



JENNIFER M. SHRIVER  
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CERTIFICATE OF THE COMPANY

THE TOLEDO EDISON COMPANY

Guarantee of Payment of Deferred Premiums

The Toledo Edison Company hereby certifies that it elects to guarantee its share of payment of deferred premiums which may be levied against the Perry Unit No. 1, the Davis-Besse Unit No. 1, and Beaver Valley Unit No. 2 by maintaining a cash reserve as permitted by 10 CFR Section 140.21(e).

The Company had cash, invested in short-term instruments, at December 31, 1987, in excess of \$8,844,000, its share of the deferred premiums for Perry Unit No. 1, Davis-Besse Unit No. 1, and Beaver Valley Unit No. 2. The deferred premiums for each unit are \$1,991,000, \$4,862,000, and \$1,991,000, respectively, based on the Company's ownership shares of 19.91% of Perry Unit No. 1, 48.62% of Davis-Besse, and 19.91% of Beaver Valley Unit No. 2. The Company agrees to maintain cash reserves totaling \$8,844,000 in cash and short-term instruments, for the year covered by this filing.

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THE TOLEDO EDISON COMPANY

By

Jennifer M. Shriver  
Jennifer M. Shriver  
Treasurer

Date 3/18/88

## Summary of Significant Accounting Policies

### General

The Toledo Edison Company (the Company) is a wholly-owned subsidiary of Centerior Energy Corporation (Centerior Energy). The Company's common stock was acquired by Centerior Energy on April 29, 1986, as a result of a June 25, 1985 affiliation agreement with The Cleveland Electric Illuminating Company (Cleveland Electric) approved by the share owners of both companies on November 26, 1985.

The Company follows the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission and adopted by The Public Utilities Commission of Ohio (PUCO).

### Reclassifications

Certain reclassifications have been made to the prior years' financial statements to conform to current year presentations.

### Related Party Transactions

Operating expenses include those amounts for transactions with affiliated companies in the ordinary course of business operations.

The Company's transactions with Cleveland Electric are primarily for interchange power, transmission line rentals and jointly-owned power plant operations and construction. See Note 1.

Centerior Service Company (Service Company), a wholly-owned subsidiary of Centerior Energy, was formed in May 1986. The Service Company provides management, financial, administrative, engineering, legal and other services to the Company and other affiliated companies at cost. The Service Company billed the Company \$21,000,000 and \$6,000,000 in 1987 and 1986, respectively, for such services.

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

### Revenues

Customers are billed on a monthly cycle basis for their energy consumption, based on rate schedules authorized by the PUCO. These revenues are recorded in the accounting period during which meters

are read. A fuel factor is added to the base rates for electric service. This factor is designed to recover fuel costs from customers. It is changed semiannually after a hearing before the PUCO.

### Fuel

The Company defers the differences between actual fuel costs and estimated fuel costs currently being recovered from customers. This matches fuel expenses with fuel related revenues.

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

### Carrying Charges and Deferred Operating Expenses

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

### Depreciation and Amortization

The cost of property, plant and equipment, except for the nuclear generating units, is depreciated over their estimated useful lives on a straight-line basis. Annual straight-line depreciation provisions expressed as a percent of average depreciable utility plant in service were 3.6% in 1987 and 3.5% in 1986 and 1985. Depreciation expense for the nuclear units is based on the units-of-production method. This includes provisions for future decommissioning costs. These provisions are estimated at \$59,000,000 in 1986 dollars for the Davis-Besse Nuclear Power Station (Davis Besse) and \$28,000,000 each for Perry Unit 1 and Beaver Valley Unit 2 in 1987 dollars. There are no restrictions on the use of the amounts currently being recovered from customers through rates for decommissioning of Davis-Besse and Perry Unit 1. The sale and leaseback agreement for Beaver Valley Unit 2 requires the external funding of the leasehold interests' share of the Unit's decommissioning costs starting by September 1992. See Note 2.

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

### Federal Income Taxes

The Company has deferred the federal income taxes for the differences between straight-line depreciation and tax depreciation for property additions since 1973. In addition, the tax effects of certain other timing differences have been deferred. This treatment is consistent with the methods used for rate-making purposes. The Company has also deferred the tax effect of the net gain and loss relating to the sale and leaseback transactions. See Note 2. The remaining timing differences are not deferred. They are recognized for book purposes, and in rates, in the year they affect taxes payable. At December 31, 1987, the cumulative income tax timing difference for which

deferred income taxes have not been provided amounted to \$151,000,000. Based on PUCO and Ohio Supreme Court decisions, such taxes can be recovered in future revenues.

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

### Interest Charges

Interest on long term debt reported on the statement of Results of Operations includes interest on nuclear fuel obligations for fuel in the reactor. Interest on nuclear fuel obligations for fuel under construction is capitalized. See Note 5.

### Property, Plant and Equipment

Property, plant and equipment are stated at original cost. Included in the cost of construction are items such as related payroll taxes, pensions, fringe benefits, management and general overheads and an allowance for funds used during construction (AFUDC). AFUDC represents the estimated composite debt and equity cost of funds used to finance construction. This noncash allowance is credited to income, except for AFUDC for Perry Unit 2. Since July 1985, Perry Unit 2 AFUDC had been credited to a deferred income account. Effective January 1, 1988, the practice of accruing AFUDC on Perry Unit 2 was discontinued. See Note 3. The AFUDC rates, net of the income tax effect, were 10.97% in 1987, 10.71% in 1986 and 10.50% in 1985.

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

## M<sub>anagement's Financial Analysis</sub>

### Results of Operations

Operating revenues increased by 5.2% in 1987, following a decrease of 0.1% in 1986 and an increase of 7.9% in 1985. The \$31,000,000 increase in electric revenues in 1987 from 1986 resulted from a \$29,000,000 increase in base rates and other revenues and a \$15,000,000 increase from kilowatt-hour sales growth offset by a \$13,000,000 decrease in fuel cost recovery revenues.

Kilowatt-hour sales increased by 3.9% in 1987 following modest gains in 1986 and 1985. Sales to industrial customers increased by 3.1% in 1987 from the level in 1986. Industrial sales growth was broad-based, particularly in the metal fabricating sector. Residential and commercial sales increased 1.9% and 2.5%, respectively, in 1987 from 1986 levels, largely because of a substantially warmer-than-normal summer in 1987. Lower fuel revenues in 1987 resulted from increased use of our nuclear units.

Operating expenses increased by 2.8% in 1987, 2.7% in 1986 and 6.3% in 1985. The increases in operating expenses in 1985 and 1986 were derived partly from the effects of an 18-month outage at Davis-Besse. This outage resulted in the use of more coal and purchased power at unit prices which exceeded the unit price of nuclear fuel generation. Other operation and maintenance expenses in 1985 and 1986 increased principally for the refurbishment of Davis-Besse. In 1987, fuel and purchased power expense dropped as Davis-Besse came back on line and Perry Unit 1 and Beaver Valley Unit 2 went into service. The reduction in fuel and purchased power expense, lower federal income taxes and savings from cost reduction programs were about offset by sale and leaseback rental expense and higher units-of-production depreciation at Davis-Besse.

Earnings available for common stock decreased by 7.0% in 1987 following a decrease of 0.4% in 1986 and an increase of 11.5% in 1985.

AFUDC and deferred carrying charges have represented an increasing proportion of earnings — 145% in 1987, 130% in 1986 and 105% in 1985. At the same time, cash flows have been impacted by the cost of additional debt and equity financing for the completion of the two nuclear units. AFUDC for the Beaver Valley Unit 2 investment was discontinued on the portion sold in the sale and leaseback transaction on September 30, 1987 and on the remaining portion when this Unit became operational in November 1987. AFUDC for the Perry Unit 1 investment was discontinued on January 1, 1988 pursuant to a PUCO accounting order. Subsequent to the November 1987 and January 1988 dates, interest carrying charges on our investments in these two Units are being credited to income at a rate lower than the full AFUDC rate. Consequently, earnings are expected to be lower in 1988, although the quality of earnings and cash flow are expected to improve. Deferral of interest carrying charges will be discontinued as the investments are recognized in rate base.

### Effect of Inflation

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

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

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

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Results of Operations

## The Toledo Edison Company

	For the years ended December 31,		
	1987	1986	1985
	(thousands of dollars)		
<b>Operating Revenues</b>			
Electric .....	\$625,222	\$594,421	\$589,172
Steam heating and gas .....	—	—	5,761
	<u>625,222</u>	<u>594,421</u>	<u>594,933</u>
<b>Operating Expenses</b>			
Fuel and purchased power .....	140,176	158,763	158,990
Other operation and maintenance .....	223,307	167,319	141,608
Depreciation and amortization .....	65,503	37,832	44,338
Taxes, other than federal income taxes .....	60,617	52,440	48,698
Perry Unit 1 and Beaver Valley Unit 2 deferred operating expenses .....	(39,797)	—	—
Federal income taxes .....	<u>30,428</u>	<u>50,763</u>	<u>61,412</u>
	<u>480,234</u>	<u>467,117</u>	<u>455,046</u>
<b>Operating Income</b> .....	<u>144,988</u>	<u>127,304</u>	<u>139,887</u>
<b>Nonoperating Income</b>			
Allowance for equity funds used during construction .....	112,529	119,954	97,725
Other income and deductions, net .....	(16,904)	(1,627)	10,669
Perry Unit 1 and Beaver Valley Unit 2 carrying charges .....	14,693	—	—
Federal income taxes — credit .....	<u>12,726</u>	<u>52,029</u>	<u>38,167</u>
	<u>113,044</u>	<u>170,356</u>	<u>146,561</u>
<b>Income Before Interest Charges</b> .....	<u>298,032</u>	<u>297,660</u>	<u>286,448</u>
<b>Interest Charges</b>			
Long-term debt .....	179,565	168,275	150,021
Short-term debt .....	3,297	3,675	4,518
Allowance for borrowed funds used during construction .....	<u>(50,001)</u>	<u>(31,207)</u>	<u>(41,604)</u>
	<u>132,861</u>	<u>120,743</u>	<u>112,935</u>
<b>Net Income</b> .....	<u>165,171</u>	<u>176,917</u>	<u>173,513</u>
Preferred dividend requirements .....	<u>42,749</u>	<u>45,243</u>	<u>41,362</u>
<b>Earnings Available for Common Stock</b> .....	<u>\$122,422</u>	<u>\$131,674</u>	<u>\$132,151</u>

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

## Management's Financial Analysis

### Capital Resources and Liquidity

We carry on a continuous program of constructing new facilities and modifying existing facilities to meet anticipated demand for electric service and to comply with governmental regulations. The capital requirements for this construction program over the three-year period 1985-1987 totaled approximately \$1,200,000,000, excluding nuclear fuel. This amount includes AFUDC. The capital required to finance our construction program is obtained from funds generated internally as well as from external sources.

About 70% of the construction program capital requirements for 1985 and 1986 was raised through bank borrowings, sales of securities and equity contributions from the parent company. In 1987, we issued \$250,000,000 of unsecured notes and debentures, \$50,000,000 of preferred stock and \$41,000,000 of first mortgage bonds. In September 1987, we sold and leased back certain interests in three generating units as discussed in Note 2. A substantial portion of the net proceeds from these transactions has been used to pay portions of short-term debt incurred to finance the construction program, to redeem outstanding securities, to pay our construction program costs and for general corporate purposes. The remainder of the funds from the sale and leaseback transactions will be used for our construction program, mandatory and optional redemption requirements and general corporate purposes.

In addition to the construction program funding requirements (as discussed in Note 3), we will require \$415,000,000 for the retirement of debt and preferred stock during the 1988-1992 period. See Note 11 for further information concerning the first mortgage bonds and the preferred and preference stock of the Company. Our available short-term borrowing arrangements are explained in Note 12.

Our ability to meet our financing needs depends upon obtaining sufficient and timely rate increases and upon availability of capital. See Note 7 for discussion of rate increase requests. The availability of capital to meet our external financing needs depends upon such factors as financial market conditions, earnings, our ability to pay dividends, the size of our construction program and our credit ratings. In 1985, rating agencies lowered their ratings on certain securities of the Company. This made our cost of capital more expensive. In April 1986, Standard and Poor's Corporation raised our first mortgage bonds and preferred stock ratings to BBB- and BB+, respectively. Those ratings have not changed through 1987. Standard and Poor's rates our unsecured notes BB+. Moody's Investors Service rates our bonds Baa3, unsecured notes Ba1 and preferred stock Ba2.

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

## Retained Earnings

### The Toledo Edison Company

	For the years ended December 31,		
	1987	1986	1985
	(thousands of dollars)		
Balance at Beginning of Year .....	\$ 305,130	\$ 276,588	\$ 221,486
Additions			
Net income .....	165,171	176,917	173,513
Deductions			
Dividends declared:			
Common stock .....	(111,500)	(102,918)	(76,566)
Preferred stock .....	(40,212)	(45,457)	(41,845)
Preferred stock redemption expenses .....	(21,368)	—	—
Earnings Reinvested During the Year .....	(7,909)	28,542	55,102
Balance at End of Year .....	\$ 297,221	\$ 305,130	\$ 276,588

## Source of Funds Invested in Plant, Facilities and Special Deposits

	For the years ended December 31,		
	1987	1986	1985
	(thousands of dollars)		
Provided from Internal Sources			
Net Income .....	\$ 165,171	\$ 176,917	\$ 173,513
Principal Non-Cash Items:			
Depreciation and amortization, net .....	57,628	37,832	44,338
Deferred federal income taxes .....	(143,036)	32,037	12,801
Investment tax credits, net .....	79,332	(21,558)	6,512
Allowance for equity funds used during construction .....	(112,529)	(119,954)	(97,725)
Funds Provided from Operations .....	46,566	105,274	139,439
Dividends paid .....	(155,515)	(148,382)	(139,072)
Net proceeds from sale and leaseback transactions .....	1,075,988	—	—
Increase in reserve for Perry Unit 2 allowance for funds used during construction .....	32,158	27,079	12,460
Net change in working capital and other accounts .....	4,195	22,608	3,905
Allowance for equity funds used during construction .....	112,529	119,954	97,725
Funds Provided from Internal Sources .....	1,115,921	126,533	114,457
Provided from External Sources			
Sale of Securities:			
Common stock .....	—	1,333	80,885
Preferred stock .....	50,000	30,000	30,000
First mortgage bonds .....	41,000	100,000	96,800
Equity contributions from parent .....	30,000	91,059	—
Net change in other debt .....	179,745	93,535	147,346
Net change in pollution control construction funds .....	5,448	25,403	(10,512)
Net increase (decrease) in short-term debt .....	46,700	(7,700)	1,000
Net (increase) decrease in temporary cash investments .....	(520,901)	41,492	(31,599)
Redemption of bonds and preferred stock .....	(459,708)	(53,031)	(52,823)
Net (decrease) increase in other noncurrent liabilities .....	(14,215)	42,047	33,486
Funds Provided from External Sources .....	(641,931)	364,138	294,583
Total Sources of Funds .....	\$ 473,990	\$ 490,671	\$ 409,040
Invested In			
Construction Expenditures .....	\$ 366,797	\$ 449,432	\$ 378,045
Deposits in Trust, sale and leaseback proceeds .....	109,976	—	—
(Decrease) Increase in Nuclear Fuel Inventory .....	(2,783)	41,239	30,995
Total Invested in Plant, Facilities and Special Deposits .....	\$ 473,990	\$ 490,671	\$ 409,040

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

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## alance Sheet

## The Toledo Edison Company

	December 31,	
	1987	1986
	(thousands of dollars)	
<b>Assets</b>		
<i>Property, Plant and Equipment</i>		
Utility plant in service .....	\$2,562,093	\$1,442,812
Less: accumulated depreciation and amortization .....	419,149	415,745
	2,142,944	1,027,067
Construction work in progress .....	67,704	1,870,649
Perry Unit 2 .....	306,570	275,055
	2,517,218	3,172,771
Nuclear fuel, net of amortization .....	265,046	267,827
Other property, less accumulated depreciation .....	2,023	1,193
	2,784,287	3,441,793
<i>Special Deposits</i>		
Pollution control construction funds, unexpended .....	883	6,331
Deposits in trust, sale and leaseback proceeds .....	109,976	—
	110,859	6,331
<i>Current Assets</i>		
Cash and temporary cash investments .....	599,117	78,974
Amounts due from customers and others, net .....	62,866	50,728
Amounts due from affiliates .....	15,840	11,539
Materials and supplies, at average cost .....	21,272	11,479
Fossil fuel inventory, at average cost .....	23,245	21,182
Taxes applicable to succeeding years .....	61,614	44,899
Other .....	14,699	2,536
	798,653	221,337
<i>Deferred Charges</i>		
Unamortized costs of terminated projects .....	17,223	22,408
Accumulated deferred federal income taxes .....	218,030	11,223
Unamortized loss, Beaver Valley Unit 2 sale .....	134,475	—
Unamortized loss on reacquired debt .....	19,784	—
Carrying charges and nuclear operating expenses .....	40,072	—
Other .....	87,027	66,436
	516,611	100,067
Total Assets .....	<u>\$4,210,410</u>	<u>\$3,769,528</u>
<b>Capitalization and Liabilities</b>		
<i>Capitalization</i>		
Common shares, \$5 par value; 60,000,000 authorized; 39,134,000 outstanding in 1987 and 1986 .....	\$ 195,687	\$ 195,687
Premium on capital stock .....	482,770	482,787
Other paid-in capital .....	121,059	91,059
Retained earnings .....	297,221	305,130
Common stock equity .....	1,096,737	1,074,663
Preferred stock .....		
With mandatory redemption provisions .....	73,340	148,797
Without mandatory redemption provisions .....	240,000	260,000
Long-term debt .....	1,400,292	1,480,947
	2,810,369	2,964,407
Other Noncurrent Liabilities, primarily nuclear fuel lease and trust obligations ..	260,429	274,644
<i>Current Liabilities</i>		
Current portion of long-term debt and preferred stock .....	36,932	28,398
Current portion of lease obligations .....	30,791	17,710
Notes payable to banks and others .....	—	15,000
Accounts payable .....	79,970	62,480
Accounts and notes payable to affiliates .....	84,269	7,767
Accrued taxes .....	95,264	46,686
Accrued interest .....	43,675	42,955
Dividends declared .....	7,497	11,300
Accrued payroll and vacations .....	8,116	8,929
Other .....	17,000	11,518
	401,514	252,743
<i>Deferred Credits</i>		
Unamortized investment tax credits .....	101,566	33,890
Accumulated deferred federal income taxes .....	237,103	189,454
Reserve for Perry Unit 2 allowance for funds used during construction ..	71,697	39,539
Unamortized gain, Bruce Mansfield Plant sale .....	275,618	—
Other .....	52,114	14,851
	738,098	277,734
Total Capitalization and Liabilities .....	<u>\$4,210,410</u>	<u>\$3,769,528</u>

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

# Statement of Cumulative Preferred and Preference Stock

The Toledo Edison Company

		1987 Shares Outstanding	Current Call Price	December 31,	
				1987	1986
(thousands of dollars)					
\$100 par value preferred, 3,000,000 shares authorized; \$25 par value preferred, 12,000,000 shares authorized; and \$25 par value preference, 5,000,000 shares authorized — none outstanding					
Subject to mandatory redemption (less current maturities):					
\$100 par	\$11.00	50,000	\$103.50	\$ 5,000	\$ 5,499
	9.575	183,400	105.43	18,340	20,005
	13.25	—	—	—	11,268
	12.65	—	—	—	18,225
	14.80	—	—	—	28,800
25 par	3.75	—	—	—	30,000
	3.72	—	—	—	35,000
	2.81	2,000,000	27.81	50,000	—
				<u>\$ 73,340</u>	<u>\$148,797</u>
Not subject to mandatory redemption:					
100 par	4.25	160,000	104.625	16,000	16,000
	4.56	50,000	101.00	5,000	5,000
	4.25	100,000	102.00	10,000	10,000
	8.32	100,000	103.54	10,000	10,000
	7.76	150,000	103.377	15,000	15,000
	7.80	150,000	102.60	15,000	15,000
	10.00	190,000	101.00	19,000	19,000
25 par	2.21	1,000,000	25.90	25,000	25,000
	2.365	1,400,000	28.45	35,000	35,000
	4.28	—	—	—	20,000
	3.47	1,200,000	30.97	30,000	30,000
	Series A Adjustable	1,200,000	—	30,000	30,000
	Series B Adjustable	1,200,000	—	30,000	30,000
				<u>\$240,000</u>	<u>\$260,000</u>

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

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Notes to the Financial Statements

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

## (2) Utility Plant Sale and Leaseback Transactions

On September 30, 1987, Cleveland Electric sold essentially all of its 470-megawatt undivided tenant-in-common interests in Units 1, 2 and 3 of the coal-fired Bruce Mansfield Plant (Mansfield Plant). Cleveland Electric had owned 6.5%, 28.6% and 24.47%, respectively, of those three units. The sale price was \$625,500,000. On the same day, the purchasers leased those interests back to Cleveland Electric (with the Company as co-lessee) for a term of about 29½ years.

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

The Company is amortizing the applicable deferred gain and loss associated with these sales of utility plant over the period of the lease terms.

As co-lessee with Cleveland Electric, the Company is also obligated for Cleveland Electric's lease payments. If Cleveland Electric is unable to make its payments under the Mansfield Plant leases, the Company would be obligated to make such payments.

The future minimum lease payments required under these operating leases as December 31, 1987 are summarized as follows:

<u>Year</u>	<u>For the Company</u>	<u>For Cleveland Electric</u>
	(thousands of dollars)	
1988 .....	\$ 88,000	\$ 54,000
1989 .....	111,000	71,000
1990 .....	111,000	71,000
1991 .....	112,000	71,000
1992 .....	115,000	71,000
Later Years .....	<u>3,052,000</u>	<u>1,968,000</u>
Total Future Minimum Lease Payments ....	\$3,369,000	\$2,286,000

No payments were made on behalf of Cleveland Electric in 1987. As discussed in Note 7, the Company is considering proposing the transfer of its Beaver Val-



designed reactors can continue to operate safely while its review is being done. The outcome of the NRC's review and its impact on the Company cannot be predicted.

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

#### *Perry Unit 1*

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

#### *Beaver Valley Unit 2*

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

#### *Other Nuclear Risks*

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

#### **(5) Nuclear Fuel**

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

The maximum amount that the Company can finance under one set of nuclear fuel leasing arrangements is \$215,000,000. It consists of a long term lease that allows the lenders to cancel their financing commitments after three years' notice. The Company's share of the maximum amount available under another arrangement, which includes leases and a trust combined, is \$83,000,000. This arrangement is subject to cancellation by the lender after one year's notice.

The lease and borrowing rates are based on bank prime and commercial paper rates. The amounts capitalized included interest charges incurred by the lessors amounting to \$17,000,000 in 1987 and 1986 and \$16,000,000 in 1985. Under the leases, rental payments are made as the fuel is burned in a reactor. The estimated future lease amortization payments based on projected burn are \$32,000,000 in 1988, \$36,000,000 in 1989, \$35,000,000 in 1990, \$41,000,000 in 1991 and \$48,000,000 in 1992. As these payments are made, the amount of credit available to the lessors is renewed and becomes available to finance additional nuclear fuel.

At December 31, 1987, a total of \$273,000,000 is committed under the leases and the trust for nuclear material and costs of processing it into fuel for the Company. This includes nuclear fuel in the Davis-Besse, Perry Unit 1 and Beaver Valley Unit 2 reactors with remaining payments of \$25,000,000, \$34,000,000 and \$26,000,000, respectively, as of December 31, 1987.

#### **(6) Nuclear Insurance**

The Price Anderson Act (Act) limits the liability of the owners of a nuclear power plant. This limit is covered by private insurance amounting to \$160,000,000 and an amount provided by an industry assessment plan. Under the plan, if any unit in the United States has an incident with losses in excess of private insurance, up to \$5,000,000 (but not more than \$10,000,000 per unit per year in the event of more than one incident) must be contributed for each licensed nuclear unit in the country by the licensees of each unit to cover liabilities arising out of the incident. Based on the Company's present ownership and leasehold interests in its three operating nuclear units, the Company's maximum potential assessment under these provisions (assuming the other CAPCO companies were to contribute their proportionate share of any assessment) would be \$4,422,000 per incident but not more than \$8,844,000 per calendar year.

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

The Company has insurance coverage for damage to its property at Davis Besse, Perry and Beaver Valley (including leased fuel and clean-up costs) in the amount of \$1,525,000,000 for each site. Damage to the Company's property could exceed the insurance coverage by a substantial amount and thereby have a material adverse effect on the Company's financial condition and results of operations in the periods following the loss. If the property damage reserves of one of the insurers are inadequate to cover claims arising out of an accident at any nuclear site in the United States covered by that insurer, the Company is obligated to pay retrospective premiums up to \$6,530,000 for the current policy year.

Insurance coverage is also held for the cost of any replacement power purchased after the occurrence of certain types of accidents at the Company's nuclear units. The amount of the coverage is limited to 90% of the estimated difference in replacement power costs per week during the 52-week period starting 26 weeks after an accident and 45% of such estimate per week for the next 52 weeks. The cost and duration of replacement power could substantially exceed the insurance coverage. Also, if the insurer's reserves are inadequate to cover claims arising out of accidents at any nuclear units in the United States covered by such insurance, the Company is obligated to pay retrospective premiums up to \$1,462,000 for the current policy year.

#### (7) Regulatory Matters

##### *Rates*

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

Date	Annualized Amount (thousands of dollars)
February 1985	\$22,700
May 1987	43,000
December 1987	4,000

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

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

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

##### *Rate Phase-in Plans for Nuclear Investments*

In February 1988, the Company filed a notice of intent to request a rate increase with the PUCO. Generally, when a new electric generating unit is, or is about to be, placed in commercial service, the Company requests a rate increase to recover all allowable costs, including current operating expenses, depreciation, interest and a fair return on its investment in the unit. Because of the size of its ownership investments in

Perry Unit 1 and Beaver Valley Unit 2, the Company has proposed to the PUCO a gradual increase in rates. These increases would "phase in" full recovery of all such costs over a 10-year period. This plan would defer costs in its initial years, but would ultimately provide for full recovery of all allowable costs, including all costs deferred pursuant to PUCO accounting orders.

The plan includes a request for an initial increase in the Company's base rates which, when coupled with a reduction in revenues from a decrease in the fuel cost recovery factor and the impact of the February 1985 emergency rate increase, would result in revenues being 7.2% higher than 1987 revenues, or \$45,000,000 annually, followed by nine annual increases. The amounts of the annual increases following the first year have yet to be finalized. They will be designed to provide for the full recovery of allowable costs relating to the Company's investments in Perry Unit 1 and Beaver Valley Unit 2. Also, as an alternative to the phase-in plan, the Company included in its notice of intent a request for an approximate 30% rate increase which reflects the increase necessary for full recovery of its investments in Perry Unit 1 and Beaver Valley Unit 2 on a nondeferred basis.

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

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

The proposed phase in plan is expected to satisfy the accounting standard for phase in plans. If the PUCO

does not approve the phase-in plan or if a phase-in plan is approved that does not meet the accounting standard, the Company's results of operations and financial condition would be adversely affected to the extent that allowable costs, including all costs being deferred pursuant to PUCO accounting orders, are not being currently recovered.

#### *Potential Disallowance of Nuclear Investments*

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

In January 1988, the PUCO issued an order stating that approximately \$27,800,000 of Perry Unit 1 construction costs were imprudently incurred or were unreasonable and that the Company's share of these costs of about \$125,000,000 must be written off and not included in its rate base. The PUCO's investigation covered the period of time starting with the decision to build the Unit through the date of fuel load on March 21, 1986. Approximately \$4,153,000,000 in construction costs of Perry Unit 1 were incurred during this period. The order also stated that further adjustments will be required to correct the additional AFUDC component to reflect subsequent delays in the in-service date and to reflect additional AFUDC associated with certain issues. The preliminary estimate of this additional amount, based on the methodology used in the PUCO's order, is \$174,100,000. The Company's share of this amount is about \$35,000,000.

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

The PUCO will also consider the prudence and reasonableness of Perry Unit 1 construction costs in

curring after the fuel load date which are estimated to be about \$1,200,000,000.

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

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

In his January 1988 recommendation, the administrative law judge also recommended that the PaPUC disallow \$372,000,000 of Beaver Valley Unit 2 construction costs which were incurred during the period until fuel was loaded and were determined to be the result of imprudent management by Duquesne. The total estimated cost of the Unit is \$4,700,000,000. In his recommendation, the administrative law judge considered the report submitted by Canatom, Inc., the engineering firm selected by the PaPUC to evaluate Duquesne's management of the construction of Beaver Valley Unit 2 and to conduct an audit of related project costs. Canatom concluded that Duquesne performed most of its duties in a reasonable manner, with the exception of certain engineering-related and other matters which increased the cost of Beaver Valley Unit 2 by an amount ranging from \$219,000,000 to \$271,000,000. Canatom concluded that those costs could have been avoided. The administrative law judge recommended a disallowance of about \$89,000,000 of the costs which Canatom had concluded were avoidable and recommended a disallowance of \$283,000,000 of costs which were not considered avoidable by Canatom. Canatom also concluded that the CAPCO companies delayed the construction of Beaver Valley Unit 2 due to capacity, load, financial, regulatory and technical considerations resulting in additional costs of \$312,000,000 to \$488,000,000 but did not characterize these delays and costs as avoidable. The administrative law judge recommended that these costs be allowed. The

Company and Duquesne do not agree with the administrative law judge's recommendations regarding disallowances or with Canatom's conclusions with respect to avoidable costs. Duquesne will challenge these recommendations in appropriate PaPUC proceedings. Neither the administrative law judge's recommendations nor the Canatom report are binding on the PaPUC, the PUCO or the Company, and any decision of the PaPUC will not be binding on the Company or the PUCO. However, the PUCO also will investigate the prudence of the costs of the Unit and will review the Canatom report in determining whether to disallow the recovery by the Company of any of its costs of the Unit. If it were to appear probable, as a result of any proceedings instituted by the PUCO, that recovery in rates of any portion of the construction costs, including a full return thereon, of Beaver Valley Unit 2 will not be allowed, then the Company's share of such costs would have to be written off. To the extent a disallowance is attributed to the Company's leasehold interests in the Unit, the Company would have to record a loss provision for the deferred and future lease rental payments.

#### *PUCO Reserve Capacity Standards*

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

the Company to earn a full return on its investment, the disallowed amount may have to be written off.

#### *Dividends and Financial Uncertainties*

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

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

#### **(8) Federal Income Tax**

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

	For the years ended December 31,		
	1987	1986	1985
(thousands of dollars)			
Book Income Before			
Federal Income Tax ...	\$152,873	\$175,651	\$196,758
Tax on Book Income at			
Statutory Rate .....	\$ 61,073	\$ 80,800	\$ 90,508
Increase (Decrease) in			
Tax Due to:			
AFUDC and Carrying			
Charges .....	(70,800)	(78,734)	(64,091)
Accelerated			
Depreciation .....	1,666	(2,728)	(367)
Other Items .....	(4,237)	(604)	(2,805)
Total Federal Income Tax			
Expense (Credit) .....	\$ (12,298)	\$ (1,266)	\$ 23,245

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

	For the years ended December 31,		
	1987	1986	1985
(thousands of dollars)			
Operating Expenses			
Current Tax Provision	\$ 71,050	\$33,288	\$39,778
Changes in Accumu-			
lated Deferred Fed-			
eral Income Tax:			
Accelerated Depre-			
ciation and			
Amortization ....	42,001	27,951	10,130
Nuclear Fuel Inter-			
est Charges .....	5,574	7,606	7,054
Sale and Leaseback			
Transactions .....	(179,555)	—	—
Property Tax			
Expense .....	5,454	1,245	752
Unbilled Revenues			
Perry Unit 1 Oper-			
ating Expenses ..	10,356	—	—
Other Items .....	(6,432)	2,284	(3,101)
Investment Tax Credits			
— Net .....	83,164	(21,611)	6,799
Total Charged to Oper-			
ating Expenses .....	30,428	50,763	61,412
Nonoperating Income			
Current Tax Provision	(31,209)	(42,915)	(37,777)
Changes in Accumu-			
lated Deferred Fed-			
eral Income Tax:			
Davis-Besse Replace-			
ment Power .....	(10,114)	(6,026)	—
Other Items .....	(1,403)	(3,088)	(390)
Total Federal Income Tax			
Expense (Credit) .....	\$ (12,298)	\$ (1,266)	\$ 23,245

The Company joins in the filing of a consolidated federal income tax return with the affiliated companies for 1986 and 1987. The method of tax allocation approximates a separate return result for each company.

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

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

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

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

We sponsor a noncontributing pension plan which covers all employee groups. The amount of retirement benefits generally depends upon the length of service. Under certain circumstances, benefits can begin as early as age 55. The plan also provides certain

death, medical and disability benefits. The Company's funding policy is to be in compliance with the Employee Retirement Income Security Act Guidelines.

In 1987, the Company adopted the new standard for accounting for pensions. Also, during 1987 the Company offered a Voluntary Early Retirement Opportunity Program (VEROP) which was accepted by 131 of the 139 eligible employees at an estimated cost of \$6,300,000. Pension and early retirement program costs for the years 1985 through 1987 were \$4,000,000, \$3,400,000 and \$5,700,000, respectively. Net pension and early retirement costs for 1987 were comprised of the following components:

	Millions of Dollars
Pension Costs:	
Service cost for benefits earned during the period .....	\$ 4
Interest cost on projected benefit obligation .....	8
Actual return on plan assets .....	(8)
Net amortization and deferral .....	(3)
Net pension cost .....	1
VEROP cost .....	4
Net pension and VEROP costs .....	\$ 5

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

	Millions of Dollars
Actuarial present value of benefit obligations:	
Vested benefits .....	\$ 86
Nonvested benefits .....	12
Accumulated benefit obligation .....	98
Effect of future compensation levels .....	30
Total projected benefit obligation ..	128
Plan assets at fair market value .....	141
Unfunded (surplus) projected benefit obligation .....	(13)
Unrecognized variance between assumptions and experience .....	(2)
Unrecognized VEROP cost .....	(2)
Transition asset at January 1, 1987, being amortized over 19 years .....	25
Net accrued pension cost included in other deferred credits on the Balance Sheet .....	\$ 8

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

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The annual mandatory redemption provisions are as follows:

Annual Mandatory Redemption Provisions				
	Shares to be Redeemed	Beginning in	Price Per Share	
Preferred:				
\$100 par \$11.00 .....	5,000	1979	\$100	
9.375 .....	16,650	1985	100	
25 par 2.81 .....	400,000	1993	25	

The annualized cumulative preferred dividend requirement as of December 31, 1987 is \$30,000,000.

The preferred dividend rates on the Company's Series A and B fluctuate based on prevailing interest rates. The dividend rates for these issues averaged 8.55% and 9.43%, respectively, in 1987.

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

There are no restrictions on the Company's ability to issue preference stock.

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

#### (d) Long-Term Debt and Other Borrowing Arrangements

Long-term debt, less current maturities is as follows:

First mortgage bonds:

Year of Maturity	Actual or Average Interest Rate	December 31,	
		1987	1986
(thousands of dollars)			
1988.....	4.00 %	\$ —	\$ 15,000
1990.....	14.00	—	65,000
1991.....	15.625	—	35,000
1991.....	15.00	70,000	70,000
1992.....	16.125	—	60,000
1993-1997.....	9.78	265,500	335,500
1998-2002.....	8.37	60,978	60,978
2003-2007.....	8.96	85,725	85,725
2008-2012.....	10.44	126,900	186,900
2013-2017.....	12.25	60,000	60,000
2018-2022.....	9.52	41,000	—
		710,103	974,103

Term bank loans, 11.19% average rate, due 1989-1990 .....	41,166	62,833
Notes, 10.83% average rate, due 1989-1997 .....	357,000	277,000
Debentures, 11.25%, due 1997 .....	125,000	—
Pollution control notes, 10.82% average rate, due 1989-2015 .....	167,500	167,600
Other — net .....	(477)	(589)
Total Long-Term Debt .....	\$1,400,292	\$1,480,947

Long-term debt matures during the next five years as follows: \$35,000,000 in 1988, \$25,000,000 in 1989, \$113,000,000 in both 1990 and 1991 and \$119,000,000 in 1992.

The mortgage of the Company constitutes a first mortgage lien on substantially all its property and franchises owned. Excluded from the lien are cash, securities, accounts receivable, fuel, supplies and automotive equipment.

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

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

Any required write-offs of the Company's plant investment could significantly affect its ability to issue additional debt. See Notes 3 and 7.

#### (12) Short-Term Borrowing Arrangements

The Company's bank credit arrangements at December 31, 1987 were as follows:

	Amount (thousands of dollars)
Bank Lines of Credit .....	\$69,350
Revolving Underwriting Facility...	25,000

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

Short-term borrowing capacity authorized by the PUCO is \$150,000,000.

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

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

#### (13) Quarterly Results of Operations (Unaudited)

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

	Quarters ended			
	March 31	June 30	Sept. 30	Dec. 31
	(thousands of dollars)			
1987				
Operating Revenues .....	\$150,155	\$153,155	\$172,414	\$149,498
Operating Income .....	37,957	33,362	39,026	34,643
Net Income .....	47,950	35,372	47,565	34,284
Earnings Available for Common Stock .....	36,637	24,364	36,210	25,211
1986				
Operating Revenues .....	152,730	138,032	154,886	148,773
Operating Income .....	36,358	33,674	34,735	22,537
Net Income .....	45,066	40,077	46,304	45,470
Earnings Available for Common Stock .....	33,973	28,545	34,975	34,181

## Auditors' Report

To the Share Owners of  
The Toledo Edison Company:

We have examined the balance sheet and statement of cumulative preferred and preference stock of The Toledo Edison Company (a wholly-owned subsidiary of Centenor Energy Corporation) as of December 31, 1987 and 1986 and the related statements of results of operations, retained earnings and source of funds invested in plant, facilities and special deposits for each of the three years in the period ended December 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

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

1. The outcome of a request for rehearing pending before The Public Utilities Commission of Ohio (PUCO) and, if necessary, an appeal to the Ohio Supreme Court regarding Perry Unit 1 cost disallowances ordered by the PUCO.
2. The outcome of further PUCO investigations regarding the prudence of construction costs at Perry Unit 1 and Beaver Valley Unit 2.
3. The outcome of future PUCO regulatory proceedings to establish a rate phase-in plan to recover the investments, lease obligations and deferred

costs relating to Perry Unit 1 and Beaver Valley Unit 2.

4. The resolution of potential excess capacity issues.
5. Whether Perry Unit 2 will be completed and whether the investment will ultimately be recoverable in rates charged to customers.

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

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties discussed above been known, the financial statements referred to above present fairly the financial position of The Toledo Edison Company as of December 31, 1987 and 1986, and the results of its operations and source of funds invested in plant, facilities and special deposits for each of the three years in the period ended December 31, 1987, all in conformity with generally accepted accounting principles applied on a consistent basis.

*Arthur Andersen & Co.*  
Arthur Andersen & Co.

Toledo, Ohio  
February 17, 1988