Engineering Institute and the Pittsburgh Supercomputing Center.

In the future, we see continued growth in both the advanced technology and the traditional commercial areas. The following examples are included in our cover illustration:

- Work is progressing on the Pittsburgh Technology Center, an advanced technology/industrial park on the former site of a steel mill, near the downtown business district.
- Ground recently was broken for the new midfield terminal of the Greater Pittsburgh International Airport, a project significant in itself, but which also will encourage the commercial, residential and industrial development of hundreds of surrounding acres.
- Ground will be broken in the spring for the new $36 million Buhl Science Center, to be located near Three Rivers Stadium.
- The proposed 10 block, $91 million Riverside festival market/entertainment complex could provide a significant boost to the nearby David L. Lawrence Convention Center, which also is under consideration for expansion.

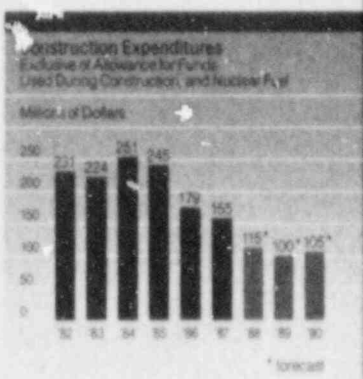
"Traditional growth in the expanding commercial market sector—office developments, restaurants, shopping complexes—has been bolstered by the emergence of a wide range of advanced technology businesses and industries."

Revenues from retail customers were down 1.7 percent, to $836 million, primarily due to the PUC ordered rate reduction. Our total operating revenues for the year were down one percent, compared to 1986, to $888 million.

Power Plant Construction Program Completed

Both Beaver Valley Unit 2 and Perry Unit 1 began commercial operation in November. We constructed and now operate Beaver Valley Unit 2. The Cleveland Electric Illuminating Company constructed and operates Perry Unit 1. Duquesne Light has a 13.74 percent interest in each unit.

We are particularly proud of the Beaver Valley project. The attention to detail, commitment to excellence, and focus on safety by Duquesne Light employees and local craftworkers make Unit 2 one of the best built nuclear plants in the country. Backed by our 30 years of nuclear experience, we are confident this state of the art unit will match or exceed the impressive operating record achieved by Beaver Valley Unit 1 in recent years. Unit 1 recently set a new continuous operation record, producing power for 185 days before it was shut down in December for a scheduled refueling.



Innovative Sale and Leaseback Arrangement

In October, Duquesne Light completed an innovative and creative sale and leaseback arrangement for our 13.74 percent interest in Beaver Valley Unit 2. In effect, the Company sold its share of the unit to several institutional investors which, in turn, immediately leased their interest back to Duquesne Light for a period of 29½ years. We continue to operate and maintain Unit 2, hold its operating license, and receive 13.74 percent of the electricity it produces. This innovative transaction also will benefit customers through rates lower than they would be otherwise.

Major Rate Case Filed

The Public Utility Commission did not consider the innovative phase-in approach we proposed in our 1986 rate request and instead ordered a $16 million rate reduction, primarily due to application of the lower corporate tax rate created by the Tax Reform Act of 1986. In June 1987, we filed a traditional case, using the "all at once" approach, in the amount of $379 million. The major reason this rate increase is needed is to recover our investment in Beaver Valley Unit 2 and Perry Unit 1. The sale and leaseback transaction later enabled us to voluntarily lower the overall amount of our request by $61 million, to $318 million.

"This innovative transaction (the sale and leaseback of our interest in Beaver Valley Unit 2) also will benefit customers through rates lower than they would be otherwise."

However, at the time of the June 1987 filing, we expressed our dissatisfaction with this rate making method and worked, to no avail, to achieve a reasonable settlement. In November, we submitted to the PUC an entirely new proposal to phase-in the proposed rate increase over six to eight years.

In early February 1988, a PUC administrative law judge recommended a $234 million rate increase for the Company, to be phased in over six years, with rate increases of about 7.8 percent each year. A final PUC decision is expected by the end of March.

GETTING CLOSER TO OUR CUSTOMERS

Competition is increasing, and we are taking the necessary steps to position Duquesne Light to successfully meet this challenge. Our primary focus is on expanding a commitment we first made when we initiated our DUQUESNE PLAN business strategy in 1980: To develop a closer relationship with our customers through expanded marketing and economic development efforts. Specifically, we are working to better understand what our customers want and need, and to deliver those energy services to them in a timely and effective manner.

"We are working to better understand what our customers want and need, and to deliver those energy services to them in a timely and effective manner."

We conducted in-depth market research, segmented our markets, and realigned our marketing force, assigning account managers to specific customer segments instead of geographic areas. This enables our people to develop creative and customized solutions to the specific needs of our customers.

1987 marked our first year of active marketing in more than a decade, with two major campaigns: one featuring residential heat pumps, and the second, commercial heating. Through these campaigns, we have formed new partnerships with key trade allies, such as builders, developers, equipment suppliers and national chain accounts...alliances we believe will result in additional marketing opportunities for our Company.

Economic development is a highly competitive business. Every state, county and town in the United States wants new jobs. Our proactive economic development program includes networking with key regional and state partners, including major universities. Together, we are selling the advantages of locating or expanding businesses in the greater Pittsburgh area.

To address this competitive challenge, we more than tripled our economic development staff in 1987. New activities include the following:

- The expansion of our computerized listing of available business sites from 250 facilities to approximately 800.
- Expanded videotaping of a number of key properties available for business expansion or relocation. These videos are made available to a variety of potential buyers.
- The creative channeling of a portion of a PUC mandated refund into a centralized program which infused $3 million into local economic development efforts.
- The expanded use of special economic development rates...another important contribution to the area's continued revitalization efforts.

Employee involvement is playing an increasingly important role as our marketing and economic development efforts continue to multiply. A variety of programs were introduced last year to encourage employees to become "ambassadors," promoting the benefits of quality electric living and looking for economic development opportunities.

"Our proactive economic development program includes networking with key regional and state partners, including major universities. Together, we are selling the advantages of locating or expanding businesses in the greater Pittsburgh area."

COMMITMENT TO EXCELLENCE

Our DUQUESNE PLAN business strategy provides flexibility to adapt to changing conditions...yet it remains constant in its commitment to excellence—emphasizing efficiency and innovation in all areas of the Company.

Doing Better With Less

We have cut costs recently by more than $100 million through a variety of measures, including downsizing our operations, and reducing our work force by approximately 13 percent. In 1987, the union and management negotiated a three year contract that recognizes the Company's financial situation by including a first year wage freeze.

"We have cut costs recently by more than $100 million through a variety of measures, including downsizing our operations, and reducing our work force by approximately 13 percent."

Fossil fueled units supplied 77 percent of our total energy production in 1987; nuclear units supplied 23 percent. Our two wholly owned coal fired plants performed well in 1987, maintaining an availability of 79 percent. Beaver Valley Unit 1 achieved an availability of 84 percent for the year. Our 1,200 nuclear employees amassed more than one million work hours without a lost time accident during 1987.

We are committed to increasing our training and development efforts because we believe properly trained and motivated employees are the key to excellence in operations. In 1987, we increased the number of training programs by more than half and doubled the number of employees trained, compared to the previous year. We conducted a variety of hands on skills training programs, such as pole top safety for line crews and an elderly awareness program for customer contact employees. In 1988, we expect our nuclear training center to be fully accredited by the National Academy for Nuclear Training.

Improving Value Through Innovation

As part of our DUQUESNE PLAN business strategy, we will continue to pursue new and non-traditional ways to improve efficiency and to enhance shareholder value. Earlier, we described two such examples—the sale and leaseback and specialized economic development rates. There are other notable examples throughout our Company.

For instance, in 1987 we sold 400,000 tons of fly ash and stabilized scrubber sludge from two of our coal fired power stations to the state for use as embankment fill on a 1,200 foot section of a new local expressway. In addition to saving our Company up to $1 million in waste disposal costs, this project is notable because it should help pave the way for other high volume uses of fly ash.

"As part of our DUQUESNE PLAN business strategy, we will continue to pursue new and non-traditional ways to improve efficiency and to enhance shareholder value."

Another example is Allegheny Development Corporation, a wholly owned subsidiary of Duquesne Light, which competitively bid on an energy services facility to supply electricity, steam and chilled water to the new midfield terminal at Greater Pittsburgh International Airport. This project represents a potential 17 megawatts of load and demonstrates our intention to provide competitively priced electricity.

Employee suggestions continued to save the Company dollars and to improve efficiency and safety in 1987. Nearly 100 specific employee ideas were approved through the Company's Suggestion System last year.

Building Partnerships

Stronger community and government coalitions will help the Pittsburgh region complete the economic transformation illustrated on the cover of this report. As a hometown company committed to the revitalization of Allegheny and Beaver counties, Duquesne Light greatly increased its visibility in 1987 on a number of fronts—especially economic development, community relations, and the political arena.

Professionals in our economic development organization serve in leadership and executive positions on the boards or executive committees of numerous local, state, national, and international economic development organizations. On a corporate level, we also are highly involved in a variety of partnerships, including the newly formed Pennsylvania Industrial Resource Center—an effort to consolidate public, private, and academic economic development efforts throughout the state.

"As a hometown company committed to the revitalization of Allegheny and Beaver counties, Duquesne Light greatly increased its visibility in 1987 on a number of fronts—especially economic development, community relations, and the political arena."

We took some special steps in 1987 to make sure our community outreach programs are effectively helping financially troubled customers. Because of the size and diversity of our service territory, we created three consumer advisory panels—one each for the City of Pittsburgh, Allegheny County, and Beaver County. Panel members provide invaluable insight into the specific problems and needs of the population they represent. Their unique perspectives are valuable resources as we evaluate our existing programs and consider new community initiatives.

1987 continued a long tradition of employee commitment to their home communities. In addition to the half million dollars pledged by our employees to the United Way, many Company sponsored and employee grassroots campaigns were conducted for a wide range of causes, including, among others, the Salvation Army Food Fund, Children's Hospital, Toys for Tots, and the Rehabilitation Institute of Pittsburgh.

Because legislative/regulatory decisions significantly influence our operations, we also have become more active in this area...working to develop closer relationships and to create a more open dialogue with government officials. Through our Stockholders Voice program, groups of shareholders, union and management employees and retirees made personal visits and wrote letters to legislators to discuss the 1987 rate case and other public policy issues. In the future, Stockholders Voice will continue to provide information on public policy issues critical to Duquesne Light and encourage members to contact their elected officials to support balanced legislative and regulatory treatment.

"In the future, Stockholders Voice will continue to provide information on public policy issues critical to Duquesne Light and encourage members to contact their elected officials to support balanced legislative and regulatory treatment."

BOARD OF DIRECTORS

From left: Daniel Berg, Eric W. Springer, William H. Knoell, Henry G. Allyn Jr. and John H. Demmler

From left: Wesley W. von Schack, G. Christian Lantzsch, Sigo Falk, Dorean S. Boyce and John M. Arthur

Wesley W. von Schack ‡§#
Chairman of the Board, President and Chief Executive Officer

Henry G. Allyn Jr. *§
Retired President and Chief Executive Officer of The Pittsburgh and Lake Erie Railroad Company

John M. Arthur ‡#•
Retired Chairman of the Board Duquesne Light Company

Daniel Berg *#
Institute Professor, Rensselaer Polytechnic Institute

Doreen E. Boyce †‡
Director, The Buhl Foundation

John H. Demmler *‡
Partner, Reed Smith Shaw & McClay Attorneys-at-Law

Sigo Falk †§
President and Chief Executive Officer, Cranberry Emergency and Diagnostic Center

William H. Knoell *#
Chairman and Chief Executive Officer, Cyclops Industries, Inc.

G. Christian Lantzsch †#
Retired Vice Chairman of Mellon Bank, and retired Vice Chairman and Treasurer of Mellon Bank Corporation

Eric W. Springer ‡§
Partner, Horty, Springer and Mattern, P.C. Attorneys-at-Law

* *Member of Audit Committee*
† *Member of Compensation Committee*
‡ *Member of Employment and Community Relations Committee*
§ *Member of Nominating Committee*
\# *Member of Nuclear Review Committee*
• *John M. Arthur retired as Chairman of the Board of Duquesne Light Company Sept. 1, 1987.*

Company Officers

Wesley W. von Schack
Chairman of the Board, President and Chief Executive Officer

John J. Carey
Executive Vice President Operations

Roger D. Beck
Vice President Marketing and Customer Services

Gary R. Brandenberger
Vice President Power Supply

Christine A. Hansen
Vice President Legal and Corporate Communications

David D. Marshall
Vice President Corporate Development

Donald O. Messner
Vice President Administrative Services

Gary L. Schwass
Vice President and Treasurer

John D. Sieber
Vice President Nuclear

Diane S. Eismont
Secretary

James O. Ellenberger
Controller

Laura Lane Amelio
Assistant Secretary

Lawrence P. Galie
Assistant Treasurer

Joan S. Senchyshyn
Assistant Secretary

A. William Stein
Assistant Treasurer

Unit Managers

George E. Bentz
General Services

Richard S. Christner
General Counsel

Thomas H. Cook
Management Information Services

James O. Crockett
Corporate Nuclear Services

William J. DeLeo
Planning, Budgeting, and Business Development

Donald H. DeVos
System Development

C. Eugene Ewing
Nuclear Quality Assurance

Thomas Hunter
Customer Services Western Division

Thomas D. Jones II
Fossil Generation

William S. Lacey
Nuclear Operations

John E. Laudenslager
Corporate Communications

H. Donald Morine
Marketing and Economic Development

Frank M. Nadolny
Rates and Regulatory Affairs

William J. Neidlinger
Corporate Performance Analysis

Thomas E. Nist
Customer Services Eastern Division

Steve L. Pernick Jr.
Environmental Affairs

Robert C. Schopper
Materials Management

Paul L. Schroeder
System Operations and Telecommunications

Donald A. Shirer Jr.
Fossil Fuels

Ernest M. Varhola
Governmental Relations

Joseph F. Zagorski
Human Resources

Armand G. Zitelli
Customer and General Services

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[illegible] Financial Statements

Management's Discussion [illegible]

Selected Financial [illegible]

COMPANY REPORT ON FINANCIAL STATEMENTS

The Company is responsible for the financial information and representations contained in the financial statements and other sections of this Annual Report. The Company believes that the financial statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances to reflect, in all material respects, the substance of events and transactions that should be included in the statements and that the other information in the Annual Report is consistent with those statements. In preparing the financial statements, the Company makes informed judgments and estimates based on currently available information about the effects of certain events and transactions.

The Company maintains a system of internal accounting control designed to provide reasonable assurance that the Company's assets are safeguarded and that transactions are executed and recorded in accordance with established procedures. There are limits inherent in any system of internal control based on the recognition that the cost of such a system should not exceed the benefits to be derived. The system of internal accounting control is supported by written policies and guidelines and is supplemented by a staff of internal auditors. The Company believes that the internal accounting control system provides reasonable assurance that its assets are safeguarded and the financial information is reliable.

The accompanying financial statements have been audited by Deloitte Haskins & Sells, independent certified public accountants, whose appointment was approved at the 1987 Annual Meeting of Stockholders. Their examination was made in accordance with generally accepted auditing standards and included a review of the system of internal accounting control and tests of transactions to the extent they considered necessary to provide reasonable assurance that the financial statements are not misleading and do not contain material errors.

The Board of Directors has an Audit Committee composed of four non-employee directors which met four times in 1987. The Audit Committee has the following duties and responsibilities: (1) recommending the independent public accountants; (2) reviewing the planned scope and results of the audit and other services to be performed by the independent public accountants; (3) reviewing the financial statements and the related report of the independent public accountants; (4) reviewing with the officers, internal auditors and the independent public accountants the adequacy of the Company's system of internal accounting control, including their recommendations with respect thereto; and (5) reviewing the planned scope and results of the internal audit function. The independent certified public accountants and internal auditors have full and free access to the Audit Committee and meet with it, with and without management being present, to discuss internal accounting control, auditing and financial reporting matters.

Wesley W. von Schack — Gary L. Schwass

Wesley W. von Schack
Chairman of the Board,
President and Chief
Executive Officer

Gary L. Schwass
Vice President
and Treasurer

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

DELOITTE HASKINS & SELLS
Certified Public Accountants
2400 One PPG Place
Pittsburgh, Pennsylvania 15222

TO THE DIRECTORS AND STOCKHOLDERS
OF DUQUESNE LIGHT COMPANY:

We have examined the balance sheets of Duquesne Light Company as of December 31, 1987 and 1986 and the related statements of income, retained earnings, capital surplus and changes in financial position 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 Note J—Rate Matters, there are several issues affecting the ultimate recoverability of the Company's investment in the Perry Unit No. 1 generating station which was completed in 1987. The Company is unable to predict what effect, if any, the Sunset Legislation or any alleged imprudence in the construction of the Unit will have on the Company's financial position or results of operations.

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, such financial statements present fairly the financial position of Duquesne Light Company at December 31, 1987 and 1986 and the results of its operations and the changes in its financial position 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.

Deloitte Haskins & Sells

February 12, 1988

STATEMENT OF INCOME

Year Ended December 31,
(Thousands of Dollars, Except Per Share Amounts)

	1987	1986	1985
OPERATING REVENUES:			
Customers	$835,986	$850,744	$872,411
Other utilities	52,018	45,519	46,049
Total Operating Revenues	888,004	896,263	918,460
OPERATING EXPENSES:			
Fuel	238,039	233,673	249,212
Purchased power	5,594	3,765	4,094
Other operation	189,783	169,555	159,188
Maintenance	66,380	74,719	60,462
Depreciation and amortization	82,172	74,325	81,066
Taxes other than income taxes	67,442	70,987	72,614
Income taxes (Note G)	52,859	79,724	100,992
Total Operating Expenses	702,269	706,748	727,628
OPERATING INCOME	185,735	189,515	190,832
OTHER INCOME AND DEDUCTIONS:			
Allowance for equity funds used during construction	71,234	81,943	72,782
Loss on cancelled generating units (Note D)	(34,263)	—	—
Loss on sale of Beaver Valley Unit No. 2 (Note E)	(23,828)	—	—
Rate refunds (including interest expense of $1,854 in 1987 and $12,953 in 1986) (Note C)	(1,854)	(57,278)	—
Income taxes—credit (Note G)	68,638	62,188	28,552
Other—net	21,654	2,692	10,801
Total Other Income and Deductions	101,581	89,545	112,135
INCOME BEFORE INTEREST CHARGES	287,316	279,060	302,967
INTEREST CHARGES:			
Interest on long-term debt	163,777	147,483	146,884
Other interest	4,566	8,792	6,357
Allowance for borrowed funds used during construction, net of income taxes	(32,343)	(28,641)	(26,231)
Total Interest Charges	136,000	127,634	127,010
NET INCOME	151,316	151,426	175,957
DIVIDENDS ON PREFERRED AND PREFERENCE STOCK	19,788	20,547	21,250
EARNINGS FOR COMMON STOCK	$131,528	$130,879	$154,707
AVERAGE NUMBER OF COMMON SHARES OUTSTANDING (000)	72,845	72,930	68,543
EARNINGS PER SHARE OF COMMON STOCK	$1.81	$ 1.79	$2.26
DIVIDENDS DECLARED PER SHARE OF COMMON STOCK	$1.20	$1.415	$2.06

See Notes to Financial Statements.

BALANCE SHEET

As of December 31,
(Thousands of Dollars)

	1987	1986
ASSETS		
PROPERTY, PLANT AND EQUIPMENT:		
Electric plant in service	$3,429,422	$2,607,433
Construction work in progress	74,094	1,324,848
Property held under capital leases (Note I)	290,907	272,721
Property held for future use (Note J)	213,128	107,045
Total	4,007,551	4,312,047
Less accumulated depreciation and amortization	908,654	821,448
Property, Plant and Equipment—Net	3,098,897	3,490,599
OTHER PROPERTY AND INVESTMENTS	20,477	18,424
CURRENT ASSETS:		
Cash and temporary cash investments (at cost which approximates market)	74,699	2,821
Cash held by trustee (Note E)	345,439	4,413
Accounts receivable:		
Customers (less allowance for uncollectible accounts of $5,417 and $5,181, respectively)	90,592	85,751
Other (including tax claims of $14,199 and $20,025, respectively)	56,538	41,749
Materials and supplies (generally at average cost):		
Coal	40,642	33,687
Other operating and construction	44,102	42,452
Other current assets	34,336	29,354
Total Current Assets	686,348	240,227
DEFERRED DEBITS:		
Extraordinary property losses (Notes B and D)	152,573	181,661
Unamortized loss on reacquired debt (Note M)	39,862	40,614
Deferred coal costs (Note J)	16,200	16,375
Income taxes on sale of Beaver Valley Unit No. 2 (Note E)	85,086	—
Other deferred debits	91,875	51,227
Total Deferred Debits	385,596	289,877
Total Assets	$4,191,318	$4,039,127

See Notes to Financial Statements.

CAPITALIZATION AND LIABILITIES

	1987	1986
CAPITALIZATION (Note M):		
Common stock (authorized—90,000,000 sh[illegible]d—73,119,446 shares)	$ 73,119	$ 73,119
Capital surplus	926,131	926,131
Retained earnings	269,965	225,733
Less treasury stock (at cost) (3,023,800 shares)	(34,748)	—
Total Common Stockholders' Equity	1,234,467	1,224,983
Non-redeemable preferred and preference stock	156,137	156,137
Redeemable preferred and preference stock	104,768	110,653
First mortgage bonds	1,401,669	1,326,135
Other long-term debt	297,599	296,137
Unamortized debt discount and premium—net	(8,668)	(8,485)
Total Capitalization	3,185,972	3,105,560
OBLIGATIONS UNDER CAPITAL LEASES (Note I)	140,535	154,887
CURRENT LIABILITIES:		
Notes payable—bank (Note F)	—	15,000
Long-term debt and lease obligations due within one year (Notes I and M)	53,529	33,071
Accounts payable	107,040	97,517
Accrued income taxes	9,968	7,805
Deferred income taxes and other accrued taxes	19,068	10,548
Accrued interest	43,597	38,792
Dividends declared	26,404	27,017
Deferred energy costs	18,064	3,313
Sinking fund and purchase requirements (Note M)	18,645	18,170
Rate refunds due within one year (Note C)	3,500	3,500
Total Current Liabilities	299,815	254,733
OTHER NONCURRENT LIABILITIES:		
Investment tax credits unamortized	165,452	198,258
Accumulated deferred income taxes	369,633	270,565
Rate refunds (Note C)	4,134	51,770
Other deferred credits	25,777	3,354
Total Other Noncurrent Liabilities	564,996	523,947
COMMITMENTS AND CONTINGENCIES (Notes B through N)		
Total Capitalization and Liabilities	$4,191,318	$4,039,127

STATEMENT OF CHANGES IN FINANCIAL POSITION

Year Ended December 31,
(Thousands of Dollars)

	1987	1986	1985
CASH PROVIDED FROM:			
Operations:			
Net income	$151,316	$151,426	$175,957
Depreciation and amortization	114,002	97,265	109,755
Allowance for equity and borrowed funds used during construction	(103,577)	(110,584)	(99,013)
Changes in working capital (see below)	5,932	(44,957)	(2,933)
Investment tax credits unamortized	(32,806)	12,988	19,468
Income taxes deferred—net (noncurrent portion)	64,077	17,176	30,756
Income taxes related to cancelled generating units	34,991	—	—
Loss on cancelled generating units	34,263	—	—
Loss on sale of Beaver Valley Unit No. 2	23,828	—	—
Rate refunds (including accrued interest)	—	51,770	—
Carrying charges on assets not in rate base	(11,093)	—	—
Total Cash Provided From Operations	280,933	175,084	233,990
Financing:			
Sale of Beaver Valley Unit No. 2	537,921	—	—
Sale of bonds	100,000	100,000	289,000
Issuance of common stock	—	27,313	102,910
Nuclear fuel obligations (including lease arrangements)	20,851	20,178	34,494
Issuance of pollution control obligations	—	—	44,250
Increase (decrease) in notes payable	(15,000)	15,000	—
Total Cash Provided From Financing	643,772	162,491	470,654
Total Cash Provided	924,705	337,575	704,644
CASH USED FOR:			
Construction expenditures (net of allowance for equity and borrowed funds used during construction)	154,959	178,765	244,859
Dividends on capital stock	107,084	123,645	162,318
Income taxes on sale of Beaver Valley Unit No. 2	85,086	—	—
Reductions of long-term obligations (including current maturities and rate refunds)	84,229	59,360	198,935
Repurchase of common stock	34,858	—	—
Nuclear fuel expenditures	20,851	20,178	34,494
Premium on reacquired debt	177	2,745	35,415
Other—net	24,557	27,040	13,194
Total Cash Used	511,801	411,733	689,215
Increase (Decrease) in Cash, Temporary Cash Investments, and Cash Held by Trustee	$412,904	$(74,158)	$ 15,429
CASH PROVIDED FROM (USED FOR) CHANGES IN WORKING CAPITAL:			
Accounts receivable	$ (19,630)	$ (10,498)	$ (14,441)
Materials and supplies	(8,605)	4,089	13,008
Other current assets	(4,982)	(15,466)	(1,597)
Accounts payable	9,523	(10,477)	(6,268)
Accrued income taxes	2,163	541	4,125
Deferred income taxes and other accrued taxes	8,520	(4,098)	(2,717)
Accrued interest	4,805	2,200	1,461
Dividends declared	(613)	(15,096)	3,305
Deferred energy costs	14,751	348	191
Rate refunds	—	3,500	—
Cash Provided From (Used For) Changes in Working Capital	$ 5,932	$ (44,957)	$ (2,933)

See Notes to Financial Statements

STATEMENT OF RETAINED EARNINGS

Year Ended December 31,
(Thousands of Dollars)

	1987	1986	1985
BALANCE AT BEGINNING OF YEAR	$225,733	$197,952	$184,313
NET INCOME FOR THE YEAR	151,316	151,426	175,957
Total	377,049	349,378	360,270
Cash dividends declared:			
Preferred stock	9,131	9,284	9,437
Preference stock	10,657	11,263	11,813
Common stock (per share: 1987—$1.20; 1986—$1.415; 1985—$2.06)	87,296	103,098	141,068
Total Cash Dividends Declared	107,084	123,645	162,318
BALANCE AT END OF YEAR	$269,965	$225,733	$197,952

STATEMENT OF CAPITAL SURPLUS

Year Ended December 31,
(Thousands of Dollars)

	1987	1986	1985
BALANCE AT BEGINNING OF YEAR	$926,131	$900,391	$804,377
Premium on common stock issued	—	25,682	96,197
Other	—	58	(183)
BALANCE AT END OF YEAR	$926,131	$926,131	$900,391

See Notes to Financial Statements.

NOTES TO FINANCIAL STATEMENTS

A. SUMMARY OF ACCOUNTING POLICIES

Property, Plant and Equipment

Properties are carried at original cost and generally are subject to a first mortgage lien. Cost includes direct labor, materials, indirect costs and an allowance for funds used during construction (AFC) of properties. AFC is included in construction work in progress (CWIP) and credited to other income for AFC attributable to equity funds and to interest expense for AFC attributable to borrowed funds, net of income taxes. AFC is a non-cash credit computed using a composite rate, which is applied to the balance of CWIP and assumes that funds used for construction are provided by borrowings and by preferred, preference and common stock equity. The average annual rate was 9%, 9.4% and 9.5% in 1987, 1986 and 1985, respectively.

Maintenance, repairs and replacements of minor units of property are expensed and replacements of retirement units of property and betterments are capitalized. The costs of property units retired, plus removal costs, less salvage, are charged to accumulated depreciation.

Revenues

Customer meters are read monthly or bimonthly and bills are rendered monthly. Revenues are recorded when billed.

Depreciation

Depreciation of electric plant, exclusive of coal properties is calculated on a straight-line basis determined in accordance with methods applied by the Pennsylvania Public Utility Commission (PUC). Depreciation, amortization and depletion of other property are calculated on various bases, such as amount of nuclear fuel burned and tons of coal mined.

The Company provides for decommissioning costs for Beaver Valley Unit No. 1 as ordered by the PUC. The Company is allowed to recover through current rates annual decommissioning annuity payments to provide for its share of the Unit's decommissioning costs, estimated to be $70 million in current dollars. At December 31, 1987 the Company had deposited $3.8 million in segregated accounts, which were established to pay for these costs.

In its 1987 rate case the Company requested similar rate treatment of its share of decommissioning costs for Perry Unit No. 1 and Beaver Valley Unit No. 2. Such costs are currently estimated to be $38 million and $20 million, respectively.

NOTES (continued)

Income Taxes

Deferred income taxes are provided principally for differences between depreciation for income tax purposes and depreciation for accounting purposes, to the extent permitted by the PUC for ratemaking purposes. Deferred taxes are also provided for expenses, such as fuel, extraordinary property losses and losses on early retirement of debt, which are deferred for accounting purposes but deducted currently for income tax purposes. Deferred tax credits are recorded for certain rate refunds which are recognized currently for accounting purposes but deducted over the refund period for income tax purposes. In compliance with regulatory accounting, income taxes are allocated between operating expenses and other income, principally with respect to interest charges related to CWIP. Investment tax credits related to regulated assets generally are deferred and amortized over the lives of the related facilities.

At December 31, 1987 the cumulative net amount of timing differences for which deferred income taxes have not been provided was approximately $269 million. These timing differences relate primarily to accelerated depreciation, certain taxes, the debt portion of AFC, pensions and certain other employee benefits.

Deferred Fuel Costs

The difference between actual fuel costs and fuel costs included in base rates is deferred until such costs are billed to customers through the energy cost rate. The energy cost rate is based on projected costs with provisions for subsequent adjustments to actual costs. Any overcollections of revenues are refunded to customers with interest.

Nuclear Fuel Costs

The Company finances its acquisition of nuclear fuel through capital lease and other arrangements. The Company's share of nuclear fuel costs under the lease agreements is charged to fuel expense based on the quantity of electric energy generated.

Under the Nuclear Waste Policy Act of 1982 (the Act), the United States Department of Energy is responsible for the ultimate storage and disposal of spent nuclear fuel removed from reactors. Under the Act the Company is required to pay a quarterly fee, which it recovers through rates.

Other

Other property and investments are stated principally at cost, less accumulated depreciation where applicable. Debt discount or premium and related expenses are amortized over the lives of the applicable issues.

Reclassifications

The 1986 and 1985 financial statements have been reclassified to conform with accounting presentations adopted during 1987.

B. EXTRAORDINARY PROPERTY LOSS

In 1967 the Company and four other electric utilities formed the Central Area Power Coordination (CAPCO) group. The CAPCO companies have placed in service three nuclear and five coal-fired generating units.

In March 1984 the CAPCO companies agreed to minimize construction work and cash expenditures on Perry Unit No. 2 pending consideration of several alternatives, including resumption of construction or cancellation of the Unit. The Company believes that any decision to resume construction of the Unit must be approved by all of the CAPCO companies. Based on present conditions, the Company will not approve resuming construction. The Company does not know what the positions of the other CAPCO companies will be with respect to the future of the Unit.

In 1987 the Company received approval from the PUC to amortize and recover its $155 million investment in the Unit over a ten-year period which began July 1, 1987 on the basis that the Company had abandoned its interest in the Unit in 1986. The unrecovered cost of the Unit at December 31, 1987 was $147.6 million. The Company is not earning a return on such unrecovered cost. See Note L.

C. RATE REFUNDS

Beaver Valley Replacement Power

A settlement in 1986 relative to a PUC investigation of certain outages at Beaver Valley Unit No. 1 provided for refunds to the Company's customers of $15.3 million, including interest, over a four-year period which began July 1, 1986. Accordingly, in 1986 the Company recorded the $11.5 million principal amount of the refunds and $2.7 million of interest expense. Additional interest expense on the unpaid balance of the refunds is being recorded over the refund period. The unpaid balance of the refunds was $6.9 million at December 31, 1987.

1981 Option Order

The Company was permitted in 1981 to increase its annual rates by $64.2 million in accordance with an option order of the PUC. In 1984 the Pennsylvania Supreme Court ruled that the option order was invalid and remanded the case to the PUC. In 1986 the PUC ordered refunds to the Company's customers of $32.8 million of revenues collected under the option order. The Company appealed the PUC's refund order to the Pennsylvania Commonwealth Court. As part of a settlement relating to the 1986 rate case (see Note J), the Company agreed to implement a refund program over an 18-month period which began July 30, 1987, pending disposition of the appeal with the Commonwealth Court.

The Company recorded the $32.8 million principal amount of the refunds and $10.3 million of interest in

1986. Interest on the unpaid balance of the refunds is being recorded over the refund period and amounted to $1.6 million in 1987.

On December 30, 1987 the Company deposited $30.8 million in an escrow account established for repayment of substantially all of the unpaid principal amount of refunds and interest accrued through December 31, 1987. This transaction has been accounted for as an extinguishment of debt. Accordingly, the liability for the refunds is not included in the Company's balance sheet as of December 31, 1987.

D. LOSS ON CANCELLED GENERATING UNITS

In 1980 the CAPCO companies cancelled the construction of four nuclear generating units. The Company received approval from the Federal Energy Regulatory Commission and the PUC to amortize and recover from its customers its share of the accumulated costs of the cancelled units ($34.3 million) over a ten-year period which began in 1983. The PUC's order approving the recovery of these costs, which was appealed by the Consumer Advocate to the Pennsylvania Commonwealth Court, was affirmed by that Court in 1985.

On October 15, 1987 the Pennsylvania Supreme Court issued an opinion as the result of a further appeal by the Consumer Advocate and other intervenors. The Court found that the Pennsylvania Public Utility Code prohibited the recovery of the cancelled generating units' costs because such units never provided service to the Company's customers. The Court remanded the matter to the PUC for proceedings consistent with its opinion.

In January 1988 the Company appealed the Pennsylvania Supreme Court's decision to the United States Supreme Court. Pending further proceedings in this matter, the Company recorded a loss in September 1987 equal to the original investment in the units of $34.3 million. The effect of recording this loss was to reduce earnings, net of income taxes of $15.5 million, by $18.8 million, or $.26 per share, in 1987.

E. BEAVER VALLEY UNIT NO. 2 SALE AND LEASEBACK

On October 2, 1987 the Company sold its 13.74% interest in Beaver Valley Unit No. 2, exclusive of transmission and common facilities. The total sale price was $537.9 million, which was the appraised value of the Company's interest in the property. Simultaneous with the sale, the Company leased back its interest in the Unit for a term of 29½ years. The leases provide for semiannual payments and are accounted for as operating leases. The semiannual lease payments for 1988 will be $26.4 million. Additionally, the Company will be required to pay fees for a letter of credit related to the sale and leaseback. Such fees will vary during the lease term and are estimated to be $1.7 million for 1988. The Company remains responsible under the terms of the leases for all operation, maintenance and decommissioning costs of the Unit.

Due to the difference between the Unit's cost at completion and its appraised value, the Company recorded a book loss of $23.8 million, or $.33 per share, in September 1987. Because AFC was not included in the tax basis of the Unit, the sale resulted in a taxable gain. The Company received permission from the PUC to recover the related taxes through rates over the term of the leases. The Company also received the benefit of certain lessors' investment tax credits resulting from the sale of the Unit. See Note G.

Proceeds from the sale were deposited with the trustee under the Company's first mortgage bond indenture and are being withdrawn in accordance with the terms of the indenture. At December 31, 1987 $345.3 million remained on deposit with the trustee.

The letter of credit referred to above secures the lessors' $116.3 million equity interest in the Unit. In addition, the Company was involved in the issuance of $421.6 million of collateralized lease bonds by an unaffiliated corporation for the purpose of financing the lessors' purchases of the Unit. Upon the occurrence of certain specified events, the leases could terminate and the letter of credit and/or the bonds would become direct obligations of the Company.

F. SHORT-TERM BORROWING AND REVOLVING CREDIT ARRANGEMENTS

The Company has two revolving credit agreements with two groups of banks totaling $225 million, available to May 15, 1988 and December 15, 1988 in the amounts of $125 million and $100 million, respectively. At December 31, 1987 no loans were outstanding under these agreements. Under certain conditions, borrowings outstanding under the two agreements may be converted to term notes. Interest rates fluctuate during the revolving and term periods, depending on the period of borrowings, at the prime rate and at percentages in excess of prime, Euro-rate and certificate of deposit rates. There is a commitment fee of ⅜% per annum on the average daily unborrowed amount of each commitment. The commitment fee on the $125 million agreement increases to ½% per annum on the average daily unborrowed amount upon the first borrowing against this commitment.

During 1987, 1986 and 1985, the maximum short-term bank and commercial paper borrowings outstanding was $46.5 million, $120 million and $23 million, the average daily short-term borrowings outstanding was $15.4 million, $59.4 million and $3.6 million, and the weighted average daily interest rate applicable to such borrowings was 7%, 6.6% and 8.2%, respectively.

NOTES (continued)

G. INCOME TAXES

	1987	1986	1985
	(Thousands of Dollars)		
Included in operating expenses:			
Currently payable:			
Federal	$ (23,929)	$ 15,913	$ 37,765
State	(1,053)	7,939	13,230
Deferred—net:			
Federal	60,911	40,871	29,034
State	1,434	(34)	743
Investment tax credits deferred—net	15,496	15,035	20,220
Total included in operating expenses	52,859	79,724	100,992
Included in other income:			
Currently payable:			
Federal	(25,655)	(28,073)	(23,015)
State	(5,966)	(6,406)	(5,252)
Deferred:			
Federal	(12,765)	(22,324)	—
State	(3,084)	(5,094)	—
Investment tax credits	(21,168)	(291)	(285)
Total included in other income	(68,638)	(62,188)	(28,552)
Total income tax expense (credit)	$ (15,779)	$ 17,536	$ 72,440

Total income taxes were less than the amount computed by applying the statutory federal income tax rate to income before income taxes. The reasons for this difference in each year were as follows:

	1987	1986	1985
Computed federal income tax at statutory rate	$ 54,147	$ 77,722	$114,262
Increase (decrease) in taxes resulting from:			
Allowance for funds used during construction	(41,379)	(50,869)	(45,546)
Excess of book over tax depreciation	(3,986)	(594)	6,215
State income taxes, net of federal income tax benefit	(5,206)	(1,941)	4,709
Amortization of deferred investment tax credits	(24,651)	(6,120)	(4,818)
Other—net	5,296	(662)	(2,382)
Total income tax expense (credit)	$ (15,779)	$ 17,536	$ 72,440

	1987	1986	1985
Sources of income taxes deferred and the related tax effects were:			
Excess of accelerated over straight-line depreciation	$ 36,427	$ 34,769	$ 20,388
Expensed on tax return and deferred on books:			
Loss on early retirement of bonds	(395)	1,403	19,362
Rate refunds (including interest)	23,196	(27,418)	—
Perry Unit No. 1 test period costs	8,319	—	—
Expensed on books but not deducted for tax purposes:			
Fuel costs	(7,810)	(1,630)	(6,572)
Loss on cancelled generating units	(17,016)	—	—
Amortization of extraordinary property losses	(3,152)	(1,738)	(1,703)
Other—net	6,927	8,033	(1,698)
Total income taxes deferred-net	$ 46,496	$ 13,419	$ 29,777

The Company's income tax returns are settled through 1981 and the returns for 1982 through 1985 have been examined. The Company's management believes that the settlement of federal and state taxes will not have a material adverse effect on the Company's financial position or results of operations. Investment tax credits included in other income relate principally to the sale and leaseback of Beaver Valley Unit No. 2. See Note E.

H. EMPLOYEE BENEFITS

The Company has trusteed retirement plans to provide pensions for all full-time employees, except coal mine employees who are covered under a plan administered by the United Mine Workers of America (UMW). Upon retirement, employees receive a monthly pension based on length of service and compensation. Pension costs, excluding the UMW plan, are funded in accordance with federal regulations and include amortization of most prior service costs over 30 years and prior service costs related to the Company's 1984 one-time early retirement program over 15 years. Pension costs charged to expense or construction for 1987, 1986 and 1985 were $12.3 million, $13.5 million and $13.4 million, respectively. Costs related to the UMW plan were $3.1 million, $2.9 million and $2.7 million for 1987, 1986 and 1985, respectively.

The Company adopted the provisions of Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions," as of January 1, 1987. Adopting this Statement did not have a material effect on the Company's pension expense for 1987.

The following sets forth the funded status of the plans and amounts recognized on the Balance Sheet at December 31, 1987. Since the UMW plan is a multi-employer plan, information concerning such plan is not determinable by the Company and is not included in the information below.

	(Thousands of Dollars)
Actuarial present value of benefit obligations:	
Vested benefits	$191,665
Nonvested benefits	14,212
Accumulated benefit obligations	$205,877
Plan assets—at fair value	$244,060
Actuarial present value of projected benefit obligations	266,389
Projected benefit obligation in excess of plan assets	$ (22,329)
Unrecognized net gain	$ 24,417
Unrecognized prior service cost	(15,159)
Unrecognized net transition liability	(30,160)
Net pension liability per balance sheet	(1,427)
Total	$ (22,329)

The projected benefit obligation was determined using assumed discount rates of 7.5% and 8% as of January 1 and December 31, 1987, respectively. The assumed change in compensation used was 5.7% and the long-term rate of return on plan assets was 7.5%. Plan assets consist primarily of common stocks, United States obligations and corporate debt securities. Net pension cost for 1987 was computed as follows:

	(Thousands of Dollars)
Service cost—benefits earned during 1987	$ 8,449
Interest on projected benefit obligations	18,645
Return on plan assets	(22,458)
Net amortization of deferrals	7,662
Net pension costs	$ 12,298

The actuarial present value of accumulated plan benefits as of January 1, 1986 was $174 million, of which $165 million was vested, and net assets available for benefits were $189 million. The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8%.

I. LEASES

	December 31,	
	1987	1986
	(Thousands of Dollars)	
Nuclear fuel	**$261,444**	$243,230
Electric plant (principally buildings and data processing equipment)	**29,463**	29,491
Total	**290,907**	272,721
Less accumulated amortization	**112,643**	85,563
Property held under capital leases—net	**$178,264**	$187,158

Leased nuclear fuel is amortized as the fuel is burned. The amortization of leased electric plant is based on the rental payments made. Amortization of leased property amounted to $27.6 million, $19.5 million and $24.9 million for 1987, 1986 and 1985, respectively.

Lease payments in 1987, 1986 and 1985 amounted to $59.9 million, $38.6 million and $43.6 million, respectively, of which $54.1 million, $35.5 million and $41.2 million (including deferred nuclear fuel lease payments), respectively, were charged to operating expenses.

The nuclear fuel leases may be terminated by the lessees or lessors with notice as defined in the agreements or by casualty or certain other contingencies, including default by the lessees. In certain situations involving a termination, the lessees may be required to purchase the leased fuel at the higher of fair market value or unamortized cost. At December 31, 1987 the Company's share of the lessors' unamortized cost of the leased fuel was $152 million, and the Company expects to finance an additional $43 million of such costs under current leasing arrangements. Approximately $70 million of the credit agreements supporting these leasing arrangements are scheduled to expire in 1988. The Company expects to enter into replacement agreements.

NOTES (continued)

The Company has certain properties or portions thereof under lease, including its corporate headquarters, subject to renewal options and in certain cases purchase options.

Future minimum lease payments for capital leases are related principally to building leases and the estimated usage of nuclear fuel, including a trust arrangement. Minimum payments for operating leases are related principally to Beaver Valley Unit No. 2 (see Note E) and corporate headquarters. Future minimum lease payments at December 31, 1987 were as follows:

Year Ending December 31,	Capital Leases	Operating Leases
	(Thousands of Dollars)	
1988	$ 40,669	$ 66,493
1989	36,752	65,684
1990	32,341	63,938
1991	24,659	62,802
1992	22,972	62,219
1993 and thereafter	92,204	1,542,700
Total minimum lease payments	249,597	$1,863,836
Less amount representing interest	58,638	
Present value of net minimum capital lease payments	$190,959	

J. RATE MATTERS

Sunset Legislation

The PUC Sunset Legislation, enacted in 1986, establishes a rebuttable presumption that a newly constructed base load generating unit is excess capacity. A unit's operating and construction costs can be recovered from ratepayers only if (1) the unit is found to be necessary to meet customer demand, including a reasonable reserve margin, and (2) the unit produces an annual economic benefit which exceeds the total annual cost of the plant.

The Company has agreed that an excess capacity adjustment shall be applicable to Beaver Valley Unit No. 2 until at least January 1, 1991. This adjustment will have an adverse effect on the Company's cash flow and results of operations until such time as the Unit is no longer considered to be excess capacity. The new law also could affect the Company's rate proceedings requesting rate treatment of Perry Unit No. 1 (see "1987 Rate Case").

Because it is uncertain how the PUC and the courts will further interpret and apply the statute relative to current and future rate proceedings, the Company is unable to predict the total effect the Sunset Legislation will have on its rates, financial position or results of operations.

1986 Rate Case

On July 16, 1987 the PUC approved a settlement of various issues relating to the Company's 1986 rate case. Under the terms of the settlement, the effective date of the $15.8 million rate reduction ordered by the PUC in the rate case was delayed from March 10, 1987 (the original date of the ordered reduction) to July 1, 1987. The Company will recover $5.2 million plus interest as a result of extending the old rates through June 30, 1987. This amount, which was recorded as revenue in 1987, will be collected over an 18-month period which began January 1, 1988. The settlement concluded all litigation relating to the 1986 rate case.

1987 Rate Case

On June 26, 1987 the Company filed with the PUC a rate schedule affecting all classes of customers and which, if approved, would increase annual revenues by approximately $379 million. In its filing the Company requested rate base treatment of its $716 million investment in Perry Unit No. 1 as well as its $665 million investment in Beaver Valley Unit No. 2. Both Units attained commercial operation, as determined by PUC guidelines, in November 1987.

On October 2, 1987 the Company completed a sale and leaseback of its 13.74% interest in Beaver Valley Unit No. 2. See Note E. In its orders approving the sale and leaseback, the PUC imposed a number of conditions, including the requirements that an excess capacity adjustment (consisting of a denial of a return on its equity investment in the Unit) will be applicable to the Unit until January 1, 1991 and that the Company's electric rates will be established as though the Company still had a 13.74% ownership interest in the Unit during this period. The PUC also required that the Company's rates in effect prior to January 1, 1992 may not reflect a common equity component greater than 42%. Finally, the Company will be unable to recover any portion of the lease expense related to the Unit until the Company's new rates are effective, which is expected to be in March 1988.

On October 28, 1987 the Company reduced the amount of its rate request to $318 million in order to reflect the effects of the sale and leaseback as well as other factors.

On February 1, 1988 an administrative law judge (ALJ) issued a decision recommending an increase in annual revenues of $234.5 million, to be phased-in over a six-year period in equal annual percentage increases not to exceed 7.8%. Interest would accumulate on the deferred amounts at the rate of 6%. The ALJ concluded that an excess capacity adjustment for Perry Unit No. 1 was unwarranted. However, he gave effect to the PUC's orders approving the sale and leaseback of Beaver Valley Unit No. 2 by imposing an excess capacity adjustment for that Unit. The adjustment, which was equivalent to a denial of the equity return on the investment in the Unit, reduced the annual revenue requirement by about $48 million. The ALJ found that no prudence adjustment was necessary for Perry Unit No. 1. However, an overall prudence disallowance for Beaver Valley Unit No. 2 of approximately

$372 million was deemed to be necessary, the Company's share of which would be $51 million. While the ALJ indicated that the disallowance should be offset by $24 million, the Company believes that a $33 million adjustment was previously recognized in connection with the sale and leaseback of the Unit. See Note E.

The ALJ's recommended decision is not binding on the PUC, which is scheduled to issue its final order in the rate case in late March 1988.

This excess capacity adjustment makes it unlikely that the Company's rates will be sufficient to recover all of the Unit's lease and other operating expenses until the adjustment is eliminated or substantially reduced. The adjustment will have an adverse effect on results of operations and cash flow until the Unit is no longer considered to be excess capacity.

Further, a finding by the PUC that all or part of Perry Unit No. 1 constitutes excess capacity or a disallowance for alleged imprudence in the construction of the Unit for the period after the date that fuel was loaded (March 21, 1986) could have a material adverse effect on the Company's results of operations and financial position.

Beaver Valley Unit No. 2
Construction Management Audit

The PUC directed that an outside consultant perform a construction management audit of Beaver Valley Unit No. 2 to determine, among other things, whether project costs were reasonable and proper. The Company has a 13.74% leasehold interest in the Unit and is the CAPCO company responsible for its construction and operation.

On September 17, 1987 the PUC released the audit report which concluded that the Company "did perform most of its overall duties in a reasonable manner", with the exception of "certain specific technical issues". The consultant estimated that the technical issues unnecessarily increased the Unit's cost by $219 to $271 million, which is five to six percent of the $4.4 billion total cost of the Unit.

In addition, the consultant concluded that the CAPCO companies extended the Unit's construction schedule due to financial, regulatory, capacity, load and technical considerations. The report quantified the cost of these extensions as being between $312 and $488 million. The report did not characterize these extensions and costs as avoidable or unreasonable.

The Company does not agree with the consultant's conclusions concerning avoidable costs and has challenged those conclusions in its pending rate case. See "1987 Rate Case" on page 28. The Company is unable to predict what action the PUC will take as a result of the audit. If the PUC concludes that any of the Unit's costs were imprudently incurred it could further disallow recovery of the lease expense related to the Unit.

Deferred Coal Costs (Mansfield)

The PUC directed the Company to limit its recovery of the cost of coal delivered to the Bruce Mansfield Plant (Mansfield coal) to the market price of similar coal, rather than the actual cost of Mansfield coal. The Company is required to defer the excess of the actual cost of Mansfield coal over the cost allowed to be recovered through its energy cost rate.

The Company believes that the total amount of deferred coal costs may vary during the term of the Mansfield coal sales agreement which expires in 1999. See Note K. Fluctuations may result depending on actual Mansfield coal costs, market price of coal and other factors. The unrecovered cost of Mansfield coal paid by the Company was $9.9 million and $11.7 million (as adjusted) at December 31, 1987 and 1986, respectively. The Company believes that the deferred costs will ultimately be recovered.

Other Deferred Coal Costs

In accordance with a 1981 PUC order, the cost of coal from the Company's wholly-owned Warwick Mine in excess of the average market price of similar quality coal purchased by Pennsylvania utilities may not be recovered through the energy cost rate, but must be deferred and recovered to the extent the cost of the coal falls below such market price. In April 1987 the PUC expanded this limit on the recovery of fuel costs to include all coal delivered to the Company's wholly and jointly owned power stations (except the Mansfield Plant). Such deferred costs amounted to $6.3 million and $7.8 million at December 31, 1987 and 1986, respectively. The Company believes that the deferred costs will ultimately be recovered. Additionally, the PUC eliminated the Warwick Mine from the Company's rate base in 1981. The exclusion from rate base was $49.1 million at December 31, 1987.

Property Held For Future Use

The PUC approved the Company's requests to place most of the Brunot Island and Phillips Power Stations in "cold reserve". The Company's net investment in the cold-reserved units was $106 million at December 31, 1987 and is included in the Balance Sheet as "Property held for future use". $36 million of this investment had been removed from rate base at December 31, 1987. The PUC's orders provide that the approvals are not to be considered precedent for excess capacity issues in the 1987 rate case (see "1987 Rate Case" on page 28) or in subsequent rate proceedings. The Company believes that its investment in the cold-reserved units eventually will be recovered.

K. COMMITMENTS AND CONTINGENCIES

Construction

The Company estimates that it will spend $545 million on construction, exclusive of nuclear fuel and AFC, during the period 1988 through 1992.

NOTES (continued)

Quarto Mining Company

The CAPCO companies originally entered into a long-term coal supply arrangement with Quarto Mining Company (Quarto), an unaffiliated company. As part of this arrangement the individual CAPCO companies severally, not jointly, guaranteed their proportionate shares of Quarto's debt and lease obligations incurred in connection with the development and equipping of Quarto's coal properties. At December 31, 1987 the Company had guaranteed $46 million of Quarto debt as well as lease obligations relating to $13.3 million of capital equipment. In general, the purchase prices paid for the coal received under the foregoing arrangements included amounts sufficient to service the guaranteed obligations.

The Company's estimated future minimum payments under the coal supply contract are:

Year Ending December 31,	(Thousands of Dollars)
1988	$ 8,672
1989	8,337
1990	8,002
1991	7,668
1992	7,455
After 1992	43,246
Total	$83,380

Pursuant to an assignment from the CAPCO companies on March 11, 1987, Consolidation Coal Company (Consol) acquired all the common stock of Quarto. On April 10, 1987 the existing contract for the delivery of coal from Quarto was substantially amended, restated in its entirety and incorporated into a contract with Consol. Under this contract, Consol is obligated to deliver up to 5 million tons of coal annually through December 31, 1999. The restated contract also includes a stated unit price (subject to escalation) for the coal rather than a cost-plus arrangement. The several guarantees of the CAPCO companies described above were not affected by these changes. It is expected that these new arrangements will make the supply of coal more secure and economical over the period of the contract. Total payments under these contracts were $25.8 million, $28.9 million and $29.4 million in 1987, 1986 and 1985, respectively.

Shareholder Suits

Subsequent to the reduction of the quarterly dividend on the Company's common stock in 1986, five complaints were filed against the Company and/or its directors. Two of the complaints have been dismissed without prejudice. While the remaining three complaints are not identical, they collectively seek compensatory and punitive damages in an undetermined amount for alleged violations of securities laws, as well as common law fraud and negligent misrepresentation.

The cases have been consolidated for all further proceedings. While discovery has commenced, no class has yet been certified in any of the claims. Although the Company is unable to predict the ultimate outcome of these matters it is continuing to contest the three complaints, and believes that the complaints are without merit and that resolution of this matter will not have a material adverse effect on its financial position or results of operations.

Nuclear Insurance

The CAPCO companies maintain a nuclear insurance program to the maximum extent available. This program currently provides $750 million of primary and excess property insurance and $775 million of decontamination liability and excess property insurance coverage for the $5.6 billion interest in Beaver Valley Units Nos. 1 and 2. The companies also have similar property insurance for the $5.8 billion interest in Perry Unit No. 1. The companies are subject to various retrospective premium adjustments in the event of accidents at these units or at certain other utilities' nuclear plants. Based on its current interest in three operating nuclear reactors, the Company's share of any such assessment would be approximately $4 million per year.

The Price-Anderson Amendments to the Atomic Energy Act limit liability to third parties to $720 million for each nuclear incident. Coverage for such liability is provided by $160 million of insurance and $560 million of retroactive assessments against all operating nuclear reactors in the United States. Based on its present interest in three operating reactors, the Company's maximum potential assessment under the Amendments would be $7.5 million per year. The current Amendments expired on August 1, 1987; however, licensees continue to be covered under the Act's expired provisions. Congress has tentatively agreed to increase the liability to third parties to approximately $7 billion for each nuclear incident.

LTV Steel Company

The Company has been involved in various regulatory and court proceedings with LTV Steel Company, Inc. (LTV), which filed for reorganization under Chapter 11 of the federal bankruptcy laws in 1986. On August 13, 1987 the federal bankruptcy court approved a Compromise and Settlement Agreement between LTV and the Company. Under the terms of the Agreement, the amount of the Company's claim in bankruptcy for $9.7 million for past service and $35.8 million under a long-term electric service contract was set at a total of $30 million. The Agreement also permitted the Company to offset LTV's share of refunds related to the 1981 option order (see Note C—"RATE REFUNDS—1981 Option Order") against the amount of the claim. Recovery of all or part of this $30 million unsecured claim will depend upon the amount of funds ultimately available to pay all of LTV's unsecured creditors.

Fuel Purchase Commitments

The Company is obligated to purchase minimum quantities of coal and nuclear fuel under various fuel supply arrangements. Prior years' purchases from an unaffiliated coal supplier were less than the minimum quantities specified in the contract and resulted in a total shortfall of 417,000 tons at December 31, 1987. The Company is currently making up this shortfall at the rate of approximately 50,000 tons per month.

Other

The Company is involved in various other legal proceedings. The Company believes such proceedings will not have a material adverse effect on its financial position or results of operations. See Note J for a description of various other contingencies related to rate matters.

L. NEW ACCOUNTING STANDARDS

In 1986 the Financial Accounting Standards Board (FASB) issued Statement No. 90, "Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs". The Statement prescribes how the Company must account for abandoned plants and disallowances of costs associated with newly-completed plants. The Company will adopt Statement No. 90 in the first quarter of 1988 and restate previously-issued financial statements.

Adoption of the Statement will reduce the Company's investment in Perry Unit No. 2 at December 31, 1987 by $35 million. As restated, net income for 1986 will decrease by $20 million and increase by $3 million in 1987 and by decreasing amounts over the remainder of the recovery period. See Note B.

The FASB issued Statement No. 92, "Regulated Enterprises—Accounting for Phase-in Plans", in August 1987. This Statement specifies how utilities must account for rate orders that gradually increase electric rates when a new plant is placed in service. Utilities whose plans do not meet the requirements of the Statement will be required to record expenses immediately, rather than deferring such expenses to later years when they would be recovered through rates. The Statement also permits the capitalization of an equity return on plant investment only during construction or in connection with phase-in plans that meet the requirements of the Statement.

Although the Company currently does not have any phase-in plans in effect, it has proposed such a plan as part of its 1987 rate case. See Note J. It is possible that a resolution of the rate case could result in the PUC's adoption of a phase-in plan which does not meet the criteria of Statement No. 92 and which would have an adverse effect on the Company's results of operations until the entire rate increase has been reflected in rates.

In December 1987 the FASB issued Statement No. 96, "Accounting for Income Taxes", which changes the method of accounting for income taxes. The Company must adopt the provisions of the Statement by January 1, 1989. The Company is currently determining what effect this Statement will have on its financial statements.

M. CAPITALIZATION

Common Stock

The Company has paid a regular quarterly common stock dividend each year beginning in 1953. The dividends for the first two quarters of 1986 were 51½ cents per share. Dividends for the last two quarters in 1986 and for each quarter in 1987 were 30 cents per share.

Dividends may be paid on the common stock to the extent permitted by law and as declared by the Board of Directors, subject to the provisions of the Company's Restated Articles which restrict the payment of cash dividends or other distributions on, or the purchase of, its capital stock ranking junior to its preferred stock. Pennsylvania law provides that dividends on common stock may only be paid out of positive retained earnings.

No dividends or distributions may be made on the common stock if dividends or sinking or purchase fund obligations on the preferred or preference stock are accumulated and unpaid. Further, the aggregate amount of junior stock payments is generally limited to certain percentages of net income and by the ratio of common stockholders' equity to total capitalization. No portion of retained earnings at December 31, 1987 was so restricted.

During the fourth quarter of 1987, the Company repurchased 3,032,600 shares of common stock at a total cost of $34.8 million. The Company expects to purchase additional shares during 1988.

In 1987 the Company's shareholders approved a Long-Term Incentive Plan through which the Company may grant options to management employees to purchase up to a total of 3 million shares of its common stock during the period 1987-1997. The exercise price of each option may not be less than the market price of the stock on the date of the grant. As of December 31, 1987 active grants totaled 1,053,845 shares at an exercise price of $12.3125 per share. Stock appreciation rights (SARs) have been granted in connection with all options outstanding. None of these options or SARs may be exercised prior to January 1, 1989.

High/low stock prices for 1987 and 1986 were as follows:

	1987		1986	
Quarter	High	Low	High	Low
1st	$14⅜	$12½	$19⅜	$16
2nd	13⅛	11½	18¾	13
3rd	12⅞	11¾	15¼	12¾
4th	12¾	10⅜	13¾	12¼

The principal trading market for the Company's Common Stock is the New York Stock Exchange. The stock also is listed on the Philadelphia Stock Exchange.

NOTES (continued)

Preferred and Preference Stock

The preferred stock is entitled to quarterly cumulative dividends. If four quarterly dividends on any series of preferred stock are in arrears, holders of the stock are entitled to elect a majority of the Board of Directors until all dividends on such stock have been paid.

The preference stock is entitled to quarterly cumulative dividends except that no dividends may be paid if dividends on any series of the preferred stock are accumulated and unpaid. If six quarterly dividends on any series of preference stock are in default, the holders of the preference stock are entitled to elect two directors until all dividends in arrears on such stock have been paid.

The outstanding preferred and preference stock generally are callable on not less than thirty days' notice at the prices stated in the table on page 33 plus accrued dividends. Certain call prices decline in future years. The $9.125 preference series is not redeemable prior to January 1, 1989 through certain refunding operations; however, it is otherwise redeemable at $100 plus a premium which decreases from $4.80 in 1988 to zero in 1998.

The $7.50 preference stock is subject to a non-cumulative purchase fund under which the holders of the stock may tender, and the Company is required to purchase, annually at $100 per share up to 4% of the number of shares originally issued. The $9.125 preference stock is subject to a cumulative sinking fund which will retire 33,300 shares on January 1 in each year through 1997 at $100 per share. The Company may on a non-cumulative basis retire an additional 33,300 shares in each such year, provided that the Company may not retire through the exercise of this option more than an aggregate of 150,000 shares.

The $8.64 preferred stock is subject to a non-cumulative purchase fund under which the Company offers to purchase annually up to 6,000 shares at not more than $100 per share. The $8.375 preferred stock is subject to a cumulative sinking fund which will retire 12,000 shares on April 1 in each year at $100 per share. The Company may on a non-cumulative basis retire an additional 12,000 shares in each such year.

As of December 31, 1987 the maximum combined aggregate sinking fund and mandatory purchase requirements for preferred and preference stock is $6,430,000 for each of the next five years.

Gains on the redemption of capital stock are recorded in capital surplus; losses, to the extent they exceed cumulative gains, are charged to retained earnings.

The following summary indicates the changes in the number of shares of common, preferred and preference stock outstanding during 1987, 1986 and 1985:

	Year Ended December 31,		
	1987	1986	1985
Common Stock:			
Shares outstanding at beginning of year	73,119,446	71,488,270	64,774,591
Issuances:			
Common stock sales	—	—	3,000,000
Dividend reinvestment plan	—	1,631,176	3,656,923
Employee stock ownership plans	—	—	56,756
Reissuances of treasury stock	8,800	—	—
Repurchase of common stock	(3,032,600)	—	—
Shares outstanding at end of year	70,095,646	73,119,446	71,488,270
Preference Stock:			
Shares outstanding at beginning of year	3,109,960	3,264,460	3,337,985
Purchases and redemptions—$2.75 Series	(55,000)	(110,000)	(27,665)
—$7.50 Series	(7,550)	(11,200)	(12,560)
—$9.125 Series	(33,300)	(33,300)	(33,300)
Shares outstanding at end of year	3,014,110	3,109,960	3,264,460
Preferred Stock:			
Shares outstanding at beginning of year	2,072,841	2,090,841	2,108,841
Purchases—$8.375 Series	(12,000)	(12,000)	(12,000)
—$8.64 Series	(6,000)	(6,000)	(6,000)
Shares outstanding at end of year	2,054,841	2,072,841	2,090,841

	Call Price Per Share	December 31, 1987 Shares Outstanding	Amount	December 31, 1986 Shares Outstanding	Amount
Capital Surplus:					
Premium on common stock			$933,325,825		$933,325,825
Capital stock expense			(7,561,053)		(7,612,032)
Other			365,711		416,748
Total Capital Surplus			$926,130,483		$926,130,541
Non-redeemable Preferred and Preference Stock:					
Preferred stock—$50 par value (cumulative) (1):					
4% Series (2)	$ 51.50	549,969	$ 27,498,450	549,969	$ 27,498,450
3.75% Series (2)	51.00	150,000	7,500,000	150,000	7,500,000
4.15% Series (2)	51.73	140,000	7,000,000	140,000	7,000,000
4.20% Series (2)	51.71	100,000	5,000,000	100,000	5,000,000
4.10% Series (2)	51.75	120,000	6,000,000	120,000	6,000,000
$2.10 Series (2)	51.84	160,000	8,000,000	160,000	8,000,000
$7.20 Series (3)	101.00	350,000	17,500,000	350,000	17,500,000
Preference stock—$1 par value (cumulative) (1):					
$2.315 Series (4)	25.90	1,200,000	1,200,000	1,200,000	1,200,000
$2.10 Series (4)	25.70	1,200,000	1,200,000	1,200,000	1,200,000
Total			80,898,450		80,898,450
Premium on non-redeemable preferred and preference stock			75,238,760		75,238,760
Total Non-redeemable Preferred and Preference Stock			$156,137,210		$156,137,210
Involuntary Liquidation Value			$155,998,450		$155,998,450
Redeemable Preferred and Preference Stock:					
Preferred stock—$50 par value (cumulative) (1):					
$8.64 Series (3)	$104.00	232,872	$ 11,643,600	238,872	$ 11,943,600
$8.375 Series (3)	112.00	252,000	12,600,000	264,000	13,200,000
Preference stock—$1 par value (cumulative) (1):					
$7.50 Series (3)	103.00	214,010	214,010	221,560	221,560
$2.75 Series (4)(5)		—	—	55,000	55,000
$9.125 Series (3)	105.28	400,100	400,100	433,400	433,400
Total			24,857,710		25,853,560
Premium on redeemable preferred and preference stock			85,040,490		91,304,640
Purchase and sinking fund requirements			(5,130,000)		(6,505,000)
Total Redeemable Preferred and Preference Stock			$104,768,200		$110,653,200
Involuntary Liquidation Value			$104,768,200		$110,653,200

(1) Authorized shares: preferred stock—4,000,000; preference stock—8,000,000.
(2) $50 per share involuntary liquidation value.
(3) $100 per share involuntary liquidation value.
(4) $25 per share involuntary liquidation value.
(5) Final redemption August 1, 1987.

NOTES (continued)

First Mortgage Bonds:	Principal Amount Outstanding at December 31,	
	1987	1986
Series due April 1, 1988 (3¾%)	$ 15,000,000	$ 15,000,000
Series due March 1, 1989 (4¼%)	10,000,000	10,000,000
Series due March 1, 1991 (13⅜%)	49,500,000	50,000,000
Series due December 1, 1992 (10¼%)	75,000,000	75,000,000
Series due June 1, 1995 (10⅜%)	50,000,000	50,000,000
Series due February 1, 1996 (5⅛%)	22,800,000	22,800,000
Series due February 1, 1997 (5¼%)	24,600,000	24,600,000
Series due February 1, 1998 (6⅛%)	34,700,000	34,700,000
Series due January 1, 1999 (7%)	30,000,000	30,000,000
Series due July 1, 1999 (7¾%)	28,947,000	28,947,000
Series due March 1, 2000 (8¾%)	30,000,000	30,000,000
Series due March 1, 2001 (7⅞%)	35,000,000	35,000,000
Series due December 1, 2001 (7½%)	26,461,000	26,461,000
Series due June 1, 2002 (7½%)	28,470,000	28,470,000
Series due January 1, 2003 (7¼%)	32,670,000	32,670,000
Series due July 1, 2003 (7¾%)	35,000,000	35,000,000
Series due April 1, 2004 (8⅜%)	44,100,000	44,100,000
Series due March 1, 2005 (9½%)	50,000,000	50,000,000
Series due June 1, 2006 (9%)	80,000,000	80,000,000
Series due April 1, 2007 (8⅜%)	97,400,000	97,400,000
Series due February 1, 2009 (10⅛%)	100,000,000	100,000,000
Series due January 1, 2010 (12¼%)	57,400,000	60,000,000
Series due May 1, 2012 (16¼%)	2,597,000	3,277,000
Series due April 1, 2013 (12⅛%)	57,914,000	60,000,000
Series due December 1, 2013 (13%)	49,500,000	50,000,000
Series due February 1, 2015 (11⅛%)	39,000,000	39,000,000
Series due December 1, 2015 (11⅜%)	123,750,000	125,000,000
Series due December 1, 2016 (9½%)	100,000,000	100,000,000
Series due February 1, 2017 (9%)	100,000,000	—
Total	1,429,809,000	1,337,425,000
Less: Current maturities—Series due April 1, 1988 (3¾%)	15,000,000	—
Current sinking fund requirements	13,140,000	11,290,000
Total First Mortgage Bonds	**$1,401,669,000**	$1,326,135,000

During 1986 and 1987 the Company reacquired a total of $26.1 million of first mortgage bonds. The difference between the purchase prices and the net carrying amounts of the bonds was $2.9 million and has been included in the Balance Sheet as "Unamortized loss on reacquired debt". The Company amortizes and recovers these losses through rates.

The trust indenture securing the first mortgage bonds provides that no additional bonds may be issued unless the "earnings applicable to bond interest", as defined by the indenture, are at least twice the annual interest requirements on the additional bonds and on all bonds outstanding. At December 31, 1987 this restriction precluded the Company from issuing additional bonds. However, a separate provision of the indenture permitted issuance of $198 million of additional bonds at December 31, 1987 on the basis of previously-issued bonds which have been retired.

Other Long-Term Debt:

Pollution Control Obligations:

Date of Issuance	Average Interest Rate	Serial Maturity or Mandatory Redemption Beginning	Final Maturity	Principal Amount Outstanding at December 31, 1987	1986
September 21, 1972	5.49%	1983	2002	$ 21,400,000	$ 22,000,000
June 21, 1973	5.685%	1984	2003	11,200,000	11,400,000
October 25, 1973	5.755%	1984	2003	14,625,000	15,000,000
August 13, 1974	7.97%	1989	2004	14,000,000	14,000,000
April 2, 1975	7.50%	1993	2005	17,000,000	17,000,000
October 29, 1975	8.40%	1991	2005	18,000,000	18,000,000
September 29, 1976	6.90%	1994	2011	15,000,000	15,000,000
March 24, 1981	12.00%	2002	2011	50,000,000	50,000,000
November 1, 1983	10.50%	—	2013	20,500,000	20,500,000
December 19, 1984	11.625%	—	2014	51,000,000	51,000,000
October 24, 1985	7.75%	—	2015	44,250,000	44,250,000
Total				276,975,000	278,150,000
Less current maturities and sinking fund requirement				1,175,000	1,175,000
Total Pollution Control Obligations				275,800,000	276,975,000
Nuclear fuel obligations				12,695,050	10,058,070
5% sinking fund debentures (authorized—$20,000,000) due March 1, 2010				9,104,000	9,104,000
Total Other Long-Term Debt				$297,599,050	$296,137,070

The pollution control obligations arise from the sale of bonds by governmental authorities in connection with the construction of pollution control facilities at the Company's plants. The Company is obligated to pay to the authorities amounts equal to the principal of and interest on such bonds.

There is an annual commitment fee of ½% for an irrevocable letter of credit which expires on October 15, 1990 and which is available for the payment of interest on or redemption of a portion of the bonds under certain circumstances. Under certain circumstances the holders may tender the bonds for mandatory purchase.

The nuclear fuel obligations result from a trust arrangement for the procurement of a portion of the Company's nuclear fuel. Interest is capitalized and included in CWIP at rates ranging from 1⅛% to 1½% over the trustee's commercial paper rate. Trust obligations will be paid by the Company as the related fuel is withdrawn from the trust.

Sinking fund requirements and maturities for the next five years of long-term debt outstanding, exclusive of nuclear fuel obligations, as of December 31, 1987 were as follows:

Year Ending December 31	Sinking Fund Requirements	Maturities
1988	$15,810,000	$15,800,000
1989	16,140,000	10,900,000
1990	16,140,000	900,000
1991	15,595,000	51,050,000
1992	15,270,000	76,000,000

The sinking fund requirements relate primarily to the first mortgage bonds and may be satisfied by the certification of property additions equal to 166⅔% of the bonds required to be redeemed.

Total interest costs incurred during 1987, 1986 and 1985 were $195.4 million, $182.1 million and $169 million, respectively, of which $128.7 million, $124.4 million and $115.6 million were capitalized or deferred, including AFC. During 1987 and 1986, approximately $2 million and $13 million, respectively, of these costs were related to rate refunds. See Note C.

NOTES (continued)

N. JOINTLY-OWNED GENERATING UNITS

The Company, together with other electric utilities, primarily the CAPCO companies, has an ownership or leasehold interest in certain jointly-owned units. Under the terms of the arrangements with the other owners of these jointly-owned units, the Company is required to provide its share of financing the costs of such units. The Company's share of the direct expenses (fuel, maintenance and other operation expenses) of the jointly-owned units is included in the corresponding operating expenses in the Statement of Income. Information regarding the Company's share of such jointly-owned units as of December 31, 1987 is as follows (thousands of dollars):

			Company's Interest		
Unit	Percentage Interest	Megawatts	Utility Plant in Service	Accumulated Depreciation	Construction Work in Progress
Fort Martin No. 1	50.0	276	$ 51,302	$ 19,986	$ 6,030
CAPCO Units:					
Eastlake No. 5	31.2	202	53,952	16,930	11,901
Sammis No. 7	31.2	187	73,448	17,945	2,186
Bruce Mansfield No. 1	29.3	228	74,102	23,681	123
Bruce Mansfield No. 2	8.0	62	20,588	5,874	103
Bruce Mansfield No. 3	13.74	110	72,007	16,102	(59)
Bruce Mansfield Common and Shared Facilities			64,998	21,210	429
Beaver Valley No. 1	47.5	385	382,251	93,955	6,203
Beaver Valley No. 2	13.74	114	5,092	0	0
Beaver Valley Common Facilities			193,557	12,464	1,244
Perry No. 1	13.74	165	742,533	0	0
Total		1,729	$1,733,830	$228,147	$28,160

O. QUARTERLY FINANCIAL INFORMATION (Unaudited)

The following is a summary of selected quarterly financial data (thousands of dollars, except per share amounts):

Quarter Ended	Operating Revenues	Operating Income	Net Income	Earnings Per Share
March 31, 1986	$232,006	$47,215	$42,875	$.52
June 30, 1986	214,379	45,461	37,543	.44
September 30, 1986	227,345	48,315	45,993	.56
December 31, 1986	222,333	48,523	25,015(1)	.27(1)
March 31, 1987	**$215,928**	**$47,599**	**$45,210**	**$.55**
June 30, 1987	**212,199**	**48,908**	**47,806**	**.59**
September 30, 1987	**240,955**	**59,41[illegible]**	**13,995**	**.12**
December 31, 1987	**218,922**	**29,814**	**44,305(2)**	**.55(2)**

(1) In the fourth quarter of 1986, the Company recorded refunds to customers related to a 1981 Option Order which reduced fourth quarter earnings by $21.1 million, or approximately $.30 per share. See Note C.

(2) In the fourth quarter of 1987, the Company recorded approximately $21 million of investment tax credits related to the sale and leaseback of Beaver Valley Unit No. 2 (see Note E) which increased fourth quarter earnings by $.29 per share.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAPITAL RESOURCES AND LIQUIDITY

Construction

Construction expenditures during 1987, exclusive of AFC and nuclear fuel, were $155 million and were primarily for the construction of Perry Unit No. 1 and Beaver Valley Unit No. 2, both of which went into commercial operation in November 1987. Expenditures were also made to improve and expand production, transmission and distribution systems and for pollution control equipment. In 1987 the Company completed an extensive construction program largely related to the construction of new generating facilities.

The Company currently estimates that its construction expenditures, exclusive of AFC and nuclear fuel, will be $115, $100, $105, $110, and $115 million for each of the years 1988 through 1992, respectively. These estimates assume, among other things, that there will be no new environmental regulation, such as "acid rain" legislation, which would require large capital expenditures.

Financing

The Company anticipates that funds for construction expenditures in the next several years will be provided from cash becoming available from operations and, to a minimal extent, the issuance of additional securities.

The percentage of internally generated funds for 1988 will be a direct result of the outcome of the Company's pending rate case and whether a phase-in plan is ordered by the PUC. See Note J.

On February 11, 1987 the Company issued $100 million of 9% first mortgage bonds, series due February 1, 2017. Portions of the net proceeds from this transaction were used to pay short-term indebtedness incurred principally for construction purposes. The balance was used for general corporate purposes. There were no issuances of the Company's equity securities in 1987.

The Company finances its nuclear fuel requirements by leasing and other arrangements whereby it may finance up to $208 million of nuclear fuel. As of December 31, 1987 $165 million of nuclear fuel, including interest, storage and other costs, was financed under these arrangements.

In 1987 $12.5 million was required for maturities of long-term debt and sinking fund and stock purchase requirements. It is anticipated that $22.9 million will be required in 1988 for similar purposes.

Interim financing has been and will continue to be provided through bank borrowings and sales of commercial paper. See Note F.

The Restated Articles of the Company require that as a condition for the issuance of preferred stock, earnings (after income taxes) available for interest charges be at least 1.5 times the sum of interest charges on all indebtedness plus preferred stock dividend requirements. This restriction currently precludes the Company from issuing preferred stock. There is no similar restriction upon the issuance of the Company's preference or common stock. Also see Note M.

In order to maintain earnings adequate to finance construction expenditures and funding requirements, the Company requires rate increases sufficient to offset increased costs and provide a fair rate of return to its stockholders.

On October 2, 1987 the Company completed the sale and leaseback of its interest in Beaver Valley Unit No. 2. See Note E. The Company intends to use the proceeds to refund, refinance or repurchase its outstanding securities and for general corporate purposes.

During the period from October 2, 1987 to February 29, 1988, the Company repurchased nearly 4 million shares of its common stock for approximately $47 million and spent approximately $16 million to retire certain first mortgage bonds.

These transactions reduced interest expense and other costs associated with the Unit and increased the Company's financial flexibility.

Rate Matters

As discussed in Note J, the outcome of prudence and excess capacity issues related to the construction of Perry Unit No. 1 have created uncertainties as to whether the Company will recover and earn a return on its entire investment in that Unit, and that an excess capacity penalty will apply to Beaver Valley Unit No. 2 until at least 1991. Additionally, the PUC's final decision in the 1987 rate case and in future rate cases will determine whether the Company fully recovers its investments and operating costs related to these units. An adverse outcome of these and other rate matters could have a material adverse effect on the Company's financial position and results of operations.

Effects of Inflation

Because the Company's rates are regulated, any increases in its cost of service will not be included in rates charged to customers until it can implement new rates through a proceeding filed with the PUC.

The Company, by holding assets such as receivables, prepayments and inventory, suffers a loss of purchasing power during periods of inflation because the amount of cash received in the future for these items will purchase less. Conversely, by incurring monetary liabilities, primarily long-term debt, the Company benefits because repayments in the future will be made with dollars having less purchasing power.

The regulatory process limits the amount of depreciation expense recovered through rates and limits utility plant in rate base to original cost. Such amounts produce cash flows which are inadequate to replace such property or preserve the purchasing power of equity capital previously invested. While this effect is partially mitigated by the benefit derived from incurring long-term debt, the Company has a net purchasing power loss which is borne by the common stockholders and can only be overcome by adequate rate relief.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (continued)

Outlook

Because the Company is no longer recording AFC on Perry Unit No. 1 and Beaver Valley Unit No. 2, the Company expects that it will experience declines in net income and earnings per share of common stock in 1988. However, since AFC is a noncash item, the Company's cash flow and thus its liquidity is not expected to be materially affected. The loss of AFC will be partially offset by the recording of carrying charges applicable to these Units through March 1988.

The extent to which funds from operations will continue to be available to pay dividends and finance the Company's capital needs depends upon its financial condition, earnings, business prospects, the regulatory climate and other relevant factors. The Company is concerned about further unfavorable decisions in rate-related proceedings, recent changes in accounting principles, and other problems which it and the electric utility industry is experiencing in bringing new generating capacity on line and fully into rate base. The Company is particularly concerned about the Pennsylvania "Sunset Legislation", discussed in Note J, and the increased uncertainty associated with the regulation of electric rates. These uncertainties could have a material adverse effect on the Company's revenues, net income and cash flow and its ability to obtain financing and pay dividends.

RESULTS OF OPERATIONS

Operating Revenues

Operating revenues increased (decreased) in the years 1985 through 1987 over the respective preceding years, for the following reasons:

	1987	1986	1985
	(Millions of Dollars)		
General rate increases (decreases)	$ (7.6)	$ [illegible]	$ 27.3
Electrical consumption	10.8	(23.3)	(19.4)
Energy cost rate revenues	(10.9)	(9.9)	.6
State tax adjustment and other	([illegible])	.6	(1.8)
Revenues from other utilities	6.5	(.5)	14.6
Total	$ (8.3)	$(22.2)	$ 21.3

Operating revenues are based on rates authorized by the PUC and are designed to recover operating expenses, plus a rate of return on the investment in utility rate base.

The general rate decrease in 1987 resulted from the final order in the 1986 rate case. See Note J. There was no rate increase in 1986. In 1985 the Company was permitted rate increases in January and November which were estimated to increase annual revenues by $31.4 million and $10.8 million, respectively. The fluctuations in electrical consumption resulted from changes in kilowatt-hour sales to industrial customers. The fluctuations in energy cost rate revenues were due to changes in kilowatt-hour sales and in the energy cost rate. The decrease in state tax adjustment revenues in 1987 was due to a reduction in the state corporate net income tax rate effective January 1, 1987. Favorable capacity situations and the requirements of neighboring utilities resulted in increased sales to other utilities during the three-year period.

Operation and Maintenance Expenses

Total operation expenses (fuel, purchased power and other operation) increased in 1987 due to increases in deferred energy costs and general and administrative expenses and rent expense associated with the Beaver Valley Unit No. 2 lease. See Note E. Total operation expenses decreased slightly in 1986 compared to 1985 due to decreases in deferred energy costs, which were substantially offset by increases in general and administrative expenses and transmission expenses.

Maintenance expense was significantly higher in 1986 than in 1987 and 1985 because of scheduled outages of the Cheswick Station and Beaver Valley Unit No. 1 in 1986.

Depreciation and Taxes

Depreciation and amortization increased in 1987 due to the amortization of Perry Unit No. 2 beginning in July 1987. See Note B. Depreciation decreased in 1986 compared to 1985 due to a service life study which increased the expected service lives of certain of the Company's assets.

The decreases in income taxes were primarily due to decreases in taxable income in 1987 and 1986 and to lower federal and state income tax rates and the amortization of deferred investment tax credits in 1987. The effective income tax rates for 1987, 1986 and 1985 were (12%), 10% and 29%, respectively.

Other Income and Deductions and Interest Charges

AFC decreased significantly when Beaver Valley Unit No. 2 was sold in October 1987 and Perry Unit No. 1 was placed in commercial operation in November 1987. This decrease was largely offset by $11.1 million of carrying charges applicable to these Units included in other income. The increase in AFC in 1986 compared to 1985 was due to increased construction costs.

Interest income increased because of greater amounts of cash available for investments and $7.2 million of interest accrued on the proceeds of the sale of Beaver Valley Unit No. 2.

The adverse effects on 1987 net income and earnings per share of the loss on cancelled generating units and the loss on sale and leaseback of Beaver Valley Unit No. 2 are discussed in Notes D and E. The adverse effects of two rate refunds recorded in 1986 are discussed in Note C.

SELECTED FINANCIAL DATA AND STATISTICAL SUMMARY

(Thousands of Dollars, Except Per Share Amounts)

	1987	1986	1985	1984	1983	1982
SUMMARY RESULTS OF OPERATIONS:						
Residential revenues	**$299,562**	$297,520	$286,260	$280,647	$267,110	$238,496
Commercial revenues	**345,585**	347,364	335,012	314,129	290,370	263,374
Industrial revenues	**165,550**	178,425	225,692	244,970	221,107	225,292
Other revenues	**25,289**	27,435	25,447	25,955	25,663	22,418
Total revenues from customers	**835,986**	850,744	872,411	865,701	804,250	749,580
Revenues from other utilities	**52,018**	45,519	46,049	31,439	10,471	28,686
Total operating revenues	**888,004**	896,263	918,460	897,140	814,721	778,266
Operation and maintenance expenses	**499,796**	481,712	472,956	466,329	400,762	431,331
Depreciation and amortization	**82,172**	74,325	81,066	77,532	73,682	62,939
Taxes other than income taxes	**67,442**	70,987	72,614	70,279	60,651	57,476
Income taxes	**(15,779)**	17,536	72,440	74,600	76,194	53,307
Interest charges, net of allowance for borrowed funds used during construction	**136,000**	127,634	127,010	116,333	109,161	100,344
Other income, principally allowance for equity funds used during construction	**92,888**	84,635	83,583	64,727	50,955	44,328
Loss on cancelled generating units	**34,263**	—	—	—	—	—
Loss on sale and leaseback	**23,828**	—	—	—	—	—
Rate refunds (including interest expense)	**1,854**	57,278	—	—	—	—
Income from continuing operations before extraordinary gain	**151,316**	151,426	175,957	156,794	145,226	117,197
Loss from discontinued steam heating operations	**—**	—	—	—	—	9,924(1)
Income before extraordinary gain	**151,316**	151,426	175,957	156,794	145,226	107,273
Extraordinary gain	**—**	—	—	—	—	9,609(2)
Net income	**151,316**	151,426	175,957	156,794	145,226	116,882
Dividends on preferred and preference stock	**19,788**	20,547	21,250	21,955	22,411	22,701
Earnings for common stock	**$131,528**	$130,879	$154,707	$134,839	$122,815	$94,181
Average number of common shares outstanding (000)	**72,845**	72,930	68,543	61,054	55,883	48,236
Earnings per share of common stock:						
Income from continuing operations	**$1.81**	$1.79	$2.26	$2.21	$2.20	$1.96
Earnings for common stock	**1.81**	1.79	2.26	2.21	2.20	1.95
Dividends declared on common stock	**1.20**	1.415	2.06	2.06	2.00	1.90
Property, plant and equipment	**$4,007,551**	$4,312,047	$4,168,993	$3,799,499	$3,293,481	$3,024,554
Accumulated depreciation and amortization	**908,654**	821,448	748,860	659,745	555,641	504,680
Property, plant and equipment—net	**$3,098,897**	$3,490,599	$3,420,133	$3,139,754	$2,737,840	$2,519,874
Total assets	**$4,191,318**	$4,039,127	$3,854,468	$3,530,310	$3,145,811	$2,883,424
Book value per share	**$17.61**	$16.75	$16.36	$16.26	$16.41	$16.29

(1) Loss from Company's steam heating subsidiary which discontinued steam service effective May 31, 1983.

(2) Extraordinary gain of $9,609,000, or $.20 per common share, resulting from the exchange of 1,406,898 shares of common stock for approximately $29,852,000 principal amount of first mortgage bonds.

SELECTED FINANCIAL DATA AND STATISTICAL SUMMARY (continued)

(Thousands of Dollars, Except Per Share Amounts)	1987	1986	1985	1984	1983	1982
CAPITALIZATION:						
Common stock	$ 73,119	$ 73,119	$ 71,488	$ 64,775	$ 58,420	$ 53,277
Capital surplus	926,131	926,131	900,391	804,377	724,147	649,376
Retained earnings	269,965	225,733	197,952	184,313	175,938	165,340
Treasury stock	(34,748)	—	—	—	—	—
Non-redeemable preferred and preference stock	156,137	156,137	156,137	156,137	156,137	156,137
Redeemable preferred and preference stock	104,768	110,653	119,653	127,414	134,979	140,829
First mortgage bonds	1,401,669	1,326,135	1,244,691	1,149,248	1,099,848	1,006,338
Other long-term debt	297,599	296,137	313,986	278,384	234,019	199,934
Unamortized debt discount and premium—net	(8,668)	(8,485)	(9,209)	(10,896)	(10,967)	(9,488)
Total Capitalization	$3,185,972	$3,105,560	$2,995,089	$2,753,752	$2,572,521	$2,361,743
AVERAGE REVENUE PER KILOWATT-HOUR—ALL CUSTOMERS	7.517¢	8.032¢	7.832¢	7.389¢	7.215¢	6.708¢
SALES OF ELECTRICITY:						
Average annual residential kilowatt-hour use	6,019	5,821	5,621	5,768	5,752	5,668
Electric energy sales billed (millions of kilowatt-hours):						
Residential	3,065	2,957	2,848	2,918	2,905	2,853
Commercial	4,899	4,724	4,537	4,393	4,257	4,163
Industrial	2,918	2,734	3,522	4,148	3,717	3,902
Other	98	99	101	104	111	120
Total sales to customers	10,980	10,514	11,008	11,563	10,990	11,038
Sales to other utilities	2,486	2,136	1,981	1,019	327	917
Total Sales	13,466	12,650	12,989	12,582	11,317	11,955
ENERGY SUPPLY AND PRODUCTION DATA:						
Energy supply (millions of kilowatt-hours):						
Net generation—system plants	14,025	13,264	13,590	12,983	11,900	12,352
Purchased and net inadvertent power	258	194	184	216	163	228
Total energy supply	14,283	13,458	13,774	13,199	12,063	12,580
Losses and Company use	(817)	(808)	(785)	(617)	(746)	(625)
Net energy supply	13,466	12,650	12,989	12,582	11,317	11,955
Generating capability (thousands of kilowatts)	2,852	2,707	3,148	3,148	3,148	3,144
Peak load (thousands of kilowatts)	2,280	2,132	2,127	2,172	2,184	2,155
Cost of fuel per million BTU	150.991¢	165.340¢	168.450¢	165.868¢	167.140¢	167.865¢
BTU per kilowatt-hour generated	10,449	10,624	10,633	10,682	10,635	10,853
Average production cost per kilowatt-hour	2.328¢	2.545¢	2.462¢	2.559¢	2.541¢	2.575¢
NUMBER OF CUSTOMERS—END OF YEAR:						
Residential	510,823	509,054	507,824	506,883	505,781	503,987
Commercial	50,904	50,346	49,927	49,837	49,493	49,320
Industrial	1,978	1,970	1,981	1,990	1,964	1,999
Other	1,831	1,826	1,817	1,588	1,633	1,647
Total Customers	565,536	563,196	561,549	560,298	558,891	556,953

SHAREHOLDER REFERENCE GUIDE

Shareholder Inquiries

Shareholder inquiries relating to changes of address, missing stock certificates, dividend reinvestment, dividends, and other account information should be directed to our Shareholder Relations Department at One Oxford Centre (17-5), 301 Grant Street, Pittsburgh, PA 15279.

You may call toll-free from anywhere in the continental United States between 7:30 a.m. and 4:30 p.m., Eastern time. The numbers are as follows:

Pittsburgh area	393-6167
Pennsylvania (except Pittsburgh)	1-800-367-6400
Outside Pennsylvania	1-800-247-0400

Questions relating to stock transfer can be handled by our Shareholder Relations Department but should be addressed to our transfer agent: The First Jersey National Bank, Attention: Ray Zanowski, Stock Transfer Department, One Exchange Place, Jersey City, NJ 07302. You may contact them by using one of the following numbers:

Toll-Free Number	1-800-631-0749, Ext. 7420
Other Numbers	201-547-7424
	201-547-7420

Financial Community Inquiries

Analysts or brokers should direct their inquiries to the Company's Corporate Finance Department at (412) 393-6420. Written inquiries should be sent to:

Assistant Treasurer—Corporate Finance
Duquesne Light Company
One Oxford Centre (28-3)
301 Grant Street
Pittsburgh, PA 15279

Annual Meeting of Stockholders

The Annual Meeting of Stockholders will be held at 10 a.m., Tuesday, May 24, 1988, in the David L. Lawrence Convention Center, Pittsburgh, Pa.

The approximate number of record holders of common stock as of the March 16, 1988, record date for the 1988 Annual Meeting is 117,000.

Form 10-K Offer

If you hold or are a beneficial owner of any class of the Company's stock as of the record date for the 1988 Annual Meeting, the Company will send you, free upon request, a copy of the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission for 1987. All requests must be made in writing to:

Corporate Secretary
Duquesne Light Company
One Oxford Centre (17-6)
301 Grant Street
Pittsburgh, PA 15279

United States General Election—November 8, 1988
The choice of our next President and the agenda he brings to office will be determined by you, the voter. It is important that:

- you are registered to vote;
- you *do* vote;
- you know the qualifications of the candidates; and
- you know where they stand on issues important to you and your Company (Duquesne Light).

For information on the candidates, please call one of the shareholder inquiry telephone numbers listed on this page.

Federal Income Tax Status of Common Stock Dividends

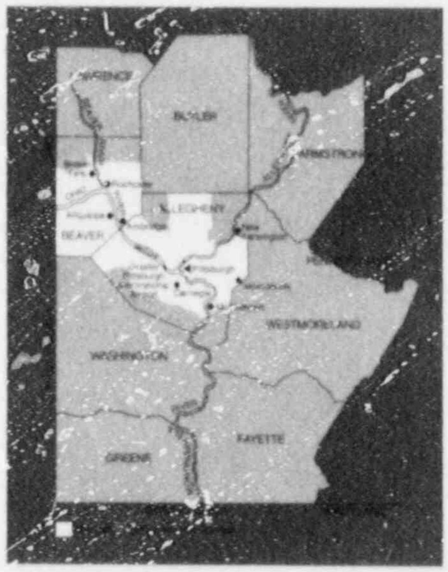
Duquesne Light expects all dividends paid on Company stock during 1987 will be fully taxable.

Corporate Offices

The corporate offices of Duquesne Light are located at:

One Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

Service Area Map



Duquesne Light
One Oxford Centre
Pittsburgh, PA 15279

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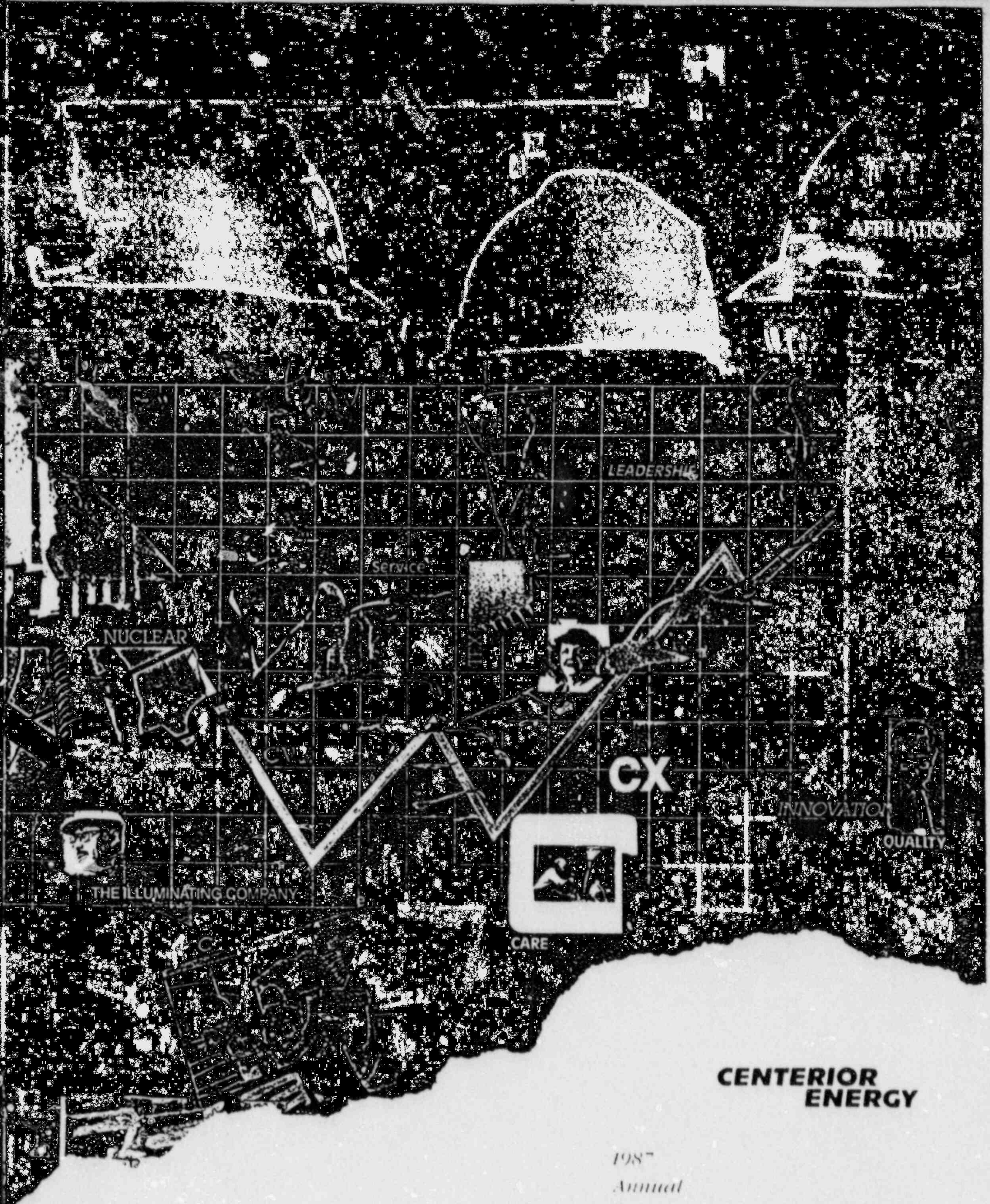


CENTERIOR ENERGY

1987
Annual
Report

~~8804070124~~ 45pp.

C ontents

Centerior Energy Corporation was formed in April 1986 upon the affiliation of The Cleveland Electric Illuminating Company and The Toledo Edison Company. With assets of more than $11 billion, Centerior Energy is one of the largest electric utility systems in the nation. Cleveland Electric and Toledo Edison serve 2.6 million people in Northern Ohio.

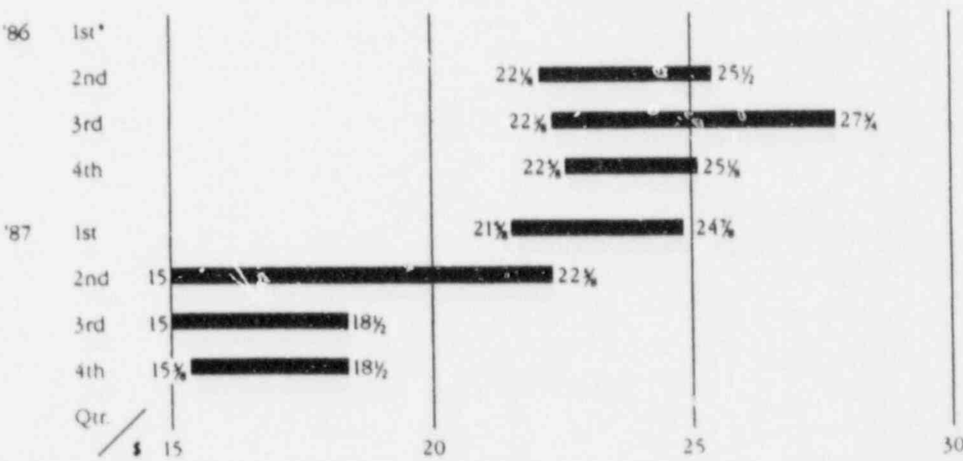
Highlights of 1987

- Beaver Valley Unit 2 achieved commercial operation on November 17. A day later, Perry Unit 1 went commercial.
- Centerior Energy completed a $1.7 billion sale and leaseback of generating units on September 30. It was the largest transaction of this type in electric utility history and helped us retire $860 million of high-cost debt and preferred and preference stock.
- Davis-Besse Nuclear Power Station was available 84 percent of the time, the best operating performance in the plant's 10-year history.
- Customers set a new record for electricity demand on July 22. The peak demand of 5,173 megawatts was three percent higher than the previous record.
- A Sylvania, Ohio family became our one millionth customer in May.
- The Public Utilities Commission of Ohio granted four rate increases totaling $104 million per year to our operating subsidiaries.
- Completion of Beaver Valley Unit 2 and Perry Unit 1 enabled us to stop issuing new common stock.

Financial Summary

	1987	1986	% Change
Earnings Per Share of Common Stock	$ 2.82	$ 3.04	(7.2)
Dividends Declared Per Share of Common Stock	$ 2.56	$ 2.49	2.8
Book Value Per Share of Common Stock at Year End	$ 22.10	$ 22.13	(0.1)
Common Stock Share Owners at Year End	207,755	210,293	(1.2)
Common Stock Shares Outstanding at Year End (000)	140,706	135,197	4.1
Operating Revenues (000)	$1,945,541	$1,917,730	1.5
Operating Expenses (000)	$1,561,931	$1,557,925	0.3
Net Income (000)	$ 390,353	$ 391,893	(0.4)
Return on Average Common Equity	12.8%	13.7%	(6.6)
Kilowatt-hour Sales (Millions of Kilowatt-hours)			
Residential	6,659	6,527	2.0
Commercial	6,350	6,239	1.8
Industrial	11,985	11,409	5.0
Other	1,348	1,151	17.1
Total	26,342	25,326	4.0
Employees at Year End	8,891	9,306	(4.5)

Quarterly Range of Centerior Energy's Common Stock Prices



*Centerior Energy's Common Stock traded for the first time on April 30, 1986.

Dear Share Owner:

For Centerior Energy, 1987 was a year of solid progress. We took aggressive actions to resolve many problems; other challenges remain.

The foremost challenges concern the resolution of the various issues that bear upon improving earnings and cash flow and determining appropriate long-term dividend policy.

During our first full year of existence, we

- Completed a large nuclear construction program,
- Set new performance records at the Davis-Besse Nuclear Power Station,
- Diligently cut operating costs,
- Executed the largest sale and leaseback of generating units in electric utility history and
- Revitalized efforts to improve service to customers.

These accomplishments provide the cornerstone for future growth. They position us to operate successfully in today's highly competitive energy business. We are concentrating on improving our financial situation now that the nuclear construction program is behind us.

We also can devote more resources to retaining existing customers and to attracting new businesses to Northern Ohio. We are not just a utility that provides reliable electricity; we are a valuable source of information, research and advice. In particular, we will continue to help industrial customers operate more efficiently and compete more effectively in the global marketplace.

Completion of the construction program was a vital step toward achieving the long-term success of your Company. As a result, we expect cash flow and the quality of earnings to improve significantly over the next few years. The downside is that 1988 earnings are expected to be lower than the $2.82 per share earned in 1987, although any decline is anticipated to be primarily in noncash accounting credits.

Future earnings also may be affected by several other factors, including The Public Utilities Commission of Ohio's attempt to disallow about $800 million of the construction costs of Perry Unit 1. Our share is about $410 million. The disallowance was considerably higher than recommendations of the PUCO's consultants and staff. We are vigorously contesting this ruling and will appeal the order to the Ohio Supreme Court.

A major challenge is to obtain rate increases that will improve our financial performance without harming customers. In early 1988, phase-in proposals were filed with the PUCO. Under these innovative proposals, customers would not pay immediately for the bulk of our new generating capacity, even though they would get the immediate advantages of the lower fuel costs and improved reliability that result from using that capacity.

We will continue to increase efficiency and improve our competitive stance, but the PUCO's future actions in allowing us to recover operating and capital costs of our new nuclear units hold the key to our continued profitability.

Another way to hold down electric bills is to squeeze every possible benefit out of the Cleveland Electric-Toledo Edison affiliation. For example, centralizing additional functions at Centerior Energy enabled us to offer a voluntary early retirement program that was accepted by 544 employees (nearly six percent of our workforce).

Where achievements are concerned, the employees of Centerior Energy have received far less credit than they deserve. Our employees have strongly supported corporate cost-cutting efforts while maintaining an excellent level of customer service and continuing to find time to help make their communities a better place to live. They give definition to the care and concern for which Centerior Energy stands.

Sincerely,

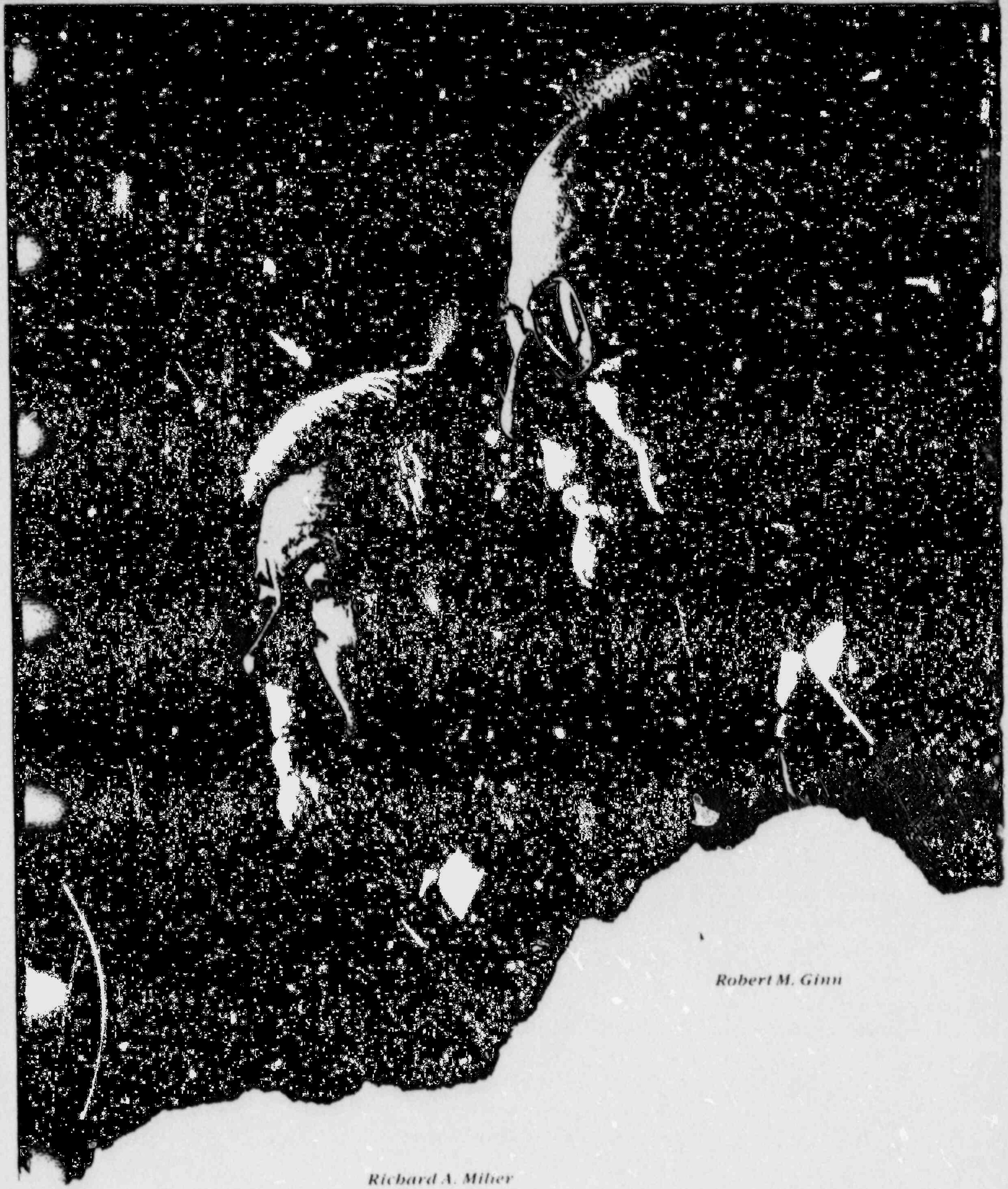
Robert M. Ginn

Robert M. Ginn
Chairman

Richard A. Miller

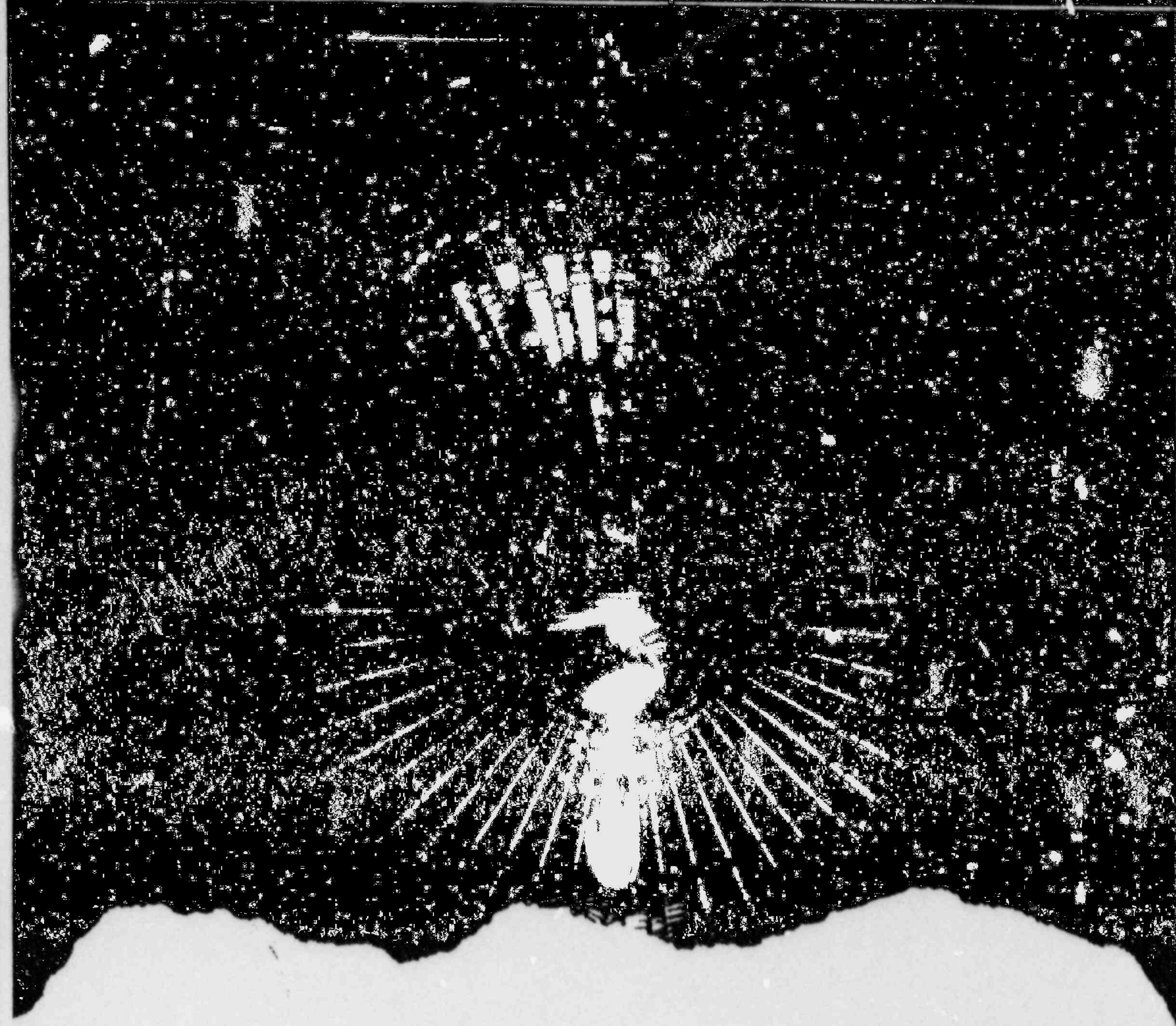
Richard A. Miller
President

February 22, 1988



Robert M. Ginn

Richard A. Miller



Above, the inside of a generator is inspected as part of our program to keep our older plants operating efficiently so as to postpone building expensive new units.

At right, Brian Nyerges, a Cleveland Electric associate environmentalist, works to preserve the marshlands near the Perry Nuclear Power Plant. Our environmental controls allow wildlife and modern technology to exist side by side.

A Year of Progress

In 1987, your Company completed its extensive capacity construction program and realized greater-than-expected benefits from the first calendar year of the affiliated operations of Cleveland Electric and Toledo Edison. Events over which we had less control, especially in the regulatory arena, did not turn out as well.

Nuclear Program Progress

On consecutive days in November, Beaver Valley Unit 2 and Perry Unit 1 were brought into commercial operation. Our third nuclear unit, Davis-Besse, recorded the best year in its 10-year operating history.

These three nuclear units assure Northern Ohio of a reliable electricity supply that not only will serve the growing needs of our current customers, but also will help attract new businesses to our service area. The availability of a reliable supply of electricity will become increasingly important in the 1990s when various regions of the country are expected to experience shortages.

The balanced mix of generating capacity will enable us to avoid the problems that can result from reliance on one fuel source. Nuclear power provides a hedge against the costly emission control expenditures that contemplated acid rain legislation would require.

In 1987, nuclear power provided 25 percent of our generation and coal-fired units 75 percent. As we rely increasingly on our existing nuclear units in the future, the percentage of generation provided by nuclear power will rise. However, coal will remain our primary fuel source.

A Delicate Balance

With completion of the new units comes a new challenge: earning a fair return on our investment by achieving a delicate balance between the need of customers for reasonably priced electricity and the need of share owners for improved financial performance by the Company. We have developed a three-pronged strategy to do this:

- An innovative sales improvement program,
- An aggressive cost containment program and
- A creative rate moderation program.

These programs are discussed in the following sections.

Increasing Sales

Increased sales will spread our fixed costs over more kilowatt-hours and reduce our need for rate increases. We expect kilowatt-hour sales to increase an average of 1.6 percent per year over the next 20 years. Innovative rate designs, knowledge of customers' businesses and providing superior service are the ways we intend to increase sales.

Innovative Rate Designs

Our rate structure can be modified so customers can use the particular operating characteristics of their facilities to lower their electric energy costs. Following are three examples of how we have retained existing business and added new business.

A Cleveland area titanium producer decided not to close a large sodium plant after Cleveland Electric created a rate design that lowers the customer's rates in any month when the plant surpasses predetermined energy usage levels. Sodium is used as a catalytic agent in making titanium. Without this special rate structure, the producer probably would have bought sodium elsewhere and closed the 28-megawatt facility.

A special contract for additional load enabled a metals manufacturer to restart an arc furnace to make ferro-silicon. The unusual operating characteristics of the furnace enabled us to offer energy prices that were extremely competitive with rates available to the customer's plants in other regions and in other countries. The restarted arc furnace added $660,000 a month to our revenues and 50 new jobs to the Ashtabula County economy.

Another special rate design helped attract a steel company to Toledo. That company plans to start building a $150 million steel rolling mill in 1988. This will eventually add 33 megawatts to Toledo Edison's load.

Knowledge of Customers' Businesses

Our marketing representatives work hard to understand the operations and needs of customers. They combine this knowledge with their expertise in electricity applications to advise industries on new production techniques that can reduce their costs, enhance their competitive stance and add to our sales.

We are assisting with installation of the world's first commercial plasma torch technology at the General Motors foundry near Defiance. Plasma torches can yield temperatures in excess of 10,000 degrees Fahrenheit while the limit in fossil fuel combustion is about 2,800 degrees F. This will facilitate the melting of iron and the processing of other materials. The plasma torch, which is expected to be in operation by mid-1988, will add eight megawatts to our load.

We helped improve productivity at the plant of a maker of specialty molds and precision patterns. After getting advice from Toledo Edison and the Center for Materials Fabrication in Columbus, the manufacturer installed a full-scale computer-aided design and manufacturing system.

We have long been active in promoting economic development in Northern Ohio. Now, more than ever, we are helping industrial customers increase their productivity by getting the utmost out of the dollars they spend on electric energy. Such efforts will help fulfill our pledge that businesses will not leave our service area because of high electric rates.

Providing Superior Service

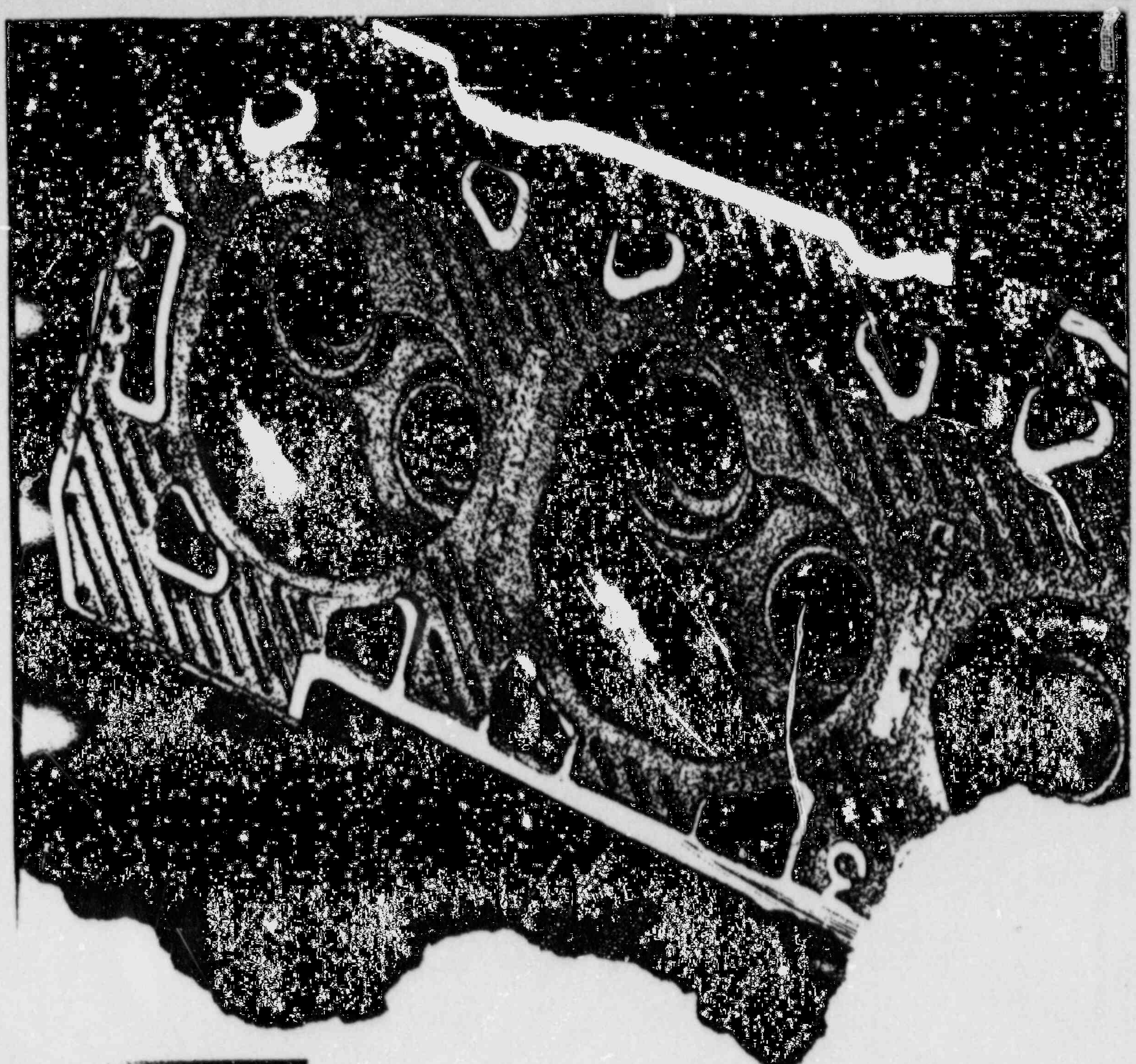
The third strategy for increasing sales is to provide the kind of service that makes customers eager to do business with us.

In the residential sector, our sales efforts stress the convenience, comfort and value provided by electricity, with special emphasis on all-electric living and outdoor lighting. We also will continue informational programs to help people use appliances more efficiently.

In 1988, we will switch from postal card billing to envelope billing. This will enable us to insert a return envelope for the convenience of customers to pay their bills. We also will be able to insert a new newsletter with monthly electric bills. This is a cost-effective way to inform customers how to get the greatest value out of the electricity they use.

We have added customer service offices in several communities to make it easier for customers to pay bills and arrange for electric service. These offices also enable us to distribute helpful tips on such topics as the most effective use of electric appliances. In 1988, we will take this convenience even more directly to customers by having a customized van make regularly scheduled appearances at shopping centers.

We emphasize quality in all corporate endeavors. All employees are aware of their responsibilities to the customers who depend on us, and the daily actions of employees reflect that care and concern. The net result of providing superior service is an increase in kilowatt-hour sales that improves the Company's bottom line.



At left, Larry Smith, a Toledo Edison branch service man helps keep the electricity flowing in a rural part of our territory.

Above is an engine head produced at the General Motors Corporation foundry near Defiance. In recent years, GM has invested more than $1 billion to modernize and expand its Northern Ohio facilities.

We raised $1.7 billion from the sale and leaseback of the Bruce Mansfield coal-fired plant, foreground, and Beaver Valley Unit 2, the nuclear unit in the background. Because of environmental control equipment, the stacks and cooling towers are emitting only harmless water vapor.

Containing Costs

Reducing operating costs is a key to improving financial performance and minimizing rate increases. Significant cost reductions achieved in 1987 underscored the success of the Toledo Edison-Cleveland Electric affiliation. Most of these savings would not have been possible for either company if they still operated independently.

More long-range decision making was centralized at Centerior Energy's headquarters. This centralization and other steps to eliminate redundancy allowed the implementation of a voluntary early retirement program. Nearly six percent of the workforce retired, resulting in an initial annual savings of $28 million in payroll and benefit costs.

Generation dispatching, coordination of power plant operations and engineering and technical support were consolidated at Centerior Energy, as was planning for substations and transmission lines. The operating subsidiaries continue to be responsible for day-to-day operation of power plants and for customer-related activities. This arrangement helps Cleveland Electric and Toledo Edison retain the customer good will they have developed over the past century.

The affiliation enabled the operating companies to increase coordination of electricity dispatching. This, along with the addition of new capacity, allowed us to retire one of the five units at Cleveland Electric's Avon Lake Power Plant. An engineering study concluded it was more economical to decommission the 192-megawatt unit than to spend money to keep it operating.

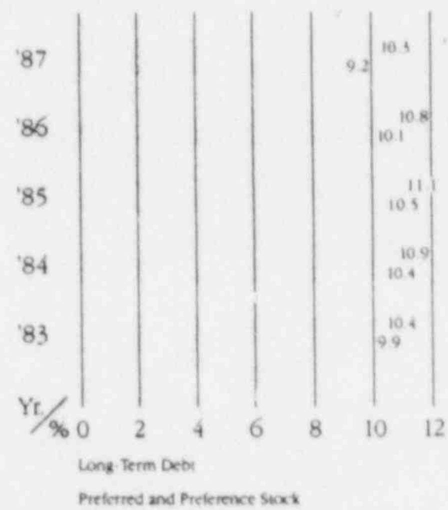
Financial Restructuring

Our standing in the financial community was strengthened by a financial restructuring. We redeemed or refunded $860 million of high-cost bonds and preferred and preference stock in 1987. This reduced our annual interest and preferred and preference dividend requirements by $123 million. See the chart on this page for the impact on our embedded costs of capital. Our stronger balance sheet showed $165 million less in long-term debt, preferred and preference stock at the end of 1987 than at year-end 1986. We expect to redeem at least another $150 million of debt and preferred stock in 1988.

A considerable portion of this debt and equity retirement program was made possible by the sale and leaseback of generating units. We sold virtually our entire interest in the three-unit Bruce Mansfield coal-fired plant for $1 billion. Toledo Edison sold 92 percent of its interest in Beaver Valley Unit 2 for $715 million. Toledo Edison would not have been able to sell and lease back that much capacity without our ability to bolster Toledo Edison's credit rating with Cleveland Electric's stronger rating. The resulting lower interest cost was another example of Toledo Edison customers reaping the benefits of the affiliation.

The transaction will result in the removal of our Bruce Mansfield investment from rate base (the property value upon which regulators allow us to earn a return). The portion of Beaver Valley Unit 2 that we sold will not be placed in rate base. Instead, we will pay rent to

Embedded Costs of Long-Term Debt and Preferred and Preference Stock
(Year End Annualized)



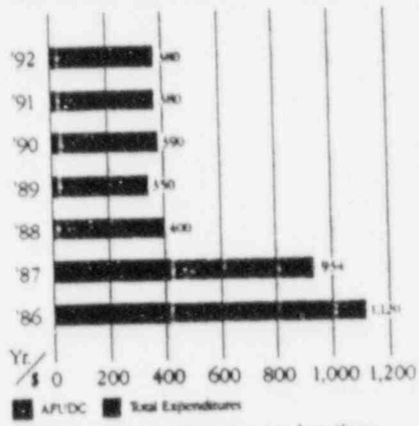
Embedded costs of long-term debt and preferred and preference stock have been reduced from their 1985 peak levels through redemptions and refundings.

the investors for the right to continue to use the generating capacity. Removing these investments from rate base will permit the placement of the capital costs of Perry Unit 1 and Beaver Valley Unit 2 in rate base without the substantial rate increases that otherwise would be required. In effect, the sale and leaseback transaction gives customers a long-term budget plan to pay for these units.

The Mansfield sale enabled us to realize a significant capital gain and to use investment tax credits that otherwise could not be used at this time, minimizing the tax on the capital gain.

Our financial situation will improve as a result of completing construction of the nuclear units. For the five-year period 1983-87, construction expenditures were $4.5 billion.

Actual and Forecast Construction Expenditures Including AFUDC (Millions)



Forecast construction costs are less than half of the level experienced in 1987 and about one-third of the peak level in 1986.

Over the next five years, construction expenditures should be about $1.9 billion (see the chart on this page). An important part of the construction program will involve the renovation of existing generating units to extend their useful lives and to increase their operating availability. This is a lower-cost option than building new generating units.

We do not expect to issue any new common stock in the foreseeable future. The dilution of per share earnings from new common stock sales that had been necessary has ended.

Despite this progress, financial problems remain. Dividends paid on common stock were $2.56 per share in 1987, substantially higher than cash flow per common share (see the chart on page 13). Furthermore, earnings in 1988 are expected to be lower than the $2.82 per share earned in 1987. Future dividend action will be determined on a quarter-to-quarter basis in light of the then recent financial results and evaluation of the corporation's future earning ability and cash flow. That, in turn, depends to a significant degree upon the success of efforts to obtain regulatory action to assure to the maximum extent possible the inclusion of the investment and operating costs of Perry and Beaver Valley in rates over the next several years (see the chart on page 14).

Moderating Rates

In February 1988, the Company proposed a rate moderation plan to phase the construction costs of the Perry and Beaver Valley units into rate base. Our ownership share is $4 billion. The rest is owned and leased by our utility partners in CAPCO (the Central Area Power Coordination Group) and other investors.

Under the rate moderation approach, Cleveland Electric revenues would increase 9.5 percent and Toledo Edison revenues would rise 7.2 percent in the first year. These increases would cover other costs of doing business as well as a portion of the nuclear construction investment. Under normal procedures, any rate increase would not go into effect before December 1988. We are, however, seeking to negotiate an agreement earlier.

To put Perry and Beaver Valley into rate base in one step would result in a rate increase of about 30 percent for our customers. We realize that price increases of that magnitude could put industrial and commercial customers at a competitive disadvantage, as well as be burdensome

At left, George Brewer, a plant supervisor, inspects the new Perry Unit 1 turbine. Perry helps provide the electricity needed to power economic expansion.

This steel coil is being produced at the Cleveland mill of American Steel & Wire Corporation, a new company we helped to succeed with an innovative rate design.

The Toledo Jeep plant is the city's largest employer. An agreement between the new Chrysler management and Jeep workers will keep the plant operating at least through 1992.

At right, Dave Zemon, a Cleveland Electric operations technician, monitors an infrared scanner that detects excessive temperatures on overhead lines and transformers. Early detection helps prevent outages.

to residential customers. We filed notices in February 1988 for rate increases of that magnitude to protect our legal rights. However, our intent is to work with The Public Utilities Commission of Ohio and other interested parties to reach agreement on our rate moderation plan.

We are not relying solely upon rate increases to produce the added earnings we need. The aggressive marketing and cost-cutting programs described previously are important elements of our strategy. Future rate increase requests, as has always been the case, will depend upon the success of these efforts. We will need a PUCO-approved plan to deal with the balance of our nuclear investment. We believe we can keep the average rate increase near the expected rate of inflation over the next decade.

Regulatory Arena

The PUCO granted disappointing rate increases to Cleveland Electric and Toledo Edison in 1987.

In March, Cleveland Electric received a \$39.8 million annual increase as the second part of a two-step increase granted in mid-1986. In December, the PUCO granted an additional increase of \$28.8 million per year. For the first 18 months, however, the increase will be only \$17 million on an annual basis since it will be offset by the "payback" of revenues previously collected under Ohio's construction-work-in-progress law.

In May, the PUCO granted Toledo Edison a \$43 million emergency rate increase. In December, that increase and a \$22.7 million emergency rate increase granted in February 1985 were made permanent by the PUCO. The December order also approved an additional \$4 million per year.

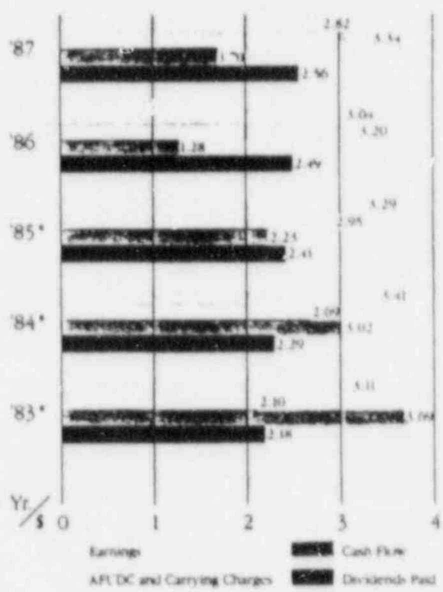
Over the past five years, the average price paid for electricity by Cleveland Electric customers has increased less than one percent per year. The average price paid by Toledo Edison's customers has increased 3.2 percent a year over that period. The annual rate of inflation from 1983-1987 was 3.3 percent.

Inadequate rate increases over the past several years coupled with the high cost of completing the nuclear construction program have contributed to the decline in the amount and quality of Centerior Energy's earnings. Utilities with inadequate rates are poor financial risks. Their borrowing costs go up because their credit ratings are lowered. Like all other expenses, these costs ultimately are reflected in customers' electric bills. So customers save money in the long run when utilities are allowed to charge reasonable rates.

Perry Disallowance

In January 1988, the PUCO ruled that \$628 million of the costs of building Perry Unit 1 were "imprudently or unreasonably incurred." This disallowance applied to costs incurred through the fuel loading date of March 21, 1986. The PUCO also required an upward adjustment to this amount relating to allowance for funds used during construction (AFUDC). AFUDC is a noncash credit to income that compensates for money invested in facilities which are not yet in rate base. We estimate that this additional AFUDC-related amount could bring the total disallowance to \$800 million, with about \$410 million being our share.

Earnings, AFUDC and Carrying Charges, Cash Flow and Dividends Paid Per Common Share



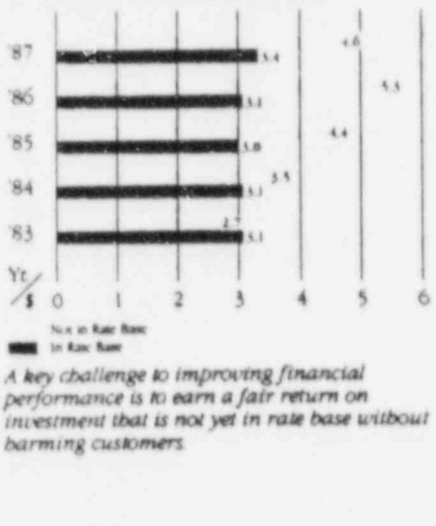
*Based on a consolidated restatement of the figures of Cleveland Electric and Toledo Edison.

All of our 1986 and 1987 earnings consisted of noncash allowance for funds used during construction (AFUDC) and carrying charges. Cash flow did not cover dividends in 1985, 1986 and 1987. However, cash flow improved nearly 33 percent in 1987 and is expected to continue to improve significantly.

The PUCO ruling was in sharp conflict with an earlier order by the Pennsylvania Public Utility Commission in a Duquesne Light Company rate case. The PaPUC determined that all of the costs of Perry through fuel loading were prudent. The PUCO's disallowance also was much higher than the recommendations of its own consultants and staff.

We will appeal the PUCO's decision to the Ohio Supreme Court. Among other things, we will cite inconsistencies and errors in the ruling. For example, the PUCO determined that Cleveland Electric "was not imprudent in its management" of issues related to General Electric Company, designer of the Unit's reactor. The PUCO also conceded its $264 million disallowance in connection with GE issues was not based on a determination of the adequacy of GE's performance. Nevertheless, the PUCO found that Cleveland Electric was responsible for the alleged costs of GE-related delays.

Investment Not in Rate Base and Investment in Rate Base (Billions)



A key challenge to improving financial performance is to earn a fair return on investment that is not yet in rate base without harming customers.

The PUCO also is investigating the reasonableness of $1.2 billion of costs incurred from the March 21, 1986 fuel loading to the start of commercial operation on November 18, 1987. In another Duquesne Light rate matter, a Pennsylvania administrative law judge ruled in January 1988 that there was no imprudent spending at Perry during that period.

The PUCO also is studying the prudency of Beaver Valley Unit 2 construction. The Pennsylvania administrative law judge found in January 1988 that $372 million (eight percent) of the cost of building the Unit was imprudently spent. The PUCO will review the Pennsylvania investigations as part of that process.

Moving Forward With Confidence

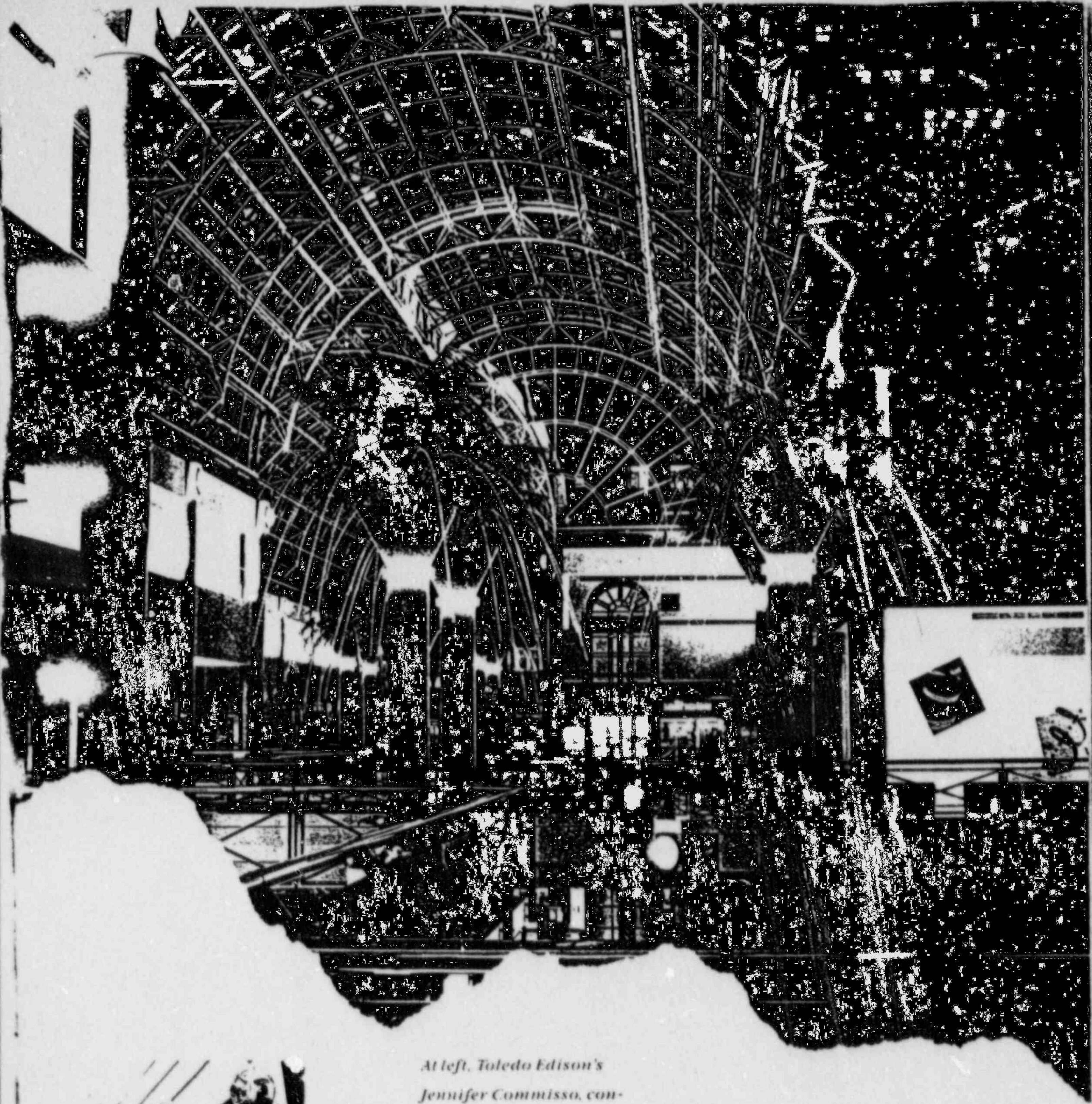
The 1980s will go down in the pages of our corporate history as an extremely difficult decade. Nevertheless, the completion and licensing of our nuclear units gives us cause for optimism about our future. The next several years will provide a bridge to a future that will be rewarding not only for Centerior Energy, but for all of our constituencies. There are many reasons for this confidence:

The *perseverance* we demonstrated in completing our huge construction program will see us through the challenge of securing a return on this investment.

The *wisdom* of providing a reliable supply of electricity for Northern Ohio will be evident in the 1990s when economic growth in some regions is short-circuited by shortages of electricity.

The *flexibility* to change in a changing business world was exemplified by the affiliation. With the benefit of operating experience, we have increased centralization and efficiency. Greater employee mobility among the subsidiaries creates a "cross-pollination" that assures the highest quality operation throughout the organization.

The *commitment* to provide outstanding service for residential, commercial and industrial customers is reflected in all corporate activities. In the highly competitive energy business, an electric utility's greatest asset is a satisfied customer. We will continue to merit that asset.



At left, Toledo Edison's Jennifer Commisso, connecting electric service to a new home in Defiance, enjoys a job that involves helping people. She symbolizes the care and concern that characterize our commitment to customers.

The new, $43 million Galleria shopping complex in downtown Cleveland embodies exciting architecture with state-of-the-art lighting.

Management's Statement of Responsibility for Financial Statements

The management of Centerior Energy Corporation is responsible for the consolidated financial statements in this Annual Report. The statements were prepared in accordance with generally accepted accounting principles. Under these principles, some of the recorded amounts are based on estimates. Such estimates are based on an analysis of the best information available.

We maintain a system of internal accounting controls. The controls are designed to assure that the financial records are reasonably complete and accurate. They also are designed to help protect the assets and their related records. We try to ensure that the costs of our control procedures do not exceed the benefits.

Our internal audit program monitors the internal accounting controls. This program gives us the opportunity to assess the adequacy and effectiveness of existing controls and to identify and institute changes where needed. Also, an examination of the consolidated financial statements is conducted by Arthur Andersen & Co., independent accountants, whose report thereon appearing on page 17 of this Annual Report, is qualified with respect to certain matters discussed therein.

Our Board of Directors is responsible for determining whether management and the independent accountants are carrying out their responsibilities. The Board is also responsible for making changes in management or independent accountants if needed. The Board has appointed an Audit Committee, comprised entirely of outside directors. The Audit Committee recommends to the Board annually the firm of independent accountants to be retained for the ensuing year. The Committee reviews the results of the accountants' examination of our consolidated financial statements and the audit practices employed by them. The Committee [illegible] the establishment and administration by management of effective internal accounting controls. The Committee also sees that our accounting system is designed to produce consolidated financial statements which present fairly our financial position. The Committee held two meetings in 198[illegible].

Auditors' Report

To the Share Owners and Board of Directors of
Centerior Energy Corporation:

We have examined the consolidated balance sheet and consolidated statement of cumulative preferred and preference stock of Centerior Energy Corporation (an Ohio corporation) and subsidiaries as of December 31, 1987 and 1986, and the related consolidated statements of results of operations, retained earnings and source of funds invested in plant, facilities and special deposits 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. We did not examine the consolidated financial statements of The Cleveland Electric Illuminating Company, a company acquired by Centerior in 1986 in a transaction accounted for as a pooling of interests, for the year ended December 31, 1985. Such statements reflect total operating revenues constituting approximately 70% of Centerior's consolidated operating revenues for the year ended December 31, 1985. These statements were examined by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for The Cleveland Electric Illuminating Company for that period is based solely upon the report of other auditors. The opinion of the other auditors is subject to the outcome of regulatory uncertainties with respect to Perry Unit 1, Perry Unit 2 and Beaver Valley Unit 2 insofar as they apply to The Cleveland Electric Illuminating Company.

As discussed further in Notes 3 and 7, significant uncertainties exist with respect to the recovery of investments, lease obligations and deferred costs relating to Perry Units 1 and 2 and Beaver Valley Unit 2, including:

1. The outcome of a request for rehearing pending before The Public Utilities Commission of Ohio (PUCO) and if necessary an appeal to the Ohio Supreme Court regarding Perry Unit 1 cost disallowances ordered by the PUCO.
2. The outcome of further PUCO investigations regarding the prudency of construction costs at Perry Unit 1 and Beaver Valley Unit 2.
3. The outcome of future PUCO regulatory proceedings to establish a rate phase-in plan to recover the investments, lease obligations and deferred costs relating to Perry Unit 1 and Beaver Valley Unit 2.
4. The resolution of potential excess capacity issues.
5. Whether Perry Unit 2 will be completed and whether the investment will ultimately be recoverable in rates charged to customers.

As a result of the uncertainties referred to above, management can give no assurance that the full investment in these units and a return thereon, applicable lease rental obligations and deferred costs will ultimately be recovered in rates charged to customers.

In our opinion, based upon our examinations and the report of other auditors referred to above, and subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties discussed above been known, the financial statements referred to above present fairly the consolidated financial position of Centerior Energy Corporation and subsidiaries as of December 31, 1987 and 1986, and the consolidated results of their operations and source of funds invested in plant, facilities and special deposits for each of the three years in the period ended December 31, 1987, all in conformity with generally accepted accounting principles applied on a consistent basis.

Arthur Andersen & Co.

Cleveland, Ohio
February 17, 1988

Summary of Significant Accounting Policies

General

Centerior Energy was organized in 1985 and acquired The Cleveland Electric Illuminating Company and Subsidiaries (Cleveland Electric) and The Toledo Edison Company (Toledo Edison) on April 29, 1986. This business combination was accounted for as a pooling of interests. The historical financial statements of Cleveland Electric and Toledo Edison (Centerior Utilities) have been combined and restated. The consolidated financial statements also include the accounts of Centerior Energy's wholly-owned subsidiary, Centerior Service Company (Service Company), which was incorporated in 1986. The Service Company provides, at cost, management, financial, administrative, engineering, legal and other services to Centerior Energy, Cleveland Electric and Toledo Edison. The Centerior Utilities operate as separate companies, each serving the customers in its service area. The first mortgage bonds, other debt obligations and preferred and preference stock of the Centerior Utilities continue to be outstanding securities of the Centerior Utilities. All significant intercompany items have been eliminated in consolidation.

Centerior Energy and the Centerior Utilities follow the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission and adopted by The Public Utilities Commission of Ohio (PUCO). The Service Company follows the Uniform System of Accounts for Mutual Service Companies as prescribed by the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935.

The Centerior Utilities are members of the Central Area Power Coordination Group (CAPCO). Other members include Duquesne Light Company (Duquesne), Ohio Edison Company (Ohio Edison) and Pennsylvania Power Company (Pennsylvania Power). The members have constructed and operate generation and transmission facilities for the use of the CAPCO companies.

Revenues

Customers are billed on a monthly cycle basis for their energy consumption, based on rate schedules authorized by the PUCO. These revenues are recorded in the accounting period during which meters are read, except for the portion of revenues which are deferred under the mirror construction work in progress (CWIP) law discussed below. A fuel factor is added to the base rates for electric service. This factor is designed to recover fuel costs from customers. It is changed semiannually after a hearing before the PUCO.

Fuel

The Centerior Utilities defer the differences between actual fuel costs and estimated fuel costs currently being recovered from customers. This matches fuel expenses with fuel-related revenues.

The cost of fossil fuel is charged to fuel expense based on inventory usage. The cost of nuclear fuel, including interest, is charged to fuel expense based on the rate of consumption. Estimated future nuclear fuel disposal costs are being recovered through the base rates.

Carrying Charges and Deferred Operating Expenses

The PUCO has authorized the Centerior Utilities to defer interest carrying costs, current operating expenses (including rental payments) and depreciation for Beaver Valley Unit 2 from its commercial in-service date through December 31, 1988 or until that Unit's costs are included in rates, whichever occurs first. The PUCO also has authorized the Centerior Utilities to defer current operating expenses and depreciation for Perry Unit 1 from June 1, 1987 through December 22, 1987, the date when these costs began to be recovered in rates, and has authorized the deferral of interest and equity carrying costs, exclusive of those associated with operating expenses and depreciation, for this Unit from June 1, 1987 through December 31, 1987 and deferral of interest carrying costs from January 1, 1988 through December 31, 1988 or until such interest carrying costs are included in rates, whichever occurs first. The PUCO determined that Perry Unit 1 was considered "used and useful" on May 31, 1987 for regulatory purposes. For financial reporting purposes, the amounts deferred for Perry Unit 1 pursuant to the PUCO accounting orders have been included in property, plant and equipment through the November 18, 1987 commercial-in-service date. Subsequent to that date, amounts deferred have been recorded as deferred charges. The PUCO did not authorize deferral of any equity carrying costs after November 17, 1987 for Beaver Valley Unit 2 or after December 31, 1987 for Perry Unit 1. See Note 7 for a discussion of regulatory matters relating to our investments in these Units.

Depreciation and Amortization

The cost of property, plant and equipment, except for the nuclear generating units, is depreciated over their estimated useful lives on a straight-line basis. Annual straight-line depreciation provisions expressed as a percent of average depreciable utility plant in service were 3.8% in 1987, 3.6% in 1986 and 3.5% in 1985. Depreciation expense for the nuclear units is based on the units-of-production method. This includes provisions for future decommissioning costs. These provisions are estimated at $122,000,000 in 1986 dollars for the Davis-Besse Nuclear Power Station (Davis-Besse) and $72,000,000 for Perry Unit 1 and $63,000,000 for Beaver Valley Unit 2 in 1987 dollars. There are no restrictions on the use of the amounts currently being recovered from customers through rates for decommissioning of Davis-Besse and Perry Unit 1. The sale and leaseback agreement for Beaver Valley Unit 2 requires the external funding of the leasehold interests' share of the Unit's decommissioning costs starting by September 1992. See Note 2.

Costs associated with four CAPCO nuclear generating units cancelled in 1980 are being amortized and recovered in rates through 1991 in accordance with PUCO rate orders. The PUCO does not allow the Centerior Utilities to earn a return on the unamortized balance. A new accounting standard will require the discounting of this balance in 1988. This discounting will not materially impact our financial statements.

Federal Income Taxes

Toledo Edison and Cleveland Electric have deferred the federal income taxes for the differences between straight-line depreciation and tax depreciation for property additions since 1973 and 1976, respectively. In addition, the tax effects of certain other timing differences have been deferred. This treatment is consistent with the methods used for rate-making purposes. The Centerior Utilities have also deferred the tax effect of the net gains and loss relating to the sale and leaseback transactions. See Note 2. The remaining timing differences are not deferred. They are recognized for book purposes, and in rates, in the year they affect taxes payable. At December 31, 1987, the cumulative income tax timing difference for which deferred income taxes have not been provided amounted to $412,000,000. Based on PUCO and Ohio Supreme Court decisions, such taxes can be recovered in future revenues.

For certain property, the Centerior Utilities received investment tax credits which have been accounted for as deferred credits. Tax credits utilized are reflected as reductions to tax expense over the life of the related property. See Note 8 for federal income tax details and a discussion of a new accounting standard for income taxes.

Interest Charges

Interest on long-term debt reported on the statement of Results of Operations does not include interest on nuclear fuel obligations. Interest on nuclear fuel obligations for fuel under construction is capitalized. See Note 5.

Property, Plant and Equipment

Property, plant and equipment are stated at original cost. Included in the cost of construction are items such as related payroll taxes, pensions, fringe benefits, management and general overheads and an allowance for funds used during construction (AFUDC). AFUDC represents the estimated composite debt and equity cost of funds used to finance construction. This noncash allowance is credited to income, except for AFUDC for Perry Unit 2. Since July 1985, Perry Unit 2 AFUDC had been credited to a deferred income account. Effective January 1, 1988, we discontinued the practice of accruing AFUDC on Perry Unit 2. See Note 3. The AFUDC rates, net of the income tax effect, averaged 10.7% in 1987 and 10.6% in 1986 and 1985.

Maintenance and repairs are charged to expense as incurred. Certain maintenance and repair expenses for Perry Unit 1 and Beaver Valley Unit 2 have been deferred pursuant to the PUCO accounting orders discussed above. The cost of replacing plant and equipment is charged to the utility plant accounts. The cost of property retired plus removal costs, after deducting any salvage value, is charged to the accumulated provision for depreciation.

Mirror Construction Work in Progress

The Ohio mirror CWIP law requires that revenues authorized by the PUCO and collected as a result of including CWIP in rate base be refunded in a subsequent period after the project is included in rate base. Such amounts are deferred and recorded as refund obligations to customers. AFUDC continues to be capitalized during the construction period. The deferred revenues are then recognized as operating revenues in the Results of Operations over the period of the refund.

Management's Financial Analysis

Results of Operations

Operating revenues increased by 1.5% in 1987, following increases of 3.8% in 1986 and 4.7% in 1985. The $27,000,000 increase in electric revenues in 1987 from 1986 resulted from an $89,000,000 increase in base rates and other revenues and a $40,000,000 increase from kilowatt-hour sales growth offset by a $56,000,000 decrease in fuel cost recovery revenues and a $46,000,000 decrease for mirror CWIP refund provisions.

Kilowatt-hour sales increased by 4% in 1987 following an increase of 1.8% in 1986 and a slight increase in 1985. Sales to industrial customers increased by 5% in 1987 from the level in 1986 and 1985. Industrial sales growth was broad-based, particularly in the steel sector. Residential and commercial sales increased 2% and 1.8%, respectively, in 1987 from 1986 levels, largely because of a substantially warmer-than-normal summer in 1987. Lower fuel revenues in 1987 resulted from increased use of our nuclear units.

Operating expenses increased by 0.3% in 1987, 7.6% in 1986 and 5% in 1985. The increases in operating expenses in 1985 and 1986 were derived partly from the effects of an 18-month outage at Davis-Besse. This outage resulted in the use of more coal and purchased power at unit prices which exceeded the unit price of nuclear fuel generation. Other operation and maintenance expenses in 1985 and 1986 increased principally for the refurbishment of Davis-Besse. In 1987, fuel and purchased power expense dropped as Davis-Besse came back on line and Perry Unit 1 and Beaver Valley Unit 2 went into service. The reduction in fuel and purchased power expense, lower federal income taxes and savings from cost reduction programs were about offset by sale and leaseback rental expense and higher units-of-production depreciation at Davis-Besse.

Earnings per share were $2.82 in 1987, down 7.2% from $3.04 in 1986 and 14.3% lower than $3.29 in 1985. The sale of Cleveland Electric's steam system reduced 1987 earnings by 13 cents per share. Increases in the average number of shares outstanding also contributed to the declines in per share results.

AFUDC and deferred carrying charges have represented an increasing proportion of earnings — 118.4% in 1987, 105.3% in 1986 and 89.5% in 1985. At the same time, cash flows have been impacted by the cost of additional debt and equity financing for the completion of the two nuclear units. AFUDC for the Beaver Valley Unit 2 investment was discontinued when this Unit became operational in November 1987. AFUDC for the Perry Unit 1 investment was discontinued on January 1, 1988 pursuant to a PUCO accounting order. Subsequent to these two dates, interest carrying charges on these investments are being credited to income at a rate lower than the full AFUDC rate. Consequently, earnings are expected to be lower in 1988, although the quality of earnings and cash flow are expected to improve. Deferral of interest carrying charges will be discontinued as the investments are recognized in rate base.

Effect of Inflation

Inflation continues to affect our business. Over the three-year period 1985-1987, our average electric rates have increased less than the Consumer Price Index. In this period, increases in the cost of labor, materials and services used in operations were moderated by a downward trend in the cost of coal.

The effect of inflation on the cost of much of our new facilities has yet to be recognized in the rate-making process. Generally, we have to raise new capital to meet growth needs at inflated costs of construction and to replace worn-out items at higher replacement costs. If rate adjustments fail to compensate for the cost of new capital, an erosion of our return on equity will occur. As a result, there will be a continuing need for rate increases.

We continue to seek adequate and timely rate increases for the Centerior Utilities and a regulatory environment which is responsive to the effect of inflation on our investment.

	For the years ended December 31,		
	1987	1986	1985
	(thousands of dollars, except per share amounts)		
Operating Revenues			
Electric	$1,932,170	$1,904,777	$1,828,131
Steam heating and gas	13,371	12,933	18,866
	1,945,54[illegible]	[illegible]	1,846,997
Operating Expenses			
Fuel and purchased power	470,[illegible]66	522,281	510,844
Other operation and maintenance	642,594	550,874	450,376
Depreciation and amortization	214,421	141,009	141,333
Taxes, other than federal income taxes	208,480	195,967	182,046
Perry Unit 1 and Beaver Valley Unit 2 deferred operating expenses	(37,623)	—	—
Federal income taxes	113,593	147,794	163,362
	1,561,931	1,557,925	1,447,961
Operating Income	383,610	359,8[illegible]5	399,036
Nonoperating Income			
Allowance for equity funds used during construction	297,239	298,781	260,632
Other income and deductions, net	(30,665)	(8,108)	5,825
Loss on steam system sale*	(27,156)	—	—
Perry Unit 1 and Beaver Valley Unit 2 carrying charges	39,303	—	—
Federal income taxes — credit	121,122	116,422	86,775
	399,843	407,095	353,232
Income Before Interest Charges	783,453	766,900	752,268
Interest Charges			
Long-term debt	425,577	397,206	360,912
Short-term debt	6,834	6,812	5,917
Allowance for borrowed funds used during construction	(125,446)	(114,038)	(98,777)
	306,965	289,980	268,052
Income After Interest Charges	476,488	476,9[illegible]0	484,216
Preferred and preference dividend requirements of subsidiaries	86.135	85,[illegible]17	82,829
Net Income	$ 390,353	$ 391,893	$ 401,387
Average Number of Common Shares Outstanding (thousands)	138,395	128,927	121,898
Earnings Per Common Share	$ 2.82	$ 3.04	$ 3.29
Dividends Declared Per Common Share	$ 2.56	$ 2.49	$ 2.20

* The one-time loss on the steam system sale reduced earnings per common share by 13 cents in 1987. See Note 11.

The accompanying notes and summary of significant accounting policies are an integral part of this statement.

Management's Financial Analysis

Capital Resources and Liquidity

We carry on a continuous program of constructing new facilities and modifying existing facilities to meet anticipated demand for electric service and to comply with governmental regulations. The capital requirements for this construction program over the three-year period 1985-1987 totaled approximately $3,000,000,000, excluding nuclear fuel. This amount includes AFUDC. The capital required to finance our construction program is obtained from funds generated internally as well as from external sources.

About 66% of the construction program capital requirements for 1985 and 1986 was raised through bank borrowings and sales of securities. Our 1987 financing activity included the issuance of over 5,500,000 shares of Centerior Energy common stock through share owner and employee stock plans, which raised about $103,000,000. See Note 12. Cleveland Electric issued $370,500,000 of first mortgage bonds and $75,000,000 of preferred stock. Toledo Edison issued $250,000,000 of unsecured notes and debentures, $50,000,000 of preferred stock and $41,000,000 of first mortgage bonds. In September 1987, we sold and leased back certain interests in four generating units as discussed in Note 2. A substantial portion of the net proceeds from these transactions has been used to pay portions of short-term debt incurred to finance the construction program, to redeem outstanding securities, to pay our construction program costs and for general corporate purposes. The remainder of the funds from the sale and leaseback transactions will be used for our construction program, mandatory and optional redemption requirements and general corporate purposes.

In addition to our construction program funding requirements (as discussed in Note 3), Cleveland Electric and Toledo Edison will require $447,000,000 and $415,000,000, respectively, for the retirement of debt and preferred stock during the 1988-1992 period. Cleveland Electric also is required to offer to purchase $38,000,000 of preferred and preference stock during the same period. We expect to finance externally about one-half to two-thirds of these requirements. See Note 12 for further information concerning the first mortgage bonds and the preferred and preference stock of Cleveland Electric and Toledo Edison. Our available short-term borrowing arrangements are explained in Note 13.

Our ability to meet our financing needs depends upon the Centerior Utilities obtaining sufficient and timely rate increases and upon availability of capital. See Note 7 for discussion of rate increase requests. The availability of capital to meet our external financing needs depends upon such factors as financial market conditions, earnings, our ability to pay dividends, the size of our construction program and our credit ratings. In 1985, rating agencies lowered their ratings on certain securities of the Centerior Utilities. This made our cost of capital more expensive. In April 1985, Standard and Poor's Corporation further lowered its ratings on the first mortgage bonds and preferred stock of Cleveland Electric to BBB− and BB+, respectively. Standard and Poor's Corporation raised Toledo Edison's first mortgage bonds and preferred stock ratings to the same levels. Those ratings have not changed through 1987. Standard and Poor's rates Toledo Edison's unsecured notes BB+. Moody's Investors Service rates Cleveland Electric's bonds and preferred stock Baa2 and Toledo Edison's bonds Baa3, unsecured notes Ba1 and preferred stock Ba2.

Our financing policy is to maintain, as near as practicable, a capitalization structure of 40%-42% common stock equity, a maximum of 48% debt and 10%-12% preferred and preference stock. At year-end 1987, the Company's consolidated capitalization consisted of 41% common stock equity, 49% debt and 10% preferred and preference stock.

For discussion of the cash flow impact of the Tax Reform Act of 1986, see Note 8.

Retained Earnings

	For the years ended December 31, 1987	1986	1985
	(thousands of dollars)		
Balance at Beginning of Year	$ 893,616	$ 820,756	$ 689,179
Additions			
Net income	390,353	391,893	401,387
Deductions			
Common stock dividends declared	(352,715)	(319,023)	(269,804)
Other, primarily preferred stock redemption expenses of subsidiaries	(22,643)	(10)	(6)
Earnings Reinvested During the Year	14,995	72,860	131,577
Balance at End of Year	$ 908,611	$ 893,616	$ 820,756

Source of Funds Invested in Plant, Facilities and Special Deposits

	For the years ended December 31, 1987	1986	1985
	(thousands of dollars)		
Provided from Internal Sources			
Net Income	$ 390,353	$ 391,893	$ 401,387
Principal Non-Cash Items:			
Depreciation and amortization, net	193,646	141,009	141,333
Deferred federal income taxes	(272,133)	86,730	69,881
Investment tax credits, net	132,699	(39,109)	18,483
Loss on steam system sale	27,156	—	—
Allowance for equity funds used during construction	(297,239)	(298,781)	(260,632)
Funds Provided from Operations	174,482	281,742	370,452
Common stock dividends	(352,715)	(319,023)	(269,804)
Net proceeds from sale and leaseback transactions	1,690,816	—	—
Net proceeds from steam system sale	7,000	—	—
Increase in reserve for Perry Unit 2 allowance for funds used during construction	80,653	63,525	30,422
Net change in working capital and other accounts	(48,208)	34,802	(38,720)
Allowance for equity funds used during construction	297,239	298,781	260,632
Funds Provided from Internal Sources	1,849,267	359,827	352,982
Provided from External Sources			
Sale of Securities:			
Common stock	102,724	208,383	175,287
Preferred stock	123,313	103,968	79,000
First mortgage bonds	411,500	325,000	385,970
Net change in other debt	166,542	84,306	114,188
Net change in pollution control construction funds	26,964	56,449	(2,544)
Net (decrease) increase in short-term debt	(9,197)	16,807	(17,978)
Net (increase) decrease in temporary cash investments	(504,720)	102,917	12,344
Redemption of bonds, preferred and preference stock	(884,258)	(127,825)	(121,296)
Net increase in other noncurrent liabilities	21,888	76,423	76,496
Funds Provided from External Sources	(545,244)	846,428	701,467
Total Sources of Funds	$1,304,023	$1,206,255	$1,054,449
Invested In			
Construction Expenditures	$ 933,744	$1,120,017	$ 983,750
Deposits in Trust, primarily sale and leaseback proceeds	374,085	—	—
(Decrease) Increase in Nuclear Fuel Inventory	(3,806)	86,238	70,699
Total Invested in Plant, Facilities and Special Deposits	$1,304,023	$1,206,255	$1,054,449

The accompanying notes and summary of significant accounting policies are an integral part of these statements.

Balance Sheet

Centerior Energy Corporation and Subsidiaries

	December 31, 1987	December 31, 1986
	(thousands of dollars)	
Assets		
Property, Plant and Equipment		
Utility plant in service	$ 8,349,696	$ 4,639,542
Less: accumulated depreciation and amortization	1,324,446	1,367,662
	7,025,250	3,271,880
Construction work in progress	224,679	4,510,962
Perry Unit 2	783,028	702,579
	8,032,957	8,485,421
Nuclear fuel, net of amortization	609,545	613,351
Other property, less accumulated depreciation	46,805	39,213
	8,689,307	9,137,985
Special Deposits		
Pollution control construction funds, unexpended	1,775	28,739
Deposits in trust, primarily sale and leaseback proceeds	374,085	—
	375,860	28,739
Current Assets		
Cash and temporary cash investments	612,775	106,794
Amounts due from customers and others, net	208,214	192,731
Materials and supplies, at average cost	65,910	44,536
Fossil fuel inventory, at average cost	73,665	62,422
Taxes applicable to succeeding years	202,394	155,373
Other	22,216	10,574
	1,185,174	572,430
Deferred Charges		
Unamortized costs of terminated projects	46,224	60,109
Accumulated deferred federal income taxes	493,473	29,214
Unamortized loss, Beaver Valley Unit 2 sale	134,475	—
Unamortized loss on reacquired debt	59,748	1,736
Carrying charges and nuclear operating expenses	89,094	—
Other	209,304	137,358
	1,032,318	228,417
Total Assets	$11,282,659	$ 9,967,571
Capitalization and Liabilities		
Capitalization		
Common shares, without par value (stated value of $191,172,000 and $87,892,000 for 1987 and 1986, respectively); 180,000,000 authorized; 140,706,000 and 135,197,000 outstanding in 1987 and 1986, respectively	$ 2,200,449	$ 2,097,725
Retained earnings	908,611	893,616
Common stock equity	3,109,060	2,991,341
Preferred stock		
With mandatory redemption provisions	330,188	465,014
Without mandatory redemption provisions	457,334	404,021
Preference stock, with mandatory redemption provisions	13,797	22,800
Long-term debt	3,718,249	3,792,402
	7,628,628	7,675,578
Other Noncurrent Liabilities		
Refund obligations to customers	33,000	—
Other, primarily nuclear fuel lease and trust obligations	598,084	609,196
	631,084	609,196
Current Liabilities		
Current portion of long-term debt and preferred stock	59,768	55,359
Current portion of lease obligations	71,396	53,470
Notes payable to banks and others	36,732	45,929
Accounts payable	185,070	180,888
Accrued taxes	326,268	193,119
Accrued interest	93,351	92,158
Dividends declared	15,348	15,724
Accrued payroll and vacations	27,308	31,074
Refund obligations to customers	13,000	—
Other	28,561	27,042
	856,802	694,763
Deferred Credits		
Unamortized investment tax credits	399,348	293,675
Accumulated deferred federal income taxes	672,817	526,981
Reserve for Perry Unit 2 allowance for funds used during construction	174,600	93,947
Unamortized gain, Bruce Mansfield Plant sale	739,910	—
Other	179,470	73,431
	2,166,145	988,034
Total Capitalization and Liabilities	$11,282,659	$ 9,967,571

The accompanying notes and summary of significant accounting policies are an integral part of this statement.

Statement of Cumulative Preferred and Preference Stock

Centerior Energy Corporation and Subsidiaries

	1987 Shares Outstanding	Current Call Price	December 31, 1987	December 31, 1986
			(thousands of dollars)	
Cleveland Electric				
Without par value, 4,000,000 preferred and 3,000,000 preference shares authorized				
Subject to mandatory redemption (less current maturities):				
Preferred:				
$ 7.35 Series C	200,000	$ 103.00	$ 20,000	$ 21,000
88.00 Series E	36,000	1,045.91	36,000	39,000
75.00 Series F	16,666	1,000.00	16,666	33,333
80.00 Series G	8,000	1,000.00	8,000	16,090
145.00 Series H	19,590	—	19,590	23,154
145.00 Series I	23,624	—	23,624	27,562
113.50 Series J	—	—	—	23,200
113.50 Series K	10,000	—	10,000	10,000
Adjustable Series M	500,000	106.76	49,000	49,000
9.125 Series N	750,000	109.13	73,968	73,968
			256,848	316,217
Preference:				
77.50 Series 1	13,797	1,000.00	13,797	22,800
Not subject to mandatory redemption:				
Preferred:				
7.40 Series A	500,000	101.00	50,000	50,000
7.56 Series B	450,000	102.26	45,071	45,071
Adjustable Series L	500,000	106.34	48,950	48,950
Remarketed Series P	750	101,500.00	73,313	—
			217,334	144,021
Toledo Edison				
$100 par value preferred, 3,000,000 shares authorized; $25 par value preferred, 12,000,000 shares authorized; and $25 par value preference, 5,000,000 shares authorized — none outstanding				
Subject to mandatory redemption (less current maturities):				
$100 par $11.00	50,000	103.50	5,000	5,499
9.375	183,400	105.43	18,340	20,005
13.25	—	—	—	11,268
12.65	—	—	—	18,225
14.80	—	—	—	28,800
25 par 3.75	—	—	—	30,000
3.72	—	—	—	35,000
2.81	2,000,000	27.81	50,000	—
			73,340	148,797
Not subject to mandatory redemption:				
100 par 4.25	160,000	104.625	16,000	16,000
4.56	50,000	101.00	5,000	5,000
4.25	100,000	102.00	10,000	10,000
8.32	100,000	103.54	10,000	10,000
7.76	150,000	103.377	15,000	15,000
7.80	150,000	102.60	15,000	15,000
10.00	190,000	101.00	19,000	19,000
25 par 2.21	1,000,000	25.90	25,000	25,000
2.365	1,400,000	28.45	35,000	35,000
4.28	—	—	—	20,000
3.47	1,200,000	30.97	30,000	30,000
Series A Adjustable	1,200,000	—	30,000	30,000
Series B Adjustable	1,200,000	—	30,000	30,000
			240,000	260,000
Centerior Energy				
Without par value, 5,000,000 preferred shares authorized	—	—	—	—
Total Preferred Stock with Mandatory Redemption Provisions			$330,188	$465,014
Total Preferred Stock without Mandatory Redemption Provisions			$457,334	$404,021
Total Preference Stock with Mandatory Redemption Provisions			$ 13,797	$ 22,800

The accompanying notes and summary of significant accounting policies are an integral part of this statement.

Notes to the Financial Statements

(1) Property Owned with Other Utilities and Investors

The Centerior Utilities own, as tenants in common with other utilities and those investors who are owner-participants in various sale and leaseback transactions (lessors), certain generating units as listed below. Each owner owns an undivided share in the entire unit. Each owner has the right to a percentage of the generating capability of each unit equal to its ownership share. Each utility owner is obligated to pay for only its respective share of the construction and operating costs. Each lessee is obligated to pay for the related lessor's share of those costs. Property, plant and equipment at December 31, 1987 includes the following facilities owned by the Centerior Utilities as tenants in common with other utilities and lessors:

Generating Unit	In-Service Date	Ownership Share	Ownership Megawatts	Power Source	Plant in Service	Construction Work in Progress
					(thousands of dollars)	
In Service:						
Seneca Pumped Storage	1970	80.00%	305	Hydro	$ 58,297	$ 54
Eastlake Unit 5	1972	68.80	446	Coal	119,594	30,878
Perry Unit 1 & Common Facilities	1987	51.02	615	Nuclear	2,787,331	—
Beaver Valley Unit 2 & Common Facilities (Note 2) ...	1987	26.12	218	Nuclear	1,350,801	9,388
Construction Suspended (Note 3):						
Perry Unit 2	Uncertain	51.02	615	Nuclear	—	783,028
					$4,316,023	$823,348

The accumulated depreciation for Seneca at December 31, 1987 was $16,000,000. Depreciation on all other plant in service owned with others has been accumulated on an account basis with all other depreciable property rather than by specific units of depreciable property. The Centerior Utilities' share of the operating expense of these generating units is included in the Results of Operations.

Ohio Edison and Pennsylvania Power have agreed to purchase 80 megawatts of Cleveland Electric's 375-megawatt ownership interest in Perry Unit 1 over an 18-month period. The purchase commenced with the commercial operation of the Unit in November 1987.

(2) Utility Plant Sale and Leaseback Transactions

On September 30, 1987, Cleveland Electric sold essentially all of its 470-megawatt undivided tenant-in-common interests in Units 1, 2 and 3 of the coal-fired Bruce Mansfield Plant (Mansfield Plant). Cleveland Electric had owned 6.5%, 26.8% and 24.47%, respectively, of those three units. The sale price was $625,500,000. On the same day, the purchasers leased those interests back to Cleveland Electric (with Toledo Edison as co-lessee) for a term of about 29½ years.

Also on September 30, 1987, Toledo Edison sold essentially all of its 294-megawatt undivided tenant-in-common interests in Units 2 and 3 of the Mansfield Plant. Toledo Edison had owned 17.3% and 19.91%, respectively, of those two units. The sale price was $398,100,000. On the same day, Toledo Edison also sold about 18.26% of Beaver Valley Unit 2. Toledo Edison had owned a 19.91% (165 megawatts) undivided tenant-in-common interest in Beaver Valley Unit 2 and has retained about a 1.65% interest in the Unit. The sale price was $715,000,000. On the same day, the purchasers leased those interests in the two plants back to Toledo Edison (with Cleveland Electric as co-lessee) for terms of about 29½ years.

The Centerior Utilities are amortizing the applicable deferred gains and loss associated with these sales of utility plant over the period of the lease terms.

Future minimum lease payments under these operating leases at December 31, 1987 are summarized as follows:

Year	Amount (thousands of dollars)
1988	$ 122,000
1989	182,000
1990	182,000
1991	183,000
1992	186,000
Later Years	5,020,000
Total Future Minimum Lease Payments	$5,875,000

The amount recorded as rental expense for the Mansfield Plant leases was $32,100,000 in 1987. Rental costs for the Beaver Valley Unit 2 lease of $18,300,000 in 1987 were recorded in a deferred charge account.

The Centerior Utilities are responsible under the leases for paying all taxes, insurance premiums, operating and maintenance costs and all other similar costs for all interests in the Units sold and leased back. The Centerior Utilities may incur additional costs in connection with capital improvements to the Units. The owners (lessors) may elect to make additional equity investments with respect to the cost of any capital improvements on terms to be agreed upon. The Centerior Utilities have options to buy the interests back at the end of the leases for the fair market value at that time or to renew the leases for a minimum of two years. Additional lease provisions provide other purchase options along with conditions for mandatory termination of the leases (and possible repurchase of the leasehold interests) for obsolescence and events of default.

(3) Construction and Contingencies

Construction Program

The estimated cost of our construction program for the 1988-1992 period is $1,900,000,000, including AFUDC and excluding nuclear fuel. Should more stringent environmental regulations be adopted, particularly in the area of acid rain pollution control, construction program costs for this period are not expected to increase substantially. However, such costs could increase substantially thereafter. No amount is included for Perry Unit 2 because its construction has been suspended.

Perry Unit 2

Perry Unit 2, exclusive of the facilities to be used in common with Perry Unit 1, is about 44% complete. Including its share of the common facilities, it is about 58% complete. Construction of Perry Unit 2 was suspended in 1985 by the CAPCO companies pending future consideration of several alternatives which include resumption of full construction with a revised estimated cost and completion date, mothballing or cancellation. None of these alternatives may be implemented without the approval of each of the CAPCO companies.

If Perry Unit 2 is cancelled, the Centerior Utilities will seek authorization from the PUCO to recover their respective investments in the Unit in rates. We have no assurance that recovery would be allowed. In the event of such a cancellation, if and when it were to appear probable that recovery would not be allowed, then our investment in Perry Unit 2 (including AFUDC), plus any cancellation costs, less any equipment usable elsewhere and less any resulting tax saving, would have to be written off. We estimate that such a write-off, based on our investment in this Unit as of December 31, 1987, would have been about $438,000,000.

In April 1986, Duquesne announced that it no longer needs the capacity of Perry Unit 2. Duquesne is continuing to pay for its 13.74% ownership share of maintaining Perry Unit 2 while construction is suspended. Duquesne has advised the Pennsylvania Public Utilities Commission (PaPUC) that it will not agree to resumption of construction of Perry Unit 2. We do not know what arrangements might be made between Duquesne and the other CAPCO companies if they want to complete Perry Unit 2 and Duquesne does not change its position.

(4) Nuclear Operations and Contingencies

Davis-Besse Nuclear Power Station

In 1987, the PUCO ordered a refund of certain replacement fuel and purchased power costs incurred and collected from customers during an outage at Davis-Besse in 1985 and 1986, plus interest. The refund requirement was based on the PUCO's conclusion that the outage was a result of imprudence in the management and maintenance of Davis-Besse by Toledo Edison. The amounts of the refunds are approximately $33,595,000 and $32,563,000 for Toledo Edison and Cleveland Electric, respectively. The refunds are to be made to customers over a period of 18 months beginning in February and March 1988, respectively, through operation of the fuel cost rate adjustment. We have appealed the order to the Ohio Supreme Court. The refunds will reduce cash flow in 1988 and 1989 up to the time of any reversal by the Court and could require financing in addition to that which otherwise would be required. The refunds will not adversely affect future results of operations as adequate reserves have been provided.

In January 1986, the Nuclear Regulatory Commission (NRC) undertook a review of the design and operation of nuclear reactors designed by Babcock & Wilcox (B&W) at several plants, including Davis-Besse. The NRC staff has concluded that the B&W-designed reactors can continue to operate safely while its review is being done. The outcome of the NRC's review and its impact on us cannot be predicted.

In December 1986, the State of Ohio and an organization each separately requested the United States Court of Appeals for the Sixth Circuit to prevent the operation of Davis-Besse until the NRC has reviewed the off-site emergency plan for Davis-Besse. That Court has not yet ruled on these requests but has ruled in our favor in a similar proceeding involving Perry Unit 1.

Perry Unit 1

Perry Unit 1 was placed in commercial operation on November 18, 1987. Although the Unit is in commercial operation, petitions are pending before various judicial and regulatory bodies to halt the operation of Perry Unit 1 or modify or terminate the operating license. We believe these petitions are unlikely to succeed. See Note 7 for a discussion of regulatory matters relating to our investment in the Unit.

Beaver Valley Unit 2

Beaver Valley Unit 2 was placed in commercial operation on November 17, 1987. See Note 7 for a discussion of regulatory matters relating to our investment in the Unit.

Other Nuclear Risks

Our interests in four nuclear units (Davis-Besse, Perry Units 1 and 2 and Beaver Valley Unit 2) are also impacted by activities or events beyond our control. Operating nuclear generating units have experienced unplanned outages or extensions of scheduled outages because of equipment problems or new regulatory requirements. A major accident at a nuclear facility anywhere in the world could cause the NRC to limit or prohibit the operation, construction or licensing of a nuclear unit.

(5) Nuclear Fuel

The Centerior Utilities have lease and trust arrangements to finance nuclear material and fuel. This nuclear fuel inventory should provide an adequate supply lasting into the mid-1990s. Substantial additional nuclear material must be obtained in the future to supply fuel for the remaining useful lives of Davis-Besse, Perry Unit 1 and Beaver Valley Unit 2. More nuclear material and fuel would be required if Perry Unit 2 is completed.

The maximum amount that the Centerior Utilities can finance under one set of nuclear fuel leasing arrangements is $495,000,000. It consists of two long-term leases that allow the lenders to cancel their financing commitments after three years' notice. The Centerior Utilities' share of the maximum amount available under another arrangement, which includes leases and a trust combined, is $173,000,000. This arrangement is subject to cancellation by the lender after one year's notice.

The lease and borrowing rates are based on bank prime and commercial paper rates. The amounts capitalized included interest charges incurred by the lessors amounting to $38,000,000 in 1987, $39,000,000 in 1986 and $38,000,000 in 1985. Under the leases, rental payments are made as the fuel is burned in a reactor. The estimated future lease amortization payments based on projected burn are $74,000,000 in 1988, $79,000,000 in 1989, $78,000,000 in 1990, $93,000,000 in 1991 and $106,000,000 in 1992. As these payments are made, the amount of credit available to the lessors is renewed and becomes available to finance additional nuclear fuel.

At December 31, 1987, a total of $628,000,000 is committed under the leases and the trust for nuclear material and costs of processing it into fuel for the Centerior Utilities. This includes nuclear fuel in the Davis-Besse, Perry Unit 1 and Beaver Valley Unit 2 reactors with remaining payments of $51,000,000, $86,000,000 and $59,000,000, respectively, as of December 31, 1987.

(6) Nuclear Insurance

The Price-Anderson Act (Act) limits the liability of the owners of a nuclear power plant. This limit is covered by private insurance amounting to $160,000,000 and an amount provided by an industry assessment plan. Under the plan, if any unit in the United States has an incident with losses in excess of private insurance, up to $5,000,000 (but not more than $10,000,000 per unit per year in the event of more than one incident) must be contributed for each licensed nuclear unit in the country by the licensees of each unit to cover liabilities arising out of the incident. Based on our present ownership and leasehold interests in our three operating nuclear units, our maximum potential assessment under these provisions (assuming the other CAPCO companies were to contribute their proportionate share of any assessment) would be $9,770,000 per incident but not more than $19,540,000 per calendar year.

Certain provisions of the Act expired on August 1, 1987. However, until new legislation is adopted, the provisions of the Act relating to the industry assessment plan and the limitation of liability will continue to apply. We cannot predict what action Congress or the President might ultimately take regarding pending legislation or the Act. If the Act is modified to increase or eliminate the liability limit, our potential assessment in the event of a nuclear incident could be significantly increased.

We have insurance coverage for damage to our property at Davis-Besse, Perry and Beaver Valley (including leased fuel and clean-up costs) in the amount of $1,525,000,000 for each site. Damage to our property could exceed the insurance coverage by a substantial amount and thereby have a material adverse effect on our financial condition and results of operations in the periods following the loss. If the property damage reserves of one of the insurers are inadequate to cover claims arising out of an accident at any nuclear site in the United States covered by that insurer, we are obligated to pay retrospective premiums up to $14,467,000 for the current policy year.

Insurance coverage is also held for the cost of any replacement power purchased after the occurrence of certain types of accidents at our nuclear units. The amount of the coverage is limited to 90% of the estimated difference in replacement power costs per week during the 52-week period starting 26 weeks after an accident and 45% of such estimate per week for the next 52 weeks. The cost and duration of replacement power could substantially exceed the insurance coverage. Also, if the insurer's reserves are inadequate to cover claims arising out of accidents at any nuclear units in the United States covered by such insurance, we are obligated to pay retrospective premiums up to $3,042,000 for the current policy year.

(7) Regulatory Matters

Rates

During the three years ended December 31, 1987, the PUCO granted increases in electric rates to the Centerior Utilities as follows:

Date	Company	Annualized Amount (thousands of dollars)
February 1985	Toledo Edison	$22,700
March 1985	Cleveland Electric	19,500
June 1986	Cleveland Electric	37,000
March 1987	Cleveland Electric	39,600
May 1987	Toledo Edison	43,000
December 1987	Cleveland Electric	28,800
December 1987	Toledo Edison	4,000

In December 1987, the PUCO granted Cleveland Electric an increase in electric rates of $28,800,000 annually. However, this increase will be reduced by $11,800,000 on an annual basis for a period of about 18 months for the return of monies collected from customers under the mirror CWIP law. The rate increase reflects inclusion of a significant part of the requested annualized operating costs for Perry Unit 1 and the continued inclusion of a portion of Perry Unit 1 cost as CWIP in rate base. The new rates went into effect in late December 1987.

In December 1987, the PUCO granted Toledo Edison an increase in electric rates of $4,000,000 annually. In addition, the order made permanent the February 1985 and May 1987 emergency rate increases. The rate increase includes a significant portion of the requested annualized operating costs for Perry Unit 1. The rate increase also reflects inclusion of a portion of Perry Unit 1 cost as CWIP in rate base. The new rates went into effect in late December 1987.

In connection with the February 1985 rate order, Toledo Edison was ordered to record a portion of its AFUDC accruals to a reserve account (rather than to income) in an amount sufficient to offset the increase in after-tax earnings resulting from the rate increase. At December 31, 1987, this AFUDC deferral amounted to $38,000,000. It is expected that when Perry Unit 1 is considered for full inclusion in Toledo Edison's rate base, the PUCO will either reduce rate base by the amount of the reserve or include such amount in rate base. If the latter option were chosen, future revenues would be reduced by the interim revenues collected, including carrying charges, over a period equal to the period the interim rates were in effect.

The Office of Consumers' Counsel (OCC) requested a rehearing objecting to inclusion of Perry Unit 1 operating costs in each of the rate decisions. The OCC also filed a second request for rehearing in each rate case on other matters. The Centerior Utilities and other interested parties also have requested rehearings. The PUCO denied the requests for rehearings with respect to the inclusion of Perry Unit 1 operating costs. The PUCO also acted on the other requests by agreeing to rehear specific issues raised in some of the requests. The OCC appealed the issue raised in its first requests for rehearings to the Ohio Supreme Court and has requested a stay relating to inclusion of such costs. The Centerior Utilities and the other parties filing requests for rehearing may also appeal to the same court if the PUCO denies their respective requests. We believe OCC's request relating to inclusion of Perry Unit 1 operating costs is unlikely to succeed.

Rate Phase-in Plans for Nuclear Investments

In February 1988, the Centerior Utilities filed notices of intent to request rate increases with the PUCO. Generally, when a new electric generating unit is, or is about to be, placed in commercial service, the Centerior Utilities request a rate increase to r... over all allowable costs, including current operating expenses, depreciation, interest and a fair return on their investment in the unit. Because of the size of their ownership investments in Perry Unit 1 and Beaver Valley Unit 2, the Centerior Utilities have proposed to the PUCO a gradual increase in their rates. These increases would "phase in" full recovery of all such costs over a 10-year period. These plans would defer costs in their initial years, but would ultimately provide for full recovery of all allowable costs, including all costs deferred pursuant to PUCO accounting orders.

Cleveland Electric's plan includes a request for an initial increase in base rates which, when coupled with a reduction in revenues from a decrease in the fuel cost recovery factor and the return of CWIP-related revenues, would result in revenues being 9.5% higher than 1987 revenues, or $125,000,000 annually, followed by nine annual increases. Toledo Edison's plan includes a request for an initial increase in base rates which, when coupled with a reduction in revenues from a decrease in the fuel cost recovery factor and the impact of the February 1985 emergency rate increase, would result in revenues being 7.2% higher than 1987 revenues, or $45,000,000 annually, followed by nine annual increases. In each of the phase-in plans, the amounts of the annual increases following the first year have yet to be finalized. They will be designed to provide for the full recovery of allowable costs relating to our investments in Perry Unit 1 and Beaver Valley Unit 2. Also, as an alternative to the phase-in plans, the Centerior Utilities included in their notices of intent requests for approximate 30% rate increases which reflect the increases necessary for full recovery of our investments in Perry Unit 1 and Beaver Valley Unit 2 on a nondeferred basis.

Rate applications reflecting the phase-in plans and the nondeferred alternatives are expected to be filed with the PUCO in March 1988. As a part of these applications, we are considering proposing the transfer of a portion or all of Toledo Edison's leased Beaver Valley Unit 2 capacity entitlement and associated rental obligations to Cleveland Electric for an undetermined period. The applications also will seek to recover our investments in facilities other than Perry Unit 1 and Beaver Valley Unit 2 and higher operating and capital costs. Irrespective of any action the PUCO may take with respect to these applications, additional rate increases may be requested in future years to recover our other investments in facilities and higher operating and capital costs.

The Chairman of the PUCO has stated that the PUCO will sponsor a settlement conference with the Centerior Utilities and intervenors in early March 1988 to begin discussions on the phase-in proposals. It is our intent to work with the PUCO and other interested parties to reach an agreement sooner than December 1988, the earliest time when, under normal procedures, any rate increases from our expected March 1988 applications would go into effect.

The proposed phase-in plans are expected to satisfy the accounting standard for phase-in plans. If the PUCO does not approve the phase-in plans of either of the Centerior Utilities or if a phase-in plan is approved that does not meet the accounting standard, our results of operations and financial condition would be adversely affected to the extent that allowable costs, including all costs being deferred pursuant to PUCO accounting orders, are not being currently recovered.

Potential Disallowance of Nuclear Investments

Depending on the ultimate outcome of prudency investigations and the related appeals, we may have to write off the disallowed costs or discontinue accruing post in-service carrying costs on a portion of our investments in Perry Unit 1 and Beaver Valley Unit 2. See Note 3 for a discussion of Perry Unit 2.

In January 1988, the PUCO issued an order stating that approximately $627,800,000 of Perry Unit 1 construction costs were imprudently incurred or were unreasonable and that the Centerior Utilities' shares of these costs of about $320,000,000 must be written off and not included in their respective rate bases. The PUCO's investigation covered the period of time starting with the decision to build the Unit through the date of fuel load on March 21, 1986. Approximately $4,153,000,000 in construction costs of Perry Unit 1 were incurred during this period. The order also stated that further adjustments will be required to correct the additional AFUDC component to reflect subsequent delays in the in-service date and to reflect additional AFUDC associated with certain issues. The preliminary estimate of this additional amount, based on the methodology used in the PUCO's order, is $174,100,000. The Centerior Utilities' share of this amount is about $89,000,000.

Specifically, the PUCO concluded that Cleveland Electric performed its project and management responsibilities in an aggressive and effective manner, except for about $298,900,000 of costs which could have been avoided through improved management and decision making, $263,600,000 of costs resulting from delays caused by General Electric Company in connection with the design and construction of the nuclear steam supply system and $65,300,000 of costs resulting from delays caused by another contractor. Although the PUCO concluded that Cleveland Electric did not act imprudently with respect to the latter two costs, the PUCO concluded that these costs should be disallowed.

The PUCO will also consider the prudency and reasonableness of Perry Unit 1 construction costs incurred after the fuel load date which are estimated to be about $1,200,000,000.

We believe all of our expenditures for Perry Unit 1 were prudently incurred and that the PUCO's findings were in error. We have requested a rehearing with the PUCO and, if the request is denied, will appeal the order to the Ohio Supreme Court. We cannot reasonably estimate the amount of loss, if any, that may result from the resolution of this matter. Accordingly, we have not written off any of our investment in Perry Unit 1 at this time. If the PUCO's decision is not reversed on appeal, we would be required to write off the disallowed amounts.

In January 1988, in a Duquesne rate case, a Pennsylvania administrative law judge recommended to the PaPUC that there be no disallowance of Perry Unit 1 construction costs incurred from the time fuel was loaded until the Unit began commercial operation. The recommendation is not binding on the PaPUC, the PUCO or the Centerior Utilities.

In his January 1988 recommendation, the administrative law judge also recommended that the PaPUC disallow $372,000,000 of Beaver Valley Unit 2 construction costs which were incurred during the period until fuel was loaded and were determined to be the result of imprudent management by Duquesne. The total estimated cost of the Unit is $4,700,000,000. In his recommendation, the administrative law judge considered the report submitted by Canatom, Inc., the engineering firm selected by the PaPUC to evaluate Duquesne's management of the construction of Beaver Valley Unit 2 and to conduct an audit of related project costs. Canatom concluded that Duquesne performed most of its duties in a reasonable manner, with the exception of certain engineering-related and other matters which increased the cost of Beaver Valley Unit 2 by an amount ranging from $219,000,000 to $271,000,000. Canatom concluded that those costs could have been avoided. The administrative law judge recommended a disallowance of about $89,000,000 of the costs which Canatom had concluded were avoidable and recommended a disallowance of $283,000,000 of costs which were not considered avoidable by Canatom. Canatom also concluded that the CAPCO companies delayed the construction of Beaver Valley Unit 2 due to capacity, load, financial, regulatory and technical considerations resulting in additional costs of $312,000,000 to $488,000,000 but did not characterize these delays and costs as avoidable. The administrative law judge recommended that these costs be allowed. We and Duquesne do not agree with the administrative law judge's recommendations regarding disallowances or with Canatom's conclusions with respect to avoidable costs. Duquesne will challenge these recommendations in appropriate PaPUC proceedings. Neither the administrative law judge's recommendations nor the Canatom report are binding on the PaPUC, the PUCO or the Centerior Utilities, and any decision of the PaPUC will not be binding on the Centerior Utilities or the PUCO. However, the PUCO also will investigate the prudency of the costs of the Unit and will review the Canatom report in determining whether to disallow the recovery by the Centerior Utilities of any of their costs of the Unit. If it were to appear probable, as a result of any proceedings instituted by the PUCO, that recovery in rates of any portion of the construction costs, including a full return thereon, of Beaver Valley Unit 2 will not be allowed, then our share of such costs would have to be written off. To the extent a disallowance is attributed to our leasehold interests in the Unit, we would have to record a loss provision for the deferred and future lease rental payments.

PUCO Reserve Capacity Standards

In November 1987, the PUCO issued an order adopting a reserve capacity policy. The policy states that an appropriate generic benchmark for an electric utility's reserve margin is 20%. A reserve margin exceeding 20% gives rise to a presumption of excess capacity, but may be appropriate if it benefits the customers or relates to unique system characteristics. Appropriate remedies for excess capacity (possibly including disallowance of costs in rates) will be determined by the PUCO on a case-by-case basis. We believe that the Centerior Utilities' reserve margins, both before and after Perry Unit 1 and Beaver Valley Unit 2 went into service, are reasonable and prudent under the circumstances and are not excessive, although they are expected to exceed the 20% benchmark for the foreseeable future. However, we are considering proposing the transfer of Toledo Edison's Beaver Valley Unit 2 leased capacity entitlement to Cleveland Electric. Moreover, since we are proposing to phase in our investments in these Units, we believe capacity not in rate base should not be included in the 20% test. We believe that, after giving effect to these proposals, our reserve margins for each company will not exceed the 20% benchmark. We cannot predict what, if any, determinations will be made with respect to generating capacity in the Centerior Utilities' rate applications to be filed in March 1988. However, if the PUCO disallows a portion of our investment because of an excess capacity finding or does not permit us to earn a full return on our investment, the disallowed amount may have to be written off.

Dividends and Financial Uncertainties

Permanent rate increases granted in 1987 and recent years by the PUCO have been significantly less than the amounts requested. Our Board of Directors declared a quarterly dividend of 64 cents per share of common stock on January 5, 1988, the same amount as the previous quarter. This action was taken prior to the PUCO order disallowing a portion of Perry Unit 1 construction costs. Future dividend action by our Board of Directors will be decided on a quarter-to-quarter basis after evaluation of financial results, potential earning capacity and cash flow in light of the anticipated outcome of our plans to phase in Perry Unit 1 and Beaver Valley Unit 2 construction costs, the potential for any material write-off of our investment in nuclear facilities and other factors.

The likelihood of the occurrence of any of the matters described in Note 3 "Construction and Contingencies — Perry Unit 2", Note 4 "Nuclear Operations and Contingencies — Other Nuclear Risks", Note 6 and this Note 7 which could have a financial impact on us cannot be determined at this time. Based on our current financial condition and level of annual income, a write-off of our investment in Perry Unit 2 or our investment in Perry Unit 1 ordered to be disallowed pursuant to the PUCO's January 1988 order would have a material adverse effect on our results of operations in the period in which it were to occur and on retained earnings. Any write-off resulting from the occurrence of any other of these matters could have such an effect depending upon the magnitude of such write-off. However, such a write-off relating to Perry Unit 2 or Perry Unit 1 individually would not reduce retained earnings sufficiently to impair our ability to declare dividends but together could have such an effect. A write-off due to the occurrence of any one or more of these other matters could, depending upon the magnitude and timing of such a write-off, reduce retained earnings sufficiently to impair our ability to declare dividends.

(8) Federal Income Tax

Federal income tax, computed by multiplying the income before taxes by the statutory rates, is reconciled to the amount of federal income tax recorded on the books as follows:

	For the years ended December 31,		
	1987	1986	1985
	(thousands of dollars)		
Book Income Before Federal Income Tax	$468,959	$508,292	$560,803
Tax on Book Income at Statutory Rate	$187,349	$233,814	$257,969
Increase (Decrease) in Tax Due to:			
AFUDC and Carrying Charges	(184,564)	(189,896)	(165,328)
Accelerated Depreciation	15,852	5,361	4,336
Other Items	(26,166)	(17,907)	(20,390)
Total Federal Income Tax Expense (Credit)	$ (7,529)	$ 31,372	$ 76,587

Federal income tax expense is recorded in the Results of Operations as follows:

	For the years ended December 31,		
	1987	1986	1985
	(thousands of dollars)		
Operating Expenses			
Current Tax Provision	$203,513	$ 87,802	$ 85,309
Changes in Accumulated Deferred Federal Income Tax:			
Accelerated Depreciation and Amortization	133,158	82,130	30,207
Nuclear Fuel Interest Charges	15,233	17,742	17,172
Sale and Leaseback Transactions	(356,584)	—	—
Property Tax Expense	11,685	3,547	2,224
Deferred CWIP Revenues	(18,377)	—	—
Unbilled Revenues	(19,706)	—	—
Perry Unit 1 Operating Expenses	29,490	—	—
Other Items	(22,030)	(4,264)	1,661
Investment Tax Credits — Net	137,211	(39,163)	26,789
Total Charged to Operating Expenses	113,593	147,794	163,362
Nonoperating Income			
Current Tax Provision	(88,934)	(101,102)	(84,016)
Changes in Accumulated Deferred Federal Income Tax:			
Davis-Besse Replacement Power	(26,154)	(6,026)	—
Other Items	(6,034)	(9,294)	(2,759)
Total Federal Income Tax Expense (Credit)	$ (7,529)	$ 31,372	$ 76,587

Approximately $27,000,000 of unused investment tax credits are available and may be used to reduce future tax obligations. The unused credits expire in varying amounts in 2001 and 2002. Utilization of these unused credits is limited by provisions of the Tax Reform Act of 1986 and the level of future taxable income to which such credits may be applied.

The Tax Reform Act of 1986 provided for a 40% average income tax rate in 1987 and a 34% income tax rate in 1988 and thereafter, the repeal of the investment tax credit, scheduled reductions in investment tax credit carryforwards, less favorable depreciation rates, a new alternative minimum tax and other items. These changes have resulted in an increase in tax payments and a reduction in cash flow during 1987. Most of the increase in tax payments is because the alternative minimum tax reduces the amount of investment tax credit allowed as an offset to federal income tax payable.

In December 1987, a new accounting standard for income taxes was issued. The standard requires a change in the accounting and reporting for income taxes from a deferral method to a liability approach. We do not anticipate adopting this standard before the effective date of January 1989. The liability approach establishes accumulated deferred income tax liabilities for amounts recorded either net of tax or after-tax and flow-through accounting items and recognizes the effect of any changes to the income tax rates. The change will result in a significant increase to the accumulated deferred income tax liability reported on the balance sheet. However, the increase in this liability will be primarily offset by an increase to a regulatory asset account also on the balance sheet. We do not expect the adoption of this standard to have any significant effect on our net income.

(9) Retirement Income Plans and Other Post-Retirement Benefits

We sponsor noncontributing pension plans which cover all employee groups. The amount of retirement benefits generally depends upon the length of service. Under certain circumstances, benefits can begin as early as age 55. The plans also provide certain death, medical and disability benefits. Our funding policy is to be in compliance with the Employee Retirement Income Security Act Guidelines.

In 1987, we adopted the new standard for accounting for pensions. Also, during 1987 we offered a Voluntary Early Retirement Opportunity Program (VEROP) which was accepted by 544 of the 589 eligible employees at an estimated cost of $31,800,000. Pension and early retirement program costs for the years 1985 through 1987 were $21,400,000, $18,100,000 and $23,300,000, respectively. Net pension and early retirement costs for 1987 were comprised of the following components:

	Millions of Dollars
Pension Costs:	
Service cost for benefits earned during the period	$16
Interest cost on projected benefit obligation	32
Actual return on plan assets	(37)
Net amortization and deferral	(14)
Net pension cost	(3)
VEROP cost	26
Net pension and VEROP costs	$23

The following table presents a reconciliation of the funded status of the plans at December 31, 1987.

	Millions of Dollars
Actuarial present value of benefit obligations:	
Vested benefits	$321
Nonvested benefits	43
Accumulated benefit obligation	364
Effect of future compensation levels	116
Total projected benefit obligation	480
Plan assets at fair market value	610
Unfunded (surplus) projected benefit obligation	(130)
Unrecognized net gain due to variance between assumptions and experience	(4)
Unrecognized prior service cost	7
Unrecognized VEROP cost	(6)
Transition asset at January 1, 1987, being amortized over 19 years	158
Net accrued pension cost included in other deferred credits on the Balance Sheet	$ 25

Assumptions used for the actuarial calculations summarized above are as follows: settlement (discount) rate — 7%, long-term rate of annual compensation increase — 5% and long-term rate of return on plan assets — 7%.

At January 1, 1986, the fair market value of net assets available for plan benefits was $550,000,000 and the vested and nonvested actuarial present value of accumulated plan benefits was $267,000,000 and $26,000,000, respectively, assuming a 7% discount rate and long-term rate of return on plan assets.

Plan assets consist primarily of investments in common stock, bonds, guaranteed investment contracts and real estate.

In 1986, we began to fund the post-retirement medical benefits and premiums. In prior years such costs were recorded when paid. The total amounts funded in 1987 and 1986 were $850,000 and $4,100,000, respectively.

(10) Guarantees

Under two long-term coal purchase arrangements, Cleveland Electric has guaranteed the loan and lease obligations of two mining companies. Toledo Edison is also a party to one of these guarantee arrangements. This arrangement also requires payments to the mining company for any actual out-of-pocket idle mine expenses (as advance payments for coal) when the mines are idle for reasons beyond the control of the mining company. At December 31, 1987, the principal amount of the mining companies' loan and lease obligations guaranteed by the Centerior Utilities was $106,000,000.

The Centerior Utilities have also guaranteed the debt obligation of a supplier. At December 31, 1987, the principal amount of the debt obligation guaranteed by the Centerior Utilities was $4,000,000.

(11) Sale of Cleveland Electric Steam System

Cleveland Electric sold its steam system on December 30, 1987 for $7,000,000. A net after-tax loss of approximately $18,000,000 reduced Nonoperating Income in the Results of Operations. This one-time loss reduced earnings per common share by 13 cents in 1987. The sale will not have a material impact on future results of operations.

(12) Capitalization

(a) Capital Stock Transactions

Shares sold and retired during the three years ended December 31, 1987 are listed below. Common stock activity prior to April 29, 1986 has been adjusted to reflect Cleveland Electric's 1.11 exchange ratio and Toledo Edison's one-for-one exchange ratio for new Centerior Energy shares.

	1987	1986	1985
	(thousands of shares)		
Common Stock:			
Public Sales	—	4,000	3,000
Dividend Reinvestment and Stock Purchase Plan	4,591	4,597	5,967
Employee Savings Plan	816	484	437
Employee Purchase Plan	61	—	107
Key Employee Incentive Stock Plan	1	22	35
1978 Key Employee Stock Option Plan	59	114	43
Total Common Stock Sales	5,528	9,217	9,589
Fractional Shares and Other Adjustments on Exchange of Shares	—	(34)	—
Treasury Shares	(19)	(17)	—
Net Change	5,509	9,166	9,589
Cumulative Preferred and Preference Stock of Subsidiaries Subject to Mandatory Redemption:			
Sales			
Cleveland Electric			
Preferred:			
Adjustable Series M	—	—	500
$9.125 Series N	—	750	—
Toledo Edison			
Preferred:			
$25 par $2.81	2,000	—	—
Retirements			
Cleveland Electric			
Preferred:			
$ 7.35 Series C	(10)	(10)	(1[illegible]
88.00 Series E	(3)	(3)	(3)
75.00 Series F	(17)	(17)	—
80.00 Series G	(8)	(8)	(8)
145.00 Series H	(4)	(2)	(2)
145.00 Series I	(4)	(2)	—
113.50 Series J	(29)	—	—
Preference:			
$77.50 Series 1	(9)	(11)	(11)
Toledo Edison			
Preferred:			
$100 par $11.00	(5)	(5)	(5)
9.375	(17)	(17)	(17)
13.25	(121)	(9)	—
12.65	(190)	(10)	—
14.80	(300)	—	—
25 par 3.75	(1,200)	—	—
3.72	(1,400)	—	—
Net Change	(1,317)	656	444
Cumulative Preferred Stock of Subsidiaries Not Subject to Mandatory Redemption:			
Sales			
Cleveland Electric			
Preferred:			
Remarketed Series P	1	—	—
Toledo Edison			
Preferred:			
$25 par			
Adjustable Series A	—	—	1,200
Adjustable Series B	—	1,200	—
Retirements			
Toledo Edison			
Preferred:			
$25 par $4.28	(800)	—	—
Net Change	(799)	1,200	1,200

No new shares of common stock will be issued for the Dividend Reinvestment and Stock Purchase Plan or the Employee Savings Plan. Shares required for the two plans are being acquired in the open market.

(b) Common Shares Reserved for Issue

Common shares reserved for issue under the Employee Savings Plan and Purchase Plan were 3,183,583 and 139,309 shares, respectively, at December 31, 1987.

Stock options to purchase unissued shares of common stock under the Key Employee Incentive Stock Plan and the 1978 Key Employee Stock Option Plan were granted at an exercise price of 100% of the fair market value at the date of the grant. The Key Employee Incentive Stock Plan expired in June 1987. No additional options may be granted under the 1978 Key Employee Stock Option Plan. The exercise prices of option shares purchased during the three years ended December 31, 1987 ranged from $14.09 to $20.73 per share, after adjustment for the exchange ratio. Shares under outstanding options held by employees were as follows:

	Key Employee Incentive Stock Plan		
	1987	1986	1985
Options Outstanding at December 31:			
Shares	—	30,636	58,517
Option Price	—	$20.21	$16.75 to $20.21

	1978 Key Employee Stock Option Plan		
	1987	1986	1985
Options Outstanding at December 31:			
Shares	391,769	481,290	601,256
Option Price	$14.09 to $20.73	$14.09 to $20.73	$14.09 to $20.73

(c) Equity Distribution Restrictions

At December 31, 1987, consolidated retained earnings were comprised almost entirely of the undistributed retained earnings of the Centerior Utilities. Substantially all of their retained earnings were available for the declaration of dividends on their respective preferred, preference and common shares. All of their common shares are held by Centerior Energy.

A loan or advance by a Centerior Utility to Centerior Energy requires PUCO authorization unless it is made in the ordinary course of business operations in which the Centerior Utility acts for Centerior Energy.

(d) Cumulative Preferred and Preference Stock

Amounts to be paid for preferred stock which must be redeemed during the next five years are $10,000,000 in years 1988 through 1990, $30,000,000 in 1991 and $20,000,000 in 1992. In addition, Cleveland Electric must offer to purchase preferred and preference stock having a total redemption price of $38,000,000 in 1988.

The annual mandatory redemption provisions are as follows:

	Annual Mandatory Redemption Provisions			
	Shares to be Redeemed	Shares at Holders' Option	Beginning in	Price Per Share
Cleveland Electric				
Preferred:				
$ 7.35 Series C	10,000	—	1984	$ 100
88.00 Series E	3,000	—	1981	1,000
75.00 Series F	—	16,667	1985	1,000
80.00 Series G	—	8,000	1984	1,000
145.00 Series H	1,782	—	1985	1,000
145.00 Series I	1,969	—	1986	1,000
113.50 Series K	10,000	—	1991	1,000
Adjustable Series M	100,000	—	1991	100
9.125 Series N	150,000	—	1993	100
Preference:				
77.50 Series 1	—	11,400	1984	1,000
Toledo Edison				
Preferred:				
$100 par $11.00	5,000	—	1979	100
9.375	16,650	—	1985	100
25 par 2.81	400,000	—	1993	25

The annualized cumulative preferred and preference dividend requirement as of December 31, 1987 is $73,000,000.

The preferred dividend rates on Cleveland Electric's Series L and M and Toledo Edison's Series A and B fluctuate based on prevailing interest rates. The dividend rates for these issues averaged 7.89%, 7.48%, 8.55% and 9.43%, respectively, in 1987. The dividend rate on Cleveland Electric's Remarketed Series P, which was issued in July 1987, averaged 8.66% in 1987.

Under its articles of incorporation, Toledo Edison cannot issue preferred stock unless certain earnings coverage requirements are met. Based on earnings for the 12 months ended December 31, 1987, Toledo Edison could issue at December 31, 1987 approximately $336,000,000 of additional preferred stock at an assumed annual dividend rate of 11%. Any required write-off by Toledo Edison of its plant investment could adversely affect its ability to issue additional preferred stock. See Notes 3 and 7. The issuance of additional preferred stock in the future will depend on earnings for any 12 consecutive months of the 15 months preceding the date of issuance, the interest on all long-term debt issued and the dividends on all preferred issues.

There are no restrictions on Cleveland Electric's ability to issue preferred or preference stock or Toledo Edison's ability to issue preference stock.

With respect to dividend and liquidation rights, each company's preferred stock is prior to its preference stock and common stock, and each company's preference stock is prior to its common stock.

(e) Long-Term Debt and Other Borrowing Arrangements

Long-term debt, less current maturities, for the Centerior Utilities is as follows:

First mortgage bonds:

Year of Maturity	Actual or Average Interest Rate	December 31, 1987	December 31, 1986
		(thousands of dollars)	
1988	4.00 %	$ —	$ 15,000
1989	3.00	20,000	20,000
1989	15.25	40,000	40,000
1989	14.375	50,000	50,000
1990	7.125	60,000	60,000
1990	14.00	—	65,000
1991	8.375	35,000	35,000
1991	14.00	25,000	25,000
1991	15.625	—	35,000
1991	15.00	70,000	70,000
1992	15.25	20,000	20,000
1992	16.125	—	60,000
1993-1997	8.76	378,750	559,882
1998-2002	8.15	100,728	115,998
2003-2007	9.79	269,475	284,745
2008-2012	9.29	678,650	946,098
2013-2017	10.30	872,550	572,550
2018-2022	9.02	205,300	93,800
		2,825,453	3,068,073
Term bank loans, 8.78% average rate, due 1989-1993		179,166	214,833
Notes, 10.83% average rate, due 1989-1997		357,000	277,000
Debentures, 11.25%, due 1997		125,000	—
Pollution control notes, 9.69% average rate, due 1989-2015		223,290	223,800
Other — net		8,340	8,696
Total Long-Term Debt		$3,718,249	$3,792,402

Long-term debt matures during the next five years as follows: $50,000,000 in 1988, $150,000,000 in 1989, $208,000,000 in 1990, $204,000,000 in 1991 and $170,000,000 in 1992.

The mortgages of Cleveland Electric and Toledo Edison constitute a first mortgage lien on substantially all their property and franchises owned. Excluded from the lien are cash, securities, accounts receivable, fuel, supplies and, in the case of Toledo Edison, automotive equipment.

The issuance of additional first mortgage bonds by Cleveland Electric is limited by two provisions of its mortgage. One relates to bondable property coverage of the bonds and the other to earnings coverage of interest on the bonds. The amount of additional bonds issuable will depend upon unbonded bondable property, earnings and interest on the bonds then outstanding and to be issued. Under these limits, Cleveland Electric would have been permitted to issue approximately $803,000,000 of additional bonds at December 31, 1987.

The issuance of additional first mortgage bonds by Toledo Edison also is limited by provisions in its mortgage similar to those in Cleveland Electric's mortgage. The mortgage also permits the issuance of refunding bonds in an amount equal to retired bonds which have not served as the basis for the issue of other bonds. Under these provisions at December 31, 1987, Toledo Edison would have been permitted to issue approximately $241,000,000 of nonrefunding bonds and $24,000,000 of refunding bonds.

Certain unsecured loan agreements of Toledo Edison contain covenants limiting to 65% of total capitalization (as defined) the total of its short-term debt in excess of $150,000,000 and funded debt, limiting secured financing other than through first mortgage bonds and certain other transactions and requiring Toledo Edison to maintain earnings (as defined) of at least 1.5 times interest on its first mortgage bonds. The earnings coverage ratio applies to $349,500,000 of unsecured loans and was 2.71 at December 31, 1987.

Any required write-offs of the Centerior Utilities' plant investments could significantly affect their ability to issue additional debt. See Notes 3 and 7.

(13) Short-Term Borrowing Arrangements

Our bank credit arrangements at December 31, 1987 were as follows:

	Cleveland Electric	Toledo Edison	Service Company	Total
	(thousands of dollars)			
Bank Lines of Credit	$152,300	$69,350	$13,000	$234,650
Revolving Underwriting Facility	—	25,000	—	25,000
Eurodollar Revolving Credit Agreement	26,000	—	—	26,000

There were no borrowings under these bank credit arrangements at December 31, 1987.

Short-term borrowing capacity authorized by the PUCO is $300,000,000 for Cleveland Electric and $150,000,000 for Toledo Edison.

Cleveland Electric

Most borrowings under Cleveland Electric's short-term bank lines of credit require a fee of approximately 0.3% per year to be paid on any unused portion of the lines of credit. For those banks without fee requirements, the average daily cash balance in the bank accounts satisfied informal compensating balance arrangements.

Any borrowings under Cleveland Electric's Eurodollar agreement are made and paid back in United States dollars. There are no requirements that compensating balances be maintained at the banks involved. However, a fee of 0.1875% to 0.375% per year is paid on any unused borrowings. The interest rate on borrowings is 0.375% to 0.625% (depending on usage) above the rate which specified banks pay for Eurodollar deposits in the London interbank markets.

At December 31, 1987, Cleveland Electric had $37,000,000 of commercial paper outstanding. Commercial paper outstanding is backed by at least an equal amount of unused bank lines of credit.

Toledo Edison

Toledo Edison's annual commitment fees range from 0.25% to 0.5% on most of its lines of credit. The rest of the lines of credit have informal compensating balance arrangements. Banks expect Toledo Edison to maintain average deposits equal to 5% of the line of credit, depending upon the amounts borrowed. The deposits provide operating balances for Toledo Edison and are not restricted legally.

Toledo Edison also has a commercial paper program. There were no such borrowings at December 31, 1987.

Centerior Service Company

Fees for the Service Company's lines of credit range from 0% to 0.375%. There are no informal compensating balance arrangements for the banks which do not require a fee.

Centerior Energy Corporation

No formal short-term borrowing arrangements were established for Centerior Energy in 1987 or 1986.

(14) Quarterly Results of Operations (Unaudited)

The following is a tabulation of the unaudited quarterly results of operations for the two years ended December 31, 1987.

	Quarters ended			
	March 31	June 30	Sept. 30	Dec. 31
	(thousands of dollars, except per share amounts)			
1987				
Operating Revenues	$487,499	$483,995	$561,076	$412,971
Operating Income	$101,514	$102,565	$131,772	$ 47,759
Net Income	$106,936	$ 93,794	$128,305	$ 61,318
Average Common Shares (thousands)	135,926	137,661	139,552	140,596
Earnings per Common Share	$ .79	$ .68	$ .92	$ .44
Dividends Paid per Common Share	$ .64	$ .64	$ .64	$ .64
1986				
Operating Revenues	$484,229	$442,502	$520,752	$470,247
Operating Income	$100,326	$ 80,568	$113,133	$ 65,778
Net Income	$ 99,549	$ 81,787	$118,125	$ 92,432
Average Common Shares (thousands)	126,732	128,052	129,197	131,519
Earnings per Common Share	$ .79	$ .64	$ .91	$ .70
Dividends Paid per Common Share	$ .60	$ .61	$ .64	$ .64

Operating revenues and operating income for the quarter ended December 31, 1987 were reduced by approximately $32,000,000 and $18,000,000, respectively, resulting from the deferral of CWIP in rate base revenues collected in prior quarters. Such deferrals were offset by the recording of AFUDC as discussed in the Summary of Significant Accounting Policies which resulted in no change in net income.

Quarterly results of operations for the quarter ended December 31, 1987 differ from the unaudited amounts previously reported because of year end adjustments and reclassifications made following the receipt of February 1988 PUCO accounting orders for Perry Unit 1 deferred costs and carrying charges as discussed in the Summary of Accounting Policies.

Financial and Statistical Review

Operating Revenues (thousands of dollars)

Year	Residential	Commercial	Industrial	Other	Total Retail	Wholesale	Total Electric	Steam Heating & Gas	Total Operating Revenues
1987	$629 663	$531 682	$689 959	$ 56 457	$1 907 761	$24 409	$1 932 170	$13 371	$1 945 541
1986	599 445	516 614	675 682	101 655	1 893 396	11 381	1 904 777	12 953	1 917 730
1985	566 666	485 269	667 450	92 710	1 812 095	16 036	1 828 131	18 866	1 846 997
1984	548 136	454 092	636 036	87 279	1 725 543	14 866	1 740 409	24 324	1 764 733
1983	546 351	440 142	599 881	83 047	1 669 421	18 421	1 687 842	25 399	1 713 241
1977	287 742	220 919	348 767	37 772	895 200	24 857	920 057	15 749	935 806

Operating Expenses (thousands of dollars)

Year	Fuel & Purchased Power	Operation & Maintenance	Depreciation & Amortization	Taxes Other Than FIT	Perry Unit 1 & Beaver Valley Unit 2 Deferred	Federal Income Taxes	Total Operating Expenses
1987	$470 466	$642 594	$214 421	$208 480	$(87 623)	$113 593	$1 561 931
1986	522 281	550 874	141 009	195 967	—	147 794	1 557 925
1985	510 844	450 376	141 333	182 046	—	163 362	1 447 961
1984	453 192	404 314	145 245	178 915	—	197 766	1 379 432
1983	454 018	384 077	145 334	172 093	—	184 157	1 339 679
1977	426 183	167 252	62 872	77 936	—	53 829	788 072

Income (thousands of dollars)

Year	Operating Income	AFUDC—Equity	Other Income—Net	Post In-Service Carrying Charges	Federal Income Tax—Credits	Income Before Interest Charges	Interest Charges	AFUDC—Debt	Income After Interest
1987	$383 610	$297 239	$(57 821)	$39 303	$121 122	$783 453	$432 411	$(125 446)	$476 488
1986	359 805	298 781	(8 108)	—	116 422	766 900	404 018	(114 038)	476 920
1985	399 036	260 632	5 825	—	86 775	752 268	366 829	(98 777)	484 216
1984	385 301	213 157	11 556	—	69 434	679 448	310 265	(75 975)	445 158
1983	373 562	152 637	5 422	—	47 402	579 023	258 449	(53 796)	374 370
1977	147 734	60 035	4 771	—	18 473	231 013	103 138	(32 508)	160 383

Income (thousands of dollars) Common Stock (dollars per share & %)

Year	Preferred & Preference Stock Dividends	Net Income	Average Shares Outstanding* (thousands)	Earnings*	Return on Average Equity (%)	Dividends Declared*	Book Value*
1987	$86 135	$390 353	138 395	$2.82	12.8%	$2.56	$22.10
1986	85 027	391 893	128 927	3.04	13.7	2.49	22.13
1985	82 829	401 387	121 898	3.29	15.7	2.20**	21.50
1984	78 349	366 809	107 622	3.41	16.4	2.29	20.64
1983	68 555	305 815	98 240	3.11	15.7	2.19	20.24
1977	33 425	126 958	46 750	2.72	14.7	1.74	19.26

NOTE: Data for years prior to 1986 are the result of combining and restating Cleveland Electric and Toledo Edison data.

*Outstanding shares for the periods prior to April 29, 1986 have been adjusted for Cleveland Electric's 1.11 exchange ratio and Toledo Edison's one-for-one exchange ratio for Centerior Energy shares.

**1985 Dividends Declared declined because Toledo Edison's first quarter 1986 dividend declaration was delayed from its usual date in 1985 to January 1986 in order to synchronize Toledo Edison's dividend declaration and payment schedules with Cleveland Electric's prior to the affiliation.

Year	Electric Sales (millions of KWH) Residential	Commercial	Industrial	Wholesale	Other	Total	Electric Customers (year end) Residential	Commercial	Industrial & Other	Total	Residential Usage Average KWH Per Customer	Price Per KWH (cents)	Average Revenue Per Customer (dollars)
1987	6 659	6 350	11 985	399	949	26 3[illegible]2	903 365	90 148	12 240	1 005 753	7 217	9.46¢	$685.43
1986	6 527	6 239	11 409	242	909	25 326	898 583	87 947	12 012	998 542	7 108	9.18	654.99
1985	6 309	5 952	11 410	331	865	24 867	892 727	87 442	12 023	992 192	6 900	8.98	622.08
1984	6 404	5 794	11 441	307	871	24 817	888 816	85 825	11 850	986 491	7 035	8.56	603.92
1983	6 327	5 606	10 641	340	854	23 768	886 024	85 769	11 557	983 350	6 967	8.64	603.22
1977	6 074	5 240	12 350	1 097	793	25 554	863 323	79 467	11 044	953 834	6 893	4.74	326.87

Year	Load (megawatts) Operable Capacity At Time Of Peak***	Peak Load	Load Factor (%)	Capacity Margin (%)	Energy (millions of KWH) Company Generated Fossil	Company Generated Nuclear	Company Generated Total	Net Purchased Power	Total	Fuel Fuel Cost Per KWH (cents)	Efficiency–BTU Per KWH
1987	5 955	5 173	63.6%	13.1%	20 878	6 897	27 775	600	28 375	1.53¢	10 461
1986	5 199	5 021	63.0	3.4	22 694	24	22 718	4 552	27 270	1.79	10 292
1985	4 539	4 512	69.1	5.9	21 610	1 964	23 574	3 283	26 857	1.85	10 313
1984	5 338	4 659	66.1	12.7	19 930	4 303	24 233	2 350	26 583	1.71	10 349
1983	6 218	4 717	63.1	24.1	19 487	4 895	24 382	1 287	25 669	1.72	10 419
1977	5 552	4 734	65.5	14.7	23 862	463	24 325	3 113	27 438	1.21	10 364

Investment (thousands of dollars)

Year	Utility Plant In Service	Accumulated Depreciation & Amortization	Net Plant	Construction Work In Progress	Nuclear Fuel and Other****	Total Property, Plant and Equipment	Utility Plant Additions	Total Assets
1987	$8 349 696	$1 324 446	$7 025 250	$1 007 707	$656 350	$8 689 307	$ 933 744	$11 282 659
1986	4 639 542	1 367 662	3 271 880	5 213 541	652 564	9 137 985	1 120 017	9 967 571
1985	4 481 451	1 264 931	3 216 520	4 280 584	564 276	8 061 380	983 750	9 002 119
1984	4 281 856	1 163 994	3 117 862	3 526 978	485 207	7 130 047	938 509	8 049 712
1983	4 180 192	1 047 318	3 132 874	2 710 352	392 268	6 235 494	784 715	6 921 890
1977	2 358 076	582 613	1 775 463	1 014 372	53 279	2 843 114	481 022	3 247 056

Capitalization (thousands of dollars)

Year	Common Stock Equity	%	Preferred Stock without Mandatory Redemption Provisions	%	Preferred & Preference Stock with Mandatory Redemption Provisions	%	Long-Term Debt	%	Total
1987	$3 109 060	41%	$457 334	6%	$343 985	4%	$3 718 249	49%	$7 628 628
1986	2 991 341	39	404 021	5	487 814	7	3 792 402	49	7 675 578
1985	2 710 098	39	374 021	5	468 306	7	3 438 928	49	6 991 353
1984	2 403 234	39	344 021	6	450 646	7	2 993 770	48	6 191 671
1983	2 065 340	39	344 021	6	412 002	8	2 503 859	47	5 325 222
1977	955 616	34	245 071	9	195 000	7	1 380 179	50	2 775 866

***Capacity was reduced because of extended generating unit outages for renovation and improvements in 1984 (720 mw), 1985 (1,490 mw) and 1986 (856 mw).

**** 1984 and prior restated for effects of capitalization of nuclear fuel lease and financing arrangements pursuant to Statement of Financial Accounting Standards 71.

Board of Directors

Richard P. Anderson, President and Chief Executive Officer, The Andersons Management Corporation, a grain, farm supply and retailing firm.

Leigh Carter, President and Chief Operating Officer of The BFGoodrich Company, a producer of chemicals, plastics and aerospace products. Also Chairman of Tremco, Incorporated, a manufacturer of specialty chemical products, a wholly-owned subsidiary of The BFGoodrich Company.

Thomas A. Commes, President and Chief Operating Officer of The Sherwin-Williams Company, a manufacturer of paints and painting supplies.

Chester Devenow, Chairman and Chief Executive Officer of Sheller-Globe Corporation, a manufacturer of automotive parts and assemblies, electrical equipment and radiation and environmental monitoring equipment.

Edwin D. Dodd, Retired Chairman and Chief Executive Officer of Owens-Illinois, Inc., a manufacturer of glass, plastic, paper and glass-ceramic products.

Robert M. Ginn, Chairman and Chief Executive Officer of the Company, Centerior Service Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company.

Roy H. Holdt, Retired Chairman of White Consolidated Industries, Inc., a manufacturer of products for the home, principally major appliances, and machinery and equipment for industry.

George H. Kaull, Chairman and Chief Executive Officer of Premix, Inc., a developer, manufacturer and fabricator of thermoset reinforced composite materials.

Richard A. Miller, President of the Company and Centerior Service Company.

Frank E. Mosier, President of BP America Inc. and President and Chief Operating Officer of The Standard Oil Company, a producer and refiner of petroleum products.

Sister Mary Marthe Reinhard, SND, President of Notre Dame College of Ohio in Cleveland.

Paul M. Smart, President of The Toledo Edison Company and Executive Vice President of the Company.

Herbert E. Strawbridge, Director and retired Chairman of The Higbee Company, a department store in Northern Ohio.

William J. Williams, Chairman and Chief Executive Officer of Huntington National Bank.

Committees of the Board

Audit
Williams, Chmn.
Dodd
Kaull
Reinhard

Compensation
Carter, Chmn.
Devenow
Mosier
Williams

Executive
Ginn, Chmn.
Anderson
Strawbridge

Finance
Miller, Chmn.
Anderson
Commes
Ginn
Holdt

Nominating
Mosier, Chmn.
Anderson
Carter
Commes
Devenow
Dodd
Ginn
Holdt
Kaull
Reinhard
Strawbridge
Williams

Executives of the Company and Subsidiaries

Centerior Energy Corporation

Chairman and Chief Executive Officer	*Robert M. Ginn*
President	*Richard A. Miller*
Executive Vice President	*Robert J. Farling*
Executive Vice President	*Paul M. Smart*
Senior Vice President	*Lyman C. Phillips*
Vice President & General Counsel	*Victor F. Greenslade*
Vice President-Finance and Chief Financial Officer	*Edgar H. Maugans*
Treasurer	*Gary M. Hawkinson*
Secretary	*E. Lyle Pepin*

Centerior Service Company

Chairman and Chief Executive Officer	*Robert M. Ginn*
President	*Richard A. Miller*
Senior Vice President-Finance and Chief Financial Officer	*Edgar H. Maugans*
Vice President-Fossil Operations & Engineering	*Richard P. Crouse*
Vice President-Nuclear	*Murray R. Edelman*
Vice President & General Counsel	*Victor F. Greenslade*
Vice President-System Engineering & Operations	*William D. Masters*
Vice President-Administration	*Stanley E. Wertheim*
Vice President-Governmental & Public Affairs	*Alan D. Wright*
Controller	*Paul G. Busby*
Treasurer	*Gary M. Hawkinson*
Secretary	*E. Lyle Pepin*

Operating Companies

The Cleveland Electric Illuminating Company

Chairman and Chief Executive Officer	*Robert M. Ginn*
President	*Robert J. Farling*
Senior Vice President	*Alan D. Wright*
Vice President-Marketing	*Gary J. Greben*
Vice President-Nuclear	*Alvin Kaplan*
Vice President-Finance, Administration & Legal	*John S. Levicki*
Vice President-Distribution & Services	*William K. McClung*
Vice President-Power Supply	*Richard A. Peterka*
Secretary & General Counsel	*Carl E. Chancellor*
Controller	*Raymond J. Jirousek*
Treasurer	*Terrence R. Moran*

The Toledo Edison Company

Chairman and Chief Executive Officer	*Robert M. Ginn*
President	*Paul M. Smart*
Executive Vice President	*Lyman C. Phillips*
Senior Vice President-Engineering & Operations	*Richard P. Crouse*
Vice President-Customer Operations	*David L. Monseau*
Vice President-Marketing	*Thomas M. Quinn*
Vice President-Finance & Administration	*Donald H. Saunders*
Vice President-Nuclear	*Donald C. Shelton*
Controller	*James P. Martin*
Secretary and Treasurer	*Jennifer M. Shriver*

Share Owner Information

Dividend Reinvestment and Stock Purchase Plan

The Company has a Dividend Reinvestment and Stock Purchase Plan which provides share owners of record and customers of the Company's subsidiaries a convenient means of purchasing shares of Company common stock by investing a part or all of their quarterly dividends as well as making cash investments. In addition, individuals may establish an Individual Retirement Account (IRA) which invests in Company common stock through the Plan. Information and a prospectus relating to the Plan and the IRA may be obtained from Share Owner Services at the Company.

Form 10-K

The Company will furnish to share owners, without charge, a copy of its most recent annual report to the Securities and Exchange Commission (Form 10-K) and, upon payment of a reasonable fee, a copy of each exhibit to Form 10-K. Requests should be directed to the Secretary of the Company.

Independent Accountants

Arthur Andersen & Co., 1717 East Ninth Street
Cleveland, Ohio 44114

Common Stock

Listed on the New York, Midwest and Pacific Stock Exchanges. New York Stock Exchange symbol—CX.

Registrar

AmeriTrust Company National Association
900 Euclid Avenue, Cleveland, Ohio 44114

Transfer Agent

Centerior Energy Corporation
Share Owner Services
P.O. Box 94661, Cleveland, Ohio 44101-4661

Stock transfers may be presented at Wells Fargo Securities Clearance Corporation, 45 Broad Street, New York, N.Y. 10004.

Share Owner Inquiries

Communications regarding stock transfer requirements, lost certificates, dividends and changes of address should be directed to Share Owner Services at the Company. To reach Share Owner Services by phone, call the following numbers:

Local calls in Cleveland area	642-6900 or 447-2400
Outside Cleveland area	1-800-433-7794

Please have your account number ready when calling.

Audio Cassettes Available

Share owners with impaired vision may obtain audio cassettes of the Company's Quarterly Reports and Annual Report. To obtain a cassette, simply write or call Share Owner Services. There is no charge for this service.

Executive Offices

Centerior Energy Corporation
6200 Oak Tree Boulevard, Independence, Ohio
Telephone Number (216) 447-3100

Mail Address

Centerior Energy Corporation
P.O. Box 94661, Cleveland, Ohio 44101-4661

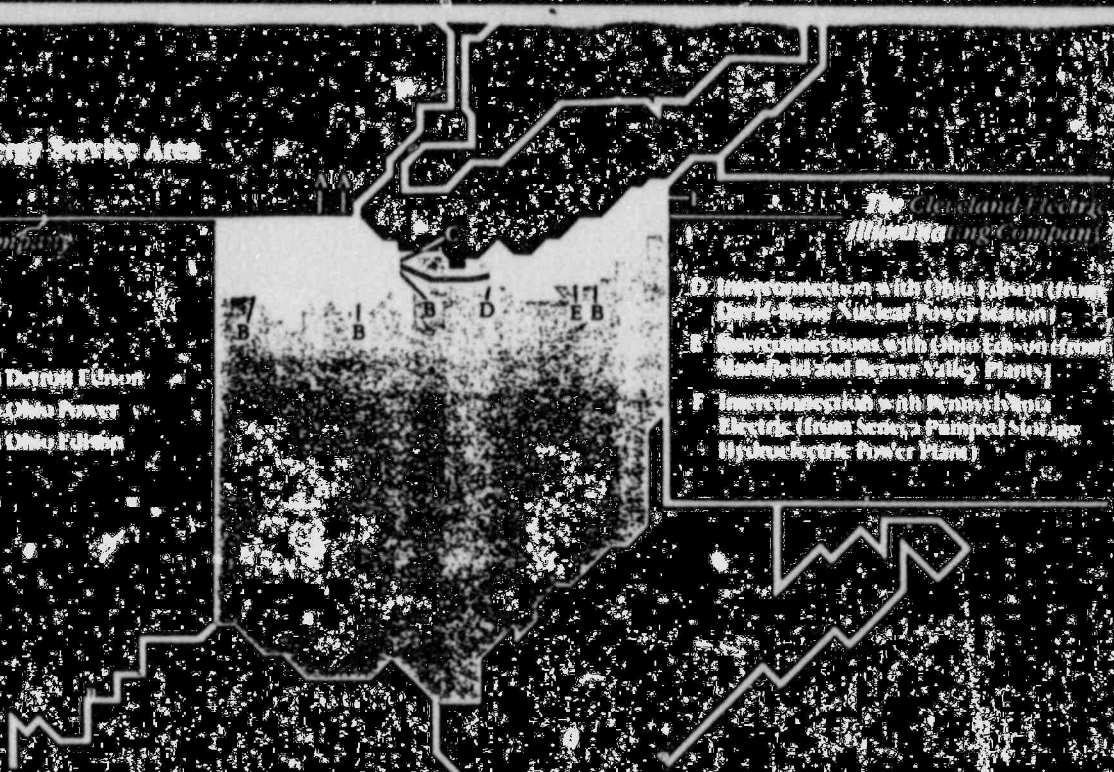
Annual Meeting

The annual meeting of the share owners of the Company will be held April 26, 1988. Owners of common stock as of February 26, 1988, the record date for the meeting, will be eligible to vote on matters brought up for share owners' consideration.

Notice: The annual report and the financial statements herein are for the general information of the share owners of the Company and are not intended to be used in connection with any sale or purchase of securities.

The Company is an equal opportunity employer.

Centerior Energy Service Area



Centerior Energy Generating Units

	Net Demonstrated Capability (Mw) Total	Company Ownership and Leasehold Share	Operating Responsibility
Coal			
Acme	268	26[illegible]	Toledo Edison
Ashtabula	420	420	Cleveland Electric
Avon	772	772	Cleveland Electric
Bay Shore	631	631	Toledo Edison
Eastlake	1,233	1,047*	Cleveland Electric
Lake Shore	245	245	Cleveland Electric
Bruce Mansfield	2,360	764*	Pennsylvania Power
Nuclear			
Beaver Valley Unit 2	833	370*	Duquesne Light
Davis-Besse	866	866*	Toledo Edison
Perry Unit 1	1,205	615*	Cleveland Electric
Perry Unit 2**	1,205	615*	Cleveland Electric
Oil			
Avon Lake	35	35	Cleveland Electric
Bay Shore	17	17	Toledo Edison
Eastlake	35	35	Cleveland Electric
Lake Shore	247	247	Cleveland Electric
Richland	42	42	Toledo Edison
Stryker	18	18	Toledo Edison
Pumped hydro			
Seneca	381	305	Pennsylvania Electric

*Owned and leased jointly by various members of the Central Area Power Coordination Group (CAPCO)—The Cleveland Electric Illuminating Company, The Toledo Edison Company, Duquesne Light Company, Ohio Edison Company and its subsidiary Pennsylvania Power Company.

**Construction suspended indefinitely


CVX
Nuclear