UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 1998

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______________ to _______________

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Commission file number 1-3187

HOUSTON INDUSTRIES INCORPORATED
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Texas | 74-0694415 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 1111 Louisiana<br>Houston, Texas | 77002 |
| (Address of principal executive offices) | (Zip Code) |

(713) 207-3000
(Registrant's telephone number, including area code)

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Commission file number 1-13265

NORAM ENERGY CORP.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 76-0511406 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 1111 Louisiana<br>Houston, Texas | 77002 |
| (Address of principal executive offices) | (Zip Code) |

(713) 207-3000
(Registrant's telephone number, including area code)

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NORAM ENERGY CORP. MEETS THE CONDITIONS SET FORTH IN GENERAL INSTRUCTION H(1)(a) AND (b) OF FORM 10-Q AND IS THEREFORE FILING THIS FORM 10-Q WITH THE REDUCED DISCLOSURE FORMAT.

Indicate by check mark whether the registrants: (1) have filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrants were required to file such reports), and (2) have been subject to such filing requirements for the past 90 days. Yes X No

As of November 9, 1998, Houston Industries Incorporated had 284,475,688 shares of common stock outstanding, including 11,751,632 ESOP shares not deemed outstanding for financial statement purposes and excluding 102,797 shares held as treasury stock. As of November 9, 1998, all 1,000 shares of NorAm Energy Corp's common stock were held by Houston Industries Incorporated.

THIS COMBINED QUARTERLY REPORT ON FORM 10-Q IS SEPARATELY FILED BY HOUSTON INDUSTRIES INCORPORATED (COMPANY) AND NORAM ENERGY CORP. (NORAM). INFORMATION CONTAINED HEREIN RELATING TO NORAM IS FILED BY THE COMPANY AND SEPARATELY BY NORAM ON ITS OWN BEHALF. NORAM MAKES NO REPRESENTATION AS TO INFORMATION RELATING TO THE COMPANY (EXCEPT AS IT MAY RELATE TO NORAM AND ITS SUBSIDIARIES), HOUSTON INDUSTRIES ENERGY, INC., HOUSTON INDUSTRIES POWER GENERATION, INC. OR ANY OTHER AFFILIATE OR SUBSIDIARY OF THE COMPANY.

HOUSTON INDUSTRIES INCORPORATED
AND NORAM ENERGY CORP.
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 1998

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AND NORAM ENERGY CORP.
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 1998

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED INCOME
(THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 1998 | 1997 | 1998 | 1997 |
| REVENUES: | | | | |
| Electric Operations | $ 1,415,832 | $ 1,387,262 | $ 3,443,694 | $ 3,286,816 |
| Natural Gas Distribution | 249,004 | 180,288 | 1,280,889 | 180,288 |
| Interstate Pipeline | 70,394 | 39,035 | 217,891 | 39,035 |
| Energy Marketing | 1,642,373 | 551,229 | 3,730,602 | 551,229 |
| International | 31,813 | 21,458 | 228,494 | 61,386 |
| Other | 214,853 | 17,132 | 264,795 | 20,199 |
| Eliminations | (155,475) | (37,853) | (322,128) | (37,853) |
| Total | 3,468,794 | 2,158,551 | 8,844,237 | 4,101,100 |
| EXPENSES: | | | | |
| Fuel and cost of gas sold | 1,134,356 | 772,306 | 3,468,553 | 1,249,514 |
| Purchased power | 970,041 | 226,952 | 1,872,557 | 406,576 |
| Operation and maintenance | 472,365 | 426,253 | 1,280,044 | 923,549 |
| Taxes other than income taxes | 118,872 | 86,168 | 298,227 | 208,507 |
| Depreciation and amortization | 267,204 | 184,156 | 677,838 | 446,889 |
| Total | 2,962,838 | 1,695,835 | 7,597,219 | 3,235,035 |
| OPERATING INCOME | 505,956 | 462,716 | 1,247,018 | 866,065 |
| OTHER INCOME (EXPENSE): | | | | |
| Unrealized loss on ACES | (40,231) | | (484,009) | |
| Time Warner dividend income | 10,313 | 10,313 | 30,937 | 31,028 |
| Other- net | 2,691 | 14,724 | 16,201 | 13,631 |
| Total | (27,227) | 25,037 | (436,871) | 44,659 |
| INTEREST AND OTHER CHARGES: | | | | |
| Interest on long-term debt | 101,229 | 91,874 | 310,584 | 217,513 |
| Other interest | 20,227 | 18,667 | 67,620 | 51,826 |
| Distributions on trust securities | 7,248 | 7,055 | 21,960 | 18,728 |
| Allowance for borrowed funds used during construction | (1,398) | (47) | (2,967) | (1,892) |
| Preferred dividends of subsidiary | | 33 | | 2,255 |
| Total | 127,306 | 117,582 | 397,197 | 288,430 |
| INCOME BEFORE INCOME TAXES AND PREFERRED DIVIDENDS | 351,423 | 370,171 | 412,950 | 622,294 |
| INCOME TAXES | 104,066 | 126,209 | 152,528 | 197,249 |
| NET INCOME | 247,357 | 243,962 | 260,422 | 425,045 |
| PREFERRED DIVIDENDS | 97 | 64 | 292 | 64 |
| NET INCOME AVAILABLE FOR COMMON STOCK | $ 247,260 | $ 243,898 | $ 260,130 | $ 424,981 |
| BASIC EARNINGS PER COMMON SHARE | $ .87 | $ .93 | $ .92 | $ 1.74 |
| DILUTED EARNINGS PER COMMON SHARE | $ .87 | $ .92 | $ .91 | $ 1.74 |

See Notes to Unaudited Consolidated Financial Statements.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

ASSETS

| | SEPTEMBER 30, 1998 | DECEMBER 31, 1997 |
|---|---|---|
| PROPERTY, PLANT AND EQUIPMENT - AT COST: | | |
| Electric plant: | | |
| Plant in service | $ 13,077,006 | $ 12,614,000 |
| Construction work in progress | 243,332 | 224,959 |
| Nuclear fuel | 263,502 | 255,567 |
| Plant held for future use | 48,588 | 48,631 |
| Gas plant and pipelines: | | |
| Natural Gas Distribution | 1,441,865 | 1,326,442 |
| Interstate Pipelines | 1,284,127 | 1,258,087 |
| Energy Marketing | 180,755 | 162,519 |
| Other property | 194,403 | 149,019 |
| Total | 16,733,578 | 16,039,224 |
| Less accumulated depreciation and amortization | 5,341,204 | 4,770,179 |
| Property, plant and equipment - net | 11,392,374 | 11,269,045 |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | 56,303 | 51,712 |
| Accounts receivable - net | 1,460,097 | 962,974 |
| Accrued unbilled revenues | 159,446 | 205,860 |
| Time Warner dividends receivable | 10,313 | 10,313 |
| Fuel stock and petroleum products | 210,395 | 88,819 |
| Materials and supplies, at average cost | 169,402 | 156,160 |
| Restricted deposit for bond redemption | 68,700 | |
| Prepayments and other current assets | 79,754 | 42,169 |
| Total current assets | 2,214,410 | 1,518,007 |
| OTHER ASSETS: | | |
| Goodwill-net | 2,109,554 | 2,026,395 |
| Investment in Time Warner securities | 990,000 | 990,000 |
| Equity investments in and advances to foreign and non-rate regulated affiliates - net | 912,596 | 704,102 |
| Deferred plant costs - net | 542,232 | 561,569 |
| Deferred debits | 520,052 | 510,686 |
| Regulatory tax asset - net | 415,870 | 356,509 |
| Unamortized debt expense and premium on reacquired debt | 208,393 | 202,453 |
| Fuel-related debits | 196,629 | 197,304 |
| Recoverable project costs - net | 47,720 | 78,485 |
| Total other assets | 5,943,046 | 5,627,503 |
| Total | $ 19,549,830 | $ 18,414,555 |

See Notes to Unaudited Consolidated Financial Statements.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

CAPITALIZATION AND LIABILITIES

| | SEPTEMBER 30, 1998 | DECEMBER 31, 1997 |
|---|---|---|
| CAPITALIZATION: | | |
| Common stock equity: | | |
| Common stock, no par value | $ 3,135,548 | $ 3,112,098 |
| Treasury stock, at cost | (2,274) | (2,066) |
| Unearned ESOP shares | (219,863) | (229,827) |
| Retained earnings | 1,956,048 | 2,013,055 |
| Cumulative foreign currency translation adjustment | (6,022) | (821) |
| Unrealized loss on marketable equity securities | (16,543) | (5,634) |
| Total common stock equity | 4,846,894 | 4,886,805 |
| Preference stock, none outstanding | | |
| Cumulative preferred stock, no par value, not subject to mandatory redemption | 9,740 | 9,740 |
| Company/NorAm obligated mandatorily redeemable trust preferred securities of subsidiary trusts holding solely subordinated debentures of Company/NorAm | 342,280 | 362,172 |
| Long-term debt: | | |
| Automatic common exchange securities (ACES) | 1,657,794 | 1,173,786 |
| Debentures | 966,157 | 669,291 |
| First mortgage bonds | 1,864,656 | 2,495,459 |
| Notes payable | 522,070 | 745,889 |
| Pollution control revenue bonds | 581,385 | 118,000 |
| Other | 14,760 | 15,590 |
| Total long-term debt | 5,606,822 | 5,218,015 |
| Total capitalization | 10,805,736 | 10,476,732 |
| CURRENT LIABILITIES: | | |
| Notes payable | 1,918,150 | 2,124,956 |
| Accounts payable | 1,424,471 | 879,612 |
| Taxes accrued | 310,583 | 240,739 |
| Interest accrued | 108,867 | 109,901 |
| Dividends declared | 111,047 | 110,716 |
| Customer deposits | 79,196 | 82,437 |
| Current portion of long-term debt | 612,062 | 251,169 |
| Other | 227,557 | 193,384 |
| Total current liabilities | 4,791,933 | 3,992,914 |
| DEFERRED CREDITS: | | |
| Accumulated deferred income taxes | 2,636,737 | 2,792,781 |
| Benefit obligations | 461,979 | 397,586 |
| Unamortized investment tax credit | 333,980 | 349,072 |
| Fuel-related credits | 117,000 | 75,956 |
| Other | 402,465 | 329,514 |
| Total deferred credits | 3,952,161 | 3,944,909 |
| COMMITMENTS AND CONTINGENCIES (NOTE 1 AND NOTE 10) | | |
| Total | $ 19,549,830 | $ 18,414,555 |

See Notes to Unaudited Consolidated Financial Statements.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CASH FLOWS
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 | NINE MONTHS ENDED SEPTEMBER 30, 1997 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 260,422 | $ 425,045 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 677,838 | 446,889 |
| Amortization of nuclear fuel | 19,753 | 21,727 |
| Deferred income taxes | (155,782) | 23,973 |
| Investment tax credit | (15,092) | (14,740) |
| Unrealized loss on ACES | 484,009 | |
| Contribution of marketable equity securities to charitable trust | | 19,463 |
| Fuel cost under recovery | (80,331) | (168,367) |
| Changes in other assets and liabilities: | | |
| Accounts receivable - net | (591,241) | 75,006 |
| Account receivable - IRS | 140,532 | |
| Fuel surcharge | 73,539 | 101,196 |
| Inventory | (129,444) | 21,260 |
| Other current assets | (37,801) | (13,584) |
| Accounts payable | 528,582 | (95,054) |
| Interest and taxes accrued | 58,810 | 73,724 |
| Other current liabilities | (17,200) | 43,590 |
| Other - net | (42,515) | (13,628) |
| Net cash provided by operating activities | 1,174,079 | 946,500 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures (including allowance for borrowed funds used during construction) | (447,152) | (180,472) |
| Purchase of NorAm Energy Corp., net of cash acquired | | (1,422,672) |
| Sale of equity investments in foreign electric system projects | 242,744 | |
| Equity investment in non-rate regulated foreign electric systems (including capitalized interest) | (240,377) | (215,020) |
| Non-rate regulated domestic electric power project acquisitions (including capitalized interest) | (275,056) | |
| Equity investments in non-rate regulated domestic electric power projects | (42,439) | |
| Sale of Time Warner securities | | 25,043 |
| Other - net | (40,339) | (10,484) |
| Net cash used in investing activities | (802,619) | (1,803,605) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from sale of ACES -net | | 1,020,770 |
| Proceeds from sale of Company obligated mandatorily redeemable trust preferred securities of subsidiary trusts holding solely subordinated debentures of Company -net | | 340,785 |
| Payment of matured bonds | (76,000) | (190,000) |
| Proceeds from issuance of debentures | 298,514 | |
| Restricted deposit for bond redemption | (68,700) | |
| Proceeds from issuance of pollution control revenue bonds | 454,258 | 115,739 |
| Redemption of preferred stock | | (153,628) |
| Payment of common stock dividends | (316,968) | (281,009) |
| Increase/(decrease) in notes payable - net | (226,836) | 144,765 |
| Extinguishment of long-term debt | (402,587) | (190,338) |
| Conversion of convertible securities | (10,399) | |
| Other - net | (18,151) | 95,427 |
| Net cash provided by (used in) financing activities | (366,869) | 902,511 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 4,591 | 45,406 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 51,712 | 8,001 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $ 56,303 | $ 53,407 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash Payments: | | |
| Interest (net of amounts capitalized) | $ 400,412 | $ 274,560 |
| Income taxes | 302,474 | 113,128 |

See Notes to Unaudited Consolidated Financial Statements.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED RETAINED EARNINGS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 1998 | 1997 | 1998 | 1997 |
| Balance at Beginning of Period | $ 1,815,435 | $ 2,003,194 | $ 2,013,055 | $ 1,997,490 |
| Net Income for the Period | 247,357 | 243,962 | 260,422 | 425,045 |
| Total | 2,062,792 | 2,247,156 | 2,273,477 | 2,422,535 |
| Preferred Stock Dividends | (97) | (64) | (292) | (64) |
| Common Stock Dividends | (106,647) | (105,766) | (317,137) | (281,145) |
| Balance at End of Period | $ 1,956,048 | 2,141,326 | 1,956,048 | 2,141,326 |

See Notes to Unaudited Consolidated Financial Statements.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) BASIS OF PRESENTATION

The unaudited interim financial statements and notes (Company's Interim Financial Statements) in this joint Form 10-Q (Form 10-Q) include the accounts of Houston Industries Incorporated (Company) and its wholly owned and majority owned subsidiaries including, effective as of August 6, 1997 (Acquisition Date), the accounts of NorAm Energy Corp. (NorAm) and its wholly owned and majority owned subsidiaries. For information regarding the Company's acquisition of NorAm, see Note 1(b) to the Company's Consolidated Financial Statements in the joint Annual Report on Form 10-K (Form 10-K) of the Company (File No. 1-3187) and NorAm (File No. 1-13265) for the fiscal year ended December 31, 1997. The Form 10-K includes the consolidated financial statements of the Company (Company's 10-K Financial Statements) and the consolidated financial statements of NorAm (NorAm's 10-K Financial Statements) for the year ended December 31, 1997.

The Company's Interim Financial Statements omit certain information included in financial statements prepared in accordance with generally accepted accounting principles and should be read in combination with the Form 10-K as updated by the joint Quarterly Reports on Form 10-Q of the Company and NorAm for the quarters ended March 31, 1998 (First Quarter 10-Q) and June 30, 1998 (Second Quarter 10-Q). For additional information regarding the presentation of interim period results, see Note 13 to the Company's Interim Financial Statements below.

The following notes to the financial statements in the Form 10-K relate to material contingencies. These notes, as updated by the notes contained in the Company's Interim Financial Statements, are incorporated herein by reference:

Company's 10-K Financial Statements: Note 1(c) (Regulatory Assets and Other Long-Lived Assets), Note 1(n) (Investments in Time Warner Securities), Note 2 (Derivative Financial Instruments (Risk Management)), Note 3 (Rate Matters), Note 4 (Jointly Owned Electric Utility Plant), Note 5 (Equity Investments in Foreign Affiliates) and Note 12 (Commitments and Contingencies).

NorAm's 10-K Financial Statements: Note 1(c) (Regulatory Assets and Regulation), Note 2 (Derivative Financial Instruments (Risk Management)), and Note 8 (Commitments and Contingencies).

(2) PRO FORMA COMBINED RESULTS OF OPERATIONS DATA

The Company's results of operations incorporate NorAm's results of operations for all periods beginning on and after the Acquisition Date. The following table presents certain unaudited pro forma information for the three and nine month periods ended September 30, 1997, as if the acquisition of NorAm had occurred on January 1, 1997.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

COMBINED RESULTS OF OPERATIONS
(IN MILLIONS, EXCEPT PER SHARE DATA)

| | THREE MONTHS ENDED SEPTEMBER 30, | | |
|---|---|---|---|
| | 1998 ACTUAL | 1997 ACTUAL | 1997 PRO FORMA |
| Revenues | $ 3,469 | $ 2,159 | $ 2,555 |
| Net Income (1) | $ 247 | $ 244 | $ 224 |
| Basic Earnings Per Share (1) | $ 0.87 | $ 0.93 | $ 0.80 |
| Diluted Earnings Per Share (1) | $ 0.87 | $ 0.92 | $ 0.80 |

| | NINE MONTHS ENDED SEPTEMBER 30, | | |
|---|---|---|---|
| | 1998 ACTUAL | 1997 ACTUAL | 1997 PRO FORMA |
| Revenues | $ 8,844 | $ 4,101 | $ 7,438 |
| Net Income (1) | $ 260 | $ 425 | $ 441 |
| Basic Earnings Per Share (1) | $ 0.92 | $ 1.74 | $ 1.57 |
| Diluted Earnings Per Share (1) | $ 0.91 | $ 1.74 | $ 1.56 |

- ------------------

(1) Includes a $26 million or $0.09 basic earnings per share and a $314 million or $1.10 basic earnings per share (after-tax) non-cash unrealized accounting loss recorded in the three and nine month periods ended September 30, 1998, respectively, relating to the Company's Automatic Common Exchange Securities (ACES). For additional information on the unrealized accounting loss, see Note 6 to the Company's Interim Financial Statements.

These and other pro forma results appearing in the Form 10-Q are based on assumptions deemed appropriate by the Company's management, have been prepared for informational purposes only and are not necessarily indicative of the combined results that would have resulted had the acquisition of NorAm occurred at the beginning of 1997. Purchase related adjustments to results of operations include amortization of goodwill and the effects on depreciation, amortization, interest expense and deferred income taxes of the revaluation of the fair value of certain NorAm assets and liabilities. For information regarding the recording of the NorAm acquisition under the purchase method of accounting, see Note 1(b) to the Company's 10-K Financial Statements.

(3) COMPREHENSIVE INCOME

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income." "Comprehensive income" is defined to include not only net income (loss), but also all changes in stockholders' equity during a reporting period except changes resulting from investments by stockholders and distributions to stockholders. The Company's comprehensive income consists of net income, foreign currency translation adjustments (net of tax) and unrealized gains (losses) on the Company's investment in marketable equity securities.

For the three months ended September 30, 1998, the Company's total comprehensive income was $241 million compared to $248 million in the corresponding period in 1997. For the nine months ended September 30, 1998, the Company's total comprehensive income was $244 million compared to $429 million in the corresponding period in 1997.

Under SFAS No. 130, the Company will begin to report and separately display total comprehensive income and the components that comprise comprehensive income in the year-end financial statements appearing in the Company's Annual Report on Form 10-K for the year ending December 31, 1998 and subsequent annual reports.

(4) FOREIGN CURRENCY ADJUSTMENTS

Assets and liabilities of the Company's international operations, where the local currency is the functional currency, have been translated into U.S. dollars using the exchange rate at the balance sheet date. Revenues, expenses, gains, and losses have been translated using the weighted average exchange rate for each month prevailing during the periods reported. Cumulative adjustments resulting from translation have been recorded in stockholders' equity. When the U.S. dollar is the functional currency, the financial statements of international operations are remeasured in U.S. dollars using historical exchange rates for non-monetary accounts and the current rate for all other accounts. All exchange gains and losses from remeasurement and foreign currency transactions are included in consolidated net income. Foreign exchange gains and losses are not material for any period presented. Fluctuations in foreign currency exchange rates relative to the U.S. dollar can have an impact on the reported equity earnings of the Company's foreign investments. For additional information about the Company's equity investments in foreign affiliates, see Note 5 to the Company's 10-K Financial Statements.

(5) DEPRECIATION

The Company calculates depreciation using the straight-line method. The Company's depreciation expense for the three and nine month periods ended September 30, 1998 was $227 million and $559 million, respectively, compared to $128 million and $334 million for the same periods in 1997. For information regarding the additional depreciation of electric utility generating assets under a transition to competition plan implemented in January 1998, see Note 10(a) to the Company's Interim Financial Statements.

(6) INVESTMENT IN TIME WARNER SECURITIES

The Company owns 11 million shares of non-publicly traded Time Warner convertible preferred stock (TW Preferred). The TW Preferred is convertible into approximately 22.9 million shares of Time Warner common stock. For additional information regarding TW Preferred (including its dividend rate, liquidation preference and voting rights), see Note 1(n) to the Company's 10-K Financial Statements.

The Company has recorded its $990 million investment in the TW Preferred under the cost method. Dividends on these securities are recognized as income at the time they are earned. The Company recorded pre-tax dividend income with respect to these securities of $10 million in each of the three month periods ended September 30, 1998 and 1997 and $31 million in each of the nine month periods ended September 30, 1998 and 1997.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

To monetize its investment in the TW Preferred, the Company sold in July 1997, 22.9 million of its unsecured 7% ACES. As a result of the issuance of the ACES, a portion of the increase in the market value above $55.5844 per share of Time Warner common stock (the security into which the TW Preferred is convertible) results in unrealized accounting losses to the Company for the ACES, pending the conversion of the Company's TW Preferred into Time Warner common stock. For example, prior to the conversion of the TW Preferred into Time Warner common stock, when the market price of Time Warner common stock increases above $55.5844, the Company records in Other Income (Expense) an unrealized, non-cash accounting loss for the ACES equal to (i) the aggregate amount of such increase as applicable to all ACES multiplied by (ii) 0.8264. In accordance with generally accepted accounting principles, this accounting loss (which reflects the unrealized increase in the Company's indebtedness with respect to the ACES) may not be offset by accounting recognition of the increase in the market value of the Time Warner common stock that underlies the TW Preferred. Upon conversion of the TW Preferred, the Company will begin recording unrealized net changes in the market prices of the Time Warner common stock and the ACES as a component of common stock equity and other comprehensive income.

As of September 30, 1998, the market price of Time Warner common stock was $87.563 per share. Accordingly, the Company recognized an increase of $40 million and $484 million during the three and nine month periods ended September 30, 1998, respectively, in the unrealized liability relating to its ACES indebtedness (which resulted in an after-tax earnings reduction for such periods of $26 million or $.09 basic earnings per share and $314 million or $1.10 basic earnings per share, respectively). The Company believes that the cumulative unrealized loss for the ACES of $605 million is more than economically offset by the approximately $1 billion unrecorded unrealized gain at September 30, 1998 relating to the increase in the fair value of the Time Warner common stock underlying the investment in TW Preferred since the date of its acquisition. For the quarter ended September 30, 1998, there was an increase in the unrecorded unrealized gain in the fair value of Time Warner common stock underlying the investment in TW Preferred of $49 million. Any gain related to the increase in the fair value of Time Warner common stock would be recognized as a component of net income upon the sale of the TW Preferred or the shares of common stock into which such TW Preferred is converted.

(7) CAPITAL STOCK

(a) Common Stock.

At September 30, 1998, the Company had 284,471,909 shares of common stock issued and outstanding (out of a total of 700,000,000 authorized shares). At December 31, 1997, the Company had 282,875,266 shares of common stock issued and outstanding. Outstanding common shares excluded (i) shares pledged to secure a loan to the Company's Employee Stock Ownership Plan (11,674,063 and 12,388,551 at September 30, 1998 and December 31, 1997, respectively) and (ii) treasury shares (102,544 and 93,459 at September 30, 1998 and December 31, 1997, respectively).

The Company has authorized the repurchase of up to $89 million of its common stock, $361 million of common stock having been previously purchased pursuant to a repurchase program authorized in 1996. Purchases of the Company's common stock, which may not be preceded by public announcement, may be made in open market or privately negotiated transactions from time to time as determined by management. Such repurchases are subject to market conditions, applicable legal requirements, available cash and other factors.

(b) Earnings Per Share.

Effective December 31, 1997, the Company adopted SFAS No. 128, "Earnings per Share" (SFAS No. 128). This statement requires restatement of all prior period earnings per share (EPS) data presented herein. SFAS No. 128 requires dual presentation of basic and diluted EPS on the face of the Statements of Consolidated Income and requires a reconciliation of the numerators and denominators used in the basic and diluted earnings per share calculations.

The following table presents a reconciliation of the Company's numerators and denominators of basic and diluted earnings per share calculations:

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

| | THREE MONTHS ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 1998(1) | 1997 | 1998(2) | 1997 |
| | (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | | | |
| Basic EPS Calculation: | | | | |
| Income before preferred dividends | $ 247,357 | $ 243,962 | $ 260,422 | $ 425,045 |
| Less: Preferred dividends | 97 | 64 | 292 | 64 |
| Net income attributable to common stock | $ 247,260 | $ 243,898 | $ 260,130 | $ 424,981 |
| Weighted average shares outstanding | 284,344 | 263,373 | 283,965 | 243,769 |
| Basic EPS: | | | | |
| Income before preferred dividends | $ 0.870 | $ 0.926 | $ 0.916 | $ 1.743 |
| Less: Preferred dividends | -- | -- | -- | -- |
| Net income attributable to common stock | $ 0.870 | $ 0.926 | $ 0.916 | $ 1.743 |
| Diluted EPS Calculation: | | | | |
| Income before preferred dividends | $ 247,357 | $ 243,962 | $ 260,422 | $ 425,045 |
| Plus: Income impact of assumed conversions: | | | | |
| Interest on 6 1/4% convertible debentures | 14 | 207 | 43 | 207 |
| Income before preferred dividends assuming dilution | 247,371 | 244,169 | 260,465 | 425,252 |
| Less: Preferred dividends | 97 | 64 | 292 | 64 |
| Net income attributable to common stock | $ 247,274 | $ 244,105 | $ 260,173 | $ 425,188 |
| Weighted average shares outstanding | 284,344 | 263,373 | 283,965 | 243,769 |
| Plus: Incremental shares from assumed conversions: | | | | |
| Stock options | 165 | 18 | 154 | 21 |
| Restricted stock | 492 | 369 | 492 | 369 |
| 6 1/4% convertible debentures | 44 | 946 | 44 | 946 |
| Weighted average shares assuming dilution | 285,045 | 264,706 | 284,655 | 245,105 |
| Diluted EPS: | | | | |
| Income before preferred dividends | $ 0.867 | $ 0.922 | $ 0.914 | $ 1.735 |
| Less: Preferred dividends | -- | -- | -- | -- |
| Net income attributable to common stock | $ 0.867 | $ 0.922 | $ 0.914 | $ 1.735 |

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(1) For the three months ended September 30, 1998, the computation of diluted EPS excludes purchase options for 379 shares of common stock, because the exercise prices for such shares (ranging from $30.18 to $35.18 per share) were greater than the $29.07 per share average market price for the period and would thus be anti-dilutive if exercised.

(2) For the nine months ended September 30, 1998, the computation of diluted EPS excludes purchase options for 379 shares of common stock, because the exercise prices for such shares (ranging from $30.18 to $35.18 per share) were greater than the $28.28 per share average market price for the period and would thus be anti-dilutive if exercised.

(c) Preferred Stock.

At September 30, 1998 and December 31, 1997, the Company had 10,000,000 authorized shares of preferred stock, of which 97,397 shares of $4.00 Preferred Stock were outstanding. The $4.00 Preferred Stock pays an annual dividend of $4.00 per share, is redeemable at $105 per share and has a liquidation price of $100 per share.

(d) Preference Stock.

At September 30, 1998 and December 31, 1997, the Company had 10,000,000 authorized shares of preference stock. Of the authorized shares of preference stock, the Company has designated 700,000 shares as Series A Preference Stock, 27,000 shares as Series B Preference Stock and 1,575 shares as Series C Preference Stock.

At September 30, 1998, the number of shares of Series B Preference Stock and Series C Preference Stock issued and outstanding was 17,000 and 1,575, respectively. The shares of Series B and Series C Preference stock are not deemed outstanding for financial reporting purposes, because the sole holders of such series are wholly owned financing subsidiaries of the Company (see Notes 7(b) and 8(c) to the Company's 10-K Financial Statements with respect to Series B Preference Stock and Notes 6(d) and 8(b) to the Company's Interim Financial Statements in the First Quarter 10-Q with respect to Series C Preference Stock). The shares of Series A Preference Stock are issuable only pursuant to the Company's Shareholder Rights Agreement. At September 30, 1998, there were no shares of Series A Preference Stock outstanding.

(8) COMPANY/NORAM OBLIGATED MANDATORILY REDEEMABLE TRUST PREFERRED SECURITIES OF SUBSIDIARY TRUSTS HOLDING SOLELY SUBORDINATED DEBENTURES OF THE COMPANY AND NORAM

For information regarding (i) $250 million of preferred securities and $100 million of capital securities issued by two statutory business trusts formed by the Company and (ii) $177.8 million of convertible preferred securities (of which $1.3 million were outstanding at September 30, 1998), issued by a statutory business trust formed by NorAm, see Note 9 to the Company's 10-K Financial Statements. The sole asset of each trust consists of junior subordinated debentures of the Company or NorAm having interest rates and maturity dates corresponding to each issue of preferred or capital securities, and the principal amounts corresponding to the common and preferred or capital securities issued by such trust.

(9) LONG-TERM DEBT AND SHORT-TERM FINANCING

(a) Consolidated Debt.

The following table summarizes the Company's outstanding consolidated long-term and short-term indebtedness. At September 30, 1998, approximately $1.8 billion of this debt represents indebtedness of NorAm.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

CONSOLIDATED LONG-TERM DEBT AND SHORT-TERM BORROWINGS
(IN MILLIONS)

| | SEPTEMBER 30, 1998 | | DECEMBER 31, 1997 | |
|---|---|---|---|---|
| | LONG-TERM | CURRENT (1) | LONG-TERM | CURRENT (1) |
| Short-Term Borrowings: | | | | |
| Commercial Paper......................... | | $ 1,465 | | $ 1,435 |
| Lines of Credit.......................... | | 150 | | 390 |
| NorAm Receivables Facility.............. | | 300 | | 300 |
| Notes Payable............................ | | 3 | | |
| Total Short-Term Borrowings................ | | 1,918 | | 2,125 |
| Long-Term Debt - net: | | | | |
| ACES..................................... | $ 1,658 | | $ 1,174 | |
| Debentures(2)(3)......................... | 966 | | 669 | |
| First Mortgage Bonds(2).................. | 1,865 | 239 | 2,495 | |
| Pollution Control Bonds.................. | 581 | | 118 | 5 |
| NorAm Medium-Term Notes(3)............... | 179 | | 182 | 79 |
| Notes Payable(3)......................... | 343 | 372 | 565 | 166 |
| Capital Leases........................... | 15 | 1 | 15 | 1 |
| Total Long-Term Debt....................... | 5,607 | 612 | 5,218 | 251 |
| Total Long-Term and Short-Term Debt...... | $ 5,607 | $ 2,530 | $ 5,218 | $ 2,376 |

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(1) Includes amounts due within one year of the date noted.

(2) Includes unamortized discount related to debentures of approximately $1 million at September 30, 1998 and December 31, 1997 and unamortized discount related to first mortgage bonds of approximately $11 million and $14 million at September 30, 1998 and December 31, 1997, respectively.

(3) Includes unamortized premium related to fair value adjustments of approximately $19 million and $16 million for debentures at September 30, 1998 and December 31, 1997, respectively. The unamortized premium for NorAm long-term and current medium-term notes was approximately $13 million and $0 at September 30, 1998, respectively, and $17 million and $3 million at December 31, 1997, respectively. The unamortized premium for long-term and current notes payable was approximately $4 million each at September 30, 1998 and $14 million and $3 million, respectively, at December 31, 1997.

Consolidated maturities of long-term debt and sinking fund requirements for the Company (including NorAm) are $156 million for the remainder of 1998.

(b) Financing Developments

Company: At September 30, 1998, a financing subsidiary of the Company had $1.3 billion in commercial paper borrowings supported by a $1.6 billion revolving credit facility. As of September 30, 1998, the weighted average interest rate of these commercial paper borrowings was 5.89%. Proceeds from the initial issuance of commercial paper under this facility were used to fund a portion of the acquisition of NorAm. For information regarding this facility, see Note 8(c) to the Company's 10-K Financial Statements and Note 8(b) to the Company's Interim Financial Statements in the First Quarter 10-Q.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

At September 30, 1998, another financing subsidiary of the Company had $150 million in borrowings under a separate credit facility. At September 30, 1998, the weighted average interest rate of these borrowings was 5.89%. Proceeds under this facility were used to fund a portion of the acquisition of electric generating plants acquired by Houston Industries Power Generation, Inc. (HIPG, Inc.) in April 1998. The facility will terminate on December 31, 1998. For additional information regarding this facility, see Note 8(b) to the Company's Interim Financial Statements in the First Quarter 10-Q.

The Company meets its short-term financing needs primarily through the sale of commercial paper supported by a $200 million revolving credit facility. At September 30, 1998, the Company had no commercial paper or other borrowings outstanding under this facility. For additional information, see Note 8(d) to the Company's 10-K Financial Statements.

In September 1998, the Brazos River Authority (BRA) issued on behalf of the Company $68.7 million aggregate principal amount of pollution control revenue refunding bonds. The BRA bonds, which bear a coupon rate of 4.90%, will mature in October 2015. The proceeds of the bond offering were deposited into a restricted trust account for the redemption in October 1998 of $68.7 million principal amount of the 7 3/4% BRA Series 1988D pollution control bonds at 102% of their aggregate principal amount. Because the redemption of the Series 1988D pollution control bonds occurred subsequent to the third quarter of 1998, the Company's Interim Financial Statements report both series of bonds to be outstanding at September 30, 1998.

For information regarding the Company's notice to change (effective in the fourth quarter of 1998) the method of interest rate determination for $118 million aggregate principal amount of pollution control bonds, see Note 12(b) to the Company's Interim Financial Statements.

For information regarding (i) the repayment at maturity of $5 million of floating-rate pollution control revenue bonds and (ii) the redemption of all outstanding 8.25% Brazos River Authority (BRA Series 1988A pollution control revenue bonds ($100 million), 8.25% BRA Series 1998B pollution control revenue bonds ($90 million), and 8.10% BRA Series 1988C pollution control revenue ($100 million) (all of which occurred in the second quarter of 1998), see Note 8(b) to the Company's Interim Financial Statements in the Second Quarter 10-Q. For information regarding the issuance of (i) $104.7 million aggregate principal amount of pollution control revenue bonds by the Matagarda County Navigation District Number One (MCND), and (ii) $290 million aggregate principal amount of pollution control revenue refunding bonds by the BRA (all of which occurred in the first quarter of 1998), see Note 8(c) the Company's Interim Financial Statements in the First Quarter 10-Q.

NorAm: During the third quarter of 1998, NorAm repurchased $6 million aggregate principal amount of its 6% convertible subordinated debentures due 2012 at an average purchase price equal to 97.4% of the aggregate principal amount of the debentures, plus accrued interest. NorAm expects to use the repurchased debentures to satisfy part of the debentures' sinking fund requirements in March 1999 and March 2000.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

During the third quarter of 1998, NorAm repaid the following medium-term notes at maturity:

| Series | Principal Amount |
|---|---|
| 9.07% due July 20, 1998 | $ 15.0 million |
| 8.60% due September 1, 1998 | 3.0 million |
| 8.58% due September 1, 1998 | 5.0 million |
| 8.64% due September 4, 1998 | 12.5 million |
| 8.50% due September 14, 1998 | 0.5 million |
| 8.60% due September 15, 1998 | 6.0 million |
| 8.43% due September 17, 1998 | 5.0 million |
| Total | $ 47.0 million |

At September 30, 1998, NorAm had $206 million in commercial paper borrowings supported by a $350 million revolving credit facility (NorAm Credit Facility). At such date, the weighted average interest rate of borrowings under this facility was 5.94%. Under a trade receivables facility that expires in August 1999, NorAm sells with limited recourse an undivided interest (limited to a maximum of $300 million) in a designated pool of accounts receivable. The amount of receivables sold and uncollected at September 30, 1998, was $300 million. The weighted average interest rate at such date was 5.5%. For additional information regarding NorAm's trade receivables facility, see Note 8(g) to the Company's 10-K Financial Statements.

For information regarding NorAm's issuance in the fourth quarter of 1998 of $500 million aggregate principal amount of debt securities, see Note 12 to the Company's Interim Financial Statements.

For information regarding NorAm's repayment at maturity of $28 million of its medium-term notes (having an average interest rate of 8.74%) in the second quarter of 1998, see Note 8(b) to the Company's Interim Financial Statements in the Second Quarter 10-Q. For information regarding (i) NorAm's issuance in February 1998 of $300 million principal amount of 6.5% debentures due February 1, 2008, (ii) NorAm's repayment at maturity of $1 million of its 9.30% medium-term notes in January 1998 and (iii) NorAm's satisfaction of the $6.5 million sinking fund requirement for its 6% convertible subordinated debentures due 2012 using debentures purchased in 1996 and 1997 in the first quarter of 1998, see Note 8(d) to the Company's Interim Financial Statements in the First Quarter 10-Q.

(10) REGULATORY MATTERS

(a) Transition Plan (Docket No. 18465)

In June 1998, the Public Utility Commission of Texas (Texas Utility Commission) issued an order approving a transition to competition plan (Transition Plan) filed by the Company's electric operations division (Electric Operations) in December 1997. The order also approved the implementation of base rate credits to residential customers of 4% in 1998 and an additional 2% in 1999. Commercial customers whose monthly billing is 1,000 kva or less receive base rate credits of 2% in each of 1998 and 1999. The Company implemented the Transition Plan effective January 1, 1998.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

In order to reduce the Company's exposure to potentially stranded costs related to generating assets, the Transition Plan permits the Company to redirect depreciation expenses that the Company otherwise would apply to transmission, distribution and general plant assets to generation assets. The redirected depreciation expense was $49 million and $145 million for the quarter and nine months ended September 30, 1998, respectively. In addition, the Transition Plan provides that all earnings by Electric Operations above a 9.844% overall annual rate of return on invested capital will be used to write-down Electric Operation's investment in generation assets. The $91 million in additional depreciation recorded in the third quarter of 1998 ($171 million for the nine months ended September 30, 1998) is an estimate of the amount of additional depreciation necessary under the earnings cap, given the uncertainty of weather and the level of revenues and expenses during the remainder of the year and the level of year end invested capital.

For additional information regarding the Transition Plan, see Note 3(b) to the Company's 10-K Financial Statements.

Review of the Texas Utility Commission's order in Docket No. 18465 is currently pending before the Travis County District Court. In August 1998, the Office of the Attorney General for the State of Texas and a Texas municipality filed an appeal seeking, among other things, to reverse the portion of the Texas Utility Commission's order relating to the redirection of depreciation expenses under the Transition Plan. For information regarding appeals of Texas Utility Commission decisions, see Note 3(a) to the Company's 10-K Financial Statements. Because of the number of variables that can affect the ultimate resolution of an appeal of Commission orders, the Company is not in a position at this time to predict the outcome of this matter or the ultimate effect that adverse action by the courts could have on the Company.

(b) Nuclear Insurance

The Company has a 30.8% interest in the South Texas Project Electric Generating Station (South Texas Project), a nuclear generating plant consisting of two 1,250 megawatt nuclear generating units.

Effective August 1998, the Nuclear Regulatory Commission increased the maximum secondary retrospective deferred premium to $88.09 million per reactor per incident (but not to exceed $10 million in any one year) from $75.5 million per reactor per incident. The premium is for liability insurance coverage for nuclear incidents at licensed, operating commercial nuclear power plants. The change reflects an inflation adjustment required by the Price-Anderson Amendments Act of 1988. For additional information on nuclear insurance, see Note 4(c) to the Company's 10-K Financial Statements.

(c) Low-level Radioactive Waste

The 1980 Federal Low-Level Radioactive Waste Policy Act directed states to assume responsibility for the disposal of low-level nuclear waste generated within their borders. Under this Act, states may combine with other states and seek consent from the U.S. Congress for regional compacts to construct and operate low-level nuclear waste sites. Two sites (the Envirocare facility in Utah and the Barnwell facility in South Carolina) are currently licensed and available to the South Texas Project for disposal of all classes of low-level waste. The South Texas Project has entered into a contract with the operator of the Barnwell facility to dispose of all of the South Texas Project's low-level nuclear waste through June 1999.

A bill establishing an interstate compact among Texas, Maine and Vermont was signed into law on September 20, 1998. The compact limits access to a Texas waste disposal facility to the three compact members and provides for contributions from Maine and Vermont toward the construction of such a facility. In October 1998, the Texas Natural Resource Conservation Commission denied the application of the Texas Low-Level Radioactive Waste Disposal Authority (Waste Disposal Authority) to build and operate a low-level waste disposal facility in Hudspeth County, Texas. In the event the Barnwell facility stops accepting waste before a Texas site is opened, the South Texas Project would store its waste in an interim storage facility located at the nuclear plant. The plant currently has storage capacity for at least five years of low-level nuclear waste generated by the project.

(11) ACQUISITIONS AND DISPOSITIONS

In July 1998, HIPG, Inc. purchased from Southern California Edison Company (SCE), a 1500 MW generating plant for $43 million.

(12) SUBSEQUENT EVENTS

(a) Investment in Colombian Distribution Company.

On October 13, 1998, HI Energy and Electricidad de Caracas, SACA, a Venezuelan electric distribution company (EDC), announced the closing of their joint acquisition of 65% of the stock of two Colombian electric distribution companies (collectively, the Corelca system companies). The Corelca system companies serve approximately 1.2 million customers in the Atlantic coastal region of Colombia, including the cities of Santa Marta, Barranquilla and Cartagena. The shares of the Corelca system companies are indirectly held by an offshore holding company jointly owned by special purpose subsidiaries of EDC and HI Energy.

The purchase price for the Corelca system companies was approximately $522 million, excluding transaction costs. The purchase price was funded with capital contributions from HI Energy and EDC and a $100 million loan obtained by the holding company from a United States bank. The loan will mature on October 31, 2003. HI Energy funded its capital contributions with a portion of the proceeds from the sale of Empresa Distribuidora de La Plata S.A. (EDELAP) and capital contributions from the company. Under the terms of a support agreement, HI Energy and EDC have agreed, among other things, to repurchase up to $50 million of the loan from the bank to the extent that the bank is unable to syndicate that portion of the loan to other banks on or prior to June 15, 1999.

(b) Pollution Control Bonds.

In October 1998, the Company delivered its notice to change the interest rate determination method for (i) the MCND Series 1997 pollution control revenue refunding bonds due November 2028 ($68 million aggregate principal amount outstanding) and (ii) the BRA Series 1997 pollution control revenue refunding bonds due November 2018 ($50 million aggregate principal amount outstanding). Subject to the satisfaction of certain conditions precedent, the notice provides that, effective November 24, 1998, the method by which interest on the bonds is calculated will convert from a floating rate mode to a long-term fixed rate mode. As set forth in the notice, the long-term interest rate for the MCND Series 1997 will be 5 1/8% and the long-term interest rate for the BRA Series 1997 will be 5.05%.

The MCND and BRA Series 1997 bonds, which were issued in January 1997, are subject to mandatory tender on November 24, 1998 in connection with the change in the interest rate determination method. The purchase price of the tendered bonds (100% of their principal amount plus accrued interest) is expected to be funded with the proceeds from the underwritten remarketing of the fixed-rate bonds. For additional information regarding the MCND and BRA Series 1997 bonds, see Note 8(f) to the Company's 10-K Financial Statements.

(c) Offering of NorAm Debt Securities.

In November 1998, NorAm sold $500 million aggregate principal amount of its 6 3/8% Term Enhanced ReMarketable Securities (TERM Notes). The net proceeds of $514 million from the offering of the TERM Notes and from the sale of the related option to remarket the TERM Notes (as described below) will be used for general corporate purposes, including the repayment of (i) $178.5 million of NorAm's outstanding commercial paper and (ii) a $150 million term loan of NorAm that matures on November 13, 1998. The TERM Notes are unsecured obligations of NorAm which bear interest at the annual rate of 6 3/8% through November 1, 2003. On November 1, 2003, the holders of the TERM Notes are required to tender their notes at 100% of their principal amount. Concurrent with the offering, NorAm received proceeds of $18.375 million from the sale of an option to remarket the notes in 2003. The proceeds received from the sale of the option will be amortized over the stated term of the securities. If the option is not exercised, NorAm will repurchase the TERM Notes at 100% of their principal amount on November 1, 2003. If the option is exercised, the TERM Notes will be remarketed on a date, selected by NorAm, within the 52-week period beginning November 1, 2003. During such period and prior to remarketing, the TERM Notes will bear interest at rates, adjusted weekly, based on an index selected by NorAm. If the TERM Notes are remarketed, the final maturity date of the TERM Notes will be November 1, 2013, subject to adjustment, and the effective interest rate on the remarketed TERM Notes will be 5.66% plus the Company's applicable credit spread at the time of such remarketing.

(13) INTERIM PERIOD RESULTS: RECLASSIFICATIONS

The Interim Financial Statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to present fairly the financial position and results of operations for the respective periods. Amounts reported in the Consolidated Statements of Income are not necessarily indicative of amounts expected for a full year period due to the effects of, among other things, (i) the acquisition of NorAm, (ii) seasonal temperature variations affecting energy consumption and (iii) the timing of maintenance and other expenditures and (iv) acquisitions and dispositions of assets and other interests. In addition, certain amounts from the prior year have been reclassified to conform to the Company's presentation of financial statements in the current year. Such reclassifications do not affect earnings.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF THE COMPANY.

The following discussion and analysis should be read in combination with Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company in Item 7 of the Form 10-K, Management's Narrative Analysis of the Results of Operations of NorAm and Consolidated Subsidiaries in Item 7 of the Form 10-K, the Company's consolidated financial statements and notes contained in Item 8 of the Form 10-K and Item 1 of this Form 10-Q. The Company from time to time makes use in its presentations and other communications of projections, forecasts and other non-historical information. For a discussion of the qualifications and assumptions underlying the use of such forward looking information, see Item 5 of this Form 10-Q.

### HOUSTON INDUSTRIES INCORPORATED

Houston Industries Incorporated (Company), together with various divisions and subsidiaries, including NorAm Energy Corp. (NorAm), is a diversified international energy services company.

The Company's electric operations segment (Electric Operations) operates the nation's tenth largest electric utility in terms of kilowatt-hour (KWH) sales; and its natural gas distribution segment (Natural Gas Distribution) operates the nation's third largest natural gas distribution operation in terms of customers served. The Company, through its interstate pipeline segment (Interstate Pipeline), operates two interstate natural gas pipelines. The Company provides natural gas transportation, supply, gathering and storage, and wholesale natural gas and electric power trading and marketing services through its energy marketing segment (Energy Marketing) and invests, through its international (International) and corporate (Corporate) segments, in foreign electric and gas utility operations and domestic non-rate regulated power generation projects.

### CONSOLIDATED RESULTS OF OPERATIONS

The Company's actual and pro forma results of operations for the third quarter and nine month periods ended September 30,1998 and 1997 are summarized in the following table. The Company's actual results of operations include results of operations for NorAm for periods on and after August 6, 1997 (Acquisition Date). The Company's pro forma results of operations give effect to the acquisition of NorAm as if it had occurred as of January 1, 1997. The pro forma information is not necessarily indicative of the results of operations of the Company and its business segments that would have occurred had the acquisition of NorAm occurred at the beginning of such period. In general, the effects of the acquisition of NorAm include (i) significant increases in amortization attributable to purchase accounting, (ii) increased shares outstanding and interest expense and (iii) inclusion of additional revenues and operating expenses from the newly acquired NorAm business.

| | THREE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | 1997 (ACTUAL) | 1997 (PRO FORMA) | PERCENT CHANGE (1998 ACTUAL TO 1997 PRO FORMA) |
|---|---|---|---|---|
| | (IN MILLIONS, EXCEPT PER SHARE DATA) | | | |
| Revenues | $ 3,469 | $ 2,159 | $ 2,555 | 36% |
| Operating Expenses | 2,963 | 1,696 | 2,107 | 41% |
| Operating Income | 506 | 463 | 449 | 13% |
| Other Expenses, Net (1) | 155 | 93 | 108 | 44% |
| Income Taxes | 104 | 126 | 117 | (11%) |
| Net Income (1) | 247 | 244 | 224 | 10% |
| Basic Earnings Per Share (1) | 0.87 | 0.93 | 0.80 | 9% |
| Diluted Earnings Per Share (1) | 0.87 | 0.92 | 0.80 | 9% |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | 1997 (ACTUAL) | 1997 (PRO FORMA) | PERCENT CHANGE (1998 ACTUAL TO 1997 PRO FORMA) |
|---|---|---|---|---|
| | (IN MILLIONS, EXCEPT PER SHARE DATA) | | | |
| Revenues | $ 8,844 | $ 4,101 | $ 7,438 | 19% |
| Operating Expenses | 7,597 | 3,235 | 6,422 | 18% |
| Operating Income | 1,247 | 866 | 1,016 | 23% |
| Other Expenses, Net (2) | 834 | 244 | 352 | 137% |
| Income Taxes | 153 | 197 | 223 | (31%) |
| Net Income (2) | 260 | 425 | 441 | (41%) |
| Basic Earnings Per Share (2) | 0.92 | 1.74 | 1.57 | (41%) |
| Diluted Earnings Per Share (2) | 0.91 | 1.74 | 1.56 | (42%) |

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(1) Includes a $40 million ($26 million after-tax) or $0.09 basic earnings per share non-cash unrealized accounting loss recorded in the three month period ended September 30, 1998, relating to the Company's 7% Automatic Common Exchange Securities (ACES). See Note 6 to the Company's Interim Financial Statements.

(2) Includes a $484 million ($314 million after-tax) or $1.10 basic earnings per share non-cash unrealized accounting loss recorded in the nine month period ended September 30, 1998, relating to the ACES. (See Note 6 to the Company's Interim Financial Statements.)

Third Quarter of 1998 Compared to Third Quarter of 1997 (Actual). The Company had net income of $247 million for the third quarter of 1998 ($0.87 basic earnings per share) compared to net income of $244 million ($0.93 basic earnings per share) in the comparable period in 1997. The Company's results of operations for the third quarter of 1998 include a $26 million (after-tax) non-cash, unrealized accounting loss on the ACES. For information regarding this accounting loss, see Note 6 to the Company's Interim Financial Statements.

Excluding the ACES accounting loss, the Company would have had adjusted net income of $273 million ($0.96 basic earnings per share) for the third quarter of 1998. The increase in third quarter adjusted net income is primarily attributable to improved earnings from the Company's non-rate regulated power generation business (reported in the Corporate segment) and its International segment. Improved results of operations from the Interstate Pipeline and Energy Marketing segments also contributed to the increase in adjusted net income. These effects were partially offset by (i) additional depreciation of Electric Operations' generation assets of $91 million ($78 million over the prior comparable period), (ii) base rate credits resulting from the Transition Plan (described below), (iii) seasonal-related operating losses at Natural Gas Distribution, and (iv) increased interest expense primarily related to the NorAm acquisition.

Third Quarter of 1998 (Actual) Compared to Third Quarter of 1997 (Pro Forma). The Company's net income for the third quarter of 1998 was $247 million ($0.87 basic earnings per share) compared to pro forma net income of $224 million ($0.80 basic earnings per share) in the third quarter of 1997. Excluding the accounting loss attributable to the ACES securities, the Company's adjusted net income for the third quarter of 1998 would have been $273 million ($0.96 basic earnings per share) compared to $224 million ($0.80 basic earnings per share) in the third quarter of 1997. The increase in actual net income over pro forma net income was caused by the same factors discussed above except for the increase in interest expense and the losses at Natural Gas Distribution which were comparable between periods (excluding non-recurring items discussed below). The decrease in income taxes in the third quarter of 1998 reflects the impact of a reduction in the Company's estimate of tax expense for the year.

Nine Month Period ended September 30, 1998 (Actual) Compared to Nine Month Period ended September 30, 1997 (Actual). The Company had net income of $260 million for the nine month period ended September 30, 1998, ($0.92 basic earnings per share) compared to net income of $425 million ($1.74 basic earnings per share) for the comparable period in 1997. The Company's results of operations for the nine month period reflect a $314 million (after-tax) non-cash, unrealized accounting loss relating to the ACES. Excluding this accounting loss, the Company would have had adjusted net income of $574 million ($2.02 basic earnings per share). The increase in adjusted net income for the nine month period is attributable to (i) an $80 million ($0.28 basic earnings per share) after-tax gain recorded in connection with the sale of an investment in an Argentine electric utility system, (ii) earnings from the Company's non-rate regulated power generation business and its International segment, and (iii) the incremental earnings generated by the business segments acquired in the NorAm acquisition.

Nine Months ended September 30, 1998 (Actual) Compared to Nine Months ended September 30, 1997 (Pro Forma). The Company's net income for the nine month period ended September 30, 1998 was $260 million ($0.92 basic earnings per share) compared to pro forma net income of $441 million ($1.57 basic earnings per share) in the first nine months of 1997.

Excluding the accounting loss relating to the ACES, the Company's adjusted net income for the nine month period ended September 30, 1998, would have been $574 million ($2.02 basic earnings per share) compared to pro forma net income of $441 million ($1.57 basic earnings per share) for the comparable period in 1997. The increase in adjusted net income is due to the $80 million after-tax gain on the sale of an investment in an Argentine electric utility system and increased equity earnings at International, and increased earnings of the Company's non-rate regulated power generation business. These factors were partially offset by decreased operating income at Natural Gas Distribution due to warmer weather in 1998 as compared to 1997. The decrease in income taxes in the nine month period ended September 30, 1998, is primarily attributable to the tax benefit associated with the unrealized accounting loss related to the ACES.

## RESULTS OF OPERATIONS BY BUSINESS SEGMENT

The following table presents operating income on (i) an actual basis for the three and nine month periods ended September 30, 1998 and 1997 and (ii) a pro forma basis for the three and nine month periods ended September 30, 1997 (assuming the NorAm acquisition had occurred on January 1, 1997) for each of the Company's business segments (other than Electric Operations, which is presented on an actual basis for all reported periods).

OPERATING INCOME (LOSS) BY BUSINESS SEGMENT

| | THREE MONTHS ENDED SEPTEMBER 30, | | |
|---|---|---|---|
| | 1998 | 1997 | 1997 |
| | (ACTUAL) | (ACTUAL) (IN MILLIONS) | (PRO FORMA)(1) |
| Electric Operations | $ 419 | $ 457 | $ 457 |
| Natural Gas Distribution | (20) | (6) | (15) |
| Interstate Pipeline | 27 | 14 | 20 |
| Energy Marketing | 7 | 5 | |
| International | 14 | 6 | 6 |
| Corporate | 59 | (13) | (19) |
| Total Consolidated | $ 506 | $ 463 | $ 449 |

| | NINE MONTHS ENDED SEPTEMBER 30, | | |
|---|---|---|---|
| | 1998 | 1997 | 1997 |
| | (ACTUAL) | (ACTUAL) (IN MILLIONS) | (PRO FORMA)(1) |
| Electric Operations | $ 855 | $ 883 | $ 883 |
| Natural Gas Distribution | 75 | (6) | 92 |
| Interstate Pipeline | 92 | 14 | 81 |
| Energy Marketing | 11 | 5 | 4 |
| International | 176 | 14 | 12 |
| Corporate | 38 | (44) | (56) |
| Total Consolidated | $ 1,247 | $ 866 | $ 1,016 |

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(1) Pro forma adjustments give effect to purchase-related adjustments, including amortization of goodwill and the revaluation of the fair market value of certain NorAm assets and liabilities since the Acquisition Date.

ELECTRIC OPERATIONS

Electric Operations activities are conducted under the name "Houston Lighting & Power Company" or "HL&P" (HL&P), an unincorporated division of the Company. Electric Operations provides electric generation, transmission, distribution and sales to approximately 1.6 million customers in a 5,000 square mile area on the Texas Gulf Coast, including Houston (the nation's fourth largest city).

The following table provides summary data regarding the results of operations of Electric Operations, including operating statistics, for the three and nine month periods ended September 30, 1998 and 1997.

| | THREE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | 1997 (ACTUAL) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Base Revenues (1) | $ 959 | $ 918 | 4% |
| Transmission Revenues | 27 | 19 | 42% |
| Reconcilable Fuel Revenues (2) | 430 | 450 | (4%) |
| Operating Expenses: | | | |
| Fuel | 361 | 366 | (1%) |
| Purchased Power | 85 | 99 | (14%) |
| Operation and Maintenance | 265 | 246 | 8% |
| Depreciation and Amortization | 209 | 151 | 38% |
| Other Taxes | 77 | 68 | 13% |
| Operating Income | $ 419 | $ 457 | (8%) |
| Electric Sales (MWH): | | | |
| Residential | 7,971,198 | 7,191,954 | 11% |
| Commercial | 4,860,627 | 4,593,227 | 6% |
| Industrial - Firm | 7,018,296 | 6,671,742 | 5% |
| Municipal & Public Utilities | 95,204 | 81,076 | 17% |
| Total Firm Billed Sales | 19,945,325 | 18,537,999 | 8% |
| Average Cost of Fuel (Cents/MMBtu) | 173.4 | 190.9 | (9%) |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | 1997 (ACTUAL) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Base Revenues (1) | $ 2,274 | $ 2,160 | 5% |
| Transmission Revenues | 70 | 64 | 9% |
| Reconcilable Fuel Revenues (2) | 1,100 | 1,062 | 4% |
| Operating Expenses: | | | |
| Fuel | 856 | 833 | 3% |
| Purchased Power | 291 | 279 | 4% |
| Operation and Maintenance | 723 | 690 | 5% |
| Depreciation and Amortization | 524 | 412 | 27% |
| Other Taxes | 195 | 189 | 3% |
| Operating Income | $ 855 | $ 883 | (3%) |
| Electric Sales (MWH): | | | |
| Residential | 16,043,238 | 14,839,034 | 8% |
| Commercial | 12,182,317 | 11,597,494 | 5% |
| Industrial - Firm | 20,160,044 | 19,377,067 | 4% |
| Municipal & Public Utilities | 253,113 | 239,531 | 6% |
| Total Firm Billed Sales | 48,638,712 | 46,053,126 | 6% |
| Average Cost of Fuel (Cents/MMBtu) | 176.7 | 184.2 | (4%) |

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(1) Includes miscellaneous revenues, certain non-reconcilable fuel revenues and certain purchased power-related revenues.

(2) Includes revenues collected through a fixed fuel factor and surcharge, net of over/under recovery. See below.

For the three month and nine month periods ended September 30, 1998, Electric Operations' operating income decreased $38 million and $28 million, respectively, below operating income for the same periods of 1997. The decrease in operating income is due to (i) additional depreciation of the South Texas Project Electric Generating Station of $91 million and $171 million for the three month and nine month periods ended September 30, 1998 (which is $78 million and $133 million more than recorded during the same periods in 1997), (ii) the implementation of transition to competition base rate credits beginning January 1, 1998 and (iii) increases in operating expenses. These factors were partially offset by increased sales as a result of unusually hot weather in 1998.

HL&P's earnings are capped at an overall rate of return on a calendar year basis as part of its transition to competition plan (Transition Plan) approved by the Public Utility Commission of Texas (Texas Utility Commission) in June 1998. As a result of this plan, any earnings above the maximum allowed return cap of 9.844 % on invested capital will be offset by additional depreciation of HL&P's generation assets. For information regarding the Transition Plan, see Note 10(a) to the Company's Interim Financial Statements.

Electric Operations' increase in base revenues of $41 million and $114 million for the three month and nine month periods ended September 30, 1998, respectively, compared to the same periods of 1997, is primarily the result of unusually hot weather, net of base rate credits implemented under the Transition Plan. The base rate credits lowered base revenues by $28 million and $56 million for the three and nine months ended September 30, 1998.

Transmission revenues include revenues collected through a pricing and billing mechanism implemented by the Texas Utility Commission for wholesale transmission services within the Electric Reliability Council of Texas (ERCOT). Electric Operations began recording these revenues and associated expenses in the second quarter of 1997. For the three and nine month periods ended September 30, 1998, transmission revenues of $27 million and $70 million, respectively, were offset by transmission expenses of $29 million and $73 million, respectively. For the three and nine month periods ended September 30, 1997, transmission revenues of $19 million and $64 million, respectively, were offset by transmission expenses of $22 million and $66 million, respectively. For information regarding transmission revenues, see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company -- Certain Factors Affecting Future Earnings of the Company and its Subsidiaries--Competition--Electric Operations -- Competition in Wholesale Market" in the Company's Form 10-K.

Fuel revenues include revenues generated by a fixed fuel factor established by the Texas Utility Commission and included in electric rates to permit the Company to recover certain fuel and purchased power costs. The fixed fuel factor is established during general rate proceedings or periodic fuel factor proceedings and is generally effective for a minimum of six months. Since reconcilable fuel revenues are adjusted monthly to equal expenses, fuel revenues and expenses have no effect on earnings unless the Texas Utility Commission subsequently determines that a utility's fuel costs are not recoverable.

In January 1998, Electric Operations filed a fuel reconciliation for the three year period ending July 1997 covering approximately $3.5 billion of eligible fuel expenses. On October 15, 1998, Electric Operations and all other parties in this proceeding filed with the Texas Utility Commission an Unanimous Stipulation resolving all fuel reconciliation issues. This case is pending final approval and is not expected to have a material effect on Electric Operations' results of operations.

In April 1998, Electric Operations filed a petition to revise the fixed fuel factor and implement a surcharge for under-collected fuel costs. The Texas Utility Commission approved implementation of the revised fixed fuel factor and a fuel surcharge in the amount of $125 million (inclusive of the previously existing fuel surcharge balance) to be collected over a 12 to 18 month period. The revised fixed fuel factor implemented July 1, 1998 is $0.019 compared to $0.017 fixed factor in place since 1995. As of September 30, 1998, Electric Operations' cumulative under-recovery of fuel costs was $182 million, including interest. For information regarding the recovery of fuel costs, see "Business - Electric Operations - Fuel - Recovery of Fuel Costs" in Item 1 of the Company's Form 10-K.

Fuel and purchased power expenses for the three month and nine month periods ended September 30, 1998 decreased by $19 million or 4% and increased by $35 million or 3%, respectively, compared to the same periods in 1997. The three month period decrease was driven by a decline in the cost of natural gas (from $2.43 to $2.08 per MMBtu), coal (from $1.98 to $1.82 per MMBtu), and nuclear fuel (from $0.53 to $0.48 per MMBtu), net of an increase in the production of electricity. The 3% increase for the nine months ended September 30, 1998 is due primarily to increased production of electricity, net of an overall decrease in the average price of fuel and purchased power. See Note 12(c) to the Company's 10-K Financial Statements for information on Electric Operations' joint dispatching agreement with the City of San Antonio for purchased power.

Operations and maintenance expenses for the three months ended September 30, 1998, increased $19 million compared to the same period in 1997 due primarily to (i) ERCOT transmission tariffs discussed above, (ii) increased liabilities associated with benefit plans and (iii) increased franchise taxes due to higher KWH sales.

For the nine month period ended September 30, 1998, operation and maintenance expense increased $33 million, due primarily to the items mentioned above, along with the scheduling of routine plant maintenance and inspection outages, additional tree-trimming activities and franchise taxes due to higher KWH sales.

NATURAL GAS DISTRIBUTION

Natural Gas Distribution operations are conducted through the Arkla, Entex and Minnegasco divisions of NorAm. These operations consist of natural gas sales to, and natural gas transportation for, residential, commercial and certain industrial customers in six states: Arkansas, Louisiana, Minnesota, Mississippi, Oklahoma and Texas.

The following table provides summary data regarding the results of operations of Natural Gas Distribution, including operating statistics, on an actual basis for the third quarter and nine month periods ended September 30, 1998 and on a pro forma basis for the third quarter and nine month periods ended September 30, 1997 (as if the acquisition of NorAm had occurred as of January 1, 1997).

| | THREE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | THREE MONTHS ENDED SEPTEMBER 30, 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 249 | $ 272 | (8%) |
| Operating Expenses: | | | |
| Natural Gas | 126 | 145 | (13%) |
| Operation and Maintenance | 91 | 90 | 1% |
| Depreciation and Amortization | 33 | 31 | 6% |
| Other Operating Expenses | 19 | 21 | (10%) |
| Total Operating Expenses | 269 | 287 | (6%) |
| Operating Loss | $ (20) | $ (15) | (33%) |
| Throughput Data (in Bcf): | | | |
| Residential and Commercial Sales | 31 | 32 | (3%) |
| Industrial Sales | 14 | 14 | -- |
| Transportation | 9 | 9 | -- |
| Total Throughput | 54 | 55 | (2%) |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | NINE MONTHS ENDED SEPTEMBER 30, 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 1,281 | $ 1,490 | (14%) |
| Operating Expenses: | | | |
| Natural Gas | 757 | 948 | (20%) |
| Operation and Maintenance | 282 | 283 | -- |
| Depreciation and Amortization | 97 | 92 | 5% |
| Other Operating Expenses | 70 | 75 | (7%) |
| Total Operating Expenses | 1,206 | 1,398 | (14%) |
| Operating Income | $ 75 | $ 92 | (18%) |
| Throughput Data (in Bcf): | | | |
| Residential and Commercial Sales | 200 | 220 | (9%) |
| Industrial Sales | 42 | 42 | -- |
| Transportation | 32 | 31 | 3% |
| Total Throughput | 274 | 293 | (6%) |

Natural Gas Distribution's operating loss increased $5 million in the third quarter of 1998, over its $15 million pro forma operating loss in the same period of 1997. The third quarter of 1997 included approximately $4 million non-recurring income recorded in connection with the successful appeal of the Minnegasco division's 1993 and 1995 rate cases.

Operating income for the nine month period ended September 30, 1998 decreased $17 million compared to pro forma operating income in the same period of 1997. The $17 million decrease in operating income is due primarily to (i) milder winter weather in the first three months of 1998, (ii) the impact in 1997 of the Minnegasco division's rate case appeal as discussed above and (iii) lower demand for natural gas heating in the second and third quarters of 1998. The decrease in operating income was partially offset by reduced charges at Arkla associated with the methodology of calculating the price of gas charged to customers (the Purchased Gas Adjustment).

Natural Gas Distribution operating revenues decreased $23 million and $209 million for the third quarter and nine months ended September 30, 1998, respectively, compared to pro forma operating revenues for the corresponding periods of 1997 due principally to (i) the weather-related decline in customer usage and (ii) lower natural gas prices. In addition, the impact in 1997 of the Minnegasco division's rate case appeal (as discussed above) also resulted in higher revenues in 1997 compared to 1998.

Operating expenses decreased $18 million and $192 million in the third quarter and nine months ended September 30, 1998, respectively, compared to pro forma operating expenses in the same period of 1997 due primarily to the reduced cost of gas and the Purchased Gas Adjustment.

Demand for natural gas distribution services is seasonal in nature, reflecting the higher demand for natural gas for use in heating in the winter months.

INTERSTATE PIPELINE

Interstate Pipeline operations are conducted primarily through NorAm Gas Transmission Company (NGT) and Mississippi River Transmission Corporation (MRT), two wholly owned subsidiaries of NorAm. The NGT system consists of approximately 6,200 miles of natural gas transmission lines located in portions of Arkansas, Kansas, Louisiana, Mississippi, Missouri, Oklahoma, Tennessee and Texas. The MRT system consists of approximately 2,000 miles of pipeline serving principally the greater St. Louis area in Missouri and Illinois.

The following table provides summary data regarding the results of operations of Interstate Pipeline, including operating statistics, on an actual basis for the third quarter and nine months ended September 30, 1998 and on a pro forma basis for third quarter and nine months ended September 30, 1997 (as if the acquisition of NorAm had occurred as of January 1, 1997).

| | THREE MONTHS ENDED SEPTEMBER 30, | | |
|---|---|---|---|
| | 1998 (ACTUAL) | 1997 (PRO FORMA) | PERCENT CHANGE |
| | (IN MILLIONS) | | |
| Operating Revenues | $ 70 | $ 67 | 4% |
| Operating Expenses: | | | |
| Natural Gas | 6 | 10 | (40%) |
| Operation and Maintenance | 20 | 20 | -- |
| Depreciation and Amortization | 13 | 13 | -- |
| Other Operating Expenses | 4 | 4 | -- |
| Total Operating Expenses | 43 | 47 | (9%) |
| Operating Income | $ 27 | $ 20 | 35% |
| Throughput Data (in million MMBtu): | | | |
| Natural Gas Sales | 4 | 4 | -- |
| Transportation | 186 | 205 | (9%) |
| Elimination (1) | (4) | (4) | -- |
| Total Throughput | 186 | 205 | (9%) |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | NINE MONTHS ENDED SEPTEMBER 30, 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 218 | $ 226 | (4%) |
| Operating Expenses: | | | |
| Natural Gas | 22 | 29 | (24%) |
| Operation and Maintenance | 60 | 66 | (9%) |
| Depreciation and Amortization | 32 | 39 | (18%) |
| Other Operating Expenses | 12 | 11 | 9% |
| Total Operating Expenses | 126 | 145 | (13%) |
| Operating Income | $ 92 | $ 81 | 14% |
| Throughput Data (in million MMBtu): | | | |
| Natural Gas Sales | 12 | 14 | (14%) |
| Transportation | 610 | 667 | (9%) |
| Elimination (1) | (11) | (13) | 15% |
| Total Throughput | 611 | 668 | (9%) |

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(1) Elimination refers to volumes of natural gas both transported and sold by Interstate Pipeline and, therefore, excluded from total throughput.

Interstate Pipeline operating income increased $7 million and $11 million in the third quarter and nine months ended September 30, 1998, respectively, over pro forma operating income for the same periods in 1997. The increase in operating income for the third quarter of 1998 is primarily due to improved operating margins and reductions in the cost of natural gas, as discussed below. The increase in operating income for the nine month period of 1998 is primarily due to $11 million of pre-tax non-recurring items recorded in 1998 for litigation and rate case settlements as well as improved operating margins and reductions in operating expenses. The increase in operating income in the nine month period ended September 30, 1998 was offset by $7 million of non-recurring transportation revenues recorded in the first quarter of 1997, as discussed below.

Operating revenues for Interstate Pipeline increased $3 million in the third quarter of 1998, over pro forma operating revenues for the same period in 1997. This increase in operating revenues is primarily due to a weather-related demand for natural gas used to fuel electric generation plants during the summer cooling season.

Operating revenues decreased $8 million in the nine month period ended September 30, 1998, from pro forma operating revenues for the same period in 1997. The decrease in revenues is due in part to $7 million of non-recurring transportation revenues recognized in the first quarter of 1997. These revenues were recognized following a settlement with the Arkla division of NorAm related to service provided in several of Arkla's operating jurisdictions. In addition, the settlement with Arkla resulted in reduced transportation rates, which also reduced revenues for the period. These decreases were partially offset by (i) the settlement of outstanding gas purchase contract litigation which resulted in the recognition of approximately $6 million of revenues in the second quarter of 1998 and (ii) the factors discussed above for the third quarter.

Natural gas expense decreased $4 million and $7 million in the third quarter and nine months ended September 30, 1998, respectively, when compared to pro forma natural gas expense in the same periods in 1997 primarily due to lower gas sales volumes and lower prices for purchased gas.

Operation and maintenance expense decreased $6 million in the nine months ended September 30, 1998, respectively, in comparison to pro forma operation and maintenance expense for the same period in 1997. The decrease was primarily due to lower costs resulting from cost control initiatives and decreased maintenance due to milder weather in the first quarter of 1998.

Depreciation expense decreased $7 million in the nine month period ended September 30, 1998, compared to pro forma depreciation expense in the same period of 1997 primarily due to a $5 million rate settlement recorded in the first quarter of 1998. The rate settlement, effective January 1998, provided for a reduction of MRT's depreciation rates retroactive to July 1996.

ENERGY MARKETING

Energy Marketing includes the operations of NorAm's wholesale energy trading and marketing business, and retail energy marketing business and natural gas gathering activities of NorAm (conducted, respectively, by NorAm Energy Services, Inc. (NES), NorAm Energy Management, Inc. and NorAm Field Services Corp., three wholly owned subsidiaries of NorAm).

The following table provides summary data regarding the results of operations of Energy Marketing, including operating statistics, on an actual basis for the third quarter and nine months ended September 30, 1998 and on a pro forma basis for the third quarter and nine months ended September 30, 1997 (as if the acquisition of NorAm had occurred as of January 1, 1997).

| | THREE MONTHS ENDED SEPTEMBER 30, | | PERCENT |
|---|---|---|---|
| | 1998 | 1997 | CHANGE |
| | (ACTUAL) | (PRO FORMA) | |
| | (IN MILLIONS) | | |
| Operating Revenues | $ 1,642 | $ 842 | 95% |
| Operating Expenses: | | | |
| Natural Gas | 687 | 587 | 17% |
| Purchased Power | 906 | 220 | 312% |
| Operation and Maintenance | 36 | 31 | 16% |
| Depreciation and Amortization | 4 | 3 | 33% |
| Other Operating Expenses | 2 | 1 | 100% |
| Total Operating Expenses | 1,635 | 842 | 94% |
| Operating Income (Loss) | $ 7 | $ -- | -- |
| Operations Data: | | | |
| Natural Gas (in Bcf): | | | |
| Sales | 364 | 284 | 28% |
| Transportation | 3 | 5 | (40%) |
| Gathering | 60 | 60 | -- |
| Total | 427 | 349 | 22% |
| Electricity: | | | |
| Wholesale Power Sales (in thousand MWH) | 22,353 | 8,099 | 176% |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | NINE MONTHS ENDED SEPTEMBER 30, 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 3,731 | $ 2,535 | 47% |
| Operating Expenses: | | | |
| Natural Gas | 2,012 | 2,022 | -- |
| Purchased Power | 1,604 | 429 | 274% |
| Operation and Maintenance | 89 | 69 | 29% |
| Depreciation and Amortization | 10 | 8 | 25% |
| Other Operating Expenses | 5 | 3 | 67% |
| Total Operating Expenses | 3,720 | 2,531 | 47% |
| Operating Income | $ 11 | $ 4 | 175% |
| Operations Data: | | | |
| Natural Gas (in Bcf): | | | |
| Sales | 1,013 | 878 | 15% |
| Transportation | 16 | 17 | (6%) |
| Gathering | 175 | 182 | (4%) |
| Total | 1,204 | 1,077 | 12% |
| Electricity: | | | |
| Wholesale Power Sales (in thousand MWH) | 52,471 | 17,660 | 197% |

Energy Marketing's operating income increased $7 million for both the three and nine months ended September 30, 1998 over pro forma operating income for the same periods in 1997. The increase in third quarter operating income primarily reflects increased margins and sales volumes at NES for the third quarter of 1998 compared to the same period of 1997. This increase was partially offset by higher operating expenses as discussed below. Operating income for the nine months ended September 30, 1997 included $17 million in hedging losses associated with sales under peaking contracts and losses from the sale of natural gas held in storage and unhedged in the first quarter of 1997.

Operating revenues for Energy Marketing increased $800 million and $1.2 billion for the third quarter and nine months ended September 30, 1998, respectively, when compared to the same periods in 1997 due primarily to increases in wholesale power sales of $692 million and $1.2 billion in the third quarter and nine month periods of 1998, respectively. The increases in operating revenues and wholesale power sales were due to increased trading activity in 1998.

Natural gas expenses increased $100 million for the third quarter of 1998, compared to the same period of 1997. This increase is attributable to increased gas marketing activities, partially offset by a decrease in the price of natural gas. In the nine months ended September 30, 1998, natural gas expenses decreased $10 million when compared to the same period of 1997. This decrease is due to the reduction in the price of natural gas in 1998 and the impact of hedging losses in 1997 mentioned above, partially offset by increased gas marketing activities.

Purchased power expenses increased $686 million and $1.2 billion for the third quarter and nine months ended September 30, 1998, respectively, compared to the same periods in 1997 due to increased power marketing activities.

Operation and maintenance expenses increased $5 million and $20 million for the third quarter and nine months ended September 30, 1998, respectively, when compared to 1997 pro forma operation and maintenance expenses for the same periods in 1997. This increase is largely due to increased staffing in support of the expanded trading and marketing efforts at NES. The Company believes that NES' energy trading, marketing and risk management services complement the development and/or acquisition of non-rate regulated generation assets in other markets. As a result, the Company has made, and expects to continue to make, significant investments in developing NES' internal software, trading and personnel resources. The increase in operation and maintenance expenses for the nine month period ended September 30, 1998 is also due to a $4 million expense associated with an increase in reserves due to increased counter party credit and performance risk associated with higher prices and higher volatility in the electric power market in the second quarter of this year.

To minimize fluctuations in the price of natural gas and transportation, the Company, primarily through NES, enters into futures transactions, swaps and options in order to hedge against market price changes affecting (i) certain commitments to buy, sell and transport natural gas, (ii) existing gas storage inventory and (iii) certain anticipated transactions, some of which carry off-balance sheet risk. NES also enters into natural gas derivatives for trading purposes and electricity derivatives for hedging and trading purposes. For a discussion about the Company's accounting treatment of derivative instruments, see Note 2 to the Company's 10-K Financial Statements, Item 7A (Quantitative and Qualitative Disclosure About Market Risk) in the Form 10-K.

INTERNATIONAL

International includes the results of operations of HI Energy, a wholly owned subsidiary of the Company that participates in the development and acquisition of foreign independent power projects and the privatization of foreign generation and distribution facilities, and the international operations of NorAm. Substantially all of International's operations to date have been in Central and South America.

Results of operations data for International are presented in the following table on an actual basis for the third quarter and nine months ended September 30, 1998, and on a pro forma basis for the third quarter and nine months ended September 30, 1997, as if the NorAm acquisition had occurred on January 1, 1997. The primary pro forma adjustment gives effect to project development costs and other expenditures incurred by NorAm prior to the Acquisition Date. The adjustment had no effect on operating revenues.

| | THREE MONTHS ENDED SEPTEMBER 30, | | PERCENT |
|---|---|---|---|
| | 1998 | 1997 | CHANGE |
| | (ACTUAL) | (PRO FORMA) | |
| | (IN MILLIONS) | | |
| Operating Revenues ............................ | $ 32 | $ 21 | 52% |
| Operating Expenses: | | | |
| Fuel ....................................... | 5 | 4 | 25% |
| Operation and Maintenance ................... | 12 | 10 | 20% |
| Depreciation and Amortization ............... | 1 | 1 | -- |
| Total Operating Expenses ................ | 18 | 15 | 20% |
| Operating Income .............................. | $ 14 | $ 6 | 133% |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 229 | $ 61 | 275% |
| Operating Expenses: | | | |
| Fuel | 15 | 16 | (6%) |
| Operation and Maintenance | 35 | 32 | 9% |
| Depreciation and Amortization | 3 | 1 | 200% |
| Total Operating Expenses | 53 | 49 | 8% |
| Operating Income | $ 176 | $ 12 | 1,367% |

International's operating income increased $8 million and $164 million for the third quarter and nine months ended September 30, 1998, respectively, compared to pro forma operating income for the same periods in 1997. The increase in operating income in the nine month period is due primarily to the $138 million pre-tax gain on the sale of International's 63 percent interest in Empresa Distribuidora de La Plata S.A. (EDELAP). Excluding the sale of its investment in EDELAP, International's operating income for the nine months ended September 30, 1998 would have been $38 million (compared to $12 million on a pro forma basis in the prior period). The increases in operating income for the third quarter and nine month period ended September 30, 1998 reflect increased equity earnings from International's investments. HI Energy's 1998 acquisitions, which include equity interests in three distribution systems in El Salvador and two distribution systems in Colombia have contributed to these increases.

For information regarding recent acquisitions and dispositions by International, see Note 12(a) to the Company's Interim Financial Statements and Note 10(a) to the Company's Interim Financial Statements in the Second Quarter 10-Q. For information regarding foreign currency matters, see Note 4 to the Company's Interim Financial Statements and "--Certain Factors Affecting Future Earnings of the Company and its Subsidiaries - Risks of International Operations." For information regarding International's investment strategies, see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company -- Results of Operations by Business Segment -- International" in the Form 10-K.

CORPORATE

General. The Company's corporate and other business segment (Corporate) includes corporate costs, certain of the Company's real estate holdings and inter-unit eliminations. In addition, Corporate includes the results of operations of (i) Houston Industries Power Generation, Inc. (HIPG, Inc.), a wholly owned subsidiary of the Company, which is engaged in the acquisition, development and operation of domestic non-rate regulated power generation facilities, and (ii) the Company's consumer and retail customer services operations. The Company's consumer and retail customer services operations provide energy products and services to a variety of industrial and commercial and residential customers, including energy efficiency services and air-conditioning services.

In the third quarter of 1998, Corporate had operating income of $59 million compared to a pro forma operating loss of $19 million for the comparable period in 1997. Corporate's operating income for the nine month period ended September 30, 1998, was $38 million compared to a pro forma operating loss of $56 million for the same period in 1997. The increases are primarily due to earnings from HIPG, Inc.'s investment in non-rate regulated generating assets and related trading and marketing activities. Also contributing to the increase for the nine month period ended September 30, 1998 are the capitalization of previously expensed development costs and non-recurring costs associated with the 1997 irrevocable contribution of 450,000 shares of Time Warner common stock (having a market value of $21.9 million and a book value of $19.5 million) to a charitable foundation established by the Company.

HIPG, Inc. HIPG, Inc. participates in the domestic independent power markets through the acquisition of existing power plants and the development of new power plants (greenfield projects). HIPG, Inc.'s business strategy is to develop a commercial generation portfolio that complements the Company's other operations, including the electric and natural gas trading and marketing operations of NES.

In April 1998, HIPG, Inc. acquired four natural gas-fired, electric generating plants (2,276 MW) from Southern California Edison Company (SCE) for approximately $230 million. In July 1998, HIPG, Inc. acquired another generating plant (1,500 MW) from SCE for approximately $43 million. All of the plants are located in southern California. Certain units of the plants have been designated as "must-run facilities" under California's Independent System Operator's (ISO) electric restructuring law. These units operate, in part, under agreements that allow the ISO to call upon them to provide voltage support, congestion management and ancillary services. NES, an affiliate of HIPG, Inc., is acting as the plants' exclusive power marketer and supplier of natural gas. In accordance with the provisions of the asset sale agreements, HIPG, Inc. was required to contract with SCE to operate and maintain the plants with existing plant employees through April 2000. HIPG, Inc. however exercises management authority over the plants' operations. HIPG, Inc. financed the purchase price of these generating plants with intercompany advances. The funds for such advances were obtained by a financing subsidiary of the Company under a $150 million bridge loan and from the issuance of commercial paper at a financing subsidiary. For information regarding the bridge loan, see Note 8(b) to the Company's First Quarter 10-Q and Note 8(b) to the Company's Interim Financial Statements.

HIPG, Inc., through its subsidiaries, is currently developing the following power projects: a 480 MW gas-fired merchant plant located in Boulder City, Nevada (El Dorado Project) and a 100 MW cogeneration plant located in Orange, Texas (Sabine Cogeneration Project). HIPG, Inc. owns a 50% interest in each of these projects. Construction of the El Dorado Project began in April 1998, and construction of the Sabine Cogeneration Project began in November 1998. The projected completion date for the El Dorado Project and the Sabine Cogeneration Project is the fourth quarter of 1999. In October 1998, the El Dorado Project obtained a $158 million non-recourse loan representing approximately 60% of the estimated total project cost. As of September 30, 1998, capitalized costs for these projects under construction or under development were approximately $46 million.

For information regarding expenditures made or to be made by HIPG, Inc. under existing commitments, see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company -- Results of Operations by Business Segment - Corporate" in the Company's Interim Financial Statements in the First Quarter 10-Q.

The Company expects that HIPG, Inc. will continue to participate actively in non-rate regulated power projects, including "greenfield" projects, competitive auctions, and other acquisitions of generation assets. The amount of expenditures associated with these activities is dependent upon the nature and extent of future project commitments; however, some of these expenditures could be substantial. HIPG, Inc. intends to finance a portion of its non-rate regulated power projects through the proceeds from project financings (financings where lenders limit their recourse for the payment of amounts loaned to a project's revenues, equity investment and physical assets), and through equity investment and loans from the Company.

The successful completion of "greenfield" and other non-rate regulated power projects is dependent upon a number of factors, which include, among other things, risks associated with failures of siting, financing, construction, permitting, governmental approvals, termination of power sales contracts (if any) as a result of a failure to meet certain construction milestones and the uncertainties arising from the gradual deregulation of HIPG Inc.'s markets. Many of the facilities being acquired or developed by HIPG, Inc. are "merchant plants" without a dedicated offtake customer and such facilities are sensitive to market and regulatory factors and other considerations.

CERTAIN FACTORS AFFECTING FUTURE EARNINGS
OF THE COMPANY AND ITS SUBSIDIARIES

For information on developments, factors and trends that may have an impact on the Company's future earnings, reference is made to Item 7 of the Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company--Certain Factors Affecting Future Earnings of the Company and its Subsidiaries."

RATE PROCEEDINGS -- ELECTRIC OPERATIONS

The Texas Utility Commission has jurisdiction (or, in some cases, appellate jurisdiction) over the electric rates of Electric Operations and, as such, monitors Electric Operations' earnings to ensure that Electric Operations is not earning in excess of a reasonable rate of return. For information regarding the Transition Plan and the pending appeal, of the Texas Utility Commission's order implementing the Transition Plan, see Note 10(a) to the Company's Interim Financial Statements.

ACCOUNTING TREATMENT OF ACES

The Company accounts for its investment in TW Preferred under the cost method. As a result of the Company's issuance of the ACES, certain increases in the market value of Time Warner common stock (the security into which the TW Preferred is convertible) could result in an accounting loss to the Company, pending the conversion of the Company's TW Preferred into Time Warner common stock. For additional information regarding the accounting treatment of the TW Preferred, see Note 6 to the Company's Interim Financial Statements.

RISKS OF INTERNATIONAL OPERATIONS

HI Energy's international operations are subject to various risks incidental to operating in emerging market countries. These risks include political risks, such as governmental instability, and economic risks, such as fluctuations in currency exchange rates, restrictions on the repatriation of foreign earnings and/or restrictions on the conversion of local currency earnings into U.S. dollars. HI Energy's international operations are also highly capital intensive and thus, dependent to a significant extent on the continued availability of bank financing and other sources of capital on commercially acceptable terms.

The devaluation of a country's local currency can generally be expected to result in an increase in the inflation rates of that country. The long-term concession contracts under which HI Energy's foreign electric distribution companies operate contain mechanisms for adjusting electricity tariffs (Adjustments) to reflect changes in operating costs resulting from inflation; however, these Adjustments are made only at specified intervals or, in certain cases, on an interim basis upon application to the local regulatory authorities. None of these Adjustments are indexed to the U.S. dollar or other non-local currencies.

Assuming that a devaluation in local currency will be reflected in an increase in the local rate of inflation and assuming that an adjustment to tariff rates is made promptly to reflect such increase, the Company believes that the results of operations of its foreign electric distribution companies should be protected, at least in part, from the effects of fluctuations in currency exchange rates. If, however, there was a significant delay in the implementation of the tariff adjustments or the economic impact of the devaluation was not completely reflected in increased inflation rates, a devaluation of local currencies could have an adverse impact on the results of operations of these companies, and to the extent of the Company's ownership interests in such companies, the Company's consolidated earnings. Depending on the length of such delays and the severity of such devaluation, such impact could be material.

HI Energy owns approximately 11.7% of the stock of Light -- Servicos de Eletricidade S.A. (Light) and, through its investment in Light, an approximate 8.8% indirect interest in the stock of Metropolitana Eletricidade de Sao Paulo S.A. (Metropolitana). Light and Metropolitana are each Brazilian corporations. Light provides electric distribution services to the city of Rio de Janeiro and surrounding areas, and Metropolitana provides electric distribution services to the metropolitan area of Sao Paulo, Brazil. The Company accounts for its investment in Light under the equity method of accounting and records its proportionate share, based on stock ownership, in the net income of Light and its affiliates (including Metropolitana) as part of the Company's consolidated net income.

At September 30, 1998, Light and Metropolitana had incurred, respectively, $2.1 billion and $1.1 billion in U.S. and other non-local currency denominated bank debt. In the event of a devaluation of the Brazilian real, the Company believes that Light and Metropolitana would record a charge to their quarterly earnings equal to the increase in the liability resulting from such devaluation. This charge to earnings would be in addition to whatever other economic impact on Light and Metropolitana might result from such devaluation. Because the Company uses the Brazilian real as the functional currency in which it reports Light's equity earnings, the resulting decrease in Light's earnings would also be reflected in the Company's consolidated earnings to the extent of the Company's 11.7% ownership interest in Light.

Although certain of HI Energy's other foreign electric distribution companies have incurred U.S. dollar and other non-local currency indebtedness (approximately $73 million at September 30, 1998), the Company believes, based on the current amount of such indebtedness and the relative size of these equity investments to the Company's overall results of operations, that a devaluation of these currencies would not have a material adverse impact on the Company's consolidated earnings.

Based on information provided by Light, the Company estimates that approximately $980 million of Light's U.S. and non-local currency denominated bank debt will mature in the second quarter of 1999 (of which $875 million represents short-term U.S. dollar indebtedness incurred in connection with Light's acquisition of Metropolitana). The Company further estimates that approximately $595 million of Metropolitana's U.S. and non-local currency denominated bank debt will mature in the second quarter of 1999 (of which $580 million represents short-term U.S. dollar denominated debt incurred to refinance Metropolitana's previously existing debt). In addition, approximately $130 million of Light's, and approximately $180 million of Metropolitana's U.S. dollar denominated commercial paper indebtedness, will mature in the first half of 1999. The ability of Light and Metropolitana to repay or refinance these debt obligations at maturity is dependent on many factors, including local and international economic conditions prevailing at the time such debt matures.

If current international and local economic conditions continue or deteriorate, it is possible that Light, Metropolitana and the other foreign electric distribution companies might encounter difficulties in refinancing their debt on terms and conditions that are commercially acceptable to them and their shareholders. In such circumstances, it is possible that lenders might seek to require, among other things, higher borrowing rates, additional equity contributions and/or increased levels of credit support from such shareholders, or that the availability or terms of refinancing such debt might otherwise be adversely affected.

IMPACT OF YEAR 2000 COMPUTER SOFTWARE ISSUES

Year 2000 Problem. At midnight on December 31, 1999, unless the proper modifications have been made, the program logic in many of the world's computer systems will start to produce erroneous results because, among other things, the systems will incorrectly read the date "01/01/00" as being January 1 of the year 1900 or another incorrect date. In addition, certain systems may fail to detect that the year 2000 is a leap year. Problems can also arise earlier than January 1, 2000, as dates in the next millennium are entered into non-compliant year 2000 programs.

Company's Plan to Address Year 2000 Problem. In 1997, the Company initiated a corporate wide year 2000 project to address mainframe application systems, information technology (IT) related equipment, system software, user-developed applications, building controls, and non-IT embedded systems such as process controls for energy production and delivery. Incorporated into this project were NorAm and other Company subsidiary mainframe applications, infrastructures, embedded systems and user-developed applications that will not be migrated into existing or planned Company systems prior to the year 2000. The evaluation of year 2000 issues included significant customers, key vendors, service suppliers and other parties material to the Company's operations. In the course of this evaluation, the Company has sought written assurances from such third parties as to their state of year 2000 readiness.

Company's State of Readiness. Work has been prioritized in accordance with business risk. The highest priority has been assigned to activities that would disrupt the physical delivery of energy; next are activities that would impact back office activities such as customer service and billing; and finally, the lowest priority has been assigned to activities that would cause inconvenience or productivity loss in normal business operations (e.g. air conditioning systems and elevators). All business units have completed an analysis of critical systems and equipment that control the production and delivery of energy, as well as corporate, departmental and personal systems and equipment.

Costs to Address Year 2000 Problem. Based on current internal studies, as well as recently solicited bids from various computer software vendors, the Company estimates that the total direct cost of resolving the year 2000 issue will be between $35 and $40 million. This estimate includes approximately $6 million related to salaries and expenses of existing employees and approximately $3 million in hardware purchases that the company expects to capitalize. In addition, the $35 to $40 million estimate includes approximately $2 million spent prior to 1998 and approximately $4 million expended through the end of the third quarter of 1998. The majority of the costs related to resolving the year 2000 issue are expected to be expended in 1999. The Company expects to fund these expenditures through internal capital resources.

In September 1997, the Company entered into an agreement with SAP America, Inc. (SAP) to license SAP proprietary R/3 enterprise software. The licensed software includes finance, human resources, materials management, service delivery, and customer care components. The Company's decision to license this software and purchase related computer hardware is part of its response to changes in the electric utility and energy services industries as well as changes in the Company's businesses and operations resulting from the acquisition of NorAm and the Company's expansion into the energy trading and marketing business. Although it is anticipated that the implementation of the SAP system will have the incidental effect of negating the need to modify many of the Company's computer systems to accommodate the year 2000 problem, the Company does not deem the costs of the SAP system as directly related to its year 2000 compliance program. The estimated cost of implementing the SAP system is approximately $182 million, inclusive of internal costs. For additional information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company -- Certain Factors Affecting Future Earnings of the Company and Its Subsidiaries -- Impact of the Year 2000 Issue and Other System Implementation Issues" in Item 7 of the Form 10-K.

Risks and Contingency Plans. The major applications which pose the greatest year 2000 risks for the Company if the year 2000 Project is not successful are the electric transmission and distribution automation system; the time in use, demand and recorder metering system for commercial and industrial customers; and the power billing system. The potential problems related to these systems are electric service interruptions to customers, interrupted revenue data gathering and poor customer relations resulting from delayed billing, respectively.

In order to assist in preparing for and mitigating the foregoing scenarios, the Company intends to complete all Year 2000 remediation and testing activity by the end of the third quarter of 1999. In addition, the Company has initiated Year 2000 communications with significant customers, key vendors, service suppliers and other parties material to the Company's operations and is diligently monitoring the progress of such third parties' Year 2000 projects. Notwithstanding the foregoing, the Company cautions that (i) the nature of testing is such that it cannot comprehensively address all future combinations of dates and events and (ii) it is impossible for the Company to assess with precision or certainty the compliance of third parties with Year 2000 remediation efforts. For these reasons, the Company intends to revise and expand its various disaster recovery, business continuation and emergency operations plans to address specific Year 2000 contingencies (including those discussed above) and alternatives in the event that Year 2000 failures of automatic systems and equipment occur. This contingency planning is still in the preliminary phase, however, final Year 2000 specific plans are scheduled to be completed prior to mid-year 1999. Due to the speculative and uncertain nature of contingency planning, there can be no assurance that such plans actually will be sufficient to reduce the risk of material impacts on the Company's operations due to Year 2000 issues.

Forward Looking Statements. The estimated costs of the Company's year 2000 project, the timetable for becoming year 2000 ready, as well as the implementation of the SAP system constitute "forward looking statements" as defined in the Private Securities Litigation Reform Act of 1995 (see Item 5 of this Form 10-Q). Investors are cautioned that such estimates are based on numerous assumptions by management, including assumptions regarding the continued availability of certain resources, the accuracy of representations made by third parties concerning their year 2000 readiness status, and other factors. The estimated year 2000 project costs also do not give effect to any future corporate acquisitions or divestitures made by the Company or its subsidiaries.

## LIQUIDITY AND CAPITAL RESOURCES

### COMPANY CONSOLIDATED SOURCES OF CAPITAL RESOURCES AND LIQUIDITY

Company. For the nine month period ended September 30, 1998, the Company's net cash provided by operating activities increased $228 million over the same period in 1997. The increase in net cash from operating activities is due primarily to (i) incremental cash flow provided by the business segments purchased in the NorAm acquisition and (ii) increased sales at Electric Operations due to unusually hot weather during the second and third quarter of 1998.

Net cash used in investing activities decreased $1 billion for the nine month period ended September 30, 1998, compared to the same period in 1997. The decline reflects the purchase price expended in 1997 for the NorAm acquisition. Investing activities for the nine month period ended September 30, 1998, included (i) the acquisition of non-rate regulated power generation projects and related project expenditures, (ii) the acquisition of investments in foreign electric distribution systems and (iii) the sale of an Argentine electric distribution company.

Net cash used in financing activities for the nine month period ended September 30, 1998, reflected a $367 million outflow compared to an inflow of $903 million in the same period in 1997. The cash inflow in 1997 included $1 billion in proceeds from the issuance of ACES and the proceeds from the issuance of $1.4 billion in commercial paper borrowings used to finance a portion of the cost of the NorAm acquisition. The proceeds from the ACES were used to retire $1 billion of commercial paper borrowings.

At September 30, 1998, the Company, exclusive of subsidiaries, had a revolving credit facility of $200 million used to support the issuance of up to $200 million of commercial paper. There were no commercial paper borrowings and no loans outstanding under this facility at September 30, 1998. In addition, at September 30, 1998, the Company had shelf registration statements providing for the future issuance, subject to market and other conditions, of $230 million aggregate liquidation value of its preferred stock and $580 million aggregate principal amount of its debt securities.

In January 1998, pollution control revenue refunding bonds aggregating $104.7 million, with $29.7 million bearing an interest rate of 5.25% and $75 million bearing an interest rate of 5.15%, were issued on behalf of the Company by the Matagorda County Navigation District Number One. The bonds will mature in 2029. Proceeds from the issuances were used in February 1998 to redeem, at 102% of the aggregate principal amount, pollution control revenue bonds aggregating $104.7 million.

In February 1998, pollution control revenue refunding bonds aggregating $290 million were issued on behalf of the Company by the Brazos River Authority (BRA). The bonds bear an interest rate of 5 1/8% and mature in May 2019 ($200 million) and November 2020 ($90 million). Proceeds from the issuances were used in May 1998 to redeem, at 102% of the aggregate principal amount, pollution control revenue bonds aggregating $290 million.

In September 1998, pollution control revenue refunding bonds aggregating $68.7 million were issued on behalf of the Company by the BRA. The bonds bear an interest rate of 4.90% and mature in October 2015. Proceeds from the issuance were used in October 1998 to redeem, at 102% of the aggregate principal amount, pollution control revenue bonds aggregating $68.7 million.

In the first quarter of 1999, $170.5 million of the Company's medium-term notes, series A, 9.8%-9.85%, will mature. The Company expects to fund these debt repayments with cash generated by operations, borrowings under other facilities and/or other capital sources.

For information about the Company's issuance of a notice to change the method of determining the interest rate on $118 million of outstanding pollution control revenue refunding bonds issued on behalf of the Company, see Note 12(b) to the Company's Interim Financial Statements.

NorAm. In February 1998, NorAm issued $300 million principal amount of 6.5% debentures due February 1, 2008. The proceeds from the sale of the debentures were used to repay short-term indebtedness of NorAm, including the indebtedness incurred in connection with the purchase of $101.4 million aggregate principal amount of its 10% debentures and the repayment of $53 million aggregate principal amount of NorAm debt that matured in December 1997 and January 1998.

In the first quarter of 1998, NorAm repaid at maturity $1 million of its 9.3% medium-term notes and satisfied the $6.5 million sinking fund requirement for its 6% convertible subordinated debentures due March 2012 using debentures purchased in 1996 and 1997. In the second quarter of 1998, NorAm repaid at maturity $28 million of medium-term notes carrying an average interest rate of 8.74%. In the third quarter of 1998, NorAm repaid at maturity $47 million of medium-term notes carrying an average interest rate of 8.74%. For information regarding these repayments, see Note 9(b) to the Company's Interim Financial Statements. During the third quarter of 1998, NorAm purchased $6 million aggregate principal amount of its 6% convertible subordinated debentures due 2012 at an average purchase price of 97.4% of the aggregate principal amount plus accrued interest. The purchased debentures are expected to be used to partially satisfy March 1999 and March 2000 sinking fund requirements.

In March 1998, NorAm replaced its $400 million revolving credit facility with a five-year $350 million revolving credit facility which supports NorAm's issuance of up to $350 million of commercial paper. Borrowings under the NorAm credit facility are unsecured. At September 30, 1998, NorAm had $205.6 million of outstanding commercial paper. At September 30, 1998, NorAm also had a $300 million trade receivables facility under which receivables of $300 million had been sold.

In November 1998, NorAm sold $500 million aggregate principal amount of its 6 3/8% Term Enhanced Remarketable Securities (TERM Notes). The net proceeds from the offering and from the related sale of an option to remarket the TERM Notes will be used for general corporate purposes, including the repayment of (i) a $178.5 million aggregate principal amount of NorAm's commercial paper and (ii) a $150 million term loan of NorAm, which matures in the fourth quarter of 1998. For additional information regarding the TERM Notes offering, see Note 12(c) to the Company's Interim Financial Statements.

Financing Subsidiaries. At September 30, 1998, Houston Industries FinanceCo LP's (FinanceCo) $1.6 billion revolving credit facility supported $1.3 billion in commercial paper borrowings having a weighted average interest rate of 5.89%. Proceeds from the initial issuances of commercial paper by FinanceCo in 1997 were used to fund the cash portion of the consideration paid to stockholders of the former NorAm Energy Corp. For additional information regarding the FinanceCo Facility, see Note 8(c) to the Company's 10-K Consolidated Financial Statements.

In March 1998, FinanceCo II, a limited partnership subsidiary of the Company, entered into a $150 million credit facility under which it had borrowed $150 million at September 30, 1998. Proceeds from borrowings under the facility were used to fund a portion of HIPG, Inc.'s April 1998 purchase of four electric generation plants. In August 1998, this facility's termination date was extended to December 31, 1998. For additional information regarding the facility, see Note 8(b) to the Company's Interim Financial Statements in the First Quarter 10-Q.

General. The Company has established a "money fund" through which its subsidiaries can borrow or invest on a short-term basis. The funding requirements of individual subsidiaries are aggregated, and borrowing or investing is based on the net cash position. The money fund's net funding requirements are generally met with commercial paper issued by a financing subsidiary.

The Company believes that its current level of cash and borrowing capability along with future cash flows from operations are sufficient to meet the needs of its existing businesses. However, to achieve its objectives, the Company may, when necessary, supplement its available cash resources by seeking funds in the equity or debt markets.

## NEW ACCOUNTING ISSUES

For calendar year 1998, the Company and NorAm will adopt SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS No. 131) and SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" (SFAS No. 132). SFAS No. 131 requires that companies report in their financial statements financial and descriptive information about reportable operating segments defined by reference to the way in which management reviews its operations in order to assess performance and allocate its resources. SFAS No. 132 revises employers' disclosures about pension and other post-retirement benefit plans.

In 2000, the Company and NorAm expect to adopt SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS No. 133). SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. The Company is in the process of determining the effect of adoption of SFAS No. 133.

For information regarding the Company's adoption, effective January 1, 1998, of SFAS No. 130, "Reporting Comprehensive Income," see Note 3 to the Company's Interim Financial Statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK OF THE COMPANY

The Company and its subsidiaries have financial instruments that involve various market risks and uncertainties. For information regarding the Company's exposure to risks associated with interest rates, equity market prices and energy commodity prices see Item 7A in the Form 10-K.

In the third quarter and nine months ended September 30, 1998, the Company recorded an additional $26 million and $314 million, respectively, unrealized loss (net of tax) related to the ACES. For further discussion of this loss, see Note 6 to the Company's Interim Financial Statements. The Company believes that this additional unrealized loss for the ACES is more than economically hedged by the unrecorded unrealized gain relating to the increase in the fair value of the Time Warner common stock underlying the investment in TW Preferred since the date of its acquisition. An increase of 10% in the price of the Time Warner common stock above its September 30, 1998 market value of $87.563 per share would result in the recognition of an additional unrealized accounting loss (net of tax) of approximately $108 million.

The Company's risk associated with interest rates, equity market prices (other than those related to ACES) and energy commodity prices have not materially changed from the market risks faced by the Company at December 31, 1997.

For a discussion of the impact of fluctuations in currency exchange rates on the Company's equity investments, see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company - Certain Factors Affecting Future Earnings of the Company and its Subsidiaries - Risks of International Operations."

ITEM 1. FINANCIAL STATEMENTS.

NORAM ENERGY CORP. AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED INCOME
(THOUSANDS OF DOLLARS)
(UNAUDITED)

| | CURRENT NORAM | CURRENT NORAM | CURRENT NORAM | FORMER NORAM | FORMER NORAM |
|---|---|---|---|---|---|
| | THREE MONTHS ENDED SEPTEMBER 30, 1998 | NINE MONTHS ENDED SEPTEMBER 30, 1998 | TWO MONTHS ENDED SEPTEMBER 30, 1997 | ONE MONTH ENDED JULY 31, 1997 | SEVEN MONTHS ENDED JULY 31, 1997 |
| REVENUES: | $ 1,930,463 | $ 5,072,969 | $ 749,412 | $ 396,868 | $ 3,337,048 |
| EXPENSES: | | | | | |
| Natural gas and purchased power, net | 1,676,274 | 4,202,962 | 528,669 | 334,176 | 2,700,400 |
| Operation and maintenance | 159,430 | 460,725 | 159,554 | 52,696 | 306,309 |
| Depreciation and amortization | 53,240 | 144,305 | 31,798 | 12,456 | 84,901 |
| Taxes other than income taxes | 24,865 | 86,734 | 17,767 | 8,419 | 73,142 |
| Merger transaction costs | | | 843 | 15,918 | 17,256 |
| | 1,913,809 | 4,894,726 | 738,631 | 423,665 | 3,182,008 |
| Operating Income | 16,654 | 178,243 | 10,781 | (26,797) | 155,040 |
| OTHER INCOME (EXPENSE): | | | | | |
| Interest expense, net | (25,736) | (78,115) | (18,471) | (10,665) | (78,660) |
| Distributions on trust securities | (106) | (533) | | (903) | (6,317) |
| Other - net | 1,049 | 5,585 | 258 | 1,115 | 7,210 |
| | (24,793) | (73,063) | (18,213) | (10,453) | (77,767) |
| Income (loss) Before Income Taxes | (8,139) | 105,180 | (7,432) | (37,250) | 77,273 |
| Income Tax Expense (Benefit) | (1,104) | 53,759 | (786) | (14,013) | 31,398 |
| Income Before Extraordinary Item | (7,035) | 51,421 | (6,646) | (23,237) | 45,875 |
| Extraordinary gain on early retirement of debt, less taxes | | | | | 237 |
| Net Income (loss) | $ (7,035) | $ 51,421 | $ (6,646) | $ (23,237) | $ 46,112 |

See Notes to NorAm's Unaudited Consolidated Financial Statements.

NORAM ENERGY CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

ASSETS

| | SEPTEMBER 30, 1998 | DECEMBER 31, 1997 |
|---|---|---|
| PROPERTY, PLANT AND EQUIPMENT | | |
| Natural Gas Distribution | $ 1,441,865 | $ 1,326,442 |
| Interstate Pipeline | 1,284,127 | 1,258,087 |
| Energy Marketing | 180,755 | 162,519 |
| Other | 13,487 | 14,972 |
| Total | 2,920,234 | 2,762,020 |
| Less accumulated depreciation and amortization | 160,936 | 59,531 |
| Property, plant and equipment - net | 2,759,298 | 2,702,489 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | 22,411 | 35,682 |
| Accounts and notes receivable, principally customer | 1,452,782 | 969,248 |
| Accounts receivable - affiliated companies | 48,409 | 10,161 |
| Income tax receivable | 50,202 | 7,292 |
| Gas in underground storage | 102,516 | 63,702 |
| Materials and supplies | 41,822 | 29,611 |
| Gas purchased in advance of delivery | 6,200 | 6,200 |
| Fuel stock and petroleum products | 65,416 | 345 |
| Other current assets | 51,037 | 16,749 |
| Total current assets | 1,840,795 | 1,138,990 |
| OTHER ASSETS | | |
| Goodwill, net | 2,060,712 | 2,026,395 |
| Prepaid pension asset | 71,357 | 92,064 |
| Investment in marketable equity securities | 9,954 | 27,046 |
| Regulatory asset for environmental costs | 20,736 | 21,745 |
| Gas purchased in advance of delivery | 21,582 | 29,048 |
| Deferred debits, net | 86,692 | 93,010 |
| Total other assets | 2,271,033 | 2,289,308 |
| TOTAL ASSETS | $ 6,871,126 | $ 6,130,787 |

See Notes to NorAm's Unaudited Consolidated Financial Statements

NORAM ENERGY CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

LIABILITIES AND STOCKHOLDER'S EQUITY

| | September 30, 1998 | December 31, 1997 |
|---|---|---|
| STOCKHOLDER'S EQUITY: | | |
| Common stock | $ 1 | $ 1 |
| Paid-in capital | 2,463,831 | 2,463,831 |
| Retained earnings | 72,268 | 20,847 |
| Unrealized loss on marketable equity securities, net of tax | (16,543) | (5,634) |
| Total stockholder's equity | 2,519,557 | 2,479,045 |
| NORAM-OBLIGATED MANDATORILY REDEEMABLE CONVERTIBLE TRUST PREFERRED SECURITIES OF SUBSIDIARY TRUST HOLDING SOLELY SUBORDINATED DEBENTURES OF NORAM, NET | 1,253 | 21,290 |
| LONG-TERM DEBT, LESS CURRENT MATURITIES | 999,211 | 916,703 |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term debt | 354,962 | 232,145 |
| Notes payable to banks | 205,600 | 390,000 |
| Notes payable to parent | | 22,100 |
| Receivables facility | 300,000 | 300,000 |
| Accounts payable, principally trade | 1,201,686 | 668,269 |
| Accounts payable - affiliated companies | 141,368 | |
| Interest payable | 19,743 | 27,273 |
| General taxes | 43,267 | 41,315 |
| Customer deposits | 35,529 | 36,626 |
| Other current liabilities | 132,351 | 133,278 |
| Total current liabilities | 2,434,506 | 1,851,006 |
| DEFERRED CREDITS AND OTHER LIABILITIES: | | |
| Accumulated deferred income taxes | 502,116 | 488,299 |
| Estimated environmental remediation costs | 20,736 | 21,745 |
| Payable under capacity lease agreement | 41,000 | 41,000 |
| Benefit obligations | 194,968 | 182,687 |
| Estimated obligations under indemnification provisions of sale Agreements | 6,581 | 11,391 |
| Other | 151,198 | 117,621 |
| Total deferred credits and other liabilities | 916,599 | 862,743 |
| Commitments and Contingencies | | |
| Total Liabilities and Stockholder's Equity | $ 6,871,126 | $ 6,130,787 |

See Notes to NorAm's Unaudited Consolidated Financial Statements

NORAM ENERGY CORP. AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CASH FLOWS
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS
(THOUSANDS OF DOLLARS)
(UNAUDITED)

| | CURRENT NORAM | CURRENT NORAM | FORMER NORAM |
|---|---|---|---|
| | NINE MONTHS ENDED SEPTEMBER 30, 1998 | TWO MONTHS ENDED SEPTEMBER 30, 1997 | SEVEN MONTHS ENDED JULY 31, 1997 |
| Cash Flows from Operating Activities: | | | |
| Net income | $ 51,421 | $ (6,646) | $ 46,112 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 144,305 | 31,798 | 84,901 |
| Deferred income taxes | 19,339 | 8,748 | 14,589 |
| Extraordinary (gain), less taxes | | | (237) |
| Changes in other assets and liabilities, net of the effects of the acquisition: | | | |
| Accounts and notes receivable-net | (521,782) | 11,805 | 313,586 |
| Inventories | (116,942) | (30,749) | 9,980 |
| Other current assets | (18,056) | (8,812) | (1,128) |
| Accounts payable | 652,629 | (63,621) | (224,590) |
| Interest and taxes accrued | (55,780) | (16,378) | (19,996) |
| Other current liabilities | (34,844) | 10,100 | (22,633) |
| Other - net | 72,028 | (1,674) | (1,312) |
| Net cash provided by (used in) operating activities | 192,318 | (65,429) | 199,272 |
| Cash Flows from Investing Activities: | | | |
| Purchase of NorAm, net cash acquired | | (1,422,672) | |
| Capital expenditures | (184,301) | (28,740) | (88,638) |
| Other - net | 4,032 | (275) | (6,424) |
| Net cash used in investing activities | (180,269) | (1,451,687) | (95,062) |
| Cash Flows from Financing Activities: | | | |
| Cash portion of capital contribution from Houston Industries | | 1,426,067 | |
| Retirements and reacquisitions of long-term debt | (76,000) | (488) | (230,667) |
| Issuance of bank term loan, due 1998 | | | 150,000 |
| Proceeds from sale of debentures | 298,514 | | |
| Increase (decrease) in notes payable | (216,931) | 107,500 | (42,500) |
| Increase in receivables facility | | 19,000 | 41,000 |
| Common and preferred stock dividends | | | (19,281) |
| Conversion of convertible securities | (10,399) | | |
| Other-net | (20,504) | (13,103) | (27,348) |
| Net cash provided by (used in) financing activities | (25,320) | 1,538,976 | (128,796) |
| Net Increase (Decrease) in Cash and Cash Equivalents | (13,271) | 21,860 | (24,586) |
| Cash and Cash Equivalents at Beginning of the Period | 35,682 | | 27,981 |
| Cash and Cash Equivalents at End of the Period | $ 22,411 | $ 21,860 | $ 3,395 |
| Supplemental Disclosure of Cash Flow Information: | | | |
| Interest (net of amounts capitalized) | $ 43,783 | $ 25,600 | $ 67,100 |
| Income taxes, net | (17,265) | 13,000 | 20,900 |

Notes to NorAm's Unaudited Consolidated Financial Statements.

# NORAM ENERGY CORP. AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF STOCKHOLDER'S EQUITY
(THOUSANDS OF DOLLARS)
(UNAUDITED)

| | COMMON STOCK(1) SHARES | COMMON STOCK(1) AMOUNT | PAID-IN CAPITAL | RETAINED EARNINGS (DEFICIT) | UNREALIZED GAIN (LOSS) ON MARKETABLE SECURITIES NET OF TAX | TOTAL |
|---|---|---|---|---|---|---|
| FORMER NORAM: | | | | | | |
| Balance at January 1, 1997 ............ | 137,908,173 | $ 86,193 | $ 1,001,053 | $ (286,703) | $ 5 | $ 800,548 |
| Net Income ............................ | | | | 46,112 | | 46,112 |
| CASH DIVIDENDS: | | | | | | |
| Common stock - $0.07 per share ......... | | | | (19,281) | | (19,281) |
| Change in Market Value of Marketable Equity Securities, net of tax ....... | | | | | 5,874 | 5,874 |
| Conversion of NorAm-Obligated Mandatorily Redeemable Convertible Trust Preferred Securities of Subsidiary Trust Holding Solely Subordinated Debentures of NorAm to Common Stock ......................... | 11,428,262 | 7,143 | 131,425 | | | 138,568 |
| Other Issuances ........................ | 347,527 | 216 | 5,796 | | | 6,012 |
| BALANCE AT JULY 31, 1997 .............. | 149,683,962 | 93,552 | 1,138,274 | (259,872) | 5,879 | 977,833 |
| CURRENT NORAM (POST MERGER): | | | | | | |
| ADJUSTMENTS DUE TO MERGER: | | | | | | |
| Eliminate Former NorAm Balances ........ | (149,683,962) | (93,552) | (1,138,274) | 259,872 | (5,879) | (977,833) |
| Capital Contribution from Parent ....... | 1,000 | 1 | 2,460,233 | | | 2,460,234 |
| Net Income ............................ | | | | (6,646) | | (6,646) |
| Change in Market Value of Marketable Equity Securities, net of tax ........ | | | | | 3,809 | 3,809 |
| BALANCE AT SEPTEMBER 30, 1997 .......... | 1,000 | 1 | 2,460,233 | (6,646) | 3,809 | 2,457,397 |
| Capital contribution from Parent ....... | | | 3,598 | | | 3,598 |
| Net Income ............................ | | | | 27,493 | | 27,493 |
| Change in Market Value of Marketable Equity Securities, net of tax ........ | | | | | (9,443) | (9,443) |
| BALANCE AT DECEMBER 31, 1997 ........... | 1,000 | 1 | 2,463,831 | 20,847 | (5,634) | 2,479,045 |
| Net Income ............................ | | | | 51,421 | | 51,421 |
| Change in Market Value of Marketable Equity Securities, net of tax ....... | | | | | (10,909) | (10,909) |
| BALANCE AT SEPTEMBER 30, 1998 .......... | 1,000 | $ 1 | $ 2,463,831 | $ 72,268 | $ (16,543) | $ 2,519,557 |

(1) $.625 par, authorized 250,000,000 shares. On the Acquisition Date, NorAm's pre-merger common stock was canceled and replaced with 1,000 shares of common stock (all of which are owned by Houston Industries).

See Notes to NorAm's Unaudited Consolidated Financial Statements.

NORAM ENERGY CORP. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) BASIS OF PRESENTATION

On August 6, 1997 (Acquisition Date), Houston Industries Incorporated (Former HI) merged with and into Houston Lighting & Power Company, which was renamed "Houston Industries Incorporated" (Houston Industries), and NorAm Energy Corp. (Former NorAm) merged with and into a subsidiary of Houston Industries, HI Merger, Inc., which was renamed "NorAm Energy Corp" (NorAm). Effective upon the mergers (collectively, the Merger), each outstanding share of common stock of Former NorAm was converted into the right to receive $16.3051 cash or 0.74963 shares of common stock of Houston Industries. For more information regarding the Merger, see Note 2 below.

The unaudited interim financial statements and notes (NorAm's Interim Financial Statements) in this Form 10-Q (Form 10-Q) include the accounts of NorAm and its wholly owned subsidiaries. NorAm's Interim Financial Statements omit certain information included in financial statements prepared in accordance with generally accepted accounting principles and should be read in combination with the joint Annual Report on Form 10-K (Form 10-K) of Houston Industries (File No. 1-3187) and NorAm (File No. 1-13265) for the year ended December 31, 1997. The Form 10-K includes the consolidated financial statements of Houston Industries (Houston Industries' 10-K Financial Statements) and the Consolidated Financial Statements of NorAm (NorAm's 10-K Financial Statements) for the year ended December 31, 1997. For additional information regarding the presentation of interim period results, see Note 6 below.

The following notes to NorAm's Form 10-K Financial Statements relate to material contingencies. These notes, as updated by the notes contained in NorAm's Interim Financial Statements, are incorporated herein by reference and include the following:

Note 1(c) (Regulatory Assets and Regulation), Note 2 (Derivative Financial Instruments (Risk Management)) and Note 8 (Commitments and Contingencies).

(2) ACQUISITION OF NORAM

The aggregate consideration paid to Former NorAm stockholders in connection with the Merger consisted of $1.4 billion in cash and 47.8 million shares of Houston Industries common stock valued at approximately $1.0 billion. The overall transaction was valued at $4.0 billion consisting of $2.4 billion paid for Former NorAm's common stock and common stock equivalents and $1.6 billion of Former NorAm's debt ($1.3 billion of which was long-term debt).

The Merger was recorded under the purchase method of accounting with assets and liabilities of NorAm reflected at their estimated fair values as of the Acquisition Date, resulting in a "new basis" of accounting. In NorAm's Interim Financial Statements, periods which reflect the new basis of accounting are labeled as "Current NorAm" and periods which do not reflect the new basis of accounting are labeled as "Former NorAm."

NorAm's Consolidated Balance Sheets for periods after the Acquisition Date reflect adjustments associated with Houston Industries' assignment of the purchase price to certain assets of NorAm, principally consisting of (1) the revaluation of certain property, plant and equipment and long-term debt to their estimated fair market value, (2) the recognition of certain pension and postretirement benefit obligations previously being recognized through amortization, (3) the recognition of goodwill as described above, (4) the elimination of NorAm's historical goodwill, (5) the elimination of NorAm's historical stockholders' equity balances and accumulated depreciation and amortization as of the Acquisition Date and (6) the recognition of the associated deferred income tax effects. In addition, NorAm's pre-merger common stock was canceled and replaced with 1,000 shares of common stock (all of which are owned by Houston Industries), rendering presentation of per share data no longer meaningful. Houston Industries' debt to fund the cash portion of the purchase consideration has not been allocated or "pushed down" to NorAm and is not reflected on NorAm's Interim Financial Statements.

NorAm's Statements of Consolidated Income for periods after the Acquisition Date are principally affected by (1) the amortization (over 40 years) of the newly-recognized goodwill, partially offset by the elimination of the amortization of NorAm's historical goodwill, (2) the amortization (to interest expense) of the revaluation of long-term debt, (3) the removal of the amortization (to operating expense) previously associated with the pension and postretirement obligations as described above and (4) the deferred income tax expense associated with these adjustments. Interest expense on Houston Industries' debt which was used to fund the cash portion of the acquisition has not been allocated or "pushed down" to NorAm and is not reflected on NorAm's Interim Financial Statements. For these reasons, among others, certain financial information for periods before and after the Acquisition Date is not comparable.

If the Merger had occurred on January 1, 1997, NorAm's unaudited pro forma net loss for the third quarter of 1997 would have been $22 million and NorAm's unaudited pro forma net loss for the first nine months of 1997 would have been $39 million. Pro forma results are based on assumptions deemed appropriate by NorAm's management, have been prepared for informational purposes only and are not necessarily indicative of the results which would have resulted had the Merger actually taken place on the date indicated.

(3) COMPREHENSIVE INCOME

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 130, "Reporting Comprehensive Income" (SFAS No. 130). "Comprehensive income" is defined to include all changes in stockholders' equity during a reporting period except changes resulting from investments by stockholders and distributions to stockholders. NorAm's comprehensive income consists of net income (loss) and unrealized gains or losses on NorAm's investment in marketable equity securities.

For the three months ended September 30, 1998, NorAm's total comprehensive loss was $13 million compared to $34 million in the corresponding period in 1997. For the nine months ended September 30, 1998, NorAm's total comprehensive income was $41 million compared to $43 million in the corresponding period in 1997.

Under SFAS No. 130, NorAm will begin to report and separately display total comprehensive income and the components that comprise comprehensive income in the year-end financial statements appearing in NorAm's Annual Report on 10-K for the year ending 1998 and subsequent annual reports.

(4) DEPRECIATION

NorAm calculates depreciation using the straight-line method. NorAm's depreciation expense for the third quarter and nine months ended September 30, 1998 was $40 million and $103 million, respectively.

(5) LONG-TERM DEBT AND SHORT-TERM FINANCINGS

During the third quarter of 1998, NorAm repurchased $6 million aggregate principal amount of its 6% convertible subordinated debentures due 2012 at an average purchase price equal to 97.4% of the aggregate principal amount of the debentures, plus accrued interest. NorAm expects to use the repurchased debentures to satisfy part of the debentures' sinking fund requirements in March 1999 and March 2000.

| Series | Principal Amount |
|---|---|
| 9.07% due July 20, 1998 | $ 15.0 million |
| 8.60% due September 1, 1998 | 3.0 million |
| 8.58% due September 1, 1998 | 5.0 million |
| 8.64% due September 4, 1998 | 12.5 million |
| 8.50% due September 14, 1998 | 0.5 million |
| 8.60% due September 15, 1998 | 6.0 million |
| 8.43% due September 17, 1998 | 5.0 million |
| Total | $ 47.0 million |

At September 30, 1998, NorAm had $206 million in commercial paper borrowings supported by a $350 million revolving credit facility (NorAm Credit Facility). At such date, the weighted average interest rate of borrowings under this facility was 5.94%. Under a trade receivables facility that expires in August 1999, NorAm sells with limited recourse an undivided interest (limited to a maximum of $300 million) in a designated pool of accounts receivable. The amount of receivables sold and uncollected at September 30, 1998, was $300 million. The weighted average interest rate at such date was 5.5%. For additional information regarding NorAm's trade receivables facility, see Note 4(a) to NorAm's 10-K Financial Statements.

For information regarding NorAm's issuance in the fourth quarter of 1998 of $500 million aggregate principal amount of debt securities, see Note 7.

For information regarding NorAm's repayment at maturity of $28 million of its medium-term notes (having an average interest rate of 8.74%), see Note 5 to NorAm's Interim Financial Statements in the Second Quarter 10-Q. For information regarding (i) NorAm's issuance in February 1998 of $300 million principal amount of 6.5% debentures due February 1, 2008, (ii) NorAm's repayment at maturity of $1 million of its 9.30% medium-term notes and (iii) NorAm's satisfaction of the $6.5 million sinking fund requirement for its 6% convertible subordinated debentures due 2012 using debentures purchased in 1996 and 1997, see Note 5 to NorAm's Interim Financial Statements in the First Quarter 10-Q.

(6) NORAM OBLIGATED MANDATORILY REDEEMABLE TRUST SECURITIES OF SUBSIDIARY TRUSTS HOLDING SOLELY SUBORDINATED DEBENTURES OF NORAM.

For information regarding $177.8 million of convertible preferred securities issued by a statutory business trust formed by Former NorAm, of which $1.3 million were outstanding at September 30, 1998, see Note 5 to NorAm's Form 10-K Financial Statements. The sole asset of the trust consists of junior subordinated debentures of NorAm having interest rates and maturity dates corresponding to the preferred securities, and the principal amount corresponding to the common and preferred securities issued by the trust.

(7) SUBSEQUENT EVENTS

In November 1998, NorAm sold $500 million aggregate principal amount of its 6 3/8% Term Enhanced ReMarketable Securities (TERM Notes). The net proceeds of $514 million from the offering of the TERM Notes and from the sale of the related option to remarket the TERM notes (as described below) will be used for general corporate purposes, including the repayment of (i) $178.5 million of NorAm's outstanding commercial paper and (ii) a $150 million term loan of NorAm that matures on November 13, 1998. The TERM Notes are unsecured obligations of NorAm which bear interest at the annual rate of 6 3/8% through November 1, 2003. On November 1, 2003, the holders of the TERM Notes are required to tender their notes at 100% of their principal amount. Concurrent with the offering, NorAm received proceeds of $18.375 million from the sale of an option to remarket the notes in 2003. The proceeds received from the sale of the option will be amortized over the stated term of the securities. If the option is not exercised, NorAm will repurchase the TERM Notes at 100% of their principal amount on November 1, 2003. If the option is exercised, the TERM Notes will be remarketed on a date, selected by NorAm, within the 52-week period beginning November 1, 2003. During such period and prior to remarketing, the TERM Notes will bear interest at rates, adjusted weekly, based on index selected by NorAm. If the TERM Notes are remarketed, the final maturity date of the TERM Notes will be November 1, 2013, subject to adjustment, and the effective interest rate on the remarketed TERM Notes will be 5.66% plus the Company's applicable credit spread at the time of such remarketing.

(8) INTERIM PERIOD RESULTS: RECLASSIFICATIONS

NorAm's Interim Financial Statements reflect all normal recurring adjustments that are, in the opinion of management, necessary to present fairly the financial position and results of operations for the respective periods. Amounts reported in the Consolidated Statements of Income are not necessarily indicative of amounts expected for a full year period due to the effects of, among other things, (i) the Merger, (ii) seasonal temperature variation affecting energy consumption and (iii) the timing of maintenance and other expenditures. In addition, certain amounts from the prior year have been reclassified to conform to NorAm's presentation of financial statements in the current year. Such reclassifications do not affect earnings.

ITEM 2. MANAGEMENT'S NARRATIVE ANALYSIS OF THE RESULTS OF OPERATIONS OF NORAM ENERGY CORP. AND CONSOLIDATED SUBSIDIARIES.

NorAm Energy Corp. (NorAm) meets the conditions specified in General Instruction H to Form 10-Q and is thereby permitted to use the reduced disclosure format for wholly owned subsidiaries of reporting companies specified therein. Accordingly, NorAm has omitted from this Form 10-Q the information called for by Item 3 (Quantitative and Qualitative Disclosures about Market Risk) of Part I and the following Part II items of Form 10-Q: Item 2 (Changes in Securities and Use of Proceeds), Item 3 (Defaults Upon Senior Securities), and Item 4 (Submission of Matters to a Vote of Security Holders). In lieu of the information called for by Item 2 (Management's Discussion and Analysis of Financial Condition and Results of Operations) of Form 10-Q, NorAm has included the following Management's Narrative Analysis of the Results of Operations of NorAm Energy Corp. and Consolidated Subsidiaries to explain material changes in the amount of revenue and expense items of NorAm between the third quarter and first nine months of 1998 and the third quarter and first nine months of 1997, respectively. Reference is made to Management's Narrative Analysis of the Results of Operations of NorAm and consolidated subsidiaries in Item 7 of the Form 10-K, NorAm's consolidated financial statements and notes contained in Item 8 of the Form 10-K and NorAm's Interim Financial Statements contained in this Form 10-Q. For a discussion of the qualifications and assumptions underlying the use of forward looking information, see Item 5 of this Form 10-Q.

## NORAM ENERGY CORP.

NorAm conducts operations primarily in the natural gas industry, including gathering, transmission, marketing, storage and distribution. Collectively, these operations accounted for in excess of 95% of NorAm's total revenues, income or loss and identifiable assets in the third quarter and first nine months of 1998. Accordingly, NorAm is not required to report on a "segment" basis, although NorAm is organized into, and the following business description focuses on, the operating units described below. NorAm also makes sales of electricity, non-energy sales and provides certain non-energy services, primarily to retail gas distribution customers. In recognition of the manner in which NorAm manages its portfolio of businesses, NorAm has segregated its results of operations into: Natural Gas Distribution, Interstate Pipeline, Energy Marketing and Corporate.

On August 6, 1997 (Acquisition Date), NorAm became a wholly owned subsidiary of Houston Industries Incorporated (Houston Industries) in a transaction involving the merger (Merger) of NorAm Energy Corp. (Former NorAm) with and into a subsidiary of Houston Industries. For additional information regarding Houston Industries' acquisition of NorAm, see Note 2 to NorAm's Interim Financial Statements.

## CONSOLIDATED RESULTS OF OPERATIONS

Seasonality and Other Factors. NorAm's results of operations are seasonal due to fluctuations in the demand for and, to a lesser extent, the price of natural gas. NorAm's results of operations are also affected by, among other things, the actions of various federal and state governmental authorities having jurisdiction over rates charged by NorAm and its subsidiaries, competition in NorAm's various business operations, debt service costs and income tax expense. For a discussion of certain other factors that may affect NorAm's future earnings see "Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company - Certain Factors Affecting Future Earnings of the Company and its Subsidiaries - Competition - Other Operations, - Impact of the Year 2000 Issue and Other System Implementation Issues, and - Environmental Expenditures" in the Form 10-K.

Accounting Impact of the Merger. The Merger created a new basis of accounting for NorAm, resulting in new carrying values for certain of NorAm's assets, liabilities and equity commencing upon the Acquisition Date. NorAm's Statements of Consolidated Income for periods after the Acquisition Date are principally affected by (1) the amortization (over 40 years) of the newly-recognized goodwill, partially offset by the elimination of the amortization of NorAm's historical goodwill, (2) the amortization (to interest expense) of the revaluation of long-term debt, (3) the removal of the amortization (to operating expense) previously associated with the pension and post-retirement obligations and (4) the deferred income tax expense associated with these adjustments. Interest expense on Houston Industries' debt which was used to fund the cash portion of the acquisition has not been allocated or "pushed down" to NorAm and is not reflected on NorAm's Interim Financial Statements. For these reasons, among others, certain financial information for periods before and after the Acquisition Date is not comparable.

Because results of operations and other financial information for periods before and after the Acquisition Date are not comparable, NorAm is presenting certain financial data on an actual basis and on a pro forma basis as if the Merger had taken place at the beginning of the period presented. These results do not necessarily reflect the results which would have been obtained if the Merger had actually occurred on the dates indicated or the results that may be expected in the future.

The following table sets forth selected financial and operating data on an actual basis for the third quarters and nine months ended September 30, 1998 and 1997 and on a pro forma basis for the third quarter and nine months ended September 30, 1997, followed by a discussion of significant variances in period-to-period results:

SELECTED FINANCIAL RESULTS:

| | THREE MONTHS ENDED SEPTEMBER 30, | | | |
|---|---|---|---|---|
| | 1998 (ACTUAL) | 1997 (ACTUAL) (1) | 1997 (PRO FORMA) (2) | PERCENTAGE CHANGE |
| | (THOUSANDS OF DOLLARS) | | | (1998 ACTUAL TO 1997 PRO FORMA) |
| OPERATING REVENUES: | | | | |
| Natural Gas Distribution | $ 249,004 | $ 272,201 | $ 272,201 | (9%) |
| Interstate Pipeline | 70,394 | 67,651 | 67,651 | 4% |
| Energy Marketing | 1,642,374 | 842,034 | 842,034 | 95% |
| Corporate and Other | 24,047 | 22,087 | 22,087 | 9% |
| Elimination of Intersegment Revenue(3) | (55,356) | (57,693) | (57,693) | 4% |
| | $ 1,930,463 | $ 1,146,280 | $ 1,146,280 | 68% |
| Operating Income (Loss): | | | | |
| Natural Gas Distribution | (20,324) | (12,735) | (15,000) | (35%) |
| Interstate Pipeline | 27,421 | 21,090 | 19,747 | 39% |
| Energy Marketing | 7,439 | 769 | | |
| Corporate and Other | 2,118 | (8,379) | (7,185) | 129% |
| | 16,654 | 745 | (2,438) | |
| Merger Transaction Costs (4) | | 16,761 | 843 | (100%) |
| Consolidated | 16,654 | (16,016) | (3,281) | 608% |
| Interest Expense, Net | 25,736 | 29,136 | 26,376 | (2%) |
| Distributions on Subsidiary Trust Securities | 106 | 903 | 903 | (88%) |
| Other (Income) and Deductions | (1,049) | (1,373) | (1,373) | 24% |
| Income Tax Expense (Benefit) | (1,104) | (14,799) | (7,099) | 84% |
| Net Income (Loss) | $ (7,035) | $ (29,883) | $ (22,088) | 68% |

| | NINE MONTHS ENDED SEPTEMBER 30, | | | |
|---|---|---|---|---|
| | 1998 (ACTUAL) | 1997 (ACTUAL) (1) | 1997 (PRO FORMA) (2) | PERCENTAGE CHANGE |
| | (THOUSANDS OF DOLLARS) | | | (1998 ACTUAL TO 1997 PRO FORMA) |
| OPERATING REVENUES: ........................ | | | | |
| Natural Gas Distribution ..................... | $ 1,280,889 | $ 1,490,020 | $ 1,490,020 | (14%) |
| Interstate Pipeline .......................... | 217,891 | 225,746 | 225,746 | (3%) |
| Energy Marketing ............................. | 3,730,602 | 2,535,348 | 2,535,348 | 47% |
| Corporate and Other .......................... | 59,773 | 57,517 | 57,517 | 4% |
| Elimination of Intersegment Revenues(3) ...... | (216,186) | (222,171) | (222,171) | 3% |
| | $ 5,072,969 | $ 4,086,460 | $ 4,086,460 | 24% |
| OPERATING INCOME (LOSS): | | | | |
| Natural Gas Distribution ..................... | 75,124 | 105,695 | 92,000 | (18%) |
| Interstate Pipeline .......................... | 92,343 | 90,467 | 81,000 | 14% |
| Energy Marketing ............................. | 10,834 | 7,982 | 4,000 | 171% |
| Corporate and Other .......................... | (58) | (20,224) | (15,362) | 100% |
| | 178,243 | 183,920 | 161,638 | 10% |
| Merger Transaction Costs(4) ..................... | | 18,099 | 843 | (100%) |
| Consolidated ................................... | 178,243 | 165,821 | 160,795 | |
| Interest Expense, Net ........................... | 78,115 | 97,131 | 77,817 | 0% |
| Distributions on Subsidiary Trust Securities .... | 533 | 6,317 | 6,317 | (92%) |
| Other (Income) and Deductions ................... | (5,585) | (7,468) | (7,467) | 25% |
| Income Tax Expense .............................. | 53,759 | 30,612 | 45,805 | 17% |
| Income Before Extraordinary Item ................ | 51,421 | 39,229 | 38,323 | 34% |
| Extraordinary Item .............................. | | 237 | 237 | (100%) |
| Net Income ...................................... | $ 51,421 | $ 39,466 | $ 38,560 | 33% |

(1) 1997 (Actual) includes two months of Current NorAm and seven months of Former NorAm.

(2) Pro forma results reflect purchase accounting adjustments as if the Merger had occurred on January 1, 1997. Adjustments for goodwill have been allocated to the respective business units.

(3) Elimination of operating revenues derived from sales to affiliated business units.

(4) Expenses associated with completion of the business combination with Houston Industries. See Note 2 of the accompanying Notes to Consolidated Financial Statements.

Third Quarter of 1998 Compared to Third Quarter of 1997 (Actual). NorAm had a consolidated net loss of $7 million for the third quarter of 1998 compared to a net loss of $30 million in the same period in 1997. The net loss for the third quarter of 1997 included $17 million of expenses associated with completion of the acquisition of NorAm by Houston Industries. Excluding these costs, earnings for the third quarter of 1998 increased $13 million compared to the same period of 1997. The increase in earnings is primarily attributable to increased operating income at Interstate Pipeline and Energy Marketing and reduced expenses at Corporate, partially offset by the purchase accounting effects of the Merger, including the amortization of goodwill and adjustments to interest expense and decreased operating income at Natural Gas Distribution.

Third Quarter of 1998 Actual Compared to Third Quarter of 1997 (Pro Forma). NorAm had a consolidated net loss of $7 million for the third quarter of 1998 compared to a pro forma consolidated net loss of $22 million in the same period in 1997. The increase in earnings is primarily attributable to increased operating income at Interstate Pipeline and Energy Marketing and reduced expenses at Corporate, partially offset by decreased operating income at Natural Gas Distribution, as described below.

Nine Months Ended September 30, 1998 Compared to Nine Months Ended September 30, 1997 (Actual). NorAm had consolidated net income of $51 million for the nine months ended September 30, 1998 compared to net income of $39 million in the same period in 1997. The increase in earnings is primarily attributable to increased operating income at Interstate Pipeline and Energy Marketing and reduced expenses at Corporate, partially offset by the purchase accounting effects of the Merger, including the amortization of goodwill and adjustments to interest expense and decreased operating income at Natural Gas Distribution, as described below.

Nine Months Ended September 30, 1998 Actual Compared to 1997 Pro Forma. NorAm had consolidated net income of $51 million for the nine months ended September 30, 1998 compared to pro forma net income of $39 million in the nine months ended September 30, 1997. The increase in earnings is primarily attributable to increased operating income at Interstate Pipeline and Energy Marketing and reduced expenses at Corporate, partially offset by decreased operating income at Natural Gas Distribution, as described below.

RESULTS OF OPERATIONS BY BUSINESS UNIT

NATURAL GAS DISTRIBUTION

Natural Gas Distribution operations are conducted through the Arkla, Entex and Minnegasco divisions of NorAm. These operations consist of natural gas sales to, and natural gas transportation for, residential, commercial and certain industrial customers in six states: Arkansas, Louisiana, Minnesota, Mississippi, Oklahoma and Texas.

The following table provides summary data regarding the results of operations of Natural Gas Distribution, including operating statistics, on an actual basis for the third quarter and nine month periods ended September 30, 1998 and on a pro forma basis for the third quarter and nine month periods ended September 30, 1997 (as if the acquisition of NorAm by Houston Industries had occurred as of January 1, 1997).

| | THREE MONTHS ENDED SEPTEMBER 30, | | PERCENT CHANGE |
|---|---|---|---|
| | 1998 (ACTUAL) | 1997 (PRO FORMA) | |
| | (IN MILLIONS) | | |
| Operating Revenues | $ 249 | $ 272 | (8%) |
| Operating Expenses: | | | |
| Natural Gas | 126 | 145 | (13%) |
| Operation and Maintenance | 91 | 90 | 1% |
| Depreciation and Amortization | 33 | 31 | 6% |
| Other Operating Expenses | 19 | 21 | (10%) |
| Total Operating Expenses | 269 | 287 | (6%) |
| Operating Loss | $ (20) | $ (15) | (33%) |
| Throughput Data (in Bcf): | | | |
| Residential and Commercial Sales | 31 | 32 | (3%) |
| Industrial Sales | 14 | 14 | -- |
| Transportation | 9 | 9 | -- |
| Total Throughput | 54 | 55 | (2%) |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | NINE MONTHS ENDED SEPTEMBER 30, 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 1,281 | $ 1,490 | (14%) |
| Operating Expenses: | | | |
| Natural Gas | 757 | 948 | (20%) |
| Operation and Maintenance | 282 | 283 | -- |
| Depreciation and Amortization | 97 | 92 | 5% |
| Other Operating Expenses | 70 | 75 | (7%) |
| Total Operating Expenses | 1,206 | 1,398 | (14%) |
| Operating Income | $ 75 | $ 92 | (18%) |
| Throughput Data (in Bcf): | | | |
| Residential and Commercial Sales | 200 | 220 | (9%) |
| Industrial Sales | 42 | 42 | -- |
| Transportation | 32 | 31 | 3% |
| Total Throughput | 274 | 293 | (6%) |

Natural Gas Distribution's operating loss increased $5 million in the third quarter of 1998, over its $15 million pro forma operating loss in the same period of 1997. The third quarter of 1997 included approximately $4 million non-recurring income recorded in connection with the successful appeal of the Minnegasco division's 1993 and 1995 rate cases.

Operating income for the nine month period ended September 30, 1998 decreased $17 million compared to pro forma operating income in the same period of 1997. The $17 million decrease in operating income is due primarily to (i) milder winter weather in the first three months of 1998, (ii) the impact in 1997 of the Minnegasco division's rate case appeal as discussed above and (iii) lower demand for natural gas heating in the second and third quarters of 1998. The decrease in operating income was partially offset by reduced charges at Arkla associated with the methodology of calculating the price of gas charged to customers (the Purchased Gas Adjustment).

Natural Gas Distribution operating revenues decreased $23 million and $209 million for the third quarter and nine months ended September 30, 1998, respectively, compared to pro forma operating revenues for the corresponding periods of 1997 due principally to (i) the weather-related factors decline in customer usage and (ii) lower natural gas prices. In addition, the impact in 1997 of the Minnegasco division's rate case appeal (as discussed above) also resulted in higher revenues in 1997 compared to 1998.

Operating expenses decreased $18 million and $192 million in the third quarter and nine months ended September 30, 1998, respectively, compared to pro forma operating expenses in the same period of 1997 due primarily to the reduced cost of gas and the Purchased Gas Adjustment.

Demand for natural gas distribution services is seasonal in nature, reflecting the higher demand for natural gas for use in heating in the winter months.

## INTERSTATE PIPELINE

Interstate Pipeline operations are conducted primarily through NorAm Gas Transmission Company (NGT) and Mississippi River Transmission Corporation (MRT), two wholly owned subsidiaries of NorAm. The NGT system consists of approximately 6,200 miles of natural gas transmission lines located in portions of Arkansas, Kansas, Louisiana, Mississippi, Missouri, Oklahoma, Tennessee and Texas. The MRT system consists of approximately 2,000 miles of pipeline serving principally the greater St. Louis area in Missouri and Illinois.

The following table provides summary data regarding the results of operations of Interstate Pipeline, including operating statistics, on an actual basis for the third quarter and nine months ended September 30, 1998 and on a pro forma basis for third quarter and nine months ended September 30, 1997 (as if the acquisition of NorAm by Houston Industries had occurred as of January 1, 1997).

| | THREE MONTHS ENDED SEPTEMBER 30, | | |
|---|---|---|---|
| | 1998 (ACTUAL) | 1997 (PRO FORMA) | PERCENT CHANGE |
| | (IN MILLIONS) | | |
| Operating Revenues | $ 70 | $ 67 | 4% |
| Operating Expenses: | | | |
| Natural Gas | 6 | 10 | (40%) |
| Operation and Maintenance | 20 | 20 | -- |
| Depreciation and Amortization | 13 | 13 | -- |
| Other Operating Expenses | 4 | 4 | -- |
| Total Operating Expenses | 43 | 47 | (9%) |
| Operating Income | $ 27 | $ 20 | 35% |
| Throughput Data (in million MMBtu): | | | |
| Natural Gas Sales | 4 | 4 | -- |
| Transportation | 186 | 205 | (9%) |
| Elimination (1) | (4) | (4) | -- |
| Total Throughput | 186 | 205 | (9%) |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | NINE MONTHS ENDED SEPTEMBER 30, 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 218 | $ 226 | (4%) |
| Operating Expenses: | | | |
| Natural Gas | 22 | 29 | (24%) |
| Operation and Maintenance | 60 | 66 | (9%) |
| Depreciation and Amortization | 32 | 39 | (18%) |
| Other Operating Expenses | 12 | 11 | 9% |
| Total Operating Expenses | 126 | 145 | (13%) |
| Operating Income | $ 92 | $ 81 | 14% |
| Throughput Data (in million MMBtu): | | | |
| Natural Gas Sales | 12 | 14 | (14%) |
| Transportation | 610 | 667 | (9%) |
| Elimination (1) | (11) | (13) | 15% |
| Total Throughput | 611 | 668 | (9%) |

- -------------

(1) ELIMINATION REFERS TO VOLUMES OF NATURAL GAS BOTH TRANSPORTED AND SOLD BY INTERSTATE PIPELINE AND, THEREFORE, EXCLUDED FROM TOTAL THROUGHPUT.

Interstate Pipeline operating income increased $7 million and $11 million in the third quarter and nine months ended September 30, 1998, respectively, over pro forma operating income for the same periods in 1997. The increase in operating income for the third quarter of 1998 is primarily due to improved operating margins and reductions in the cost of natural gas, as discussed below. The increase in operating income for the nine month period of 1998 is primarily due to $11 million of pre-tax non-recurring items recorded in 1998 for litigation and rate case settlements as well as improved operating margins and reductions in operating expenses. The increase in operating income in the nine month period ended September 30, 1998 was offset by $7 million of non-recurring transportation revenues recorded in the first quarter of 1997, as discussed below.

Operating revenues for Interstate Pipeline increased $3 million in the third quarter of 1998, over pro forma operating revenues for the same period in 1997. This increase in operating revenues is primarily due to a weather-related demand for natural gas used to fuel electric generation plants during the summer cooling season.

Operating revenues decreased $8 million in the nine month period ended September 30, 1998, from pro forma operating revenues for the same period in 1997. The decrease in revenues is due in part to $7 million of non-recurring transportation revenues recognized in the first quarter of 1997. These revenues were recognized following a settlement with the Arkla division of NorAm related to service provided in several of Arkla's operating jurisdictions. In addition, the settlement with Arkla resulted in reduced transportation rates, which also reduced revenues for the period. These decreases were partially offset by (i) the settlement of outstanding gas purchase contract litigation which resulted in the recognition of approximately $6 million of revenues in the second quarter of 1998 and (ii) the factors discussed above for the third quarter.

Natural gas expense decreased $4 million and $7 million in the third quarter and nine months ended September 30, 1998, respectively, when compared to pro forma natural gas expense in the same periods in 1997 primarily due to lower gas sales volumes and lower prices for purchased gas.

Operation and maintenance expense decreased $6 million in the nine months ended September 30, 1998, respectively, in comparison to pro forma operation and maintenance expense for the same period in 1997. The decrease was primarily due to lower costs resulting from cost control initiatives and decreased maintenance due to milder weather in the first quarter of 1998.

Depreciation expense decreased $7 million in the nine month period ended September 30, 1998, compared to pro forma depreciation expense in the same period of 1997 primarily due to a $5 million rate settlement recorded in the first quarter of 1998. The rate settlement, effective January 1998, provided for a reduction of MRT's depreciation rates retroactive to July 1996.

ENERGY MARKETING

Energy Marketing includes the operations of NorAm's wholesale energy trading and marketing business, and retail energy marketing business and natural gas gathering activities of NorAm (conducted, respectively, by NorAm Energy Services, Inc. (NES), NorAm Energy Management, Inc. and NorAm Field Services Corp., three wholly owned subsidiaries of NorAm).

The following table provides summary data regarding the results of operations of Energy Marketing, including operating statistics, on an actual basis for the third quarter and nine months ended September 30, 1998 and on a pro forma basis for the third quarter and nine months ended September 30, 1997 (as if the acquisition of NorAm by Houston Industries had occurred as of January 1, 1997).

| | THREE MONTHS ENDED SEPTEMBER 30, | | PERCENT CHANGE |
|---|---|---|---|
| | 1998 (ACTUAL) | 1997 (PRO FORMA) | |
| | (IN MILLIONS) | | |
| Operating Revenues | $ 1,642 | $ 842 | 95% |
| Operating Expenses: | | | |
| Natural Gas | 687 | 587 | 17% |
| Purchased Power | 906 | 220 | 312% |
| Operation and Maintenance | 36 | 31 | 16% |
| Depreciation and Amortization | 4 | 3 | 33% |
| Other Operating Expenses | 2 | 1 | 100% |
| Total Operating Expenses | 1,635 | 842 | 94% |
| Operating Income (Loss) | $ 7 | $ -- | -- |
| Operations Data: | | | |
| Natural Gas (in Bcf): | | | |
| Sales | 364 | 284 | 28% |
| Transportation | 3 | 5 | (40%) |
| Gathering | 60 | 60 | -- |
| Total | 427 | 349 | 22% |
| Electricity: | | | |
| Wholesale Power Sales (in thousand MWH) | 22,353 | 8,099 | 176% |

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 (ACTUAL) | 1997 (PRO FORMA) | PERCENT CHANGE |
|---|---|---|---|
| | (IN MILLIONS) | | |
| Operating Revenues | $ 3,731 | $ 2,535 | 47% |
| Operating Expenses: | | | |
| Natural Gas | 2,012 | 2,022 | -- |
| Purchased Power | 1,604 | 429 | 274% |
| Operation and Maintenance | 89 | 69 | 29% |
| Depreciation and Amortization | 10 | 8 | 25% |
| Other Operating Expenses | 5 | 3 | 67% |
| Total Operating Expenses | 3,720 | 2,531 | 47% |
| Operating Income | $ 11 | $ 4 | 175% |
| Operations Data: | | | |
| Natural Gas (in Bcf): | | | |
| Sales | 1,013 | 878 | 15% |
| Transportation | 16 | 17 | (6%) |
| Gathering | 175 | 182 | (4%) |
| Total | 1,204 | 1,077 | 12% |
| Electricity: | | | |
| Wholesale Power Sales (in thousand MWH) | 52,471 | 17,660 | 197% |

Energy Marketing's operating income increased $7 million for both the three and nine months ended September 30, 1998 over pro forma operating income for the same periods in 1997. The increase in third quarter operating income primarily reflects increased margins and sales volumes at NES for the third quarter of 1998 compared to the same period of 1997. This increase was partially offset by higher operating expenses as discussed below. Operating income for the nine months ended September 30, 1997 included $17 million in hedging losses associated with sales under peaking contracts and losses from the sale of natural gas held in storage and unhedged in the first quarter of 1997.

Operating revenues for Energy Marketing increased $800 million and $1.2 billion for the third quarter and nine months ended September 30, 1998, respectively, when compared to the same periods in 1997 due primarily to increases in wholesale power sales of $692 million and $1.2 billion in the third quarter and nine month periods of 1998, respectively. The increases in operating revenues and wholesale power sales were due to increased trading activity in 1998.

Natural gas expenses increased $100 million for the third quarter of 1998, compared to the same period of 1997. This increase is attributable to increased gas marketing activities, partially offset by a decrease in the price of natural gas. In the nine months ended September 30, 1998, natural gas expenses decreased $10 million when compared to the same period of 1997. This decrease is due to the reduction in the price of natural gas in 1998 and the impact of hedging losses in 1997 mentioned above, partially offset by increased gas marketing activities.

Purchased power expenses increased $686 million and $1.2 billion for the third quarter and nine months ended September 30, 1998, respectively, compared to the same periods in 1997 due to increased power marketing activities.

Operation and maintenance expenses increased $5 million and $20 million for the third quarter and nine months ended September 30, 1998, respectively, when compared to 1997 pro forma operation and maintenance expenses for the same periods in 1997. This increase is largely due to increased staffing in support of the expanded trading and marketing efforts at NES. NorAm believes that NES' energy trading, marketing and risk management services complement the development and/or acquisition of non-rate regulated generation assets in other markets. As a result, NorAm has made, and expects to continue to make, significant investments in developing NES' internal software, trading and personnel resources. The increase in operation and maintenance expenses for the nine month period ended September 30, 1998 is also due to a $4 million expense associated with an increase in reserves due to increased counter party credit and performance risk associated with higher prices and higher volatility in the electric power market in the second quarter of this year.

To minimize fluctuations in the price of natural gas and transportation, NorAm, primarily through NES, enters into futures transactions, swaps and options in order to hedge against market price changes affecting (i) certain commitments to buy, sell and transport natural gas, (ii) existing gas storage inventory and (iii) certain anticipated transactions, some of which carry off-balance sheet risk. NES also enters into natural gas derivatives for trading purposes and electricity derivatives for hedging and trading purposes. For a discussion about the NorAm's treatment of derivative instruments, see Note 2 to the NorAm's 10-K Financial Statements, Item 7A (Quantitative and Qualitative Disclosure About Market Risk) in the Form 10-K, and Item 3 (Quantitative and Qualitative Disclosures About Market Risk) in this Form 10-Q.

CORPORATE

NorAm's corporate and other business (Corporate) includes the operations of NorAm's unregulated retail services business, international operations, certain real estate investments, corporate costs and elimination of transactions between affiliated business units.

Corporate operating loss decreased $10 million and $20 million, respectively, in the third quarter and nine months ended September 30, 1998 compared to the same periods of 1997. The decreases are primarily attributable to reduced corporate expenses as a result of the Merger.

For information about the impact of year 2000 software issues, see "Management's Discussion and Analysis and Financial Condition of Resulting Operations - Certain Factors Affecting Future Earnings of the Company and its Subsidiaries - Impact of Year 2000 Computer Software Issues." Based on current internal studies, as well as recently solicited bids from various software vendors, NorAm estimates that the total direct cost of resolving the year 2000 issue will be between $4.5 million and $5.5 million, of which $2.8 million has already been expended.

NEW ACCOUNTING ISSUES

Reference is made to "Management's Discussion and Analysis of Financial Condition and Results of Operations of NorAm's - New Accounting Issues" in Item 2 (Houston Industries) in the Form 10-Q for a discussion of certain new accounting issues.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

For a description of legal proceedings affecting the Company and its subsidiaries, including NorAm, see (i) Part I, Item 3, of the Company's Form 10-K, Notes 3, 5 and 12 to the Company's Financial Statements in the Form 10-K and Note 8 to NorAm's Financial Statements in the Form 10-K, (ii) Part II, Item 1, of the First Quarter 10-Q, (iii) Part II, Item 1, of the Second Quarter 10-Q and (iv) Note 10(a) to the Company's Interim Financial Statements.

ITEM 5. OTHER INFORMATION.

Forward Looking Statements. From time to time, the Company and NorAm may make statements regarding their assumptions, projections, expectations, intentions, or beliefs about future events. These statements and other statements that are not historical facts are intended as "forward-looking statements" under the Private Securities Litigation Reform Act of 1995. The Company and NorAm caution that assumptions, projections, expectations, intentions, or beliefs about future events may and often do vary materially from actual results and the differences between assumptions, projections, expectations, intentions or beliefs and actual results can be material. Accordingly, there can be no assurance actual results will not differ materially from those expressed or implied by the forward looking statements.

The following are some of the factors that could cause actual results to differ from those expressed or implied in forward looking statements: (i) state and federal legislative and regulatory initiatives that affect cost and investment recovery, have an impact on rate restructures and affect the speed and degree to which competition enters the electric and natural gas industries; (ii) industrial, commercial and residential growth in service territories of the Company and NorAm; (iv) the weather and other natural phenomena; (v) the timing and extent of changes in commodity prices and interest rates; (vi) changes in environmental and other laws and regulations to which the Company, NorAm and their respective subsidiaries are subject or other external factors over which the Company and NorAm have no control; (vii) the results of financing efforts; (viii) growth in opportunities for the Company's and NorAm's subsidiaries and diversified operations; (ix) risks incidental to the Company's overseas operations (including the effects of fluctuations in foreign currency exchange rates); (x) the effect of the Company's and NorAm's accounting policies; and (xi) other factors discussed in this and other filings by the Company and NorAm with the Securities and Exchange Commission (SEC).

When used in the Company's or NorAm's documents or oral presentations, the words "anticipate," "estimate," "expect," "objective," "projection," "forecast," "goal" or similar words are intended to identify forward-looking statements.

Shareholder Proposals. In September 1998, the Board of Directors of the Company amended the provisions of the Company's bylaws that relate to certain resolutions or motions proposed by the Company's shareholders. Under the amendments, a resolution or motion proposed by a shareholder will be considered for vote of the shareholders only if it meets the criteria of Article II, Section 9 (Proper Business Annual Meeting of Shareholders), or Article II, Section 10 (Proper Business - Special Meeting of Shareholders), as the case may be. For additional information, reference is made to the Company's Amended and Restated Bylaws filed as exhibit 3 to this Form 10-Q.

Under applicable SEC regulations, the persons named in the proxies solicited by the Company's Board of Directors may exercise discretionary voting authority with respect to any shareholder proposal (other than certain proposals submitted for inclusion in a proxy statement) that are received on and after February 10, 1999.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits.

Company:

Exhibit 3 - Amended and Restated Bylaws (adopted on September 2, 1998).

Exhibit 12 - Ratio of Earnings to Fixed Charges and Preferred Dividends.

Exhibit 27 - Financial Data Schedule (included in electronic filing only).

Exhibit 99(a) - Notes 1(c), 1(n), 2, 3, 4, 5 and 12 to the Company's Financial Statements included on pages 64 through 65, 68 through 77 and 92 through 94 of the Form 10-K.

NorAm:

Exhibit 12 - Ratio of Earnings to Fixed Charges and Preferred Dividends

Exhibit 27 - Financial Data Schedule (included in electronic filing only) .

Exhibit 99(a) - Notes 1(c), 2 and 8 to the NorAm Financial Statements included on pages 116 through 121 and pages 132 through 135 of the Form 10-K.

(b) Reports on Form 8-K.

Company:

Form 8-K (Item 5 Other Events) dated October 13, 1998, and filed on October 21, 1998

NorAm:

Form 8-K (Item 5 Other Events) dated November 5, 1998, and filed on November 10, 1998

SIGNATURE

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.

HOUSTON INDUSTRIES INCORPORATED
(Registrant)

/s/ Mary P. Ricciardello
--------------------------------
Vice President and Comptroller
(Principal Accounting Officer)

Date: November 12, 1998

SIGNATURE

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.

NORAM ENERGY CORP.
(Registrant)

/s/ Mary P. Ricciardello
------------------------------
Vice President and Comptroller
(Principal Accounting Officer)

Date: November 12, 1998

# INDEX TO EXHIBITS

| EXHIBITS | DESCRIPTION |
|---|---|
| COMPANY: | |
| Exhibit 3 - | Amended and Restated Bylaws (adopted on September 2, 1998). |
| Exhibit 12 - | Ratio of Earnings to Fixed Charges and Preferred Dividends. |
| Exhibit 27 - | Financial Data Schedule (included in electronic filing only). |
| Exhibit 99(a) - | Notes 1(c), 1(n), 2, 3, 4, 5 and 12 to the Company's Financial Statements included on pages 72 through 77 and 92 through 94 of the Form 10-K. |
| NORAM: | |
| Exhibit 12 - | Ratio of Earnings to Fixed Charges and Preferred Dividends |
| Exhibit 27 - | Financial Data Schedule (included in electronic filing only). |
| Exhibit 99(a) - | Notes 1(c), 2 and 8 to the NorAm Financial Statements included on pages 116 through 121 and pages 132 through 135 of the Form 10-K. |

# AMENDED AND RESTATED BYLAWS

# OF

# HOUSTON INDUSTRIES INCORPORATED

Adopted and Amended by Resolution of the Board of Directors on September 2, 1998

## ARTICLE I

## CAPITAL STOCK

Section 1. Share Ownership. Shares for the capital stock of the Company may be certificated or uncertificated. Owners of shares of the capital stock of the Company shall be recorded in the share transfer records of the Company and ownership of such shares shall be evidenced by a certificate or book entry notation in the share transfer records of the Company. Any certificates representing such shares shall be signed by the Chairman of the Board, if there is one, the Chief Executive Officer, if there is one, the President or a Vice President and either the Secretary or an Assistant Secretary and shall be sealed with the seal of the Company, which signatures and seal may be facsimiles. In case any officer who has signed or whose facsimile signature has been placed upon such certificate shall have ceased to be such officer before such certificate is issued, it may be issued by the Company with the same effect as if he were such officer at the date of its issuance.

Section 2. Shareholders of Record. The Board of Directors of the Company may appoint one or more transfer agents or registrars of any class of stock of the Company. The Company may be its own transfer agent if so appointed by the Board of Directors. The Company shall be entitled to treat the holder of record of any shares of the Company as the owner thereof for all purposes, and shall not be bound to recognize any equitable or other claim to, or interest in, such shares or any rights deriving from such shares, on the part of any other person, including (but without limitation) a purchaser, assignee or transferee, unless and until such other person becomes the holder of record of such shares, whether or not the Company shall have either actual or constructive notice of the interest of such other person.

Section 3. Transfer of Shares. The shares of the capital stock of the Company shall be transferable in the share transfer records of the Company by the holder of record thereof, or his duly authorized attorney or legal representative. All certificates representing shares surrendered for transfer, properly endorsed, shall be canceled and new certificates for a like number of shares shall be issued therefor. In the case of lost, stolen, destroyed or mutilated certificates representing shares for which the Company has been requested to issue new certificates, new certificates or other evidence of such new shares may be issued upon such conditions as may be required by the Board of Directors or the Secretary for the protection of the Company and any transfer agent or registrar. Uncertificated shares shall be transferred in the share transfer records of the Company upon the written instruction originated by the appropriate person to transfer the shares.

Section 4. Shareholders of Record and Fixing of Record Date. For the purpose of determining shareholders entitled to notice of or to vote at any meeting of shareholders or any adjournment thereof, or entitled to receive a distribution by the Company (other than a distribution involving a purchase or redemption by the Company of any of its own shares) or a share dividend, or in order to make a determination of shareholders for any other proper purpose (other than determining shareholders entitled to consent to action by shareholders proposed to be taken without a meeting of shareholders), the Board of Directors may provide that the share transfer records shall be closed for a stated period of not more than sixty days, and in the case of a meeting of shareholders not less than ten days, immediately preceding the meeting, or it may fix in advance a record date for any such determination of shareholders, such date to be not more than sixty days, and in the case of a meeting of shareholders not less than ten days, prior to the date on which the particular action requiring such determination of shareholders is to be taken. If the share transfer records are not closed and no record date is fixed for the determination of shareholders entitled to notice of or to vote at a meeting of shareholders, or shareholders entitled to receive a distribution (other than a distribution involving a purchase or redemption by the Company of any of its own shares) or a share dividend, the date on which notice of the meeting is mailed or the date on which the resolution of the Board of Directors declaring such distribution or share dividend is adopted, as the case may be, shall be the record date for such determination of shareholders. When a determination of shareholders entitled to vote at any meeting of shareholders has been made as herein provided, such determination shall apply to any adjournment thereof except where the determination has been made through the closing of the share transfer records and the stated period of closing has expired.

## ARTICLE II

## MEETINGS OF SHAREHOLDERS

Section 1. Place of Meetings. All meetings of shareholders shall be held at the registered office of the Company, in the City of Houston, Texas, or at such other place within or without the State of Texas as may be designated by the Board of Directors or officer calling the meeting.

Section 2. Annual Meeting. The annual meeting of the shareholders shall be held on such date and at such time as shall be designated from time to time by the Board of Directors or as may otherwise be stated in the notice of the meeting. Failure to designate a time for the annual meeting or to hold the annual meeting at the designated time shall not work a dissolution of the Company.

Section 3. Special Meetings. Special meetings of the shareholders may be called by the Chairman of the Board, if there is one, the Chief Executive Officer, if there is one, the President, the Secretary, the Board of Directors, the holders of not less than one-tenth of all of the shares outstanding and entitled to vote at such meeting or such other persons as may be authorized in the Articles of Incorporation of the Company.

Section 4. Notice of Meeting. Written or printed notice of all meetings stating the place, day and hour of the meeting and, in case of a special meeting, the purpose or purposes for which the meeting is called, shall be delivered not less than ten nor more than sixty days before the date of the meeting, either personally or by mail, by or at the direction of the Chairman of the Board, if there is one, the Chief Executive Officer, if there is one, the President, the Secretary or the officer or person calling the meeting to each shareholder of record entitled to vote at such meetings . If mailed, such notice shall be deemed to be delivered when deposited in the United States mail addressed to the shareholder at his address as it appears on the share transfer records of the Company, with postage thereon prepaid.

Any notice required to be given to any shareholder, under any provision of the Texas Business Corporation Act, as amended (TBCA), the Articles of Incorporation of the Company or these Bylaws, need not be given to a shareholder if notice of two consecutive annual meetings and all notices of meetings held during the period between those annual meetings, if any, or all (but in no event less than two) payments (if sent by first class mail) of distributions or interest on securities during a 12-month period have been mailed to that person, addressed at his address as shown on the share transfer records of the Company, and have been returned undeliverable. Any action or meeting taken or held without notice to such person shall have the same force and effect as if the notice had been duly given. If such a person delivers to the Company a written notice setting forth his then current address, the requirement that notice be given to that person shall be reinstated.

Section 5. Voting List. The officer or agent having charge of the share transfer records for shares of the Company shall make, at least ten days before each meeting of shareholders, a complete list of the shareholders entitled to vote at such meeting or any adjournment thereof, arranged in alphabetical order, with the address of and the number of shares held by each, which list, for a period of ten days prior to such meeting, shall be kept on file at the registered office of the Company and shall be subject to inspection by any shareholder at any time during usual business hours. Such list shall also be produced and kept open at the time and place of the meeting and shall be subject to the inspection of any shareholder during the whole time of the meeting. The original share transfer records shall be prima facie evidence as to who are the shareholders entitled to examine such list or to vote at any meeting of shareholders. Failure to comply with any requirements of this Section 5 shall not affect the validity of any action taken at such meeting.

Section 6. Voting; Proxies. Except as otherwise provided in the Articles of Incorporation of the Company or as otherwise provided in the TBCA, each holder of shares of capital stock of the Company entitled to vote shall be entitled to one vote for each share standing in his name on the records of the Company, either in person or by proxy executed in writing by him or by his duly authorized attorney-in-fact. A proxy shall be revocable unless expressly provided therein to be irrevocable and the proxy is coupled with an interest. At each election of directors, every holder of shares of the Company entitled to vote shall have the right to vote, in person or by proxy, the number of shares owned by him for as many persons as there are directors to be elected, and for whose election he has a right to vote, but in no event shall he be permitted to cumulate his votes for one or more directors.

Section 7. Quorum and Vote of Shareholders. Except as otherwise provided by law, the Articles of Incorporation of the Company or these Bylaws, the holders of a majority of shares entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of shareholders, but, if a quorum is not represented, a majority in interest of those represented may adjourn the meeting from time to time. Directors shall be elected by a plurality of the votes cast by the holders of shares entitled to vote in the election of directors at a meeting of shareholders at which a quorum is present. With respect to each matter other than the election of directors as to which no other voting requirement is specified by law, the Articles of Incorporation of the Company or in this Section 7 or in Article VII of these Bylaws, the affirmative vote of the holders of a majority of the shares entitled to vote on that matter and represented in person or by proxy at a meeting at which a quorum is present shall be the act of the shareholders. With respect to a matter submitted to a vote of the shareholders as to which a shareholder approval requirement is applicable under the shareholder approval policy of the New York Stock Exchange, Rule 16b-3 under the Securities Exchange Act of 1934, as amended (Exchange Act), or any provision of the Internal Revenue Code, in each case for which no higher voting requirement is specified by law, the Articles of Incorporation of the Company or these Bylaws, the affirmative vote of the holders of a majority of the shares entitled to vote on, and voted for or against, that matter at a meeting at which a quorum is present shall be the act of the shareholders, provided that approval of such matter shall also be conditioned on any more restrictive requirement of such shareholder approval policy, Rule 16b- 3 or Internal Revenue Code provision, as applicable, being satisfied. With respect to the approval of independent public accountants (if submitted for a vote of the shareholders), the affirmative vote of the holders of a majority of the shares entitled to vote on, and voted for or against, that matter at a meeting of shareholders at which a quorum is present shall be the act of the shareholders.

Section 8. Presiding Officer and Conduct of Meetings. The Chairman of the Board, if there is one, or in his absence, the Chief Executive Officer, if there is one, or in his absence, the President shall preside at all meetings of the shareholders or, if such officers are not present at a meeting, by such other person as the Board of Directors shall designate or if no such person is designated by the Board of Directors, the most senior officer of the Company present at the meeting. The Secretary of the Company, if present, shall act as secretary of each meeting of shareholders; if he is not present at a meeting, then such person as may be designated by the presiding officer shall act as secretary of the meeting. Meetings of shareholders shall follow reasonable and fair procedure. Subject to the foregoing, the conduct of any meeting of shareholders and the determination of procedure and rules shall be within the absolute discretion of the officer presiding at such meeting (Chairman of the Meeting), and there shall be no appeal from any ruling of the Chairman of the Meeting with respect to procedure or rules. Accordingly, in any meeting of shareholders or part thereof, the Chairman of the Meeting shall have the sole power to determine appropriate rules or to dispense with theretofore prevailing rules. Without limiting the foregoing, the following rules shall apply:

(a) If disorder should arise which prevents continuation of the legitimate business of meeting, the Chairman of the Meeting may announce the adjournment of the meeting; and upon so doing, the meeting shall be immediately adjourned.

(b) The Chairman of the Meeting may ask or require that anyone not a bona fide shareholder or proxy leave the meeting.

(c) A resolution or motion proposed by a shareholder shall only be considered for vote of the shareholders if it meets the criteria of Article II, Section 9 (Proper Business -- Annual Meeting of Shareholders) or Article II, Section 10 (Proper Business -- Special Meeting of Shareholders), as the case may be. The Chairman of the Meeting may propose any resolution or motion for vote of the shareholders.

(d) The order of business at all meetings of shareholders shall be determined by the Chairman of the Meeting.

(e) The Chairman of the Meeting may impose any reasonable limits with respect to participation in the meeting by shareholders, including, but not limited to, limits on the amount of time taken up by the remarks or questions of any shareholder, limits on the number of questions per shareholder and limits as to the subject matter and timing of questions and remarks by shareholders.

(f) Before any meeting of shareholders, the Board of Directors may appoint three persons other than nominees for office to act as inspectors of election at the meeting or its adjournment. If no inspectors of election are so appointed, the Chairman of the Meeting may, and on the request of any shareholder or a shareholder's proxy shall, appoint inspectors of election at the meeting of the shareholders and the number of such inspectors shall be three. If any person appointed as inspector fails to appear or fails or refuses to act, the Chairman of the Meeting may, and upon the request of any shareholder or a shareholder's proxy shall, appoint a person to fill such vacancy.

The duties of the inspectors shall be to:

(i) determine the number of shares outstanding and the voting power of each, the shares represented at the meeting, the existence of a quorum, and the authenticity, validity and effect of proxies and ballots;

(ii) receive votes or ballots;

(iii) hear and determine all challenges and questions in any way arising in connection with the vote;

(iv) count and tabulate all votes;

(v) report to the Board of Directors the results based on the information assembled by the inspectors; and

(vi) do any other acts that may be proper to conduct the election or vote with fairness to all shareholders.

Notwithstanding the foregoing, the final certification of the results of the election or other matter acted upon at a meeting of shareholders shall be made by the Board of Directors.

All determinations of the Chairman of the Meeting shall be conclusive unless a matter is determined otherwise upon motion duly adopted by the affirmative vote of the holders of at least 80% of the voting power of the shares of capital stock of the Company entitled to vote in the election of directors held by shareholders present in person or represented by proxy at such meeting.

Section 9. Proper Business -- Annual Meeting of Shareholders. At any annual meeting of shareholders, only such business shall be conducted as shall be a proper subject for the meeting and shall have been properly brought before the meeting. To be properly brought before an annual meeting of shareholders, business (other than business relating to (i) any nomination of directors, which is governed by Article III, Section 3, or (ii) any alteration, amendment or repeal of the Bylaws or any adoption of new Bylaws, which is governed by Article VII hereof) must (a) be specified in the notice of such meeting (or any supplement thereto) given by or at the direction of the Board of Directors (or any duly authorized committee thereof), (b) otherwise be properly brought before the meeting by or at the direction of the Chairman of the Meeting or the Board of Directors (or any duly authorized committee thereof) or (c) otherwise (i) be properly requested to be brought before the meeting by a shareholder of record entitled to vote in the election of directors generally, in compliance with the provisions of this Section 9 and (ii) constitute a proper subject to be brought before such meeting. For business to be properly brought before an annual meeting of shareholders, any shareholder who intends to bring any matter (other than a matter relating to (i) any nomination of directors, which is governed by Article III, Section 3, or (ii) any alteration, amendment or repeal of the Bylaws or any adoption of new Bylaws, which is governed by Article VII hereof) before an annual meeting of shareholders and is entitled to vote on such matter must deliver written notice of such shareholder's intent to bring such matter before the annual meeting of shareholders, either by personal delivery or by United States mail, postage prepaid, to the Secretary of the Company. Such notice must be received by the Secretary not less than 90 days nor more than 180 days prior to the date on which the immediately preceding year's annual meeting of shareholders was held. In no event shall the public disclosure of an adjournment of an annual meeting of shareholders commence a new time period for the giving of a shareholder's notice as described above.

To be in proper written form, a shareholder's notice to the Secretary shall set forth as to each matter the shareholder proposes to bring before the annual meeting of shareholders (a) a brief description of the business desired to be brought before the meeting and the reasons for conducting such business at the meeting, (b) the name and address, as they appear on the Company's books and records, of the shareholder proposing such business, (c) evidence reasonably satisfactory to the Secretary of the Company, of such shareholder's status as such and of the number of shares of each class of capital stock of the Company of which such shareholder is the beneficial owner, (d) a description of all arrangements or understandings between such shareholder and any other person or persons (including their names) in connection with the proposal of such business by such shareholder and any material interest of such shareholder in such business and (e) a representation that such shareholder intends to appear in person or by proxy at the annual meeting to bring such business before the meeting. No business shall be conducted at an annual meeting of shareholders except in accordance with the procedures set forth in this Section 9. Beneficial ownership shall be determined in accordance with Rule 13d-3 under the Exchange Act. When used in these Bylaws, "person" has the meaning ascribed to such term in Section 2(a)(2) of the Securities Act of 1933, as amended, as the context may require.

Within thirty days after such shareholder shall have submitted the aforesaid items, the Secretary or the Board of Directors of the Company shall determine whether the proposed business has been properly requested to be brought before the annual meeting of shareholders and shall notify such shareholder in writing of its determination. If such shareholder fails to submit a required item in the form or within the time indicated, or if the Secretary or the Board of Directors of the Company determines that the proposed business otherwise has not been properly requested, then such proposal by such shareholder shall not be voted upon by the shareholders of the Company at such annual meeting of shareholders. The Chairman of the Meeting shall, if the facts warrant, determine and declare to the meeting that a proposal made by a shareholder of the Company pursuant to this Section 9 was not made in accordance with the procedures prescribed by these Bylaws, and if he should so determine, he shall so declare to the meeting and the defective proposal shall be disregarded.

Nothing in this Section 9 shall be interpreted or construed to require the inclusion of information about any such proposal in any proxy statement distributed by, at the direction of, or on behalf of the Board of Directors or the Company.

Section 10. Proper Business -- Special Meeting of Shareholders. At any special meeting of shareholders, only such business shall be conducted as shall have been stated in the notice of such meeting or shall otherwise have been properly brought before the meeting by or at the direction of the Chairman of the Meeting or the Board of Directors (or any duly authorized committee thereof).

ARTICLE III

DIRECTORS

Section 1. Classification of Board of Directors; Qualifications. The business and affairs of the Company shall be managed by the Board of Directors.

Each director elected by the holders of Preferred Stock pursuant to Section 6 of Division A of Article VI of the Articles of Incorporation of the Company (or elected by such directors to fill a vacancy) shall serve for a term ending upon the earlier of the election of his successor or the termination at any time of a right of the holders of Preferred Stock to elect members of the Board of Directors.

At each annual election, the directors chosen to succeed those whose terms then expire shall be of the same class as the directors they succeed, unless, by reason of any intervening changes in the authorized number of directors, the Board of Directors shall designate one or more directorships whose term then expires as directorships of another class in order more nearly to achieve equality of number of directors among the classes.

Notwithstanding the rule that the three classes shall be as nearly equal in number of directors as possible, in the event of any change in the authorized number of directors, each director then continuing to serve as such shall nevertheless continue as a director of the class of which he is a member until the expiration of his current term, or his prior death, resignation, disqualification or removal. If any newly created directorship may, consistent with the rule that the three classes shall be as nearly equal in number of directors as possible, be allocated to any of the three classes, the Board of Directors shall allocate it to that available class whose term of office is due to expire at the earliest date following such allocation. No decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

No person shall be eligible to serve as a director of the Company subsequent to the annual meeting of shareholders occurring on or after the first day of the month immediately following the month of such person's seventieth birthday. No person shall be eligible to stand for reelection at the annual meeting of shareholders on or immediately following the tenth anniversary of such person's initial election or appointment to the Board of Directors. Any vacancy on the Board of Directors resulting from any director being rendered ineligible to serve as a director of the Company by the immediately preceding two sentences shall be filled by the shareholders entitled to vote thereon at such annual meeting of shareholders. Any director chosen to succeed a director who is so rendered ineligible to serve as a director of the Company shall be of the same class as the director he succeeds. Notwithstanding the rule that a director may not stand for reelection at the annual meeting of shareholders on or immediately following the tenth anniversary of such person's initial election or appointment to the Board of Directors, an incumbent director may nevertheless continue as a director until the expiration of his current term, or his prior death, resignation, disqualification or removal; provided, however, that no person serving as a director as of April 1, 1992 shall be affected by such term limitation provision, nor shall such term limitation provision apply to directors who are also employees of the Company or its corporate affiliates.

The above notwithstanding, each director shall serve until his successor shall have been duly elected and qualified, unless he shall resign, become disqualified, disabled or shall otherwise be removed.

No person shall be eligible for election or reelection or to continue to serve as a member of the Board of Directors who is an officer, director, agent, representative, partner, employee, or nominee of, or otherwise acting at the direction of, or acting in concert with, (a) a "public-utility company" (other than any direct or indirect subsidiary of the Company) as such term is defined in Section 2(a)(5) of the Public Utility Holding Company Act of 1935, as in effect on May 1, 1996 (35 Act), or (b) an "affiliate" (as defined in either Section 2(a)(11) of the 35 Act or in Rule 405 under the Securities Act of 1933, as amended) of any such "public-utility company" specified in clause (a) immediately preceding.

Section 2. Newly Created Directorships and Vacancies. Newly created directorships resulting from any increase in the number of directors may be filled by the affirmative vote of a majority of the directors then in office for a term of office continuing only until the next election of one or more directors by the shareholders entitled to vote thereon, or may be filled by election at an annual or special meeting of the shareholders called for that purpose; provided, however, that the Board of Directors shall not fill more than two such directorships during the period between two successive annual meetings of shareholders. Except as provided in Section 1 of this Article III, any vacancies on the Board of Directors resulting from death, resignation, disqualification, removal or other cause may be filled by the affirmative vote of a majority of the remaining directors then in office, even though less than a quorum of the Board of Directors, or may be filled by election at an annual or special meeting of the shareholders called for that purpose. Any director elected to fill any such vacancy shall hold office for the remainder of the full term of the director whose departure from the Board of Directors created the vacancy and until such newly elected director's successor shall have been duly elected and qualified.

Notwithstanding the foregoing paragraph of this Section 2, whenever holders of outstanding shares of Preference Stock are entitled to elect members of the Board of Directors pursuant to the provisions of Section 6 of Division A of Article VI of the Articles of Incorporation of the Company, any vacancy or vacancies resulting by reason of the death, resignation, disqualification or removal of any director or directors or any increase in the number of directors shall be filled in accordance with the provisions of such section.

Section 3. Nomination of Directors. Nominations for the election of directors may be made by the Board of Directors or by any shareholder (Nominator) entitled to vote in the election of directors. Such nominations, other than those made by the Board of Directors, shall be made in writing pursuant to timely notice delivered to or mailed and received by the Secretary of the Company as set forth in this Section 3. To be timely in connection with an annual meeting of shareholders, a Nominator's notice, setting forth the name and address of the person to be nominated, shall be delivered to or mailed and received at the principal executive offices of the Company not less than ninety days nor more than 180 days prior to the date on which the immediately preceding year's annual meeting of shareholders was held. To be timely in connection with any election of a director at a special meeting of the shareholders, a Nominator's notice, setting forth the name of the person to be nominated, shall be delivered to or mailed and received at the principal executive offices of the Company not less than forty days nor more than sixty days prior to the date of such meeting; provided, however, that in the event that less than forty-seven days' notice or prior public disclosure of the date of the special meeting of the shareholders is given or made to the shareholders, the Nominator's notice to be timely must be so received not later than the close of business on the seventh day following the day on which such notice of date of the meeting was mailed or such public disclosure was made. At such time, the Nominator shall also submit written evidence, reasonably satisfactory to the Secretary of the Company, that the Nominator is a shareholder of the Company and shall identify in writing (a) the name and address of the Nominator, (b) the number of shares of each class of capital stock of the Company owned beneficially by the Nominator, (c) the name and address of each of the persons with whom the Nominator is acting in concert, (d) the number of shares of capital stock beneficially owned by each such person with whom the Nominator is acting in concert, and (e) a description of all arrangements or understandings between the Nominator and each nominee and any other persons with whom the Nominator is acting in concert pursuant to which the nomination or nominations are to be made. At such time, the Nominator shall also submit in writing (i) the information with respect to each such proposed nominee that would be required to be provided in a proxy statement prepared in accordance with Regulation 14A under the Exchange Act and (ii) a notarized affidavit executed by each such proposed nominee to the effect that, if elected as a member of the Board of Directors, he will serve and that he is eligible for election as a member of the Board of Directors. Within thirty days (or such shorter time period that may exist prior to the date of the meeting) after the Nominator has submitted the aforesaid items to the Secretary of the Company, the Secretary of the Company shall determine whether the evidence of the Nominator's status as a shareholder submitted by the Nominator is reasonably satisfactory and shall notify the Nominator in writing of his determination. The failure of the Secretary of the Company to find such evidence reasonably satisfactory, or the failure of the Nominator to submit the requisite information in the form or within the time indicated, shall make the person to be nominated ineligible for nomination at the meeting at which such person is proposed to be nominated. The presiding person at each meeting of shareholders shall, if the facts warrant, determine and declare to the meeting that a nomination was not made in accordance with the procedures prescribed by these Bylaws, and if he should so determine, he shall so declare to the meeting and the defective nomination shall be disregarded. Beneficial ownership shall be determined in accordance with Rule 13d-3 under the Exchange Act.

Section 4. Place of Meetings and Meetings by Telephone. Meetings of the Board of Directors may be held either within or without the State of Texas, at whatever place is specified by the officer calling the meeting. Meetings of the Board of Directors may also be held by means of conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Participation in such a meeting by means of conference telephone or similar communications equipment shall constitute presence in person at such meeting, except where a director participates in a meeting for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened. In the absence of specific designation by the officer calling the meeting, the meetings shall be held at the principal office of the Company.

Section 5. Regular Meetings. The Board of Directors shall meet each year immediately following the annual meeting of the shareholders for the transaction of such business as may properly be brought before the meeting. The Board of Directors shall also meet regularly at such other times as shall be designated by the Board of Directors. No notice of any kind to either existing or newly elected members of the Board of Directors for such annual or regular meetings shall be necessary.

Section 6. Special Meetings. Special meetings of the Board of Directors may be held at any time upon the call of the Chairman of the Board, if there is one, the Chief Executive Officer, if there is one, the President or the Secretary of the Company or a majority of the directors then in office. Notice shall be sent by mail, facsimile or telegram to the last known address of the director at least two days before the meeting, or oral notice may be substituted for such written notice if received not later than the day preceding such meeting. Notice of the time, place and purpose of such meeting may be waived in writing before or after such meeting, and shall be equivalent to the giving of notice. Attendance of a director at such meeting shall also constitute a waiver of notice thereof, except where he attends for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened. Except as otherwise provided by these Bylaws, neither the business to be transacted at, nor the purpose of, any regular or special meeting of the Board of Directors need be specified in the notice or waiver of notice of such meeting.

Section 7. Quorum and Voting. Except as otherwise provided by law, the Articles of Incorporation of the Company or these Bylaws, a majority of the number of directors fixed in the manner provided in these Bylaws as from time to time amended shall constitute a quorum for the transaction of business. Except as otherwise provided by law, the Articles of Incorporation of the Company or these Bylaws, the affirmative vote of a majority of the directors present at any meeting at which there is a quorum shall be the act of the Board of Directors. Any regular or special directors' meeting may be adjourned from time to time by those present, whether a quorum is present or not.

Section 8. Compensation. Directors shall receive such compensation for their services as shall be determined by the Board of Directors.

Section 9. Removal. No director of the Company shall be removed from his office as a director by vote or other action of the shareholders or otherwise except (a) with cause, as defined below, by the affirmative vote of the holders of at least a majority of the voting power of all outstanding shares of capital stock of the Company entitled to vote in the election of directors, voting together as a single class, or (b) without cause by (i) the affirmative vote of at least 80% of all directors then in office at any regular or special meeting of the Board of Directors called for that purpose or (ii) the affirmative vote of the holders of at least 80% of the voting power of all outstanding shares of capital stock of the Company entitled to vote in the election of directors, voting together as a single class.

Except as may otherwise be provided by law, cause for removal of a director shall be construed to exist only if: (a) the director whose removal is proposed has been convicted, or where a director is granted immunity to testify where another has been convicted, of a felony by a court of competent jurisdiction and such conviction is no longer subject to direct appeal; (b) such director has been found by the affirmative vote of at least 80% of all directors then in office at any regular or special meeting of the Board of Directors called for that purpose or by a court of competent jurisdiction to have been negligent or guilty of misconduct in the performance of his duties to the Company in a matter of substantial importance to the Company; or (c) such director has been adjudicated by a court of competent jurisdiction to be mentally incompetent, which mental incompetency directly affects his ability as a director of the Company.

Notwithstanding the first paragraph of this Section 9, whenever holders of outstanding shares of Preference Stock are entitled to elect members of the Board of Directors pursuant to the provisions of Section 6 of Division A of Article VI of the Articles of Incorporation of the Company, any director of the Company may be removed in accordance with the provisions of such section.

No proposal by a shareholder to remove a director of the Company, regardless of whether such director was elected by holders of outstanding shares of Preference Stock (or elected by such directors to fill a vacancy), shall be voted upon at a meeting of the shareholders unless such shareholder shall have delivered or mailed in a timely manner (as set forth in this Section 9) and in writing to the Secretary of the Company (a) notice of such proposal, (b) a statement of the grounds, if any, on which such director is proposed to be removed, (c) evidence, reasonably satisfactory to the Secretary of the Company, of such shareholder's status as such and of the number of shares of each class of the capital stock of the Company beneficially owned by such shareholder, (d) a list of the names and addresses of other beneficial owners of shares of the capital stock of the Company, if any, with whom such shareholder is acting in concert, and of the number of shares of each class of the capital stock of the Company beneficially owned by each such beneficial owner, and (e) an opinion of counsel, which counsel and the form and substance of which opinion shall be reasonably satisfactory to the Board of Directors of the Company (excluding the director proposed to be removed), to the effect that, if adopted at a duly called special or annual meeting of the shareholders of the Company by the required vote as set forth in the first paragraph of this Section 9, such removal would not be in conflict with the laws of the State of Texas, the Articles of Incorporation of the Company or these Bylaws. To be timely in connection with an annual meeting of shareholders, a shareholder's notice and other aforesaid items shall be delivered to or mailed and received at the principal executive offices of the Company not less than ninety nor more than 180 days prior to the date on which the immediately preceding year's annual meeting of shareholders was held. To be timely in connection with the removal of any director at a special meeting of the shareholders, a shareholder's notice and other aforesaid items shall be delivered to or mailed and received at the principal executive offices of the Company not less than forty days nor more than sixty days prior to the date of such meeting; provided, however, that in the event that less than forty-seven days' notice or prior public disclosure of the date of the special meeting of shareholders is given or made to the shareholders, the shareholder's notice and other aforesaid items to be timely must be so received not later than the close of business on the seventh day following the day on which such notice of date of the meeting was mailed or such public disclosure was made. Within thirty days (or such shorter period that may exist prior to the date of the meeting) after such shareholder shall have delivered the aforesaid items to the Secretary of the Company, the Secretary and the Board of Directors of the Company shall respectively determine whether the items to be ruled upon by them are reasonably satisfactory and shall notify such shareholder in writing of their respective determinations. If such shareholder fails to submit a required item in the form or within the time indicated, or if the Secretary or the Board of Directors of the Company determines that the items to be ruled upon by them are not reasonably satisfactory, then such proposal by such shareholder may not be voted upon by the shareholders of the Company at such meeting of shareholders. The presiding person at each meeting of shareholders shall, if the facts warrant, determine and declare to the meeting that a proposal to remove a director of the Company was not made in accordance with the procedures prescribed by these Bylaws, and if he should so determine, he shall so declare to the meeting and the defective proposal shall be disregarded. Beneficial ownership shall be determined as specified in accordance with Rule 13d-3 under the Exchange Act.

Section 10. Executive and Other Committees. The Board of Directors, by resolution or resolutions adopted by a majority of the full Board of Directors, may designate one or more members of the Board of Directors to constitute an Executive Committee, and one or more other committees, which shall in each case be comprised of such number of directors as the Board of Directors may determine from time to time. Subject to such restrictions as may be contained in the Company's Articles of Incorporation or that may be imposed by the TBCA, any such committee shall have and may exercise such powers and authority of the Board of Directors in the management of the business and affairs of the Company as the Board of Directors may determine by resolution and specify in the respective resolutions appointing them, or as permitted by applicable law, including, without limitation, the power and authority to (a) authorize a distribution, (b) authorize the issuance of shares of the Company and (c) exercise the authority of the Board of Directors vested in it pursuant to Article 2.13 of the TBCA or such successor statute as may be in effect from time to time. Each duly-authorized action taken with respect to a given matter by any such duly-appointed committee of the Board of Directors shall have the same force and effect as the action of the full Board of Directors and shall constitute for all purposes the action of the full Board of Directors with respect to such matter.

The designation of any such committee and the delegation thereto of authority shall not operate to relieve the Board of Directors, or any member thereof, of any responsibility imposed upon it or him by law, nor shall such committee function where action of the Board of Directors cannot be delegated to a committee thereof under applicable law. The Board of Directors shall have the power at any time to change the membership of any such committee and to fill vacancies in it. A majority of the members of any such committee shall constitute a quorum. The Board of Directors shall name a chairman at the time it designates members to a committee. Each such committee shall appoint such subcommittees and assistants as it may deem necessary. Except as otherwise provided by the Board of Directors, meetings of any committee shall be conducted in accordance with the provisions of Sections 4 and 6 of this Article III as the same shall from time to time be amended. Any member of any such committee elected or appointed by the Board of Directors may be removed by the Board of Directors whenever in its judgment the best interests of the Company will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed. Election or appointment of a member of a committee shall not of itself create contract rights.

## ARTICLE IV

## OFFICERS

Section 1. Officers. The officers of the Company shall consist of a President and a Secretary and such other officers and agents as the Board of Directors may from time to time elect or appoint, which may include, without limitation, a Chairman of the Board, a Chief Executive Officer, one or more Vice Presidents (whose seniority and titles, including Executive Vice Presidents, Senior Vice Presidents and such assistant or subordinate Vice Presidents, may be specified by the Board of Directors), a Treasurer, one or more Assistant Treasurers, and one or more Assistant Secretaries. Each officer shall hold office until his successor shall have been duly elected and shall qualify or until his death or until he shall resign or shall have been removed in the manner hereinafter provided. Any two or more offices may be held by the same person. Except for the Chairman of the Board, if any, no officer need be a director.

Section 2. Vacancies; Removal. Whenever any vacancies shall occur in any office by death, resignation, increase in the number of offices of the Company, or otherwise, the officer so elected shall hold office until his successor is chosen and qualified. The Board of Directors may at any time remove any officer of the Company, whenever in its judgment the best interests of the Company will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed. Election or appointment of an officer or agent shall not of itself create contract rights.

Section 3. Powers and Duties of Officers. The officers of the Company shall have such powers and duties as generally pertain to their offices as well as such powers and duties as from time to time shall be conferred by the Board of Directors.

# ARTICLE V

## INDEMNIFICATION

Section 1. General. The Company shall indemnify and hold harmless the Indemnitee (as this and all other capitalized words are defined in this Article or in Article 2.02-1 of the TBCA), to the fullest extent permitted, or not prohibited, by the TBCA or other applicable law as the same exists or may hereafter be amended (but in the case of any such amendment, with respect to Matters occurring before such amendment, only to the extent that such amendment permits the Company to provide broader indemnification rights than said law permitted the Company to provide prior to such amendment). The provisions set forth below in this Article are provided as means of furtherance and implementation of, and not in limitation on, the obligation expressed in this Section 1.

Section 2. Advancement or Reimbursement of Expenses. The rights of the Indemnitee provided under Section 1 of this Article shall include, but not be limited to, the right to be indemnified and to have Expenses advanced (including the payment of expenses before final disposition of a Proceeding) in all Proceedings to the fullest extent permitted, or not prohibited, by the TBCA or other applicable law. If the Indemnitee is not wholly successful, on the merits or otherwise, in a Proceeding, but is successful, on the merits or otherwise, as to any Matter in such Proceeding, the Company shall indemnify the Indemnitee against all Expenses actually and reasonably incurred by him or on his behalf relating to each Matter. The termination of any Matter in a Proceeding by dismissal, with or without prejudice, shall be deemed to be a successful result as to such Matter. In addition, to the extent the Indemnitee is, by reason of his Corporate Status, a witness or otherwise participates in any Proceeding at a time when he is not named a defendant or respondent in the Proceeding, he shall be indemnified against all Expenses actually and reasonably incurred by him or on his behalf in connection therewith. The Indemnitee shall be advanced Expenses, within ten days after any request for such advancement, to the fullest extent permitted, or not prohibited, by Article 2.02-1 of the TBCA; provided that the Indemnitee has provided to the Company all affirmations, acknowledgments, representations and undertakings that may be required of the Indemnitee by Article 2.02-1 of the TBCA.

Section 3. Determination of Request. Upon written request to the Company by an Indemnitee for indemnification pursuant to these Bylaws, a determination, if required by applicable law, with respect to an Indemnitee's entitlement thereto shall be made in accordance with Article 2.02-1 of the TBCA; provided, however, that notwithstanding the foregoing, if a Change in Control shall have occurred, such determination shall be made by Special Legal Counsel selected by the Indemnitee, unless the Indemnitee shall request that such determination be made in accordance with Article 2.02-1F (1) or (2). The Company shall pay any and all reasonable fees and expenses of Special Legal Counsel incurred in connection with any such determination. If a Change in Control shall have occurred, the Indemnitee shall be presumed (except as otherwise expressly provided in this Article) to be entitled to indemnification under this Article upon submission of a request to the Company for indemnification, and thereafter the Company shall have the burden of proof in overcoming that presumption in reaching a determination contrary to that presumption. The presumption shall be used by Special Legal Counsel, or such other person or persons determining entitlement to indemnification, as a basis for a determination of entitlement to indemnification unless the Company provides information sufficient to overcome such presumption by clear and convincing evidence or the investigation, review and analysis of Special Legal Counsel or such other person or persons convinces him or them by clear and convincing evidence that the presumption should not apply.

Section 4. Effect of Certain Proceedings. The termination of any Proceeding or of any Matter therein, by judgment, order, settlement or conviction, or upon a plea of nolo contendere or its equivalent, shall not (except as otherwise expressly provided in this Article) of itself adversely affect the right of the Indemnitee to indemnification or create a presumption that (a) the Indemnitee did not conduct himself in good faith and in a manner which he reasonably believed, in the case of conduct in his official capacity as a director of the Company, to be in the best interests of the Company, or, in all other cases, that at least his conduct was not opposed to the Company's best interests, or (b) with respect to any criminal Proceeding, that the Indemnitee had reasonable cause to believe that his conduct was unlawful.

Section 5. Expenses of Enforcement of Article. In the event that an Indemnitee, pursuant to this Article, seeks a judicial adjudication to enforce his rights under, or to recover damages for breach of, rights created under or pursuant to this Article, the Indemnitee shall be entitled to recover from the Company, and shall be indemnified by the Company against, any and all Expenses actually and reasonably incurred by him in such judicial adjudication but only if he prevails therein. If it shall be determined in said judicial adjudication that the Indemnitee is entitled to receive part but not all of the indemnification or advancement of Expenses sought, the Expenses incurred by Indemnitee in connection with such judicial adjudication shall be reasonably prorated in good faith by counsel for the Indemnitee. Notwithstanding the foregoing, if a Change in Control shall have occurred, Indemnitee shall be entitled to indemnification under this Section regardless of whether indemnitee ultimately prevails in such judicial adjudication.

Section 6. Nonexclusive Rights. The rights of indemnification and to receive advancement of Expenses as provided by this Article shall not be deemed exclusive of any other rights to which the Indemnitee may at any time be entitled under applicable law, the Articles of Incorporation of the Company, these Bylaws, agreement, insurance, arrangement, a vote of shareholders or a resolution of directors, or otherwise. No amendment, alteration or repeal of this Article or any provision thereof shall be effective as to any Indemnitee for acts, events and circumstances that occurred, in whole or in part, before such amendment, alteration or repeal. The provisions of this Article shall continue as to an Indemnitee whose Corporate Status has ceased and shall inure to the benefit of his heirs, executors and administrators.

Section 7. Invalidity. If any provision or provisions of this Article shall be held to be invalid, illegal or unenforceable for any reason whatsoever, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby; and, to the fullest extent possible, the provisions of this Article shall be construed so as to give effect to the intent manifested by the provision held invalid, illegal or unenforceable.

Section 8. Definitions. For purposes of this Article:

"Change of Control" means a change in control of the Company occurring after the date of adoption of these Bylaws in any of the following circumstances: (a) there shall have occurred an event required to be reported in response to Item 6(e) of Schedule 14A of Regulation 14A (or in response to any similar item on any similar schedule or form) promulgated under the Exchange Act, whether or not the Company is then subject to such reporting requirement; (b) any "person" (as such term is used in Section 13(d) and 14(d) of the Exchange Act), other than a trustee or other fiduciary holding securities under an employee benefit plan of the Company or a corporation or other entity owned directly or indirectly by the shareholders of the Company in substantially the same proportions as their ownership of stock of the Company, shall have become the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing 30% or more of the combined voting power of the Company's then outstanding voting securities without prior approval of at least two-thirds of the members of the Board of Directors in office immediately prior to such person attaining such percentage interest; (c) the Company is a party to a merger, consolidation, share exchange, sale of assets or other reorganization, or a proxy contest, as a consequence of which members of the Board of Directors in office immediately prior to such transaction or event constitute less than a majority of the Board of Directors thereafter; (d) during any fifteen month period, individuals who at the beginning of such period constituted the Board of Directors (including for this purpose any new director whose election or nomination for election by the Company's shareholders was approved by a vote of at least two- thirds of the directors then still in office who were directors at the beginning of such period) cease for any reason to constitute at least a majority of the Board of Directors.

"Corporate Status" means the status of a person who is or was a director, officer, partner, venturer, proprietor, trustee, employee (including an employee acting in his Designated Professional Capacity), or agent or similar functionary of the Company or of any other foreign or domestic corporation, partnership, joint venture, sole proprietorship, trust, employee benefit plan or other enterprise which such person is or was serving in such capacity at the request of the Company. The Company hereby acknowledges that unless and until the Company provides the Indemnitee with written notice to the contrary, the Indemnitee's service as a director, officer, partner, venturer, proprietor, trustee, employee, agent or similar functionary of an Affiliate of the Company shall be conclusively presumed to be at the Company's request. An Affiliate of the Company shall be deemed to be (a) any foreign or domestic corporation in which the Company owns or controls, directly or indirectly, 5% or more of the shares entitled to be voted in the election of directors of such corporation; (b) any foreign or domestic partnership, joint venture, proprietorship or other enterprise in which the Company owns or controls, directly or indirectly, 5% or more of the revenue interests in such partnership, joint venture, proprietorship or other enterprise; or (c) any trust or employee benefit plan the beneficiaries of which include the Company, any Affiliate of the Company as defined in the foregoing clauses (a) and (b) or any of the directors, officers, partners, venturers, proprietors, employees, agents or similar functionaries of the Company or of such Affiliates of the Company.

"Expenses" shall include all reasonable attorneys' fees, retainers, court costs, transcript costs, fees of experts, witness fees, travel expenses, duplicating costs, printing and binding costs, telephone charges, postage, delivery service fees, and all other disbursements or expenses of the types customarily incurred in connection with prosecuting, defending, preparing to prosecute or defend, investigating, or being or preparing to be a witness in a Proceeding.

"Indemnitee" includes any person who is, or is threatened to be made, a witness in or a party to any Proceeding as described in Section 1 or 2 of this Article by reason of his Corporate Status.

"Matter" is a claim, a material issue, or a substantial request for relief.

"Proceeding" includes any threatened, pending or completed action, suit, arbitration, alternate dispute resolution proceeding, investigation, administrative hearing and any other proceeding, whether civil, criminal, administrative, investigative or other, any appeal in such action, suit, arbitration, proceeding or hearing, or any inquiry or investigation, whether conducted by or on behalf of the Company, a subsidiary of the Company or any other party, formal or informal, that the Indemnitee in good faith believes might lead to the institution of any such action, suit, arbitration, proceeding, investigation or hearing, except one initiated by an Indemnitee pursuant to Section 5 of this Article.

"Special Legal Counsel" means a law firm, or member of a law firm, that is experienced in matters of corporation law and neither presently is, nor in the five years previous to his selection or appointment has been, retained to represent: (a) the Company or the Indemnitee in any matter material to either such party; (b) any other party to the Proceeding giving rise to a claim for indemnification hereunder; or (c) the beneficial owner, directly or indirectly, of securities of the Company representing 30% or more of the combined voting power of the Company's then outstanding voting securities. Notwithstanding the foregoing, the term "Special Legal Counsel" shall not include any person who, under the applicable standards of professional conduct then prevailing, would have a conflict of interest in representing either the Company or the Indemnitee in an action to determine the Indemnitee's rights to indemnification under these Bylaws.

For the purposes of this Article, an employee acting in his "Designated Professional Capacity" shall include, but not be limited to, a physician, nurse, psychologist or therapist, registered surveyor, registered engineer, registered architect, attorney, certified public accountant or other person who renders such professional services within the course and scope of his employment, who is licensed by appropriate regulatory authorities to practice such profession and who, while acting in the course of such employment, committed or is alleged to have committed any negligent acts, errors or omissions in rendering such professional services at the request of the Company or pursuant to his employment (including, without limitation, rendering written or oral opinions to third parties).

Section 9. Notice. Any communication required or permitted to the Company under this Article shall be addressed to the Secretary of the Company and any such communication to the Indemnitee shall be addressed to his home address unless he specifies otherwise and shall be personally delivered or delivered by overnight mail or courier delivery.

Section 10. Insurance and Self-Insurance Arrangements. The Company may procure or maintain insurance or other similar arrangements, at its expense, to protect itself and any Indemnitee against any expense, liability or loss asserted against or incurred by such person, incurred by him in such a capacity or arising out of his Corporate Status as such a person, whether or not the Company would have the power to indemnify such person against such expense or liability. In considering the cost and availability of such insurance, the Company (through the exercise of the business judgment of its directors and officers) may, from time to time, purchase insurance which provides for any and all of (a) deductibles, (b) limits on payments required to be made by the insurer, or (c) coverage which may not be as comprehensive as that previously included in insurance purchased by the Company. The purchase of insurance with deductibles, limits on payments and coverage exclusions will be deemed to be in the best interest of the Company but may not be in the best interest of certain of the persons covered thereby. As to the Company, purchasing insurance with deductibles, limits on payments, and coverage exclusions is similar to the Company's practice of self-insurance in other areas. In order to protect the Indemnitees who would otherwise be more fully or entirely covered under such policies, the Company shall indemnify and hold each of them harmless as provided in Section 1 or 2 of this Article, without regard to whether the Company would otherwise be entitled to indemnify such officer or director under the other provisions of this Article, or under any law, agreement, vote of shareholders or directors or other arrangement, to the extent (i) of such deductibles, (ii) of amounts exceeding payments required to be made by an insurer or (iii) that prior policies of officer's and director's liability insurance held by the Company or its predecessors would have provided for payment to such officer or director. Notwithstanding the foregoing provision of this Section, no Indemnitee shall be entitled to indemnification for the results of such person's conduct that is intentionally adverse to the interests of the Company. This Section is authorized by Section 2.02-1(R) of the TBCA as in effect on May 1, 1996, and further is intended to establish an arrangement of self-insurance pursuant to that section.

## ARTICLE VI

## MISCELLANEOUS PROVISIONS

Section 1. Offices. The principal office of the Company shall be located in Houston, Texas, unless and until changed by resolution of the Board of Directors. The Company may also have offices at such other places as the Board of Directors may designate from time to time, or as the business of the Company may require. The principal office and registered office may be, but need not be, the same.

Section 2. Resignations. Any director or officer may resign at any time. Such resignations shall be made in writing and shall take effect at the time specified therein, or, if no time be specified, at the time of its receipt by the Chairman of the Board, if there is one, the Chief Executive Officer, if there is one, the President or the Secretary. The acceptance of a resignation shall not be necessary to make it effective, unless expressly so provided in the resignation.

Section 3. Seal. The seal of the Company shall be circular in form, with the name "HOUSTON INDUSTRIES INCORPORATED."

Section 4. Separability. If one or more of the provisions of these Bylaws shall be held to be invalid, illegal or unenforceable, such invalidity, illegality or unenforceability shall not affect any other provision hereof and these Bylaws shall be construed as if such invalid, illegal or unenforceable provision or provisions had never been contained herein.

## ARTICLE VII

## AMENDMENT OF BYLAWS

Section 1. Vote Requirements. The Board of Directors shall have the power to alter, amend or repeal the Bylaws or adopt new Bylaws by the affirmative vote of at least 80% of all directors then in office at any regular or special meeting of the Board of Directors, subject to repeal or change by the affirmative vote of the holders of at least 80% of the voting power of all the shares of the Company entitled to vote in the election of directors, voting together as a single class.

Section 2. Shareholder Proposals. No proposal by a shareholder made pursuant to Section 1 of this Article VII may be voted upon at an annual meeting of shareholders unless such shareholder shall have delivered or mailed in a timely manner (as set forth in this Section 2) and in writing to the Secretary of the Company (a) notice of such proposal and the text of the proposed alteration, amendment or repeal, (b) evidence reasonably satisfactory to the Secretary of the Company, of such shareholder's status as such and of the number of shares of each class of capital stock of the Company of which such shareholder is the beneficial owner, (c) a list of the names and addresses of other beneficial owners of shares of the capital stock of the Company, if any, with whom such shareholder is acting in concert, and the number of shares of each class of capital stock of the Company beneficially owned by each such beneficial owner and (d) an opinion of counsel, which counsel and the form and substance of which opinion shall be reasonably satisfactory to the Board of Directors of the Company, to the effect that the Bylaws (if any) resulting from the adoption of such proposal would not be in conflict with the Articles of Incorporation of the Company or the laws of the State of Texas. To be timely in connection with an annual meeting of shareholders, a shareholder's notice and other aforesaid items shall be delivered to or mailed and received at the principal executive offices of the Company not less than ninety nor more than 180 days prior to the date on which the immediately preceding year's annual meeting of shareholders was held. In no event shall the public disclosure of an adjournment of an annual meeting of shareholders commence a new time period for the giving of a shareholder's notice as described above.

Within thirty days after such shareholder shall have submitted the aforesaid items, the Secretary or the Board of Directors of the Company shall determine whether the items to be ruled upon by them are reasonably satisfactory and shall notify such shareholder in writing of its determination. If such shareholder fails to submit a required item in the form or within the time indicated, or if the Secretary or the Board of Directors of the Company determines that the items to be ruled upon by them are not reasonably satisfactory, then such proposal by such shareholder may not be voted upon by the shareholders of the Company at such annual meeting of shareholders. The Chairman of the Meeting shall, if the facts warrant, determine and declare to the meeting that a proposal by a shareholder of the Company made pursuant to Section 1 of this Article VII was not made in accordance with the procedures prescribed by these Bylaws, and if he should so determine, he shall so declare to the meeting and the defective proposal shall be disregarded. Beneficial ownership shall be determined in accordance with Rule 13d-3 under the Exchange Act.

Nothing in this Section 2 shall be interpreted or construed to require the inclusion of information about any such proposal in any proxy statement distributed by, at the direction of, or on behalf of the Board of Directors or the Company.

No proposal by a shareholder made pursuant to Section 1 of this Article VII shall be voted upon at a special meeting of shareholders unless such proposal has been stated in the notice of such special meeting or shall otherwise have been properly brought before the meeting by or at the direction of the Chairman of the Meeting or the Board of Directors (or any duly authorized committee thereof).

HI -- EXHIBIT 12

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES
COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES
(THOUSANDS OF DOLLARS)

| | | NINE MONTHS ENDED SEPTEMBER 30, 1998 | TWELVE MONTHS ENDED SEPTEMBER 30, 1998 |
|---|---|---|---|
| FIXED CHARGES AS DEFINED: | | | |
| (1) | Interest on Long-Term Debt | $ 310,584 | 413,916 |
| (2) | Other Interest | 67,620 | 92,906 |
| (3) | Capitalized Interest | 8,187 | 10,357 |
| (4) | Distribution on Trust Securities | 21,960 | 29,462 |
| (5) | Interest Component of Rentals Charged to Operating Expense. | 7,863 | 10,705 |
| (6) | Total Fixed Charges | $ 416,214 | $ 557,346 |
| EARNINGS AS DEFINED: | | | |
| (7) | Income from Continuing Operations | $ 260,422 | $ 256,487 |
| (8) | Income Taxes for Continuing Operations | 152,528 | 161,653 |
| (9) | Fixed Charges (line 6) | 416,214 | 557,346 |
| (10) | Capitalized Interest | (8,187) | (10,357) |
| (11) | Income from Continuing Operations Before Income Taxes and Fixed Charges | $ 820,977 | $ 965,129 |
| RATIO OF EARNINGS TO FIXED CHARGES (LINE 11 DIVIDED BY LINE 6) | | 1.97 | 1.73 |
| PREFERRED DIVIDENDS REQUIREMENTS: | | | |
| (12) | Preferred Stock Dividends | $ 292 | $ 390 |
| (13) | Less Tax Deduction for Preferred Dividends | 27 | 54 |
| (14) | Total | $ 265 | $ 336 |
| (15) | Ratio of Pre-Tax Income from continuing operations to Net Income (line 7 plus line 8 divided by line 7) | 1.59 | 1.63 |
| (16) | Line 14 times line 15 | $ 421 | $ 548 |
| (17) | Add Back Tax Deduction (line 13) | 27 | 54 |
| (18) | Preferred Dividends Factor | 448 | 602 |
| (19) | Total Fixed Charges (line 6) | $ 416,214 | $ 557,346 |
| (20) | Preferred Dividends Factor (line 18) | 448 | 602 |
| (21) | Total | 416,662 | 557,948 |
| RATIOS OF EARNINGS TO FIXED CHARGES AND PREFERRED DIVIDENDS (LINE 11 DIVIDED BY LINE 21) | | 1.97 | 1.73 |

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HOUSTON INDUSTRIES INCORPORATED

9-MOS
DEC-31-1998
JAN-01-1998
SEP-30-1998
PER-BOOK
9,552,268
3,742,702
2,214,410
4,040,450
0
19,549,830
2,890,846
0
1,956,048
4,846,894
0
9,740
5,934,342
0
452,900
1,465,250
610,923
0
14,760
1,139
6,213,882
19,549,830
8,844,237
152,528
7,597,219
7,597,219
1,247,018
(436,871)
810,147
397,197
260,422
292
260,130
317,137
255,333
1,174,079
0.92
0.91

TOTAL ANNUAL INTEREST CHARGES ON ALL BONDS IS AS OF YEAR-TO-DATE 9/30/98.

HOUSTON INDUSTRIES INCORPORATED AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE YEARS ENDED DECEMBER 31, 1997

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(c) Regulatory Assets and Other Long-Lived Assets.

The Company and certain subsidiaries of NorAm apply the accounting policies established in SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation," to the accounts of Electric Operations, Natural Gas Distribution and the Interstate Pipeline operations of MRT. In general, SFAS No. 71 permits a company with cost-based rates to defer certain costs that would otherwise be expensed to the extent that the rate regulated company is recovering or expects to recover such costs in rates charged to its customers.

The following is a list of regulatory assets and liabilities reflected on the Company's Consolidated Balance Sheet as of December 31, 1997, detailed by Electric Operations and other segments.

| | ELECTRIC OPERATIONS | OTHER | TOTAL COMPANY |
|---|---|---|---|
| | (MILLIONS OF DOLLARS) | | |
| Deferred plant costs -- net | $ 562 | | $ 562 |
| Recoverable project costs -- net | 78 | | 78 |
| Regulatory tax asset -- net | 357 | | 357 |
| Unamortized loss on reacquired debt | 127 | | 127 |
| Deferred debits | 71 | $ 48 | 119 |
| Accumulated deferred income taxes -- regulatory tax asset | (99) | | (99) |
| Total | $1,096 | $ 48 | $1,144 |

If, as a result of changes in regulation or competition, the Company and NorAm's ability to recover these assets and/or liabilities would not be assured, then pursuant to SFAS No. 101, "Accounting for the Discontinuation of Application of SFAS No. 71" and SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," the Company and NorAm would be required to write off or write down such net regulatory assets to the extent that they ultimately were determined not to be recoverable.

Effective January 1, 1996, the Company and NorAm adopted SFAS No. 121. SFAS No. 121 requires that long-lived assets and certain identifiable intangibles to be held and used or disposed of by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Adoption of the standard did not result in a write-down of the carrying amount of any asset on the books of the Company or NorAm.

In July 1997, the Emerging Issues Task Force (EITF) of the FASB reached a consensus on Issue No. 97-4, "Deregulation of the Pricing of Electricity -- Issues Related to the Application of FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No. 101, Regulated Enterprises -- Accounting for the Discontinuation of Application of FASB Statement No. 71" (EITF 97-4). EITF 97-4 concluded that the application of SFAS No. 71 to a segment which is subject to a deregulation plan should cease when the legislation and enabling rate order contain sufficient detail for the utility to reasonably determine what the transition plan will entail. In addition, EITF 97-4 requires the regulatory assets and liabilities to be allocated to the applicable portion of the electric utility from which the source of the regulated cash flows will be derived. On June 2, 1997, the Texas legislature adjourned without having adopted or taken any formal action with respect to various proposals concerning the restructuring of the Texas electric utility industry, including proposals related to retail electric competition and stranded cost recovery. At this time, the Company cannot predict what, if any, action the Texas legislature may take in the next legislative session (scheduled to commence in 1999) with respect to any of these proposals or the ultimate form in which such proposals may be adopted, if at all. Although the Company has determined that no impairment loss or write-offs of regulatory assets need be recognized for applicable assets of continuing operations as of December 31, 1997, this conclusion may change in the future (i) as competition influences wholesale and retail pricing in the electric utility industry, (ii) depending on regulatory action, if any and (iii) depending on legislation, if any, that is passed.

(n) Investments in Time Warner Securities.

The Company owns 11 million shares of non-publicly traded Time Warner convertible preferred stock (TW Preferred). The TW Preferred is redeemable after July 6, 2000, has an aggregate liquidation preference of $100 per share (plus accrued and unpaid dividends), is entitled to annual dividends of $3.75 per share until July 6, 1999, is currently convertible by the Company and after July 6, 1999 is exchangeable by Time Warner into approximately 22.9 million shares of Time Warner common stock. Each share of preferred stock is entitled to two votes (voting together with the holders of the Time Warner common stock as a single class).

The Company has recorded its investment in these securities at a value of $990 million on the Company's Consolidated Balance Sheets. Investment in the TW Preferred is accounted for under the cost method. Dividends on these securities are recognized as income at the time they are earned. The Company recorded pre-tax dividend income with respect to the Time Warner securities of $41.3 million, $41.6 million and $20.1 million in 1997, 1996 and 1995, respectively.

To monetize its investment in the TW Preferred, the Company sold in July 1997, 22.9 million of its unsecured 7% ACES. For additional information about the offering of ACES, see Note 8(e). As a result of the issuance of the ACES, a portion of the increase in the market value above $55.5844 per share of Time Warner common stock (the security into which the TW Preferred is convertible) results in unrealized accounting losses to the Company for the ACES, pending the conversion of the Company's TW Preferred into Time Warner common stock. For example, prior to the conversion of the TW Preferred into Time Warner common stock, when the market price of Time Warner common stock increases above $55.5844, the Company records in Other Income (Expense) an accounting loss for the ACES equal to (i) the aggregate amount of such increase as applicable to all ACES multiplied by (ii) 0.8264. In accordance with generally accepted accounting principles, this accounting loss (which reflects the unrealized increase in the Company's indebtedness with respect to the ACES) may not be offset by accounting recognition of the increase in the market value of the Time Warner common stock that underlies the TW Preferred. Upon conversion of the TW Preferred, the Company will begin recording unrealized net changes in the market prices of the Time Warner common stock and the ACES as a component of common stock equity.

As of December 31, 1997, the market price of Time Warner common stock was $62.00 per share. Accordingly, the Company recognized an increase of $121 million in the unrealized liability relating to its ACES indebtedness (which resulted in an after-tax earnings reduction of $79 million or $.31 per share). The Company believes that this unrealized loss for the ACES is more than economically hedged by the approximately $430 million unrecorded unrealized gain at December 31, 1997 relating to the increase in the fair value of the Time Warner common stock underlying the investment in TW Preferred since the date of its acquisition. As of February 28, 1998, the price of Time Warner common stock was $67.50 per share which would have resulted in the Company recognizing an additional increase of $104 million in the unrealized liability represented by its indebtedness under the ACES. The related unrecorded unrealized gain as of February 28, 1998 would have been computed as an additional $126 million.

(2) DERIVATIVE FINANCIAL INSTRUMENTS (RISK MANAGEMENT)

(a) Trading Activities.

The Company, through NES, a subsidiary of NorAm, offers price risk management services primarily in the natural gas and electric industries. NES provides these services through, and by utilizing, a variety of derivative financial instruments, including fixed-price swap agreements, variable-price swap agreements, exchange-traded energy futures and option contracts, and swaps and options traded in the over-the-counter financial markets. Fixed-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between a fixed and variable price for the commodity. Variable-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between either industry pricing publications or exchange quotations.

Certain trading transactions qualify for hedge accounting and accordingly unrealized gains and losses associated with these transactions are deferred. For trading transactions that do not qualify for hedge accounting, NES uses mark- to-market accounting. Accordingly, such financial instruments are recorded at fair value with realized and unrealized gains (losses) recorded as a component of operating revenues in the Company's Consolidated Statements of Income. The recognized, unrealized balance is recorded as a deferred debit on the Company's Consolidated Balance Sheets.

The notional quantities and maximum terms of derivative financial instruments held for trading purposes at December 31, 1997 are presented below (volumes in billions of British thermal units equivalent (Bbtue)):

| | VOLUME-FIXED PRICE PAYOR | VOLUME-FIXED PRICE RECEIVER | MAXIMUM TERM (YEARS) |
|---|---|---|---|
| Natural gas | 85,701 | 64,890 | 4 |
| Electricity | 40,511 | 42,976 | 1 |

In addition to the fixed-price notional volumes above, NES also has variable-price swap agreements, as discussed above, totaling 101,465 Bbtue. Notional amounts reflect the volume of transactions but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure the Company's exposure to market or credit risks.

The estimated fair value of derivative financial instruments held for trading purposes at December 31, 1997 are presented below (dollars in millions):

| | FAIR VALUE | | AVERAGE FAIR VALUE(a) | |
|---|---|---|---|---|
| | ASSETS | LIABILITIES | ASSETS | LIABILITIES |
| Natural gas | $ 46 | $39 | $56 | $48 |
| Electricity | $ 6 | $ 6 | $ 3 | $ 2 |

- -----------

(a) Computed using the ending balance of each month.

Substantially all of the fair value shown in the table above at December 31, 1997 has been recognized in income. The fair value as of and for the year ended December 31, 1997 was estimated using quoted prices where available and considering the liquidity of the market for the derivative financial instruments. The prices are subject to significant changes based on changing market conditions. The derivative financial instruments included in the NES trading portfolio as of and for the year ended December 31, 1996 were immaterial.

The weighted-average term of the trading portfolio, based on volumes, is less than one year. The maximum and average terms disclosed herein are not indicative of likely future cash flows as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and the Company's risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

(b) Non-Trading Activities.

To reduce the risk from market fluctuations in the price of electric power, natural gas and related transportation, NorAm and certain of its subsidiaries enter into futures transactions, swaps and options (Energy Derivatives) in order to hedge certain natural gas in storage, as well as certain expected purchases, sales and transportation of natural gas and electric power (a portion of which are firm commitments at the inception of the hedge). Energy Derivatives are also utilized to fix the price of compressor fuel or other future operational gas requirements, although usage to date for this purpose has not been material. Usage of electricity derivative financial instruments by the Company and its subsidiaries for purposes other than trading is immaterial.

Certain subsidiaries of the Company also utilize interest-rate derivatives (principally interest-rate swaps) in order to adjust the portion of its overall borrowings which are subject to interest-rate risk, and also utilize such derivatives to effectively fix the interest rate on debt expected to be issued for refunding purposes.

For transactions involving either Energy Derivatives or interest-rate derivatives, hedge accounting is applied only if the derivative (i) reduces the price risk of the underlying hedged item and (ii) is designated as a hedge at its inception. Additionally, the derivatives must be expected to result in financial impacts which are inversely correlated to those of the item(s) to be hedged. This correlation (a measure of hedge effectiveness) is measured both at the inception of the hedge and on an ongoing basis, with an acceptable level of a correlation of at least 80% for hedge designation. If and when correlation ceases to exist at an acceptable level, hedge accounting ceases and mark-to-market accounting is applied.

In the case of interest-rate swaps associated with existing obligations, cash flows and expenses associated with the interest-rate derivative transactions are matched with the cash flows and interest expense of the obligation being hedged, resulting in an adjustment to the effective interest rate. When interest rate swaps are utilized to effectively fix the interest rate for an anticipated debt issuance, changes in the market value of the interest-rate derivatives are deferred and recognized as an adjustment to the effective interest rate on the newly issued debt.

Unrealized changes in the market value of Energy Derivatives utilized as hedges are not generally recognized in the Company's Consolidated Statements of Income until the underlying hedged transaction occurs. Once it becomes probable that an anticipated transaction will not occur, deferred gains and losses are recognized. In general, the financial impact of transactions involving these Energy Derivatives is included in the Company's Statement of Consolidated Income under the captions (i) fuel expenses, in the case of natural gas transactions, and (ii) purchased power, in the case of electric power transactions. Cash flows resulting from these transactions in Energy Derivatives are included in the Company's Statements of Consolidated Cash Flows in the same category as the item being hedged.

At December 31, 1997, subsidiaries of NorAm were fixed-price payors and fixed-price receivers in Energy Derivatives covering 38,754 Bbtu and 7,647 Bbtu of natural gas, respectively. Also, at December 31, 1997 subsidiaries of NorAm were parties to variable-priced Energy Derivatives totaling 3,630 Bbtu of natural gas. The weighted average maturity of these instruments is less than one year.

The notional amount is intended to be indicative of the Company and its subsidiaries' level of activity in such derivatives, although the amounts at risk are significantly smaller because, in view of the price movement correlation required for hedge accounting, changes in the market value of these derivatives generally are offset by changes in the value associated with the underlying physical transactions or in other derivatives. When Energy Derivatives are closed out in advance of the underlying commitment or anticipated transaction, however, the market value changes may not offset due to the fact that price movement correlation ceases to exist when the positions are closed as further discussed below. Under such circumstances, gains (losses) are deferred and recognized as a component of income when the underlying hedged item is recognized in income.

The average maturity discussed above and the fair value discussed in Note 13 are not necessarily indicative of likely future cash flows as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and the Company's risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

(c) Trading and Non-trading -- General Policy.

In addition to the risk associated with price movements, credit risk is also inherent in the Company and its subsidiaries' risk management activities. Credit risk relates to the risk of loss resulting from non-performance of contractual obligations by a counterparty. While, as yet, the Company and its subsidiaries have experienced no significant losses due to the credit risk associated with these arrangements, the Company has off-balance sheet risk to the extent that the counterparties to these transactions may fail to perform as required by the terms of each such contract. In order to minimize this risk, the Company and/or its subsidiaries, as the case may be, enter into such contracts primarily with those counterparties with a minimum Standard & Poor's or Moody's rating of BBB- or Baa3, respectively. For long-term arrangements, the Company and its subsidiaries periodically review the financial condition of such firms in addition to monitoring the effectiveness of these financial contracts in achieving the Company's objectives. Should the counterparties to these arrangements fail to perform, the Company would seek to compel performance at law or otherwise, or obtain compensatory damages in lieu thereof. The Company might be forced to acquire alternative hedging arrangements or be required to honor the underlying commitment at then current market prices. In such event, the Company might incur additional loss to the extent of amounts, if any, already paid to the counterparties. In view of its criteria for selecting counterparties, its process for monitoring the financial strength of these counterparties and its experience to date in successfully completing these transactions, the Company believes that the risk of incurring a significant financial statement loss due to the non-performance of counterparties to these transactions is minimal.

The Company's policies prohibit the use of leveraged financial instruments.

The Company has established a Risk Oversight Committee to oversee all corporate price and credit risk, including NES' risk management and trading activities. The Risk Oversight Committee's responsibilities include reviewing the Company and its subsidiaries' overall risk management strategy and monitoring risk management activities to ensure compliance with the Company's risk management limitations, policies and procedures.

(3) RATE MATTERS

(a) Electric Proceedings.

The Texas Utility Commission has original (or in some cases appellate) jurisdiction over Electric Operations' electric rates and services. Texas Utility Commission orders may be appealed to a District Court in Travis County, and from that court's decision an appeal may be taken to the Court of Appeals for the 3rd District at Austin (Austin Court of Appeals). Discretionary review by the Supreme Court of Texas may be sought from decisions of the Austin Court of Appeals. In the event that the courts ultimately reverse actions of the Texas Utility Commission, such matters are remanded to the Texas Utility Commission for action in light of the courts' orders.

(b) Transition and Price Reduction Plan.

In 1997, the Texas legislature considered but did not pass legislation intended to address various issues concerning the restructuring of the electric utility industry, including proposals that would permit Texas retail electric customers to choose their own electric suppliers beginning on December 31, 2001. The legislative proposals included provisions relating to full stranded cost recovery; rate reductions; rate freezes; the unbundling of generation operations, transmission and distribution and customer service operations; securitization of regulatory assets; and consumer protections. Although the Company and certain other parties (including the Texas Utility Commission) supported the bill, it was not enacted prior to the expiration of the legislative session.

In October 1997, the Company announced a proposed transition to competition plan intended to address certain aspects of the proposals contained in the legislation formerly pending before the Texas legislature. By mid December 1997, negotiations resulted in a settlement agreement (Settlement Agreement) executed by the Company, the staffs of the Texas Utility Commission and the City of Houston, representatives of the state's principal consumer and industrial groups and others. The Settlement Agreement was subsequently filed with the Texas Utility Commission, where it is currently under consideration.

Under the terms of the Settlement Agreement, residential customers will receive a 4% credit to the base cost of electricity in 1998, increasing to 6% in 1999. Small and mid-sized businesses will receive a 2% credit to their base costs beginning in 1998. The combined effect of these reductions is expected to decrease base revenues by $166 million over a two year period. In addition, the Company (over the next two years) will be permitted, as a way to assist the Company in mitigating its potentially stranded costs, to (i) redirect to production property all of its current depreciation expenses that would otherwise be credited to accumulated depreciation for transmission and distribution property, and (ii) apply any and all earnings above a rate of return cap of 9.95% to increase the depreciation of production property. The Company estimates that redirected depreciation over the two-year period of 1998 and 1999 will be approximately $364 million. As part of the Settlement Agreement, the Company agreed to support proposed legislation in the 1999 Texas legislative session that includes provisions providing for retail customer choice effective December 31, 2001 and other provisions consistent with those in the 1997 proposed legislation.

The Settlement Agreement is currently under consideration by the Texas Utility Commission, the City of Houston and other cities served by HL&P. In December 1997, the Texas Utility Commission approved the petition filed by the Company to implement the requested base rate credits on a temporary basis beginning January 1, 1998, and pending final Texas Utility Commission consideration. The approval also included the accounting order necessary to permit the Company to begin redirecting depreciation from its transmission and distribution facilities to production property on a temporary basis pending final Texas Utility Commission consideration. A procedural schedule has been developed by the Texas Utility Commission whereby a final decision regarding the Settlement Agreement would be reached by the end of March 1998.

(c) 1995 Rate Case.

In August 1995, the Texas Utility Commission unanimously approved a settlement resolving the Company's most recent rate case (Docket No. 12065) as well as a separate proceeding (Docket No. 13126) regarding the prudence of operation of the South Texas Project.

See Note 1(f) regarding additional depreciation and amortization that is permitted under the 1995 Rate Case Settlement with respect to the South Texas Project and the Company's investment in certain lignite reserves associated with a canceled generating station.

(d) Docket No. 6668.

In September 1997, the Company received a judgment dismissing all outstanding appeals of the Texas Utility Commission's order in Docket No. 6668, an inquiry into the prudence of the planning and construction of the South Texas Project. In that order, the Texas Utility Commission had determined that $375.5 million of the Company's $2.8 billion investment in the South Texas Project had been imprudently incurred. That ruling was incorporated into Electric Operations' 1988 and 1991 rate cases. As a result of this judgment, all outstanding appeals of prior rate cases involving the Company have now been dismissed and the orders granted in such cases are now final.

(4) JOINTLY OWNED ELECTRIC UTILITY PLANT

(a) Investment in South Texas Project.

The Company has a 30.8% interest in the South Texas Project, which consists of two 1,250 MW nuclear generating units, and bears a corresponding 30.8% share of capital and operating costs associated with the project. As of December 31, 1997, the Company's investment in the South Texas Project was $1.8 billion (net of $714 million accumulated depreciation). The Company's investment in nuclear fuel (including AFUDC) was $51 million (net of $205 million amortization) as of such date.

Effective November 1997, the Company and the other three owners of the South Texas Project completed the transfer of the Company's responsibilities for operation of the South Texas Project to a new Texas non-profit corporation formed by the four owners and known as the STP Nuclear Operating Company (STPNOC). STPNOC was formed exclusively for the purpose of operating the South Texas Project, and the Company's officers and employees who had been responsible for day-to-day operation and management of the South Texas Project were transferred to the operating company in October, 1997 and the related employee benefit obligations were transferred in December, 1997. The operating company is managed by a board of directors composed of one director from each of the four owners, along with the chief executive officer of STPNOC. Formation of STPNOC did not affect the underlying ownership of the South Texas Project, which continues as a tenancy in common among the four owners, with each owner retaining its undivided ownership interest in the two nuclear-fueled generating units and the electrical output from those units. The four owners continue to provide overall oversight of the operations of the South Texas Project through an owners' committee composed of representatives of each of the owners and through the board of directors of STPNOC.

(b) 1996 Settlement of South Texas Project Litigation.

In 1996, the Company recorded an aggregate $95 million ($62 million net of tax) charge in connection with various settlements of lawsuits filed by co-owners of the South Texas Project. The formation of STPNOC by the four co-owners (including the Company) of the South Texas Project was contemplated by these settlements. For information about the execution of an operations agreement with the City of San Antonio in connection with one of these settlements, see Note 12(c).

(c) Nuclear Insurance.

The Company and the other owners of the South Texas Project maintain nuclear property and nuclear liability insurance coverage as required by law and periodically review available limits and coverage for additional protection. The owners of the South Texas Project currently maintain $2.75 billion in property damage insurance coverage, which is above the legally required minimum, but is less than the total amount of insurance currently available for such losses. This coverage consists of $500 million in primary property damage insurance and excess property insurance in the amount of $2.25 billion. With respect to excess property insurance, the Company and the other owners of the South Texas Project are subject to assessments, the maximum aggregate assessment under current policies being $11.5 million during any one policy year. The application of the proceeds of such property insurance is subject to the priorities established by the Nuclear Regulatory Commission (NRC) regulations relating to the safety of licensed reactors and decontamination operations.

Pursuant to the Price Anderson Act (Act), the maximum liability to the public of owners of nuclear power plants, such as the South Texas Project, was $8.72 billion as of December 1997. Owners are required under the Act to insure their liability for nuclear incidents and protective evacuations by maintaining the maximum amount of financial protection available from private sources and by maintaining secondary financial protection through an industry retrospective rating plan. The assessment of deferred premiums provided by the plan for each nuclear incident is up to $79.3 million per reactor, subject to indexing for inflation, a possible 5% surcharge (but no more than $10 million per reactor per incident in any one year) and a 3% state premium tax. The Company and the other owners of the South Texas Project currently maintain the required nuclear liability insurance and participate in the industry retrospective rating plan.

There can be no assurance that all potential losses or liabilities will be insurable, or that the amount of insurance will be sufficient to cover them. Any substantial losses not covered by insurance would have a material effect on the Company's financial condition and results of operations.

(d) Nuclear Decommissioning.

The Company contributes $14.8 million per year to a trust established to fund its share of the decommissioning costs for the South Texas Project. For a discussion of securities held in the Company's nuclear decommissioning trust, see Note 1(o). In May 1994, an outside consultant estimated the Company's portion of decommissioning costs to be approximately $318 million (1994 dollars). The consultant's calculation of decommissioning costs for financial planning purposes used the DECON methodology (prompt removal/dismantling), one of the three alternatives acceptable to the NRC, and assumed deactivation of Units Nos. 1 and 2 upon the expiration of their 40-year operating licenses. While the current and projected funding levels currently exceed minimum NRC requirements, no assurance can be given that the amounts held in trust will be adequate to cover the actual decommissioning costs of the South Texas Project. Such costs may vary because of changes in the assumed date of decommissioning, changes in regulatory and accounting requirements, changes in technology and changes in costs of labor, materials and equipment.

(e) Assessment Fees for Spent Fuel Disposal and Enrichment and Decommission

By contract, the United States Department of Energy (DOE) has committed itself ultimately to take possession of all spent fuel generated by the South Texas Project. The DOE contract currently requires payment of a spent fuel disposal fee on nuclear plant-generated electricity of one mill (one-tenth of a cent) per net KWH sold. This fee is subject to adjustment to ensure full cost recovery by the DOE. The Energy Policy Act also includes a provision that assesses a fee upon domestic utilities that purchased nuclear fuel enrichment services from the DOE before October 24, 1992. The South Texas Project's assessment is approximately $2 million per year (subject to escalation for inflation). The Company has a remaining estimated liability of $5.5 million for such assessments.

(5) EQUITY INVESTMENTS IN FOREIGN AFFILIATES

HI Energy, a wholly owned subsidiary of the Company formed in 1993, participates primarily in the development and acquisition of foreign independent power projects and the privatization of foreign generating and distribution companies.

The Company accounts for affiliate investments of its subsidiaries under the equity method of accounting where: (i) the subsidiary's ownership interest in the affiliate ranges from 20% to 50%, (ii) the ownership interest is less than 20% but the subsidiary exercises significant influence over operating and financial policies of such affiliate or (iii) the subsidiary's ownership interest in the affiliate exceeds 50% but the subsidiary does not exercise control over the affiliate. The Company's proportionate share of the equity in net income in these affiliates for the years ended December 31, 1997, 1996 and 1995 was $48.6 million, $17 million and $.5 million, respectively, which amounts are included on the Company's Statements of Consolidated Income in Revenues -- International.

The Company's and its subsidiaries' equity investments in foreign and non-regulated affiliates at December 31, 1997 and 1996 were $704 million and $502 million, respectively.

(a) Acquisitions.

In May 1996, a subsidiary of HI Energy acquired 11.35% of the common stock of Light, a publicly held Brazilian corporation, for $393 million which includes the direct costs of the acquisition. Light is the operator under a 30-year concession agreement of an integrated electric power and distribution system that serves a portion of the state of Rio de Janeiro, Brazil, including the city of Rio de Janeiro. The winning bidders in the government-sponsored auction of Light, including a subsidiary of HI Energy, formed a consortium whose aggregate ownership interest of 50.44% represents a controlling interest in Light.

In June 1997, a consortium of investors which included a subsidiary of HI Energy, acquired for $496 million a 56.7% controlling ownership interest in Empresa de Energia del Pacifico S.A.E.S.P. (EPSA), an electric utility system serving the Valle de Cauca region of Colombia, including the area surrounding the city of Cali. HI Energy contributed $152 million of the purchase price for a 28% ownership interest in EPSA. In addition to its distribution facilities, EPSA owns 850 MW of electric generation capacity.

In May 1997, HI Energy increased its indirect ownership interest in Empresa de la Plata S.A. (EDELAP), an Argentina electric utility, from 48% to 63%. The purchase price of the additional interest was $28 million. HI Energy has recorded its investment in EDELAP using the equity method because of the significance of the participatory rights held by a minority shareholder.

HI Energy has accounted for these transactions under purchase accounting and has recorded its investments and its interest in the affiliates' earnings after the acquisition dates using the equity method. The purchase prices were allocated on the basis of the estimated fair market values of the assets acquired and the liabilities assumed as of the dates of acquisition. The differences between the amounts paid and the underlying fair values of the net assets acquired are being amortized as a component of earnings attributable to unconsolidated affiliates over the estimated lives of the projects ranging from 30 to 40 years. Purchase price adjustments to fixed assets are being amortized over the underlying assets' estimated useful lives.

(b) Valuation Allowance.

HI Energy is an investor in two waste tire-to-energy projects in the State of Illinois. The projects had been developed by HI Energy in reliance upon a state subsidy intended to encourage development of energy project facilities for the disposal of solid waste. In March 1996, the State of Illinois repealed the subsidy. As a result of the loss of the subsidy, the Company recorded (i) a $28 million valuation allowance effective in the fourth quarter of 1995 (resulting in an $18 million after-tax charge in that year) and (ii) an additional $8 million valuation allowance in the first quarter of 1996 (resulting in a $5 million after-tax charge in that year). At the time of the Illinois legislature's actions, construction work on one of the waste-to-energy projects had been substantially completed.

The valuation allowance reflects the combined amounts lent to the projects on a subordinated basis by HI Energy. HI Energy also is a party to two separate note purchase agreements committing it, under certain circumstances, to lend up to an additional $16 million. The Company has entered into a support agreement to enable HI Energy to honor its obligation under these note purchase agreements. In the Company's opinion, it is unlikely that additional loans would be required to be made under the note purchase agreements relating to the facility for which construction had been substantially completed (Ford Heights Project). In March 1996, a subsidiary of HI Energy purchased from a senior lending bank all notes relating to the project for which construction had not yet commenced (Fulton Project) (approximately $4.1 million). As a consequence, HI Energy has discretion over when, if ever, the construction activities for the Fulton project will resume and, in turn, control over future obligations of HI Energy to acquire additional subordinated notes for the Fulton project.

The Company and HI Energy are defendants in various lawsuits filed in connection with the Ford Heights Project. CGE Ford Heights, L.L.C., (CGE Ford Heights) the owner of the project, has filed for reorganization under Chapter 11 of the Federal Bankruptcy Code. In October 1997, CGE Ford Heights filed a lawsuit against First Trust National Association, HI Energy and Zurn Industries, Inc. (Zurn). CGE Ford Heights is seeking a determination of the funding obligations of HI Energy and Zurn. In addition, the trustee for the holders of the bonds issued to finance the project has filed suit against the Company, HI Energy and Zurn. The trustee alleges that the Company and HI Energy are obligated to contribute to CGE Ford Heights approximately $15 million in the form of subordinated debt obligations. The Company and HI Energy are vigorously contesting the matter. The Company does not believe that the litigation will have a material adverse impact on the Company's or HI Energy's financial statements.

(12) COMMITMENTS AND CONTINGENCIES

(a) Commitments.

The Company has various commitments for capital expenditures, fuel, purchased power, cooling water and operating leases. Commitments in connection with Electric Operations' capital program are generally revocable by the Company, subject to reimbursement to manufacturers for expenditures incurred or other cancellation penalties. The Company's and its subsidiaries' other commitments have various quantity requirements and durations. However, if these requirements could not be met, various alternatives are available to mitigate the cost associated with the contracts' commitments.

(b) Fuel and Purchased Power.

The Company is a party to several long-term coal, lignite and natural gas contracts which have various quantity requirements and durations. Minimum payment obligations for coal and transportation agreements are approximately $200 million in 1998, $203 million in 1999 and $177 million in 2000. Additionally, minimum payment obligations for lignite mining and lease agreements are approximately $9 million for 1998, $9 million for 1999 and $10 million for 2000. Minimum payment obligations for both natural gas purchase and storage contracts associated with Electric Operations are approximately $9 million annually in 1998, 1999 and 2000.

The Company also has commitments to purchase firm capacity from cogenerators of approximately $22 million in both 1998 and 1999. Texas Utility Commission rules currently allow recovery of these costs through Electric Operations' base rates for electric service and additionally authorize the Company to charge or credit customers through a purchased power cost recovery factor for any variation in actual purchased power costs from the cost utilized to determine its base rates. In the event that the Texas Utility Commission, at some future date, does not allow recovery through rates of any amount of purchased power payments, the two principal firm capacity contracts contain provisions allowing the Company to suspend or reduce payments and seek repayment for amounts disallowed.

(c) Operations Agreement with City of San Antonio.

As part of the settlement with the City of San Antonio, the Company entered into a 10-year joint operations agreement under which the Company and the City of San Antonio, acting through the City Public Service Board of San Antonio (CPS), share savings resulting from the joint dispatching of their respective generating assets in order to take advantage of each system's lower cost resources. Under the terms of the joint operations agreement entered into between CPS and Electric Operations, the Company has guaranteed CPS minimum annual savings of $10 million and a minimum cumulative savings of $150 million over the 10-year term of the agreement. Based on current forecasts and other assumptions regarding the combined operation of the two generating systems, the Company anticipates that the savings resulting from joint operations will equal or exceed the minimum savings guaranteed under the joint operating agreement. In 1996, savings generated for CPS' account for a partial year of joint operations were approximately $14 million. In 1997, savings generated for CPS' account for a full year of operation were approximately $22 million.

(d) Transportation Agreement.

NorAm had an agreement (the ANR Agreement) with ANR Pipeline Company (ANR) which contemplated a transfer to ANR of an interest in certain of NorAm's pipeline and related assets, representing capacity of 250 Mmcf/day, and pursuant to which ANR had advanced $125 million to the Company. The ANR Agreement has been restructured and, after refunds of $84 million through December 31, 1997, NorAm currently retains $41 million (recorded as a liability) in exchange for ANR's or its affiliates' use of 130 Mmcf/ day of capacity in certain of NorAm's transportation facilities. The level of transportation will decline to 100 Mmcf/day in the year 2003 with a refund of $5 million to ANR and the ANR Agreement will terminate in 2005 with a refund of the remaining balance.

(e) Lease Commitments.

The following table sets forth certain information concerning NorAm's obligations under operating leases:

Minimum Lease Commitments at December 31, 1997(1)

| | (MILLIONS OF DOLLARS) |
|---|---|
| 1998 | $ 24 |
| 1999 | 19 |
| 2000 | 16 |
| 2001 | 15 |
| 2002 | 9 |
| 2003 and beyond | 22 |
| Total | $105 |

- ---------

(1) Principally consisting of rental agreements for building space and data processing equipment and vehicles (including major work equipment).

NorAm has a master leasing agreement which provides for the lease of vehicles, construction equipment, office furniture, data processing equipment and other property. For accounting purposes, the lease is treated as an operating lease. At December 31, 1997, NorAm had leased assets with a value of approximately $58.1 million under this lease with a basic term of one year. NorAm does not expect to lease additional property under this lease agreement.

Lease payments related to NorAm's master leasing agreement are included in the preceding table for only their basic term. Total rental expense for all leases since the Acquisition Date was approximately $15 million in 1997.

(f) Letters of Credit.

At December 31, 1997, NorAm had letters of credit incidental with its ordinary business operations totaling approximately $42 million under which NorAm is obligated to reimburse drawings, if any.

(g) Indemnity Provisions.

At December 31, 1997, NorAm has $11.4 million accounting reserve on the Company's Consolidated Balance Sheet in Other Deferred Credits for possible indemnity claims asserted in connection with its disposition of NorAm's former subsidiaries or divisions, including the sale of (i) Louisiana Intrastate Gas Corporation, a former NorAm subsidiary engaged in the intrastate pipeline and liquids extraction business; (ii) Arkla Exploration Company, a former NorAm subsidiary engaged in oil and gas exploration and production activities; and (iii) Dyco Petroleum Company, a former NorAm subsidiary engaged in oil and gas exploration and production.

(h) Other.

Electric Operations' service area is heavily dependent on oil, gas, refined products, petrochemicals and related businesses. Significant adverse events affecting these industries would negatively affect the revenues of the Company. The Company and NorAm are involved in legal, tax and regulatory proceedings before various courts, regulatory commissions and governmental agencies regarding matters arising in the ordinary course of business, some of which involve substantial amounts. The Company's management regularly analyzes current information and, as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. The Company's management believes that the effect on the Company's and NorAm's respective financial statements, if any, from the disposition of these matters will not be material.

In February 1996, the cities of Wharton, Galveston and Pasadena filed suit, for themselves and a proposed class, against the Company and Houston Industries Finance Inc. (formerly a wholly owned subsidiary of the Company) citing underpayment of municipal franchise fees. The plaintiffs claim, among other things, that from 1957 to the present, franchise fees should have been paid on sales taxes collected by HL&P on non-electric receipts as well as electric sales. Plaintiffs advance their claims notwithstanding their failure to notice such claims over the previous four decades. Because all of the franchise ordinances affecting HL&P expressly impose fees only on electric sales, the Company regards plaintiffs' allegations as spurious and is vigorously contesting the matter. The plaintiffs' pleadings assert that their damages exceed $250 million. No trial date is currently set. Although the Company believes the claims to be without merit, the Company cannot at this time estimate a range of possible loss, if any, from the lawsuit, nor can any assurance be given as to its ultimate outcome

The Company is a party to litigation (other than that specifically noted) which arises in the normal course of business. Management regularly analyzes current information and, as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. Management believes that the effect on the Company's financial statements, if any, from the disposition of these matters will not be material.

NorAm -- EXHIBIT 12

NORAM ENERGY CORP. AND SUBSIDIARIES
COMPUTATION OF RATIOS OF EARNINGS TO FIXED CHARGES
(THOUSANDS OF DOLLARS)

| | NINE MONTHS ENDED SEPTEMBER 30, 1998 | TWELVE MONTHS ENDED SEPTEMBER 30, 1998 |
|---|---|---|
| Income from Continuing Operations | $ 51,421 | $ 78,914 |
| Income Taxes for Continuing Operations | 53,759 | 78,928 |
| Non-Utility Interest Capitalized | 0 | 0 |
| Income from Continuing Operations Before Income Taxes | 105,180 | 157,842 |
| Fixed Charges: | | |
| Interest | 78,115 | 107,134 |
| Distribution on Trust Securities | 533 | 812 |
| Portion of Rents Considered to Represent an Interest Factor | 6,747 | 9,241 |
| Total Fixed Charges | 85,395 | 117,187 |
| Income from Continuing Operations Before Income Taxes and Fixed Charges | $ 190,575 | $ 275,029 |
| Ratio of Earnings to Fixed Charges | 2.23 | 2.35 |

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NORAM ENERGY CORP.

9-MOS
DEC-31-1998
JAN-01-1998
SEP-30-1998
PER-BOOK
1,332,139
1,437,113
1,840,795
2,261,079
0
6,871,126
1
2,447,288
72,268
2,519,557
0
0
1,000,464
0
300,000
205,600
354,962
0
0
0
2,490,543
6,871,126
5,072,969
53,759
4,894,726
4,894,726
178,243
5,585
183,828
78,648
51,421
0
51,421
0
78,115
192,318
0
0

TOTAL ANNUAL INTEREST CHARGES ON ALL BONDS IS AS OF YEAR-TO-DATE 9/30/98.

NORAM ENERGY CORP. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE YEARS ENDED DECEMBER 31, 1997

(c) Regulatory Assets and Regulation.

In general, NorAm's interstate pipelines are subject to regulation by the Federal Energy Regulatory Commission, while its natural gas distribution operations are subject to regulation at the state or municipal level. Historically, all of NorAm's rate-regulated businesses have followed the accounting guidance contained in Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation" . NorAm discontinued application of SFAS No. 71 to NGT in 1992. As a result of the continued application of SFAS No. 71 to MRT and the natural gas distribution operations, NorAm's financial statements contain assets and liabilities which would not be recognized by unregulated entities.

At December 31, 1997 approximately $48 million in regulatory assets are reflected on NorAm's Consolidated Balance Sheet as deferred debits. These assets represent probable future revenue to NorAm associated with certain incurred costs as these costs are recovered through the rate making process. These costs are being recovered through rates over varying periods up to 40 years.

(2) DERIVATIVE FINANCIAL INSTRUMENTS (RISK MANAGEMENT)

(a) Trading Activities.

NorAm, through NES, offers price risk management services primarily in the natural gas and electric industries. NES provides these services through, and by utilizing, a variety of derivative financial instruments, including fixed-price swap agreements, variable-price swap agreements, exchange-traded energy futures and option contracts, and swaps and options traded in the over-the-counter financial markets. Fixed-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between a fixed and variable price for the commodity. Variable-price swap agreements require payments to, or receipts of payments from, counterparties based on the differential between either industry pricing publications or exchange quotations.

Certain trading transactions qualify for hedge accounting and accordingly unrealized gains and losses associated with these transactions are deferred. For trading transactions that do not qualify for hedge accounting, NES uses mark-to-market accounting. Accordingly, such financial instruments are recorded at fair value with realized and unrealized gains (losses) recorded as a component of revenues in NorAm's Statements of Consolidated Income. The recognized, unrealized balance is recorded as a deferred debit on NorAm's Consolidated Balance Sheets.

The notional quantities and maximum terms of derivative financial instruments held for trading purposes at December 31, 1997 are presented below (volumes in billions of British thermal units equivalent (Bbtue)):

| | VOLUME-FIXED PRICE PAYOR | VOLUME-FIXED PRICE RECEIVER | MAXIMUM TERM (YEARS) |
|---|---|---|---|
| Natural gas.................................. | 85,701 | 64,890 | 4 |
| Electricity.................................. | 40,511 | 42,976 | 1 |

In addition to the fixed-price notional volumes above, NES also has variable-price swap agreements, as discussed above, totaling 101,465 Bbtue. Notional amounts reflect the volume of transactions but do not represent the amounts exchanged by the parties to the financial instruments. Accordingly, notional amounts do not accurately measure NorAm's exposure to market or credit risks.

The estimated fair value of derivative financial instruments held for trading purposes at December 31, 1997 are presented below (dollars in millions):

| | FAIR VALUE | | AVERAGE FAIR VALUE(A) | |
|---|---|---|---|---|
| | ASSETS | LIABILITIES | ASSETS | LIABILITIES |
| Natural gas.................................. | $46 | $39 | $56 | $48 |
| Electricity.................................. | $ 6 | $ 6 | $ 3 | $ 2 |

- ---------------

(a) Computed using the ending balance of each month.

Substantially all of the fair value shown in the table above at December 31, 1997 has been recognized in income. The fair value as of and for the year ended December 31, 1997 was estimated using quoted prices where available and considering the liquidity of the market for the derivative financial instruments. The prices are subject to significant changes based on changing market conditions. The derivative financial instruments included in the NES trading portfolio as of and for the year ended December 31, 1996 were immaterial.

The weighted-average term of the trading portfolio, based on volumes, is less than one year. The maximum and average terms disclosed herein are not indicative of likely future cash flows as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and NorAm's risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

(b) Non-Trading Activities.

To reduce the risk from market fluctuations in the price of electric power, natural gas and related transportation, NorAm and certain of its subsidiaries enter into futures transactions, swaps and options (Energy Derivatives) in order to hedge certain natural gas in storage, as well as certain expected purchases, sales and transportation of natural gas and electric power (a portion of which are firm commitments at the inception of the hedge). Energy Derivatives are also utilized to fix the price of compressor fuel or other future operational gas requirements, although usage to date for this purpose has not been material. Usage of electricity derivative financial instruments by NorAm and its subsidiaries for purposes other than trading is immaterial.

NorAm also utilizes interest-rate derivatives (principally interest-rate swaps) in order to adjust the portion of its overall borrowings which are subject to interest-rate risk, and also utilizes such derivatives to effectively fix the interest rate on debt expected to be issued for refunding purposes.

For transactions involving either Energy Derivatives or interest-rate derivatives, hedge accounting is applied only if the derivative (i) reduces the price risk of the underlying hedged item and (ii) is designated as a hedge at its inception. Additionally, the derivatives must be expected to result in financial impacts which are inversely correlated to those of the item(s) to be hedged. This correlation (a measure of hedge effectiveness) is measured both at the inception of the hedge and on an ongoing basis, with an acceptable level of correlation of 80% for hedge designation. If and when correlation ceases to exist at an acceptable level, hedge accounting ceases and mark-to-market accounting is applied.

In the case of interest-rate swaps associated with existing obligations, cash flows and expenses associated with the interest-rate derivative transactions are matched with the cash flows and interest expense of the obligation being hedged, resulting in an adjustment to the effective interest rate. When interest rate swaps are utilized to effectively fix the interest rate for an anticipated debt issuance, changes in the market value of the interest-rate derivatives are deferred and recognized as an adjustment to the effective interest rate on the newly issued debt.

Unrealized changes in the market value of Energy Derivatives utilized as hedges are not generally recognized in NorAm's Statements of Consolidated Income until the underlying hedged transaction occurs. Once it becomes probable that an anticipated transaction will not occur, deferred gains and losses are recognized. In general, the financial impact of transactions involving these Energy Derivatives is included in NorAm's Statements of Consolidated Income under the caption natural gas and purchased power, net. Cash flows resulting from these transactions in Energy Derivatives are included in NorAm's Statements of Consolidated Cash Flows in the same category as the item being hedged.

At December 31, 1997, subsidiaries of NorAm were fixed-price payors and fixed-price receivers in Energy Derivatives covering 38,754 Bbtu and 7,647 Bbtu of natural gas, respectively. At December 31, 1996, subsidiaries of NorAm were fixed-price payors and fixed-price receivers in Energy Derivatives covering approximately 150,300 Bbtu and 66,500 Bbtu of natural gas, respectively. Also, at December 31, 1997, subsidiaries of NorAm were parties to variable-priced Energy Derivatives totaling 3,630 Bbtu of natural gas. The weighted average maturity of these instruments at December 31, 1997 and 1996, respectively, is less than one year.

NorAm has entered into options with various third parties which principally serve to limit the year-to-year escalation from January 1998 to April 1999 in the purchase price of gas which NorAm is committed to deliver to a distribution affiliate. These options, which covered 9,800 Bbtu and 2,400 Bbtu at December 31, 1997 and 1996, respectively, expired in January 1998 unexercised. NorAm previously established a reserve equal to its projected maximum exposure to losses during the term of this commitment and, accordingly, no impact on earnings is expected.

The notional amount is intended to be indicative of NorAm and its subsidiaries' level of activity in such derivatives, although the amounts at risk are significantly smaller because, in view of the price movement correlation required for hedge accounting, changes in the market value of these derivatives generally are offset by changes in the value associated with the underlying physical transactions or in other derivatives. When Energy Derivatives are closed out in advance of the underlying commitment or anticipated transaction, however, the market value changes may not offset due to the fact that price movement correlation ceases to exist when the positions are closed as further discussed below. Under such circumstances gains (losses) are deferred and recognized as a component of income when the underlying hedged item is recognized in income.

The average maturity discussed above and the fair value discussed in Note 10 are not necessarily indicative of likely future cash flows as these positions may be changed by new transactions in the trading portfolio at any time in response to changing market conditions, market liquidity and NorAm's risk management portfolio needs and strategies. Terms regarding cash settlements of these contracts vary with respect to the actual timing of cash receipts and payments.

(c) Trading and Non-trading -- General Policy.

In addition to the risk associated with price movements, credit risk is also inherent in NorAm and its subsidiaries' risk management activities. Credit risk relates to the risk of loss resulting from non performance of contractual obligations by a counterparty. While, as yet, NorAm and its subsidiaries have experienced no significant losses due to the credit risk associated with these arrangements, NorAm has off-balance sheet risk to the extent that the counterparties to these transactions may fail to perform as required by the terms of each such contract. In order to minimize this risk, NorAm and/or its subsidiaries, as the case may be, enter into such contracts primarily with those counterparties with a minimum Standard & Poor's or Moody's rating of BBB- or Baa3, respectively. For long-term arrangements, NorAm and its subsidiaries periodically review the financial condition of such firms in addition to monitoring the effectiveness of these financial contracts in achieving NorAm's objectives. Should the counterparties to these arrangements fail to perform, NorAm would seek to compel performance at law or otherwise, or obtain compensatory damages in lieu thereof. NorAm might be forced to acquire alternative hedging arrangements or be required to honor the underlying commitment at then-current market prices. In such event, NorAm might incur additional loss to the extent of amounts, if any, already paid to the counterparties. In view of its criteria for selecting counterparties, its process for monitoring the financial strength of these counterparties and its experience to date in successfully completing these transactions, NorAm believes that the risk of incurring a significant financial statement loss due to the non-performance of counterparties to these transactions is minimal.

NorAm's policies prohibit the use of leveraged financial instruments.

Houston Industries has established a Risk Oversight Committee that oversees all price and credit risk, including NES's risk management and trading activities. The Risk Oversight Committee's responsibilities include reviewing NorAm's overall risk management strategy and monitoring risk management activities to ensure compliance with Houston Industries' risk management limitations, policies and procedures.

(8) COMMITMENTS AND CONTINGENCIES

(a) Lease Commitments.

The following table sets forth certain information concerning NorAm's obligations under operating leases:

Minimum Lease Commitments at December 31, 1997(1)

| | (MILLIONS OF DOLLARS) |
|---|---|
| 1998 | $ 24 |
| 1999 | 19 |
| 2000 | 16 |
| 2001 | 15 |
| 2002 | 9 |
| 2003 and beyond | 22 |
| Total | $ 105 |

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(1) Principally consisting of rental agreements for building space and data processing equipment and vehicles (including major work equipment).

NorAm has a master leasing agreement which provides for the lease of vehicles, construction equipment, office furniture, data processing equipment and other property. For accounting purposes, the lease is treated as an operating lease. At December 31, 1997, NorAm had leased assets with a value of approximately $58.1 million under this lease with a basic term of one year. NorAm does not expect to lease additional property under this lease agreement.

Lease payments related to NorAm's leasing agreements are included in the preceding table for only their basic term. Total rental expense for all leases was $24.0 million, $33.4 million and $48.9 million in 1997, 1996 and 1995, respectively.

(b) Letters of Credit.

At December 31, 1997, NorAm had letters of credit incidental to its ordinary business operations totaling approximately $42 million under which NorAm is obligated to reimburse drawings, if any.

(c) Indemnity Provisions.

At December 31, 1997, NorAm has an $11.4 million accounting reserve on its Consolidated Balance Sheets in "Estimated obligations under indemnification provisions of sale agreements" for possible indemnity claims asserted in connection with its disposition of former subsidiaries or divisions, including the sale of (i) Louisiana Intrastate Gas Corporation, a former subsidiary engaged in the intrastate pipeline and liquids extraction business (1992); (ii) Arkla Exploration Company, a former subsidiary engaged in oil and gas exploration and production activities (June 1991); and (iii) Dyco Petroleum Company, a former subsidiary engaged in oil and gas exploration and production (1991).

(d) Sale of Receivables.

Certain of NorAm's receivables are collateral for receivables which have been sold pursuant to the terms of NorAm's receivables facility, see "Receivables Facility" included in Note 4(a).

(e) Gas Purchase Claims.

In conjunction with settlements of "take-or-pay" claims, NorAm has prepaid for certain volumes of gas, which prepayments have been recorded at their net realizable value and, to the extent that NorAm is unable to realize at least the carrying amount as the gas is delivered and sold, NorAm's earnings will be reduced, although such reduction is not expected to be material. In addition to these prepayments, NorAm is a party to a number of agreements which require it to either purchase or sell gas in the future at prices which may differ from then prevailing market prices or which require it to deliver gas at a point other than the expected receipt point for volumes to be purchased. To the extent that NorAm expects that these commitments will result in losses over the contract term, NorAm has established reserves equal to such expected losses.

(f) Transportation Agreement.

NorAm had an agreement (ANR Agreement) with ANR Pipeline Company (ANR) which contemplated a transfer to ANR of an interest in certain of NorAm's pipeline and related assets, representing capacity of 250 Mmcf/day, and pursuant to which ANR had advanced $125 million to NorAm. The ANR Agreement has been restructured and, after refunds of $50 million and $34 million in 1995 and 1993, respectively, NorAm currently retains $41 million (recorded as a liability) in exchange for ANR's or its affiliates' use of 130 Mmcf/ day of capacity in certain of NorAm's transportation facilities. The level of transportation will decline to 100 Mmcf/day in the year 2003 with a refund of $5 million to ANR and the ANR Agreement will terminate in 2005 with a refund of the remaining balance.

(g) Environmental Matters.

To the extent that potential environmental remediation costs are quantified within a range, NorAm establishes reserves equal to the most likely level of costs within the range and adjusts such accruals as better information becomes available. In determining the amount of the liability, future costs are not discounted to their present value and the liability is not offset by expected insurance recoveries. If justified by circumstances within NorAm's business subject to SFAS No. 71, corresponding regulatory assets are recorded in anticipation of recovery through the rate making process.

Manufactured Gas Plant Sites. NorAm and its predecessors operated a manufactured gas plant (MGP) adjacent to the Mississippi River in Minnesota formerly known as Minneapolis Gas Works (FMGW) until 1960. NorAm has completed remediation of the main site other than ongoing water monitoring and treatment. There are six other former MGP sites in the Minnesota service territory. Remediation has been completed on one site. Of the remaining five sites, NorAm believes that two were neither owned nor operated by NorAm; two were owned by NorAm at one time but were operated by others and are currently owned by others; and one site was previously operated by NorAm but was owned by others. NorAm believes it has no liability with respect to the sites it neither owned nor operated.

At December 31, 1997, NorAm had estimated a range of $15 million to $77 million for possible remediation of the Minnesota sites. The low end of the range was determined based on only those sites presently owned or known to have been operated by NorAm, assuming use of NorAm's proposed remediation methods. The upper end of the range was determined based on the sites once owned by NorAm, whether or not operated by NorAm. The cost estimates for the FMGW site are based on studies of that site. The remediation costs for other sites are based on industry average costs for remediation of sites of similar size. The actual remediation costs will be dependent upon the number of sites remediated, the participation of other potentially responsible parties, if any, and the remediation methods used.

In its 1995 rate case, NorAm's Minnegasco division was allowed to recover approximately $7 million annually for remediation costs. Such costs are subject to a true-up mechanism whereby any over or under recovered amounts, net of certain insurance recoveries, plus carrying charges, would be deferred for recovery or refund in the next rate case. At December 31, 1997 and 1996, Minnegasco had recorded a liability of $20.6 million and $35.9 million, respectively, to cover the cost of future remediation. In addition, at December 31, 1997, Minnegasco had receivables from insurance settlements of $2.9 million. These insurance settlements will be collected through 1999. Minnegasco expects that approximately half of its accrual as of December 31, 1997 will be expended within the next five years. The remainder will be expended on an ongoing basis for an estimated 40 years. In accordance with the provisions of SFAS No. 71, a regulatory asset has been recorded equal to the liability accrued. Minnegasco is continuing to pursue recovery of at least a portion of these costs from insurers. Minnegasco believes the difference between any cash expenditures for these costs and the amount recovered in rates during any year will not be material to NorAm's overall cash requirements, results of operations or cash flows.

At December 31, 1997 and 1996, NorAm had recorded an accrual of $3.3 million (with a maximum estimated exposure of approximately $18 million) and an offsetting regulatory asset for environmental matters in connection with a former fire training facility and a landfill for which future remediation may be required. This accrual is in addition to the accrual for MGP sites as previously discussed.

Issues relating to the identification and remediation of MGPs are common in the natural gas distribution industry. NorAm has received notices from the EPA and others regarding its status as a potentially responsible party for other sites. Based on current information, NorAm has not been able to quantify a range of environmental expenditures for potential remediation expenditures with respect to other MGP sites.

Mercury Contamination. Like other natural gas pipelines, NorAm's pipeline operations have in the past employed elemental mercury in meters used on its pipelines. Although the mercury has now been removed from the meters, it is possible that small amounts of mercury have been spilled at some of those sites in the course of normal maintenance and replacement operations and that such spills have contaminated the immediate area around the meters with elemental mercury. Such contamination has been found by NorAm at some sites in the past, and NorAm has conducted remediation at sites found to be contaminated. Although NorAm is not aware of additional specific sites, it is possible that other contaminated sites exist and that remediation costs will be incurred for such sites. Although the total amount of such costs cannot be known at this time, based on experience by NorAm and others in the natural gas industry to date and on the current regulations regarding remediation of such sites, NorAm believes that the cost of any remediation of such sites will not be material to NorAm's financial position, results of operation or cash flows.

Potentially Responsible Party Notifications. From time to time NorAm and its subsidiaries have been notified that they are potentially responsible parties with respect to properties which environmental authorities have determined warrant remediation under state or federal environmental laws and regulations. In October 1994 the United States Environmental Protection Agency issued such a notice with respect to a landfill site in West Memphis, Arkansas, and in December 1995, the Louisiana Department of Environmental Quality advised that one of NorAm subsidiaries had been identified as a potentially responsible party with respect to a hazardous waste site in Shreveport, Louisiana. Considering the information currently known about such sites and the involvement of NorAm or its subsidiaries in activities at these sites, NorAm does not believe that these matters will have a material adverse effect on NorAm's financial position, results of operation or cash flows.

(h) Other

NorAm Merger Lawsuit. In August 1996, a purported NorAm stockholder filed a lawsuit, Shaw v. NorAm Energy Corp., et al., in the District Court of Harris County, Texas, against NorAm, certain of its officers and directors and the Company to enjoin the Merger or to rescind the Merger and/or to recover damages in the event that the Merger was consummated. In February 1998, the plaintiffs withdrew their lawsuit and the court issued an order of non-suit dismissing the litigation.

NorAm is a party to litigation (other than that specifically noted) which arises in the normal course of business. Management regularly analyzes current information and, as necessary, provides accruals for probable liabilities on the eventual disposition of these matters. Management believes that the effect on NorAm's financial statements, if any, from the disposition of these matters will not be material.