ITRONICS INC
Form SB-2/A
February 14, 2006

As filed with the Securities and Exchange Commission on February 14, 2006
Registration No. 333-127855

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

AMENDMENT NO. 5 TO

FORM SB-2
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

ITRONICS INC.
(Name of small business issuer in its charter)

Texas	**2870**	**75-2198369**
(State or other Jurisdiction of Incorporation or Organization)	(Primary Standard Industrial Classification Code Number)	(I.R.S. Employer Identification No.)

6490 S. McCarran Blvd., Bldg C-23
Reno, Nevada 89509
(775) 689-7696
(Address and telephone number of principal executive offices and principal place of business)

Dr. John W. Whitney, Chief Executive Officer
ITRONICS INC.
6490 S. McCarran Blvd., Bldg C-23
Reno, Nevada 89509
(775) 689-7696
(Name, address and telephone number of agent for service)

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APPROXIMATE DATE OF PROPOSED SALE TO THE PUBLIC:
From time to time after this Registration Statement becomes effective.

If any securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box: x

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ________

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ________

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o ________

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o ________

CALCULATION OF REGISTRATION FEE

Title of each class of securities to be registered	Amount to be registered (1)	Proposed maximum offering price per share (2)	Proposed maximum aggregate offering price	Amount of registration fee
Common stock, $.001 par value issuable upon conversion of the secured convertible notes	49,241,000(3)	$.08	$3,939,280	$421.50
Common stock, $.001 par value issuable upon exercise of warrants	759,000(4)	$.08	$60,720	$6.50
Total	50,000,000		$4,000,000	$428.00*

* We previously paid a filing fee in the aggregate amount of $376.64 in the initial filing of this registration statement on Form SB-2. We registered an additional 10,000,000 shares of our common stock in Amendment No. 3 on Form SB-2 which was filed on February 6, 2006, including 9,850,000 shares underlying the secured convertible notes and 150,000 shares underlying warrants. Accordingly, we paid a filing fee of $51.36 upon the filing of Amendment No. 3

(1) Includes shares of our common stock, par value $0.001 per share, which may be offered pursuant to this registration statement, which shares are issuable upon conversion of secured convertible notes and the exercise of warrants held by the selling stockholders. In addition to the shares set forth in the table, the amount to be registered includes an indeterminate number of shares issuable upon conversion of the secured convertible notes and exercise of the warrants, as such number may be adjusted as a result of stock splits, stock dividends and similar transactions in accordance with Rule 416. The number of shares of common stock registered hereunder represents a good faith estimate by us of the number of shares of common stock issuable upon conversion of the secured convertible notes and upon exercise of the warrants. For purposes of estimating the number of shares of common stock to be included in this registration statement, we calculated a good faith estimate of the number of shares of our common stock that we believe will be issuable upon conversion of the secured convertible notes and upon exercise of the warrants to account for market fluctuations, and antidilution and price protection adjustments, respectively. Should the conversion ratio result in our having insufficient shares, we will not rely upon Rule 416, but will file a new registration statement to cover the resale of such additional shares should that become necessary. In addition, should a decrease in the exercise price as a result of an issuance or sale of shares below the then current market price, result in our having insufficient shares, we will not rely upon Rule 416, but will file a new registration statement to cover the resale of such additional shares should that become necessary.

(2) Estimated solely for purposes of calculating the registration fee in accordance with Rule 457(c) and Rule 457(g) under the Securities Act of 1933, using the average of the high and low price as reported on the Over-The-Counter Bulletin Board on February 3, 2006, which was $.08 per share.

(3) Includes a good faith estimate (200%) of the shares underlying secured convertible notes to account for market fluctuations.

(4) Includes a good faith estimate of the shares underlying warrants exercisable at $.15 per share to account for antidilution and price protection adjustments.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said

Section 8(a), may determine.

THE INFORMATION CONTAINED IN THIS PROSPECTUS IS NOT COMPLETE AND MAY BE CHANGED. WE MAY NOT SELL THESE SECURITIES UNTIL THE REGISTRATION STATEMENT FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS EFFECTIVE. THIS PROSPECTUS IS NOT AN OFFER TO SELL THESE SECURITIES AND IT IS NOT SOLICITING AN OFFER TO BUY THESE SECURITIES IN ANY STATE WHERE THE OFFER OR SALE IS NOT PERMITTED.

PRELIMINARY PROSPECTUS SUBJECT TO COMPLETION, DATED FEBRUARY 14, 2006

ITRONICS INC.
50,000,000 SHARES OF
COMMON STOCK

This prospectus relates to the resale by the selling stockholders of up to 50,000,000 shares of our common stock, including up to 49,241,000 shares of common stock underlying secured convertible notes in a principal amount of $3,250,000 and up to 759,000 shares of common stock issuable upon the exercise of common stock purchase warrants. The secured convertible notes are convertible into our common stock at the lower of $0.10 or at a 45% discount to the average of the three lowest intraday trading prices for the common stock on a principal market for the 20 trading days before but not including the conversion date. The selling stockholders may sell common stock from time to time in the principal market on which the stock is traded at the prevailing market price or in negotiated transactions. The selling stockholders may be deemed underwriters of the shares of common stock, which they are offering. We will pay the expenses of registering these shares.

Our common stock is registered under Section 15(d) of the Securities Exchange Act of 1934 and is listed on the Over-The-Counter Bulletin Board under the symbol "ITRO". The last reported sales price per share of our common stock as reported by the Over-The-Counter Bulletin Board on February 3, 2006, was $.08.

Investing in these securities involves significant risks. See "Risk Factors" beginning on page 6.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this Prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is ________, 2006.

The information in this Prospectus is not complete and may be changed. This Prospectus is included in the Registration Statement that was filed by Itronics Inc. with the Securities and Exchange Commission. The selling stockholders may not sell these securities until the registration statement becomes effective. This Prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the sale is not permitted.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus and any prospectus supplement contain forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events.

In some cases, you can identify forward-looking statements by words such as “may,” “should,” “expect,” “plan,” “coul “anticipate,” “intend,” “believe,” “estimate,” “predict,” “potential,” “goal,” or “continue” or similar terminology. These s are only predictions and involve known and unknown risks, uncertainties and other factors, including the risks outlined under “Risk Factors,” that may cause our or our industry’s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements.

Unless we are required to do so under U.S. federal securities laws or other applicable laws, we do not intend to update or revise any forward-looking statements.

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PROSPECTUS SUMMARY

The following summary highlights selected information contained in this prospectus. This summary does not contain all the information you should consider before investing in the securities. Before making an investment decision, you should read the entire prospectus carefully, including the "risk factors" section, the financial statements and the notes to the financial statements.

ITRONICS INC.

We are the inventor and developer of the "Beneficial Use Photochemical, Silver, and Water Recycling" technology that produces environmentally beneficial GOLD'n GRO fertilizers and silver bullion.

We are a process technology company that has developed what we believe is a unique technology for photochemical recycling. We, through our subsidiary, Itronics Metallurgical, Inc., extract more than 99% of the silver and virtually all of the other toxic heavy metals from used photoliquids. We then use this “Beneficial Use Photochemical, Silver and Water Recycling” technology to produce environmentally beneficial chelated multinutrient liquid fertilizer products sold under the trademark GOLD’n GRO, animal repellant/fertilizer products to be sold under the trademark GOLD’n GRO Guardian, and silver bullion. We also provide process planning and technical services to the mining industry.

For the years ended December 31, 2004 and 2003, we generated net revenues in the amount of $1,720,049 and $1,268,787 and net losses of $2,839,872 and $2,752,291, respectively. For the nine months ended September 30, 2005, we generated net revenues in the amount of $1,110,697 and a net loss of $2,665,012. As a result of recurring losses from operations and an accumulated deficit of $22,944,959 as of December 31, 2004, our Independent Registered Public Accounting Firm, in their report dated May 19, 2005, have expressed substantial doubt about our ability to continue as going concern.

Our principal offices are located at 6490 S. McCarran Blvd., Bldg C-23, Reno, Nevada 89509, and our telephone number is (775) 689-7696. We are a Texas corporation.

Common stock offered by selling stockholders	Up to 50,000,000 shares, including the following:
	– up to 49,241,000 shares of common stock underlying secured convertible notes in the principal amount of $3,250,000 (includes a good faith estimate of the shares underlying secured convertible notes to account for market fluctuations and antidilution protection adjustments, respectively),
	– up to 759,000 shares of common stock issuable upon the exercise of common stock purchase warrants at an exercise price of $.15 per share (includes a good faith estimate of the shares underlying warrants to account for antidilution protection adjustments),
	This number represents 25.35% of our current outstanding stock.

Common stock to be outstanding after the offering	Up to 247,248,179 shares
Use of proceeds	We will not receive any proceeds from the sale of the common stock. However, we will receive the sale price of any common stock we sell to the selling stockholders upon exercise of the warrants. We expect to use the proceeds received from the exercise of the warrants, if any, for general working capital purposes. However, AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., and New Millennium Partners II, LLC will be entitled to exercise up to 3,000,000 warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event that AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., or New Millennium Partners II, LLC exercise the warrants on a cashless basis, then we will not receive any proceeds from the exercise of those warrants. In addition, we have received gross proceeds $2,750,000 from the sale of the secured convertible notes and the investors are obligated to provide us with an additional $500,000 within five days of this prospectus being declared effective. The proceeds received from the sale of the secured convertible notes will be used for business development purposes, working capital needs, pre-payment of interest, payment of consulting and legal fees and purchasing inventory.
Over-The-Counter Bulletin Board Symbol	ITRO

The above information regarding common stock to be outstanding after the offering is based on 197,248,179 shares of common stock outstanding as of February 14, 2006 and assumes the subsequent conversion of our issued secured convertible notes and exercise of warrants by our selling stockholders.

EXPLANATORY NOTE:On July 15, 2005, we entered into a Securities Purchase Agreement with four accredited investors. In addition, on July 5, 2005 we entered into a Finder's Agreement with Confin International Investments, which acted as selling agent in connection with the July 2005 Securities Purchase Agreement. Any issuance of shares of common stock pursuant to the Securities Purchase Agreement and Finder's Agreement that would require us to issue shares of common stock in excess of our authorized capital is contingent upon us obtaining shareholder approval to increase our authorized shares of common stock from 250,000,000 to 1,000,000,000 and filing the certificate of amendment to our certificate of incorporation. We filed a proxy statement with the Securities and Exchange Commission on August 31, 2005, asking a super majority of our shareholders to authorize the increase in our authorized shares of common stock. If a super majority of our shareholders approve an increase in our authorized shares of common stock, we intend on filing the certificate of amendment to our certificate of incorporation immediately following our shareholder meeting. We are registering 50,000,000 shares of common stock pursuant to this prospectus that are underlying the secured convertible notes and warrants issued in connection with the Securities Purchase Agreement. Upon filing the certificate of amendment, we will amend this prospectus to include additional shares of common stock that are issuable pursuant to the Securities Purchase Agreement and the shares of common stock that are issuable pursuant to the Finder's Agreement.

JULY 2005 SECURITIES PURCHASE AGREEMENT

To obtain funding for our ongoing operations, we entered into a Securities Purchase Agreement with four accredited investors on July 15, 2005 for the sale of (i) $3,250,000 in secured convertible notes and (ii) warrants to buy 3,000,000 shares of our common stock.

The investors are obligated to provide us with the funds (gross proceeds) as follows:

· $250,000 was disbursed on July 15, 2005;

· $1,000,000 was disbursed on August 1, 2005, upon receipt by the investors of a certificate representing the pledged shares of Dr. John W. Whitney, our President, as security for repayment of the secured convertible notes in the aggregate amount of 14,550,558 shares pursuant to the Guaranty and Pledge Agreement dated as of July 15, 2005;

· $1,000,000 was disbursed within five days of the filing of this registration statement;

· $500,000 was disbursed on January 26, 2006 as an advance on the final traunche; and

· $500,000 will be disbursed within five days of the effectiveness of this prospectus.

The secured convertible notes bear interest at 8%, mature three years from the date of issuance, and are convertible into our common stock, at the selling stockholders' option, at the lower of (i) $0.10 or (ii) a 45% discount to the average of the three lowest intraday trading prices for the common stock on a principal market for the 20 trading days before but not including the conversion date. Accordingly, there is in fact no limit on the number of shares into which the notes may be converted. As of August 22, 2005, the average of the three lowest intraday trading prices for our common stock during the preceding 20 trading days as reported on the Over-The-Counter Bulletin Board was $.06 and, therefore, the conversion price for the secured convertible notes was $.033. Based on this conversion price, the $3,250,000 secured convertible notes, excluding interest, were convertible into 98,484,848 shares of our common stock.

AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd. and New Millennium Partners II, LLC have contractually agreed to restrict their ability to convert or exercise their warrants and receive shares of our common stock such that the number of shares of common stock held by them and their affiliates after such conversion or exercise does not exceed 4.99% of the then issued and outstanding shares of common stock.

Confin International Investments (the "Selling Agent") acted as selling agent in connection with the offering. We will issue will issue up to a total of 3,000,000 warrants to the Selling Agent and the Selling Agent will receive gross fees of $260,000, representing 8% of the total gross proceeds received by us, as consideration for services performed in connection with the issuance of the secured convertible notes and warrants to the investors pursuant to the July 2005 Securities Purchase Agreement.

On January 26, 2006, we received a $500,000 advance on the final traunche of the Securities Purchase Agreement pursuant to which we issued an aggregate of $500,000 in secured convertible notes and warrants to purchase an aggregate of 461,539 shares of our common stock to AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd. and New Millennium Partners II, LLC. The remaining $500,000 pursuant to the Securities Purchase Agreement will be funded upon the effectiveness of this registration statement.

See the "Selling Stockholders" and "Risk Factors" sections for a complete description of the secured convertible notes.

RISK FACTORS

This investment has a high degree of risk. Before you invest you should carefully consider the risks and uncertainties described below and the other information in this prospectus. If any of the following risks actually occur, our business, operating results and financial condition could be harmed and the value of our stock could go down. This means you could lose all or a part of your investment.

Risks Relating to Our Business:

We Have a History Of Losses Which May Continue, and May Negatively Impact Our Ability to Achieve Our Business Objectives.

We incurred net losses of $2,839,872 and $2,752,291 for the years ended December 31, 2004 and 2003, respectively. For the nine months ended September 30, 2005, we incurred a net loss of $3,031,666. We cannot assure you that we can achieve or sustain profitability on a quarterly or annual basis in the future. Our operations are subject to the risks and competition inherent in the establishment of a business enterprise. There can be no assurance that future operations will be profitable. Revenues and profits, if any, will depend upon various factors, including whether we will be able to continue expansion of our revenue. We may not achieve our business objectives and the failure to achieve such goals would have an adverse impact on us.

We Anticipate That the Proceeds From Our July 2005 Private Placement Could Be Spent By as Early as March 2006. If We Are Unable to Obtain Additional Funding, Our Business Operations Will be Harmed. In Addition, Section 4e of the July 2005 Securities Purchase Agreements Contains Certain Restrictions and Limitations on Our Ability to Seek Additional Financing. If We Do Obtain Additional Financing, Our Then Existing Shareholders May Suffer Substantial Dilution.

We anticipate that the proceeds from our July 2005 private placement will be spent by as early as March 2006. Accordingly, we will require additional funds to sustain and expand our sales and marketing activities. Additional capital will be required to effectively support the operations and to otherwise implement our overall business strategy. Without the prior written consent of a majority-in-interest of the investors for a period ending on the later of (i) 270 days from the closing date, or (ii) 180 days from the date that this registration statement is declared effective by the SEC, Section 4e of our July 2005 Securities Purchase Agreement limits our ability to seek additional financing, including negotiating or contracting with any party to obtain additional equity financing (including debt financing with an equity component) which involves the following:

- the issuance of shares of our common stock at a discount to the market price on the date of issuance;
- the issuance of convertible securities that are convertible into an indeterminate number of shares of our common stock; or
- the issuance of warrants to purchase shares of our common stock.

There can be no assurance that financing will be available in amounts or on terms acceptable to us, if at all, or if a majority-in-interest of the investors under our July 2005 Securities Purchase Agreement will provide their prior written consent for us to engage in additional financing involving the issuance of our securities as set forth above. The inability to obtain additional capital will restrict our ability to grow and may reduce our ability to continue to conduct business operations. If we are unable to obtain additional financing, we will likely be required to curtail our marketing and development plans and possibly cease our operations. Any additional equity financing may involve substantial dilution to our then existing shareholders.

Our Independent Registered Public Accounting Firm Has Stated There is Substantial Doubt About Our Ability to Continue As a Going Concern, Which May Hinder Our Ability to Obtain Future Financing.

In their report dated May 19, 2005 on our financial statements as of and for the year ended December 31, 2004, our independent registered public accounting firm stated that our recurring losses from operations and our accumulated deficit as of December 31, 2004 raised substantial doubt about our ability to continue as a going concern. Since December 31, 2004, we have continued to experience net operating losses. Our ability to continue as a going concern is subject to our ability to generate a profit and/or obtain necessary funding from outside sources, including obtaining additional funding from the sale of our securities, increasing sales or obtaining loans and grants from various financial institutions where possible. Our continued net operating losses and stockholders' deficiency increase the difficulty in meeting such goals and there can be no assurances that such methods will prove successful.

Our Fertilizer Sales Are Dependent Upon Our Contract With Western Farm Service, Inc., Which Accounted for $989,084, or 97% of 2004 Fertilizer Sales. The Loss of This Contract Could Cause Us to Cease Operations.

In March 1998 we signed a definitive licensing, manufacturing, and distribution agreement with Western Farm Service, Inc. (WFS), a wholly owned subsidiary of Agrium, Inc. (a NYSE company) to market our GOLD'n GRO fertilizer products. The five-year agreement, with optional five-year renewal periods, was extended for another five years in March 2003. After the initial five year period, the contract may be terminated by either party in any subsequent year by giving the other party written notice 120 days prior to December 31 st of each year. Substantially all of our fertilizer sales (97%, or an aggregate of $989,084 during 2004; a similar percentage is expected for 2005) are to WFS and we would be materially adversely affected if the contract were terminated. Any such termination may cause us to curtail or cease operations.

Our Photochemical Recycling and Related Silver Refining Revenue Were Dependent on Our Contract with Shutterfly, Inc., Which Accounted for $201,291, or 59%, of Such 2004 Revenue. Shutterfly, Inc. Also Supplied 65% of Our Used Photochemicals Which We Use as a Raw Material in our GOLD'n GRO Fertilizer Products.

We entered into our standard recycling services contract with Shutterfly, Inc., a private company in the digital imaging and processing industry, in July 2001. In December 2004, our photochemical recycling services provided to Shutterfly, Inc. were discontinued by mutual agreement. Due to the nature of our business, our photochemical recycling customers are also suppliers of our used photochemical raw material needed for fertilizer manufacturing. This raw material is the primary ingredient that distinguishes our GOLD'n GRO fertilizer products from competing fertilizer products. If we are unable to find new customers to replace the lost volume of used photochemicals, we would use up our present inventory of used photochemicals which would limit fertilizer sales to less than our present volumes. If this were to occur, we would be prevented from expanding fertilizer sales to a level required to become profitable, resulting in continuing substantial losses.

The EPA Registration Process for GOLD'n GRO Guardian Animal Repellent Will Be Lengthy and Expensive. There is No Guarantee That the Product Will Be Approved By the EPA and There Is No Guarantee That The Product Will Be Accepted In the Markets We Are Targeting. If Our Registration is Not Approved or if This Product is Not Accepted in the Markets Which We Are Targeting, Substantial Losses Could Occur.

Registration of GOLD'n GRO Guardian with the Federal EPA, followed by registration in each state in which it will be sold, is necessary before the product can be sold in any state. The product is an animal repellent fertilizer and represents a new category of fertilizer for us. Our main risk is that the registration may take longer than anticipated, and that the cost could be higher than presently budgeted. After registration is complete, normal market introduction timing of 2 to 3 years can be expected, and there is always the risk that another company with superior resources may develop a similar product The revenues to be generated by product sales, after the product is registered, are expected to be supplemental to the regular GOLD'n GRO fertilizer sales but could grow to become a significant part of total fertilizer sales within a few years after introduction.

There is no assurance that the registration of GOLD'n GRO Guardian will be approved or that even if approved, that this product will be accepted in the markets which we are targeting. If our registration is not approved or if GOLD'n

GRO Guardian is not accepted in the marketplace, substantial losses could occur.

If We Are Unable to Retain the Services of Dr. John W. Whitney or If We Are Unable to Successfully Recruit Qualified Personnel Having Experience in Business, We May Not Be Able to Continue Our Operations.

Our success depends to a significant extent upon the continued service of Dr. John W. Whitney, our current President, Treasurer and Director. Loss of the services of Dr. Whitney could have a material adverse effect on our growth, revenues, and prospective business. However, Dr. Whitney is bound by several confidentiality agreements, which specifically include non-compete clauses. We have applied for a "key man" life insurance policy on the life of Dr. Whitney in the amount of $5,000,000. In addition, in order to successfully implement and manage our business plan, we will be dependent upon, among other things, successfully recruiting qualified personnel having experience in business. Competition for qualified individuals is intense. There can be no assurance that we will be able to find, attract and retain existing employees or that we will be able to find, attract and retain qualified personnel on acceptable terms.

We Are in Default on Substantially All of Our Equipment Leases, Which if Not Settled, Could Result in the Repossession of Certain Equipment and Cause Us to Cease Operations

As of January 31, 2006, delinquent payments on our equipment leases totaled approximately $555,000. As discussed in the Legal Proceedings section, many of these leases are subject to ongoing litigation or the lessor has received a judgment. The creditors with judgments may seize the secured equipment and/or other assets at any time without notice. Also as discussed in the Legal Proceedings section, we have renegotiated several other leases. These leases are subject to stipulated judgments that allow the lessor to repossess the secured equipment and/or seize other assets without further court action if we become delinquent on future payments. The loss of our equipment could cause us to cease operations.

If We Are Not Able to Successfully Market and Gain Public Awareness of Our Products and Services, We May Sustain Substantial Losses Which Could Require Us to Curtail or Cease Our Operations.

The production of photochemical fertilizer for commercial and consumer applications is a new business concept characterized by competition with established fertilizer manufacturers who have historically produced products that have heretofore fulfilled the market demand. Achieving market awareness and acceptance for products being introduced and under development requires substantial marketing efforts and expenditure of significant marketing and advertising funds. There is uncertainty as to the rate of sales expansion and the degree of market acceptance of our products. Because of this, we are currently developing and evaluating, and anticipate that we will continue to develop, marketing and advertising for such new products or services; we will devote resources, financial and otherwise to such efforts. The failure of these efforts could result in substantial losses.

Our Success is Dependant on The Ability of Our Products and Services to Compete in Our Various Industries.

We operate in three highly competitive industries which have been characterized by pricing pressures, business consolidations, and flat or low growth trends in revenues and sales. Each of the industries in which we are operating has its own competitive characteristics. The mining technical services segment is somewhat dependent on metals prices in relation to production costs; the industry is under price pressure and consolidations are occurring. The need for technical services in this environment is reduced for certain types of services, but increased for others. There is increased competition from foreign firms who have exchange rate differentials that provide them a competitive advantage in provision of certain services. Our photochemical recycling segment operates in the photowaste hauling and disposal industry. A few large service companies and a few smaller regional companies characterize this industry. Expansion into international markets will also bring direct competition from foreign firms. The photochemical recycling segment also operates in the fertilizer industry. The fertilizer market consists of "Specialty Agriculture Market", the "Bulk Field Crop Market", and the "Urban Fertilizer Market". We are currently concentrating on increasing bulk GOLD'n GRO fertilizer sales, primarily in the Specialty Agriculture and the Bulk Field Crops markets. The fertilizer markets are mature and dominated by a few large manufacturers and distributors. The western U.S. distributor for the GOLD'n GRO fertilizers is one of these companies. Because the markets are mature, the rate of growth to be achieved when introducing new products is uncertain because of the need to displace existing products.

Our markets are not characterized by rapid technological change. These industries are characterized by the need to make large capital investments in order to be participants. This limits the rate of technological change and makes it more difficult for entry by new competitors. Prior to our photochemical recycling technology development, the recovery and disposal of hazardous photochemical waste was characterized by low or limited technology and consisted primarily of hauling and dumping the chemical for a fee. Most of the existing companies recover and sell a portion of the contained silver. The main risk is price fluctuations in the silver market.

The fertilizer industry is stable and new product development and introduction is a long-term process. The reason is that crops grow on seasonal cycles and crop nutrition is complex and affected by many factors. It takes years to

develop a new fertilizer product due to the complexity of the plant nutrition process. Because of this, innovation in the fertilizer nutrient product market is low. Now that some of our products and nutrition programs are being introduced into the marketplace, there is no assurance that we will be able to maintain our product development lead if companies with larger resources decide to attempt to produce products that duplicate some of the characteristics of our products.

Our Success is Dependant Upon Regulatory Enforcement of the Waste Control Environment.

Regulatory enforcement of the waste control environment is critical to our competitive position by making it more difficult for service companies with minimal compliance to operate and offer lower pricing. Generally, all 50 states continue to strengthen their regulatory enforcement but our competitive position in obtaining liquid photowastes, the basic process raw material, is somewhat dependent on the continuation of regulations and regulatory enforcement. Similar regulatory enforcement may not be available to us to aid in establishing and developing our international operations.

Our Success is Dependant Upon Our Ability to Adequately Protect Our Trade Secrets, Know-How, Patents and Trademarks.

We own the Itronics logo and name pursuant to common law and"GOLD'n GRO â" is a registered trademark. We have only four patents with respect to our technology. Where patent protection is not available, we rely for protection of our intellectual property on trade secret law and nondisclosure and confidentiality agreements with our employees and others. There can be no assurance that such agreements will provide meaningful protection for our trade secrets or proprietary know-how in the event of any unauthorized use or disclosure of such trade secrets or know-how. In addition, others may obtain access to or independently develop technologies or know-how similar to ours.

Our success will also depend on our ability to avoid infringement of patent or other proprietary rights of others. We are not aware that we are infringing any patent or other such rights, nor are we aware of proprietary rights of others for which we will be required to obtain a license in order to develop our products. However, there can be no assurance that we are not infringing proprietary rights of others, or that we will be able to obtain any technology licenses we may require in the future.

We Rely on Contractual Relationships With Our Key Suppliers, Vendors, Customers and Consultants. A Loss of One or More of These Contractual Relationships, Our Ability to Maintain or Increase Revenues Could Be Adversely Affected.

We rely on contractual relationships with our key suppliers, vendors, customers and consultants ("Key Contacts"). If we were to lose these Key Contacts, our ability to maintain or increase revenues could be adversely affected. While we believe our relationship with our Key Contacts is good, there can be no assurance that any relationship will continue to exist.

Our Mining Technical Services Revenues Were Dependent Upon Our Contract With Golden Phoenix Minerals, Inc., Which Accounted for $224,039, or 75% of Such Revenue. Our Contract With Golden Phoenix Minerals, Inc. Expired in March 2005 And Accordingly, We No Longer Realize A Revenue Stream Associated With Said Contract.

We entered into a three year contract with Golden Phoenix Minerals, Inc. (GPXM), a publicly traded precious metal mining company, in March 1999 to provide consulting services. Our mining technical service revenues were dependent upon our contract with Golden Phoenix, which accounted for $224,039, or 75%.The contract was renewed for another three years in March 2002 and expired in March 2005 and was not renewed. Accordingly, we no longer realize a revenue stream associated with said contract.

We Are Refocusing Our Technical Services Segment to Include an Internet Information Portal to Support That Division. We Do Not Know If, or How Long, It Will Be Before Revenue Will Sustain Current Spending Levels. Additional Substantial Losses Could Occur.

The redirection of Whitney & Whitney, Inc. to reduce emphasis on technical consulting services and to launch an Internet information portal is brought about by the fact that Dr. Whitney, our President, has often been the lead person in generating new consulting contracts. Our President's increased responsibilities for managing the expanding photochemical recycling segment and overall corporate activities has reduced his time availability to actively participate in the consulting segment. The main risk in establishing the information portal is the length of time and the related support costs that will be expended during the time needed to get subscriptions to a break- even level.

We do not know if, or how long, it will be before revenue will sustain current spending levels. If it takes a long period of time to launch our Internet information portal and if we expend substantial support costs with respect to such reconfiguration without realizing any revenues related thereto, additional substantial losses could occur.

Any Future Acquisitions Could Disrupt Our Existing Business and Harm Our Financial Position.

An element of our growth strategy includes the acquisition of companies which we believe have synergistic business models. Acquisitions entail a number of risks that could materially and adversely affect business and operating results. Such risks would include problems integrating the acquired operations, technologies or products; diversion of management's time and attention from core businesses; difficulties in retaining business relations with suppliers and customers of the acquired company; risks associated with entering markets in which our management lacks prior experience, and potential loss of key employees from the acquired company.

A Substantial Portion of Our Accounts Receivables Are Due From Western Farm Service, Inc. (WFS)

As of September 30, 2005, $18,575, or 17% of our total accounts receivables were due to us from WFS. This percentage may fluctuate up or down depending on the time of year. For example, as of December 31, 2005, we expect this percentage to be zero. If WFS became unable or unwilling to pay the amounts due, we would be materially adversely affected.

Risks Relating to Our Current Financing Arrangement:

If We Fail to Obtain Stockholder Approval to Increase our Authorized Shares of Common Stock, We May be Subject to Various Penalties and Will be in Default of the Securities Purchase Agreement.

We presently do not have an adequate amount of authorized and unissued shares of common stock to issue upon the conversion of the secured convertible notes and the exercise of the warrants in connection with the July 2005 Securities Purchase Agreement. As of February 3, 2006, there were 197,248,179 shares of common stock outstanding. We filed a proxy statement on Schedule 14A with the Securities and Exchange Commission on August 31, 2005 and will hold a special meeting of our stockholders pursuant to which we will ask our stockholders to approve an amendment to our certificate of incorporation to increase our authorized common stock from 250,000,000 shares to 1,000,000,000 shares. In the event that we are unable to obtain an increase in our authorized common stock, we will be required to pay penalties to the investors of the July 2005 Securities Purchase Agreement and will be in default of the agreement. If we are in default, we will be required to repay the secured convertible notes. If we are required to repay the secured convertible notes, we would be required to use our limited working capital and raise additional funds. If we were unable to repay the notes when required, the note holders could commence legal action against us and foreclose on all of our assets to recover the amounts due. Any such action would require us to curtail or cease operations.

There Are a Large Number of Shares Underlying Our Secured Convertible Notes and Warrants That May be Available for Future Sale and the Sale of These Shares May Depress the Market Price of Our Common Stock.

As of December 31, 2005, we had 197,148,179 shares of common stock issued and outstanding, 7,144,103 common shares to be issued to management and other employees for unpaid salary and accrued interest in the amount of $573,380, unsecured convertible notes outstanding that may be converted into an estimated 22,229,550 shares of common stock at conversion prices ranging from $0.125 to $1.18, outstanding warrants to purchase 25,070,183 shares of common stock at exercise prices ranging from $0.075 to $0.24, and outstanding compensatory options to purchase 6,108,000 shares of common stock at exercise prices ranging from $0.15 to $0.90 per share. We also have secured convertible notes outstanding, and are obligated to issue secured convertible notes, that may be converted into an estimated 196,969,697 shares of common stock at current market prices and related warrants to purchase 3,000,000 shares of common stock at an exercise $0.15 per share. In addition, the number of shares of common stock issuable upon conversion of the outstanding secured convertible notes may increase if the market price of our stock declines. All of the shares, including all of the shares issuable upon conversion of the secured convertible notes and upon exercise of our warrants, may be sold without restriction. The sale of these shares may adversely affect the market price of our common stock.

The Continuously Adjustable Conversion Price Feature of Our Secured Convertible Notes Could Require Us to Issue a Substantially Greater Number of Shares, Which Will Cause Dilution to Our Existing Stockholders.

Our obligation to issue shares upon conversion of our secured convertible notes is essentially limitless. The following is an example of the amount of shares of our common stock that are issuable, upon conversion of the principal amount of our secured convertible notes, based on market prices 25%, 50% and 75% below the market price as of February 3, 2006 of $0.08.

% Below Market	Price Per Share	With Discount at 45%	Number of Shares Issuable	% of Outstanding Stock
25%	$.06	$.033	98,484,848	33.30%
50%	$.04	$.022	147,727,273	42.82%
75%	$.02	$.011	295,454,545	59.97%

As illustrated, the number of shares of common stock issuable upon conversion of our secured convertible notes will increase if the market price of our stock declines, which will cause dilution to our existing stockholders.

The Continuously Adjustable Conversion Price Feature of our Secured Convertible Notes May Have a Depressive Effect on the Price of Our Common Stock.

The secured convertible notes are convertible into shares of our common stock at a 45% discount to the trading price of the common stock prior to the conversion. The significant downward pressure on the price of the common stock as the selling stockholders convert and sell material amounts of common stock could have an adverse effect on our stock price. In addition, not only the sale of shares issued upon conversion or exercise of secured convertible notes and warrants, but also the mere perception that these sales could occur, may adversely affect the market price of the common stock.

The Issuance of Shares Upon Conversion of the Secured Convertible Notes and Exercise of Outstanding Warrants May Cause Immediate and Substantial Dilution to Our Existing Stockholders.

The issuance of shares upon conversion of the secured convertible notes and exercise of warrants may result in substantial dilution to the interests of other stockholders since the selling stockholders may ultimately convert and sell the full amount issuable on conversion. Although AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., and New Millennium Partners II, LLC may not convert their secured convertible notes and/or exercise their warrants if such conversion or exercise would cause them to own more than 4.99% of our outstanding common stock, this restriction does not prevent AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., and New Millennium Partners II, LLC from converting and/or exercising some of their holdings and then converting the rest of their holdings. In this way, AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., and New Millennium Partners II, LLC could sell more than this limit while never holding more than this limit. There is no upper limit on the number of shares that may be issued which will have the effect of further diluting the proportionate equity interest and voting power of holders of our common stock, including investors in this offering.

In The Event That Our Stock Price Declines, The Shares Of Common Stock Allocated For Conversion Of The Secured Convertible Notes and Registered Pursuant To This Prospectus May Not Be Adequate And We May Be Required to File A Subsequent Registration Statement Covering Additional Shares. If The Shares We Have Allocated And Are Registering Herewith Are Not Adequate And We Are Required To File An Additional Registration Statement, We May Incur Substantial Costs In Connection Therewith.

Based on our current market price and the potential decrease in our market price as a result of the issuance of shares upon conversion of the secured convertible notes, we have made a good faith estimate as to the amount of shares of common stock that we are required to register and allocate for conversion of the secured convertible notes. Accordingly, we have allocated 196,969,697 shares to cover the conversion of the secured convertible notes. In the event that our stock price decreases, the shares of common stock we have allocated for conversion of the secured convertible notes and are registering hereunder may not be adequate. If the shares we have allocated to the registration statement are not adequate and we are required to file an additional registration statement, we may incur substantial costs in connection with the preparation and filing of such registration statement.

If We Are Required for any Reason to Repay Our Outstanding Secured Convertible Notes, We Would Be Required to Deplete Our Working Capital, If Available, Or Raise Additional Funds. Our Failure to Repay the Secured Convertible Notes, If Required, Could Result in Legal Action Against Us, Which Could Require the Sale of Substantial Assets.

In July 2005, we entered into a Securities Purchase Agreement for the sale of an aggregate of $3,250,000 principal amount of secured convertible notes. The secured convertible notes are due and payable, with 8% interest, three years from the date of issuance, unless sooner converted into shares of our common stock. Although we currently have $2,750,000 secured convertible notes outstanding, the investors are obligated to purchase additional secured convertible notes in the aggregate of $500,000. In addition, any event of default such as our failure to repay the principal or interest when due, our failure to issue shares of common stock upon conversion by the holder, our failure to timely file a registration statement or have such registration statement declared effective, breach of any covenant, representation or warranty in the Securities Purchase Agreement or related convertible note, the assignment or appointment of a receiver to control a substantial part of our property or business, the filing of a money judgment, writ or similar process against our company in excess of $50,000, the commencement of a bankruptcy, insolvency, reorganization or liquidation proceeding against our company and the delisting of our common stock could require the early repayment of the secured convertible notes, including a default interest rate of 15% on the outstanding principal balance of the notes if the default is not cured with the specified grace period. We anticipate that the full amount of the secured convertible notes will be converted into shares of our common stock, in accordance with the terms of the secured convertible notes. If we were required to repay the secured convertible notes, we would be required to use our

limited working capital and raise additional funds. If we were unable to repay the notes when required, the note holders could commence legal action against us and foreclose on all of our assets to recover the amounts due. Any such action would require us to curtail or cease operations.

If an Event of Default Occurs under the Securities Purchase Agreement, Secured Convertible Notes, Warrants, Security Agreement or Intellectual Property Security Agreement, the Investors Could Take Possession of all Our Goods, Inventory, Contractual Rights and General Intangibles, Receivables, Documents, Instruments, Chattel Paper, and Intellectual Property.

In connection with the Securities Purchase Agreements we entered into in July 2005, we executed a Security Agreement and an Intellectual Property Security Agreement in favor of the investors granting them a first priority security interest in all of our goods, inventory, contractual rights and general intangibles, receivables, documents, instruments, chattel paper, and intellectual property. The Security Agreements and Intellectual Property Security Agreements state that if an even of default occurs under the Securities Purchase Agreement, Secured Convertible Notes, Warrants, Security Agreements or Intellectual Property Security Agreements, the Investors have the right to take possession of the collateral, to operate our business using the collateral, and have the right to assign, sell, lease or otherwise dispose of and deliver all or any part of the collateral, at public or private sale or otherwise to satisfy our obligations under these agreements.

Risks Relating to Our Common Stock:

If We Fail to Remain Current on Our Reporting Requirements, We Could be Removed From the OTC Bulletin Board Which Would Limit the Ability of Broker-Dealers to Sell Our Securities and the Ability of Stockholders to Sell Their Securities in the Secondary Market.

Companies trading on the OTC Bulletin Board, such as us, must be reporting issuers under Section 12 of the Securities Exchange Act of 1934, as amended, and must be current in their reports under Section 13, in order to maintain price quotation privileges on the OTC Bulletin Board. If we fail to remain current on our reporting requirements, we could be removed from the OTC Bulletin Board. As a result, the market liquidity for our securities could be severely adversely affected by limiting the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market.

Our Common Stock is Subject to the "Penny Stock" Rules of the SEC and the Trading Market in Our Securities is Limited, Which Makes Transactions in Our Stock Cumbersome and May Reduce the Value of an Investment in Our Stock.

The Securities and Exchange Commission has adopted Rule 15g-9 which establishes the definition of a "penny stock," for the purposes relevant to us, as any equity security that has a market price of less than $5.00 per share or with an exercise price of less than $5.00 per share, subject to certain exceptions. For any transaction involving a penny stock, unless exempt, the rules require:

- that a broker or dealer approve a person's account for transactions in penny stocks; and
- the broker or dealer receive from the investor a written agreement to the transaction, setting forth the identity and quantity of the penny stock to be purchased.

In order to approve a person's account for transactions in penny stocks, the broker or dealer must:

- obtain financial information and investment experience objectives of the person; and
- make a reasonable determination that the transactions in penny stocks are suitable for that person and the person has sufficient knowledge and experience in financial matters to be capable of evaluating the risks of transactions in penny stocks.

The broker or dealer must also deliver, prior to any transaction in a penny stock, a disclosure schedule prescribed by the Commission relating to the penny stock market, which, in highlight form:

- sets forth the basis on which the broker or dealer made the suitability determination; and
- that the broker or dealer received a signed, written agreement from the investor prior to the transaction.

Generally, brokers may be less willing to execute transactions in securities subject to the "penny stock" rules. This may make it more difficult for investors to dispose of our common stock and cause a decline in the market value of our stock.

Disclosure also has to be made about the risks of investing in penny stocks in both public offerings and in secondary trading and about the commissions payable to both the broker-dealer and the registered representative, current quotations for the securities and the rights and remedies available to an investor in cases of fraud in penny stock transactions. Finally, monthly statements have to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks.

USE OF PROCEEDS

This prospectus relates to shares of our common stock that may be offered and sold from time to time by the selling stockholders. We will not receive any proceeds from the sale of shares of common stock in this offering. However, we will receive the sale price of any common stock we sell to the selling stockholder upon exercise of the warrants. We expect to use the proceeds received from the exercise of the warrants, if any, for general working capital purposes. However, AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., and New Millennium Partners II, LLC will be entitled to exercise up to 3,000,000 warrants on a cashless basis if the shares of common stock underlying the warrants are not then registered pursuant to an effective registration statement. In the event that AJW Partners, LLC, AJW Qualified Partners, LLC, AJW Offshore, Ltd., or New Millennium Partners II, LLC exercise the warrants on a cashless basis, then we will not receive any proceeds from the exercise of those warrants. In addition, we have received gross proceeds $2,750,000 from the sale of the secured convertible notes and the investors are obligated to provide us with an additional $500,000; within five days of this prospectus being declared effective. The proceeds received from the sale of the secured convertible notes will be used for business development purposes, working capital needs, pre-payment of interest, payment of finder's and legal fees and payment of indebtedness.

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is quoted on the OTC Bulletin Board under the symbol "ITRO."

For the periods indicated, the following table sets forth the high and low bid prices per share of common stock. These prices represent inter-dealer quotations without retail markup, markdown, or commission and may not necessarily represent actual transactions.

	High($)	Low ($)
Fiscal Year 2003		
First Quarter	0.16	0.09
Second Quarter	0.14	0.08
Third Quarter	0.23	0.11
Fourth Quarter	0.17	0.11
Fiscal Year 2004		
First Quarter	0.22	0.14
Second Quarter	0.17	0.10
Third Quarter	0.10	0.06
Fourth Quarter	0.08	0.05
Fiscal Year 2005		
First Quarter	0.13	0.05
Second Quarter	0.08	0.05
Third Quarter	0.09	0.06
Fourth Quarter	0.08	0.03

Fiscal Year 2006		
First Quarter(1)	0.08	0.05

(1) Through February 3, 2006

HOLDERS

As of December 31, 2005, we had approximately 1,074 holders of our common stock. The number of record holders was determined from the records of our transfer agent and does not include beneficial owners of common stock whose shares are held in the names of various security brokers, dealers, and registered clearing agencies. The transfer agent of our common stock is Securities Transfer Corporation, 2591 Dallas Parkway, Suite 102, Frisco, Texas 75034.

We have never declared or paid any cash dividends on our common stock. We do not anticipate paying any cash dividends to stockholders in the foreseeable future. In addition, any future determination to pay cash dividends will be at the discretion of the Board of Directors and will be dependent upon our financial condition, results of operations, capital requirements, and such other factors as the Board of Directors deem relevant.

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

Some of the information in this prospectus contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as "may," "will," "expect," "anticipate," "believe," "estimate" and "continue," or similar words. You should read statements that contain these words carefully because they:

- discuss our future expectations;
- contain projections of our future results of operations or of our financial condition; and
- state other "forward-looking" information.

We believe it is important to communicate our expectations. However, there may be events in the future that we are not able to accurately predict or over which we have no control. Our actual results and the timing of certain events could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under "Risk Factors," "Business" and elsewhere in this prospectus. See "Risk Factors."

General Overview

We are the inventor and developer of the "Beneficial Use Photochemical, Silver, and Water Recycling" technology that produces environmentally beneficial GOLD'n GRO fertilizers and silver bullion.

We are a process technology company that has developed what we believe is a unique technology for photochemical recycling. We, through our subsidiary, Itronics Metallurgical, Inc., extract more than 99% of the silver and virtually all of the other toxic heavy metals from used photoliquids and use this “Beneficial Use Photochemical, Silver and Water Recycling” technology to produce environmentally beneficial chelated multinutrient liquid fertilizer products sold under the trademark GOLD’n GRO, animal repellent/fertilizer products to be sold under the trademark GOLD’n GRO Guardian, and silver bullion. We also provide process planning and technical services to the mining industry.

Our fertilizer is sold primarily through Western Farm Service, Inc. (WFS), a wholly owned subsidiary of Agrium, Inc. (a NYSE company). Our distribution agreement with WFS gives them exclusive rights to sell our fertilizer products in Arizona, California, Hawaii, Idaho, Oregon, and Washington, which represented 97% of our fertilizer sales in 2004 and 93% of our sales in 2003. This agreement is discussed in more detail in the Business section. Our plans to increase GOLD’n GRO fertilizer sales, including plans to expand the product line, expand to more geographical regions in the U.S., enter new market segments, and add new distributors, are discussed in more detail in the Growth Plan and Implementation section.

We obtain a significant portion of our raw materials to manufacture fertilizer from used photoliquids. A byproduct of our fertilizer manufacturing process is silver. We sell three types of silver: silver bullion, 5 troy ounce 99.9% pure Silver Nevada Miner numismatic bars, and recycled film containing silver. Our processed silver bullion is sold to a commercial refiner under standard industry terms, which include pricing the silver based on published market quotes and applicable service fees. The Silver Nevada Miner bars sell to the consumer collectibles market. Recycled film is primarily X-ray film from hospitals that we sort and sell to a commercial film recycler; we are paid based on the value of contained silver, 45 to 60 days after shipment.

Our fertilizer manufacturing process uses several commodities. We separate silver from photochemicals, then we add zinc and other raw materials to the demetallized liquid to make our fertilizer formulations. Prices for fertilizer raw materials are generally increasing over time. We maintain limited quantities of these commodities and purchase them on a just in time basis. When prices of these commodities rise, we pass this cost on to our customers, so commodity price fluctuations have not had a significant impact on our results of operations.

The majority of our raw material inventory is comprised of silver in photochemical solutions. The table below indicates that silver prices were relatively stable in 2001 to 2003, then rose dramatically in 2004 and 2005. We regularly compare our weighted average cost of silver per ounce to current market prices; historically we have not had impairment losses. The average London spot price of silver is shown as follows:

			Year		6 mos June 30,
Year	2001	2002	2003	2004	2005
Silver	$4.36	$4.60	$4.88	$6.67	$7.06

We also provide consulting services to the mining industry. To supplement this business line, we recently launched an internet website which we plan to maintain with existing professional staff. Our plans with regard to the website are discussed more fully in the Growth Plan and Implementation section below.

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires that management make a number of assumptions and estimates that affect the reported amounts of assets, liabilities, revenues and expenses in our consolidated financial statements and accompanying notes. Management bases its estimates on historical information and assumptions believed to be reasonable. Although these estimates are based on management’s best knowledge of current events and circumstances that may impact the Company in the future, actual results may differ from these estimates.

Our critical accounting policies are those that affect our financial statements materially and involve a significant level of judgment by management.

Revenue Recognition**.**

We operate two divisions: Photochemical Fertilizer and Technical Services. Within the fertilizer division, revenue is derived from three sources (1) sales of fertilizer, (2) photochemical recycling including pick up and transportation of photochemical waste and sales of Photochemical Silver Concentrators, and (3) sales of silver. Revenue from the sale of fertilizer, Photochemical Silver Concentrators, and silver is recognized in income when the goods are shipped. Returns since inception have been nominal; therefore, the Company has not established a returns allowance. Photochemical recycling fees are recognized in income after the used photochemical solution is removed from our customer sites and transported to our manufacturing facility.

Within the technical services division, revenue is derived from consulting services. Revenue is recognized in income as services are rendered. When the Company is responsible for subcontractor services and related expenses, such pass-through costs are included in both revenue and cost of revenues. Markups, if any, are included in revenues.

Inventory.

Inventory is carried on the balance sheet at the lower of cost or market value using the average cost valuation method. Because a large part of our inventory is silver contained in used photochemical solution and the market value of silver changes daily on the commodities market, we regularly monitor the carrying value of our silver in solution inventory to ensure it is carried at the lower of cost or its current market value. If silver on the open market were less than our carrying value, then we would write down the carrying value of our inventory by reducing recorded inventory and increasing cost of sales. If the amount of the write down were material, we would separately include the item in our statement of operations.

Recent Accounting Pronouncements

On December 16, 2004 the FASB issued SFAS No. 123R, “Share-Based Payment,” which is an amendment to SFAS No. 123, “Accounting for Stock-Based Compensation.” This new standard eliminates the ability to account for share-based compensation transactions using Accounting Principles Board, or APB, Opinion No. 25, “Accounting for Stock Issued to Employees,” and generally requires such transactions be accounted for using a fair-value-based method and the resulting cost recognized in our financial statements. This new standard is effective for awards that are granted, modified or settled in cash in interim and annual periods beginning after June 15, 2005, December 15, 2005 for small business issuers. In addition, this statement will apply to unvested options granted prior to the effective date. The Company will adopt this new standard effective for the first fiscal quarter of 2006 and it has not yet determined what impact this standard will have on its financial position or results of operations.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs: an amendment of ARB No. 43, Chapter 4,” to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe the provisions of SFAS No. 151, when applied, will have a material impact on our financial position or results of operations.”

In June 2005 the FASB, through its Derivative Implementation Group, issued DIG B-38 which provides guidance on whether certain put or call options are embedded derivatives in a host contract. In our case, this will apply to the prepayment penalty feature of our callable secured convertible debt. The new DIG becomes effective for the first fiscal quarter beginning after December 15, 2005. Beginning January 1, 2006 we have two embedded derivatives, the beneficial conversion feature and the prepayment penalty. When there is more than one embedded derivative in a

single debt instrument, it must be valued as a whole. Therefore the Black-Scholes option pricing model, which we presently use to value derivative instruments, will not be appropriate for determining the estimated fair value of these embedded derivatives. Consequently, we will need to determine a new valuation method. We will adopt this new standard effective for the first fiscal quarter of 2006. We have not determined the fair value of this combined embedded derivative, nor have we determined what impact the change in valuation method will have on the total estimated fair value of our derivative. However, we expect the quarter to quarter changes in estimated fair value will be material due to the high volatility of our stock price.

Results of Operations

The primary factors affecting our revenue fluctuation between periods in fertilizer sales are seasonality and weather conditions. Sales are greater during the growing season, and are negatively affected by cold winter weather and rainy weather. In most of our markets there are two primary fertilization seasons, spring and fall, with spring being the stronger of the two. The spring season generally starts in March and goes through June and the fall season generally starts in September and runs into December. Adverse weather conditions delay the start of, or can significantly shorten, a growing season. Farmers do not fertilize their crops in rainy or cold weather; therefore they do not buy fertilizer; consequently, our distributor does not buy fertilizer from us. Additionally, we have experienced varying lengths of time for acceptance in the market of our new fertilizer products; farmers are inherently very slow to accept new products so market penetration time can be lengthy. Our short history in the fertilizer market demonstrates that new products, if successful, obtain meaningful sales typically between two and four years after product launch.

The primary factors affecting the revenue fluctuation between periods in photochemical recycling revenue are our need to acquire this material for use in fertilizer production and our ability to store this material until it is needed. We have an unusual business model in that we need to sell our photowaste management services in order to acquire a raw material necessary for the production of our fertilizer products, as opposed to purchasing it from suppliers as most businesses do. Our management goal is to combine the incoming volume of photowastes with existing stored photowastes to meet the peaks in demand for fertilizer products. In the liquid fertilizer industry, the practice of both our distributor and the ultimate consumer, the farmer, is to purchase fertilizer on a just in time basis, to minimize their storage requirements and related costs. For this same reason, we process our photowastes as needed for fertilizer production. Because of this, the need to seek new customers to expand the service side of our business is driven by fertilizer sales. There is also a seasonal factor in the consumer photography portion of our photowaste management services business, with the Christmas holiday season being the busiest, followed by the early summer, school graduation period. At present volumes of photowaste, this is not a significant factor, but it could become one as we grow.

The primary factor affecting the revenue fluctuation between periods in sales of silver bullion is our dependence on the timing of processing used photochemical wastes, which is primarily dependent on fertilizer manufacturing and related sales. Our silver in solution is separated from the photowaste materials during processing of the photowastes for use in fertilizer manufacturing. As described above, the timing of processing of photowastes is dependent on fertilizer sales, therefore sales of silver bullion is also dependent on the level of fertilizer sales. Market price changes will also contribute to silver revenue fluctuations by increasing or decreasing revenues depending on whether the silver price increases or decreases.

Comparison of the Year Ended December 31, 2004 with the Year Ended December 31, 2003

We reported consolidated revenues of $1,720,049 for the year ended December 31, 2004, compared to $1,268,787 for the prior year, an increase of 36%. Revenues for the Photochemical Fertilizer segment increased by $486,016, or 52%. Revenues from the Mining Technical Services segment declined $34,754, or 10%. We reported a gross profit of $32,296 for the year ended December 31, 2004, compared to a gross loss of $159,853 for the year ended December 31, 2003, an improvement of $192,149. The consolidated net loss for 2004 was $2,839,872 or $0.020 per share compared to a 2003 loss of $2,752,291 or $0.026 per share.

To provide a more complete understanding of the factors contributing to the changes in revenues, operating expenses and the resultant operating loss and net loss, the discussion presented below is separated into our two operating segments.

PHOTOCHEMICAL FERTILIZER

	Year Ended December 31, 2004	2003
Revenue		
Fertilizer	$ 1,019,789	$ 554,320
Photochemical recycling	$ 301,609	$ 327,306
Silver	$ 101,531	$ 55,287
Total Segment Revenue	$ 1,422,929	$ 936,913
Gross profit (loss)	$ (34,687)	$ (182,918)
Operating income (loss)	$ (2,024,481)	$ (1,834,621)
Net income (loss) before taxes	$ (2,626,694)	$ (2,849,442)

Revenues for the Photochemical Fertilizer segment totaled $1,422,900 in 2004, compared to $936,900 in 2003, an increase of $486,000, or 52%.

Fertilizer sales were $1,019,800 (1,829 tons) and $554,300 (944 tons) for 2004 and 2003, respectively. This represents an increase of 84% in dollars and 94% in tonnage. Our fertilizer product sales are presently grouped into two primary categories, Chelated Liquid Micro-nutrients and Chelated Liquid Multi-nutrients. The Micro-nutrient category includes five products, which includes the two zinc products, GOLD'n GRO 9-0-1+7% Zinc and GOLD'n GRO 9-0-2+3% Zinc. These zinc products were introduced in 2001 and 2004, respectively. The Multi-nutrient category has a total of six products, which includes the GOLD'n GRO 4-0-9+6.6% Sulphur Base Liquid, which was introduced in 2003. Sales of Micro-nutrients were $873,600 (1,399 tons) and $474,500 (808 tons) for 2004 and 2003, respectively, an increase of 84% in dollars and 73% in tonnage. Sales of the Multi-nutrients were $125,700 (430 tons) and $47,800 (136 tons) for 2004 and 2003, respectively, an increase of 163% in dollars and an increase of 216% in tonnage. The dollar and tonnage increases are primarily attributable to increased bulk sales of the GOLD'n GRO 9-0-1+7% Zinc, but meaningful sales were also achieved with the GOLD'n GRO 9-0-2+3% Zinc and the GOLD'n GRO 4-0-9+6.6% Sulphur. Sales tonnage rose faster than sales dollars in spite of a modest price increase in the second quarter of 2004 because of the increase in tonnage of the Chelated Liquid Multi-nutrients which sell at lower prices. The overall increase in sales tonnage is primarily due to the acceptance of our products by more of WFS' retail branches due to successful field results over the past three years, and to a lesser extent on the introduction of the two new products.

Photochemical recycling revenue was $301,600 and $327,300 in 2004 and 2003, respectively, a decrease of 8%. The recycling service fee portion of this revenue category increased $46,200. The increase is attributable to the rapid growth of Shutterfly, Inc., a digital imaging and processing company. This increase was offset by a reduction in sales of Photochemical Silver Concentrators. In 2004 we sold one Concentrator for $20,000 compared to two sold in 2003 for a total of $91,900. Photochemical Silver Concentrators have widely varying prices, depending on the needs of the customer. Consequently, sales volumes and amounts are not consistent from period to period.

In December 2004, photochemical recycling services provided to Shutterfly, Inc. were discontinued by mutual agreement; the photochemical volume from this customer had been growing so rapidly that the supply was exceeding our need for the chemicals in fertilizer manufacturing, resulting in storage costs and plant inefficiencies. Shutterfly accounted for $201,300 or 59% of 2004 photochemical recycling revenue. Due to the nature of our business, our photochemical recycling customers supply the used photochemical raw material needed for fertilizer manufacturing. Shutterfly supplied 65% of this raw material received in 2004. Based on 2004 usage of used photochemicals to

manufacture fertilizer, our other customers supplied an overall 56% of the photochemicals needed to produce the fertilizer manufactured in 2004; so if we are unable to find new photowaste customers to replace Shutterfly, future fertilizer sales would be limited to approximately that level of 2004 fertilizer sales once our inventory of used photochemicals is depleted. It should be noted that this is only a rough estimate of future fertilizer production levels as we receive different types of photochemical raw materials from different customers, which are used in varying amounts in the fertilizer products, each fertilizer product uses a varying proportion of used photochemicals, and as we continue to improve our fertilizer products, the proportion of used photochemical in each product may change.

We previously developed statistical information that more than 100 million gallons of used liquid silver-bearing photochemicals are generated in the United States annually. Using conversion ratios developed for the GOLD'n GRO fertilizers, this is enough volume to support manufacture and sale of more than 200 million gallons of liquid fertilizer products, or about 1 million tons, so we believe the raw material is available in the market to meet future manufacturing needs. We estimate that current supplies of photochemical raw material in storage at our manufacturing plant, combined with ongoing receipts of material from other existing customers, is sufficient to meet fertilizer production needs for the next twelve to eighteen months, depending on fertilizer sales volumes.

We are in contact with both small and large photochemical generators, and are actively marketing Photochemical Silver Concentrators. The concentrators allow us to receive the raw materials needed to manufacture our fertilizer in much smaller volume, resulting in a higher content of chemicals desirable for fertilizer manufacturing, reducing the storage problems we were facing. The Photochemical Silver Concentrators are manufactured under contract by a third party to meet the specifications of each customer. Concentrators typically sell for $20,000 to $200,000, so part of the loss in photochemical recycling service revenues is expected to be offset by growth in Photochemical Silver Concentrator sales in future years. By using a third party manufacturer to produce the Concentrators, we are outsourcing the fixed and variable costs that are associated with assembling them. Primarily, these are the facilities space needed to assemble the various parts and the specialized equipment and labor required for the assembly. Generally, we have self financed the production of Concentrators sold in the past. In the future, we anticipate that non-governmental customers will advance the funds necessary to acquire the parts and labor needed to produce the Concentrators. For our most recent governmental customer, we borrowed the funds needed to fulfill the contract from an unrelated individual. We anticipate using similar arrangements for future Concentrators sold to governmental customers.

During the first quarter of 2005 we received an order for two Concentrators and requests for proposal from several other potential customers that could lead to more than $500,000 in sales of the Photochemical Silver Concentrators. This marks the beginning of a shift in market focus from obtaining the majority of photochemical raw materials by picking up the materials by truck directly from the customer’s location to obtaining the majority of our photochemical raw materials by receiving concentrated material through the interstate commercial trucking system.

Silver revenue was $101,500 and $55,300 for 2004 and 2003, respectively, an increase of $46,200, or 84%. Of this increase, $18,500 was from the sale of Silver Nevada Miner silver bars and $16,700 was from the sale of silver in recycled film.

Combined cost of sales and operating expenses for the segment amounted to $3,447,400 in 2004, compared to $2,771,500 in 2003, a 24% increase. Cost of sales increased approximately $337,800 due primarily to a $265,400 increase in direct material costs related to increased sales and $61,000 in payroll and related costs. The changes in revenues and cost of sales resulted in a gross loss of $34,700 in 2004, compared to $182,900 in 2003, an improvement of $148,200. Operating costs increased $338,100 due primarily to increases of $228,800 in sales and marketing and $60,000 in general and administrative costs. Sales and marketing increased due to a combination of the addition of a fertilizer sales representative in early 2004 and increased corporate marketing. General and administrative expenses increased due to a $98,000 prior year credit for expired options.

These changes in revenues and operating expenses resulted in a segment operating loss of $2,024,500 in 2004, compared to $1,834,600 in 2003, an increased loss of $189,900 or 10%.

Other income (expense) decreased to a net expense of $602,200 for 2004, compared to a net expense of $1,014,800 in 2003, an improvement of $412,600. Interest expense decreased $175,000 due to the conversion into common stock of convertible promissory notes. Other income of $187,800 was due to debt forgiveness income from the write off of long term leases.

The changes in operating loss and other expenses resulted in a segment net loss before taxes of $2,626,700 for 2004, compared to a net loss of $2,849,400 for 2003, a decreased loss of $222,700 or 8%.

MINING TECHNICAL SERVICES

	Year Ended December 31,	
	2004	2003
Revenue	$ 297,120	$ 331,874
Gross profit (loss)	$ 66,983	$ 23,065
Operating income (Loss)	$ (382,145)	$ (359,324)
Net income (loss) before taxes	$ (213,178)	$ 97,151

Mining technical services revenue totaled $297,100 for 2004 compared to $331,900 for 2003, a decrease of 10%. Included in these revenue figures are pass-through expenses of $108,300 and $118,700 for 2004 and 2003, respectively. Excluding these amounts, revenues amounted to $188,900 and $213,100 for 2004 and 2003, respectively, a decrease of 11%. The number of clients we serve and the amount of work needed by those clients varies from period to period.

On March 1, 2005 the technical services contract with Golden Phoenix Minerals, Inc. expired and was not renewed. Excluding pass through revenue, revenue from this client was $124,300 for 2004 and $15,000 for the two months ended February 2005. In response, in May 2005 we closed the satellite office for technical services and reduced staff the equivalent of approximately three people.

Combined cost of sales and operating expenses totaled $679,300 for 2004 compared to $691,200 for 2003, a nominal decrease. Included in these operating expense figures are pass-through expenses of $108,300 and $118,700 for 2004 and 2003, respectively. Excluding these amounts, combined cost of sales and operating expenses amounted to $571,000 and $572,500 for 2004 and 2003, respectively, a nominal decrease. Included in operating expense is $74,200 in research and development costs that were not incurred in the prior year. This expense is related to the development

of the insidemetals.com website. The majority of this expense is an allocation of personnel costs, which was offset by an $81,000 decrease in payroll and related costs that are included in cost of sales expenses.

The above changes in revenues and operating expenses resulted in a segment operating loss of $382,100 for 2004, compared to $359,300 for 2003, an increased operating loss of $22,800 or 6%.

Other income (expense) decreased to $169,000 for 2004, compared to $456,500 in 2003, a decline of $287,500. The decline is due to decreased gain on sale of GPXM shares and other marketable securities.

The changes in operating loss and other income resulted in a segment net loss before taxes of $213,200 for 2004, compared to a net income of $97,200 for 2003, a decrease of $310,300.

Changes in Financial Condition; Capitalization

Cash amounted to $5,200 as of December 31, 2004 compared to $34,500 as of December 31, 2003. Net cash used by operations was $1,417,900 in 2004 compared to $1,626,500 in 2003. Operating resources utilized to finance the 2004 loss of $2,839,900 include approximately $681,900 in expenses paid with our common stock. Cash amounting to approximately $56,800 was invested in property and equipment in 2004, primarily for equipment in the manufacturing plant. Sales of Golden Phoenix Minerals, Inc. stock and other marketable securities provided $356,100 in cash from investing activities. Financing sources of cash in 2004 were $843,500 in proceeds from the private placement of restricted common stock, $235,000 from the exercise of warrants, and $150,000 from short term loans from an officer/stockholder.

Total assets decreased from $4,440,500 at December 31, 2003 to $4,147,900 at December 31, 2004. Current assets decreased $88,300, net property and equipment decreased $38,900, and other assets decreased $165,300. The primary changes in current assets were a decrease in marketable securities of $387,100 due to the sale of GPXM and other stock, an increase in accounts receivable of $92,400 due to a one-time billing on the GPXM consulting contract, an increase of $146,200 in inventory due primarily to the build-up of unprocessed silver in photochemical solutions, and an increase in prepaid expenses of $89,400 due to corporate marketing contracts. We are actively selling our GPXM shares to assist with our working capital needs. Our investment in GPXM stock decreased to a total value of $26,200 at December 31, 2004, all of which is classified in current assets.

Total liabilities decreased from $8,142,200 at December 31, 2003 to $6,712,200 at December 31, 2004, a decrease of $1,430,000. Of this amount, current liabilities decreased $510,600 and long-term liabilities decreased $919,400. The overall decrease in liabilities is due primarily to the conversion of $1,962,200 in convertible promissory notes and accrued interest into restricted common stock. Current liabilities decreased primarily due to a net reduction in convertible promissory notes of $665,300. This reduction was partially offset by increases in accounts payable of $91,800, accrued management salaries of $170,900, and accrued expenses of $185,400. Nearly all of the increase in accrued expenses is attributable to delinquent federal and state payroll taxes. Subsequent to December 31, 2004 $115,600 of the federal payroll taxes were paid.

The above discussion and the discussion of various legal proceedings elsewhere in this prospectus does not succinctly summarize the progress that we have made in implementing our business plan and improving our financial condition over the last several years. However, there has been significant progress. First, in 2004 fertilizer sales exceeded $1 million for the first time, compared to sales in the $500,000 range for each of the two previous years. This resulted in a gross loss for the photochemical fertilizer segment of $34,700, which was a $148,200 improvement over 2003 and a $217,100 improvement over 2002. This demonstrates one of the fundamental concepts in the business plan, that a large part of our operating cost structure is fixed or semi-fixed, which means that as sales rise, many of the costs will not rise proportionally, resulting in gross profits that will contribute to paying general overhead costs. This improvement in the photochemical fertilizer segment, combined with a gross profit from the technical services segment, resulted in an overall gross profit for the year, which is the first time that this was accomplished since before the move to the Stead manufacturing facility in 2000.

Addressing our financial condition, improvements have been made there as well. The stockholders' deficit, $4,587,900 at December 31, 2002, has been reduced to a deficit of $2,564,300 at December 31, 2004, an improvement of $2,023,600. This has been achieved by the conversion of approximately $3.4 million in convertible notes and accrued interest into common stock. One significant area of difficulty for us has been meeting the payments on capital lease obligations. However, the capital lease obligation at December 31, 2002 of $1,193,900 has been reduced to $807,700 at December 31, 2004, a reduction of $386,200. This includes the write off five leases as debt forgiveness income in 2004 of $187,800. We expect to make further meaningful progress expanding sales and reducing debt in 2005.

Comparison of the Three and Nine Months Ended September 30, 2005 with the Three and Nine Months Ended September 30, 2004

Results of Operations

We reported consolidated revenues of $243,396 for the quarter ended September 30, 2005, compared to $289,734 for the prior year quarter, a decrease of 16%. The decrease was due to a decrease in Photochemical Fertilizer segment revenue of $20,700, or 8% and to a decrease of $25,600 in Mining Technical Services segment revenues, a decrease of 68%. The consolidated net loss was $1,298,672, or $0.007 per share, for the quarter ended September 30, 2005, compared to a net loss of $769,956 or $0.005 per share for the comparable 2004 period, an increased loss of $528,700, or 69%. Consolidated revenues for the first nine months of 2005 were $1,110,697 compared to $1,322,744 for the prior year period, a decrease of 16%. The consolidated net loss was $3,031,666 or $0.016 per share, for the nine

months ended September 30, 2005, compared to a net loss of $2,283,245 or $0.017 per share for the comparable 2004 period, an increased loss of 33%.

To provide a more complete understanding of the factors contributing to the changes in revenues, operating expenses, other income (expense) and the resultant operating income (loss) and net income (loss) before taxes, the discussion presented below is separated into our two operating segments.

PHOTOCHEMICAL FERTILIZER

	Three months Ended Sept 30,		Nine Months Ended Sept 30,	
	2005	2004	2005	2004
Revenues				
Fertilizer	$ 107,378	$ 152,230	$ 803,276	$ 858,619
Photochemical recycling	$ 59,699	$ 82,373	$ 101,768	$ 212,016
Silver	$ 64,089	$ 17,285	$ 109,963	$ 81,760
Total Revenue	$ 231,166	$ 251,888	$ 1,015,007	$ 1,152,395
Gross profit (loss)	$ (47,845)	$ (39,434)	$ (69,291)	$ (32,701)
Operating income (loss)	$ (514,097)	$ (498,312)	$ (1,611,904)	$ 1,490,401)
Other income (loss)	$ (671,911)	$ (191,379)	$ (1,037,685)	
Grants of restricted shares of common stock	785	1,989		
Issuance of performance shares	1,193	565		
Acquisition of treasury stock for options exercised	—	500		

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B. New Accounting Standards

In June 2011, the FASB issued new guidance to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The new guidance requires an entity to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both presentations, an entity would have been required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. Historically, the Company has used the consecutive two-statement approach; however, this new guidance would have required additional disclosure on the Company's statement of operations and related notes. In December 2011, the FASB issued new guidance to defer the effective date for amendments to the presentation of reclassification of items out of accumulated other comprehensive income. Deferring the effective date will allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, the Company will continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before the guidance issued in June 2011 until further guidance becomes available.

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

Texas Regulatory Matters

2009 Texas Retail Rate Case. On December 9, 2009, the Company filed an application with the PUCT for authority to change rates, to reconcile fuel costs, to establish formula-based fuel factors and to establish an energy efficiency cost-recovery factor. This case was assigned PUCT Docket No. 37690. The filing included a base rate increase which was based upon an adjusted test year ended June 30, 2009. On July 30, 2010, the PUCT approved a settlement in the 2009 Texas retail rate case in PUCT Docket No. 37690. The settlement called for an annual non-fuel base rate increase of $17.15 million effective for usage beginning July 1, 2010. The new rate structure resulted in net increases in base rates during the peak summer season of May through October and net decreases in base rates during November through April. This increase was partially offset by the provision that, consistent with a prior rate agreement, effective July 1, 2010, the Company shares 90% of off-system sales margins with customers and retains 10% of such margins. Previously, the Company retained 75% of off-system sales margins. The PUCT also approved the use of a formula-based fuel factor which provides for more timely recovery of fuel costs. The PUCT also approved an energy efficiency cost-recovery factor that includes the recovery of deferred energy efficiency costs over a three-year period.

2012 Texas Retail Rate Case. The Company filed a rate increase request with the PUCT (Docket No. 40094), the City of El Paso, and other Texas cities on February 1, 2012. The rate filing was made in response to a resolution adopted by the El Paso City Council (the "Council") requiring the Company to show cause why its base rates for customers in the El Paso city limits should not be reduced. The rate filing used a historical test year ended September 30, 2011. The filing at the PUCT also included a request to reconcile $356.5 million of fuel expense for the period July 1, 2009 through September 30, 2011. On November 15, 2011, the Council adopted a resolution which established current rates as temporary rates for the Company's customers residing within the city limits of El Paso.

On April 17, 2012, the Council approved the settlement of the Company's 2012 Texas retail rate case and fuel reconciliation in PUCT Docket No. 40094. The settlement reflects discussions with the the PUCT, the City of El Paso and other intervenors in Docket No. 40094. The approval by the Council (i) resolves the local, City of El Paso rate proceeding that commenced with the October 4, 2011 show cause order of the Council, (ii) implements new rates within the city limits of El Paso commencing with bills rendered on and after May 1, 2012, and (iii) rescinds and withdraws the temporary rate order that the Council issued on November 15, 2011.

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For Texas service areas outside of the city limits of El Paso, the settlement was filed with the PUCT on April 19, 2012 and no intervenors are opposing the settlement. On April 26, 2012, the administrative law judges issued an order (i) implementing the settlement rates as temporary rates effective May 1, 2012, and (ii) dismissing the case before the State Office of Administrative Hearings sending the settlement to the PUCT for final approval. While the Company can give no assurance whether the settlement will receive the required approvals, the PUCT has placed this matter on its agenda for May 18, 2012.

Under the terms of the settlement, among other things, the Company has agreed to:

- A reduction in its current non-fuel base rates of $15 million annually, with the decrease being allocated primarily to Texas retail commercial and industrial customer classes. The rate decrease will be effective as of May 1, 2012;
- New tariffs that will include an Economic Development Rate Rider that provides discounts in the demand charge and is intended to spur new business development in the Company's Texas service area;
- Revised depreciation rates for the Company's gas-fired generating units and for transmission and distribution plant that will lower depreciation expense by $4.1 million annually;
- Continuation of the 10.125% return on equity for the purpose of calculating the allowance for funds used during construction;
- A two-year amortization of rate case expenses, none of which will be included in future regulatory proceedings; and
- Palo Verde decommissioning funding of $3.6 million annually on a Texas jurisdictional basis, which will be subject to review and adjustment on a going-forward basis in future proceedings.

As part of the settlement the Company has agreed to withdraw its request to reconcile fuel costs for the period from July 1, 2009 through September 30, 2011. The Company will file a fuel reconciliation request covering the period beginning July 1, 2009 and ending no later than June 30, 2013 by December 31, 2013 or as part of its next rate case, if earlier.

Fuel and Purchased Power Costs. The Company's actual fuel costs, including purchased power energy costs, are recoverable from its customers. The PUCT has adopted a fuel cost recovery rule (“Texas Fuel Rule”) that allows the Company to seek periodic adjustments to its fixed fuel factor. The Company received approval on July 30, 2010 in PUCT Docket No. 37690, to implement a formula to determine its fuel factor which adjusts natural gas and purchased power to reflect natural gas futures prices. The Company can seek to revise its fixed fuel factor based upon the approved formula at least four months after its last revision except in the month of December. The Texas Fuel Rule requires the Company to request to refund fuel costs in any month when the over-recovery balance exceeds a threshold material amount and it expects fuel costs to continue to be materially over-recovered. The Texas Fuel Rule also permits the Company to seek to surcharge fuel under-recoveries in any month the balance exceeds a threshold material amount and it expects fuel cost recovery to continue to be materially under-recovered. Fuel over and under-recoveries are considered material when they exceed 4% of the previous twelve months' fuel costs. All such fuel revenue and expense activities are subject to periodic final review by the PUCT in fuel reconciliation proceedings.

On April 12, 2012, the Company filed with the PUCT a request to reduce its fixed fuel factor charged to Texas retail customers. The fixed fuel factor is based upon a formula that reflects current costs of fuel for changes in prices for natural gas and the revision reflects recent declines in prices for natural gas. The impact of the reduction in the fuel factor will be a reduction in annual fuel revenues of approximately $30 million. On April 25, 2012, the administrative law judge issued an order approving a new fuel factor effective May 1, 2012.

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The Company has filed the following petitions with the PUCT to refund recent fuel cost over-recoveries, due primarily to fluctuations in natural gas markets and consumption levels. The table summarizes the docket number assigned by the PUCT, the dates the Company filed the petitions and the dates a final order was issued by the PUCT approving the refunds to customers. The fuel cost over-recovery periods represent the months in which the over-recoveries took place and the refund periods represent the billing month(s) in which customers received the refund amounts shown, including interest:

Docket No.	Date Filed	Date Approved	Recovery Period	Refund Period	Refund Amount (In Thousands)
38253	May 12, 2010	July 15, 2010	December 2009 – March 2010	July – August 2010	$11,100
38802	October 20, 2010	December 16, 2010	April – September 2010	December 2010	12,800
39159	February 18, 2011	May 3, 2011	October – December 2010	April 2011	11,800

The Company has filed the following petitions with the PUCT to revise its fixed fuel factor pursuant to the fuel factor formula authorized in PUCT Docket No. 37690:

Docket No.	Date Filed	Date Approved	Increase(Decrease) in Fuel Factor	Effective Billing Month
38895	November 23, 2010	January 6, 2011	(14.7)%	January 2011
39599	July 15, 2011	August 30, 2011	9.4%	August 2011
40302	April 12, 2012	April 25, 2012	(18.5)%	May 2012

Application of El Paso Electric Company to Amend its Certificate of Convenience and Necessity ("CCN") for Five Solar Power Generation Projects. On December 9, 2011, the Company filed a petition seeking a CCN to construct five solar powered generation projects, totaling approximately 2.6 MW, at four locations within the City of El Paso and one location in the Town of Van Horn. This case was assigned PUCT Docket No. 39973 and is still pending.
Generation CCN Filing. On May 2, 2012, the Company filed a petition with the PUCT requesting a CCN to construct a new generation facility to be located at a new plant site in far east El Paso. The new facility will initially consist of two 88 MW simple-cycle aeroderivative combustion turbines, which will be powered by natural-gas. The first unit is scheduled to become operational in 2014. This case was assigned PUCT Docket No. 40301.

New Mexico Regulatory Matters

Application for Approval to Recover Regulatory Disincentives and Incentives. On August 31, 2010, the Company filed an application for approval of its proposed rate design methodology to recover regulatory disincentives and incentives associated with the Company's energy efficiency and load management programs in New Mexico. On March 18, 2011, the Company entered into an uncontested stipulation which would provide for a rate per kWh of energy efficiency savings that would be recovered through the efficient use of energy rider. A hearing on the uncontested stipulation was held on April 26, 2011 and briefs were filed on September 26, 2011. A final order was issued on November 22, 2011 in which the NMPRC did not adopt the unopposed stipulation, but modified the structure of the energy rider to reduce the return to two percent and made the mechanism temporary. The Company filed a Notice of Appeal with the Supreme Court of the State of New Mexico on January 20, 2012 on the grounds that the NMPRC's decision is arbitrary and without substantial evidence.
Application for Approval of 2011 New and Modified Energy Efficiency Programs. On February 15, 2011, the Company filed its Application for Approval of New and Modified Energy Efficiency Programs for 2011 with the NMPRC. On June 22, 2011, parties to this case entered into a partial stipulation, agreeing on all issues, except for a

military base free-ridership issue. On June 24, 2011, the New Mexico Attorney General filed a statement in opposition to the proposed partial stipulation. On January 25, 2012, a hearing examiner issued a recommended decision modifying the stipulation by approving the Energy Efficiency programs and budgets with the exception of the Commercial Lighting Program, approving the adder for 2011 but not for 2012 or 2013 and excluding the Military Research & Development Class from participation in the rate rider and reducing the Company's

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required saving goals accordingly. On February 2, 2012, the Company filed certain exceptions to the recommended decision and requested an interim order related to this matter. The NMPRC issued a final order approving the partial stipulation and rejecting the Company's exceptions on February 21, 2012. On March 5, 2012, the Company filed an unopposed motion to immediately implement the approved programs and to initiate further proceedings to allow the parties to supplement the record to support the stipulated adders for 2012 and 2013. On March 20, 2012 the NMPRC issued an order granting the unopposed motion. On April 4, 2012, the hearing examiner issued a procedural order requiring additional information supporting the stipulated adders and recovery of regulatory disincentives. The Company filed direct testimony on April 25, 2012 in response to the procedural order.

Generation CCN Filing. On May 2, 2012, the Company filed a petition with the NMPRC requesting a CCN to construct a new generation facility to be located at a new plant site in far east El Paso. The new facility will initially consist of two 88 MW simple-cycle aeroderivative combustion turbines, which will be powered by natural-gas. The first unit is scheduled to become operational in 2014. This case was assigned NMPRC Case No. 12-00137-UT.

Revolving Credit Facility and Guarantee of Debt. On October 13, 2011, the Company received final approval from the NMPRC in Case No. 11-00349-UT to amend and restate the Company's $200 million revolving credit facility, which includes an option, subject to lender's approval, to expand the size to $300 million, and to incrementally issue up to $300 million of long-term debt as and when needed. Obtaining the ability to issue up to $300 million of new long-term debt, from time to time, provides the Company with the flexibility to access the debt capital markets when needed and when conditions are favorable.

On November 15, 2011, the Company and Rio Grande Resources Trust ("RGRT") amended and restated the $200 million unsecured RCF with JP Morgan Chase Bank, N.A., as administrative agent and issuing bank, and Union Bank, N.A., as syndication agent, and various lending banks party thereto. The amended and restated revolving credit facility ("RCF") reduces borrowing costs and extends the maturity from September 2014 to September 2016.

On March 29, 2012, the Company and The Bank of New York Mellon Trust Company, N.A., as trustee of the Rio Grande Resources Trust, entered into the Incremental Facility Assumption Agreement (the "Assumption Agreement") related to the RCF discussed above with JPMorgan Chase Bank, N.A., as administrative agent and issuing bank, Union Bank, N.A., as syndication agent, and various lending banks party thereto. The Assumption Agreement provides for the Company's exercise in full of the accordion feature provided for under the RCF, increasing the aggregate unsecured borrowing available from $200 million to $300 million. In addition, the Assumption Agreement reflects the addition of a new lender under the RCF. No other material modifications were made to the terms and conditions of the RCF.

Federal Regulatory Matters

Transmission Dispute with Tucson Electric Power Company (“TEP”). On August 31, 2011, the FERC issued an order approving the settlement of a long standing transmission dispute between TEP and the Company which became effective November 1, 2011. The settlement reduces TEP’s transmission rights under the Transmission Agreement from 200 MW to 170 MW and TEP and the Company have entered into two new firm transmission agreements under which TEP is purchasing from the Company new transmission service at the Company's applicable tariff rates for a total of 40 MW. Those two new service agreements were entered into and became effective November 1, 2011. Also under the terms of the settlement, TEP made a lump-sum cash payment to the Company of approximately $5.4 million for the period February 1, 2006 through September 30, 2011, including interest income. This adjustment was recorded in the three months ended September 30, 2011. The Company shared with its customers 25% of the transmission revenues earned before July 1, 2010, or approximately $0.7 million, through a credit to Texas fuel recoveries.

Revolving Credit Facility and Guarantee of Debt. On October 13, 2011, the Company received final approval from the FERC in Docket No. ES11-43-000 to amend and restate the Company's $200 million RCF, which includes an option,

subject to lender's approval, to expand the size to $300 million, and to incrementally issue up to $300 million of long-term debt as and when needed. Obtaining the ability to issue up to $300 million of new long-term debt provides the Company with the flexibility to access the debt capital markets when needed and when conditions are favorable. The Company has two years in which to issue this newly-authorized long-term debt. As noted above, on November 15, 2011, the RCF was amended and restated and on March 29, 2012, the aggregate unsecured borrowing available under the RCF was increased to $300 million.

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D. Common Stock

Repurchase Program. No shares of common stocks were repurchased during the first quarter of 2012. Details regarding the Company's stock repurchase program are presented below:

	Since 1999 (a)	Authorized Shares
Shares repurchased	25,406,184	
Cost, including commission (in thousands)	$423,647	
Total remaining shares available for repurchase at March 31, 2012		393,816

(a) Represents repurchased shares and cost since inception of the stock repurchase program in 1999.

The Company may in the future make purchases of its common stock pursuant to its authorized programs in open market transactions at prevailing prices and may engage in private transactions, where appropriate. The repurchased shares will be available for issuance under employee benefit and stock incentive plans, or may be retired.

Dividend Policy. On March 30, 2012, the Company paid $8.8 million of quarterly dividends to shareholders.

Basic and Diluted Earnings Per Share. The basic and diluted earnings per share are presented below (in thousands except for share data):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Weighted average number of common shares outstanding:				
Basic number of common shares outstanding	39,911,032	42,308,097	40,756,509	42,776,922
Dilutive effect of unvested performance awards	66,201	169,426	180,851	126,051
Dilutive effect of stock options	22,276	45,762	24,647	61,217
Diluted number of common shares outstanding	39,999,509	42,523,285	40,962,007	42,964,190
Basic net income per common share:				
Net income	$3,344	$6,775	$100,108	$95,929
Income allocated to participating restricted stock	(24)	(28)	(440)	(391)
Net income available to common shareholders	$3,320	$6,747	$99,668	$95,538
Diluted net income per common share:				
Net income	$3,344	$6,775	$100,108	$95,929
Income reallocated to participating restricted stock	(24)	(28)	(439)	(390)
Net income available to common shareholders	$3,320	$6,747	$99,669	$95,539
Basic net income per common share:				
Distributed earnings	$0.22	$—	$0.88	$—
Undistributed earnings	(0.14)	0.16	1.57	2.23
Basic net income per common share	$0.08	$0.16	$2.45	$2.23
Diluted net income per common share:				
Distributed earnings	$0.22	$—	$0.88	$—
Undistributed earnings	(0.14)	0.16	1.55	2.22
Diluted net income per common share	$0.08	$0.16	$2.43	$2.22

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The amount of restricted stock awards, performance shares and stock options excluded from the calculation of the diluted number of common shares outstanding because their effect was antidilutive is presented below:

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Restricted stock awards	59,800	94,076	73,084	78,792
Performance shares (a)	—	—	—	24,225
Stock options	—	—	—	—

(a) Performance shares were excluded from the computation of diluted earnings per share, as no payouts would have been required based upon performance at the end of the corresponding period. This amount assumes a 100% performance level payout.

E. Long-Term Debt and Financing Obligations

The Company maintains a revolving credit facility (“RCF”) for working capital and general corporate purposes and financing of nuclear fuel through the Rio Grande Resources Trust (“RGRT”). RGRT is the trust through which the Company finances its portion of nuclear fuel for Palo Verde and is consolidated in the Company's financial statements. The RCF has a term ending September 2016. On March 29, 2012, the Company and the Bank of New York Mellon Trust Company, N.A., as trustee of the RGRT, entered into the Incremental Facility Assumption Agreement (the “Assumption Agreement”) related to the RCF with JP Morgan Chase Bank, N.A., as administrative agent and issuing bank, Union Bank, N.A., as syndication agent, and various lending banks party thereto. The Assumption Agreement provides for the Company's exercise in full of the accordion feature provided for under the RCF, increasing the aggregate unsecured borrowing available from $200 million to $300 million. In addition, the Assumption Agreement reflects the addition of a new lender under the RCF. No other material modifications were made to the terms and conditions of the RCF. The total amount borrowed for nuclear fuel by RGRT was $149.6 million at March 31, 2012, of which $39.6 million had been borrowed under the RCF and $110 million was borrowed through senior notes. Interest costs on borrowings to finance nuclear fuel are accumulated by RGRT and charged to the Company as fuel is consumed and recovered through fuel recovery charges. At March 31, 2012, $53.0 million was outstanding under the RCF for working capital or general corporate purposes.

F. Income Taxes

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

For the three months ended March 31, 2012 and 2011, the Company’s consolidated effective tax rate was 18.9% and 22.8%, respectively. For the twelve months ended March 31, 2012 and 2011, the Company's consolidated effective tax rate was 34.4% and 32.8%, respectively. The Company's consolidated effective tax rate for the three and twelve months ended March 31, 2012 differs from the federal statutory tax rate of 35.0% primarily due to the allowance for equity funds used during construction and state income taxes.

G. Commitments, Contingencies and Uncertainties

For a full discussion of commitments and contingencies, see Note K of Notes to Consolidated Financial Statements in the 2011 Form 10-K. In addition, see Note C above and Notes C and E of Notes to Consolidated Financial Statements

in the 2011 Form 10-K regarding matters related to wholesale power sales contracts and transmission contracts subject to regulation and Palo Verde, including decommissioning, spent fuel storage, disposal of low-level radioactive waste, and liability and insurance matters.

Power Purchase and Sale Contracts

To supplement its own generation and operating reserves, and to meet required renewable portfolio standards, the Company engages in firm power purchase arrangements which may vary in duration and amount based on evaluation of the Company's

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resource needs, the economics of the transactions, and specific renewable portfolio requirements. For a full discussion of power purchase and sale contracts that the Company has entered into with various counterparties, see Note K of Notes to Consolidated Financial Statements in the 2011 Form 10-K. In addition to the contracts disclosed in the 2011 Form 10-K, in March 2012, the Company entered into a purchase contract with Southwestern Public Service Company for 65 MW during the months of June through August 2012.

Environmental Matters

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

Air Emissions. The U.S. Clean Air Act (“CAA”) and comparable state laws and regulations relating to air emissions impose, among other obligations, limitations on pollutants generated during the Company’s operations, including sulfur dioxide (“SO_2”), particulate matter ("PM"), nitrogen oxides (“NOx”) and mercury.

Clean Air Interstate Rule. The U.S. Environmental Protection Agency’s (“EPA”) Clean Air Interstate Rule (“CAIR”), as applied to the Company, involves requirements to limit emissions of NOx from the Company’s power plants in Texas and/or purchase allowances representing other parties’ emissions reductions starting in 2009. The U.S. Court of Appeals for the District of Columbia voided CAIR in 2008; however, the Company has complied with CAIR since 2009, and such rule is binding. The annual reconciliation to comply with CAIR is due by March 31 of the following year. The Company has purchased allowances and expensed the following costs to meet its annual requirements (in thousands):

Compliance Year	Amount
2010	$370
2011	90

Cross-State Air Pollution Rule. In July 2011, the EPA finalized the Cross-State Air Pollution Rule (“CSAPR”) which is intended to replace CAIR. CSAPR requires 28 states, including Texas, to further reduce power plant emissions of SO_2 and NOx. Under CSAPR, reductions in annual SO_2 and NOx emissions were required to begin January 1, 2012, with further reductions required beginning January 1, 2014. On December 30, 2011, the U.S. Court of Appeals for the District of Columbia Circuit issued its ruling to stay CSAPR, including the supplemental final rule, pending judicial review, which delays CSAPR's implementation date beyond January 1, 2012. The court is scheduled to hear the cases against the rule in 2012. Under this timeframe, the court could issue its decision by summer or early fall 2012. As the outcome of the judicial review and any other legal or Congressional challenges are uncertain, the Company is unable to determine what impact CSAPR may ultimately have on its operations and consolidated financial results, but it could be material. Until the legal challenges to CSAPR are resolved, the Company's obligations under CAIR remains in effect.

National Ambient Air Quality Standards. Under the CAA, the EPA sets National Ambient Air Quality Standards ("NAAQS") for six criteria emissions considered harmful to public health and the environment, including PM, NOx, CO and SO_2. Areas meeting the NAAQS are designated attainment areas while those that do not meet the NAAQS are considered nonattainment areas. Each state must develop a plan to bring nonattainment areas into compliance with the NAAQS. NAAQS must be reviewed by the EPA at five-year intervals. In 2010, the EPA strengthened the NAAQS for

both NOx and SO_2. The Company is currently evaluating what impact this could have on its operations. If the Company is required to install additional equipment to control emissions at its facilities, the revised NAAQS could have a material impact on its operations and consolidated financial results. In addition, the EPA is currently reviewing the PM NAAQS. The Company cannot at this time predict the impact of this review and any possible new standards on its operations or consolidated financial results, but it could be material. The EPA had been in the process of revising the NAAQS for ozone. However, in September 2011, President Obama ordered the EPA to withdraw its proposal. Work, however, is underway to support EPA's planned reconsideration of the standards in 2013.

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Utility MACT. The operation of coal-fired power plants, such as the Company's Four Corners plant, results in emissions of mercury and other air toxics. In December 2011, the EPA finalized Mercury and Air Toxics Standards (known as the "Utility MACT") for power plants, which replaces the prior federal Clean Air Mercury Rule and requires significant reductions in emissions of mercury and other air toxics. Companies impacted by the new standards will have up to four (and in certain cases five) years to comply. The Company is currently evaluating the new standards and cannot at this time determine the impact they may have on its Four Corners plant, but the cost of compliance could be material.

Climate Change. A significant portion of the Company's generation assets are nuclear or gas-fired, and as a result, the Company believes that its greenhouse gas (“GHG”) emissions are low relative to electric power companies who rely on more coal-fired generation. However, regulations governing the emission of GHGs, such as carbon dioxide, could impose significant costs or limitations on the Company. In recent years, the U.S. Congress has considered new legislation to restrict or regulate GHG emissions, although federal efforts directed at enacting comprehensive climate change legislation stalled in 2010 and appear unlikely to recommence in the near future. Nonetheless, it is possible that federal legislation related to GHG emissions will be considered by Congress in the future. The EPA has also proposed using the CAA to limit carbon dioxide and other GHG emissions, and other measures are being imposed or offered by individual states, municipalities and regional agreements with the goal of reducing GHG emissions.

In September 2009, the EPA adopted a rule requiring approximately 10,000 facilities comprising a substantial percentage of annual U.S. GHG emissions to inventory their emissions starting in 2010 and to report those emissions to the EPA beginning in 2011. The Company's fossil fuel-fired power generating assets are subject to this rule, and the first report containing 2010 emissions was submitted to the EPA prior to the September 30, 2011 due date. The Company also has inventoried and implemented procedures for electrical equipment containing sodium hexafluoride ("SF6"), another GHG. The Company is tracking these GHG emissions pursuant to the EPA's new SF6 reporting rule that was finalized in late 2010 and became effective January 1, 2011. The first report to EPA under this rule was originally due on March 31, 2012, but in November 2011, EPA delayed its submittal to September 26, 2012.

The EPA has also proposed and finalized other rulemakings on GHG emissions that affect electric utilities. Under EPA regulations finalized in May 2010 (referred to as the “Tailoring Rule”), the EPA began regulating GHG emissions from certain stationary sources in January 2011. The regulations are being implemented pursuant to two CAA programs: the Title V Operating Permit program and the program requiring a permit if undergoing construction or major modifications (referred to as the “PSD” program). Obligations relating to Title V permits will include recordkeeping and monitoring requirements. With respect to PSD permits, projects that cause a significant increase in GHG emissions (currently defined to be more than 75,000 tons or 100,000 tons per year, depending on various factors), will be required to implement “best available control technology,” or “BACT”. Pursuant to the rule, the EPA may reduce the 75,000 tons threshold referenced above in 2012 or thereafter. The EPA has issued guidance on what BACT entails for the control of GHGs, and individual states are now required to determine what controls are required for facilities within their jurisdiction on a case-by-case basis. The ultimate impact of these new regulations on the Company's operations cannot be determined at this time, but the cost of compliance with new regulations could be material. Also, on December 23, 2010, the EPA announced a settlement agreement with states and environmental groups regarding setting new source performance standards for GHG emissions from new and existing coal-, gas- and oil-based power plants. Pursuant to this agreement, and certain agreed upon extensions, the EPA intends to issue proposed rules for new and modified electric generating units ("EGUs") in 2012. On March 27, 2012, EPA released its proposed GHG New Source Performance Standard ("NSPS") for EGUs. The Company is currently determining how this proposed rule may impact existing and future operations, and plans to provide comments to EPA during the 60-day comment period that began on April 13, 2012. The impact of these rules on the Company is unknown at this time, but they could result in significant costs.

In addition, almost half of the states, either individually or through multi-state regional initiatives, have begun to consider how to address GHG emissions and are actively considering the development of emission inventories or regional GHG cap and trade programs.

It is not currently possible to predict with confidence how any pending, proposed or future GHG legislation by Congress, the states, or multi-state regions or regulations adopted by EPA or the state environmental agencies will impact the Company's business. However, any such legislation or regulation of GHG emissions or any future related litigation could result in increased compliance costs or additional operating restrictions or reduced demand for the power the Company generates, could require the Company to purchase rights to emit GHG, and could have a material adverse effect on the Company's business, financial condition, reputation or results of operations.

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Climate change also has potential physical effects that could be relevant to the Company's business. In particular, some studies suggest that climate change could affect the Company's service area by causing higher temperatures, less winter precipitation and less spring runoff, as well as by causing more extreme weather events. Such developments could change the demand for power in the region and could also impact the price or ready availability of water supplies or affect maintenance needs and the reliability of Company equipment.

The Company believes that material effects on the Company's business or operations may result from the physical consequences of climate change, the regulatory approach to climate change ultimately selected and implemented by governmental authorities, or both. Substantial expenditures may be required for the Company to comply with such regulations in the future and, in some instances, those expenditures may be material. Given the very significant remaining uncertainties regarding whether and how these issues will be regulated, as well as the timing and severity of any physical effects of climate change, the Company believes it is impossible at present to meaningfully quantify the costs of these potential impacts.
Contamination Matters. The Company has a provision for environmental remediation obligations of approximately $0.5 million at March 31, 2012, related to compliance with federal and state environmental standards. However, unforeseen expenses associated with environmental compliance or remediation may occur and could have a material adverse effect on the future operations and financial condition of the Company.

The Company incurred the following expenditures during the three and twelve months ended March 31, 2012 and 2011 to comply with federal environmental statutes (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Clean Air Act (1)	$229	$58	$887	$456
Clean Water Act	46	56	254	200

(1) Includes an accrual of $0.2 million, in the first quarter of 2012, related to Four Corners generating station discussed below.

Environmental Litigation and Investigations. On April 6, 2009, APS received a request from the EPA under Section 114 of the CAA seeking detailed information regarding projects and operations at Four Corners. The EPA has taken the position that many utilities have made certain physical or operational changes at their plants that should have triggered additional regulatory requirements under the New Source Review provisions of the CAA. APS responded to this request in 2009. On February 16, 2010, a group of environmental organizations filed a petition with the United States Departments of Interior and Agriculture requesting that the agencies certify to the EPA that emissions from Four Corners are causing “reasonably attributable visibility impairment” under the CAA. If the agencies certify impairment, the EPA is required to evaluate and, if necessary, determine “best available retrofit technology" (“BART”) for Four Corners. On January 19, 2011, a similar group of environmental organizations filed a lawsuit against the Departments of Interior and Agriculture, alleging, among other things, that the agencies failed to act on the February 2010 petition “without unreasonable delay” and requesting the court to order the agencies to act on the petition within 30 days. Since July 2011, the U.S. Department of Justice ("DOJ"), on behalf of the EPA, and APS have been engaged in substantive settlement negotiations. Most recently, by letter dated March 2, 2012, the DOJ submitted a revised settlement proposal. Settlement discussions have included provisions for a civil penalty and environmental mitigation projects. The Company has determined that payment of a penalty and payment for environmental mitigation projects

is likely to occur and that the current range for the Company's loss contingency exposure is $0.2 million to $0.9 million. The Company has accrued $0.2 million related to this matter. The settlement discussions have emphasized that the environment mitigation projects that address alleged harm to the Navajo Nation be spent within five years of the date a decree is entered.

The Company received word that Earthjustice filed a lawsuit in the United States District Court for New Mexico on October 4, 2011 for alleged violations of the Prevention of Significant Deterioration provisions of the CAA related to Four Corners. Subsequent to filing its original Complaint, on January 6, 2012, Earthjustice filed a First Amended Complaint adding claims for violations of the CAA's NSPS program. Among other things, the plaintiffs seek to have the court enjoin operations at Four Corners until APS applies for and obtains any required PSD permits and complies with the NSPS. The plaintiffs further request the court to order the payment of civil penalties, including a beneficial mitigation project. APS advised that it believes the claims in this matter are without merit and will vigorously defend against them. The Company is unable to predict the outcome of these alleged violations.

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H. Litigation

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

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

I. Employee Benefits

Retirement Plans

The net periodic benefit cost recognized for the three and twelve months ended March 31, 2012 and 2011 is made up of the components listed below as determined using the projected unit credit actuarial cost method (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Components of net periodic benefit cost:				
Service cost	$2,225	$1,743	$7,332	$6,307
Interest cost	3,378	3,495	13,870	13,699
Amendments	—	—	—	838
Expected return on plan assets	(3,610)	(3,533)	(14,172)	(13,900)
Amortization of:				
Net loss	2,965	1,583	7,926	4,232
Prior service cost	27	27	115	117
Net periodic benefit cost	$4,985	$3,315	$15,071	$11,293

During the three months ended March 31, 2012, the Company contributed $6.4 million of its projected $19.8 million 2012 annual contribution to its retirement plans.

Other Postretirement Benefits

The net periodic benefit cost recognized for the three and twelve months ended March 31, 2012 and 2011 is made up of the components listed below (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Components of net periodic benefit cost:				
Service cost	$1,070	$738	$3,320	$3,371
Interest cost	1,415	1,290	5,504	6,229
Expected return on plan assets	(435)	(458)	(1,800)	(1,612)
Amortization of:				
Prior service benefit	(1,470)	(1,482)	(5,915)	(3,626)
Net loss (gain)	160	(108)	229	(283)
Net periodic benefit cost	$740	$(20)	$1,338	$4,079

During the three months ended March 31, 2012, the Company contributed $0.6 million of its projected $2.5 million 2012 annual contribution to its postretirement plan.

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J. Financial Instruments and Investments
FASB guidance requires the Company to disclose estimated fair values for its financial instruments. The Company has determined that cash and temporary investments, investment in debt securities, accounts receivable, decommissioning trust funds, long-term debt, short-term borrowings under the RCF, accounts payable and customer deposits meet the definition of financial instruments. The carrying amounts of cash and temporary investments, accounts receivable, accounts payable and customer deposits approximate fair value because of the short maturity of these items. Investments in debt securities and decommissioning trust funds are carried at fair value.
Long-Term Debt and Short-Term Borrowings Under the RCF. The fair values of the Company's long-term debt and short-term borrowings under the RCF are based on estimated market prices for similar issues and are presented below (in thousands):

	March 31, 2012		December 31, 2011	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Pollution Control Bonds	$193,135	$210,598	$193,135	$206,756
Senior Notes	546,675	647,840	546,662	700,371
RGRT Senior Notes (1)	110,000	117,405	110,000	116,985
RCF (1)	92,570	92,570	33,379	33,379
Total	$942,380	$1,068,413	$883,176	$1,057,491

(1) Nuclear fuel financing as of March 31, 2012 is funded through the $110 million RGRT Senior Notes and $39.6 million under the RCF and $53.0 million was outstanding under the RCF for working capital and general corporate purposes. The interest rate on the Company's borrowings under the RCF is reset throughout the quarter reflecting current market rates. Consequently, the carrying value approximates fair value.

Marketable Securities. The Company's marketable securities, included in decommissioning trust funds in the balance sheets, are reported at fair value which was $178.5 million and $168.0 million at March 31, 2012 and December 31, 2011, respectively. These securities are classified as available for sale under FASB guidance for certain investments in debt and equity securities and are valued using prices and other relevant information generated by market transactions involving identical or comparable securities. The reported fair values include gross unrealized losses on marketable securities whose impairment the Company has deemed to be temporary. The tables below present the gross unrealized losses and the fair value of these securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

	March 31, 2012					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Description of Securities (1):						
Federal Agency Mortgage Backed Securities	$20	$(1)	$1,304	$(33)	$1,324	$(34)
U.S. Government Bonds	3,271	(34)	2,395	(56)	5,666	(90)
Municipal Obligations	3,310	(26)	4,981	(189)	8,291	(215)
Corporate Obligations	2,334	(14)	732	(9)	3,066	(23)
Total Debt Securities	8,935	(75)	9,412	(287)	18,347	(362)
Common Stock	7,546	(1,016)	1,611	(356)	9,157	(1,372)

Total Temporarily Impaired Securities	$16,481	$(1,091)	$11,023	$(643)	$27,504	$(1,734)

(1) Includes approximately 87 securities.

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	December 31, 2011					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Description of Securities (2):						
Federal Agency Mortgage Backed Securities	$515	$(8)	$1,233	$(23)	$1,748	$(31)
U.S. Government Bonds	100	(1)	2,413	(38)	2,513	(39)
Municipal Obligations	2,275	(31)	4,731	(144)	7,006	(175)
Corporate Obligations	3,525	(118)	1,234	(43)	4,759	(161)
Total Debt Securities	6,415	(158)	9,611	(248)	16,026	(406)
Common Stock	10,688	(2,065)	1,740	(489)	12,428	(2,554)
Total Temporarily Impaired Securities	$17,103	$(2,223)	$11,351	$(737)	$28,454	$(2,960)

(2) Includes approximately 96 securities.

The Company monitors the length of time the security trades below its cost basis along with the amount and percentage of the unrealized loss in determining if a decline in fair value of marketable securities below recorded cost is considered to be other than temporary. In addition, the Company will research the future prospects of individual securities as necessary. As a result of these factors, as well as the Company's intent and ability to hold these securities until their market price recovers, these securities are considered temporarily impaired. The Company will not have a requirement to expend monies held in trust before 2044 or a later period when the Company begins to decommission Palo Verde.

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

	March 31, 2012		December 31, 2011	
	Fair Value	Unrealized Gains	Fair Value	Unrealized Gains
Description of Securities:				
Federal Agency Mortgage Backed Securities	$23,470	$1,141	$25,077	$1,220
U.S. Government Bonds	11,473	640	10,263	972
Municipal Obligations	26,577	1,506	30,310	1,792
Corporate Obligations	9,733	599	7,641	459
Total Debt Securities	71,253	3,886	73,291	4,443
Common Stock	75,351	22,956	62,479	15,681
Cash and Cash Equivalents	4,420	—	3,739	—
Total	$151,024	$26,842	$139,509	$20,124

The Company's marketable securities include investments in municipal, corporate and federal debt obligations. Substantially all of the Company's mortgage-backed securities, based on contractual maturity, are due in 10 years or more. The mortgage-backed securities have an estimated weighted average maturity which generally range from 3 to 7 years and reflects anticipated future prepayments. The contractual year for maturity of these available-for-sale securities as of March 31, 2012 is as follows (in thousands):

	Total	2012	2013 through 2016	2017 through 2021	2022 and Beyond
Municipal Debt Obligations	$34,868	$999	$11,698	$14,977	$7,194
Corporate Debt Obligations	12,799	—	3,692	5,517	3,590
U.S. Government Bonds	17,139	1,209	4,272	7,868	3,790

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The Company recognizes impairment losses on certain of its securities deemed to be other than temporary. In accordance with FASB guidance, these impairment losses are recognized in net income, and a lower cost basis is established for these securities. For the three and twelve months ended March 31, 2012 and 2011, the Company recognized other than temporary impairment losses on its available-for-sale securities as follows (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Gross unrealized holding losses included in pre-tax income	$—	$—	$(2,116)	$(263)

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

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Proceeds from sales of available-for-sale securities	$19,579	$14,231	$88,274	$56,383
Gross realized gains included in pre-tax income	$389	$264	$1,604	$897
Gross realized losses included in pre-tax income	(176)	(59)	(838)	(520)
Gross unrealized losses included in pre-tax income	—	—	(2,116)	(263)
Net gains (losses) in pre-tax income	$213	$205	$(1,350)	$114
Net unrealized holding gains included in accumulated other comprehensive income	$8,158	$2,173	$7,555	$6,415
Net (gains) losses reclassified out of accumulated other comprehensive income	(213)	(205)	1,350	(114)
Net gains in other comprehensive income	$7,945	$1,968	$8,905	$6,301

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

- Level 1 – Observable inputs that reflect quoted market prices for identical assets and liabilities in active markets. Financial assets utilizing Level 1 inputs include the nuclear decommissioning trust investments in active exchange-traded equity securities and U.S. treasury securities that are in a highly liquid and active market.
- Level 2 – Inputs other than quoted market prices included in Level 1 that are observable for the asset or liability either directly or indirectly. Financial assets utilizing Level 2 inputs include the nuclear decommissioning trust investments in fixed income securities. The fair value of these financial instruments is based on evaluated prices that reflect observable market information, such as actual trade information of similar securities, adjusted for observable differences.
- Level 3 – Unobservable inputs using data that is not corroborated by market data and primarily based on internal Company analysis using models and various other analyses. Financial assets utilizing Level 3 inputs include the Company's investments in debt securities.

The securities in the Company's decommissioning trust funds are valued using prices and other relevant information generated by market transactions involving identical or comparable securities. FASB guidance identifies this valuation technique as the

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EL PASO ELECTRIC COMPANY AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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"market approach" with observable inputs. The Company analyzes available-for-sale securities to determine if losses are other than temporary.
The fair value of the Company's decommissioning trust funds and investments in debt securities, at March 31, 2012 and December 31, 2011, and the level within the three levels of the fair value hierarchy defined by FASB guidance are presented in the table below (in thousands):

Description of Securities	Fair Value as of March 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Trading Securities:				
Investments in Debt Securities	$1,240	$—	$—	$1,240
Available for sale:				
U.S. Government Bonds	$17,139	$17,139	$—	$—
Federal Agency Mortgage Backed Securities	24,794	—	24,794	—
Municipal Bonds	34,868	—	34,868	—
Corporate Asset Backed Obligations	12,799	—	12,799	—
Subtotal Debt Securities	89,600	17,139	72,461	—
Common Stock	84,508	84,508	—	—
Cash and Cash Equivalents	4,420	4,420	—	—
Total available for sale	$178,528	$106,067	$72,461	$—

Description of Securities	Fair Value as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Trading Securities:				
Investments in Debt Securities	$1,120	$—	$—	$1,120
Available for sale:				
U.S. Government Bonds	$12,776	$12,776	$—	$—
Federal Agency Mortgage Backed Securities	26,825	—	26,825	—
Municipal Bonds	37,316	—	37,316	—
Corporate Asset Backed Obligations	12,400	—	12,400	—
Subtotal Debt Securities	89,317	12,776	76,541	—
Common Stock	74,907	74,907	—	—
Cash and Cash Equivalents	3,739	3,739	—	—
Total available for sale	$167,963	$91,422	$76,541	$—

There were no transfers in and out of Level 1 and Level 2 fair value measurements categories during the three and twelve month periods ending March 31, 2012 and March 31, 2011.
During the fourth quarter of 2011, the Company sold an investment in a debt security for $2.0 million that was categorized as a Level 3 investment. The Company realized in the consolidated statement of operations as investment and interest income a gain on the sale of the debt security of $0.4 million during the twelve month period ending March 31, 2012. There were no other purchases, sales, issuances, or settlements related to the assets in the Level 3 fair

value measurement category during the three month periods ending March 31, 2012 and 2011 and the twelve month periods ending March 31, 2012 and 2011.

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Report of Independent Registered Public Accounting Firm
The Board of Directors and Shareholders
El Paso Electric Company:

We have reviewed the consolidated balance sheet of El Paso Electric Company and subsidiary as of March 31, 2012, the related consolidated statements of operations and comprehensive operations for the three-month and twelve-month periods ended March 31, 2012 and 2011, and the related consolidated statements of cash flows for the three-month periods ended March 31, 2012 and 2011. These consolidated financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of El Paso Electric Company and subsidiary as of December 31, 2011, and the related consolidated statements of operations, comprehensive operations, changes in common stock equity, and cash flows for the year then ended (not presented herein); and in our report dated February 24, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2011, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP
Houston, Texas
May 4, 2012

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
The information contained in this Item 2 updates, and should be read in conjunction with, the information set forth in Part II, Item 7 of our 2011 Form 10-K.

FORWARD-LOOKING STATEMENTS
Certain matters discussed in this Quarterly Report on Form 10-Q other than statements of historical information are "forward-looking statements." The Private Securities Litigation Reform Act of 1995 has established that these statements qualify for safe harbors from liability. Forward-looking statements may include words like we "believe", "anticipate", "target", "expect", "pro forma", "estimate", "intend" and words of similar meaning. Forward-looking statements describe our future plans, objectives, expectations or goals. Such statements address future events and conditions concerning and include, but are not limited to, such things as:

- capital expenditures,
- earnings,
- liquidity and capital resources,
- ratemaking/regulatory matters,
- litigation,
- accounting matters,
- possible corporate restructurings, acquisitions and dispositions,
- compliance with debt and other restrictive covenants,
- interest rates and dividends,
- environmental matters,
- nuclear operations, and
- the overall economy of our service area.

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

- the financial impact of the proposed settlement to our rate case filed February 1, 2012 which is expected to be approved by the PUCT in May or June 2012,
- our ability to recover our costs and earn a reasonable rate of return on our invested capital through rates,
- ability of our operating partners to maintain plant operations and manage operation and maintenance costs at the Palo Verde and Four Corners plants, including costs to comply with any potential new or expanded regulatory requirements,
- reductions in output at generation plants operated by us,
- unscheduled outages including outages at Palo Verde,
- the size of our construction program and our ability to complete construction on budget and on a timely basis,
- electric utility deregulation or re-regulation,
- regulated and competitive markets,
- ongoing municipal, state and federal activities,
- economic and capital market conditions,
- changes in accounting requirements and other accounting matters,
- changing weather trends and the impact of severe weather conditions,
- rates, cost recovery mechanisms and other regulatory matters including the ability to recover fuel costs on a timely basis,

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- changes in environmental laws and regulations and the enforcement or interpretation thereof, including those related to air, water or greenhouse gas emissions or other environmental matters,
- political, legislative, judicial and regulatory developments,
- the impact of lawsuits filed against us,
- the impact of changes in interest rates,
- changes in, and the assumptions used for, pension and other post-retirement and post-employment benefit liability calculations, as well as actual and assumed investment returns on pension plan and other post-retirement plan assets,
- the impact of recent U.S. health care reform legislation,
- the impact of changing cost escalation and other assumptions on our nuclear decommissioning liability for Palo Verde,
- Texas, New Mexico and electric industry utility service reliability standards,
- homeland security considerations, including those associated with the U.S./Mexico border region,
- coal, uranium, natural gas, oil and wholesale electricity prices and availability, and
- other circumstances affecting anticipated operations, sales and costs.

These lists are not all-inclusive because it is not possible to predict all factors. A discussion of some of these factors is included in the 2011 Form 10-K under the headings “Management’s Discussion and Analysis” “-Summary of Critical Accounting Policies and Estimates” and “-Liquidity and Capital Resources.” This report should be read in its entirety. No one section of this report deals with all aspects of the subject matter. Any forward-looking statement speaks only as of the date such statement was made, and we are not obligated to update any forward-looking statement to reflect events or circumstances after the date on which such statement was made except as required by applicable laws or regulations.

Summary of Critical Accounting Policies and Estimates

The preparation of our financial statements requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes for the periods presented and actual results could differ in future periods from those estimates. Critical accounting policies and estimates are both important to the portrayal of our financial condition and results of operations and require complex, subjective judgments and are more fully described in the “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our 2011 Form 10-K.

Summary

The following is an overview of our results of operations for the three and twelve month periods ended March 31, 2012 and 2011. Income before extraordinary item for the three and twelve month periods ended March 31, 2012 and 2011 is shown below:

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2012	2011	2012	2011
Income before extraordinary item (in thousands)	$3,344	$6,775	$100,108	$85,643
Basic earnings per share before extraordinary item	0.08	0.16	2.45	1.99

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The following table and accompanying explanations show the primary factors affecting the after-tax change in income before extraordinary item between the 2012 and 2011 periods presented (in thousands):

	Three Months Ended	Twelve Months Ended
March 31, 2011 income before extraordinary item	$6,775	$85,643
Change in (net of tax):		
Increased retail non-fuel base revenues (a)	1,339	26,412
Increased transmission revenues (b)	196	2,894
Increased operations and maintenance at fossil fuel generating plants (c)	(1,638)	(6,162)
Decreased allowance for funds used during construction (d)	(1,533)	(6,025)
Decreased deregulated Palo Verde Unit 3 revenues (e)	(849)	(938)
Decreased (increased) Palo Verde operations and maintenance expense (f)	(680)	75
Increased transmission and distribution operating and maintenance expense (g)	(241)	(1,878)
Other	(25)	87
March 31, 2012 income before extraordinary item	$3,344	$100,108

(a) Retail non-fuel base revenues increased for the three and twelve months ended March 31, 2012 compared to the same periods in 2011 primarily due to a 3.3% and 4.0% increase, respectively, in kWh sales to retail customers reflecting a 1.5% growth in the average number of retail customers served in both the three and twelve month periods. Retail non-fuel base revenues exclude fuel recovered through New Mexico base rates. For a complete discussion of non-fuel rate base revenues, see page 25.

(b) Transmission revenues increased for the twelve months ended March 31, 2012 compared to the same period last year due to a settlement agreement with Tucson Electric Power Company involving a transmission dispute that resulted in a one-time adjustment to income of $3.9 million, pre-tax.

(c) Operations and maintenance expense increased in both the three and twelve month periods primarily due to the timing of planned maintenance of our fossil fuel generating units. In the three months ended March 31, 2012, we performed scheduled major maintenance at Rio Grande Unit 8 and at Newman Unit 1. In the twelve months ended March 31, 2012, we also performed scheduled major maintenance at Newman Unit 4 and at the Four Corners generating plant.

(d) Allowance for funds used during construction ("AFUDC") decreased in the three and twelve months ended March 31, 2012 compared to the same periods last year primarily due to lower balances of construction work in progress subject to AFUDC.

(e) Revenues from retail sales of deregulated Palo Verde Unit 3 power decreased for the three months ended March 31, 2012 compared to the same period last year due to lower proxy market prices associated with the decline in natural gas prices and a 12% decrease in generation at Palo Verde Unit 3 due to a refueling outage beginning on March 17, 2012 which was completed on April 17, 2012. Revenues from retail sales of deregulated Palo Verde Unit 3 power decreased for the twelve months ended March 31, 2012 compared to the same period last year due to lower proxy market prices and increased costs of nuclear fuel.

(f) Palo Verde operations and maintenance expense for the three months ended March 31, 2012 compared to the same period last year increased primarily due to the timing of the Unit 3 spring refueling outage which began on March 17, 2012 and was completed on April 17, 2012. In 2011, the Unit 2 spring refueling outage began on April 2, 2011 and was completed on May 6, 2011.

(g) Transmission and distribution operating and maintenance expense increased for the twelve months ended March 31, 2012 compared to the same period last year primarily due to increased wheeling costs and expenses incurred to comply with specific NERC Critical Infrastructure Protection recommendations.

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Historical Results of Operations

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

Operating revenues

We realize revenue from the sale of electricity to retail customers at regulated rates and the sale of energy in the wholesale power market generally at market-based prices. Sales for resale (which are wholesale sales within our service territory) accounted for less than 1% of revenues.

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

No retail customer accounted for more than 4% of our non-fuel base revenues during such periods. Residential and small commercial customers comprise 75% or more of our revenues. While this customer base is more stable, it is also more sensitive to changes in weather conditions. The current rate structure in New Mexico and Texas reflects higher base rates during the peak summer season of May through October and lower base rates during November through April for our residential and small commercial and industrial customers. As a result, our business is seasonal, with higher kWh sales and revenues during the summer cooling season.

Weather significantly impacts our residential, small commercial and industrial customers, and to a lesser extent, our sales to public authorities. For the three months ended March 31, 2012, retail non-fuel base revenues were negatively impacted by mild winter weather. Heating degree days decreased 8% when compared to the same period in 2011 and were 9% below the 30-year average. For the twelve months ended March 31, 2012, retail non-fuel base revenues were positively impacted by hotter summer weather when compared to the same period in 2011. Heating and cooling degree days can be used to evaluate the effect of weather on energy use. For each degree that the average outdoor temperature varies from a standard of 65 degrees Fahrenheit, a degree day is recorded. The table below shows heating and cooling degree days compared to a 30-year average.

	Three Months Ended March 31,		30-Year	Twelve Months Ended March 31,		30-Year
	2012	2011	Average	2012	2011	Average*
Heating degree days	1,159	1,265	1,273	2,296	2,142	2,426
Cooling degree days	37	41	13	3,131	2,770	2,410

* Calendar year basis.

Customer growth is a key driver of the growth of retail sales. The average number of retail customers grew 1.5% for both the three and twelve months ended March 31, 2012 when compared to the same periods last year. See the tables presented on pages 27 and 28 which provide detail on the average number of retail customers and the related revenues and kWh sales.

Retail non-fuel base revenues. Our rate structure effective July 1, 2010 through April 30, 2012 in Texas was based on the final order in PUCT Docket No. 37690 which approved a settlement that called for an annual increase of $17.15 million in non-fuel base rates. On April 17, 2012, the City Council (the “Council”) of El Paso, Texas approved the settlement of our 2012 Texas retail rate case and fuel reconciliation in PUCT Docket No. 40094 and on April 26, 2012, the administrative law judge issued an order implementing the settlement rates as temporary rates effective May 1, 2012. Under the terms of the settlement, among other things, we have agreed to a reduction in our current non-fuel base rates of $15 million annually, with the decrease being allocated primarily to Texas retail commercial and industrial customer classes.

Retail non-fuel base revenues increased by $2.1 million or 2.0% for the three months ended March 31, 2012 when compared to the same period last year primarily due to a 3.3% increase in kWh sales to retail customers reflecting a

1.5% growth in the average number of customers served. Sales increased despite mild winter weather. Retail non-fuel base revenues also increased in the three month period due to a 7.5% increase in kWh sales to our large commercial and industrial customers. Retail non-fuel base revenues for the twelve months ended March 31, 2012 increased by $41.9 million or 7.9% compared to the same period in 2011 primarily due to a 4.0% increase in kWh sales to retail customers reflecting hotter summer weather and a 1.5% growth in the average number of customers served. During the twelve months ended March 31, 2012, cooling degree days were 13% above the same period in 2011 and 30% above the 30-year average. KWh sales to residential customers and small commercial and industrial customers increased 6.2% and 3.3%, respectively, during the twelve months ended March 31, 2012 compared to the

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same period last year. KWh sales to large commercial and industrial customers increased 3.1% and sales to other public authorities increased 2.3% primarily due to increased sales to military bases.

Fuel revenues. Fuel revenues consist of (i) revenues collected from customers under fuel recovery mechanisms approved by the state commissions and the FERC, (ii) deferred fuel revenues which are comprised of the difference between fuel costs and fuel revenues collected from customers, and (iii) fuel costs recovered in base rates in New Mexico. In New Mexico and with our sales for resale customer, the fuel adjustment clause allows us to recover under-recoveries or refund over-recoveries of current fuel costs above the amount recovered in base rates with a two-month lag. In Texas, fuel costs are recovered through a fixed fuel factor. We can seek to revise our fixed fuel factor based upon an approved formula at least four months after our last revision except in the month of December. In addition, if we materially over-recover fuel costs, we must seek to refund the over-recovery, and if we materially under-recover fuel costs, we may seek a surcharge to recover those costs. Fuel over and under recoveries are considered material when they exceed 4% of the previous twelve months' fuel costs.

In the three months ended March 31, 2012, we over-recovered our fuel costs by $11.9 million compared to a fuel under-recovery of $1.0 million in the same period in 2011. In the twelve months ended March 31, 2012, we under-recovered our fuel costs by $0.9 million compared to fuel over-recoveries of $28.7 million in the same period last year. Refunds of $12.0 million and $23.0 million were returned to our Texas customers in the twelve months ended March 31, 2012 and 2011, respectively. At March 31, 2012, we had a net fuel over-recovery balance of $4.9 million, including $1.5 million in Texas and $3.4 million in New Mexico.

Off-system sales. Off-system sales are wholesale sales into markets outside our service territory. Off-system sales are primarily made in off-peak periods when we have competitive generation capacity available after meeting our regulated service obligations. We shared 25% of our off-system sales margins with our Texas and New Mexico customers and retained 75% of off-system sales margins through June 30, 2010. Pursuant to rate agreements in prior years, effective July 1, 2010, we share 90% of off-system sales margins with our Texas and New Mexico customers, and we retain 10% of off-system sales margins. We are sharing 25% of our off-system sales margins with our sales for resale customer under the terms of a contract which was effective April 1, 2008.

Typically, we realize a significant portion of our off-system sales margins in the first quarter of each calendar year when our native load is lower than at other times of the year, allowing for the sale in the wholesale market of relatively larger amounts of off-system energy generated from lower cost generating resources. Palo Verde's availability is an important factor in realizing these off-system sales margins.

Off-system sales revenues decreased $4.6 million, or 21.4% for the three months ended March 31, 2012 when compared to the same period last year as a result of lower average market prices for power and a 7.7% decline in MWh sales. However, retained margins from off-system sales increased $0.2 million for the three months ended March 31, 2012 compared to the same period last year due to the negative impact of power purchases required for system reliability during extremely cold weather in February 2011. Off-system sales revenues decreased $14.5 million, or 16.5% for the twelve months ended March 31, 2012 when compared to the same period last year as a result of lower average market prices for power and a 4.2% decline in MWh sales. Retained margins from off-system sales decreased approximately $1.6 million for the twelve months ended March 31, 2012 compared to the corresponding period in 2011. Off-system sales margins decreased due to lower average market prices for power, a decrease in MWh sales, and the increased sharing of off-system sales margins with customers effective July 1, 2010.

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

Quarter Ended March 31:	2012	2011	Increase (Decrease) Amount	Percent	
kWh sales:					
Retail:					
Residential	555,569	541,282	14,287	2.6 %	
Commercial and industrial, small	491,237	478,521	12,716	2.7	
Commercial and industrial, large	246,358	229,232	17,126	7.5	
Sales to public authorities	343,511	334,969	8,542	2.6	
Total retail sales	1,636,675	1,584,004	52,671	3.3	
Wholesale:					
Sales for resale	11,807	11,653	154	1.3	
Off-system sales	708,679	767,620	(58,941)	(7.7)	
Total wholesale sales	720,486	779,273	(58,787)	(7.5)	
Total kWh sales	2,357,161	2,363,277	(6,116)	(0.3)	
Operating revenues:					
Non-fuel base revenues:					
Retail:					
Residential	$46,025	$44,977	$1,048	2.3 %	
Commercial and industrial, small	33,801	33,214	587	1.8	
Commercial and industrial, large	9,371	8,801	570	6.5	
Sales to public authorities	16,940	17,020	(80)	(0.5)	
Total retail non-fuel base revenues	106,137	104,012	2,125	2.0	
Wholesale:					
Sales for resale	398	550	(152)	(27.6)	
Total non-fuel base revenues	106,535	104,562	1,973	1.9	
Fuel revenues:					
Recovered from customers during the period	32,534	25,863	6,671	25.8	
Under (over) collection of fuel	(11,931)	1,038	(12,969)	—	
New Mexico fuel in base rates	16,964	16,369	595	3.6	
Total fuel revenues	37,567	43,270	(5,703)	(13.2)	(1)
Off-system sales:					
Fuel cost	15,466	20,262	(4,796)	(23.7)	
Shared margins	1,188	1,165	23	2.0	
Retained margins	140	(61)	201	—	
Total off-system sales	16,794	21,366	(4,572)	(21.4)	
Other	7,682	6,914	768	11.1	(2)
Total operating revenues	$168,578	$176,112	$(7,534)	(4.3)	
Average number of retail customers:					
Residential	339,469	334,832	4,637	1.4 %	
Commercial and industrial, small	38,008	37,064	944	2.5	
Commercial and industrial, large	49	50	(1)	(2.0)	
Sales to public authorities	4,555	4,536	19	0.4	
Total	382,081	376,482	5,599	1.5	

(1) Includes deregulated Palo Verde Unit 3 revenues for the New Mexico jurisdiction of $2.6 million and $3.9 million, respectively.

(2) Represents revenues with no related kWh sales.

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Twelve Months Ended March 31:	2012	2011	Increase (Decrease) Amount	Percent	
kWh sales:					
Retail:					
Residential	2,647,677	2,493,836	153,841	6.2 %	
Commercial and industrial, small	2,364,934	2,289,776	75,158	3.3	
Commercial and industrial, large	1,113,166	1,080,032	33,134	3.1	
Sales to public authorities	1,588,107	1,551,801	36,306	2.3	
Total retail sales	7,713,884	7,415,445	298,439	4.0	
Wholesale:					
Sales for resale	62,810	56,110	6,700	11.9	
Off-system sales	2,628,690	2,742,614	(113,924)	(4.2)	
Total wholesale sales	2,691,500	2,798,724	(107,224)	(3.8)	
Total kWh sales	10,405,384	10,214,169	191,215	1.9	
Operating revenues:					
Non-fuel base revenues:					
Retail:					
Residential	$235,134	$217,757	$17,377	8.0 %	
Commercial and industrial, small	196,680	182,405	14,275	7.8	
Commercial and industrial, large	45,977	43,432	2,545	5.9	
Sales to public authorities	94,290	86,564	7,726	8.9	
Total retail non-fuel base revenues	572,081	530,158	41,923	7.9	
Wholesale:					
Sales for resale	1,970	2,186	(216)	(9.9)	
Total non-fuel base revenues	574,051	532,344	41,707	7.8	
Fuel revenues:					
Recovered from customers during the period	151,801	158,418	(6,617)	(4.2)	(1)
Under (over) collection of fuel	948	(28,680)	29,628	—	
New Mexico fuel in base rates	74,049	72,416	1,633	2.3	
Total fuel revenues	226,798	202,154	24,644	12.2	(2)
Off-system sales:					
Fuel cost	69,940	80,917	(10,977)	(13.6)	
Shared margins	3,906	5,819	(1,913)	(32.9)	
Retained margins	(359)	1,244	(1,603)	—	
Total off-system sales	73,487	87,980	(14,493)	(16.5)	
Other	36,143	26,717	9,426	35.3	(3)
Total operating revenues	$910,479	$849,195	$61,284	7.2	
Average number of retail customers:					
Residential	337,378	333,143	4,235	1.3 %	
Commercial and industrial, small	37,887	36,665	1,222	3.3	
Commercial and industrial, large	50	49	1	2.0	
Sales to public authorities	4,630	4,594	36	0.8	
Total	379,945	374,451	5,494	1.5	

(1) Excludes $12.0 million and $23.0 million of refunds in 2012 and 2011, respectively, related to Texas deferred fuel revenues.

(2) Includes deregulated Palo Verde Unit 3 revenues for the New Mexico jurisdiction of $13.5 million and $14.9 million, respectively.

(3)

Represents revenues with no related kWh sales. Includes $3.9 million related to the settlement of a transmission dispute with Tucson Electric Power Company recorded in the third quarter of 2011.

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Energy expenses

Our sources of energy include electricity generated from our nuclear, natural gas and coal generating plants and purchased power. Palo Verde represents approximately 35% of our available net generating capacity and approximately 63% and 55% of our Company-generated energy for the three and twelve months ended March 31, 2012, respectively. Fluctuations in the price of natural gas, which also is the primary factor influencing the price of purchased power, have had a significant impact on our cost of energy.

Energy expenses decreased $9.2 million or 15.1% for the three months ended March 31, 2012 when compared to 2011 primarily due to (i) decreased costs of purchased power of $5.9 million due to a 19.2% decrease in the market prices for power and a 15.9% decrease in the MWhs purchased, (ii) decreased natural gas costs of $2.7 million due to a 21.2% decrease in the average price of natural gas and an 8.9% decrease in MWhs generated with natural gas, and (iii) decreased coal costs of $1.7 million primarily due to a $2.3 million adjustment for the amortization of final coal reclamation costs in accordance with the final order in PUCT Docket No. 38361 in 2011 partially offset by increase MWh generation in 2012. These decreases were partially offset by increased nuclear fuel costs of $1.0 million due to a 13.2% increase in the cost of nuclear fuel consumed. The table below details the sources and costs of energy for the three months ended March 31, 2012 and 2011.

	Three Months Ended March 31,					
	2012			2011		
Fuel Type	Cost	MWh	Cost per MWh	Cost	MWh	Cost per MWh
	(in thousands)			(in thousands)		
Natural gas (a)	$23,681	562,439	$42.10	$26,343	617,334	$53.44
Coal (b)	3,700	193,483	19.12	5,363	166,971	18.13
Nuclear	12,053	1,281,180	9.41	11,053	1,329,807	8.31
Total	39,434	2,037,102	19.36	42,759	2,114,112	22.27
Purchased power	12,559	472,752	26.57	18,474	561,928	32.88
Total energy	$51,993	2,509,854	20.72	$61,233	2,676,040	24.49

(a) Natural gas costs have been adjusted for energy expenses capitalized related to Newman Unit 5 phase II pre-commercial testing recorded in 2011.

(b) Coal costs include $2.3 million adjustment for final coal reclamation amortization in accordance with PUCT Docket No. 38361 recorded in 2011.

Our energy expenses increased $14.4 million or 5.2% for the twelve months ended March 31, 2012 when compared to 2011. The increase was primarily due to increased natural gas costs of $19.6 million primarily due to an 11.4% increase in MWhs generated with natural gas partially offset by a 4.5% decrease in the average cost of natural gas. The increase in energy expenses was also due to a $7.4 million or 19.7% increase in nuclear fuel costs due to (i) a $3.3 million DOE refund recorded in the fourth quarter of 2010 with no comparable activity in the current period, and (ii) an 11.9% increase in the price of nuclear fuel partially offset by a 1.6% decrease in MWh generated by nuclear fuel. These increases in energy expenses were partially offset by decreased costs of purchased power of $12.3 million due to a 14.7% decrease in MWhs purchased. The table below details the sources and costs of energy for the twelve month periods ended March 31, 2012 and 2011.

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Fuel Type	Twelve Months Ended March 31, 2012 Cost	MWh	Cost per MWh	2011 Cost	MWh	Cost per MWh
	(in thousands)			(in thousands)		
Natural gas (a)	$161,598	3,291,894	$48.03	$141,994	2,954,642	$50.31
Coal (b)	13,610	674,444	20.18	13,940	696,798	16.65
Nuclear (c)	44,974	4,893,428	9.19	37,561	4,974,808	8.21
Total	220,182	8,859,766	24.46	193,495	8,626,248	23.31
Purchased power	69,234	2,023,420	34.22	81,543	2,372,774	34.37
Total energy	$289,416	10,883,186	26.27	$275,038	10,999,022	25.70

(a) Natural gas costs have been adjusted for energy expenses capitalized related to Newman Unit 5 phase II pre-commercial testing recorded in 2011.

(b) Coal costs include $2.3 million adjustment for final coal reclamation amortization in accordance with PUCT Docket No. 38361 recorded in 2011.

(c) Includes a DOE refund of $3.3 million for spent fuel storage costs recorded in the fourth quarter of 2010.

Other operations expense

Other operations expense increased $0.3 million for the three months ended March 31, 2012 compared to the same period last year due primarily to increased administrative and general expense of $0.9 million due to increased employee pension and benefits costs as a result of changes in actuarial assumptions used to calculate expenses for our pension and OPEB plans partially offset by a $0.8 million decrease in the ARO accretion expense. The accretion expense decreased as a result of the Palo Verde license extension approved by the NRC in April 2011.

Other operations expense increased $1.7 million for the twelve months ended March 31, 2012 compared to the same period last year. The increase is primarily due to (i) increased transmission operations expense of $2.6 million primarily due to increased wheeling expense and a reliability study for the North American Electric Reliability Corporation, and (ii) increased administrative and general expense of $1.5 million primarily due to increased pension and benefits expenses reflecting changes in actuarial assumptions used to calculate expense for our pension plan. These increases were partially offset by a $3.3 million decrease in the ARO accretion expense. The accretion expense decreased as a result of the Palo Verde license extension approved by the NRC in April 2011.

Maintenance expense

Maintenance expense increased $3.7 million, or 30.5%, for the three months ended March 31, 2012 compared to the same period last year primarily due to the timing of planned maintenance at our gas fired generating plants and the timing of the Palo Verde Unit 3 spring refueling outage. The Palo Verde Unit 3 spring refueling outage began on March 17, 2012, two weeks earlier than the 2011 Palo Verde Unit 2 spring refueling outage, and was completed by April 17, 2012. Maintenance expense increased $11.3 million, or 20.6%, for the twelve months ended March 31, 2012 compared to the same period last year primarily due to increased maintenance of $9.9 million largely as a result of weather-related damage during severe winter weather in February 2011 and freeze protection upgrades at our fossil-fuel generating plants and the timing of planned outages at these plants.

Depreciation and amortization expense

Depreciation and amortization expense decreased $0.4 million and $1.8 million, or 2.0% and 2.1%, for the three and twelve months ended March 31, 2012 compared to the same periods last year primarily due to a reduction in depreciation rates related to the Palo Verde plant resulting from the approval of a license extension for Palo Verde by the NRC in April 2011, partially offset by increases in depreciable plant balances including Phase II of Newman Unit 5.

Taxes other than income taxes

Taxes other than income taxes increased $0.5 million and $0.2 million, or 3.9% and 0.4%, for the three and twelve months ended March 31, 2012 compared to the same periods last year primarily due to an increase in taxable property and property tax rates, and payroll taxes.

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Other income (deductions)
Other income (deductions) decreased $1.7 million and $6.2 million for the three and twelve months ended March 31, 2012 compared to the same periods last year due to decreased allowance for equity funds used during construction as a result of lower balances of construction work in progress reflecting the completion of Newman Unit 5 in April 2011. Also during the 2012 twelve month period we incurred a net unrealized and realized loss on equity investments in our decommissioning trust of $1.3 million compared to a $0.1 million realized gain for the same period in 2011.

Interest charges (credits)

Interest charges (credits) increased $0.6 million and $3.5 million, or 5.2% and 8.2%, for the three and twelve months ended March 31, 2012 compared to the same periods last year, respectively, primarily due to decreased allowance for borrowed funds used during construction ("ABFUDC") as a result of lower balances of construction work in progress in the 2012 periods reflecting the completion of Newman Unit 5 in April 2011.
Income tax expense
Income tax expense decreased by $1.2 million, or 61.1%, in the first quarter of 2012 compared to 2011, primarily as a result of decreased pre-tax income. Income tax expense, before extraordinary item, increased by $11.5 million, or 27.9%, in the twelve months ended March 31, 2012 compared to 2011, primarily due to increased pre-tax income and a decrease in the domestic production activities deduction.
Extraordinary Item
As a regulated electric utility, we prepare our financial statements in accordance with the FASB guidance for regulated operations. FASB guidance for regulated operations requires us to show certain items as assets or liabilities on our balance sheet when the regulator provides assurance that these items will be charged to and collected from our customers or refunded to our customers. In the final order for PUCT Docket No. 37690, we were allowed to include the previously expensed loss on reacquired debt associated with the refinancing of first mortgage bonds in 2005 in our calculation of the weighted cost of debt to be recovered from our customers. We recorded the impacts of the re-application of FASB guidance for regulated operations to our Texas jurisdiction in 2006 as an extraordinary item. In order to establish this regulatory asset, we recorded an extraordinary gain of $10.3 million, net of income tax expense of $5.8 million, in our statements of operations for the quarter ended September 30, 2010. This item was recorded as a regulatory asset at September 30, 2010 pursuant to the final order received from the PUCT and will be amortized over the remaining life of our 6% Senior Notes due in 2035.
New Accounting Standards
In June 2011, the FASB issued new guidance to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The new guidance requires an entity to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both presentations, an entity would have been required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. Historically, we have used the consecutive two-statement approach; however, this new guidance would have required additional disclosure on our statement of operations and related notes. In December 2011, the FASB issued new guidance to defer the effective date for amendments to the presentation of reclassification of items out of accumulated other comprehensive income. Deferring the effective date will allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, we will continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before the guidance issued in June 2011 until further guidance becomes available.
Inflation

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

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Liquidity and Capital Resources

We continue to maintain a strong balance of common stock equity in our capital structure which supports our bond ratings, allowing us to obtain financing from the capital markets at a reasonable cost. At March 31, 2012, our capital structure, including common stock, long-term debt and current maturities of long-term debt, and short-term borrowings under the revolving credit facility, consisted of 44.6% common stock equity and 55.4% debt. At March 31, 2012, we had on hand $6.1 million in cash and cash equivalents.

Our principal liquidity requirements in the near-term are expected to consist of capital expenditures to expand and support electric service obligations, expenditures for nuclear fuel inventory, interest payments on our indebtedness, operating expenses including fuel costs, maintenance costs, dividends and taxes.

On April 17, 2012, the Council approved the settlement of our 2012 Texas retail rate case and fuel reconciliation in PUCT Docket No. 40094 and on April 26, 2012, the administrative law judge issued an order implementing the settlement rates as temporary rates effective May 1, 2012. Under the terms of the settlement, among other things, we have agreed to a reduction in our current non-fuel base rates of $15 million annually. As part of the settlement we have agreed to withdraw our request to reconcile fuel costs for the period from July 1, 2009 through September 30, 2011. On April 12, 2012, we filed with the PUCT a request to reduce our fixed fuel factor charged to Texas retail customers. The fixed fuel factor is based upon a formula that reflects current costs of fuel for changes in prices for natural gas and the revision reflects recent declines in prices for natural gas. The impact of the reduction in the fuel factor will be a reduction in annual fuel revenues of approximately $30 million. On April 25, 2012, the administrative law judge issued an order approving a new fuel factor effective May 1, 2012.

Capital Requirements. During the three months ended March 31, 2012, our capital requirements primarily consisted of expenditures for the construction and purchase of electric utility plant, purchases of nuclear fuel, and payment of common stock dividends. Projected utility construction expenditures are to expand and update our transmission and distribution systems, add new generation, and make capital improvements and replacements at Palo Verde and other generating facilities. We are constructing Rio Grande Unit 9, an aeroderivative unit with a net dependable generating capacity of 87 MW that should reach commercial operation by May 2013, at an estimated cost of approximately $83.9 million. As of March 31, 2012, we had expended $48.9 million on Rio Grande Unit 9, including $11.7 million during 2012. These amounts included AFUDC. Estimated cash construction expenditures for all capital projects for 2012 are approximately $227 million, excluding AFUDC, and we expect cash from operations and short-term borrowings from our revolving credit facility to continue to be a primary source of funds for these capital expenditures. See Part I, Item 1, “Business - Construction Program” in our 2011 Form 10-K. Cash capital expenditures for new electric plant were $48.2 million in the three months ended March 31, 2012 compared to $45.4 million in the three months ended March 31, 2011.

On March 30, 2012, we paid $8.8 million of quarterly dividends to shareholders. At the current payout rate, we would expect to pay cash dividends of approximately $35.2 million during 2012. The Board of Directors plans to review the Company's dividend policy annually, in conjunction with the annual shareholders meeting held in the second quarter of each year. Our current expectation is that our payout ratio will trend upward from its current level, with a payout ratio of approximately 45% being the anticipated target for 2012. In addition, we may repurchase common stock in the future. Since 1999, we have returned cash to stockholders through a stock repurchase program pursuant to which we have bought approximately 25.4 million shares of common stock at an aggregate cost of $423.6 million, including commissions. Under our program, purchases can be made at open market prices or in private transactions, and repurchased shares are available for issuance under employee benefit and stock incentive plans, or may be retired. No shares of common stock were repurchased during the three months ended March 31, 2012. As of March 31, 2012, 393,816 shares remain eligible for purchase.

We will continue to maintain a prudent level of liquidity as well as take market conditions for debt and equity securities into account. With the initiation of a dividend in early 2011, we are moving toward primarily utilizing the dividend to maintain a balanced capital structure, supplemented by share repurchases when appropriate. Our liquidity needs can fluctuate quickly based on fuel prices and other factors and we are continuing to make investments in new electric plant and other assets in order to reliably serve our customers. In light of these factors, we expect it will be a

number of years before we achieve a dividend payout equivalent to industry average.
Our cash requirements for federal and state income taxes vary from year to year based on taxable income, which is influenced by the timing of revenues and expenses recognized for income tax purposes. Due to accelerated tax deductions and net operating loss carryforwards, tax payments are expected to be minimal in 2012.

We continually evaluate our funding requirements related to our retirement plans, other postretirement benefit plans, and decommissioning trust funds. We contributed $6.4 million of the projected $19.8 million 2012 annual contribution to our retirement plans during the three months ended March 31, 2012. In the three months ended March 31, 2012, we contributed $0.6 million of

the projected $2.5 million 2012 annual contribution to our OPEB plan, and $1.1 million of the projected $4.6 million 2012 annual contribution to our decommissioning trust funds. We are in compliance with the funding requirements of the federal government for our benefit plans and decommissioning trust. We will continue to review our funding for these plans in order to meet our future obligations.

Capital Resources. Cash from operations has been impacted by the timing of the recovery of fuel costs through fuel recovery mechanisms in Texas and New Mexico and our sales for resale customer. We recover actual fuel costs from customers through fuel adjustment mechanisms in Texas, New Mexico, and from our sales for resale customer. We record deferred fuel revenues for the under-recovery or over-recovery of fuel costs until they can be recovered from or refunded to customers. In Texas, fuel costs are recovered through a fixed fuel factor. Effective July 1, 2010, we can seek to revise our fixed fuel factor at least four months after our last revision except in the month of December based upon our approved formula which allows us to adjust fuel rates to reflect changes in costs of natural gas.

During the three months ended March 31, 2012, we had increased cash from operations when compared to the same period in 2011 due primarily to the increased collection of deferred fuel revenues in 2012. During the three months ended March 31, 2012, we had an over-recovery of fuel costs, net of refunds, of $11.9 million, compared to an under-recovery, net of refunds, of $1.2 million during the three months ended March 31, 2011. At March 31, 2012, we had a net fuel over-recovery balance of $4.9 million, including $1.5 million in Texas and $3.4 million in New Mexico.

We maintain a revolving credit facility (“RCF”) for working capital and general corporate purposes and the financing of nuclear fuel through the Rio Grande Resources Trust (“RGRT”). RGRT is the trust through which we finance our portion of nuclear fuel for Palo Verde and is consolidated in our financial statements. The RCF has a term ending in September 2016. On March 29, 2012, the Company increased the aggregate unsecured borrowing available under the RCF from $200 million to $300 million. The terms of the agreement provide that amounts we borrow under the RCF may be used for working capital and general corporate purposes. The total amount borrowed for nuclear fuel by RGRT was $149.6 million at March 31, 2012, of which $39.6 million had been borrowed under the revolving credit facility and $110 million was borrowed through senior notes. At March 31, 2011, the total amounts borrowed for nuclear fuel by RGRT was $123.0 million of which $13.0 million was borrowed under the revolving credit facility and $110 million was borrowed through senior notes. Interest costs on borrowings to finance nuclear fuel are accumulated by RGRT and charged to us as fuel is consumed and recovered from customers through fuel recovery charges. At March 31, 2012, $53.0 million was outstanding under the RCF for working capital or general corporate purposes, and no borrowings were outstanding at March 31, 2011.

We believe we have adequate liquidity through our current cash balances, cash from operations, and our revolving credit facility to meet all of our anticipated cash requirements through 2012. In addition, we may issue long-term debt in the capital markets to finance capital requirements.

Off-Balance Sheet Arrangements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk due to changes in interest rates, equity prices and commodity prices. See our 2011 Form 10-K, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” for a complete discussion of the market risks we face and our market risk sensitive assets and liabilities. As of March 31, 2012, there have been no material changes in the market risks we face or the fair values of assets and liabilities disclosed in Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” in our 2011 Form 10-K.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures. Under the supervision and with the participation of our management, including our chief executive officer and our chief financial officer, we conducted an evaluation pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934 of our disclosure controls and procedures as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934. Based on that evaluation, our chief executive

officer and our chief financial officer concluded that, as of March 31, 2012, our disclosure controls and procedures are effective.

Changes in internal control over financial reporting. There were no changes in our internal control over financial reporting in connection with the evaluation required by paragraph (d) of the Securities Exchange Act of 1934 Rules 13a-15 or 15d-15, that occurred during the quarter ended March 31, 2012, that materially affected, or that were reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings
We hereby incorporate by reference the information set forth in Part I of this report under Notes C and H of Notes to Consolidated Financial Statements.

Item 1A. Risk Factors
Our 2011 Form 10-K includes a detailed discussion of our risk factors.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) Issuer Purchases of Equity Securities.

Period	Total Number of Shares Purchased	Average Price Paid per Share (Including Commissions)	Total Number of Shares Purchased as Part of a Publicly Announced Program	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
January 1 to January 31, 2012	—	$—	—	393,816
February 1 to February 29, 2012	—	—	—	393,816
March 1 to March 31, 2012	—	——	——	393,816

Item 6. Exhibits
See Index to Exhibits incorporated herein by reference.

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SIGNATURES

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

EL PASO ELECTRIC COMPANY

By: /s/ DAVID G. CARPENTER
David G. Carpenter
Senior Vice President - Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)

Dated: May 4, 2012

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EL PASO ELECTRIC COMPANY
INDEX TO EXHIBITS

Exhibit Number	Exhibit
†10.01	Form of Directors' Restricted Stock Award Agreement between the Company and certain directors of the Company. (Identical in all material respects to Exhibit 10.07 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1999)
10.02	Incremental Facility Assumption Agreement dated as of March 29, 2012, related to the Amended and Restated Credit Agreement, referred to in Exhibit 10.25-01 to the Company's Annual Report on Form 10-K for the year ended December 31, 2011, among the Company and The Bank of New York Mellon Trust Company, N.A., not in its individual capacity, but solely in its capacity as successor trustee of the Rio Grande Resources Trust II, the lenders from time to time party thereto, JPMorgan Chase Bank, N.A., as issuing bank and as administrative agent and Union Bank, N.A., as syndication agent.
15	Letter re Unaudited Interim Financial Information
31.01	Certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.01	Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Linkbase Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

† In lieu of non-employee director cash compensation, six agreements, dated as of January1 and April 1, 2012, substantially identical in all material respects to this Exhibit, have been entered into with Catherine A. Allen; Patricia Z. Holland-Branch; and Stephen N. Wertheimer; directors of the Company.