Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The Company is primarily engaged as a utility providing electric and natural gas sales and services. The Energy Delivery business includes retail electric and natural gas distribution and transmission services. Usage by retail customers varies from year to year primarily as a result of weather conditions, the economy in the Company's service area, customer growth, conservation, appliance efficiency and other technology. The Energy Trading and Market Services (Energy Trading) business includes generation and production, electric and natural gas commodity trading and energy services. Revenues from the sale of energy to other utilities and the cost of electric power purchases vary from year to year depending on the electric wholesale power market, which is affected by several factors, including the availability of water for hydroelectric generation, the availability of base load plants in the region and the demand for power in other areas of the country. Other factors affecting the wholesale power market include an increasing number of power brokers and marketers and competition from low cost generation being developed by independent power producers.

RESULTS OF OPERATIONS

Overall Operations

Overall earnings per share for 1996 were $1.35, compared to $1.41 in 1995 and $1.28 in 1994. The 1996 results reflect $11.1 million in after-tax operating expenses related to storm damage on the electric distribution system and the expensing of $10.3 million in after-tax non-operating costs related to the terminated proposed merger between the Company and Sierra Pacific Resources (see Note 16 to the Financial Statements for additional information about the merger termination). The 1996 results also reflect improved energy earnings, primarily from wholesale electric activities, and transactional gains totaling $15.1 million recorded by Pentzer Corporation (Pentzer) primarily as a result of the sale of property by one of its subsidiary companies and the sale of stock in ITRON, Inc. (ITRON). The 1995 results include improved earnings from the Company's electric operations and $6.1 million in transactional gains from Pentzer, primarily due to the sale of ITRON stock. The 1994 earnings include $8.0 million of transactional gains recorded by Pentzer primarily as a result of the sale of ITRON stock.

Energy operating income available for common stock decreased $8.8 million, or 14%, in 1996 after increasing $8.3 million, or 15%, in 1995. Energy operating income contributed $0.97 to earnings per share in 1996, compared to $1.14 in 1995 and $1.03 in 1994. The ice storm (see below) and merger-related expenses resulted in decreases of $0.20 and $0.18, respectively, in earnings per share for 1996. Non-energy operating income available for common stock increased $6.2 million, or 42%, in 1996 and $1.2 million in 1995 and contributed $0.38 to earnings per share in 1996, compared to $0.27 in 1995 and $0.25 in 1994.

On November 19, 1996, the eastern Washington and northern Idaho region experienced an ice storm that resulted in damage to the Company's electric transmission and distribution system. The Company's service area was affected by continuing snow and rain, which hampered the Company's efforts to restore electric service to some customers until December 1, 1996. Initially, over one-third, or 100,000, of the Company's retail electric customers were without electric service. However, the Company estimates that approximately 75% of those customers had their electric service fully restored within 72 hours of the first storm. Repairing the damage to the Company's system cost approximately $21.8 million, of which $17.1 million (pre-tax) was attributable to operations and maintenance expenses, including labor and materials, for the repair of damaged lines, transformers and other equipment. The remainder of the cost represents capital expenditures to replace poles and other equipment damaged beyond repair. No increase in rates will occur as a result of these costs.

Income from Energy Delivery operations decreased $19.1 million, or 18%, in 1996 from 1995, primarily due to $17.1 million in pre-tax expenses associated with the storm damage on the electric distribution system. Income from Energy Delivery operations decreased $5.4 million, or 5%, in 1995 from 1994, primarily due to increased operating expenses. Income from Energy Trading operations increased $14.6 million, or 21%, in 1996 over 1995, and $32.7 million, or 90%, in 1995 over 1994, primarily due to increased wholesale electric revenues, resulting from both new power contracts and improved streamflow conditions. In 1995, purchased power and fuel expense decreased from 1994, both a result of the improved streamflows.

Interest expense increased $4.2 million in 1996, as compared to 1995, and $6.0 million in 1995, as compared to 1994, with both increases primarily due to higher levels of outstanding debt. In 1996, $20 million in preferred stock was redeemed, which increased short-term borrowings. During 1996 and 1995, $38.0 million and $45.0 million, respectively, of long-term debt matured or was redeemed, while $78.0 million in long-term debt was issued in 1995. At December 31, 1996, long-term debt outstanding was $26.2 million higher than at December 31, 1995, due to increased borrowings from banks. Long-term debt outstanding at December 31, 1995, was $17.1 million higher than at the end of 1994.

Preferred stock dividend requirements decreased $1.1 million, or 13%, in 1996 from 1995 due to the redemption of $20 million of Preferred Stock, Series I in June 1996. Preferred stock dividend requirements increased $0.5 million in 1995 over 1994 due to higher interest rates in 1995.