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KNIGHTON, G. W. PWR Project Directorate 7

SUBJECT: Forwards response to request for addl info re equity investors, including El Paso Electric Co ownership interest in plant. Interim & annual financial stateaments for equity investors encl.

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August 7, 1986

Director of Nuclear Reactor Regulation
Attention: Mr. George W. Knighton, Project Director
PWR Project Directorate #7
Division of Pressurized Water Reactor Licensing-B
Nuclear Regulatory Commission
Washington, D.C. 20555

Re: Application in Respect of Sale and Leaseback Transactions by El Paso Electric Company Dated April 15, 1986 - Palo Verde Nuclear Generating Station Unit 2 (Docket No. STN 50-529)

FINAL EQUITY INVESTOR LIST

Dear Mr. Knighton:

At Paragraph 6 of the above-captioned application, El Paso Electric Company (El Paso) undertook to provide the Commission with certain information concerning equity investors with respect to El Paso's ownership interest in Palo Verde Nuclear Generating Station (PVNGS) Unit 2. Enclosed is certain information with respect to the Equity Investors which have been identified to date.

In addition, there is enclosed certain supplemental financial information with respect to El Paso (Tab 1) and other supporting material (Tabs 2-4). This information is responsive to El Paso's undertaking as set forth in Paragraph 6 of the above-captioned application: "El Paso will in due course file with the Commission the anticipatory response of El Paso based upon the expectation that a request similar to the November 7, 1985 Request for Additional Information made by George W. Knighton, Chief, Licensing Branch No. 3, Division of Licensing to Public Service Company of New Mexico in connection with its sale and leaseback of the PNM Unit 1 Facilities will be made to El Paso with respect to the Unit 2 Facilities transactions."

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Following is a table which shows the identity of the parent company of each Equity Investor from whom a commitment has been received and the expected amount of equipment cost involved:

Prospective Equity Investor[1]	Equipment Cost	Equity[2]	Debt[2]
Drexel Burnham Lambert Incorporated[3]	$100,000,000	22%	78%
Chrysler Financial Corporation	110,000,000	22	78
Palatine Hills Leasing Inc.[4]	100,000,000	22	78
Alexander Hamilton Life Insurance Company[5]	50,000,000	22	78
Energy Investments Inc.[6]	75,000,000	22	78
Commercial Federal Corporation	65,000,000	22	78
TOTAL	$500,000,000[7]		

(1) The prospective Equity Investor will be a direct or indirect subsidiary or affiliate of the named corporation.
(2) Approximate, with an equity range of 22% to 28%.
(3) Financial information previously provided by Public Service Company of New Mexico (PNM) in Docket No. STN 50-529 in connection with PNM's sale and leaseback transactions.
(4) A joint venture company owned 80% by Square D Co. and 20% by Household International Inc.
(5) A subsidiary of Household International Inc.
(6) A subsidiary of Utilicorp United, a Missouri-based electric and gas distribution utility.
(7) Equipment cost allocated to one or more Equity Investors may be increased or decreased prior to closing so that, in the aggregate, up to the full $700 million or as little as $300 million in total value of El Paso's 15.8% undivided interest in PVNGS Unit 2 would be sold and leased back.

Enclosed herewith are the currently available interim and annual financial statements for each of the Equity Investors identified above (other than those for which such information was provided by Public Service Company of New Mexico under cover of letters dated June 10 and July 29, 1986 and filed in the above-captioned Docket). See Tabs 5-14. As the application makes clear, no Equity Investor will, as a result of its interest in PVNGS Unit 2, have any liability for payment of operation or decommissioning costs or costs of capital improvements for such unit. El Paso is and remains responsible for these and similar items.

Information with respect to the prospective Equity Investors has been provided to assist the Staff in its review of the El Paso sales and leaseback transactions. Counsel to the Equity Investors have requested that the information so provided, including information as to their identity and affiliations, not be used for any other purpose.

If I can be of further assistance, please do not hesitate to call.

Sincerely,

Timothy M. Toy

Timothy Michael Toy

Copies with enclosure to:

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EL PASO ELECTRIC COMPANY

Sale and Leaseback Transactions
with respect to
Palo Verde Nuclear Generating Station Unit 2
(Docket No. STN-529)

Supplemental Information
with respect to
El Paso Electric Company
and
Financial Information
with respect to
Prospective Equity Investors

August 7, 1986

1021.700.2898.12:1

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1. EL PASO ELECTRIC COMPANY (EPE) IS CURRENTLY REQUIRED TO PAY 15.8 PERCENT OF ALL PALO VERDE UNIT NO. 2 (PV2) OPERATING COSTS TO ARIZONA PUBLIC SERVICE COMPANY AND 15.8 PERCENT OF FUTURE DECOMISSIONING COSTS. PLEASE EXPLAIN IN DETAIL THE SOURCE OF THIS 15.8 PERCENT SHARE OF TOTAL PV2 COSTS UNDER THE PROPOSED REFINANCING ARRANGEMENT. INCLUDE AN EXPLANATION OF THE MANNER IN WHICH ALL INCREASES IN OPERATING AND DECOMISSIONING COSTS WILL BE COVERED FOLLOWING THE REFINANCING FOR THE TERM OF THE LICENSE.

RESPONSE

The current responsibility of EPE to fund the 15.8 percent share of the costs discussed above arises from EPE's status as a "Participant" as defined in the Arizona Nuclear Power Project Participation Agreement dated August 23, 1973, as amended (the ANPP Participation Agreement). This document governs the construction, operation and maintenance of Palo Verde (including PV2) and the rights and duties of the joint owners and participants. The proposed refinancing arrangement will conform to the criteria set forth in amendment 10 to the above mentioned agreement which specifies requirements for a sale and leaseback transaction. As such, the proposed transaction will not alter EPE's status as a participant, nor mitigate the rights or duties associated with such participation.

This responsibility of EPE to continue to fund these costs is further set forth in the requirement that the proposed leases be "net leases" as set forth in the EPE's April 15, 1986 Application, Section 3.6. These net lease provisions are intended to shield the lessors from any operational or business risks. EPE will therefore remain responsible for all taxes, insurance, operating and maintenance costs, and all other similar costs associated with PV2 (including the obligations which arise as a result of EPE's participant status.)

The source of funds for such expenses is not affected by the proposed transaction and is therefore identical to the source of funds in the absence of a sale and leaseback transaction. The source in both cases will be revenues from EPE's retail and wholesale customers. Such items will ultimately be included as recoverable expenses in a cost of service study and form the basis for rate levels in EPE's various jurisdictions.

The proposed transaction will not effect the level of expenditure for operating or decommissioning costs. Any increases in such costs must be funded through increased revenues collected from

EPE's customers. Estimated expenditures for decommissioning may be included as part of the lease payment; however, any liability in excess of funds collected through the lease payments will remain with EPE.

If EPE's leases expire and EPE does not purchase the facilities from the lessors, EPE will remain responsible under the ANPP Participation Agreement for operating and decommissioning costs until and unless a transferee (a new lessee or purchaser) assumes such obligations and the other PVNGS Participants have consented to a release of EPE from such liabilities. In such a case, the NRC will retain control over responsibilities for decommissioning, since any transfer will require action by the NRC in the form of a license transfer or amendment.

Under the ANPP Participation Agreement, if EPE (or the subsequent transferee) should default in its obligations, then the non-defaulting Participants are required to pay a pro-rata share of such defaulted amounts to assure that such costs will be paid. If a default continues for a specified period of time, the defaulting Participant may lose its share of the power and energy from PVNGS and also lose its representation on the project committees until the default is cured.

2. PLEASE PROVIDE A DETAILED EXPLANATION OF THE EXPECTED FINANCIAL EFFECTS ON EPE RESULTING FROM THE REFINANCING OF ITS PV2 INTEREST. INCLUDE EFFECTS ON ITS INCOME STATEMENT AND BALANCE SHEET AND ON ITS ABILITY TO FUND ITS SHARE OF PV2 OPERATING AND DECOMMISSIONING COSTS INCLUDING ANY FUTURE COST INCREASES.

RESPONSE

The proposed sale and leaseback transaction should have significant positive financial effects on EPE. The proceeds from the sale will provide a substantial amount of cash which will enable EPE to defer future financings as well as avail itself of the opportunity to restructure existing capitalization. The implicit cost of the lease is well below the existing blended cost of EPE's capitalization. This will provide opportunity to substantially lower the fixed obligations related to the operation of PV2. Additionally, in those instances where the investment tax credit (ITC) is passed through to the investors, the sale of ITC to investors provides opportunity for EPE to utilize, and pass on to its customers, benefits which might not have been realized for many years. This more efficient use of available tax credits, combined with the lower costs of funds implicit in the lease should result in an overall improvement in the ability of EPE to fund its shares of operating and decommissioning expenses. In the case of some of the investors, the investors may elicit to pass the investment credit back to EPE. Detailing the effects on EPE's financial statements requires some assumption regarding the ultimate use of proceeds from the transaction. The Company has outlined certain initial uses of said proceeds, including the redemption of short term debt as well as two issues of long term debt. The use of the remainder of the proceeds is not certain at this time, but may include the redemption, acquisition by tender or purchase, retirement or reduction of other outstanding debt securities of the Company, the repurchase or redemption of outstanding equity securities of the Company, and/or the making of lawful distributions and investments.

In order to provide an effect in the following pro-forma statements which is perhaps more indicative of the ultimate results on EPE's financial condition, assumptions were made which involve the utilization of the entire proceeds towards the redemption of securities. These redemptions are modeled purely for illustrative purposes and are not intended as any form of representation by EPE as to the actual use of said proceeds. The ultimate use could be expected to provide a return at least equal to that available from redeeming available securities and, as such, the attached pro-formas

provide a reasonable estimate of the results of the proposed transaction.

The attached pro-forma income statement and balance sheet represent the probable effect on EPE's operations had the proposed transaction been consumated on May 1, 1986. The effects are detailed on a pro-forma statement of income for the 12 months ended April 30, 1986 (Schedule 1) and a pro-forma balance sheet as of the same date (Schedule II). The proceeds were assumed utilized to retire existing debt and equity securities. Such retirements were further assumed to occur on the date of closing (i.e. May 1, 1986.) The effects on income were exclusive of any change in revenues collected (which might be expected to occur as a regulatory response to the change in EPE's overall cost of capital) and, therefore, tend to overstate the improvement in earnings which might be expected.

3. **PLEASE EXPLAIN THE RATEMAKING AUTHORITY AND RESPONSIBILITY OF THE NEW MEXICO PUBLIC SERVICE COMMISSION OR THE PUBLIC UTILITY COMMISSION OF TEXAS AS IT WILL RELATE TO PROVISION OF REVENUES TO COVER PV2 OPERATING AND DECOMMISSIONING COSTS APPLICABLE TO EPE'S REFINANCED OWNERSHIP INTEREST.**

RESPONSE

The proposed transactions will have no effect on the ratemaking authority or responsibility of the New Mexico Public Service Commission or of the Public Utility Commission of Texas. Both Commissions have authority over the retail rates charged by EPE as established by statute in both States. In addition, EPE is subject to the jurisdiction of the Federal Energy Regulatory Commission with respect to wholesale customers. Each of these regulatory bodies has had, and will continue to have, authority over the amounts and types of expenses that are recoverable in a utility's rate structure. Such expenses have traditionally been recoverable and EPE believes will continue to be recoverable; however, no change will occur in the recoverability of any such expenses as a result of the proposed transactions.

4. CERTAIN REVISED ESTIMATES FROM SECTION 12 OF APRIL 15, 1986 APPLICATION

The Company has revised its preliminary estimate regarding the reduction in ratepayer revenue requirements associated with PV2 and the present value thereof. In Section 12 of the EPE's April 15, 1986 Application, it was preliminarily estimated that the proposed transactions would reduce revenue requirements associated with PV2 by approximately $500 million over the life of PV2 representing a savings of approximately $300 million, in present value terms, over continued traditional financing. These figures have been revised to estimate that revenue requirements will be reduced by $338 million, with a present value savings of $290 million using an 11.95% cost of capital as a discount rate.

Schedule I

EL PASO ELECTRIC COMPANY
STATEMENT OF INCOME
12 MONTHS ENDED APRIL 30, 1986

	Before Adjustments	Adjustments Showing Effect of Proposed Transaction	After Adjustments
		(Thousands of Dollars)	
Operating revenues	$334,853	$	$334,853(6)
Operating expenses:			
Operations:			
Fuel	48,425		48,425
Purchased and interchanged power	77,382		77,382
Other	46,259	50,895(1)	97,154
Maintenance	11,026		11,026
Depreciation and amortization	15,424		15,424
Taxes:			
Federal income	37,229	(4,128)(2)	33,101
Other	17,567		17,567
	253,312	46,767	300,079
Operating income	81,541	(46,767)	34,774
Other income (deductions):			
Allowance for equity funds used during construction	59,507		59,507
Other net	7,199		7,199
Federal income taxes applicable to other income	(2,137)		(2,137)
	64,569		64,569
Income before interest charges	146,110	(46,767)	99,343
Interest charges (credits):			
Interest on long-term obligations	80,697	(42,725)(3)	37,972
Other interest	581		581
Other interest capitalized	(3,257)		(3,257)
Allowance for borrowed funds used during construction	(42,104)		(42,104)
	35,917	(42,725)	(6,808)
Net income	110,193	(4,042)	106,151
Preferred stock dividend requirements	14,591	(5,609)(4)	8,982
Net income applicable to common stock	$ 95,602	$ 1,567	$ 97,169
Net income per share of common stock	$ 2.77		$ 4.50(6)
Weighted average number of common shares outstanding (000)	34,498	(12,920)(5)	21,578

(1) Annual lease expense, net of amortization.
(2) Net change in current FIT.
(3) Reduction of long-term interest, after partial redemption of long-term debt.
(4) Reduction of preferred dividends due to redemption of related preferred stock.
(5) Reduction of outstanding shares of common stock, reclassified as treasury stock.
(6) Revenues are shown exclusive of any regulatory adjustments in rate levels which might be expected to accrue as a result of the changes in overall capital costs. The exclusion of such effects tends to overstate revenues and earnings.

Schedule II

EL PASO ELECTRIC COMPANY
BALANCE SHEET
AS OF APRIL 30, 1986

ASSETS

	Before Transaction	Adjustments To Record Proposed Transaction (Thousands of Dollars)	After Transaction
Utility plant:			
Electric plant in service	$1,103,373	$	$1,103,373
Less accumulated depreciation and amortization	135,805		135,805
Net plant in service	967,568		967,568
Construction work in progress	731,534	(484,074)(1)	247,460
Nuclear fuel:			
Under capital lease	51,739		51,739
In process	11,496		11,496
Held for future use	2,536		2,536
Net utility plant	1,764,873	(484,074)	1,280,799
Nonutility property	457		457
Investments	20,564		20,564
Current assets:			
Cash and temporary investments	61,784	16,244 (2)	78,028
Accounts receivable:			
Trade	31,407		31,407
Federal income taxes refundable	5,028		5,028
Other	12,944		12,944
Inventories:			
Materials and supplies	4,648		4,648
Fuel	9,670		9,670
Prepayments	7,448		7,448
Other	2,603		2,603
Total current assets	135,532	16,244	151,776
Deferred charges and other assets	20,377	100,740 (3)	121,117
Total Assets	$1,941,803	$(367,090)	$1,574,713

(1) Book value of asset to be sold.
(2) Change in cash, net of tax.
(3) Represents the deferral of taxes related to the book gain on the sale, the deferral of the assumed loss on reacquired debt and related amortizations of these entries.

Schedule II
(cont'd)

EL PASO ELECTRIC COMPANY
BALANCE SHEET
AS OF APRIL 30, 1986

CAPITALIZATION AND LIABILITIES

	Before Transaction	Adjustments To Record Proposed Transaction	After Transaction
		(Thousands of Dollars)	
Capitalization:			
Common stock	$ 329,816	$	$ 329,816
Additional paid-in-capital	475	(475)(1)	0
Retained earnings	235,492	15,640 (2)	251,132
Treasury stock	-	(209,045)(1)	(209,045)
Common stock equity	565,783	(193,880)	371,903
Preferred stock, redemption required	130,250	(50,000)(1)	80,250
Redemption not required	18,873		18,873
Long-term obligations	846,237	(326,541)(1)	519,696
Total capitalization	1,561,143	(570,421)	990,722
Current liabilities:			
Current portion of long-term obligations	25,777		25,777
Commercial paper	56,900		56,900
Fuel purchase commitment	9,587		9,587
Accounts payable	19,591		19,591
Taxes accrued	9,550	(856)(3)	8,694
Interest accrued	11,626		11,626
Other	27,001		27,001
Total current liabilities	160,032	(856)	159,176
Deferred credits and other liabilities:			
Accumulated deferred Federal income taxes	171,382	(44,169)(3)	127,213
Accumulated deferred investment tax credit	44,633	43,465 (3)	88,098
Other	4,613	204,891 (4)	209,504
Total deferred credits and other liabilities	220,628	204,187	424,815
Total capitalization and liabilities	$1,941,803	$(367,090)	$1,574,713

(1) Proceeds used to restructure capitalization.
(2) Net change in retained earnings.
(3) Taxes resulting from the gain on sale and the effect of recapitalization, net of amortization.
(4) Deferred gain, net of amortization.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

ELECTRIC RATES: Declaratory Order; Jurisdiction; Securities; Assumption of Liability; Sale of Assets

Before Commissioners: Anthony G. Sousa, Acting Chairman; Charles G. Stalon, Charles A. Trabandt and C. M. Naeve.

El Paso Electric Company) Docket No. EC86-18-000

ORDER DISCLAIMING JURISDICTION, AUTHORIZING ISSUANCE OF SECURITIES AND ASSUMPTION OF LIABILITIES, AND TERMINATING DOCKET

(Issued July 16, 1986)

On April 21, 1986, as amended on June 3, 1986, and supplemented on July 3 and July 14, 1986, El Paso Electric Company (EPEC) requested that the Commission issue an order disclaiming jurisdiction over a proposed sale and lease-back of EPEC's ownership interest in the Palo Verde Nuclear Generating Station (PVNGS) Unit 2 and certain associated common facilities.

Specifically, EPEC requests a disclaimer of Commission jurisdiction, under section 203 of the Federal Power Act (FPA), over the sale of facilities alleged by EPEC to be non-jurisdictional. EPEC also seeks a Commission order determining that the equity investors and lessors involved in the transaction will not, as a result of their acquiring an ownership interest in PVNGS or the lease-back of such interest to EPEC, become "public utilities" as defined in section 201(e) of the FPA. Furthermore, EPEC requests Commission authorization, pursuant to section 204 of the FPA, to issue securities and assume obligations and liabilities in connection with the proposed transaction.

Background

PVNGS consists of three 1,270 MW generating units. EPEC proposes to enter into one or more sale and lease-back transactions relating to all or a portion of EPEC's 15.8% undivided ownership interest in PVNGS Unit 2, a proportionate share of EPEC's undivided ownership interest in one-third of certain of the PVNGS Common Facilities, and certain real property interests

associated with PVNGS Unit 2 and the Common Facilities (collectively, PVNGS Unit 2 Facilities). 1/

Notice of EPEC's petition was published in the Federal Register, 2/ with comments due on or before May 8, 1986. The City of El Paso, Texas (City) filed a timely motion to intervene. The Office of Public Utility Counsel of the State of Texas (OPC) and the Public Utility Commission of Texas (PUC) filed untimely motions to intervene on May 23, 1986. The intervenors do not raise any specific issues in their pleadings. 3/

Proposed Transaction

EPEC states that it will sell only generation or generation-associated facilities. The facilities would be sold to a grantor trust or trusts, the beneficiaries of which would be institutional equity investors (Equity Investors). Each such investor would enter into a trust agreement with the First National Bank of Boston (Owner Trustee), who would hold title to the PVNGS Unit 2 Facilities and lease the facilities back to EPEC under separate lease agreements on behalf of each institutional investor. The purchase price at which the facilities are to be sold to the lessors may be as much as $697 million. Assuming that all of EPEC's undivided interest in the PVNGS Unit 2 Facilities is sold, this would result in a book gain to EPEC of approximately $212.9 million. EPEC proposes to defer the gain and amortize it over the life of the leases as an offset to the lease rental charges.

The lessors (Lessors), acting for the Equity Investors, would lease the property back to EPEC pursuant to a "net lease" under which EPEC would pay all taxes, insurance premiums, operating and maintenance costs, and all other similar costs associated with the facilities. In addition, EPEC would make semi-annual lease payments to the Lessors which would repay and provide a return on the Equity Investors' capital investment and

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1/ Other participants in PVNGS include: Arizona Public Service Company (29.1%), Public Service Company of New Mexico (10.2%), Southern California Edison Company (15.8%), the Salt River Project Agricultural Improvement and Power District (17.49%), the Southern California Public Power Authority (5.91%), and the Department of Water and Power of the City of Los Angeles (5.7%).

2/ 51 Fed. Reg. 18,578 (1986).

3/ In addition, the City and the PUC request waiver of the Commission's filing fee. There is, however, no fee for the filing of motions to intervene.

pay the principal and interest on the debt obligations issued to finance the purchase.

The Lessors would borrow approximately 70-78% of the purchase price of the PVNGS Unit 2 Facilities from a funding corporation (Funding Corporation) formed for that purpose. The loans to be made by the Funding Corporation to the Lessors would be without recourse to the general credit of the Lessors and the Equity Investors. The loans would be evidenced by non-recourse obligations of the respective lessors (Lessor Notes), which will be secured by an assignment in favor of the Funding Corporation of the rents and certain other payments to be made by EPEC under the leases. The Lessor Notes would be repayable from rentals and other payments to be made by EPEC pursuant to the leases.

It is proposed that the Funding Corporation issue, through an underwritten public offering, its debt securities (Lease Obligation Bonds) to acquire the funds necessary for the purchase of the lessor notes. The Lease Obligation Bonds would have terms which may differ as to maturity dates, interest rates, sinking fund obligations, redemption rights, and other matters. The terms of the Lease Obligation Bonds will be determined by prevailing market conditions. The terms of the Lessor Notes to be acquired by the Funding Corporation with the proceeds of the Lease Obligation Bonds will be secured by a first security interest in all of the assets of the funding corporation, which will consist primarily of the Lessor Notes. Due to the non-recourse nature of the Lessor Notes, payment of the principal of and premium, if any, and interest on the Lease Obligation Bonds would be made exclusively from payments made by EPEC under the leases.

It is expected that the Lease Obligation Bonds will be registered under the Securities Act of 1933, as amended (1933 Act), 4/ and that the indenture pursuant to which the Lease Obligation Bonds are issued will be qualified under the Trust Indenture Act of 1939, as amended (1939 Act). 5/ Although EPEC will not be the actual obligor of the Lease Obligation Bonds, it will be considered the issuer thereof for purposes of the 1933 Act and the obligor with respect thereto for purposes of the 1939 Act. The registration statement filed under the 1933 Act relating to the Lease Obligation Bonds will name EPEC as the sole registrant and will be signed on behalf of EPEC, as the sole registrant, by such officers and directors of EPEC as may be required under the 1933 Act and the rules, regulations, and forms of the Securities and Exchange Commission thereunder.

4/ 15 U.S.C. §§ 77a, et seq.

5/ 15 U.S.C. §§ 77aaa, et seq.

The basic lease term is anticipated to be 27 1/2 years, with an option to renew each lease for a renewal term equaling the lesser of: (a) the maximum fixed rate renewal permitted by Federal tax law without disqualifying the leases as "true leases" for Federal tax purposes; or (b) 13 years, and at a renewal rate equal to 50% of the stipulated basic rent during the base lease term. EPEC will also have the option, at the end of the basic lease term and at the end of any renewal term, to purchase the PVNGS Unit 2 Facilities at their fair market value at that time.

Any addition, betterment, or enlargement, of the facilities, or replacement of units of property within the facilities (capital improvements) will be EPEC's obligation under the leases. EPEC may, but will not be obligated to, request that the Lessors provide supplemental financing for their respective shares of the capital improvements. Concurrently with any supplemental financing, the lease rentals will be adjusted to support the amortization of the additional debt issued in connection with the supplemental financing and to preserve the Equity Investors' net economic return. In this proceeding, EPEC is requesting authority from the Commission to finance up to $40,000,000 of capital improvements through supplemental financings.

EPEC also states that the Lessors and EPEC would enter into support agreements which would provide the Lessors with such rights in parts of EPEC's interest in PVNGS not constituting PVNGS Unit 2 Facilities as may be necessary to enable the Lessors to realize the residual value of their interests. More specifically, certain rights in retained assets would be granted to the Lessors for the estimated economic life of the facilities to satisfy Internal Revenue Service requirements for a true lease classification. 6/ In the event of a total loss of the facilities, EPEC would be required to pay to the Lessors an amount equal to any deficiency between an agreed upon "casualty value" and the proceeds of any insurance received by the Lessors. Payment of this amount for the benefit of the Equity Investors would allow repayment of outstanding debt plus interest, the recovery of any equity investment remaining, and the payment of taxes, if any, resulting from a recapture of tax benefits previously taken by the equity investors.

EPEC's petition recognizes possible changes in the Internal Revenue Code which may affect the proposed sale and lease-back. Adjustments to rent and casualty values are likely to be required

6/ EPEC will retain its entire 15.8% ownership in all so-called "Section 1250 property" such as the administrative building, the administrative annex building, the technical support center, and the visitation center. EPEC will also retain its entire interest in all nuclear fuel and transmission facilities associated with PVNGS.

by amendments affecting the tax characteristics of the Equity Investors' investment. Adjustment may be required to protect the Equity Investors' net economic return in consequence of elimination of the investment tax credit with respect to the PVNGS Unit 2 Facilities. EPEC states that it will negotiate the nature and extent of any such adjustments.

In the event that a Lessor or Equity Investor becomes subject to regulation as a "public utility," EPEC would be required to repurchase the interest of the affected Lessor or Equity Investor. The purpose of this provision is to ensure that the Lessors and Equity Investors are subject only to normal financing risks and not operational risks or responsibilities.

Inasmuch as the proposed sale and lease-back is intended as only a financing transaction, the Equity Investors and Lessors are to have no authority or responsibility for the operation and maintenance of the facilities. EPEC would continue to be responsible for the operation and maintenance of the facilities in accordance with agreements with other Palo Verde participants and would be required to return the plant in the same condition as originally leased (ordinary wear and tear excepted) upon termination of the leases. EPEC would have the right to make virtually all decisions regarding construction, modifications, and operations as if EPEC remained the owner. Arizona Public Service Company will continue to be the operator of PVNGS through agreements with EPEC and other utility-owners of PVNGS.

EPEC states that the primary advantages of the proposed sale and lease-back transaction are two-fold. First, the net present value of total capital costs would allegedly be reduced because the Lessors would be better able than EPEC to finance a greater portion of the facilities with debt; in addition, the investment tax credit and accelerated depreciation for the facilities would provide greater current benefits to the Equity Investors than to EPEC if EPEC were to retain its ownership interest. Second, revenue requirements would allegedly be levolized over the life of the facilities under the proposed transaction. EPEC's preliminary estimate is that the proposed transactions will reduce revenue requirements approximately $338 million over the life of the facilities compared to traditional ratemaking assumptions. In present value terms, this would represent savings of approximately $290 million over continued traditional financing.

In requesting that the Commission find that the proposed transaction is not subject to jurisdiction under the FPA, EPEC contends that such a disclaimer of jurisdiction is fully consistent with the applicable provisions of the FPA and Commission precedent, inasmuch as the facilities include only generation facilities, and the Lessors and Equity Investors would receive no operational control or authority over any facilities. In addition, the Commission would retain plenary regulatory authority over EPEC. According to the petition, none of the participants other than

EPEC is currently a "public utility," and Commission jurisdiction over sales of electricity from the PVNGS would not be affected by the transaction.

Discussion

Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure (18 C.F.R. § 385.214), the timely, unopposed motion to intervene serves to make the City a party to the proceeding. Furthermore, given the interests of the constituencies which they represent, the early stage of this proceeding, and the apparent absence of any undue prejudice or delay, we find that good cause exists to grant the untimely interventions of the OPC and the PUC.

The basis for EPEC's request for a disclaimer of jurisdiction is that the facilities involved are related exclusively to the generation of electric energy. Section 201(b) of the FPA 7/ provides, in relevant part:

> The provisions of this Part shall apply to the transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce....The Commission shall have jurisdiction...over all facilities for such transmission or sale of electric energy, but shall not have jurisdiction ...over facilities used for the generation of electric energy....

Section 201(e) 8/ defines a "public utility" as "any person who owns or operates facilities subject to the jurisdiction of the Commission under this Part...." Section 203(a) of the FPA 9/ provides, in relevant part:

> No public utility shall sell, lease, or otherwise dispose of the whole of its facilities subject to the jurisdiction of the Commission, ...or by any means whatsoever, directly or indirectly, merge or consolidate such facilities or any part thereof with those of any other person... without first having secured an order of the Commission authorizing it to do so.

7/ 16 U.S.C. § 824(b).

8/ 16 U.S.C. § 824(e).

9/ 16 U.S.C. § 824(b)(a).

Based upon our review of EPEC's petition and the representations contained in it, we find that the proposed sale and lease-back involves only generating facilities or ancillary facilities used solely for generation, which are not subject to our jurisdiction under section 201(b) of the FPA and, therefore, are not jurisdictional facilities for the purpose of Commission approval within the meaning of section 203 of the FPA. We shall therefore grant EPEC's request to disclaim jurisdiction over the proposed transaction. Accord, United Illuminating Co., 29 FERC ¶ 61,270 (1984).

With respect to EPEC's request to disclaim jurisdiction over the Lessors and the Equity Investors, the Commission has in the past found that certain lease transactions similar to that described by EPEC do not give rise to jurisdictional consequences for non-utility entities involved in the transaction solely for investment or financing purposes. In Pacific Power & Light Company, 3 FERC ¶ 61,119 (1978), a public utility entered into a transaction conveying its interest in a generating facility to a construction company which, in turn, entered into a loan agreement with a group of banks to obtain interim financing. The construction company sold the facility to a trustee, acting on behalf of financial institutions. The trustee leased the property back to the utility under a net lease arrangement, and the utility requsted that the Commission disclaim jurisdiction over the owner trustee, the owner participants, bondholders, and an indenture trustee. The Commission granted the request, stating:

> ...we conclude that the Parties' participation in the proposed transaction is not such that they should be deemed public utilities for the purpose of section 201(e) of the Act. It would be inconsistent with the intent of the Act to label the Parties as public utilities and include them within our jurisdiction just because the parties hold mere equitable or legal title to the subject electric facilities and where they are clearly removed from the actual operation of facilities and the sale of power. The leveraged lease arrangement is essentialy a financing device which serves to reduce Applicant's cost of service, and the Parties' participation does not make them public utilities. We will, therefore, disclaim jurisdiction over the above Parties as requested by Applicant. 3 FERC at 61,337. 10/

10/ Accord, Montana Power Co., 35 FERC ¶ 61,084 (1984); Public Service Co. of New Mexico, 33 FERC ¶ 61,325 (1985).

Under the described sale and lease-back of EPEC's interest in PVNGS Unit 2, the Lessors and the Equity Investors receive no operational control or authority over the subject facilities. As in Pacific Power & Light Co., the transaction is essentially a financing device which is expected to reduce EPEC's cost of financing the facilities in question and improve the utility's credit ratings. The Commission will retain its regulatory authority over EPEC. None of the participants other than EPEC is currently a "public utility," and the Commission's jurisdiction over the sale of electricity from the PVNGS Unit 2 will be unaffected by the transaction. Consistent with Pacific Power & Light Company, we shall disclaim jurisdiction over the Lessors and Equity Investors with respect to this transaction and shall not consider them to be "public utilities" as a result of their participation in the instant transaction, as it has been described.

EPEC requests that the Commission grant authorization, pursuant to section 204 of the FPA, to: (1) enter into the leases; (2) issue securities and assume obligations and liabilities in connection with the proposed sale and lease-back; and (3) exempt the proposed transactions from the competitive bidding requirements established in section 34.2 of the Commission's regulations. 11/

Section 204(a) 12/ of the FPA provides:

> No public utility shall issue any security, or assume any obligation or liability as guarantor, indorser, surety, or otherwise in respect of any security of another person, unless and until ... the Commission by order authorizes such issue or assumption of liability. The Commission shall make such order if it finds that such issue or assumption (a) is for some lawful object, within the corporate purposes of the applicant and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by the applicant of service as a public utility and which will not impair its ability to perform that service, and (b) is reasonably necessary or appropriate for such purposes....

In Pacific Power & Light Co., 52 FPC 244 (1974), the Commission held that a lease arrangement similar to that proposed by EPEC did

11/ 18 C.F.R. § 34.2 (1985).

12/ 16 U.S.C. § 824c(a).

not constitute a security and, thus, was not subject to review under section 204 of the FPA. However, the Commission does have jurisdiction over certain other arrangements in which EPEC is either issuing debt in its own right or guaranteeing obligations of another person. These arrangements, in which EPEC would issue securities or assume obligations as guarantor, relate to: (a) surety by EPEC of public debt issued by the Funding Corporation; (b) issuance, assumption, or guarantee of interim financing, including bank loans to the Funding Corporation which would be refunded by public debt; (c) assumption of debt, including the Lease Obligation Bonds and casualty bonds, by EPEC; (d) issuance of Lease Obligation Bonds resulting from adjustments as a result of economic effects on the Lessors' earned rate of return; and (e) execution of supplements to the lease to include capital improvements.

Based upon our review of EPEC's application, we find that the company's entry into the arrangements listed above complies with the requirements of section 204 of the FPA. EPEC is empowered, pursuant to its Articles of Incorporation, to supply electric energy and to issue securities and evidence of indebtedness. 13/ The proposed financing was approved by EPEC's Board of Directors on February 25, 1986. Thus, the transactions appear to be within the applicant's corporate purpose. Further, we find that the proposed sale and lease-back is compatible with the public interest. EPEC's application indicates that, if consummated, the proposed sale and lease-back would reduce substantially the company's financing costs and would result in savings to ratepayers, without adversely affecting EPEC's financial integrity or continued regulatory oversight. In order that the anticipated benefits may be realized as expeditiously as possible, we shall grant EPEC's request, pursuant to sections 34.2(a)(1)(iv) and 34.2(b)(2) of the Commission's regulations, for exemption from the competitive bidding requirements.

Finally, we have reviewed EPEC's proposed accounting for the sale and lease-back of the PVNGS 2 Facilities and the associated financing. Three aspects need to be addressed. First, EPEC asserts that the Lease Obligation Bonds will not be stated on its balance sheet, because they will be merely evidences of guarantee agreements and will not constitute the issuance of debt securities by EPEC. We are not prepared, at this time, to conclude whether the Lease Obligation Bonds do constitute a debt obligation which should be recorded in EPEC's accounts. Therefore, we shall reserve any determination as to the propriety of the accounting for the Lease Obligation Bonds. Second, we do not, by the issuance of this order, make any determination as to the propriety of EPEC's proposed accounting for the long-term financing arrangements as operating leases. Third, EPEC's proposal to defer the gain

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13/ [illegible]ated Articles of Incorporation, Articles II and IV.

from the proposed sale and lease-back and to amortize such gain over the term of the leases is found to be acceptable and consistent with prior Commission practice. Therefore, we shall order such treatment in connection with EPEC's proposal.

<u>The Commission orders</u>:

(A) The OPC's and the PUC's untimely motions to intervene are hereby granted, subject to the Commission's Rules of Pratice and Procedure.

(B) The sale and lease-back of the PVNGS 2 Facilities, as described in EPEC's petition and application, as amended and supplemented, does not constitute a transaction requiring authorization pursuant to section 203 of the Federal Power Act.

(C) The Lessors and Equity Investors, participating in the proposed sale and lease-back of facilities, as set forth in EPEC's petition and application, as amended and supplemented, shall not become "public utilities" solely by virtue of such participation.

(D) EPEC is authorized under section 204 of the Federal Power Act to issue securities and to assume obligations and liabilities, as proposed in its petition and application, as amended and supplemented, in connection with the proposed transaction as indicated in the body of this order.

(E) EPEC's request for an exemption from the competitive bidding requirements of section 34.2 of the Commission's regulations is hereby granted.

(F) EPEC is directed to defer, for accounting purposes, the gain from the proposed sale and lease-back of the PVNGS 2 Facilities and to amortize such gain ratibly over the term of the leases.

(G) This order is without prejudice to the authority of this Commission or any other regulatory body with respect to rates, service, accounts, valuation, estimates, determinations of cost, or any other matter whatsoever now pending or which may come before the Commission.

(H) Nothing in this order shall be construed as implying any guarantee or obligation on the part of the United States of America with respect to the any security the issuance of which is authorized herein.

(I) Docket No. EC86-18-000 is hereby terminated.

By the Commission.

(S E A L)

Kenneth F. Plumb

Kenneth F. Plumb,
Secretary.

BEFORE THE NEW MEXICO PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF EL PASO ELECTRIC COMPANY FOR AUTHORIZATIONS RELATING TO A PROPOSED SALE AND LEASEBACK OF AN UNDIVIDED OWNERSHIP INTEREST IN UNIT 2 AND CERTAIN COMMON FACILITIES AT THE PALO VERDE NUCLEAR GENERATING STATION,	Case No. 2032
EL PASO ELECTRIC COMPANY, Applicant.	

ORDER APPROVING SALE-LEASEBACK

THIS MATTER having come before the New Mexico Public Service Commission ("Commission") at its open meeting upon the Recommended Decision of the Hearing Examiner Michael Barlow, and the Commission finding and concluding that it has jurisdiction over the parties and the subject matter herein and that the Recommended Decision of the Hearing Examiner is well taken and should be adopted with certain changes as follow here; the Commission being otherwise fully informed of the premises; the Commission adopts the following Order:

STATEMENT OF THE CASE

On April 21, 1986, El Paso Electric Company ("EPEC") filed an Application with the New Mexico Public Service Commission ("Commission") to enter into one or more sale and leaseback transactions relating to all or a portion of EPEC's undivided

15.8% ownership interest in Unit 2 at the Palo Verde Nuclear Generating Station ("PVNGS"), a proportionate share of EPEC's undivided ownership interest in one-third of certain facilities, the use of which is common to all of the three generating units at PVNGS ("Common Facilities"), and certain real property interests associated with PVNGS Unit 2 and the Common Facilities. EPEC further requested Commission approval for the issuance, assumption and guarantee of securities in connection with the proposed sale and leaseback transactions to the extent that the transactions would involve or constitute the issuance, assumption or guarantee of securities.

The Commission appointed Michael Barlow as Hearing Examiner for this case by Memorandum dated April 28, 1986. On May 5, 1986, the Hearing Examiner issued an Order setting a prehearing conference for May 19, 1986 and providing that good cause existed to continue this matter beyond the thirty day requirement of NMSA 1978, Section 62-6-9 (Repl.Pamp. 1984) because approvals were also being sought to sell and lease public utility plant or property pursuant to NMSA 1978, Section 62-6-12, (Repl.Pamp. 1984).

Following the prehearing conference, the Hearing Examiner issued a Procedural Order and Notice setting June 19, 1986 as the date of the public hearing on the Company's Application in this case. The Notice, setting forth the procedural requirements and hearing date, was duly published.

Motions for Leave to Intervene were filed by the Attorney General of the State of New Mexico, Large Power Users Coalition, County of Dona Ana, City of Las Cruces, Public Service Company of New Mexico, and the United States Executive Agency's Department of Defense. A Motion to Intervene as a commentator was also filed by the Texas-New Mexico Power Company.

On May 22, 1986, the Staff filed its opposition to Public Service Company of New Mexico's Motion for Leave to Intervene.

On June 2, 1986, Public Service Company of New Mexico filed its response to the Staff's opposition.

On June 5, 1986, the Hearing Examiner issued his Order denying Public Service Company of New Mexico's Motion for Leave to Intervene.

EPEC filed amendments to its Application in this case on June 3, and 27, 1986. On June 18, 1986, EPEC filed with the Commission, as supplemental information, the commitment letter which EPEC entered with First City National Bank of Houston and Chemical Bank regarding the interim debt financing for the proposed transaction. The June 3 amendment contains a request that the Commission issue a final order in this case by July 18, 1986 because Unit 2 was synchronized with the main transmission grid on May 20, 1986. EPEC stated that the transaction must be consummated within three months of that synchronization date under the Internal Revenue Code for the investment tax credits attributable to the unit to be transferred to the Equity Investors.

Upon Notice duly given and published, this matter came on for hearing before the Hearing Examiner at the time and place designated in said Notice. The following appearances were made:

For EPEC:

David H. Wiggs, Jr., Esq.
Kemp, Smith, Duncan & Hammond
El Paso, Texas

and

Jeff Allder, Esq.
Staff Counsel
El Paso Electric Company
El Paso, Texas

For the Attorney General of New Mexico:

Steven S. Michel, Esq.
Assistant Attorney General
Santa Fe, New Mexico

For the Large Power Users Coalition:

Wayne Shirley, Esq.
Campbell, Pica & Olson
Albuquerque, New Mexico

For the United States Executive Agencies:

Peter Q. Nyce, Esq.
Regulatory Law Office
Falls Church, Virginia

For Commission Staff:

Tiane Sommer, Esq.
Staff Counsel
Santa Fe, New Mexico

For Texas-New Mexico Power Company as a Commentator:

Dan Najjar, Esq.

Sutin, Thayer & Browne
Santa Fe, New Mexico

No other appearances were made and no commentators from the public appeared at the hearing. The following individuals presented prefiled and oral testimony in this matter:

<u>For EPEC</u>:

Billy E. Bostic
William J. Johnson

<u>For Attorney General of New Mexico</u>:

Michael D. Dirmeier

<u>For Commission Staff</u>:

Richard A. Baudino
Alex Salazar

At the conclusion of the hearing, the parties submitted a schedule for the remaining procedural dates for this case which the Hearing Examiner adopted by Order. The parties were required to file any requested forms of order on or before June 27, 1986 and the Hearing Examiner's Recommended Decision would be issued on or before July 3, 1986. Only EPEC and Staff filed exceptions to the Recommended Decision. By letter accompanying the Exceptions, EPEC also stated that a Final Order was necessary in the case by July 16, 1986. The Attorney General filed a Notice of Intent to Not File Brief on Exceptions. The A.G.'s office on July 11, 1986 filed a letter stating that it did not oppose Staff's proposals contained in their exceptions. On July 14, 1986, the Staff, EPEC and the AG filed a Stipulation resolving

the issues disputed in the Exceptions and proposing modifications of the Recommended Decision for adoption by the Commission. On July 15, 1986, the Commission scheduled a hearing for 10:00 a.m., July 16, 1986, at the offices of the Commission for purposes of receiving testimony and argument in support of the proposed stipulation. Telephone notice of the hearing was given on July 15 to all parties who appeared at the June 27, 1986 hearing. The hearing was convened during the Commission's Open Meeting of July 16, 1986. The following appearances were made:

FOR EPEC:

Michael McQueen,
Dane George (by telephone)
Kemp, Smith, Duncan & Hammond
El Paso, Texas

FOR THE ATTORNEY GENERAL OF NEW MEXICO:

Steven S. Michel, Esq.
Assistant Attorney General
Santa Fe, New Mexico

FOR THE COMMISSION STAFF:

Tiane Sommer, Esq.
Staff Counsel
Santa Fe, New Mexico

FOR THE LARGE POWER USERS COALITION:

Wayne Shirley, Esq.
Campbell, Pica & Olson
Albuquerque, New Mexico

No other appearances were made at the hearing.

The following individuals presented oral testimony:

FOR EPEC:

David G. Crane (by telephone)
Babcock & Brown, Inc.
New York City, New York

DISCUSSION:

EPEC'S proposal relates to its PVNGS Unit 2 Facilities which include its undivided 15.8% ownership interest in the unit, a proportionate share of EPEC's undivided ownership interest in one-third of certain facilities common to all of the PVNGS units ("Common Facilities") and certain real estate interests associated with Unit 2. All these assets are collectively referred to as "PVNGS Unit 2 Facilities" or "Facilities". EPEC proposes to sell the PVNGS Unit 2 Facilities, including, without limitation, all or a portion of EPEC's 15.8% generation entitlement share in Unit 2, to grantor trusts. The beneficiaries of these trusts would be institutional equity investors ("Equity Investors").

Each Equity Investor would enter into a trust agreement with a trustee (Owner Trustee) that would hold title to the PVNGS Unit 2 Facilities. Presently, EPEC proposes to have The First National Bank of Boston serve as the trustee. The trustee would enter into separate leases on behalf of the Equity Investors to lease the PVNGS Unit 2 Facilities, together with the generation entitlement share, back to EPEC. The leases would be for a base term of approximately 27 years for a basic rental amount with the trustee as lessor.

To date, EPEC has received commitments from certain institutional investors that have subscribed to about 70% of the proposed transaction. These investors include Burnham Leasing Corporation and Chrysler Capital Corporation. EPEC is seeking commitments from additional Equity Investors for the remaining portion of the PVNGS Unit 2 Facilities. The additional Equity Investors might include affiliates and subsidiaries of other utilities, including electric utilities. Such utilities would have the same investment purposes as any other Equity Investor. The participation of such entities in the proposed sale and leaseback transactions will have no effect whatsoever on the operation of PVNGS, or the generation of electricity or transmission thereof, and the presence of such entities as Equity Investors, therefore, should have no impact on the approvals requested in this case from the Commission. No affiliates or subsidiaries of EPEC would be included in the group of Equity Investors.

If the sale and leaseback transactions are completed as to less than all of EPEC's interest in the PVNGS Unit 2 Facilities, EPEC would retain an undivided ownership interest in the PVNGS Unit 2 Facilities.

EPEC would retain ownership of easements, right-of-ways and other real property rights and certain transmission facilities associated with the PVNGS Unit 2 Facilities if the Application is approved. However, by easements and other agreements, EPEC would make such rights and facilities available to the lessors for a period equal to the economic useful life of the PVNGS Unit 2 facilities. EPEC would retain the right to use all such rights and facilities during the terms of the leases.

The PVNGS Unit 2 Facilities would be sold to the lessors for a purchase price equal to the fair market value of the Facilities which EPEC estimates to be approximately $697,000,000 if all of EPEC's undivided ownership interest therein is sold. Prior to the closing, an appraisal would be required to confirm that the purchase price of the PVNGS Unit 2 Facilities was a reasonable estimate of fair market value, in order to comply with certain Internal Revenue Service requirements to preserve the tax benefits of the transactions.

The lessors would borrow approximately 70% to 80% of the purchase price by causing public debt to be issued by a funding corporation (the "Funding Corporation") formed for that purpose. The loans to be made by the Funding Corporation to the lessors would be without recourse to the general credit of the lessors and the Equity Investors and would be evidenced by non-recourse obligations of the respective lessors (hereinafter referred to as "Lessor Notes"). The Lessor Notes would be secured by an assignment in favor of the Funding Corporation of the rents and certain other payments to be made by EPEC under the leases to be negotiated. The Funding Corporation could have a lien on and a security interest in the PVNGS Unit 2 Facilities to additionally secure the Lessor Notes.

The Lessor Notes would be repayable from rentals and other payments to be made by EPEC pursuant to the leases. The Funding Corporation would issue debt securities ("Lease Obligation Bonds") through an underwritten public offering to acquire the funds necessary for the purchase of the Lessor Notes. EPEC proposes to have Smith Barney, Harris Upham & Co. Incorporated, Paine Webber Incorporated and Drexel Burnham Lambert Incorporated act as the managing underwriters for the public offering of the Lease Obligation Bonds. The Lease Obligation Bonds would have terms that differ as to maturity dates, interest rates, sinking fund obligations, redemption rights and other matters. The terms of the Lease Obligation Bonds would be determined by prevailing market conditions. The terms of the Lessor Notes to be acquired by the Funding Corporation with the proceeds of the Lease Obligation Bonds would reflect the terms of the Lease Obligation Bonds.

The Lease Obligation Bonds would be secured by a first security interest in substantially all of the assets of the Funding Corporation, which would consist primarily of the Lessor Notes. Due to the non-recourse nature of the Lessor Notes, payment of the principal of and premium, if any, and interest on the Lease Obligation Bonds would be made exclusively from rental and other payments made by EPEC under the leases. The Lease Obligation Bonds would be registered under the Securities Act of 1933, as amended (the "1933 Act"), and an indenture pursuant to which the Lease Obligation Bonds would be issued would be

qualified under the Trust Indenture Act of 1939, as amended (the "1939 Act"). Although EPEC would not be the actual obligor of the Lease Obligation Bonds, it would be considered the issuer thereof for purposes of the 1933 Act and the obligor with respect thereto for purposes of the 1939 Act. The registration statement filed under the 1933 Act relating to the Lease Obligation Bonds would name EPEC as the sole registrant and would be signed on behalf of EPEC as the sole registrant, by such officers and directors of EPEC as would be required under the 1933 Act and the rules, regulations and forms of the Securities and Exchange Commission.

In order to provide flexibility so that EPEC might be able to take advantage of market conditions without being tied to a particular closing date, it may be necessary that the Lease Obligation Bonds be issued and sold prior to the closing of the Lease Transactions in which case the net proceeds from the sale of the Lease Obligation Bonds would, pending the closing of the Lease Transactions, be held in trust and would be direct obligations of EPEC. Depending upon market conditions, EPEC might also elect that the debt securities to be issued by the Funding Corporation to purchase the Lessor Notes be issued initially on a private interim basis (which would be in the form of long-term debt) to commercial banks, insurance companies and other institutional lenders. In such event, the privately placed debt securities would be refunded with the proceeds of the Lease Obligation Bonds when issued.

The Lessor Notes would provide that, upon the occurrence of certain casualty events, termination events, deemed loss events and special loss events, either (i) EPEC would assume the obligations represented by the Lessor Notes or (ii) EPEC would purchase the equity interests of the Equity Investors, and the lessors would then grant a lien and security interest in the PVNGS Unit 2 Facilities to the Funding Corporation to secure the Lessor Notes. The assumption or purchase noted above would be in partial satisfaction of EPEC's obligation to make payments required of it upon early termination of the leases in consequence of any such event.

Although the lessors would be the owners of the PVNGS Unit 2 Facilities, neither the Equity Investors nor the lessors would have any direct responsibility for the operation or maintenance of such Facilities. During the term of the leases, EPEC would continue to be responsible for operation and maintenance of the PVNGS Unit 2 Facilities in accordance with the agreements with the other PVNGS participants. EPEC would continue to be empowered with respect to the PVNGS Unit 2 Facilities to be and act as the "Participant" under the Arizona Nuclear Power Project Participation Agreement, which governs the construction, operation and maintenance of PVNGS and the rights and duties of the joint owners and participants in PVNGS. Additionally, unless EPEC is in default under the Leases, EPEC would retain the exclusive right to sell and dispose of the power and energy derived from the generation entitlement share in PVNGS Unit 2

associated with the PVNGS Unit 2 Facilities. The leases would be "net leases" under which EPEC would be responsible for paying all taxes, insurance premiums, operating and maintenance costs, and all other similar costs associated with the PVNGS Unit 2 Facilities.

Following the initial term of the Leases of approximately twenty-seven years, EPEC will have one or more renewal options to be negotiated. In addition, EPEC would have certain options to repurchase the PVNGS Unit 2 Facilities. During the base lease term, EPEC would make semi-annual rental payments to the lessors in an amount sufficient to pay the principal of and premium, if any, and interest on the Lessor Notes. The rental payments are also anticipated to provide an investment return to the Equity Investors. The "lease factors" which determine the rent payable under the Leases would include transaction costs payable by the Equity Investors, the interest rate on the Lease Obligation Bonds, and the amortization schedule for the repayment of principal on the Lease Obligation Bonds.

The rent, casualty value, special casualty value and termination value payable pursuant to the leases would be subject to upward or downward adjustment to preserve the net economic return to the Equity Investors to reflect, among other things, debt terms and other changes in pricing assumptions and to reflect changes enacted by Congress in the Internal Revenue Code which affect the tax characteristics of the Equity Investors' investment.

Any addition, betterment or enlargement of the PVNGS Unit 2 facilities, or replacements of units of property within the Facilities would be EPEC's obligation under the leases. EPEC anticipates that the lessors would agree to permit financing under the leases ("Supplemental Financing") for their respective shares of Capital Improvements. In addition, the Equity Investors may elect to make additional equity investments with respect to any Supplemental Financing of capital improvements on terms to be agreed upon. The terms and conditions of such Supplemental Financings would be subject to negotiation between EPEC and the Equity Investors. Concurrently with any Supplemental Financing, the rentals payable under the Leases would be adjusted to support the amortization of the additional debt issued in connection with the Supplemental Financing and to preserve the net economic return to the Equity Investors. In this proceeding, EPEC is requesting authority from the Commission to finance up to $40,000,000 of Capital Improvements through Supplemental Financings pursuant to the leases.

In the Application, EPEC states that, with Commission approval, the proceeds from the sale will be used for one or more of the following purposes: the acquisition of additional property; the construction, completion, extension or improvement of EPEC's facilities; the improvement or maintenance of its service; the discharge or lawful refunding of its obligations; the reimbursement of monies actually expended for such purposes from income or from any other monies in EPEC's treasury not

secured by or obtained from the issue, assumption or guarantee of securities within five years next prior to the filing of the Application in this case; or for any of the aforesaid purposes. The proceeds would be invested temporarily pending application to the purposes cited above.

EPEC estimates the savings in required revenue requirements growing out of the proposed sale and leaseback to be $338 million over the 27 year period of the leases as compared to ownership of Unit 2 and ratebase treatment thereof. Bostic Testimony, p.7 and BEB-4, p.3 of 4. This estimate assumes a lease rate of 7.8% which was supplied to EPEC by Babcock and Brown Financial Corporation. Bostic, p.5. At the hearing, EPEC took the position that while the lease rate would now be slightly higher due to the recent increase in the cost of debt, the savings would remain approximately the same. T.P., pp.27-28. For the analysis, EPEC utilized a needed return on rate base of 11.95% and the necessary revenues to collect the book depreciation expense on the asset over the 27 year period. Bostic, p.6. This return on rate base is EPEC's most recent authorized return in Texas and would approximate the allowed New Mexico return if the debt component for the capital structure were to be adjusted to the current situation. T.P., pp.31-32. The estimated savings in revenue requirements reflect the elimination of $484 million from EPEC's total company rate base due to the sale of the PVNGS Unit 2 Facilities and a sales price thereof of $697 million. Bostic, pp.3-4. The estimated present value of the revenue requirement

savings is $290 million using the 11.95% cost of capital as a discount rate. Bostic, p.7, BEB-4, p.4 of 4. For the first year of the lease, these savings would translate into a cost per kWh of 4.1 cents under the leases versus 9.1 cents for ratebase treatment. Bostic, p.7.

EPEC asserts that there will be no increase in property taxes because of the sale and leaseback.

If EPEC is incorrect, the increase in property taxes would lower the present value benefits of the transaction. Baudino, Testimony, p.3. Under an EPEC analysis in response to an interrogatory, the present value of the lease advantage could be lowered by some $14.058 million if the sale results in a higher property tax basis. AG Exhibit 1, Response (d). EPEC, as previously noted, does not believe the basis will increase. T.P., p.41.

Commission Staff recommends that the Commission approve the request of EPEC in this case. Baudino, p.5. Staff takes the position that all ratemaking issues associated with the transaction should be reserved for future proceedings. Baudino, pp.6-7.

Counsel for EPEC stated at the outset of the hearings that:

> [s]pecifically, what the Company is not requesting is any ratemaking treatment, any commitment of any kind of ratemaking treatment, any argument that anything done here has any precedential value for ratemaking purposes.

T.P., p.5. See also, T.P., p.6 and p.120.

This reservation of issues relating to ratemaking includes the treatment of any gain arising out of the proposed sale. T.P., p.5 and p.7.

The Attorney General recommends that EPEC's Application be approved, but that such approval should contain certain restrictions. Dirmeier, p.3. The Attorney General advocates the reservation of issues relating to revenue requirements for future dockets. Dirmeier, p.3. However, the Attorney General had addressed the treatment of any gain from the sale because EPEC had mentioned the gain to demonstrate ratepayer benefits. Dirmeier, p.4; T.P., pp.5-6. At the hearing the Attorney General agreed that treatment of the gain should be addressed in a future case dealing with ratemaking issues. T.P., p.7.

The Attorney General initially requested that the Commission, (1) reserve the authority to disallow cost in the future on the finding of imprudence or excess capacity; (2) reserve the authority to disallow costs in the future if extraordinary events such as an accident occur which result in a loss or damage to EPEC's investment in or lease of PVNGS; (3) specify the maximum extent to which the lease factor can be adjusted in the future for tax law changes, and for all changes taken together; and, (4) announce that the ultimate decommissioning costs for Unit 2 will be borne by New Mexico ratepayers only to the extent that such costs represent a fair and equitable share to the New Mexico jurisdiction. Dirmeier, pp.4-6. Concerning the decommissioning costs, the Attorney

General advocates adoption of the language recommended by the Hearing Examiner in Case No. 1995:

> It is the policy of the Commission that PNM's ratepayers should not be responsible for decommissioning costs associated with Palo Verde Nuclear Generating Station Unit 1 associated with that portion of the life of such unit during which it is not owned or leased by PNM.

Dirmeier, p.34.

At the outset of the hearing, counsel for EPEC agreed that the Commission has the authority to consider the disallowance of PVNGS Unit 2 costs, including the "extraordinary events" costs, and all or a portion of the lease payments in future proceedings. T.P., pp.6-9. This position was repeated during the proceeding. T.P., pp.118-119, 121-122. Further, EPEC took the position that while decommissioning costs are ratemaking in nature, the company does not object to the language advocated by the Attorney General quoted above. T.P., p.9, p.122, p.180. EPEC'S nonobjection to the decommissioning language proposed by the Attorney General goes to the rate making policy stated in the proposed language, and should not be construed as agreement that the language accurately reflects the obligations of the parties under the proposed sale and leaseback transactions (which is that EPEC, with respect to the Equity Investors, will be obligated for the decommissioning cost of Unit 2).

The Attorney General initially advocated two "caps" on adjustments to the basic rent that EPEC can commit to in the

leases. The first cap would limit the extent to which the basic rent expense can increase due to changes in the tax laws. Dirmeier, p.30. While EPEC will negotiate such a cap in the actual leases (See, Exhibit A to EPEC's Exhibit 2, p.10), there would not be a limit on this cap absent Commission adoption of the Attorney General recommendation. The Attorney General initially sought to have the Commission adopt the 11% limitation that was placed on Public Service Company of New Mexico's sale and leaseback transaction in Case No. 1995. Dirmeier, p.31.

The second cap advocated by the Attorney General was one that would have limited the maximum extent to which the lease factor could change taking into consideration all future rent adjustments such as tax law changes, debt term changes and the other pricing assumptions. In Case No. 1995, the Commission imposed such a cap of 11.7% which was 17% over the assumed lease factor of 10%. In the instant case, EPEC has utilized an assumed lease rate of 7.8%. The Attorney General recommended an overall lease factor cap of 9.1% which is 17% over the assumed lease rate. Dirmeier, pp.31-32.

EPEC took the position that caps on lease adjustment factors are uncalled for since the "amount of lease payment to be included in rates is totally left open for another proceeding." T.P., p.6. Staff initially agreed with EPEC's position. T.P., pp.201-202. The Attorney General recognizes that the amount of the lease payments to be included in rates will be left open for future proceedings, but advocates that EPEC should not be given "carte blanche" to negotiate any lease factor that EPEC deems proper. T.P., p.8. The Hearing Examiner recommended that the Commission impose the caps on the lease adjustment factors presented by the Attorney General.

EPEC excepted to the recommended caps claiming that the recommendation would prevent the consummation of the proposed sale-leaseback transactions. In its letter accompanying its Exceptions, EPEC also notified the Commission and all parties that it was considering structuring the sale and leaseback so that the Lessors could pass the investment tax credit back to EPEC rather than claiming it themselves.

Staff also excepted to the cap, concerned that their imposition would be subject to attack as arbitrary based on the record in this case. Staff proposed that the caps be imposed here as presumptions of imprudency to be rebutted by clear and convincing evidence at future ratemaking proceedings. The Attorney General's office filed a letter on July 11, 1986, stating that it would not oppose Staff's proposal based on EPEC's representations.

On July 14, 1986, the AG, EPEC and Staff filed a stipulation as to the cap issues. The Stipulation first provides that the Lessors may elect to pass back to EPEC the investment tax credit, in which case the revenue requirement effect would reflect the credit grossed up to a pre-tax number.

It further provided, in effect, that no cap would be placed in this proceeding on the basic rent to be charged EPEC's

customers under the leases due to tax law changes (hereinafter tax change cap), and that the overall lease factor cap proposed by the AG would be modified to provide for a 9.4% cap if the investment tax credit associated with PVNGS Unit 2 is transferred to the Lessors or a 10.3% cap if it is not. This cap would operate so that the overall lease factor, as calculated under the stipulation, would be presumed imprudent during ratemaking proceedings if greater than the appropriate cap, unless rebutted by clear and convincing evidence presented by EPEC. The caps would apply only for purposes of ratemaking proceedings, and would not limit EPE's authority to enter into or perform its obligations under the sale and leaseback transactions themselves.

At the hearing on July 16, EPEC provided testimony that it was reasonable to omit the tax change cap because a cap amount would be too uncertain due to the state of flux surrounding the proposed federal tax law changes at the present time. The overall lease factor cap amounts were changed to reflect reasonable cap amounts considering current fluctuations in the debt market and to provide Lessors with a higher rent under the 10.3% cap to offset the tax benefits foregone by Lessors if they elect to permit EPEC to retain the investment tax credits.

While it is true that the Commission could disallow excessive or imprudent portions of the lease payments attributable to adjustments in the lease factor in future proceedings, the Commission has a duty to protect the public interest, the interests of consumers and the interests of investors. After the

fact disallowances of excessive or imprudent expenses in the future may not protect these interests from the adverse effects of such disallowances. On the other hand, the Commission does not want the transaction to unwind. The caps as proposed by the stipulation provide sufficient disincentive for EPEC to bargain for lease factors outside a range that will benefit ratepayers. They reflect the reality of the debt market, EPEC's position in the financial community, and the current tax law change proposals before Congress. Also, in a ratemaking proceeding, EPEC will be required to carry the normal burden of proof to establish prudency of its lease factors up to the cap and as adjusted for tax law changes under the stipulation. For these reasons, we determine that the stipulation should be approved and the findings proposed therein incorporated in this Order.

The final issue before the Commission in this case is that of imposition of restrictions on the use of the proceeds for the sale by EPEC. If EPEC's entire interest in the PVNGS Unit 2 Facilities are sold, the Company will receive some $697 million as a sales price. After deducting the approximate $100 million in taxes and $14 to $15 million in transaction costs, EPEC would have over $580 million in cash. The only restrictions on the use of these proceeds presented in this case in the Application or prefiled testimony are the statutory restrictions set forth on pages 12 and 13 hereof. However, through live testimony, the Attorney General advocated a further restriction on the proceeds at the hearing.

Mr. Dirmeier recommends that EPEC be required to "invest the proceeds on a short-term basis as opposed to retiring securities pending the outcome of Case 2009." T.P., p.155. He notes that as a result of Case No. 2009, there are potential disallowances from EPEC's rates that may make it difficult for EPEC to issue securities in the future for the operations of the Company. Therefore, he would have the Commission restrict EPEC's use of the sale proceeds as previously noted.

EPEC plans to retire securities with a portion of the proceeds including a $75 million second mortgage bond issue, approximately $100 million in short term debt, and a $40 million first mortgage bond issue. T.P., pp.60-62, 77-78. Other than those plans, the funds are to be put to the general uses referred to above.

The Hearing Examiner did not recommend that the Commission impose the restrictions on the proceeds of the sale raised by the Attorney General, and we adopt his recommendation. The possibility of disallowances and/or the potential effects of Case No. 2009 are too remote and uncertain to justify the Attorney General's recommendation.

EPEC also proposed in its Exceptions certain language changes to the Recommended Decision to reflect more accurately the transaction documentation. Those changes have been incorporated here.

THEREFORE, the Commission F I N D S and C O N C L U D E S:

1. El Paso Electric Company ("EPEC") is a Texas corporation qualified to do business in the State of New Mexico, that owns, operates, leases or controls plant, property or facilities for the generation, transmission, distribution, sale or furnishing to or for the public of electricity for light, heat, power or other uses within the State of New Mexico.

2. EPEC is certified and authorized to conduct the business of providing public utility service within the State of New Mexico.

3. EPEC is a public utility as defined in the Public Utility Act, NMSA 1978, Sections 62-3-1, et seq., (Repl. Pamp. 1984).

4. The Commission has jurisdiction over the parties and over the subject matter herein.

5. EPEC owns an undivided interest in three units and in common facilities of an electric generating project known as the Arizona Nuclear Power Project and as the Palo Verde Nuclear Generating Station ("ANPP" or "PVNGS").

6. This Commission has granted EPEC in NMPSC Case No. 1216 a Certificate of Convenience and Necessity ("CCN"), subject to such conditions and modifications as may be necessary or appropriate.

7. EPEC proposes to enter into one or more leveraged lease financing transactions ("Lease Transactions") for all or a portion of its 15.8 percent undivided ownership interest in Unit 2 of PVNGS, and up to all or a proportionate share of its 15.8

percent undivided ownership interest in one-third of certain Common Facilities of PVNGS and certain real property interests associated with PVNGS Unit 2 and the Common Facilities, hereinafter referred to collectively as the "Facilities" or the "PVNGS Unit 2 Facilities.

8. Specifically, the Lease Transactions which EPEC proposes involve EPEC's sale of the Facilities to, and then lease of the Facilities back from, institutional investors (the "Equity Investors"). Through a process of competitive bidding and negotiation, Burnham Leasing Corporation and Chrysler Capital Corporation have tentatively been selected as Equity Investors for a portion of the Facilities. EPEC is seeking one or more additional Equity Investors for all or a portion of the remainder.

9. Under the proposed Lease Transactions, the Equity Investors will be the beneficiaries of grantor trusts, the Owner Trustee of which is expected to be The First National Bank of Boston. The Owner Trustee will take and hold title to, and act as lessor (the "Lessor") of, the Facilities and will lease the Facilities to EPEC under one or more leases ("Leases"). If the sale and leaseback transactions are completed as to less than all of EPEC's interest in the PVNGS Unit 2 Facilities EPEC will retain an undivided ownership interest in the PVNGS Unit 2 Facilities. EPEC will continue to be responsible for operation and maintenance of the PVNGS Unit 2 Facilities. EPEC will be empowered with respect to the Facilities to be and act as the

"Participant" under the ANPP Participation Agreement with full and exclusive authority to exercise and perform all of the rights and duties of a Participant thereunder. Arizona Public Service Company ("APS") is and will continue to be the project manager and operating agent of PVNGS through agreements with the PVNGS participants.

10. EPEC has requested authority to finance up to $40 million of capital improvements through Supplemental Financings pursuant to the Leases. The terms and conditions of such Supplemental Financings are subject to negotiations between EPEC and the Equity Investors. The rentals payable by EPEC under the Leases will be adjusted, in connection with any Supplemental Financing, to support amortization of the additional debt issued 2727onnection with the Supplemental Financing and to preserve the net economic return to the Equity Investors.

11. The Facilities will be sold to the Lessors at a fair market price that is expected to result in a taxable and book gain to EPEC, and which may be as much as $697,000,000 if all of EPEC's interest in Unit 2 and one-third of EPEC's interest in the related common facilities is sold.

12. An appraisal will be conducted by an independent appraiser to be selected by the Equity Investors to confirm that the purchase price is a reasonable estimate of fair market value. The appraisal will also determine that, after the expiration of the basic lease term and permitted fixed rate renewal term(s), the estimated remaining economic life of the

PVNGS Unit 2 Facilities will be long enough, and their estimated remaining value will be great enough, to establish the Leases as "true leases" for Federal tax purposes.

13. The Lessors will borrow approximately 70% to 80% of the purchase price by causing public debt to be issued by a funding corporation (the "Funding Corporation") formed for that purpose. Although the public debt would be issued by the Funding Corporation, such debt would be non-recourse to the Lessors and the Equity Investors. The public debt would be indirectly secured by an assignment of the rentals due from EPEC under the Leases.

14. In connection with the issuance of the public offering debt securities ("Lease Obligation Bonds"), EPEC will be considered the issuer thereof for purposes of the Securities Act of 1933, as amended, and the obligor with respect thereto for purposes of the Trust Indenture Act of 1939, as amended; and EPEC will be the named "registrant" in the Registration Statement that will be filed with the United States Securities and Exchange Commission.

15. The initial term of the Leases will be approximately twenty-seven years, and EPEC will have certain renewal options. In addition, EPEC will have one or more renewal options to be negotiated to repurchase the Facilities. The rent to be paid by EPEC over the term of the Leases will be a function of the interest rates payable on the public debt, among other things. The rent will be subject to adjustment in the event the United

States Congress enacts certain legislation affecting tax benefits.

16. The evidence indicates that the present value cost of the Facilities to ratepayers will be lower under the Lease Transactions than under EPEC ownership, although quantification of the precise benefit will depend upon the rate-making treatment applied in future cases.

17. The Lease Transactions also will provide substantial benefits to EPEC's shareholders and improve the financial integrity of EPEC.

18. The Lease Transactions fairly balance the interests of EPEC's ratepayers and shareholders and the public interest.

19. The proceeds to EPEC from the Lease Transactions may be used for one or more of the following purposes: the acquisition of additional property; the construction, completion, extension or improvement of EPEC's facilities; the improvement or maintenance of its service; the discharge or lawful refunding of its obligations; the reimbursement of monies actually expended for said purposes from income or from any other monies in the treasury of EPEC not secured by or obtained from the issue, assumption or guarantee of securities within five years next prior to the filing of the Application herein; or for any of the aforesaid purposes. The purposes of the Lease Transactions are permitted by the Public Utility Act, Section 62-3-1, et seq., NMSA 1978 as amended.

20. The aggregate amount of securities of EPEC outstanding and proposed to be outstanding after the consummation of the Lease Transactions will not exceed the fair value of the properties and business of EPEC.

21. For purposes of this Order and for future accounting treatment, the Common Facilities at the PVNGS should be allocated equally among the three units of the project.

22. All issues of ratemaking treatment for the Lease Transactions should be determined in a separate case or cases. The Commission retains full authority over the Facilities, and over all issues of ratemaking treatment for the lease payments, the costs of and any gains or losses from the sale and leaseback concerning said Facilities, including the authority to disallow any or all of the lease expenses and transaction costs on a used-and-useful basis, on the basis of imprudency in the cost of the Facilities, or on any other lawful basis, and the approval of the Lease Transactions granted by this Order is contingent on the Commission's retention of such full authority.

23. The cases described in paragraph 23 of the Findings and Conclusions should include, but not necessarily be limited to the determinations:

a. what responsibility, if any, ratepayers should bear for costs from any casualty losses at PVNGS or indemnification costs which EPEC may have to pay the Equity Investors if certain changes in the tax law occur in the future;

b. what share, if any, ratepayers should bear of the costs of consummating the Lease Transactions; and

c. what rate-making treatment should apply to the gain expected from the Lease Transactions.

24. In any proceeding in which EPE seeks recognition of the lease expense for ratemaking purposes, any lease expense greater than the lease expense which would result from a weighted annual lease payment factor of 9.4% if the investment tax credit associated with the PVNGS Unit 2 Facilities is transferred to the Lessors or 10.3% if the investment tax credit is not so transferred will be presumed to be an imprudent expenditure unless EPE rebuts such presumption by clear and convincing evidence. No presumption will apply to lease expense below these levels.

The weighted annual lease payment factor shall include (a) the effect of any rental adjustments that may be required under the Leases (but excluding any such adjustments required under the Leases in connection with either tax law changes or supplemental financing of capital improvements) and (b) the amortization over the initial lease term of any gain or loss to EPE from any hedging or interest protection program implemented by EPE with respect to the debt to be issued in connection with the lease transactions.

25. Restrictions upon the use of the proceeds, beyond the authorizations herein contained, should not be imposed by this Order, given the absence of substantial evidence in the record

showing a need upon which to base such restrictions, and especially given the testimony of EPEC witness Mr. Billye E. Bostic to the effect that EPEC intends to use the proceeds, first, for the retirement of second-mortgage bonds (in the approximate amount of $75 million); second, for the retirement of certain short-term debt (in the approximate amount of $100 million); third, for the retirement of first-mortgage bonds (in the approximate amount of $40 million); and thereafter, for such general corporate purposes as EPEC deems necessary and appropriate to improve its financial integrity and provide economic benefit to EPEC's ratepayers.

26. It is the policy of the Commission that EPEC's New Mexico jurisdictional ratepayers should not be responsible for decommissioning costs associated with PVNGS Unit 2 for any portion of the life of such unit during which it was not owned or leased by EPEC.

27. The Lease Transactions are not exempt within the meaning of NMSA 1978, Section 62-6-8.

28. The prior approval by the Commission of the Lease Transactions is required under NMSA 1978, Section 62-6-6.

29. The purposes of the Lease Transactions are permitted under NMSA 1978, Section 62-6-6.

30. Due and timely notice of this proceeding was published in a newspaper of general circulation in the county in which EPEC's principal New Mexico office is located.

31. The Lease Transactions as described in the Application as amended and supplemented, and the testimony and exhibits of EPEC and as summarized herein should be approved, subject to the limitations and conditions set forth in this Order.

32. The Commission has jurisdiction over the parties to this proceeding and the subject matter herein.

33. The Lease Transactions are not unlawful or inconsistent with the public interest.

34. The Stipulation entered and filed by the AG, EPEC and the Commission Staff should be approved.

WHEREFORE, the Commission O R D E R S:

A. To the full extent that the approval and authorization of the Commission are required by the laws of the State of New Mexico, the Commission hereby approves the Application as amended herein and authorizes EPEC to undertake and consummate the Lease Transactions substantially in accordance with the structure and business terms reflected in the Application, First Amendment to Application, the Second Amendment to Application, the Filing of June 18, 1986 supplementing the Application, and the testimony and exhibits of EPEC, and to take all such action as may be necessary or appropriate in connection therewith, subject to the limitations and conditions contained in this Order.

B. EPEC is hereby granted authority to sell and lease back, subject to the limitations and conditions contained in this Order, all or a portion of its 15.8 percent undivided ownership interest in Unit 2, and up to all or a proportionate share of its 15.8 percent undivided ownership interest in one-third of Common Facilities of the Arizona Nuclear Power Project, pursuant to NMSA 1978, Section 62-6-12, (Repl.Pamp. 1984).

C. EPEC is hereby granted authority to exercise its options to renew the Leases or any of the Leases and to repurchase all or any portion of the Facilities in accordance with the terms of the Leases at the fair market value of the Facilities at the time of such repurchase.

D. EPEC is hereby granted the authority, pursuant to NMSA 1978, Section 62-6-6, (Repl.Pamp. 1984), to issue, assume and guarantee securities in order to consummate, and to perform its obligations and exercise its options under the Lease Transactions (including financing of up to $40 million of additional Capital Improvements as required or permitted by the terms of the Leases, the costs of which will be reflected in an adjustment to lease rentals, as indicated in the Application of EPEC), including but not limited to: (a) early placement of public debt, secured by the direct obligation of EPEC, (b) issuance, assumption or guarantee of securities necessary for any private interim financing, (c) issuance of securities necessary for any releveraging of debt following any adjustment of rental payments or any reoptimization of debt under the lease; (d) assumption of debt by EPEC in connection with any requirement under the Leases that EPEC pay Casualty Value, Special Casualty Value, Special Loss Value or Termination Value, (e) adjustment of rents from

time to time as required by the Leases, and (f) execution of supplements to the Leases as required or permitted by the Leases.

E. The Commission hereby acknowledges that, by virtue of NMSA 1978, Section 62-3-4.1.A, (Repl.Pamp. 1984), the Lease Transactions shall not cause any of the Equity Investors or the Lessors to be deemed to be a "public utility" subject to the jurisdiction, control or regulation of the Commission.

F. The terms of the Leases and other documents to be entered into, in connection with the Lease Transactions, are hereby approved, as such terms are outlined in the Application, First Amendment to Application, Second Amendment to Application, the Filing of June 18, 1986 supplementing the Application, and testimony and exhibits of EPEC.

G. The terms of the Leases and other documents to be entered into in connection with the Lease Transactions, and the transactions contemplated thereby, including without limitation any acquisition of securities or utility assets by the Equity Investors or the Lessors are hereby approved, pursuant to NMSA 1978, Section 62-3-4.1.B, for the purpose of enabling each of the Equity Investors and the Lessors to qualify for an exemption by the United States Securities and Exchange Commission from the Public Utility Holding Company Act of 1935, as amended (Chapter 2C of Title 15 of the United States Code).

H. For purposes of this Order and for future accounting treatment the Common Facilities at the Arizona Nuclear Power

Project shall be allocated equally among the three units of the Project.

I. The Certificate of Convenience and Necessity issued in Commission Case No. 1216 is hereby modified to reflect the approval of the Lease Transactions granted herein.

J. EPEC is hereby authorized from time to time to use and apply the proceeds received from the Lease Transactions for one or more of the following purposes: the acquisition of additional property; the construction, completion, extension or improvement of EPEC's facilities; the improvement or maintenance of its service; the discharge or lawful refunding of its obligations; the reimbursement of monies actually expended for such purposes from income or from any other monies in EPEC's treasury not secured by or obtained from the issue, assumption or guarantee of securities within five years next prior to the filing of the Application herein; or for any of the aforesaid purposes. The proceeds may be invested temporarily pending application to the foregoing purposes.

K. Approval of the Lease Transactions does not include participation by any "affiliated interest" of EPEC within the meaning of NMSA 1978, Section 62-3-3(A), (Repl.Pamp. 1984), nor by any person ten percent or more of whose voting securities are owned or held, directly or indirectly, by an "affiliated interest" of EPEC. EPEC shall seek and obtain separate approval by the Commission prior to any agreement, by any subsidiary or affiliate of EPEC to participate in the Lease Transactions.

L. Nothing contained in this Order shall be considered to be consideration or approval of any lease transactions other than the Lease Transactions described in the Application, First Amendment to Application, Second Amendment to Application, the June 18, 1986 filing supplementing the Application and testimony and exhibits of EPEC and summarized herein.

M. Except as expressly determined in this Order, nothing contained herein shall be considered as a determination by the Commission of the value of any of EPEC's properties or the justness or reasonableness of any cost or expense incurred by EPEC.

N. Nothing contained herein shall be considered as a determination of the appropriate ratemaking treatment for the Lease Transactions, nor of any costs, gains or losses associated therewith. Such ratemaking treatment will be addressed in other proceedings before this Commission. The approvals contained herein are contingent upon the retention by the Commission of full authority over the ratemaking treatment of the Lease Transactions and all costs, gains or losses associated therewith. In any proceeding in which EPE seeks recognition of the lease expense for ratemaking purposes, any lease expense greater than the lease expense which would result from a weighted annual lease payment factor of 9.4% if the investment tax credit associated with the PVNGS Unit 2 Facilities is transferred to the Lessors or 10.3% if the investment tax credit is not so transferred will be presumed to be an imprudent expenditure

unless EPE rebuts such presumption by clear and convincing evidence. No presumption will apply to lease expense below these levels. The weighted annual lease payment factor shall include (a) the effect of any rental adjustments that may be required under the Leases (but excluding any such adjustments required under the Leases in connection with either tax law changes or supplemental financing of capital improvements) and (b) the amortization over the initial lease term of any gain or loss to EPE from any hedging or interest protection program implemented by EPE with respect to EPE with respect to the debt to be issued in connection with the lease transactions.

O. Nothing contained herein shall be construed to mean or to imply that the State of New Mexico, or any officer, agent or employee thereof, has verified the accuracy, completeness or fairness of any factual information contained in any offering circular, registration statement, prospectus, or any other document prepared or delivered in connection with the Lease Transactions, or the accuracy, completeness or fairness of any statements made in connection with the Lease Transactions. Accordingly, nothing contained herein shall be construed to mean or to imply that the State of New Mexico, or any officer, agent or employee thereof, has expressed or expresses an opinion as to whether any statement made or document delivered in connection with the Lease Transactions contains any untrue statement of a material fact, or omits to state a material fact necessary to

make the statements made, in light of the circumstances under which they were made, not misleading.

P. Nothing contained herein shall be construed to mean or to imply that the State of New Mexico, or any officer, agent or employee thereof, shall have any responsibility for the application or disposal by EPEC, or its officers, agents or employees, of any of the proceeds derived from the Lease Transactions.

Q. EPEC shall, within ninety days following the closing of the Lease Transactions, file with this Commission a report, verified by an officer of EPEC before a notary public, stating the consummation, the amount of proceeds, the expenses actually incurred by EPEC and the terms and conditions thereof.

R. Within thirty days following the closing of the Lease Transactions, EPEC shall file with the Commission true and correct copies of all documents executed in connection with the Lease Transactions, all filings with any governmental authority required to consummate the Lease Transactions, and any order or other official action taken by any other governmental authority which is required to consummate the Lease Transactions.

S. EPEC shall, within six months from the date of this Order, file with this Commission a report, verified by an officer of EPEC before a notary public, reflecting the application made by EPEC of the proceeds of the Lease Transactions to the purposes herein authorized, and the amounts applied to each such purpose, including, but not limited to:

1. the type of investments in which the proceeds received from the Lease Transactions were invested temporarily pending application to the purposes set forth in paragraph J of this Order, the amount of income received from such temporary investments, and the dispositions of such income;

2. whether (as presently intended by EPEC and expected by the Commission) EPEC refunded or called or otherwise retired with a portion of the proceeds $75 million in second-mortgage bonds, $100 million of short-term debt, $40 million of first-mortgage bonds, or any other existing securities. If so, then the disposition of the savings achieved thereby. If not, then the reasons for not refunding, calling or otherwise retiring such securities and debt with a portion of said proceeds;

3. whether (as presently intended by EPEC and expected by the Commission) EPEC utilized the remainder of the proceeds to improve the financial integrity of EPEC and provide economic benefits to its ratepayers. If so, then the disposition of the savings achieved thereby. If not, then the reasons for not so utilizing the remainder of the proceeds. EPEC shall file like reports at intervals of not more than six months thereafter, until EPEC has accounted for the application of the entire proceeds of the Lease Transactions;

T. The Stipulation entered and filed on July 14, 1986 by the AG, EPEC and the Commission Staff is hereby approved.

U. This Order is effective immediately; and.

V. A copy of this Order shall be mailed to EPEC, to counsel record for all parties to this case, and to any parties appearing without counsel.

I S S U E D at Santa Fe, New Mexico this 16th day of July, 1986.

NEW MEXICO PUBLIC SERVICE COMMISSION

MARILYN C. O'LEARY, CHAIRMAN

DAVID B. SMITH, COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

Amendment No. 1
to an
Application for an Order Under
Section 6(c) of the Investment Company
Act of 1940.

File No. 812-__________

EL PASO FUNDING CORPORATION
(Name of Applicant)

1209 Orange Street
Wilmington, Delaware 19801
(Address of Principal Office of Applicant)

Please send communications to:

Robert B. Michel, Esq.
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New York, New York 10038
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UNITED STATES OF AMERICA

Before the Securities and Exchange Commission

In the Matter of EL PASO FUNDING CORPORATION File 812-__________	Amendment No. 1 to an Application for an Order Pursuant to Section 6(c) of the Investment Company Act of 1940.

The undersigned applicant, EL PASO FUNDING CORPORATION (hereinafter called the Applicant), hereby amends its application pursuant to Section 6(c) of the Investment Company Act of 1940 filed with the Commission on April 11, 1986 (hereinafter called the Application), by adding the information and making the other revisions set forth below. Unless otherwise defined herein, capitalized terms used herein and not defined herein shall have the respective meanings set forth in the Application.

1. The fourth paragraph of Section I.A. of the Application is amended by adding at the end thereof the following:

> "The rates and services of El Paso in Texas municipalities are regulated by the municipalities and in unincorporated areas of Texas by the Public Utility Commission of Texas which also has exclusive de novo appellate jurisdiction to review municipal orders and ordinances. The New Mexico Public Service Commission has authority over El Paso's rates and services in New Mexico, the issuance of securities by El Paso and certain other matters directly affecting the operations of El Paso. El Paso is also subject to regulation by the Federal Energy Regulatory Commission in certain matters that include wholesale electric rates and the issuance of securities."

2. The seventh paragraph of Section I.A. of the Application is amended by adding at the end of the first sentence thereof the following:

> "This will be so regardless of whether the beneficiary of any of the grantor trusts formed for the purpose of the lease financing shall be a direct or indirect subsidiary of El Paso.".

3. The first paragraph of Section I.B. of the Application is amended by adding at the end of the first sentence thereof the following:

"the First National Bank of Boston will serve as Lessor in each of the Leases."

4. The first paragraph of Section I.C. of the Application is amended by adding at the end of the fourth sentence thereof the following:

"These permitted encumbrances will include (a) the respective interests of the El Paso, the Lessor, the beneficiary under the grantor trust, the Applicant and the Trustee under the Lease Indenture under the lease transaction documents, (b) the rights of any sublessee or assignee permitted by the Lease, (c) the lien of El Paso's existing mortgages securing its debt obligations on its leasehold estate under the Lease, (d) liens for taxes either not yet due or which are being contested in good faith and by appropriate proceedings diligently conducted, (e) inchoate materialmen's, mechanics', workmen's and other similar liens arising in the ordinary course of business for PVNGS and not delinquent, (f) choate liens that have either been bonded for the full amount in dispute or for which security arrangements have been made in connection with a contest, or for which security arrangements have been made pending an appeal or proceeding for review and for the payment of which adequate reserves shall have been provided, (g) the rights of the United States Nuclear Regulatory Commission under the operating license granted for PVNGS, (h) the rights of the other utility participants in PVNGS under the Project Participation Agreement identified in the third paragraph of Section A. above and (i) liens which may exist on the undivided interests in Unit 2 of PVNGS of the other utility participants in PVNGS."

5. The last sentence of the first paragraph of Section I.C. of the Application is amended to read as follows:

"Each Lease Indenture will include as events of default, without limitation, payment defaults on the Lessor Notes issued thereunder and certain events of default under the related Lease."

6. The second paragraph of Section I.C. of the Application is amended by adding at the end thereof the following:

"Hence, the amount of principal and interest payable in respect of the Lessor Notes will be adequate to discharge the interest, principal and all other costs and

expenses payable by the Applicant in respect of the Lease Obligation Bonds."

7. The first paragraph of Section I.D. of the Application is amended by deleting the last sentence thereof.

8. The third paragraph of Section I.D. of the Application is amended by adding at the end thereof the following:

"El Paso has been informally advised by the rating agencies that it might anticipate a rating for the initial issuance of Lease Obligation Bonds one 'notch' below that of El Paso's first mortgage bonds at the time the Lease Obligation Bonds are rated. The current ratings of El Paso's first mortgage bonds are A3 by Moody's Investors Service, Inc. and BBB+ by Standard & Poor's Corporation. On the foregoing basis, the initial series of Lease Obligation Bonds would be rated Baa 1 by Moody's and BBB by Standard & Poor's."

9. The second sentence of the first paragraph of Section I.E. of the Application is amended to read as follows:

"As a holder of the Lessor Notes, the Trustee will have the right to exercise any voting powers and give consents and waivers in respect of such Lessor Notes and the Lease Indentures under which such Lessor Notes are issued and to exercise the rights and remedies afforded a holder of such Lessor Notes under the respective Lease Indentures, including the right to exercise remedies under the Leases and with respect to the Lease rentals and other payments in lieu thereof securing such Lessor Notes in the circumstances and subject to the conditions set forth in the Lease Indentures."

10. The first sentence of the third paragraph of Section I.E. of the Application is amended to read as follows:

"Thus, if El Paso were to default in the payment of that portion of rent required to pay all amounts due and payable in respect of the Lessor Notes, the Applicant (if the Lease Indenture was a Loan and Security Agreement) or the Trustee (if the Lease Indenture was a Trust Indenture and Security Agreement) under the related Lease Indenture would have the right and, upon the direction of a majority in principal amount of the Lessor Notes relating to such Lease (which by virtue of the pass - through voting mechanism, would be a majority of the principal amount of the Lease Obligation Bonds), would be required to declare all of such Lessor Notes to be due and payable and to exercise, concurrently with the exercise by the Lessor under such

Lease of any remedies available to it under such Lease, the remedies available under such Lease Indenture."

11. The proposed form of Notice of Application for an Order Pursuant to Section 6(c) of the Act Exempting Applicant From All Provisions of the Act, attached as Exhibit B to the Application, is amended in its entirety to read as set forth on Exhibit A to this Amendment No. 1.

Authorization

The execution of this Amendment No. 1 and the filing thereof are within the authorization described in the Application.

Dated: July 11, 1986

EL PASO FUNDING CORPORATION

By Robert B. Michel
Robert B. Michel
Secretary

STATE OF NEW YORK)
) .ss:
COUNTY OF NEW YORK)

The undersigned, being duly sworn, deposes and says that he has duly executed the attached Amendment No. 1 dated July 11, 1986 for and on behalf of **EL PASO FUNDING CORPORATION**, that he is Secretary of such company; and that all actions by stockholders, directors and other bodies necessary to authorize deponent to execute and file such instrument have been taken. Deponent further states that he is familiar with such instrument, and the contents thereof, and that the facts set forth therein are true to the best of his knowledge, information and belief.

Robert B. Michel

Robert B. Michel

Subscribed and sworn to before me a notary public this 11th day of July, 1986.

[Notary Seal]

Anna Marie Napoli

ANNA MARIE NAPOLI
Notary Public, State of New York
No. 24-4759288
Qualified in Kings County
Certificate Filed in New York County
Commission Expires August 31, 19.88

EXHIBIT A

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT COMPANY ACT OF 1940
Release No. __________ / ______ __, 1986

\- - - - - - - - - - - - - x

In the Matter of

EL PASO FUNDING CORPORATION
1209 Orange Street
Wilmington, Delaware 19801

(File No. 812-_____)

\- - - - - - - - - - - - - x

NOTICE OF APPLICATION FOR AN ORDER PURSUANT TO SECTION 6(c) OF THE ACT FOR EXEMPTION FROM ALL PROVISIONS OF THE ACT

NOTICE IS HEREBY GIVEN that El Paso Funding Corporation (Applicant), a Delaware corporation, filed an application on April 11, 1986, and an Amendment No. 1 thereto dated July 11, 1986, for an order of the Commission pursuant to Section 6(c) of the Investment Company Act of 1940 (Act), exempting Applicant from all provisions of the Act. All interested persons are referred to the application on file with the Commission for a statement of the representations made therein, which are summarized below, and to the Act for the text of its relevant provisions.

According to the application, Applicant is a Delaware corporation and expects to have all of its shares of common stock owned by The Corporation Trust Company, or a company controlled by it. Applicant represents that there has been, and undertakes that in the future there will be, no public offering of Applicant's common stock or of any other equity security. Applicant further represents that there is, and in the future will be, no class of equity securities of Applicant other than its common stock. Applicant has been created to participate as lender in one or more leveraged lease transactions (Leases), in which El Paso Electric Company, a Texas corporation (El Paso), is the lessee (Lessee).

Applicant's sole purpose is to assist El Paso in the financing and refinancing, in whole or in part, of El Paso's 15.8%

undivided ownership interest in the Palo Verde Nuclear Generating Station (PVNGS). PVNGS, located near Phoenix, Arizona, consists primarily of three 1,270 megawatt electric generating units, each containing a pressurized water nuclear steam supply system, and certain related common facilities. Ownership of PVNGS is governed by the Arizona Nuclear Power Project Participation Agreement, dated August 23, 1973, as amended, and pursuant thereto, Arizona Public Service Company, an Arizona utility, is authorized to act as agent for the owners of PVNGS, and has responsibility and control over construction, operation and maintenance of PVNGS.

Applicant states that its participation as lender in the Leases will be limited to making loans pursuant to a Loan and Security Agreement or a Trust Indenture and Security Agreement (in either case, a **Lease Indenture**) to certain lessors (**Lessors**) under such Leases which will be payable primarily from rentals and other payments by the Lessee. Applicant states that the Lessor under each Lease will be the First National Bank of Boston acting as trustee for one or more beneficiaries pursuant to a trust agreement formed exclusively for the purpose of the lease financing. Applicant states that a portion of the purchase price of the property owned by the Lessors and leased to the Lessee (**Leased Property**) will be paid by the beneficiaries of the grantor trust that acts as Lessor and that amount will constitute their equity investment in the Leased Property. The loans by Applicant will be without recourse to the general credit of the Lessors or their respective beneficiaries, and will be evidenced by non-recourse obligations of the respective Lessors (**Lessor Notes**). Applicant states that under each Lease, the Lessee will be obligated to make rental payments sufficient to pay principal of and premiums, if any, and interest on the Lessor Notes issued in connection therewith. Applicant further states that such obligations of the Lessee will be required to be absolute and unconditional, without right of counter-claim, setoff, deduction or defense. Applicant expects to enter into an agreement (the **Commitment Agreement**) with El Paso pursuant to which Applicant will agree to make loans to one or more Lessors designated by El Paso from time to time.

Applicant intends to acquire the funds necessary for the purchase of the Lessor Notes through the issuance of its debt securities in one or more series with differing maturities (**Lease Obligation Bonds**) which will be secured on a parity basis by a first lien on, and a security interest in, all of the assets of Applicant, consisting primarily of the Lessor Notes so acquired and previously acquired and which may include a lien on or security interest in the Leased Property. Lessor Notes held by Applicant may only consist of Lessor Notes issued in connection with any Leases to which El Paso is a party, as lessee, in conjunction with its ownership interest in PVNGS.

Applicant states that the Lease Obligation Bonds will be issued under a common indenture and a separate supplemental indenture

for each series other than the initial series (collectively, the Collateral Trust Indenture) which will establish the terms of the Lease Obligation Bonds of that series. It is expected that the trustee under the Collateral Trust Indenture (Trustee) will be a bank or trust company not affiliated with any of the Lessors and will not be a trustee under any indenture of El Paso or its subsidiaries. At each Lease closing the Lessor Notes will be pledged and assigned directly to the Trustee. Applicant expects that the Lessor Notes will be issued under circumstances making such transactions exempt from the registration requirements under the Securities Act of 1933 (Securities Act).

Applicant states that the Lease Indentures will set forth the terms and conditions under which the Lessor Notes will be issued. Applicant represents that each Lease Indenture will require the Lessor to grant to the Applicant (if the Lease Indenture is a Loan and Security Agreement) or a trustee under the Lease Indenture (Lease Indenture Trustee) (if the Lease Indenture is a Trust Indenture and Security Agreement), an assignment of rents, including basic rentals and certain other payments, to be made by the Lessee under the applicable Lease. The Lease Indenture Trustee or the Applicant may have a lien on or security interest in, the Leased Property. In the event no such lien or security interest is created, the Lessor will covenant that, so long as any Lessor Note is outstanding, it will not incur any other debt not constituting Lessor Notes or otherwise in connection with the Leased Property, and except for certain limited permitted liens, it will not create any lien or security interest in such property. Thus, Applicant states, these two covenants combined ensure that if a Lessor defaults on a Lessor Note, the Leased Property will be available to satisfy the claims of the Trustee, acting for the benefit of Lease Obligation Bondholders. Applicant states that it will be precluded from purchasing any Lessor Note unless (i) such Lessor Note is issued in respect of Leased Property having a fair market sales value at the time of purchase at least equal to 110% of the original principal amount of such Lessor Note or, (ii) such Lessor Note and all other Lessor Notes (if any) issued by the relevant Lessor are issued in respect of Leased Property having an aggregate fair market value (measured, in each case, as of the date such Leased Property was first financed under the Lease) at least equal to 110% of the original principal amount of such Lessor Note and such other Lessor Notes. Further, Applicant states that each Lease Indenture will include as events of default, without limitation: (a) payment defaults on the Lessor Notes issued thereunder and (b) certain events of default under the related Lease.

According to the application, the various series of Lease Obligation Bonds will have terms which may differ as to interest rates, sinking fund obligations of Applicant, the right of Applicant to redeem such Lease Obligation Bonds and other matters. The interest rates, maturities and principal amounts of each series of

Lease Obligation Bonds will be established based on prevailing market conditions, thereby giving Applicant flexibility to take advantage of changing market conditions. If the maturity dates and cash flow of the Lessor Notes exceed the cash requirements of Applicant's obligations under the Lease Obligation Bonds, the resulting funds (Temporary Funds) will be invested by Applicant in certain investments (Permitted Investments), in each case maturing at such time as necessary to pay Applicant's obligations under the Lease Obligation Bonds. Applicant states that Lease Obligation Bonds, which may include commercial paper and intermediate-term and long-term obligations, will be issued in the private or public markets in the United States, and in offerings outside the United States under circumstances reasonably designed to assure that such Lease Obligation Bonds are not offered or sold to citizens and/or residents of the United States.

Applicant proposes that the initial issuance of Lease Obligation Bonds will be through an underwritten public offering of one or more series having an aggregate principal amount of approximately $490 to $546 million (assuming a total sales price for El Paso's 15.8% interest in PVNGS Unit 2 of $700 million). Applicant represents that, although El Paso will not be the actual issuer of the Lease Obligation Bonds, it will be considered the "issuer" thereof for purposes of the Securities Act. Any registration statement filed under the Securities Act relating to the Lease Obligation Bonds will name El Paso as the sole registrant and will be signed on behalf of El Paso as the sole registrant by such officers and directors of El Paso as may be required under the Securities Act and the rules, regulations and forms of the Commission thereunder.

Applicant represents that it will assign and pledge to the Trustee under the Collateral Trust Indenture, as security for the payment of the principal of and premium, if any, and interest on all Lease Obligation Bonds, the Lessor Notes and other assets held by the Applicant including any lien or security interest it may have in the Leased Property. Each such Lessor Note will in turn be secured by the assigned rentals and other assigned payments under such Lease and may be secured by a lien or security interest in the Leased Property. Applicant states that the Trustee will give immediate notice to the Lease Obligation Bondholders of any rights granted by the Collateral Trust Indenture to it, which will include the right to exercise voting powers in respect of the Lessor Notes, to give any consents or waivers with respect thereto or to exercise any rights and remedies in respect thereof. The Collateral Trust Indenture will authorize the Lease Obligation Bondholders to direct by notice to the Trustee within a specific period of time, that it take any action or cast any vote in its capacity as a holder of the Lessor Notes. As a result of this pass-through voting mechanism, the rights and remedies of Lessor Noteholders will be exercisable directly by the Lease Obligation Bondholders through their fiduciary, the Trustee. The principal amount of Lessor Notes directing any action or being voted

for or against any proposal will be the principal amount of the Lease Obligation Bondholders taking the corresponding position. To the extent the Trustee does not receive instruction, it will take such action with respect to the Lessor Notes as a prudent man would in the care of his own property.

Applicant states that in the event El Paso defaults in the payment of that portion of rent necessary to pay all amounts due and payable in respect of the Lessor Notes, the Applicant or the Lease Indenture Trustee, as the case may be, would have the right to exercise, concurrently with the Lessor under the applicable Lease of any remedies available to it under such Lease all of the rights and remedies against El Paso provided in the related Lease. The exercise of such rights and remedies would be at the direction of the Lease Obligation Bondholders through the Trustee's instructions to the Lease Indenture Trustee or as pledgee of the Applicant's interest in such Lease Indenture.

Applicant states that among the rights and remedies of a holder of Lessor Notes included under the Lease Indenture is the right to demand, after a specified grace period, that El Paso pay all unpaid basic rent plus a stipulated amount which, in all cases, will be sufficient to pay the principal of and premium, if any, and interest on the related Lessor Notes. Amounts payable by El Paso under the Leases, to the extent of the amount of the principal, interest and premium, if any, on the relevant Lessor Notes, will be paid directly to the Trustee for distribution to the Lease Obligation Bondholders. Applicant thus asserts that Lease Obligation Bondholders will have access under the Collateral Trust Indenture and the Lease Indentures to the credit of El Paso. Moreover, Applicant asserts that Lease Obligation Bondholders will be entitled to realize on the security afforded by the assignment of rentals in an amount up to the aggregate unpaid amount of the relevant Lessor Notes secured by such assignment of rentals. The combination of the Lessor Notes and the obligation of El Paso under the Leases, Applicant asserts, grants holders of Lease Obligation Bonds access to the general credit of El Paso and is thus the equivalent of a general unsecured obligation of El Paso without limitation as to source of payment. The Lessor Notes and the Lease Indenture will provide that, upon the occurrence of certain casualty events, and certain other events which require the collapsing of the lease transaction, either (i) El Paso shall assume the obligations represented by the Lessor Notes or (ii) El Paso shall purchase from the beneficiaries of the trusts issuing the Lessor Notes the beneficial interest in such trusts and the Lessors will grant a lien and security interest in the Leased Property to secure the Lessor Notes. The assumption or purchase described in the preceding sentence will be in partial satisfaction of El Paso's obligation to make payments required of it upon early termination of the Leases in consequence of any such event. Applicant asserts that in circumstances where the Lessor Notes are not secured by the Leased Property, there will be no need to prepay

the Lessor Notes in the event of a casualty. The preservation of a right for El Paso to assume the Lessor Notes in certain circumstances assures that El Paso will not be faced with an accelerated obligation to prepay the Lessor Notes under provisions of the Leases.

Applicant states that the issue, sale and delivery of a particular series of Lease Obligation Bonds may be effected, at maximum, two months prior to the date for the consummation of the Leases (Lease Closing Date) applicable to the Leased Property financed with the Lease Obligation Bond proceeds. Pending the Lease Closing Date, the net proceeds of the Lease Obligation Bonds will be held by the Trustee, pursuant to the terms of the Collateral Trust Indenture. The Trustee may invest proceeds in Permitted Investments, which include direct obligations of the United States or obligations fully guaranteed by the United States, certificates of deposit issued by or bankers' acceptances of, or time deposits with, banks organized under United States law and limited to amounts of less than $15 million in principal at any one time and from any one bank, or commercial paper of companies incorporated in or doing business under the laws of the United States or one State, in an amount not exceeding $15 million in principal amount at any one time from any one company. The commercial paper will also have the highest rating by a nationally recognized rating organization. Permitted Investments, Applicant states, also include repurchase agreements, fully collateralized by the Permitted Investments, pursuant to which a United States bank, trust company or national banking association having a net worth of at least $200 million is obligated to repurchase the obligation not later than 90 days after its purchase.

Except to the extent payable from the proceeds of refunding Lease Obligations Bonds, proceeds of Temporary Investments or the proceeds of the initial issuance of the Lease Obligation Bonds, where the relevant Lease Closing Date does not occur simultaneously, due to the nonrecourse nature of Lessor Notes and the limited scope of Applicant's activities, payment of the principal of and premium, if any, and interest on the Lease Obligation Bonds will be made exclusively from amounts paid by the Lessee under the Leases.

Applicant asserts that its proposed activities are appropriate in the public interest because the proposed issuance of Lease Obligation Bonds would provide a convenient mechanism for El Paso to obtain access to segments of the debt capital market other than the institutional private placement market. Applicant further asserts that an exemption would be consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act because, among other things, investors will be protected under the proposed arrangements to the same extent as under equivalent arrangements where the Act is inapplicable.

NOTICE IS FURTHER GIVEN that any interested person wishing to request a hearing on the application may, not later than _____ __, 1986, at 5:30 p.m., do so by submitting a written request setting forth the nature of his/her interest, the reasons for the request, and the specific issues of fact or law that are disputed, to the Secretary, Securities and Exchange Commission, Washington, D.C. 20549. A copy of the request should be served personally or by mail upon Applicant at the address stated above with a copy to Robert B. Michel, Esq., Mudge Rose Guthrie Alexander & Ferdon, 180 Maiden Lane, New York, New York 10038. Proof of service (by affidavit or, in the case of an attorney-at-law, by certificate) shall be filed with the request. After said date, an order disposing of the application will be issued unless the Commission orders a hearing upon request or upon its own motion.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

John Wheeler
Secretary

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HAND SIGNED

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CHRYSLER
CORPORATION

annual report

FOR THE YEAR ENDED DECEMBER 31, 1985

Filed Pursuant to Section 13

of the

Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1985. Commission file number 1-686.

CHRYSLER CORPORATION
(Exact name of registrant as specified in its charter)

STATE OF DELAWARE	38-0419960
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
12000 Chrysler Drive, Highland Park, Michigan	48203*
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (313) 956-5252

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, without par value	New York Stock Exchange
	Midwest Stock Exchange
	Pacific Coast Stock Exchange
	Philadelphia Stock Exchange
8-7/8% Sinking Fund Debentures Due 1995	New York Stock Exchange
8% Sinking Fund Debentures Due 1998	New York Stock Exchange
12-3/4% Notes Due 1992	New York Stock Exchange
13% Debentures Due 1997	New York Stock Exchange
12% Debentures Due 2015	New York Stock Exchange

The Common Stock of the Registrant is listed for trading on the following additional stock exchanges:

Montreal Stock Exchange	Montreal, Quebec, Canada
Toronto Stock Exchange	Toronto, Ontario, Canada
The Stock Exchange, London	London, England
Paris Stock Exchange	Paris, France
Geneva Stock Exchange	Geneva, Switzerland
Basel Stock Exchange	Basel, Switzerland
Zurich Stock Exchange	Zurich, Switzerland
Frankfurt Stock Exchange	Frankfurt, Germany

*Post Office Box 1919, Detroit, Michigan 48288

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes _X_. No___.

The aggregate market value of voting Common Stock held by non-affiliates of the registrant was approximately $5.7 billion as of February 28, 1986.

The registrant had 150,338,448 shares of Common Stock outstanding as of February 28, 1986.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information in Chrysler Corporation's Annual Report to Shareholders for the year ended December 31, 1985 is incorporated by reference in Part II (Items 5, 6, 7 and 8) of this Form 10-K.

Certain information in Chrysler Corporation's definitive combined Proxy Statement and Prospectus for its 1986 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission pursuant to Regulation 14A, not later than 120 days after the end of the fiscal year, is incorporated by reference in Part III (Items 10, 11, 12 and 13) of this Form 10-K.

CHRYSLER CORPORATION

FORM 10-K

Year Ended December 31, 1985

Chrysler Corporation's Annual Report to Shareholders for the year ended December 31, 1985, a complete copy of which is provided herein, contains much of the financial information required by this Form 10-K. Such information is incorporated in and made a part of this Form 10-K by reference to its location in such Annual Report. With the exception of the information specifically referred to herein as incorporated by reference, the 1985 Annual Report to Shareholders is not deemed to be incorporated by reference in this Form 10-K.

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PART I

Item 1. BUSINESS

General

Chrysler Corporation (Chrysler) and its subsidiaries manufacture, assemble and sell in the United States, Canada and Mexico Chrysler, Dodge and Plymouth passenger cars, Dodge trucks and related automotive parts and accessories. Chrysler produces trucks only in light-duty and van/wagon models, which represent the largest segment of the truck market. The passenger cars are offered in various size classes and models. Chrysler also imports and distributes under the Dodge and Plymouth trade names certain small passenger cars and trucks manufactured in Japan by Mitsubishi Motors Corporation (MMC), a company in which Chrysler has a 24% interest. Chrysler and MMC have formed a joint venture, Diamond-Star Motors Corporation, to manufacture small cars in the U.S.

Chrysler currently participates in markets outside the United States, Canada and Mexico principally through minority investments in MMC, and Peugeot S.A. (PSA) a company in which Chrysler has a 12% interest. Chrysler and its subsidiaries also sell part of their production of automatic and manual transmissions, transfer cases, electronic equipment, chemical and plastic products and powdered metal components to unaffiliated companies, principally in the United States.

Chrysler acquired, on August 16, 1985, 100% of the outstanding capital stock of Gulfstream Aerospace Corporation, a producer of jet aircraft for corporate, personal and governmental use.

Chrysler's automotive operations currently account for virtually all of the total dollar sales of Chrysler and its consolidated subsidiaries.

The Automotive Industry in the United States

The automotive industry in the United States is highly competitive. It is composed of the three principal domestic passenger car and truck manufacturers - General Motors, Ford and Chrysler as well as a number of foreign manufacturers that distribute automobiles and trucks assembled both overseas and domestically.

The Automotive Industry in the United States - continued

The tables below set forth the percentage breakdown for retail sales of cars and trucks for the major domestic manufacturers (including cars and trucks imported by them) and for foreign companies:

U.S. Car Market Share *
Years Ended December 31

	1985	1984	1983	1982	1981	1980
	(Percent of Total Industry)					
U.S. Manufacturers (Including Imports)						
General Motors	42.7%	44.6%	44.3%	44.2%	44.6%	46.0%
Ford	18.9	19.2	17.2	16.9	16.6	17.2
Chrysler	11.4	10.4	10.3	10.0	9.9	8.8
American Motors	1.2	2.0	2.5	1.9	2.0	2.0
Total U.S. Manufacturers	74.2	76.2	74.3	73.0	73.1	74.0
Imports by Foreign Companies **						
Toyota	5.3	5.0	5.9	6.6	6.7	6.5
Honda	5.0	4.9	4.4	4.6	4.4	4.2
Nissan	5.2	4.7	5.7	5.9	5.5	5.8
Mazda	1.9	1.6	1.9	2.1	2.0	1.8
All Other	8.4	7.6	7.8	7.8	8.3	7.7
Total Imports by Foreign Companies	25.8	23.8	25.7	27.0	26.9	26.0
Total U.S. New Car Retail Sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Memo:

	(In thousands)					
U.S. Car Retail Deliveries						
Total Industry	10,980	10,324	9,147	7,955	8,514	8,952
Chrysler	1,245	1,079	945	794	841	789

* All U.S. retail sales data are based on publicly available information on manufacturers from the Motor Vehicle Manufacturers Association, and data on foreign company imports from Ward's Automotive Reports, a trade publication.

** "Imports by Foreign Companies" include cars manufactured and sold in the United States.

The Automotive Industry in the United States - continued

U.S. Truck Market Share *
Years Ended December 31

	1985	1984	1983	1982	1981	1980
	(Percent of Total Industry)					
U.S. Manufacturers (Including Imports)						
General Motors	34.8%	34.5%	39.5%	40.2%	37.2%	37.4%
Ford	26.8	28.1	31.4	30.7	31.5	31.6
Chrysler	12.8	12.6	8.7	9.5	8.2	9.9
American Motors	3.8	3.7	2.6	2.5	2.8	3.1
Navistar	1.5	1.7	1.7	1.9	3.0	3.2
All Other	1.9	1.8	1.3	1.4	2.4	2.5
Total U.S. Manufacturers	81.6	82.4	85.2	86.2	85.1	87.7
Imports by Foreign Companies **						
Toyota	7.9	7.4	5.8	5.7	6.1	5.4
Nissan	5.4	4.9	4.3	4.2	5.3	4.4
Mazda	2.4	2.9	2.4	1.6	0.7	0.3
Isuzu	1.6	1.1	0.8	0.7	0.4	-
All Other	1.1	1.3	1.5	1.6	2.4	2.2
Total Imports by Foreign Companies	18.4	17.6	14.8	13.8	14.9	12.3
Total U.S. New Truck Retail Sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Memo:	(In thousands)					
U.S. Truck Retail Deliveries						
Total Industry	4,745	4,160	3,163	2,582	2,279	2,515
Chrysler	606	526	274	246	187	250

* All U.S. retail sales data are based on publicly available information on manufacturers from the Motor Vehicle Manufacturers Association, and data on foreign company imports from Ward's Automotive Reports, a trade publication.

** "Imports by Foreign Companies" include trucks manufactured and sold in the United States.

As illustrated above, depressed levels of industry sales occurred during the 1980 through 1982 period. This condition was caused by a number of factors to which the automobile industry has been particularly sensitive, including the prolonged economic recession, high interest rates, inflation and a wide-spread lack of consumer confidence. Sales of vehicles manufactured in the United States have been adversely affected by increased competition from foreign automotive manufacturers. Chrysler was particularly affected in 1980 by its limited ability to produce smaller, more fuel-efficient lines of cars and consumer concern about the viability of Chrysler.

The Automotive Industry in the United States - continued

The improvement in Chrysler's retail car market share from the 1980 level is largely attributable to the successful introduction of a range of new front-wheel-drive products beginning with the Plymouth Reliant and Dodge Aries, followed by the Chrysler New Yorker and Dodge 600 six-passenger models, Chrysler Laser and Dodge Daytona sports cars and most recently by the Chrysler LeBaron GTS and Dodge Lancer sedans. The improvement in Chrysler's retail truck market share in 1984 and 1985 is attributable to the introduction of Chrysler's new front-wheel-drive miniwagons the Plymouth Voyager and Dodge Caravan and the Mini Ram Van.

As has been the case historically, in 1985, Chrysler was third in the United States industry in unit retail sales of both passenger cars and trucks.

Chrysler Canada

Chrysler's consolidated subsidiary, Chrysler Canada Ltd. (Chrysler Canada), operates assembly and manufacturing facilities in Canada. Its operations are substantially integrated with Chrysler's United States operations. In 1985, Chrysler Canada produced 390,120 vehicles, of which 347,429 were shipped to the United States. In the same year, Chrysler Canada sold a total of 249,043 vehicles, of which 190,711 were produced in the United States. Chrysler Canada manufactures components and assembles rear-wheel-drive van/wagons and front-wheel-drive minivan/wagons.

In 1985, factory unit sales by Chrysler Canada accounted for approximately 11.5% of Chrysler's total car and truck sales, compared to 11.3% in 1984 and 11.9% in 1983. Chrysler Canada's retail unit sales accounted for 16.0% of the total Canadian car market and 16.2% of the total Canadian truck market in 1985, compared to 17.3% and 15.7%, respectively, in 1984. In 1985, Chrysler Canada was third in the industry in retail unit sales of both passenger cars and trucks.

Chrysler de Mexico

Chrysler de Mexico operates assembly and manufacturing facilities in Mexico. It is the third largest manufacturer of both passenger cars and trucks in Mexico, accounting for approximately 16.0% of the retail car market and approximately 18.1% of the retail truck market in 1985. The Mexican subsidiary depends upon Chrysler for product development as well as for approximately 40% of the material necessary for vehicle assembly in Mexico. Chrysler, in turn, obtains certain major automobile components, including engines and air conditioner condensers, from Chrysler de Mexico and, to a lesser extent, from unaffiliated Mexican suppliers.

In 1985, Chrysler de Mexico earned $33.8 million on domestic sales of 65,871 units compared to $11.9 million on 54,916 units in 1984. The increased profitability in 1985 was largely due to an improvement in the Mexican economy. Chrysler de Mexico's operations continue to be subject to the substantial uncertainties in the Mexican economy and to the various regulations imposed by the Mexican Government.

In 1985, Chrysler de Mexico exported 11,918 Plymouth Reliant and Dodge Aries passenger cars to the U.S. compared to 4,489 in 1984. In 1985, Chrysler de Mexico began production of, and exported to the U.S., 4,905 Dodge Ramcharger sport utility vehicles. During 1985, Mexican government regulations made it impractical to continue production of medium duty trucks. Prior to phase-out, 1,582 medium duty trucks were sold compared to 3,734 in 1984.

Operations Outside the United States, Canada and Mexico

Automotive markets outside the United States, Canada and Mexico have grown significantly in recent years and exceed the United States, Canadian and Mexican market in number of vehicles sold. Most of the demand in these markets is met by vehicles produced outside the United States, Canada and Mexico principally in Western Europe and Japan. Chrysler no longer has significant sales in these markets as a result of the sale of its former European subsidiaries to PSA (see Item 1. Business-Chrysler-PSA Agreements), and the sale of substantially all of Chrysler's interests in its various South American, South African and Australian operations. Chrysler's two principal domestic competitors have substantial overseas operations and are better positioned to participate in growth and opportunities for profits in markets outside the United States, Canada and Mexico. Chrysler conducts sales activities on a small scale in markets outside the United States, Canada and Mexico and also participates in such markets through PSA and MMC.

For information concerning sales, earnings and identifiable assets attributable to different geographic areas in which Chrysler operates, see Note 15 of Notes to Financial Statements in Chrysler's 1985 Annual Report, a complete copy of which is provided herein.

Competition

The automotive industry in the United Sates is highly competitive with respect to quality, price, appearance, size, special features, distribution organization, warranties, product reliability, fuel economy and financing terms. Many of Chrysler's competitors have larger sales volumes and greater financial resources than Chrysler. As a result, Chrysler is at a competitive disadvantage in responding to substantial changes in consumer preferences or government regulations that require major additional capital expenditures. Chrysler is particularly dependent on economic conditions in the United States, Canada and Mexico because it does not have significant sales in other areas. In addition, Chrysler's ability to increase vehicle prices is significantly affected by the pricing actions of its principal competitors.

Competition from foreign car manufacturers, particularly those in Japan, has increased sharply in recent years. The market share for foreign passenger cars sold in the United States increased from 21.0% in 1979 to 25.8% in 1985. Approximately 80% of the passenger cars imported into the United States during the 1979-1985 period were of Japanese origin. Japanese producers still have a significant cost advantage over domestic manufacturers, as a result, among other factors, of differences in labor practices, wage rates and tax policies, although recent pressures on the value of the yen relative to the dollar have reduced slightly the magnitude of the difference. Changes in the yen-dollar relationship will continue to affect this cost advantage. Voluntary restraints limiting exports of new passenger cars (excluding station wagons) from Japan to the United States have been in effect since 1981 and continued in effect through 1985 by a unilateral decision of the Japanese Government. The restraints for the period April 1, 1986 through March 31, 1987 limit such Japanese exports to 2.3 million units. If the restraints are eliminated, the level of competition will increase, and Chrysler believes that unrestrained importation of significantly increased numbers of cars manufactured in Japan will adversely affect the sales and profitability of its domestically produced smaller product offerings.

Product Plans

Chrysler began its program to "down-size" its cars in the 1978 model year. It first concentrated on the development and production of relatively small, fuel-efficient, front-wheel-drive cars, and more recently Chrysler introduced new front-wheel-drive, fuel-efficient, middle-sized and larger cars. Chrysler's product strategy through the 1980s is to continue the expansion of its line of fuel-efficient, front-wheel-drive vehicles.

Chrysler introduced the Dodge Lancer and Chrysler LeBaron GTS five-door sport sedans in the 1985 model year. In the spring of 1986, Chrysler will introduce two new small sedans, the Dodge Shadow and Plymouth Sundance and a new mid-sized pickup truck, the Dodge Dakota. Additionally, in the fall of 1986, Chrysler will introduce a new mid-sized coupe in two-door and convertible models.

Chrysler is also planning to introduce in 1987 a luxury, two-seat sport convertible which is being developed jointly with Maserati and in 1988 Chrysler plans to bring out an all-new compact four-door sedan.

The success of Chrysler's products will depend on a number of factors, including the state of the economy and consumer confidence, the degree of competition from foreign and domestic manufacturers, fuel price levels, consumer preferences, the effects of government regulation and the strength of Chrysler's marketing network. Chrysler is substantially committed to the types of vehicles contemplated by its product plans and could be adversely affected by developments requiring a major shift in product design.

Marketing

New passenger cars and trucks are sold at retail principally by dealers who are franchised by the manufacturer and purchase cars, trucks, parts and accessories from the manufacturer for sale to retail customers. In the United States, Chrysler had 4,007 dealers at December 31, 1985, compared to 3,994 dealers at December 31, 1984 and 3,872 at December 31, 1983. The United States dealers sold an average of 462 vehicles each in 1985, 402 vehicles each in 1984 and 315 vehicles each in 1983. In Canada, Chrysler had 555, 539 and 522 dealers at December 31, 1985, 1984, and 1983, respectively. The Canadian dealers sold an average of 443 vehicles each in 1985, 401 vehicles each in 1984 and 324 vehicles each in 1983.

Chrysler's ability to maintain, expand and improve the quality of its dealer organization will have an important effect on its sales in the future. Chrysler maintains programs to provide dealership operating capital by equity investments where sufficient private capital is not available. The programs contemplate that the dealer receiving such assistance will eventually purchase Chrysler's equity investment from their share of the profits of the dealership. Chrysler's equity investments in United States dealerships totaled $12 million in 74 dealerships at December 31, 1985, $12 million in 85 dealerships at December 31, 1984 and $19 million in 122 dealerships at December 31, 1983.

Item 1. BUSINESS - continued

sler-PSA Agreements

Under a 1978 agreement, Chrysler sold its principal European automotive operations, including Chrysler France, Chrysler United Kingdom and Chrysler Espana, to PSA for 1.8 million shares of PSA stock (representing approximately 12% of the total equity of PSA) plus $230 million in cash. Chrysler has a seat on the Supervisory Board of PSA. Following the sale by Chrysler to PSA, CFC also sold its European operations to PSA for approximately $87 million in cash.

Chrysler's investment in PSA was originally valued on Chrysler's balance sheet at $323.9 million, representing the value of the net assets of the companies sold to PSA, less the cash consideration received net of transaction costs. This investment was written down to $100 million in 1983 to reflect the decline in its value resulting from losses and the reduced value of the French Franc.

Mitsubishi Motors Corporation

Chrysler imports and distributes in the United States and Canada selected models of passenger cars and light trucks manufactured in Japan by MMC, a corporation owned by Mitsubishi Heavy Industries (61%), certain other members of the Mitsubishi Group (15%), and Chrysler Corporation (20%) and certain consolidated Chrysler subsidiaires (4%). In 1985, Chrysler sold 203,180 MMC-manufactured vehicles (of which 128,042 were cars), representing 9.4% of Chrysler's total vehicle sales.

Voluntary restraints administered by the Japanese Government on exports of new enger cars (station wagons and special purpose vehicles, as well as passenger car rts to Puerto Rico, are also restrained under separate administration) by Japanese manufacturers to the United States have been in effect since April 1, 1981. For the 12 month period April 1, 1985 through March 31, 1986, MMC's passenger car shipments to the U.S. are limited to approximately 195,000 units. During February 1986, the government of Japan announced a continuation of these restraints through March 31, 1987, at the same level.

Under the terms of the United States Distribution Agreement currently in effect between Chrysler and MMC, Mitsubishi Motors Sales of America (MMSA) shares co-exclusive rights to distribute MMC passenger cars and light trucks with Chrysler. During the period of voluntary restraints currently in effect, MMC and Chrysler have agreed to allocate to Chrysler 71.4% of the passenger cars which MMC may export in 1985/6 and 1986/7.

The United States Distribution Agreement, which continues in effect until at least 1995 and year-by-year therafter unless terminated by one of the parties, gives Chrysler and MMSA the co-exclusive right to distribute any or all MMC passenger car and light truck models which are available for sale in the United States. In practice, Chrysler and MMSA share the distribution of certain models and have exclusive rights to distribute other models.

In the 1986 model year Chrysler has the exclusive right to distribute the Colt four door models and the Colt Vista. The Colt three door, Conquest, Ram 50 and Power Ram 50 models are marketed under separate name plates by both Chrysler and MMSA.

Mitsubishi Motors Corporation - continued

Similar agreements are in effect covering the Canadian market. However, in practice Chrysler Canada acts as sole distributor of MMC products and is allocated all MMC vehicles allowed to be imported under restraints in effect. The Canadian Government currently limits imports from Japan to approximately 18% of the passenger car market. Restraints on truck imports into Canada from Japan expired during 1985. Under agreements in effect for the Japanese 1985 fiscal year, MMC's total passenger car shipments to Canada are limited to approximately 9,000. Chrysler does not know whether the Canadian Government or the Japanese Government will continue restraints after March 31, 1986.

In addition to vehicles, Chrysler purchases from MMC 2.6-liter, four-cylinder engines for use in the production of the Dodge Caravan and Plymouth Voyager. Chrysler intends to buy approximately 216,500 such engines during the 1986 model year and 94,000 in the 1987 model year.

In 1984, Chrysler and MMC entered into an agreement under which Chrysler plans to purchase, over five years, up to 2,250,000 of 3.0 liter, V-6 engines manufactured by MMC in Japan. These engines will be used in United States and Canadian built Chrysler vehicles beginning in the 1987 model year.

During 1985, Chrysler and MMC entered into an agreement creating Diamond-Star Motors Corporation as a 50/50 joint venture to produce small cars in the United States. Construction of an assembly and stamping plant, to be located at Bloomington-Normal, Illinois, will begin in 1986 and is scheduled to commence production in the latter half of 1988.

Chrysler Financial Corporation

Chrysler's wholly-owned unconsolidated subsidiary, Chrysler Financial Corporation (CFC), provides financing for Chrysler's dealers and for retail sales of Chrysler products in the United States, Canada and Mexico. Its financing operations consist primarily of providing inventory or wholesale financing for automobile dealers in new Chrysler cars and trucks, and limited amounts of inventory financing of used vehicles of any make for certain of such dealers, as well as retail financing for new Chrysler cars and trucks and used vehicles of any make sold or leased by such dealers. In addition, secured capital loans are made to dealers in order to provide working capital and to permit them to expand their businesses.

CFC provided wholesale financing for 62.8% of Chrysler's total automotive sales in the United States in 1985. Wholesale financing accounted for 62.3% of the total automotive financing volume of CFC in 1985 and represented 24.4% of outstanding automotive receivables at December 31, 1985.

In 1985, CFC provided financing for approximately 33.7% of the new Chrysler cars and trucks sold at retail in the United States. Alternative sources of financing available to retail customers of Chrysler products are, primarily, banks and credit unions.

Under an Income Maintenance Agreement between CFC and Chrysler, Chrysler is required to make payments to CFC to maintain earnings available for fixed charges at 125% of fixed charges on an annual basis, in order to maintain the required coverage under CFC's private debt covenants. No payments were required from Chrysler pursuant to the agreement in 1985, 1984 and 1983. The agreement extends until December 31, 2000.

Chrysler Financial Corporation - continued

Effective July 31, 1985 CFC purchased the common stock of E. F. Hutton Credit Corporation (renamed Chrysler Capital Corporation) from the E. F. Hutton Group Inc. for $125.0 million in cash. Chrysler Capital Corporation is engaged principally in the business of financing capital equipment by arranging leases, secured loans and conditional sales contracts.

Effective November 22, 1985 CFC purchased the common stock of FinanceAmerica Corporation and BA Financial Services Corporation (subsequently merged and renamed Chrysler First Inc.) from BankAmerica Corporation for $405.2 million, subject to certain post-closing adjustments. Chrysler First Inc. is a diversified finance company engaged in the business of consumer direct lending, and private brand wholesale and retail financing services.

Effective October 1, 1985 Chrysler contributed to CFC the capital stock of its wholly-owned subsidiary, Chrysler Realty Corporation. Chrysler Realty Corporation, owns more than 244 dealerships properties in the United States and has multi-year leases on another 226 such properties. Dealers on these properties accounted during 1985 for some 29% of Chrysler's total car and trucks sales in the United States.

On April 1, 1985 CFC entered into a $3.2 billion revolving credit agreement extendable one year at a time before maturity and a three year $1.1 billion receivable facility, increasing its credit facilities to $7.3 billion of which $6.9 billion was unused at year end 1985. Under the new borrowing facilities none of CFC's indebtedness is secured and Chrysler, with the consent of CFC's lenders, terminated the lenders' option to purchase 51% of the capital stock of CFC.

Chrysler made cash contributions to capital of $100 million on January 2, 1985 and $405.2 million on November 22, 1985. The November 22, 1985 contribution was used by CFC to acquire Chrysler First Inc.

The retained earnings of Chrysler include net accumulated earnings of CFC of $297.2 million at December 31, 1985 which cannot be paid to Chrysler in dividends due to CFC's loan covenants.

Government Regulation

Fuel economy, safety and emissions regulations and standards applicable to motor vehicles have been issued from time to time under a number of federal statutes, including the National Traffic and Motor Vehicle Safety Act of 1966, the Clean Air Act, Titles I and V of the Motor Vehicle Information and Cost Savings Act and the Noise Control Act of 1972. In addition, the State of California has promulgated exhaust emission standards, some of which are more stringent than the federal standards. Under the Clean Air Act, certain other states may also adopt vehicle emission standards identical to those adopted by California, although no other state has yet done so.

The Motor Vehicle Information and Cost Savings Act, as amended by the Energy Policy and Conservation Act, requires vehicle manufacturers to produce vehicles that comply with federally mandated fuel economy standards. The Secretary of Transportation has set standards for passenger cars and certain vans and light-duty trucks. Under the Act, a manufacturer earns credits for exceeding the applicable fuel economy standards,

Government Regulation - continued

however, fuel economy credits earned on cars may not be used for trucks. Failure to meet the average fleet fuel economy standards can result in the imposition of penalties unless a manufacturer has sufficient fuel economy credits from the preceding three years or projects that it will generate sufficient credits over the succeeding three years. In addition, the Energy Tax Act of 1978 imposes a graduated "gas guzzler" tax on automobiles with a fuel economy rating below specified levels. Chrysler will pay a $500 per vehicle tax for each of its M-Body rear-wheel-drive vehicles that are sold in model year 1986 and beyond, pursuant to this law.

Chrysler currently meets emissions standards applicable to its products, and projects substantial compliance with all fuel economy standards now promulgated, with the exception of the combined truck fuel economy standard. Chrysler did not achieve compliance with the 1984 truck standard. However, a plan has been submitted to the National Highway Traffic Safety Administration that projects sufficient carry-back credits in subsequent years to avoid the payment of any penalties.

In 1984, the Secretary of Transportation promulgated a standard requiring that 10% of Chrysler's 1987 model passenger cars sold in the United States be equipped with automatic seat belts or other passive restraints such as air bags for front seat occupants. The requirement increases to 25% for the 1988 model year, 40% for the 1989 model year and 100% for each model year thereafter. Chrysler's plans for compliance with these standards will have no material effect on its expenditures, earnings or competitive position in the industry.

Expenditures presently planned by Chrysler to comply with federal, state and local provisions regulating the discharge of materials or otherwise relating to environment protection, other than those discussed above relating to its products, and to comply with provisions relating to occupational health and safety, will not have a material effect on Chrysler's capital expenditures, earnings or competitive position in the industry. Chrysler is unable to predict what expenditures may be required in the future as a result of future standards relating to occupational health and safety or present standards now being contested before the government agency involved or in the courts.

The practice of recalling vehicles for various reasons has been a part of the automotive industry for many years, but with the passage of the National Traffic and Motor Vehicle Safety Act of 1966 and its reporting requirements, recalls have received substantially more publicity. Recalls vary as to cause, some involving problems that are relatively serious in nature, while others are much less significant. In addition, since it is often unknown which vehicle may contain a defect, large numbers of vehicles must be recalled to find, in many cases, a very low percentage of vehicles with defects. While Chrysler has not had significant recalls in recent years, it cannot assure that there will not be recalls in the future.

Research and Development

For the years ended December 31, 1985, 1984 and 1983, Chrysler and its consolidated subsidiaries spent $609 million, $452 million and $365 million, respectively, for company-sponsored research and development activities. These activities related to the development of new products and services and the improvement of existing products and services, as well as to enable Chrysler's products to comply with standards that have been and are being promulgated by the government.

Manufactured and Purchased Components and Materials

Chrysler manufactures substantially all of its requirements for six-cylinder, eight-cylinder and 2.2-liter and derivative, four-cylinder gasoline engines for cars and trucks, gray iron casting for cylinder blocks for such engines, stampings for passenger car bodies, transmissions for cars and trucks, axles, automatic and manual transaxles, alternators, voltage regulators, distributors, instrument clusters, radios, automotive air conditioners, vinyl trim and seat cushion and back covers, and processes about two-thirds of its requirements for fabricated glass parts.

Chrysler uses over 16,000 unaffiliated suppliers for services, supplies, equipment, materials, parts and components, and purchases from one or more of such firms substantially all of its requirements for 1.6 liter and 2.6 liter four-cylinder gasoline engines, constant velocity joints, batteries, bearings, bumpers, carburetors, carpets, cloth for trim and seat covers, cylinder heads for four-, six- and eight-cylinder gasoline engines, decorative die castings, malleable iron, nuts, bolts and other fasteners, radiators, raw glass, seat belts, steel, tires, wheels and certain other items. Chrysler purchases a larger proportion of its materials, parts and other components from unaffiliated suppliers than do its principal domestic competitors. Chrysler expects to continue purchasing its requirements of these items.

Employees

As of December 31, 1985, Chrysler and its consolidated subsidiaries had a total of approximately 114,200 employees worldwide, including 89,500 in the United States. For the years ended December 31, 1985, 1984 and 1983, the average monthly number of employees of Chrysler and consolidated subsidiaries in the United States was 84,804, [illegible]233, and 65,832, and the wages and salaries paid to them totaled $3.5 billion, $3.0 billion and $2.2 billion, respectively. These amounts do not include substantial additional expenditures made by Chrysler and consolidated subsidiaries under plans and programs operated for the benefit of their employees.

Substantially all of Chrysler's hourly employees and about 26% of its salaried employees in the United States and Canada are included in collective bargaining units represented by unions. Of these represented employees, 97% of hourly and 89% of salaried employees are represented by the UAW.

In October 1985, after a 5-day national strike, Chrysler's Canadian UAW represented employees ratified a new collective bargaining agreement. This agreement became effective on October 20, 1985 and extends through September 14, 1987. This agreement puts Chrysler's wage and benefit levels on a comparable basis with its major Canadian domestic competitors.

In October 1985, after a 12-day national strike, Chrysler's United States UAW represented employees ratified a new collective bargaining agreement. This agreement became effective on October 28, 1985 and extends through September 14, 1988, one year beyond the expiration date of collective bargaining agreements at its major domestic competitors. This agreement puts Chrysler's labor cost on a comparable basis with its major United States domestic competitors.

Employees - continued

In November 1985, after a 22-day strike, Chrysler's St. Louis Plant II UAW represented employees ratified a new local plant collective bargaining agreement. Currently, one assembly plant and three single source component plants in the United States are operating without new UAW local agreements. It is Chrysler's objective to negotiate these local agreements without an interruption in production, but Chrysler cannot predict the outcome of these negotiations.

Patents, Trademarks and Licenses Thereunder

Chrysler has numerous patents, trademarks and licenses under patents of others relating to its products and their manufacture. Chrysler grants licenses to others under Chrysler patents and trademarks and receives fees and royalties under some of these licenses. While Chrysler does not consider any particular patent or group of patents to be absolutely essential to its business as a whole, it does consider its patents, its trademarks and its license rights thereunder important to the overall conduct of its business.

Gulfstream Aerospace Corporation

On August 16, 1985 Chrysler acquired 100% of the outstanding shares of Gulfstream Aerospace Corporation (Gulfstream) for $641.8 million. Gulfstream is engaged in the design, development, production and sale of general aviation aircraft. The majority of Gulfstream's aircraft are sold to national and multinational corporations, governments and individuals. Gulfstream markets its product line and related services directly through five sales offices located in the United States, including its headquarters in Savannah, Georgia and one distributor in Saudi Arabia.

The estimated number of aircraft to be produced from the date of acquisition under the combined Gulfstream III/IV program is 308. At December 31, 1985, 13 aircraft had been delivered under the program and the backlog included 3 Gulfstream III and 84 Gulfstream IV orders.

Many materials and items of equipment, including the engines, used in the production of Gulfstream's aircraft are purchased from other manufacturers. In addition, Gulfstream subcontracts to other companies the production of components of its aircraft such as wings and landing gear.

Item 2. PROPERTIES

The principal properties relating to the automotive operations of Chrysler and its consolidated subsidiaries in the United States and those operating outside the United States at December 31, 1985 are summarized in the following table:

	Square Feet of Floor Space					
	United States			Outside the United States		
	Owned	Leased	Total	Owned	Leased	Total
	(In thousands)					
Manufacturing plants	24,443.9	307.3	24,751.2	2,317.9	-	2,317.9
Assembly plants	18,640.8	-	18,640.8	5,637.6	-	5,637.6
Parts depots	2,619.6	4,198.4	6,818.0	282.2	1,307.0	1,589.2
Engineering and research facilities	2,962.1	110.0	3,072.1	74.9	-	74.9
Warehouses, general offices and miscellaneous space	2,988.9	821.5	3,810.4	453.6	118.2	571.8
	51,655.3	5,437.2	57,092.5	8,766.2	1,425.2	10,191.4

Approximately 50% of all Chrysler's manufacturing and assembly space in the United States shown in the table is located in the Detroit area. The automotive manufacturing plants include foundries, forging plants, machining plants, metal stamping plants, engine plants, transmission plants, trim plants, parts and equipment plants, an air conditioning equipment plant, an axle plant and a glass fabricating plant. Other manufacturing plants include plastic plants, powdered metal plants and chemical products plants. All the United States manufacturing plants are situated in Michigan, Ohio, and Indiana, except for a transmission plant located in New York and an electronics plant located in Alabama.

Chrysler's United States car assembly plants are located in Detroit, Michigan; Sterling Heights, Michigan; Belvidere, Illinois; Newark, Delaware; and two are located in Fenton, Missouri. The United States truck assembly plant is located in Warren, Michigan. Extensive expansion programs were started in 1985 at both the Warren Truck Plant and the Sterling Heights Plant to accommodate production of new models. The parts depots, warehouses and sales offices are situated in various sections of the United States, while Chrysler's principal engineering and research facilities and its general offices are located in Michigan. Included in automotive properties outside the United States are those of Chrysler Canada, with an aggregate of 6.4 million square feet, and Chrysler de Mexico, with an aggregate of 3.8 million square feet.

Gulfstream Aerospace Corporation operates production facilities located in Savannah, Georgia and Bethany, Oklahoma. The Savannah facility contains approximately 1.1 million square feet and the Bethany facility contains approximately .5 million square feet.

The statements concerning ownership of such properties are made without regard to taxes or assessment liens, rights of way, contracts, easements or like encumbrances or questions of survey and are based on the records of Chrysler and its consolidated subsidiaries. Chrysler knows of no material defects in title to, or adverse claim against, any of such properties, nor any existing material lien or encumbrance against Chrysler or its properties, except the lien of the mortgages securing the loans from the states of Indiana and Michigan, the mortgage loan on the Sterling Heights Assembly plant and the mortgage on real property of the Mexican Truck Plant securing debentures.

Item 3. LEGAL PROCEEDINGS

In July, 1981, the Equal Employment Opportunity Commission (the "EEOC") filed an action in the United States District Court for the Eastern District of Michigan, alleging, inter alia, that since at least 1978 Chrysler has violated the Age Discrimination in Employment Act of 1967 (the "ADEA"), through a practice of terminating, because of their age, certain Michigan non-bargaining unit salaried employees between the ages of 55 and 70 pursuant to a policy of special early retirement at corporate option. The EEOC seeks various forms of relief, including reinstatement of the retired employees, back pay and liquidated damages and an injunction against continuation of the alleged illegal practices. The EEOC thereafter filed a motion for preliminary injunctive relief. Chrysler filed a motion for summary judgment asking the District Court to rule that Chrysler's special early retirement policy did not violate the ADEA and a motion for a determination that the EEOC may seek back pay only on behalf of the two individuals named in its complaint. In September, 1982, the Court denied Chrysler's motions but granted the EEOC's request for injunctive relief and mandated the immediate reinstatement of approximately 40 corporate option retirees and 3 other retirees who rebutted the presumed voluntariness of their retirements. Chrysler immediately appealed the order granting preliminary injunctive relief and in February, 1983, filed for permission to appeal the order denying summary judgment and to consolidate both appeals. In March, 1983, the Court of Appeals denied Chrysler permission to appeal the order denying summary judgment. On October 31, 1983, the Court of Appeals heard oral arguments on Chrysler's appeal of the District Court's preliminary injunctive order. In the interim, the District Court denied an EEOC motion for summary judgment on June 9, 1983, which had asked the Court to grant the group of corporate option retirees reinstatement, back pay, lost benefits and liquidated damages. Chrysler filed another motion for summary judgment on October 19, 1983, contending that the EEOC did not have valid authority to enforce the ADEA. The District Court denied the motion on January 23, 1984 and Chrysler appealed the ruling to the Court of Appeals. On December 4, 1984, the Court of Appeals denied Chrysler leave to appeal. The suit is presently in discovery.

In addition, Chrysler and its subsidiaries are parties to various legal proceedings, including some purporting to be class actions, and some which assert claims for damages in large amounts. Chrysler believes each of such proceedings constitutes ordinary routine litigation incidental to the business and activities conducted by Chrysler and its subsidiaries, or will not result in ultimate liability that is material in amount.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None during the fourth quarter ended December 31, 1985.

EXECUTIVE OFFICERS OF THE REGISTRANT

The names of the executive officers of Chrysler, their ages as of March 29, 1986, the date from which they have served as officers and their present positions are as follows:

Name	Age	Officer Since	Present Position
Lee A. Iacocca	61	November 2, 1978	Chairman of the Board and Chief Executive Officer*
Gerald Greenwald	50	May 15, 1979	Chairman-Chrysler Motors*
H. K. Sperlich	56	March 24, 1977	President-Chrysler Motors*
B. E. Bidwell	58	June 2, 1983	Vice Chairman of the Board*
R. S. Miller, Jr.	44	November 6, 1980	Vice Chairman of the Board*
R. E. Dauch	43	April 17, 1980	Executive Vice President-Manufacturing, Chrysler Motors
S. Sharf	65	December 13, 1978	Executive Vice President-International Business Development*
C. J. Steffen	44	April 9, 1981	Executive Vice President-Finance, Chrysler Motors
J. D. Withrow	53	September 20, 1979	Executive Vice President-Product Development, Chrysler Motors
B. K. Bates	51	December 12, 1979	Vice President-Public Relations, Chrysler Motors
G. F. Butts	62	September 13, 1973	Vice President-Quality and Productivity, Chrysler Motors
J. A. Campana	49	October 7, 1982	Vice President-Marketing, Chrysler Motors
M. J. Closs	58	May 7, 1981	Vice President-Chrysler Motors & President, Chrysler Canada Ltd.
G. Denomme	46	April 9, 1981	Vice President-Corporate Planning and Marketing Strategies
T. C. Gale	42	April 4, 1985	Vice President-Product Design, Chrysler Motors
G. J. Giocondi	54	June 13, 1985	Vice President-Service and Parts Operations, Chrysler Motors
R. Goodyear	44	October 8, 1981	Vice President, General Counsel and Secretary
L. D. Gschwind	52	November 6, 1980	Vice President-Program Management, Chrysler Motors
J. L. Mathis	45	February 5, 1981	Vice President-Chrysler Motors & Managing Director, Chrysler de Mexico S.A.
T. W. Miner	58	February 5, 1981	Vice President-Chrysler Motors
E. T. Pappert	46	November 5, 1981	Group Vice President-Sales, Chrysler Motors
R. A. Perkins	51	June 4, 1981	Vice President-Washington Affairs
D. R. Platt	58	May 13, 1980	Vice President-Procurement and Supply, Chrysler Motors
E. A. Reickert	50	October 4, 1984	Vice President-Advance Product Planning, Chrysler Motors

*Also a member of the Board of Directors.

Name	Age	Officer Since	Present Position
L. H. Runk	46	February 5, 1981	Vice President-Component Business Operations, Chrysler Motors
[illegible]. P. St. John	49	February 6, 1986	Vice President-Industrial Relations, Chrysler Motors
R. M. Sinclair	58	December 8, 1983	Vice President-Engineering, Chrysler Motors
R. L. Stewart	43	July 7, 1983	Vice President-Body and Assembly Operations, Chrysler Motors
J. L. Tolley	56	September 2, 1982	Vice President-Public Affairs
G. E. White	59	January 11, 1968	Vice President-Personnel and Organization
J. B. York	47	March 7, 1985	Vice President-Advance Manufacturing Operations, Chrysler Motors
F. W. Zuckerman	51	December 3, 1981	Vice President and Treasurer

There are no family relationships, as defined for reporting purposes, between any of the executive officers named above and there is no arrangement or understanding between any of the executive officers named above and any other person pursuant to which he was selected as an officer. All of the executive officers named above except Mr. Giocondi and Mr. St. John were elected by the Board of Directors on May 17, 1985 to serve until the first meeting of the Board following the next annual meeting of stockholders. All of the executive officers named above, except Messrs. Bidwell, Goodyear, Reickert, St. John and Tolley have been in the employ of Chrysler or its subsidiaries for more than five years. During the last five years, and preceding employment by Chrysler: Mr. Bidwell was President and Chief Operating Officer of the Hertz Corporation from February, 1981 to June, 1983 and Vice President - Car and Truck Group - North American Automotive Operations of Ford Motor Company from November, 1977 to February, 1981; Mr. Goodyear was President of Occidental Resource Recovery Systems, Inc. from May, 1979 to July, 1981; Mr. Reickert was employed by Ford Motor Company in various executive positions in product planning from 1965 to January, 1984; Mr. St. John was employed by Bethlehem Steel Corporation in various executive positions in legal and industrial matters from 1965 to June, 1985; and Mr. Tolley was Vice President - Public Affairs of American Motors Corporation from 1978 to July, 1982.

PART II

Items 5 through 8.

As indicated in the Index to this Form 10-K, Items 5 through 8 of Part II are incorporated by reference from the Chrysler Corporation Annual Report to Shareholders for the year ended December 31, 1985, a complete copy of which is provided herein. Information relating to Item 5 - Market for Registrant's Common Equity and Related Stockholder Matters appears on pages 48, 49 and 51 of the 1985 Annual Report to Shareholders, Item 6 - Selected Financial Data on page 48, Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations on pages 26 and 27, and Item 8 - Financial Statements and Supplementary Data on pages 28 through 47, all which information is hereby incorporated by reference in and made a part of this Form 10-K. The information on all pages referred to above that does not relate to an Item in Form 10-K and on all other pages of Chrysler Corporation's 1985 Annual Report to Shareholders is not deemed to be incorporated by reference in this Form 10-K.

Item 9. Disagreements on Accounting and Financial Disclosure

None

PART III

Items 10, 11, 12 and 13.

Information required by Part III (Items 10, 11, 12 and 13) of this Form 10-K is incorporated by reference from Chrysler Corporation's definitive combined Proxy Statement and Prospectus for its 1986 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission, pursuant to Regulation 14A, not later than 120 days after the end of the fiscal year, all of which information is hereby incorporated by reference in and made a part of this Form 10-K.

PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) The following documents are filed as a part of this report:

1. Financial Statements

The financial statements of Chrysler Corporation and consolidated subsidiaries are incorporated by reference from Chrysler Corporation's Annual Report to Shareholders for the year ended December 31, 1985, a complete copy of which follows page F-1 in this Form 10-K.

2. Financial Statement Schedules

Financial Statements and Schedules Omitted:

Schedules other than those listed above are omitted because they are not required under instructions contained in Regulation S-X or because the information called for is shown in the financial statements and notes thereto.

Individual or group financial statements of unconsolidated subsidiaries, excluding Chrysler Financial Corporation and subsidiaries, are not included because, considered in the aggregate as a single subsidiary, they would not constitute a significant subsidiary.

Chrysler Financial Corporation and Subsidiaries

The financial statements and related footnotes and schedules for the years ended December 31, 1985, 1984 and 1983 contained in the Annual Report on Form 10-K filed by Chrysler Financial Corporation are hereby incorporated by reference in and made part of this Annual Report.

Chrysler Overseas Capital Corporation

Chrysler Overseas Capital Corporation (a wholly-owned consolidated subsidiary) has filed an Annual Report on Form 10-K for the year ended December 31, 1985.

3. Exhibits:

3-A	Copy of Composite Certificate of Incorporation of Chrysler Corporation dated June 5, 1925 as amended to July 17, 1981 and presently in effect. Filed as Exhibit 3-A to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1981 and incorporated herein by reference.
*3-B	Copy of By-Laws of Chrysler Corporation as amended November 7, 1985 and presently in effect.
4-A	Certificate of Incorporation, and By-Laws of Chrysler Corporation. See Exhibits 3-A to 3-B above.
*4-B	Conformed copy of Indenture dated as of March 1, 1985 between Chrysler Corporation and Manufacturers Hanover Trust Company, as Trustee, relating to Debt Securities, Appendix A thereto relating to 12 3/4% Notes Due 1992, and Appendix B thereto relating to 13% Debentures Due 1997, and Appendix C thereto relating to 12% Debentures Due 2015.

*Filed herewith.

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

*4-C Conformed copy of $2,350,000,000 Revolving Credit Agreement, dated as of November 30, 1985, among Chrysler Corporation, the several Banks parties to the Agreement and Manufacturers Hanover Trust Company, as agent for such Banks.

4-D Copy of Indenture, dated as of June 1, 1985, between Chrysler Financial Corporation and Manufacturers Hanover Trust Company, Trustee, related to Chrysler Financial Corporation Senior Debt Securities. Filed as Exhibit 4-A to the Quarterly Report of Chrysler Financial Corporation on Form 10-Q for the quarter ended June 30, 1985, and incorporated herein by reference.

4-E Copy of Indenture, dated as of June 1, 1985, between Chrysler Financial Corporation and Irving Trust Company, Trustee, related to Chrysler Financial Corporation Junior Subordinated Debt Securities. Filed as Exhibit 4-B to the Quarterly Report of Chrysler Financial Corporation on Form 10-Q for the quarter ended June 30, 1985, and incorporated herein by reference.

4-F Copy of Indenture, dated as of July 15, 1985 between Chrysler Financial Corporation and Bankers Trust Company, Trustee, related to Chrysler Financial Corporation Subordinated Debt Securities. Filed as Exhibit 4-C to the Quarterly Report of Chrysler Financial Corporation on Form 10-Q for the quarter ended June 30, 1985, and incorporated herein by reference.

4-G-1 Copy of the Revolving Credit Agreement, dated as of April 1, 1985, among Chrysler Financial Corporation, as the Borrower, the several financial institutions parties thereto (the "Banks"), Manufacturers Hanover Trust Company, as agent for the Banks, and Swiss Bank Corporation, New York Branch, as co-agent for the Banks. Filed

*Filed herewith.

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

3. Exhibits - continued:

as Exhibit 4-A to the Quarterly Report of Chrysler Financial Corporation on Form 10-Q for the quarter ended March 31, 1985, and incorporated herein by reference.

4-G-2 Copy of Amendment, dated as of September 15, 1985, among Chrysler Financial Corporation, Manufacturers Hanover Trust Company and Swiss Bank Corporation to the Revolving Credit Agreement among such parties, dated as of April 1, 1985. Filed as Exhibit 10-I to the Annual Report of Chrysler Financial Corporation on Form 10-K for the year ended December 31, 1985 and incorporated herein by reference.

4-G-3 Copy of Amendment, dated as of January 1, 1986, among Chrysler Financial Corporation, Manufacturers Hanover Trust Company and Swiss Bank Corporation to the Revolving Credit Agreement among such parties, dated as of April 1, 1985. Filed as Exhibit 10-J to the Annual Report of Chrysler Financial Corporation on Form 10-K for the year ended December 31, 1985 and incorporated herein by reference.

10-A-1 Copy of Chrysler Corporation Nonqualified Stock Option Plan as in effect on and after February 24, 1977 and before May 3, 1977. Filed as Exhibit 5-G to Registration No. 2-61671 of Chrysler Corporation and incorporated herein by reference.

10-A-2 Copy of Chrysler Corporation Nonqualified Stock Option Plan as amended and in effect on and after May 3, 1977 and before December 3, 1981. Set forth in the Prospectus for Amendment No. 1 to Fourth Post-Effective Amendment to Registration No. 2-48020 of Chrysler Corporation and incorporated herein by reference.

10-A-3 Copy of Chrysler Corporation Stock Option Plan (previously called the Chrysler Corporation Nonqualified Stock Option Plan) as amended and in effect on and after December 3, 1981 and before June 3, 1982. Filed as Exhibit 10-D-4 of Chrysler

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

3. Exhibits - continued:

Corporation Annual Report on Form 10-K for the year ended December 31, 1981 and incorporated herein by reference.

10-A-4 Copy of Chrysler Corporation Stock Option Plan as amended and in effect on and after June 3, 1982 and before July 1, 1982. Filed as Exhibit A to Proxy Statement of Chrysler Corporation dated April 8, 1982, for the Annual Meeting of Stockholders held June 3, 1982, File No. 1-686, and incorporated herein by reference.

10-A-5 Copy of Chrysler Corporation Stock Option Plan as amended and in effect on and after July 1, 1982 and before July 7, 1983. Filed as Exhibit 10-D-6 to Registration No. 2-82086 of Chrysler Corporation and incorporated herein by reference.

10-A-6 Copy of Chrysler Corporation Stock Option Plan as amended and in effect on and after July 7, 1983 and before December 8, 1983. Filed as Exhibit 10-D-7 to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1983 and incorporated herein by reference.

10-A-7 Copy of Chrysler Corporation Stock Option Plan as amended and in effect on and after December 8, 1983. Filed as Exhibit 10-D-8 to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1983 and incorporated herein by reference.

10-A-8 Form of Letter Agreement amending option agreements for options granted before February 24, 1977 under the Chrysler Corporation Nonqualified Stock Option Plan. Filed as Exhibit 2(b) to Fourth Post-Effective Amendment to Registration No. 2-48020 of Chrysler Corporation and incorporated herein by reference.

10-A-9 Form of Option Agreement for options granted on and after February 24, 1977 and before December 3, 1981 under the Chrysler Corporation Nonqualified Stock Option Plan. Filed as Exhibit 2(a) to Fourth Post-Effective Amendment to Registration

3. Exhibits - continued:

No. 2-48020 of Chrysler Corporation and incorporated herein by reference.

10-A-10 Form of Option Agreement for Incentive Stock Options granted on and after December 3, 1981 and before July 1, 1982 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-9 to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1981 and incorporated herein by reference.

10-A-11 Form of Option Agreement for Nonqualified Stock Options granted on and after December 3, 1981 and before July 1, 1982 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-10 to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1981 and incorporated herein by reference.

10-A-12 Form of Option Agreement for Incentive Stock Options granted on and after July 1, 1982 and before July 7, 1983 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-13 to Registration No. 2-82086 of Chrysler Corporation and incorporated herein by reference.

10-A-13 Form of Option Agreement for Nonqualified Stock Options granted on and after July 1, 1982 and before July 7, 1983 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-14 to Registration No. 2-82086 of Chrysler Corporation and incorporated herein by reference.

10-A-14 Form of Letter Amendment, dated December 13, 1982, to form of Option Agreement for Incentive Stock Options granted before July 1, 1982 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-15 to Registration No. 2-82086 of Chrysler Corporation and incorporated herein by reference.

10-A-15 Form of Letter Amendment, dated December 13, 1982, to form of Option Agreement for Nonqualified Stock Options

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

3. Exhibits - continued:

	granted before July 1, 1982 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-16 to Registration No. 2-82086 of Chrysler Corporation and incorporated herein by reference.
10-A-16	Form of Option Agreement for Nonqualified Stock Options granted on and after July 7, 1983 under the Chrysler Corporation Stock Option Plan. Filed as Exhibit 10-D-18 to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1983 and incorporated herein by reference.
10-A-17	Form of Amendment dated July 7, 1983, to form of Option Agreement for Nonqualified Stock Options granted before July 7, 1983. Filed as Exhibit 10-D-19 to Chrysler Corporation Annual Report on Form 10-K for the year ended December 31, 1983 and incorporated herein by reference.
*10-B	Copy of Chrysler Corporation Incentive Compensation Plan as amended through June 13, 1985 and currently in effect.
10-C-1	Copy of letters dated October 26, 1978 and November 1, 1978 between Chrysler Corporation and Lee A. Iacocca. Filed as Exhibit B to the Current Report of Chrysler Corporation on Form 8-K dated March 1, 1979 and incorporated herein by reference.
10-C-2	Copy of agreements dated December 8, 1983 between Chrysler Corporation and Lee A. Iacocca. Filed as Exhibit 20-10-F-2 to the Current Report of Chrysler Corporation on Form 8-K dated February 2, 1984 and incorporated herein by reference.
*10-D	Copy of Employment Agreement between Gulfstream Aerospace Corporation and Allen E. Paulson.
10-E-1	Copy of Income Maintenance Agreement made December 20, 1968, among Chrysler

*Filed herewith.

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

3. Exhibits - continued:

Financial Corporation, Chrysler Corporation and Chrysler Motors Corporation. Filed as Exhibit 13-D to Registration Statement No. 2-32037 of Chrysler Financial Corporation, and incorporated herein by reference.

10-E-2 Copy of Agreement, made April 19, 1971, among Chrysler Financial Corporation, Chrysler Corporation and Chrysler Motors Corporation, amending the Income Maintenance Agreement among such parties. Filed as Exhibit 13-B to Registration Statement No. 2-40110 of Chrysler Financial Corporation and Chrysler Corporation, and incorporated herein by reference.

10-E-3 Copy of Agreement, made May 29, 1973, among Chrysler Financial Corporation, Chrysler Corporation and Chrysler Motors Corporation, further amending the Income Maintenance Agreement among such parties. Filed as Exhibit 5-C to Registration Statement No. 2-49615 of Chrysler Financial Corporation, and incorporated herein by reference.

10-E-4 Copy of Agreement, made as of July 1, 1975 among Chrysler Financial Corporation, Chrysler Corporation and Chrysler Motors Corporation, further amending the Income Maintenance Agreement among such parties. Filed as Exhibit D to the Annual Report of Chrysler Financial Corporation on Form 10-K for the year ended December 31, 1975, and incorporated herein by reference.

10-E-5 Copy of Agreement, made June 4, 1976, between Chrysler Financial Corporation and Chrysler Corporation further amending the Income Maintenance Agreement between such parties. Filed as Exhibit 5-H to Registration Statement No. 2-56398 of

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

3. Exhibits - continued:

Chrysler Financial Corporation, and incorporated herein by reference.

10-F-1 Copy of the Accounts Receivable Participation Agreement, dated as of April 1, 1985, among Manufacturers Hanover Trust Company and the several financial institutions listed on the signature pages thereto, to which is annexed as Annex I thereto a copy of the Wholesale/Retail Receivables Purchase Agreement, dated as of April 1, 1985, among Manufacturers Hanover Trust Company, Chrysler Credit Corporation and Chrysler Financial Corporation. Filed as Exhibit 2-A to the Quarterly Report of Chrysler Financial Corporation on Form 10-Q for the quarter ended March 31, 1985, and incorporated herein by reference.

10-F-2 Copy of First Amendment, dated as of February 18, 1986, among Manufacturers Hanover Trust Company, Chrysler Credit Corporation and Chrysler Financial Corporation to the Wholesale/Retail Purchase Agreement, dated as of April 1, 1985, among such parties. Filed as Exhibit 10-L to the Annual Report of Chrysler Financial Corporation on Form 10-K for the year ended December 31, 1985 and incorporated herein by reference.

*11 State re computation of per share earnings.

*13 Annual Report to Shareholders for the year ended December 31, 1985.

*22 Subsidiaries of the Registrant.

*24 Consent of Touche Ross & Co.

*25 Powers of Attorney executed by officers and directors who signed this Annual Report on Form 10-K by an attorney-in-fact.

*Filed herewith.

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K - CONTINUED

3. Exhibits - continued:

In lieu of filing certain instruments with respect to the long-term debt of the type described in Item 601 (b)(4) of Regulation S-K with respect to the long-term debt of Chrysler Corporation and its consolidated subsidiaries, Chrysler Corporation agrees to furnish a copy of such instruments to the Securities and Exchange Commission on request.

(b) Reports on Form 8-K:

There were no reports on Form 8-K filed during the three months ended December 31, 1985.

C348600 112813

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13
OF THE SECURITIES EXCHANGE ACT OF 1934

PROCESSED BY MAY 21 1986 DISCLOSURE INCORPORATED

For Quarter Ended March 31, 1986.
Commission File Number 1-696.

CHRYSLER CORPORATION
(Exact name of registrant as specified in its charter.)

STATE OF DELAWARE	38-0419960
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

12000 Chrysler Drive, Highland Park, Michigan	48203*
(Address of principal executive offices)	(Zip Code)

(313) 956-5252
(Registrant's telephone number, including area code)

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

The registrant had 147,962,962 shares of common stock outstanding as of April 30, 1986.

*Post Office Box 1919 Detroit, MI 48288.

CHRYSLER CORPORATION AND CONSOLIDATED SUBSIDIARIES

INDEX

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

The financial statements and notes thereto in Chrysler Corporation's report to shareholders for the three months ended March 31, 1986, a complete copy of which is filed herewith as Exhibit 20, are hereby incorporated by reference in and made a part of this Quarterly Report.

The unaudited consolidated financial statements of Chrysler and its consolidated subsidiaries for the three months ended March 31, 1986 reflect all adjustments which are, in the opinion of management, necessary to a fair statement of the results for the interim period. The operating results for the three months ended March 31, 1986 are not necessarily indicative of results of operations for an entire year.

The financial information for the three months ended March 31, 1986 and 1985 contained in the Quarterly Report (Form 10-Q) filed by Chrysler Financial Corporation is hereby incorporated by reference in and made a part of this Quarterly Report.

SUPPLEMENTAL FINANCIAL INFORMATION

Inventories

Inventories are summarized by major classifications as follows:

	1986	1985	
	Mar. 31	Dec. 31	Mar. 31
	(In millions of dollars)		
Automotive:			
Finished products, including service parts	$ 724.3	$ 690.4	$ 621.9
Raw materials, work in process and finished production parts	809.5	862.8	880.4
Supplies	63.3	64.4	56.7
Total Automotive	$ 1,597.1	$ 1,617.6	$ 1,559.0
Aerospace:			
Gulfstream III/IV program inventories	359.3	301.2	-
Less: Customer progress payments	219.6	158.6	-
	139.7	142.6	-
Used aircraft and service parts	96.5	102.5	-
Total Aerospace	236.2	245.1	-
Total	$ 1,833.3	$ 1,862.7	$ 1,559.0

ITEM 1. FINANCIAL STATEMENTS - CONTINUED

Common Stock, Additional Paid-In Capital, and Retained Earnings

	Three Months Ended 3/31/86	Twelve Months Ended 12/31/85	Three Months Ended 3/31/85
	(In millions of dollars)		
Common Stock:			
Balance at beginning of period	$ 153.2	$ 123.9	$ 123.9
Newly issued shares sold under provisions of the Chrysler Salaried Employees' Savings Plan, Employee Stock Ownership Plan and the Stock Option Plan (1986 - None; 1985 - 187,688; and 187,612)	-	.1	.1
Shares purchased from the Employee Stock Ownership Plan and retired (1986 - None; 1985 - 14,390,232 and None)	-	(9.6)	-
Shares purchased under Chrysler's Stock Purchase Program and retired (1986 - None; 1985 - 18,397,982 and None)	-	(12.3)	-
Shares issued - stock split (1986 - None; 1985 - 51,076,215 and None)	-	51.1	-
Shares issued on exercise of warrants (1986-None; 1985-300 and None)	-	-	-
Reduction of shares issued - stock split, for fractional shares paid in cash (1986 - (26,910); 1985 - None and None)	-	-	-
Balanced at end of period	$ 153.2	$ 153.2	$ 124.0
Additional Paid-In Capital:			
Balance at beginning of period	$ 1,943.2	$ 2,325.3	$ 2,325.3
Gain on issuance of Treasury Stock in conversion of Chrysler Overseas Capital Corporation debentures for Chrysler common stock	.4	-	-
Treasury stock cost in excess of stock option price (shares sold 1986 - 31,568; 1985 - None and 25,300)	(.4)	-	(.4)
Excess of market value of newly issued shares over $1.00 per share stated value	-	1.1	1.5
Allocation of excess of purchase price over stated value of common shares purchased from Employee Stock Ownership Plan and retired	-	(92.6)	-
Allocation of excess of purchase price over stated value of common shares purchased under Chrysler's Stock Purchase Program and retired	-	(239.5)	-
Shares issued - stock split	-	(51.1)	-
Balance at end of period	$ 1,943.2	$ 1,943.2	$ 2,326.4

Note: All share data has been adjusted to reflect the February, 1986 three-for-two stock split.

Item 1. FINANCIAL STATEMENTS - CONTINUED

Common Stock, Additional Paid-In Capital, and Retained Earnings

	Three Months Ended 3/31/86	Twelve Months Ended 12/31/85	Three Months Ended 3/31/85
	(In millions of dollars)		
Retained Earnings:			
Balance at beginning of period	$ 2,153.3	$ 921.2	$ 921.2
Net earnings	356.9	1,635.2	507.6
Dividends	(37.6)	(115.5)	(30.1)
Income tax effect of the purchase of Warrants	-	175.9	-
Allocation of excess of purchase price over stated value of common shares purchased from Employee Stock Ownership Plan and retired	-	(325.3)	-
Allocation of excess of purchase price over stated value of common shares purchased under Chrysler's Stock Purchase Program and retired	-	(170.5)	-
Treasury stock cost in excess of stock option price (shares sold 1986 - 47,503; 1985 - 351,488 and None)	(.6)	(4.9)	-
Payment of fractional shares resulting from three-for-two stock split	(1.0)	-	-
Cumulative adjustment for accounting change due to increased investment in Mitsubishi Motors Corporation, including translation adjustment	7.3	37.2	-
Balance at end of period	$ 2,478.3	$ 2,153.3	$ 1,398.7
Treasury Stock - Common Stock:			
Balance at beginning of period	$ (34.4)	$ (64.5)	$ (64.5)
Shares purchased for treasury (1986 - 2,250,555; 1985 - 17,329,773 and 2,782,809)	(83.0)	(415.1)	(55.7)
Shares issued for the exchange of Chrysler Overseas Capital Corporation debentures (1986 - 58,628; 1985 - None and None)	1.4	-	-
Shares retired (1986 - None; 1985 - 18,397,982 and None)	-	422.3	-
Less shares recorded as a non-current asset for use in employee benefit plans (1986 - None; 1985 - 1,200,000 and 450,000)	-	22.9	3.4
Balance at end of period	$ (116.0)	$ (34.4)	$ (121.8)

Note: All share data has been adjusted to reflect the February, 1986 three-for-two stock split.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

First Quarter of 1986 compared with First Quarter 1985

Chrysler's worldwide factory sales for the first quarter of 1986 were up 3.6 percent to 566,771 units, compared to sales of 547,047 units in the first quarter of 1985, despite the loss of full size pick-up truck production in the first quarter of 1986 due to the modernization of its Dodge City Truck Plant.

Chrysler reported earnings before taxes of $604.7 million in the first quarter of 1986, a decrease of $120.4 million over the same period of 1985 when Chrysler reported earnings before taxes of $725.1 million. Net earnings were $356.9 million in the first quarter of 1986 ($2.36 per share of common stock - on a post split basis), compared to $507.6 million ($2.79 per share of common stock - on a post split basis) for the first quarter of 1985.

The decrease in earnings before taxes reflects higher costs for new product development and labor not yet fully offset by productivity and a less favorable product mix, partially offset by increased factory unit sales. The decrease in net earnings reflected these same factors as well as a higher estimated tax rate for 1986.

Selected Comparison of Elements of Revenue and Costs

Net sales were $5.8 billion in the first quarter of 1986, compared to $5.4 billion in the same period of 1985, reflecting higher factory sales volumes and the addition of Gulfstream Aerospace Corporation. The increase in equity in earnings of unconsolidated subsidiaries was mainly attributable to the improvement in operations of Chrysler Financial Corporation (CFC), Chrysler's unconsolidated finance subsidiary. CFC had earnings before taxes on income of $70.0 million in the first quarter of 1986, an improvement of $16.6 million over the same period in 1985. CFC's improved performance during the first quarter of 1986, compared to the same period of 1985, was primarily due to higher volume of receivables acquired and finance receivables outstanding.

Depreciation of plant and equipment increased $1.4 million in the first quarter of 1986 over the same period in 1985, a result of both new and modernized facilities placed in service, offset in part by a reduction in the provision for obsolescence in the first quarter of 1986. Amortization of special tools decreased $6.0 million in the first quarter of 1986, compared with the first quarter of 1985, reflecting the extension of certain product life cycles and the corresponding period of time in which the related tools are used in the productive process.

Item 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS - CONTINUED

RESULTS OF OPERATIONS - CONTINUED

Selected Comparison of Elements of Revenue and Costs - continued

Selling and administrative expenses rose 16.9 percent to $336.4 million in the first quarter of 1986, compared to $287.7 million in the first quarter of 1985, reflecting increased labor costs, the addition of Gulfstream Aerospace Corporation and increased selling activities. Pension expense increased 12.2 percent in the first quarter of 1986 to $63.6 million compared to the same period of 1985, primarily due to benefit increases negotiated as part of the new labor agreements, offset partially by a change in the pension asset investment return assumption. Net interest income was $7.5 million in the first quarter of 1986, compared to net interest income of $25.7 million during the first quarter of 1985. This decrease was mainly attributable to an increase in interest expense related to higher levels of debt in the first quarter of 1986 compared to the first quarter of 1985.

In the first quarter of 1986, taxes on income provides for Federal, State and Foreign income taxes and was reduced by investment tax credits expected to be earned in 1986, resulting in an estimated tax rate of 41 percent.

In the first quarter of 1985, taxes on income provides for estimated income taxes at an effective tax rate of 30 percent, reflecting both the utilization of investment tax credits earned in 1985 and carried forward from prior years.

LIQUIDITY AND CAPITAL RESOURCES

Cash and marketable securities increased $437.2 million during the first quarter of 1986, principally through funds provided by operations, offset partially by capital expenditures of $340.4 million and the acquisition of common stock under Chrysler's stock purchase program of $83.0 million. Reflecting these same factors, Chrysler's working capital improved to a positive level of $692.0 million, an improvement of $107.7 million over its working capital of $584.3 million at December 31, 1985.

Effective January 1, 1986, CFC's private lenders consented to an amendment in the Income Maintenance Agreement between Chrysler and CFC to reduce the minimum required coverage of earnings available for fixed charges from 125 percent to 110 percent of fixed charges.

On May 5, 1986, Chrysler repaid its outstanding debt to the State of Michigan in the amount of $75.7 million, including accrued interest. This amount was included in current liabilities at March 31, 1986.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

In July, 1981, the Equal Employment Opportunity Commission (the "EEOC") filed an action in the United States District Court for the Eastern District of Michigan, alleging, inter alia, that since at least 1978 Chrysler has violated the Age Discrimination in Employment Act of 1967 (the "ADEA"), through a practice of terminating, because of their age, certain Michigan non-bargaining unit salaried employees between the ages of 55 and 70 pursuant to a policy of special early retirement at corporate option. The EEOC seeks various forms of relief, including reinstatement of the retired employees, back pay and liquidated damages and an injunction against continuation of the alleged illegal practices. The EEOC thereafter filed a motion for preliminary injunctive relief. Chrysler filed a motion for summary judgement asking the District Court to rule that Chrysler's special early retirement policy did not violate the ADEA and a motion for a determination that the EEOC may seek back pay only on behalf of the two individuals named in its complaint. In September, 1982, the Court denied Chrysler's motions but granted the EEOC's request for injunctive relief and mandated the immediate reinstatement of approximately 40 corporate option retirees and 3 other retirees who rebutted the presumed voluntariness of their retirements. Chrysler immediately appealed the order granting preliminary injunctive relief and in February, 1983, filed for permission to appeal the order denying summary judgment and to consolidate both appeals. In March, 1983, the Court of Appeals denied Chrysler permission to appeal the order denying summary judgement. On October 31, 1983, the Court of Appeals heard oral arguments on Chrysler's appeal of the District Court's preliminary injunctive order. In the interim, the District Court denied an EEOC motion for summary judgement on June 9, 1983, which had asked the Court to grant the group of corporate option retirees reinstatement, back pay, lost benefits and liquidated damages. Chrysler filed another motion for summary judgement on October 19, 1983, contending that the EEOC did not have valid authority to enforce the ADEA. The District Court denied the motion on January 23, 1984 and Chrysler appealed the ruling to the Court of Appeals. On December 4, 1984, the Court of Appeals denied Chrysler leave to appeal. The suit is presently in discovery.

In addition, Chrysler and its subsidiaries are parties to various legal proceedings, including some purporting to be class actions, and some which assert claims for damages in large amounts. Chrysler believes each of such proceedings constitutes ordinary routine litigation incidental to the business and activities conducted by Chrysler and its subsidiaries, or will not result in ultimate liability that is material in amount.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a). Exhibits.

The exhibits filed with this Report are listed in the Exhibit Index which immediately precedes such exhibits.

(b) Reports on Form 8-K.

There were no reports on Form 8-K filed during the three months ended March 31, 1986.

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.

CHRYSLER CORPORATION
(Registrant)

Date: May 9, 1986

By R. S. Miller

R. S. MILLER, JR.

Vice Chairman of the Board
and
Principal Financial Officer

EXHIBIT INDEX

For Quarterly Report on Form 10-Q For the
Three Months Ended March 31, 1986

Exhibit

11 Statement regarding computation of per share earnings.

20 Chrysler Corporation report to shareholders for the first quarter of 1986

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

2/6/...

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1985 Commission file number 1-8198

HOUSEHOLD INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

Delaware	36-3121988
(State of incorporation)	(I.R.S. Employer Identification No.)
2700 Sanders Road, Prospect Heights, Illinois	60070
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (312) 564-5000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $1 par value	New York Stock Exchange and Midwest Stock Exchange
Preferred Stock Purchase Rights	New York Stock Exchange and Midwest Stock Exchange
$6.25 Cumulative Convertible Voting Preferred Stock, no par, $50.00 stated value	New York Stock Exchange
$2.375 Cumulative Convertible Voting Preferred Stock, no par, $6.75 stated value	New York Stock Exchange
$2.50 Cumulative Convertible Voting Preferred Stock, no par, $4.50 stated value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark whether the registrant (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes/✓/ No/ /

At March 17, 1986, there were 43,182,140 shares of registrant's common stock outstanding (excluding 8,513,091 shares held in treasury by Household International), and the aggregate market value of the voting stock held by nonaffiliates of the registrant was approximately $2.2 billion.

DOCUMENTS INCORPORATED BY REFERENCE

Registrant's 1985 Annual Report to Shareholders for the fiscal year ended December 31, 1985: Parts I, II, and IV.

Registrant's definitive Proxy Statement dated March 28, 1986: Part I and Part III.

Part I.

Item 1. Business.

Registrant Household International, Inc. ("Household International" or the "Company") is a publicly owned holding company with subsidiaries engaged in three lines of business: financial services, manufacturing, and transportation. Financial information pertaining to the Company's industry segments and its foreign and domestic operations is incorporated by reference to pages 36-37 of Household International's 1985 Annual Report to Shareholders ("1985 Annual Report").

On December 31, 1985, the Company sold its wholly owned subsidiary, Household Merchandising, Inc., to a group of investors. Information regarding the sale of Household Merchandising is included in note 21 of the Company's Financial Statements in its 1985 Annual Report and in Household International's Current Reports on Form 8-K dated October 22, 1985, and December 31, 1985, which are incorporated herein by reference.

FINANCIAL SERVICES

Consumer Finance

Household International's Financial Services business employs approximately 9,200 people. Its principal business is the making of cash loans, including home equity loans secured by first and second mortgages, directly to consumers in the United States, Canada, the United Kingdom, and Australia (through a 50% interest in HFC Financial Services Limited). Loans are made through both branch lending offices owned by the Company's subsidiary, Household Finance Corporation ("HFC"), and through the Company's wholly owned consumer banking subsidiaries. At December 31, 1985, HFC had 1,068 branch lending offices located in the United States, 235 in Canada, and 117 in Australia.

Through internal growth and acquisitions, Household International's consumer banking subsidiaries are becoming a larger part of its Financial Services business. At December 31, 1985, the Company owned the following deposit-taking operations: Household Bank, f.s.b., a federally-chartered savings bank with 42 offices in California, Colorado, Illinois, Kansas, Maryland, and Ohio; Valley National Bank, The Household Bank, a federally-chartered bank with 11 offices in California; HFC Trust & Savings Limited, which operates 194 offices in the United Kingdom; and 44 other thrifts, industrial banks, and trusts operating in two states and Canada at year-end 1985. Valley National Bank operates as a consumer bank and does not make commercial loans. Total assets of the consumer banking operations at December 31, 1985, were $2.2 billion, compared to $1.2 billion a year earlier.

During 1985, Household Bank acquired savings and loan associations in Ohio, Kansas, and Colorado, information on which is included in note 19 to the Company's Financial Statements in its 1985 Annual Report incorporated herein by reference. Also in 1985, HFC Financial Services Limited acquired the Australian consumer and commercial finance business of a major competitor with 75 branch offices in Australia and approximately $255 million (Australian dollars) in receivables.

Consumer receivables on the dates indicated, and the number of financial service offices (including consumer banking offices), were as follows (excluding Australia):

December 31	Number of Accounts Outstanding (thousands)	Aggregate Balance Due (millions)	Average Balance Due Per Customer	Number of Offices
1985	2,093	$5,665	$2,707	1,594
1984	1,988	4,554	2,291	1,665
1983	1,863	3,933	2,111	1,675
1982	1,722	3,625	2,105	1,669
1981	1,961	3,715	1,894	1,760

Of the outstanding consumer receivables at year-end, $4.7 billion were attributable to United States operations, $629 million to Canadian operations, and $318.3 million to United Kingdom operations. The five jurisdictions with the largest percentage of consumer receivables in the system, and the percentage of consumer receivables to total consumer receivables in such jurisdictions, were as follows:

Jurisdictions	Percentage of Consumer Receivables To Total Consumer Receivables
California	24.1%
Ohio	6.4%
Maryland	5.9%
United Kingdom	5.6%
Illinois	5.6%

Real estate secured receivables represented approximately 50% of the aggregate balance due on consumer receivables at December 31, 1985, compared to 46% a year ago. Personal loans, including revolving credit accounts and sales finance contracts, comprised the remaining portion of the consumer loan portfolio. Revolving credit accounts consist of merchant participation products and Visa and MasterCard credit cards issued primarily by Valley National Bank. At December 31, 1985, there were approximately 69,000 credit card accounts representing $62.6 million in receivables and $368.3 million in other outstanding merchant participation products. Sales finance receivables totaled $491.8 million at year-end 1985. Expenses in the making and collecting of consumer loans are substantial and represent a higher percentage of the amounts owed on smaller loans than in the case of larger transactions.

Credit Losses and Delinquencies

Receivables are written off when the possibility that an account is uncollectible becomes apparent; for unsecured consumer receivables, writeoff is mandatory when a full payment has not been received for more than five months. Selected items for the periods indicated, in amount and percentage of the average consumer receivables outstanding, are shown in the following table (millions of dollars):

Year Ended December 31	Gross Writeoffs		Net Writeoffs (Gross Writeoffs Less Recoveries)		Provisions for Losses On Consumer Finance Receivables Charged to Income
	Amount	%	Amount	%	
1985	$ 61.4	1.27	$45.2	0.93	$55.4
1984	60.1	1.46	43.6	1.06	46.8
1983	64.1	1.70	46.7	1.24	50.8
1982	58.9	1.63	42.2	1.17	38.6
1981	104.8	3.00	88.5	2.54	73.7

The allowance for credit losses at December 31, 1985 was $164.6 million or 2.9% of total consumer receivables outstanding. Provisions for credit losses are made in amounts sufficient to maintain the allowance at a level considered necessary to cover anticipated losses resulting from future liquidation of the existing portfolio in the ordinary course of business.

Methods of computing statistics on delinquent customer accounts vary among companies. The Financial Services business has consistently computed delinquency for internal management purposes on a recency-of-payment basis, referring to the date of the last payment in any amount from the customer. Based on this computational method and operating practices, the percentage of consumer receivables on which two or more calendar months have elapsed since receipt of the last payment (but excluding paid ahead accounts) was 1.96%, 1.93%, 1.72%, 1.86% and 2.09% as of the end of each of the years 1981 through 1985, respectively.

Regulation and Competition

Generally, consumer branch lending offices are regulated by legislation and licensed in those jurisdictions where they operate. Such licenses are revocable for cause. In addition to a licensing provision, statutes in some jurisdictions may provide that a loan not exceed a certain period of time, or may place limits on the size or interest rate of the loan. Consumer finance operations also are subject to federal laws relating to discrimination in credit extensions, use of credit reports, disclosure of credit terms, and correction of billing errors.

Because of their ownership of Household Bank, Household International and HFC are savings and loan holding companies subject to registration, reporting, and other regulations of the Federal Home Loan Bank Board. Household Bank and Valley National Bank are subject to various federal laws and regulations common to the banking and savings and loan industries generally, including reserve requirements, investment restrictions, and limitations on transactions with affiliates.

As of December 31, 1985, all Canadian provinces, the United Kingdom, and approximately half of the states in the United States permitted essentially deregulated rates of charge. Over 58% of total consumer receivables were originally made in jurisdictions which are essentially deregulated.

The financial services industry is highly competitive, and the Company's Financial Services business competes with a number of institutions that extend credit to consumers. The Federal Reserve Board estimated that the total amount of consumer instalment credit outstanding in the United States on December 31, 1985 was $550 billion. As the table below shows, $339 billion of that amount was held by four general categories of financial institutions as representing consumer instalment credit (excluding automobile and mobile home credit). The estimated gross amounts for each of the last five years ended December 31 are as follows (millions of dollars):

Consumer Instalment Credit (Excluding Auto and Mobile Home Credit) Held By:	1985		1984		1983		1982		1981	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Finance Companies.....	$ 68,677	20.3	$ 50,653	18.3	$ 44,179	19.6	$ 40,577	21.2	$ 40,049	21.9
Commercial Banks	142,403	42.0	117,280	42.3	94,579	41.9	83,534	43.6	77,987	42.5
Credit Unions....	40,447	11.9	34,684	12.5	27,330	12.1	24,154	12.6	23,490	12.8
Other*	87,542	25.8	74,446	26.9	59,734	26.4	43,255	22.6	41,853	22.8
	$339,059	100.0	$277,063	100.0	$225,822	100.0	$191,520	100.0	$183,359	100.0

* Includes retailers, savings and loans, and mutual savings banks; does not include gasoline companies.

Financial Services' corresponding gross consumer finance receivables in the United States (excluding receivables held by its consumer banking operations, which totaled $1.1 billion at December 31, 1985), reported to the Federal Reserve Board as of the same dates, were as follows (millions of dollars):

	1985	1984	1983	1982	1981
Consumer Instalment Credit	$4,052	$3,612	$3,477	$3,451	$3,655

Commercial Finance

During 1985, the Financial Services business formed a new subsidiary, Household Commercial Financial Services, Inc. ("HCFS"), to formally consolidate its existing commercial finance activities and to provide a staff organizational structure to support its existing activities as well as its expansion into other commercial lending programs.

HCFS's Specialty Products Division invests in privately-placed, limited-term preferred stocks and purchased vehicle and agricultural equipment receivables. HCFS's total investment in preferred stocks (primarily in companies with "AA" or "A" debt ratings) increased to $452 million in 1985 from $260.9

million a year earlier. Generally, 85% of the dividends received on preferred stocks is not taxable to corporations for federal income tax purposes. The Capital Equipment Division is engaged in the leveraged leasing of capital equipment, such as commercial aircraft, ocean-going vessels, rail cars, and the sale and lease back of real estate. Leasing provides the Company with the near-term cash flow benefits of ownership associated with investment tax credits and income tax deferrals as well as potential long-term benefits from the ultimate sale of the Company's interest in the equipment. The Company's equity investment in such equipment at year-end 1985 increased to $373.6 million from $248.4 million a year ago. The Capital Equipment Division also has arranged joint ventures in leveraged leasing transactions for non-affiliated companies. HCFS's Real Estate Services Division makes real estate secured loans on commercial income producing property through a network of twelve offices located in the United States. HCFS's Business Equipment Division is a newly-formed division to provide various middle market financial products and services to sellers and purchasers of a variety of office and factory support equipment.

Total commercial receivables for the Financial Services business at year-end 1985 and 1984 were $1.5 billion and $900.9 million, respectively, and credit loss reserves provided against such receivables at December 31, 1985 and 1984 amounted to $16.6 and $13.4 million, respectively. The provision for losses on commercial finance receivables charged to income was $.8, $.3, $1.3, $1.6, and $3.2 million in each of the years 1981 through 1985, respectively. Further information on the Company's commercial finance activities is contained in notes 3 and 20 of the Company's Financial Statements in its 1985 Annual Report incorporated herein by reference.

Alexander Hamilton Life Insurance Company of America

In conjunction with its consumer finance operations and where applicable laws permit, the Financial Services business makes available to customers credit life, credit accident and health, and household contents insurance. Credit life and credit accident and health insurance are generally directly written by or reinsured with the Company's insurance subsidiary, Alexander Hamilton Life Insurance Company of America ("Alexander Hamilton"). Alexander Hamilton also sells credit insurance to customers of banks, consumer finance companies, credit unions, and retail merchants not affiliated with Household International.

Alexander Hamilton, in addition to selling credit insurance, also is engaged in the sale of whole and term ordinary life insurance policies, annuities, and universal life insurance products. Sales are primarily made through approximately 6,200 independent agents, with 28% of new insurance sold during 1985 (based on amount issued) originated through HFC's branch offices. Insurance products are sold in all states except New York, with seven states (Michigan, Ohio, California, Indiana, Oregon, Missouri, and Pennsylvania) accounting for 50% of life premium income. Alexander Hamilton also writes reinsurance for ordinary and credit life insurance.

As an insurance company, Alexander Hamilton is subject to regulatory supervision under the laws of the states in which it operates. Regulations vary from state to state but generally cover licensing of insurance companies, premium rates, types of insurance that may be sold, permissible investments, policy reserve requirements, and insurance marketing practices.

Premium income for Alexander Hamilton totaled $486.8 million in 1985, compared to $313 and $219.5 million for 1984 and 1983, respectively. For the three year period ended December 31, 1985, premium income from annuities increased 347% to $275.1 million. Earned premiums from ordinary life insurance products for 1985 were $140.9 million, increasing 54% over the last three fiscal years, and premium income from credit insurance products for 1985 was $67.5 million, increasing 26% over the last three fiscal years.

Data on life insurance in force and written by Alexander Hamilton during the last five years are as follows (millions of dollars):

Life Insurance in Force at December 31	1985	1984	1983	1982	1981
Direct insurance:					
Ordinary life	$ 9,857.7	$ 7,555.9	$ 5,960.6	$ 4,493.7	$ 3,305.6
Credit life	2,284.2	2,059.9	1,828.1	1,563.6	1,618.4
Group life	202.6	403.8	417.7	461.7	418.9
Subtotal, direct	12,344.5	10,019.6	8,206.4	6,519.0	5,342.9
Reinsurance assumed (all categories)	9,482.4	9,037.3	7,449.5	7,747.5	8,017.0
Reinsurance ceded	(2,256.4)	(1,570.2)	(2,220.4)	(3,179.4)	(1,558.2)
Total life insurance in force at December 31	$19,570.5	$17,486.7	$13,435.5	$11,087.1	$11,801.7
Total new life insurance written during the year	$ 5,974.2	$ 6,216.4	$ 5,734.3	$ 4,169.5	$ 3,390.2

MANUFACTURING

Household Manufacturing, Inc. ("Household Manufacturing") is engaged in the manufacture of power components, building products, tools, consumer products, and specialty products, as described below.

Power Components

In its power components business, Household Manufacturing produces and sells components for diesel and gasoline engines under the Schwitzer® tradename and, in Brazil, under the Lacom-Schwitzer® tradename. These products consist of turbochargers, superchargers, metal and plastic fans, fan clutches, water pumps, and vibration dampers. These products are usually designed and engineered for a particular engine and are used in construction, agricultural and off-highway equipment, stationary engines, trucks, and passenger cars. Household Manufacturing's customers in the engine components business are most of the major United States engine manufacturers, automobile companies, and heavy equipment manufacturers. In addition, a line of positive displacement industrial air pumps also is manufactured and sold for applications such as pneumatic conveying and sewage treatment. A portion of Household Manufacturing's products is sold to parts distributors for resale in replacement markets.

Household Manufacturing also manufactures custom gears, gear assemblies, speed reducers, and custom-built products involving gearing under the Illinois Gear®, Ohio Gear®, and Richmond Gear® tradenames. The custom products are manufactured to customer order for original equipment and replacement markets in a wide variety of industries in the United States, Canada, and overseas. Non-custom products are sold by company sales personnel and by industrial distributors to original equipment manufacturers and users throughout the United States.

Building Products

In its building products business, Household Manufacturing produces plumbing products consisting of the Eljer® brand enameled cast iron, formed steel, vitreous china, and fiberglass fixtures for residential and commercial structures. Household Manufacturing also manufactures single and dual control mixing faucets sold principally under the Valley® and Aqua-Line® tradenames, brass shutoff valves, fittings, and corrugated flexible brass and copper connectors sold principally under the Eastman® tradename, and polybutylene and celcon valves, pipes, and fittings sold under the Qest® tradename. These products are sold nationally to plumbing, heating, and hardware wholesalers, to wholesalers for mobile home manufacturers, and to other manufacturers and retail outlets. Household Manufacturing also manufactures Halsey Taylor® brand electric water coolers and drinking fountains.

The building products operations also include heating and ventilating equipment which consists of prefabricated steel chimneys and gas vent systems, sold under the Selkirk-Metalbestos® tradename,

metal registers, grilles, and diffusers for heating and air conditioning systems sold under the Air Mate®, and Lloydaire® tradenames, and metal fireplaces and wood stoves sold under the Selkirk-Metalbestos® and Acorn® tradenames. These products are sold in the United States, Canada, and Europe primarily to plumbing, heating, general hardware, building supply, and sheet metal wholesalers, although a small portion is sold directly to contract accounts who purchase the items for resale.

Tools

Household Manufacturing's tools business consists of the manufacture of circular and band saws, hacksaws, machine knives, creasing and perforating tools, files, and precision ground steel products under the Simonds® tradename, and socket sets, flat wrenches, solid joint pliers, and tool boxes under the Thorsen® and other tradenames. Various other products, such as screwdrivers, punches, chisels, adjustable wrenches, and hammers are distributed as part of these operations. These products are sold to industrial and consumer markets primarily through industrial supply and other wholesale outlets.

Household Manufacturing also manufactures and distributes various electronic supplies for sale in the electronics, industrial, and consumer markets. This product line includes plugs, jacks, cables, hand tools, chemicals and adhesives for cleaning and coating electronic parts, switches, relays, and television and citizen band radio antennas and accessories. These products are sold directly to original equipment manufacturers and retail electronics stores, and through electronics and industrial wholesale distributors.

Consumer Products

Household Manufacturing's consumer products business includes outdoor living products which are widely distributed under several well-known brand names, most prominently Thermos® and Structo®, to customers throughout the world. These products include vacuum bottles, lunch kits, and a wide variety of outdoor living and leisure time merchandise such as jugs, chests, and gas and charcoal barbecue grills. Many of the above items also are available as private brands of national chain retailers. Distribution methods include the use of direct sales forces, representatives, distributors, wholesalers, jobbers, and incentive premium and stamp redemption merchandise houses.

Specialty Products

Household Manufacturing also manufactures Scotsman® automatic ice machines and other industrial products including metal finishing machines, industrial casters, temperature control devices for electric ranges and microwave ovens, and metallized films, papers, and blankets. Specialty products are sold by Household Manufacturing's sales personnel and through representatives and distributors.

General Information

For its manufacturing processes, Household Manufacturing purchases a variety of raw materials and parts, which are generally available from a number of sources. Principal materials include plastics, rubber products, and various metals, such as iron, steel, aluminum, brass, and copper.

Household Manufacturing has numerous competitors in its product lines. Principal methods of competition are price, customer service, warranty, product performance, and manufacturing capabilities, the importance of any one method varying by product line. Household Manufacturing has registered those trademarks which it considers of substantial importance to its business. Household Manufacturing possesses United States and foreign patents important to the competitive position of its power components business; however, Household Manufacturing does not believe its patents to be a significant factor in the conduct of its business as a whole.

During 1985, 1984, and 1983, Household Manufacturing expended \$15, \$16.2, and \$14.5 million, respectively, on research and development activities primarily related to its power components business.

Household Manufacturing has approximately 10,800 employees. Household Manufacturing has generally enjoyed satisfactory labor relations with its employees and is a party to a number of collective bargaining agreements with its employees.

TRANSPORTATION

National Car Rental System, Inc. ("National") is principally engaged in the renting and leasing of cars and trucks. As a by-product of its principal business, National also engages in the sale of its used vehicles. Cars are rented from both company-owned and independent licensee locations. National receives fees from its licensees for the right to use the National Car Rental name and for other services. National licensees are required to conduct their business pursuant to standards and procedures established by National. At December 31, 1985, National and its licensees rented cars from 1,094 outlets in the United States, serving a substantial number of cities, including 361 locations at U.S. airports. The number of cars in service in National's rental car system in the United States at year-end 1985 was approximately 104,000, of which approximately 75% were operated from company-owned locations. A significant part of National's business is renting cars to individuals for vacation and other recreational driving, but National's primary customer base is business and professional personnel and commercial and industrial concerns. Generally, rental periods vary from a day to a month.

Under the Lend Lease name, National engages in car leasing and truck renting and leasing. For these services, Lend Lease operates approximately 54,000 cars and trucks in the United States and approximately 6,000 cars in Canada. Cars and trucks, singly or in fleets of varying sizes, are leased to commercial and industrial concerns or to individuals for lease periods of one to six years.

Under the Mud Cat name, National also markets a small dredge-like apparatus used for the environmental control of lakes and industrial settling ponds. Mud Cat also markets an aquatic weed harvester and a cutterhead dredge.

Outside of the United States, National is represented by its own licensees in Central and South America, the Caribbean, and the Pacific basin. In Europe, Africa, and the Middle East, National is represented by Europcar and, in Canada, by Tilden. In addition to continuing to license outlets, National established company-owned operations on a limited basis in Australia during 1985.

National will be testing the insurance rental business in limited market areas in the United States. These efforts will involve separate and segregated facilities and identification different from the established "National" trademarks.

The vehicle renting and leasing business is highly competitive in price and service. In any given location National may encounter competition from nationwide, regional, and local companies. The main competitors for daily car rentals at airport locations are Hertz, Avis, and Budget. Car rental demand is slightly seasonal with demand somewhat lower from November through February.

The total home office staff and field force of National and its subsidiaries approximates 8,300 persons.

Item 2. Properties.

The Company, through one of its subsidiaries, owns its headquarters building in Prospect Heights, Illinois. Substantially all branch office, banking, and divisional headquarters space for the Financial Services business is rented with the exception of a headquarters building in Toronto, Canada; Alexander Hamilton's headquarters building in Farmington Hills, Michigan; and administration buildings in Northbrook, Illinois and Salinas, California. National owns a corporate headquarters building in Minneapolis, Minnesota. Most of the land for rental and service facilities operated by National and its subsidiaries is leased. The terms of leases for service facilities at airport locations generally range from 10 to 25 years subject to continuation of counter concession rights within airport terminals.

Household Manufacturing operates 49 plants located in the United States, Canada, Mexico, the United Kingdom, Italy, and Brazil. These plants contain approximately 9 million square feet of floor space. Five of the plants, aggregating approximately .8 million square feet of floor space, are leased. The remainder of the plants are owned in fee or leased under industrial revenue bonds. In addition, Household Manufacturing occupies owned and leased warehouse, sales, and office space. Household Manufacturing maintains its headquarters in the Company's offices in Prospect Heights, Illinois.

Item 3. Legal Proceedings.

There is no litigation pending which management and counsel for the Company consider to be material.

On August 17, 1984, John A. Moran, a former director of Household International, and the Dyson-Kissner-Moran Corporation ("DKM"), a Household International stockholder, brought an action in the Delaware Chancery Court against Household International and several of its directors seeking declaratory and permanent injunctive relief declaring the Company's Preferred Stock Purchase Rights ("Rights") to be invalid and unlawful and voiding the Rights. Subsequently, Gretl Golter, a Household International stockholder, intervened in the action as a plaintiff and asserted similar claims against Household International and several of its directors. Household International and its directors who were defendants in this action denied the Plaintiffs' allegations and filed a counterclaim asserting that Moran and DKM participated in an unlawful scheme to acquire Household International in violation of the fiduciary duties Moran and DKM owed to Household International. On January 29, 1985, the Delaware Chancery Court ruled in favor of Household International and its defendant-directors with respect to plaintiffs' claims against them but also dismissed Household International's counterclaim. The Court said that Household International's Rights Plan had been properly adopted under Delaware law, was not intended for the entrenchment of management, serves a rational corporate purpose, and was an appropriate exercise of management judgment. Mr. Moran and DKM, and the intervenor Gretl Golter, appealed the decision to the Delaware Supreme Court, and on November 19, 1985, the Delaware Supreme Court affirmed the decision of the Chancery Court.

Item 4. Submission of Matters to a Vote of Security Holders.

Inapplicable.

Executive Officers of the Registrant.

The following information on executive officers of Household International is included pursuant to Item 401(b) of Regulation S-K. Information with respect to Messrs. Clark, James, and Dillon is incorporated by reference to "Information Regarding Nominees" in Household International's definitive proxy statement dated March 28, 1986. References herein to Household refer to Household Finance Corporation prior to June 26, 1981 (the effective date of the corporate restructuring by which Household International became the holding company of Household Finance Corporation) and to Household International, Inc. on and after such date.

J. Richard Hull, age 52, was appointed Senior Vice President and General Counsel of Household in June 1984. From 1979 until joining Household, Mr. Hull was Vice President and General Counsel of American Hospital Supply Corporation, which manufactured and distributed health care products and services.

James L. McCormick, age 59, is Senior Vice President—Government and Public Affairs of Household, and has served Household in that position since 1978.

James D. Pinkerton, age 45, is Senior Vice President-Administration and Secretary of Household. He was appointed Secretary in 1974 and Senior Vice President-Administration in 1980.

Edward A. Wiegner, age 46, joined Household in 1986 as Senior Vice President and Chief Financial Officer. Prior thereto, he was Executive Vice President, Chief Administrative Officer, and a

director of American Natural Resources Company ("ANR"), a diversified energy company, since 1985 and Chief Financial Officer since 1982. When ANR was acquired in 1985 by the Coastal Corporation, also a diversified energy company, Mr. Wiegner was appointed a Senior Vice President of Coastal Corporation. Between 1974 and 1982, Mr. Wiegner was an officer and director of Wisconsin Power and Light Company.

Gaylen N. Larson, age 46, is Group Vice President and Controller of Household. Mr. Larson was a partner of Deloitte Haskins & Sells prior to joining Household in 1979.

Theodore K. Thornton, age 36, joined Household in February 1985 as Vice President and Treasurer. From 1979 to 1984, Mr. Thornton was employed by the Colgate-Palmolive Company, a manufacturer and distributor of cleaning and personal and health care products, and was promoted to Assistant Treasurer in 1981. From 1984 until joining Household, he was Corporate Assistant Treasurer of Sperry Corporation, a manufacturer of electronic and defense system products.

Edward G. Harshfield, age 49, joined the Company's Financial Services subsidiary, Household Finance Corporation, in 1984 as Executive Vice President—Consumer Banking Services. He was promoted to Senior Executive Vice President—Chief Operating Officer in 1985 and became President and Chief Executive Officer in 1986. Prior thereto, Mr. Harshfield worked for fifteen years for Citibank, N.A., most recently as Senior Vice President—Division Head, Asia, Pacific, and Australia.

Bemiss A. Roifs, age 49, has been President and Chief Executive Officer of National Car Rental System, Inc., Household's vehicle rental and leasing subsidiary, since 1981. From 1978 to 1981, he was Executive Vice President—Operations of National.

William D. Hendry, age 65, a director of Household, retired as President and Chief Executive Officer of Household Finance Corporation at the end of 1985, a position he had held since 1981. Mr. Hendry began his career with Household Finance Corporation in 1940.

There are no family relationships among the executive officers of the registrant. The term of office of each executive officer is at the discretion of the Board of Directors.

Part II.

Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters.

The approximate number of record holders of Household International's Common Stock, as of March 17, 1986, was 20,800. The Company declares dividends on a quarterly basis, and the annual per share dividend declared on its Common Stock during 1985 and 1984 was $1.78 and $1.725, respectively. Additional information required by this Item is incorporated by reference to page 59 of Household International's 1985 Annual Report.

Item 6. Selected Financial Data.

Information required by this Item is incorporated by reference to page 24 of Household International's 1985 Annual Report.

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

Information required by this Item is incorporated by reference to pages 24-31 and 53-55 of Household International's 1985 Annual Report.

Item 8. Financial Statements and Supplementary Data.

Financial statements of Household International and subsidiaries, including supplementary inflation data, meeting the requirements of Regulation S-X are incorporated by reference to pages 32-55 of the Company's 1985 Annual Report. Supplementary financial information specified by Item 302 of Regulation S-K is incorporated by reference to pages 52-55 of Household International's 1985 Annual Report.

Item 9. Disagreements on Accounting and Financial Disclosure.

Inapplicable.

Part III.

Item 10. Directors and Executive Officers of the Registrant.

Information required by this Item is incorporated by reference to "Information Regarding Nominees" in Household International's definitive proxy statement dated March 28, 1986. Also, information on certain Executive Officers appears in Part I of this Annual Report on Form 10-K.

Item 11. Executive Compensation.

Information required by this Item is incorporated by reference to "Remuneration of Executive Officers", "Savings, Stock Ownership, and Pension Plans", "Incentive and Stock Option Plans", and "Directors' Compensation" in Household International's definitive proxy statement dated March 28, 1986.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

Information required by this Item is incorporated by reference to "Shares of Household Common Stock Beneficially Owned by Directors, Nominees, and Officers" and "Security Ownership of Certain Beneficial Owners" in Household International's definitive proxy statement dated March 28, 1986.

Item 13. Certain Relationships and Related Transactions.

Information required by this Item is incorporated by reference to "Remuneration of Executive Officers" and "Security Ownership of Certain Beneficial Owners" in Household International's definitive proxy statement dated March 28, 1986.

Part IV.

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K.

(a) Financial Statements

The following financial statements, together with the opinion thereon of Arthur Andersen & Co. dated February 14, 1986, appearing on pages 32-55 of the Company's 1985 Annual Report are incorporated herein by reference. Opinions of Arthur Andersen & Co. and Deloitte Haskins & Sells are also included in this Report on Form 10-K.

Household International, Inc. and Subsidiaries:

Statements of Income for the Three Years Ended December 31, 1985.

Balance Sheets, December 31, 1985 and 1984.

Statements of Changes in Financial Position for the Three Years Ended December 31, 1985.

Statements of Changes in Other Shareholders' Equity for the Three Years Ended December 31, 1985.

Business Segment Data.

Notes to Financial Statements.

Selected Quarterly Financial Data (Unaudited).

Supplementary Information on the Impact of Inflation on Accounting Data (Unaudited). Management Comments, and Comparison of Selected Financial Data Adjusted for the Effects of Inflation.

(b) Reports on Form 8-K

During the three months ended December 31, 1985, the Company filed with the Securities and Exchange Commission its Current Reports on Form 8-K dated October 22, 1985, and December 31, 1985, disclosing information under Item 2, "Acquisition or Disposition of Assets", and Item 7, "Financial Statements and Exhibits".

(c) Exhibits

2(a) Stock Purchase Agreement between Household International, Inc. and HMI Holdings, Inc. dated as of October 22, 1985 (incorporated by reference to Exhibit 2 of the Company's Current Report on Form 8-K dated October 22, 1985).

2(b) First Amendment, dated December 27, 1985, to Stock Purchase Agreement between Household International, Inc. and HMI Holdings, Inc. (incorporated by reference to Exhibit 2(b) of the Company's Current Report on Form 8-K dated December 31, 1985).

3(a) Restated Certificate of Incorporation of Household International, Inc., including the Certificates of Designation, Preferences and Rights of the Company's \$2.375 and \$2.50 Cumulative Convertible Voting Preferred Stock and its Series A Junior Participating Preferred Stock (incorporated by reference to Exhibit 3(a) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1984).

3(b) Bylaws of Household International, Inc. (incorporated by reference to Exhibit 3 of the Company's Current Report on Form 8-K dated September 9, 1985).

4(a) Rights Agreement dated as of August 14, 1984, between the Company and Harris Trust and Savings Bank, as Rights Agent, as supplemented by a Supplemental Agreement dated as of August 28, 1984 (incorporated by reference to Exhibit 4 of the Company's Current Report on Form 8-K dated August 23, 1984).

4(b) Amendment Agreement to Rights Agreement dated as of January 14, 1986, between the Company and Harris Trust and Savings Bank, as Rights Agent (incorporated by reference to Exhibit 4(a) of the Company's Current Report on Form 8-K dated January 14, 1986).

4(c) The principal amount of debt outstanding under each instrument defining the rights of holders of long-term senior and senior subordinated debt of Household International and its subsidiaries does not exceed 10% of the total assets of Household International and its subsidiaries on a consolidated basis. Household International agrees to furnish to the Securities and Exchange Commission, upon request, a copy of each instrument defining the rights of holders of long-term senior and senior subordinated debt of Household International and its subsidiaries.

10(a) Household International Corporate Executive Bonus Plan (incorporated by reference to Exhibit 10(a) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1984).

10(b) Household International Non-qualified Unfunded Deferred Compensation Plan for Annual Bonus Awards (incorporated by reference to Exhibit 10(b) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1984).

10(c)	1976 Employee Stock Option Plan and form of stock option agreement thereunder (incorporated by reference to Exhibit 10(c) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1984).
10(d)	Household International Long-term Executive Incentive Compensation Plan and form of stock option agreement thereunder (incorporated by reference to Exhibit 10(d) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1984).
10(e)	Form of tandem stock option-stock appreciation right agreement under the Household International Long-term Executive Incentive Compensation Plan.
10(f)	Household International Non-Qualified Unfunded Deferred Compensation Plan for Performance Unit Awards (incorporated by reference to Exhibit 10(e) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1984).
10(g)	Household International Directors' Retirement Income Plan.
10(h)	Household International Deferred Fee Plan for Directors.
10(i)	Employment Agreement and Supplemental Employment Agreement between the Company and D. C. Clark.
10(j)	Employment Agreement between the Company and J. W. James.
10(k)	Employment Agreement and Supplemental Employment Agreement between the Company and G. G. Dillon.
10(l)	Employment Agreement and Supplemental Employment Agreement between the Company and J. R. Hull.
10(m)	Stock Purchase Agreement dated as of March 25, 1986, among Household International, the Dyson-Kissner-Moran Corporation, and others listed in such Stock Purchase Agreement
13	1985 Annual Report to Shareholders for the fiscal year ended December 31, 1985.
22	List of Household International subsidiaries.
24(a)	Consent of Arthur Andersen & Co., Certified Public Accountants.
24(b)	Consent of Deloitte Haskins & Sells, Certified Public Accountants.
28	Annual Report on Form 11-K for the Household International Tax Reduction Investment Plan (to be filed by amendment).

Copies of exhibits referred to above will be furnished to stockholders upon written request at a cost of fifteen cents per page. Requests should be made to Household International, Inc., 2700 Sanders Road, Prospect Heights, Illinois 60070, Attention: Secretary.

(d) Schedules

Opinions of Independent Certified Public Accountants.

III—Condensed Financial Information of Registrant.

VIII—Valuation and Qualifying Accounts.

X—Supplementary Statement of Income Information.

Supplementary Note.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Household International has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HOUSEHOLD INTERNATIONAL, INC.

Dated: March 27, 1986 By ______________________
D. C. Clark, Chairman of the Board, President, and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Household International and in the capacities and on the dates indicated.

Signature	Title
(D. C. Clark)	Chairman of the Board, President, Chief Executive Officer and Director
(J. C. Biegler)	Director
(G. G. Dillon)	Director
Mary J. Evans (Mary J. Evans)	Director
(D. C. Fill)	Director
(W. D. Hendry)	Director

Dated:
March 27, 1986

Signature	Title
(J. W. James)	Executive Vice President, Director
(G. P. Osler)	Director
(A. E. Rasmussen)	Director
(G. W. Rauch)	Director
(R. C. Tower)	Director
(Miller Upton)	Director
(E. A. Wiegner)	Senior Vice President-- Chief Financial Officer
(G. N. Larson)	Group Vice President-- Controller (Chief Accounting Officer)

Dated:
March 27, 1986

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Household International, Inc.:

In connection with our examination of the consolidated financial statements included in the December 31, 1985 annual report to shareholders of Household International, Inc. and subsidiaries and incorporated herein by reference, we have also examined the supplemental schedules of Household International, Inc. and subsidiaries, as of December 31, 1985 and for the year then ended, listed in Item 14(d). Our examination of the consolidated financial statements was made for the purpose of forming an opinion on those statements taken as a whole. The schedules listed in Item 14(d) are presented for purposes of complying with the Securities and Exchange Commission's rules and are not part of the consolidated financial statements. These schedules have been subjected to the auditing procedures applied in the examination of the consolidated financial statements and, in our opinion, fairly state in all material respects the financial data required to be set forth therein for the year ended December 31, 1985 in relation to the consolidated financial statements taken as a whole.

Arthur Andersen & Co.

ARTHUR ANDERSEN & CO.

Chicago, Illinois
February 14, 1986

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Household International, Inc.:

We have examined the balance sheets of Household International, Inc. and subsidiaries as of December 31, 1984 and the related statements of income, changes in other shareholders' equity and changes in financial position for each of the two years in the period ended December 31, 1984. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned financial statements present fairly the financial position of Household International, Inc. and subsidiaries at December 31, 1984 and the results of their operations and the changes in their financial position for each of the two years in the period ended December 31, 1984, in conformity with generally accepted accounting principles applied on a consistent basis.

Our examinations also comprehended the supplemental schedules of Household International, Inc. and subsidiaries as of December 31, 1984 and for each of the two years in the period then ended, listed in Item 14(d). In our opinion, such supplemental schedules, when considered in relation to the basic financial statements, present fairly in all material respects the information shown therein.

Deloitte Haskins & Sells

DELOITTE HASKINS & SELLS
Chicago, Illinois
February 7, 1985

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(All amounts other than per share data are stated in millions of dollars.)

CONDENSED STATEMENTS OF INCOME

	Year ended December 31		
	1985	1984	1983
Equity in income of subsidiaries	$210.9	$227.0	$197.3
Expenses:			
Administrative	26.2	23.2	18.3
Interest	50.7	50.9	35.8
Income tax benefits	(33.9)	(31.6)	(23.6)
Total expenses	43.0	42.5	30.5
Equity in income of discontinued operation	43.0	49.6	39.6
Net income	$210.9	$234.1	$206.4
Earnings per common share:			
Primary	$ 3.65	$ 4.18	$ 3.68
Fully diluted	3.54	3.95	3.50

CONDENSED BALANCE SHEETS

	December 31	
	1985	1984
Assets:		
Investments in and advances from subsidiaries	$1,607.2	$1,442.9
Investments and note receivable from sale of discontinued operation	628.0	
Other	90.5	59.9
Net assets of discontinued operation		565.8
Total assets	$2,325.7	$2,068.6
Liabilities and shareholders' equity:		
Note payable	$ 150.0	
Accounts payable, accrued liabilities and deferred income taxes	122.9	$ 51.9
Debt	249.3	317.3
Convertible preferred stock subject to mandatory redemption	172.6	172.7
Other shareholders' equity	1,630.9	1,526.7
Total liabilities and shareholders' equity	$2,325.7	$2,068.6

SCHEDULE III—(Continued)

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(All amounts are stated in millions of dollars.)

CONDENSED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year ended December 31		
	1985	1984	1983
CASH AT JANUARY 1	$ 0.3	$ 0.2	$ 0.8
CASH PROVIDED (USED) BY OPERATIONS AND RETAINED IN THE BUSINESS			
Dividends paid to parent	164.9	166.3	121.7
Cash provided (used) by continuing operations	(94.0)	(139.8)	31.5
Cash provided (used) by discontinued operation	80.0	26.0	(10.0)
Dividends to shareholders	(114.5)	(110.9)	(107.8)
Cash provided (used) by operations and retained in the business	36.4	(58.4)	35.4
INVESTMENT IN OPERATIONS			
Investment in and advances to/from subsidiaries, net	(116.6)	67.4	40.8
Proceeds from sale of discontinued operation	628.0		
Investments and note receivable from sale of discontinued operation	(628.0)		
Investment in subsidiaries resulting from Corporate reorganization			(105.0)
Cash increase (decrease) from investment in operations	(116.6)	67.4	(64.2)
FINANCING TRANSACTIONS			
Bank borrowings	150.0		
Issuance of debt	28.4	141.1	78.2
Retirement of debt	(98.0)	(150.0)	(50.0)
Cash increase (decrease) from financing transactions	80.4	(8.9)	28.2
CASH AT DECEMBER 31	$ 0.5	$ 0.3	$ 0.2

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED FINANCIAL INFORMATION OF REGISTRANT

NOTES TO CONDENSED FINANCIAL STATEMENTS OF REGISTRANT

1. Debt

Debt at December 31 consisted of the following (millions of dollars):

	1985	1984
Notes payable to Subsidiary	$134.3	$202.3
11⅜% notes; due 1988	20.0	20.0
11.95% notes; due 1987	35.0	35.0
12% notes; due 1989	60.0	60.0
Total	$249.3	$317.3

Household International has unconditionally guaranteed the payment of principal and interest on $59.5 million of 5⅞% Swiss Franc notes due March 15, 1990, $68 million of 7⅛% Swiss Franc notes due April 17, 1994 and $28.4 million 11⅝% notes due December 1, 1990, issued by Household Finance International, N.V. ("International N.V.") a wholly owned subsidiary of Household International. The net proceeds of the notes received by International N.V. were loaned to Household International under separate intercompany note agreements. The principal balances of the 5⅞% and 7⅛% Swiss Franc and 11⅝% intercompany notes are due to International N.V. on March 13, 1990, April 15, 1994 and November 30, 1990, respectively.

In 1984, Household International entered into a Eurodollar revolving credit facility. This facility, which is shared with HFC on an either/or basis, provides for borrowings, repayments and reborrowings for up to $400 million through December 12, 1989. Borrowings under this facility are available at a surcharge over the London Interbank Offered Rate. Provisions of the agreement require an annual commitment fee of $.5 million. There were no borrowings outstanding under this facility at December 31, 1985.

2. Commitments

In connection with commercial paper financing activities of the Company's Rental and Leasing subsidiary, National Car Rental System, Inc. ("National"), Household International has agreed to maintain at least 80 percent ownership of National's common stock and 100 percent ownership of HFC's common stock. Additionally, Household International and HFC have agreed to cause National to maintain a ratio of debt to equity of no more than 6 to 1, and to maintain National's ratio of income before interest expense and income taxes to interest expense of no less than 1.5 to 1 (for purposes of the latter ratio, capital contributions to National are included in income available for interest charges). During 1985, $51 million in capital contributions were made to National to help maintain these ratios. Additionally, in 1983, a capital contribution of $5 million was made by HFC prior to the transfer of National from HFC to Household International.

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

VALUATION AND QUALIFYING ACCOUNTS FOR THE THREE YEARS ENDED DECEMBER 31, 1985

(All amounts are stated in millions of dollars.)

Column A	Column B	Column C		Column D	Column E
		Additions			
Description	Balance at Beginning of Year	Charged (Credited) to Income	Charged (Credited) to Other Accounts	Deductions	Balance at End of Year
Year Ended December 31, 1983:					
Reserves deducted from assets to which they apply:					
Allowance for credit losses on finance receivables	$136.3	$ 52.1	$17.5 (a) 8.8 (f)	$64.1 (c) 0.7 (b)	$149.9
Allowance for doubtful accounts—trade receivables	$ 8.8	$ 4.8	$ 1.8 (a) (0.7) (g)	$ 6.1 (c) 0.1 (b)	$ 8.5
Insurance reserves applicable to finance receivables:					
Policy	$ 75.7	$(48.8)	$57.9 (d)	$ 0.1 (b)	$ 84.7
Claims	18.5	24.2		22.7 (e) 1.0 (b)	19.0
Total	$ 94.2	$(24.6)	$57.9	$23.8	$103.7
Year Ended December 31, 1984:					
Reserves deducted from assets to which they apply:					
Allowance for credit losses on finance receivables	$149.9	$ 48.4	$16.5 (a) 37.4 (f)	$60.1 (c) 2.4 (b)	$189.7
Allowance for doubtful accounts—trade receivables	$ 8.5	$ 4.8	$ 1.3 (a)	$ 4.9 (c) 0.2 (b)	$ 9.5
Insurance reserves applicable to finance receivables:					
Policy	$ 84.7	$(50.9)	$58.2 (d)	$ 0.7 (b)	$ 91.3
Claims	19.0	24.9		20.6 (e) 1.3 (b)	22.0
Total	$103.7	$(26.0)	$58.2	$22.6	$113.3
Year Ended December 31, 1985:					
Reserves deducted from assets to which they apply:					
Allowance for credit losses on finance receivables	$189.7	$ 58.6	$16.2 (a) 0.2 (b) 7.8 (f)	$61.8 (c) 18.4 (h) 4.4 (i) 6.7 (j)	$181.2
Allowance for doubtful accounts—trade receivables	$ 9.5	$ 4.6	$ 1.5 (a) 0.2 (b) (0.7) (g)	$ 6.3 (c)	$ 8.8
Insurance reserves applicable to finance receivables:					
Policy	$ 91.3	$(52.1)	$42.4 (d) 0.9 (b)		$ 82.5
Claims	22.0	21.9	0.1 (b)	$23.0 (e)	21.0
Total	$113.3	$(30.2)	$43.4	$23.0	$103.5

(a) Recoveries on receivables previously written off.
(b) Foreign currency translation adjustments.
(c) Receivables written off.
(d) Net premiums written and reinsurance assumed.
(e) Death claims and insurance benefits paid.
(f) Reserves applicable to receivables purchased.
(g) Reserves of disposed operations.
(h) Tax effect of 1984 purchase accounting adjustments for business acquired.
(i) Reserves associated with transfer of real estate owned to other assets.
(j) Specific chargeoffs, recoveries and other items.

SCHEDULE X

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

SUPPLEMENTARY STATEMENT OF INCOME INFORMATION
FOR THE THREE YEARS ENDED DECEMBER 31, 1985

(All amounts are stated in millions of dollars.)

Column A Item	Column B Charged to Costs and Expenses
Year Ended December 31, 1983:	
Maintenance and repairs	$71.6
Advertising costs	41.2
Year Ended December 31, 1984:	
Maintenance and repairs	$76.8
Advertising costs	51.2
Year Ended December 31, 1985:	
Maintenance and repairs	$91.1
Advertising costs	50.6

SUPPLEMENTARY NOTE

EVENT (unaudited) SUBSEQUENT TO THE DATE OF AUDITORS' REPORT

On March 25, 1986, Household and the Dyson-Kissner-Moran Corporation ("DKM") entered into a Stock Purchase Agreement for Household to purchase from DKM and its affiliates 500,000 shares of Household's Common Stock and approximately 1.8 million shares of Household's $6.25 Preferred Stock for approximately $190 million. The per share purchase price is the average of the closing bid and asked market prices of such stock on March 20, 1986. The transaction is scheduled to close on April 1, 1986 and has been approved by each company's Board of Directors.

H 709620

FORM 10-Q

106843

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended March 31, 1986

Commission file number
1-8198

22

HOUSEHOLD INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

36-3121988
(I.R.S. Employer Identification No.)

2700 Sanders Road, Prospect Heights, Illinois 60070
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (312) 564-5000

Indicate by check mark whether the registrant (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ____

At April 30, 1986, there were 42,643,563 shares of registrant's common stock outstanding (excluding 9,133,331 shares held in treasury by Household International).

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

Part I. FINANCIAL INFORMATION

Financial Statements

Household International, Inc. and Subsidiaries
CONDENSED STATEMENTS OF INCOME

All amounts other than per share data are stated in millions of dollars.		
Three Months Ended March 31	1986	1985
NET SALES AND REVENUES		
Financial Services	$458.8	$397.5
Manufacturing	229.6	238.5
Transportation	203.1	185.8
Total net sales and revenues	891.5	821.8
COSTS AND EXPENSES		
Financial services operating expenses	217.0	190.9
Cost of manufactured products sold	173.3	175.3
Transportation operating and maintenance costs	162.0	141.7
Selling and administrative expenses	102.8	96.6
Interest expense	171.3	147.5
Total costs and expenses	826.4	752.0
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	65.1	69.8
Income taxes	20.6	27.3
INCOME FROM CONTINUING OPERATIONS	44.5	42.5
Income from discontinued operation, net of income taxes		4.0
NET INCOME	$ 44.5	$ 46.5
EARNINGS PER COMMON SHARE		
PRIMARY		
Continuing operations	$ .83	$ .72
Discontinued operation		.08
Primary	$ .83	$ .80
FULLY DILUTED		
Continuing operations	$ .81	$ .70
Discontinued operation		.08
Fully diluted	$ .81	$ .78
DIVIDENDS DECLARED PER COMMON SHARE	$.4525	$.4375

See notes to condensed financial statements.

Financial Statements (Continued)

Household International, Inc. and Subsidiaries
CONDENSED BALANCE SHEETS

All amounts are stated in millions of dollars.

	March 31, 1986	Dec. 31, 1985
ASSETS		
Cash	$ 42.7	$ 42.1
Note receivable - sale of discontinued operation		520.0
Investments in securities	1,785.1	1,619.4
Finance receivables	7,451.8	7,114.8
Trade receivables	268.0	231.6
Inventories	220.2	215.3
Revenue-earning vehicles	993.7	954.3
Properties and equipment	495.0	494.5
Cost of investments in acquired businesses in excess of net tangible assets at acquisition	217.2	218.7
Other	474.5	517.8
Total assets	$11,948.2	$11,928.5
LIABILITIES AND SHAREHOLDERS' EQUITY		
Commercial paper, bank and other borrowings	$ 2,364.8	$ 2,434.7
Customer banking deposits	1,563.2	1,376.0
Accounts payable and accrued liabilities	1,258.2	1,242.9
Insurance policy and claim reserves	974.4	895.7
Senior and senior subordinated debt (with original maturities over one year)	4,335.8	4,175.7
Total liabilities	10,496.4	10,125.0
Convertible preferred stock subject to mandatory redemption	172.4	172.6
Other shareholders' equity:		
Convertible preferred stock	3.2	3.7
Common stock	51.8	51.4
Additional paid-in capital	217.1	212.2
Retained earnings	1,502.1	1,482.8
Foreign currency translation adjustments	(120.6)	(124.3)
Unrealized gain on marketable equity securities	11.3	7.2
Common stock in treasury	(385.5)	(2.1)
Total other shareholders' equity	1,279.4	1,630.9
Total liabilities and shareholders' equity	$11,948.2	$11,928.5

See notes to condensed financial statements.

Part I. FINANCIAL INFORMATION (Continued)

1. Financial Statements (Continued)

Household International, Inc. and Subsidiaries
CONDENSED STATEMENTS OF CHANGES IN FINANCIAL POSITION

All amounts are stated in millions of dollars.		
Three months ended March 31	1986	1985
CASH AT JANUARY 1	$ 42.1	$ 47.5
CASH PROVIDED BY OPERATIONS AND RETAINED IN THE BUSINESS		
Income from continuing operations	44.5	42.5
Add (deduct) items not affecting cash:		
Provision for credit losses on finance receivables	20.4	9.9
Policyholders' future benefits	85.8	98.0
Depreciation and amortization of tangible assets	78.9	68.0
Trade receivables	(36.4)	(48.0
Inventories	(4.9)	(1.8
Accounts payable and accrued liabilities	15.3	65.9
Other	45.6	(25.2
Cash provided by continuing operations	249.2	209.3
Cash provided by discontinued operation:		
Income from discontinued operation		4.0
Other, net		3.5
Total cash provided by discontinued operation		7.5
Dividends to shareholders	(25.2)	(28.2
Cash provided by operations and retained in the business	224.0	188.6
INVESTMENTS IN OPERATIONS		
Finance receivables, net of collections	(349.7)	(166.2
Revenue-earning vehicles, net of disposals	(100.0)	(154.
Properties and equipment, net of disposals	(18.4)	(26.
Securities, net	(165.7)	(329.
Note receivable - sale of discontinued operation	520.0	
Cash (decrease) from investments in operations	(113.8)	(676.
Cash increase (decrease) before financing transactions	110.2	(488.
FINANCING TRANSACTIONS		
Commercial paper, bank and other borrowings	(69.9)	151.
Customer banking deposits	187.2	101.
Issuance of senior and senior subordinated debt	336.1	301.
Retirement of senior and senior subordinated debt	(179.6)	(64.
Purchase of treasury stock	(383.4)	
Cash increase (decrease) from financing transactions	(109.6)	490.
CASH AT MARCH 31	$ 42.7	$ 49.

See notes to condensed financial statements.

I. FINANCIAL INFORMATION (Continued)

Financial Statements (Continued)

Household International, Inc. and Subsidiaries
BUSINESS SEGMENT DATA

All amounts are stated in millions of dollars.

Three Months Ended March 31	1986	1985
NET SALES AND REVENUES		
FINANCIAL SERVICES:		
Consumer	$301.1	$252.7
Commercial	41.0	24.0
Ordinary life insurance	116.7	120.8
Total Financial Services	458.8	397.5
MANUFACTURING:		
Power components	31.4	35.6
Building products	75.1	76.7
Tools	25.2	32.4
Consumer products	58.8	57.2
Specialty products	39.1	36.6
Total Manufacturing	229.6	238.5
TRANSPORTATION	203.1	185.8
TOTAL	$891.5	$821.8
INCOME (LOSS)		
FINANCIAL SERVICES:		
Consumer	$ 23.1	$ 29.2
Commercial	11.1	9.2
Ordinary life insurance	2.0	1.7
Total Financial Services	36.2	40.1
MANUFACTURING:		
Power components	(0.1)	(1.4)
Building products	3.5	2.6
Tools		0.8
Consumer products	3.8	4.6
Specialty products	4.6	3.8
Total Manufacturing	11.8	10.4
TRANSPORTATION	1.7	5.5
CORPORATE:		
Administrative	(5.6)	(6.3)
Unallocated interest income (expense)	0.6	(11.7)
Unallocated taxes	(0.2)	4.5
Total Corporate	(5.2)	(13.5)
Income from continuing operations	44.5	42.5
Income from discontinued operation		4.0
TOTAL	$ 44.5	$ 46.5

See notes to condensed financial statements.

Financial Statements (Continued)

NOTES TO CONDENSED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Accounting policies used in the preparation of the quarterly condensed financial statements are consistent with accounting policies described in the notes to financial statements contained in the Company's 1985 Annual Report to Shareholders, except for the implementation of Statement of Financial Accounting Standards ("FAS") No. 87 "Employers' Accounting for Pensions". Purchases of the Company's common stock for treasury are recorded using the cost method. The Company's businesses are subject to seasonal factors and, accordingly, quarterly results are not necessarily indicative of results for the entire year.

2. ACCOUNTING CHANGE
Effective January 1, 1986, the Company adopted FAS No. 87 "Employers' Accounting for Pension Plans" for the Company's defined benefit pension plans. The new standard favorably affected net income by $2.7 million in the first quarter. This accounting change increased primary and fully diluted earnings per share by $.06 and $.05, respectively.

3. FINANCE RECEIVABLES
Finance receivables consisted of the following (millions of dollars):

	March 31, 1986	Dec. 31, 1985
Consumer:		
Real estate secured	$3,111.4	$2,856.0
Other	2,907.4	2,809.2
Allowance for credit losses	(164.4)	(164.6)
Unearned credit insurance premiums and claim reserves	(100.4)	(103.5)
Consumer finance receivables, net	5,754.0	5,397.1
Commercial:		
Purchased vehicle contracts	135.1	205.5
Leveraged leases	371.8	373.6
Term preferred stocks	460.[illegible]	452.0
Direct financing leases	294.4	287.4
Other	452.8	415.8
Allowance for credit losses	(17.2)	(16.6)
Commercial finance receivables, net	1,697.8	1,717.7
Finance receivables, net	$7,451.8	$7,114.8

4. INVENTORIES
Inventories consisted of the following (millions of dollars):

	March 31, 1986	Dec. 31, 1985
Finished goods	$105.1	$ 96.3
Work in process	49.0	49.1
Raw materials	66.1	69.9
Total inventories	$220.2	$215.3

Part I. FINANCIAL INFORMATION (Continued)

1. Financial Statements (Continued)

5. INCOME TAXES

Effective tax rates for the three months ended March 31, 1986 and 1985 of 31.6 percent and 39.1 percent, respectively, differ from the statutory federal income tax rate of 46 percent because of the effects of (a) purchase accounting entries relating to the charge-off of acquired loans, (b) dividends received deduction applicable to term preferred stocks, (c) investment tax credits and (d) state and local income taxes, net of federal tax benefit.

6. EARNINGS PER COMMON SHARE

Computations of earnings per share were as follows (in millions, except per share data):

Three months ended March 31	1986 Primary	1986 Fully Diluted	1985 Primary	1985 Fully Diluted
Earnings:				
Income from continuing operations	$44.5	$44.5	$42.5	$42.5
Income from discontinued operation			4.0	4.0
Preferred dividends	(5.6)		(5.9)	(5.4)
Adjusted earnings	$38.9	$44.5	$40.6	$41.1
Average shares:				
Common	46.5	46.5	50.4	50.4
Common equivalents	0.4	8.1	0.4	2.4
Total	46.9	54.6	50.8	52.8
Earnings per common share:				
Continuing operations	$ .83	$ .81	$ .72	$ .70
Discontinued operation			.08	.08
Total	$ .83	$ .81	$ .80	$ .78

Common equivalents assume exercise of stock options, if dilutive. Fully diluted earnings per share computations also assume conversion of dilutive preferred stock into common equivalents. Preferred stock is considered dilutive if its dividend rate per common share assuming conversion is less than primary earnings per share. In the first quarter of 1985, the $6.25 cumulative preferred stock was anti-dilutive.

BUSINESS SEGMENT DATA
Annuity products sold through nonaffiliated lending institutions increased significantly in 1985. Accordingly, in the fourth quarter of 1985 the Financial Services business reclassified revenues and income from these products to the ordinary life insurance segment from the consumer segment. Revenues and income from these products have been reclassified for the first quarter 1985 to conform to the current year presentation.

8. SUBSEQUENT EVENT
On March 25, 1986, Household and the Dyson-Kissner-Moran Corporation ("DKM") entered into an agreement for Household to purchase from DKM and its affiliates 500,000 shares of Household's common stock and approximately 1.8 million shares of Household's $6.25 preferred stock at the then market prices. The transaction, which was completed on April 1, was approved by each company's board of directors. The total cost of shares purchased, including fees and expenses, was approximately $191 million.

HOUSEHOLD INTERNATIONAL, INC. AND SUBSIDIARIES

Part I. FINANCIAL INFORMATION (Continued)

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

SUMMARY OF RESULTS

Sales and revenues were $891.5 million in the first quarter of 1986, an 8 percent increase over the comparable 1985 period. Income from continuing operations in the first quarter was $44.5 million, a 5 percent increase over the prior year.

During 1985, the Financial Accounting Standards Board issued new standards on employers' accounting for pensions. Household elected to implement Financial Accounting Standards ("FAS") No. 87, "Employers' Accounting for Pensions", in the first quarter of 1986. Due to the over-funded position in many of the Company's defined benefit pension plans, the effect of this accounting change increased income of the Financial Services business by $1.5 million and the Manufacturing business by $1.3 million. Transportation income was negatively affected by $.1 million and there was a minimal favorable impact at Corporate.

FINANCIAL SERVICES

Revenues from Financial Services increased 15 percent to $458.8 million. Total Financial Services' receivables at March 31, 1986 increased 35 percent to a record $7.2 billion compared with $5.3 billion at the end of the first quarter of 1985. During the first quarter of 1986, receivables increased $327.1 million or 5 percent primarily from increased consumer lending. Income from Financial Services declined 10 percent to $36.2 million primarily due to lower earnings for the consumer segment.

Consumer segment revenues increased 19 percent to $301.1 million in the first quarter, up from $252.7 million in the comparable 1985 period. Average receivables outstanding during the period increased 29 percent to $5.9 billion compared with $4.6 billion last year. U.S. consumer finance and consumer banking operations accounted for most of the increase in both revenues and receivables where increased marketing efforts and more desirable credit products have resulted in receivables growth and improved market share.

Income from the consumer segment decreased 21 percent to $23.1 million compared with $29.2 million in the comparable 1985 period. This decline was due to lower interest rate spreads and increased operating expenses. Consumer lending interest rate spreads declined to 8.9 percent in the first quarter of 1986 compared with 10.4 percent in the first quarter of 1985. The decline in spreads is a result of the higher proportion of variable rate products and a substantial increase in the relative size of Household Bank as a component of the consumer portfolio. Household Bank primarily holds lower yielding first mortgages. The overall cost of funds declined to 8.8 percent in the first quarter of 1986 compared with 9.1 percent during the comparable 1985 period reflecting generally lower market interest rates. Customer banking deposits at March 31, 1986 increased 54 percent to $1.6 billion compared with $1 billion at the end of the first quarter of 1985. Deposits increased $187.2 million or 14 percent during the first quarter of 1986 as a result of aggressive deposit gathering programs.

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

Operating expenses in the consumer finance and consumer banking operations increased $24.9 million compared with the first quarter of 1985. This planned increase was primarily due to personnel, marketing and systems expenses required to achieve and support the higher level of receivables, as well as development of the consumer banking business. Operating expenses as a percent of average receivables increased modestly to 1.8 percent, compared with 1.7 percent in the prior year.

The delinquency level increased modestly during the quarter. Net charge-off of consumer receivables was $12.2 million or .21 percent of average consumer receivables, unchanged from a year ago. The provision for credit losses was increased by approximately $6.3 million and income taxes decreased by a similar amount due to the tax effects of purchase accounting entries related to the charge-off of loans owned by savings and loan associations acquired in prior years.

Revenues from the commercial segment increased 71 percent to $41 million, up from $24 million in the first quarter of 1985. Average commercial receivables increased 61 percent to $1.4 billion compared with $896 million in 1985. Income from the commercial segment increased 21 percent to $11.1 million compared with $9.2 million. Investments in leveraged leases, preferred stocks and real estate services have increased compared with the same period a year ago. Interest rate spreads were 5.8 percent in the first quarter compared with 6.5 percent in the comparable 1985 period reflecting a changing mix of business.

Revenues from the ordinary life insurance segment decreased 3 percent to $116.7 million compared to $120.8 million in the comparable 1985 period as fewer annuity products were sold. Income from this segment increased 18 percent to $2 million from the prior year level of $1.7 million.

MANUFACTURING

Household Manufacturing's sales in the first quarter decreased 4 percent to $229.6 million compared with $238.5 million in the comparable 1985 period. The decline in sales was primarily due to the absence of divested operations. Income increased 13 percent to $11.8 million compared with $10.4 million in 1985.

Sales and income from the power components segment reflected continued weakness in markets served, particularly heavy duty truck and agricultural and drilling equipment. First quarter 1985 results were unfavorably affected by a $2.4 million charge related to the closing of the Richmond Gear facility.

Building products reported a strong increase in earnings although sales declined modestly. The earnings improvement in this segment was principally driven by manufacturing efficiencies and strong sales at Eljer Plumbingware.

Sales from the tools segment declined due to weak demand for tools in many industrial markets, the shutdown of domestic manufacturing operations at the Thorsen division which occurred in the first quarter of 1985 and the absence of revenue from the Ktrax/Newcarb division which was divested in March 1985. The decline in income for the segment was principally attributable to the decline in sales as well as lower margins at the Simonds N.A. division.

Part I. FINANCIAL INFORMATION (Continued)

Management's Discussion and Analysis of Financial Condition and Results of Operations

Sales from the consumer products segment increased modestly while income declined. The decline in income was primarily due to lower sales of Thermos' carafe products which had a particularly strong performance in the first quarter of the prior year.

The specialty products segment experienced good increases in sales and earnings for the quarter. The increases were due to higher sales levels at both the King-Seeley and Frimont divisions resulting from increased demand by manufacturers for consumer appliance controls and favorable currency exchange rates, respectively.

TRANSPORTATION
Revenues for Transportation increased 9 percent to $203.1 million in the first quarter of 1986. Income decreased 69 percent to $1.7 million compared with $5.5 million in the same period a year ago. Most of the decline was due to lower income at car rental operations. Car rental transactions, however, increased 5 percent over the 1985 level. National is beginning to benefit from some price increases that have been implemented in recent months. Insurance expense increased 53 percent in the quarter compared with a year ago. Although the used car market has improved somewhat since the beginning of the year, it is still depressed compared with the first quarter of 1985. As a result, the gain on the sale of used vehicles was about two-thirds the level of a year ago.

CORPORATE
Corporate expenses declined substantially compared with the first quarter of 1985 principally as a result of $7.6 million investment income earned on the proceeds from the 1985 sale of the Merchandising business. Cash proceeds were temporarily invested before being used in the stock repurchase program.

II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibit

(10) Household International Non-Qualified Unfunded Deferred Compensation Plan for Annual Bonus Awards, as amended.

The Registrant agrees to furnish to the Securities and Exchange Commission, upon request, a copy of each instrument defining the rights of holders of long-term debt of the Registrant and its subsidiaries (each debt issue not exceeding 10% of the total assets of the Registrant and its subsidiaries on a consolidated basis).

(b) Reports on Form 8-K

The registrant has filed a report on Form 8-K dated January 14, 1986, disclosing information under Item 5, "Other Events", and Item 7, "Financial Statements and Exhibits".

The information furnished herein reflects all adjustments which are, in the opinion of management, necessary to a fair statement of the results for the interim periods.

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.

Household International, Inc.
(Registrant)

Date: May 9, 1986

By: Gaylen N. Larson
Gaylen N. Larson, Group Vice President and Controller, Principal Accounting Officer, and on behalf of Household International, Inc.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-K

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

1986 MAR 10 PM 5:52
N.Y. STOCK EXCHANGE

For the fiscal year ended December 31, 1985 Commission File Number 1-2188

SQUARE D COMPANY
(Exact name of registrant as specified in its charter)

782

Michigan	36-2440683
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1415 South Roselle, Palatine, Illinois	60067
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (312) 397-2600

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common stock, par value $1.66-2/3	New York Stock Exchange
Common stock purchase rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

68
52

None
(Title of class)

Indicate by check mark whether the registrant (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ____

As of January 31, 1986, 28,897,019 common shares were outstanding and the aggregate market value of the common shares (based upon the closing price of these shares on the New York Stock Exchange on such date) of Square D Company held by nonaffiliates was approximately $1.268 billion.

DOCUMENTS INCORPORATED BY REFERENCE

Document	Part of Form 10-K
Portions of the Proxy Statement for Square D Company's 1986 Annual Meeting of Shareholders which will be filed with the Commission within 120 days of the close of Square D Company's fiscal year.	Part III

Index to Exhibits listed on pages 50 and 51.

SQUARE D COMPANY
INDEX TO THE ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 31, 1985

PART I

Item 1. Business

General development of business

Square D Company ("Square D") was incorporated in Michigan in 1903. As used herein, the term "Square D" includes Square D Company and its domestic and non-domestic subsidiaries.

In October, 1985, the company announced its intention to dispose of the Building Products Division. The Building Products Division manufactures wiring and signaling devices including weatherproof electrical equipment and door chimes, along with electric heating and air conditioning equipment. Plants are located in Emmaus and Allentown, Pennsylvania; Mesquite, Texas; Orting, Washington; and New York City, New York. Management anticipates the disposal of the Building Products Division will be completed during 1986.

Segment and Geographic Financial Information

Refer to the Segment and Geographic Information in Note O of Notes to Consolidated Financial Statements.

Narrative description of business

Square D has two business segments: electrical equipment and electronic products.

Electrical equipment

In its electrical equipment segment, Square D is engaged in the design, manufacture and sale of a broad range of electrical equipment which it sells in virtually every major marketing area in the world. Square D's products in this segment are primarily used in the distribution and control of electricity and can be classified generally as distribution and control equipment. Distribution equipment is used principally in distributing electricity from the end of transmission lines to points of utilization within a residential, commercial, industrial or other type of building. Products falling within this general classification include circuit breakers, safety switches, panelboards, switchboards, switchgear, busways and transformers. Control equipment controls the electricity used in the operation of power utilization devices or processes. Control equipment includes electromechanical devices and other equipment such as push-buttons, motor starters, relays, limit switches, pressure switches, vacuum switches and adjustable frequency motor controls. Square D manufactures products for use by electric utilities such as transmission, distribution and substation hardware and instrument transformers.

No class of similar products or services in the electrical equipment segment accounted for ten percent or more of consolidated net sales in any of the last three fiscal years. There has been no announcement of, or public information concerning new products or industry segments requiring the investment of a material amount of the assets of Square D, or which would otherwise be considered material to Square D's business.

Each manufacturing plant in the electrical equipment segment designs and produces a single device or a small number of devices and, in essence, there is no duplication of devices at the various manufacturing locations. The principal raw materials purchased are steel, copper, aluminum and silver, as well as ingredients used in the production of molded plastic parts. Principal parts purchased include a wide variety of electronic and other component parts. Generally, raw materials and parts are available from various sources so that Square D is not dependent on particular suppliers. In addition to manufacturing plants, regional assembly plants are strategically located to assemble basic components and products into engineered assemblies designed to meet specific customer or job requirements. The assembly plants are involved in custom engineering, construction of the framework or sheet metal, wiring, busing and assembly and testing of the basic products and components for the customer's order.

Square D's Distribution System warehouses, redistributes and delivers substantially all products from the plants to the customers. The Distribution System consists of a central warehouse and strategically located redistribution warehouses which store and ship Square D's products to customers in their designated service areas.

The Marketing organization establishes marketing, sales and pricing policies and is responsible for all sales and marketing functions such as direct sales, advertising, promotional programs, etc. The sales organization consists of field engineers and other sales personnel employed by Square D. Most of the field engineers are graduate engineers and they are responsible for the marketing of products produced by Square D. These technical sales representatives maintain customer contact, call on prospects, introduce new products and assist customers with the layout or design of distribution and control systems. This sales organization is supported by technical product specialists and customer service personnel. In addition, Square D also engages a few independent sales agents to sell certain products.

In this segment, Square D utilizes a network of independent electrical distributors, or wholesalers, to market its products. Square D also makes some sales directly to industrials, utilities, original equipment manufacturers and some large retailers. The network of authorized distributors consists of individual distributors which are selected by Square D to provide service to all classes of trade, including contractors, utilities, industrials and original equipment manufacturers. These authorized distributors may be individual houses, local multi-house or national multi-house operations.

Within the Square D network of independent electrical distributors are a group of houses under the control of Graybar Electric Company, Inc., which accounted for approximately ten percent of the 1985 net sales of Square D. Each distributor house in the Square D authorized network is considered a separate operation, capable of providing full sales coverage in its designated area of operation. Each distributor must qualify, under Square D requirements, independently from any parent company or multi-house affiliation. No other single customer or group of customers account for a significant portion of this segment's revenues.

As of December 31, 1985, the electrical equipment backlog was $141.1 million, compared with $128.7 million as of December 31, 1984.. It is anticipated that substantially all of these orders should be filled within the current year.

The electrical industry in which Square D participates is highly competitive. All of the principal methods of competition including pricing, promotion, product quality, product availability, service, company reputation and personal selling are to some extent considered important to Square D's success. Square D has traditionally maintained a strong competitive position in terms of all of these factors.

The electrical industry consists of thousands of individual firms engaged in the manufacture and sale of electrical equipment of one kind or another. They range in size from the very small specialty manufacturers to large diversified corporations. Square D encounters direct competition from many of these companies while almost all of them are potential competitors. In its United States markets, substantial competition is encountered mainly from domestic companies, while in international markets, substantial competition emanates from both domestic and non-domestic manufacturers.

Electronic products

The electronic products segment consists primarily of the manufacture and sale of electrodeposited copper foil, power conditioning equipment and semiconductor devices. Other products in this segment include programmable controllers, infrared radiation thermometers and pyrometers, computerized control and data gathering systems, industrial assembly robots, snap dome switches, emergency lighting equipment and other electronic devices.

Square D is one of three major suppliers of electrodeposited copper foil to the world market. While industry statistics are not published, Square D believes that, together with its Japanese affiliate, it supplies about forty percent of the world market for electrodeposited copper foil. Gould, Inc. and Oake Mitsui are the principal worldwide competitors of Square D.

The principal raw material used in manufacturing electrodeposited copper foil is scrap copper, a widely traded commodity, which is purchased principally from scrap metal dealers. Typically, there is no difficulty in obtaining scrap copper as needed and, therefore, large inventories of raw materials are generally not maintained.

Virtually, all of the electrodeposited copper foil produced is used in the manufacture of printed circuits for electronic and electrical applications. The electrodeposited copper foil is sold to laminators who bond the foil to various types of substrates, both rigid and flexible, which provide the surface upon which electronic components are mounted.

There are approximately one hundred twenty-five manufacturers of copper clad laminates in the world, of which less than fifty can be considered significant in terms of their market share of printed circuit laminate production. As a result of the relatively small customer base, Square D operates without an extensive sales and marketing force. No outside sales representatives or agents are used by Square D.

The manufacture of electrodeposited copper foil, as well as the design and construction of related machinery and manufacturing facilities, is the product of a considerable amount of proprietary "know-how" and specially developed skills. Process developments, product enhancements and design improvements are safeguarded by patents or as proprietary trade secrets.

Square D also manufactures and markets a broad line of power conditioning equipment which protects computers and other sensitive devices from errors and damage caused by disturbances on electrical power systems. Products include Ultra-Isolators which protect against power-line noise, Power Conditioners which protect against brownouts and other variations in voltage as well as power-line noise, and Uninterruptible Power Systems which, in addition to protecting against the disturbances referred to above, protect against blackouts.

The principal markets for power conditioning equipment are original equipment manufacturers and users of computer and computer peripheral equipment, process control equipment, instruments and communications equipment. Market conditions in the industry continue to be influenced by aggressive competition. All raw materials used in the manufacture of power conditioning equipment are available from several sources.

Square D also manufactures and markets semiconductor devices used in various electronic circuits. A semiconductor device controls the passage of electronic signals. The products are used primarily to control or divert the flow of electrical energy and find application in the telecommunications, computer, aerospace and automotive industries.

Square D's principal semiconductor product lines are in a highly competitive market. The key raw materials and components used in the manufacture of semiconductor devices are silicon wafers, processed piece parts, and various types of metals. All materials and components are available from several national suppliers.

The electronic product backlog as of December 31, 1985 was $27.3 million compared to $32.8 million as of December 31, 1984. It is anticipated that substantially all of these orders should be filled within the current year.

No class of similar products or services in the electronic products segment accounted for ten percent or more of consolidated net sales in any of the last three fiscal years. There has been no announcement of, or public

information concerning new products or industry segments requiring the investment of a material amount of the assets of Square D, or which would otherwise be considered material to Square D's business.

There is no single customer or group of customers, the loss of any one of which would have an adverse effect on the electronic products segment.

Both of Square D's business segments own a number of patents in the United States and other countries. No one patent or group of patents is critical to either segment or to the success of the business as a whole.

Square D owns and uses a number of trademarks. Although the "D in a Square" trademark is important to the business as a whole, there is no likelihood of Square D losing its rights in that trademark because of its long period of continuous and extensive use.

Square D has a small number of licenses involving patents which are not critical to the business as a whole.

There is no significant seasonal nature to either segment of the business.

No material portion of the business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of the government.

Research and development

All research and development activities are sponsored by Square D. Research and development costs were $41,394,000, $40,049,000 and $34,941,000 in 1985, 1984 and 1983, respectively.

Protection of the environment

Compliance with federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, has had no, and is not expected to have any, material effects upon Square D's capital expenditures, earnings or competitive position.

Employees

Square D employs approximately 21,500 persons, worldwide.

Item 2. Properties

Square D operates 43 manufacturing plants in 41 cities within the United States and 29 manufacturing plants in 14 foreign countries.

Manufacturing Space
(Amounts in Square Feet)

	Owned	Leased	Total
Electrical	7,377,000	283,000	7,660,000
Electronic	1,673,000	235,000	1,908,000
	9,050,000	518,000	9,568,000

In addition to the foregoing facilities, Square D also owns and leases some office and warehouse space. Most leases are on a short-term basis and no one lease is considered material.

Square D believes that all of its properties are in good operating condition. Most are modern single story plants.

Item 3. Legal Proceedings

None

Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the three months ended December 31, 1985.

Executive Officers of the Registrant

Name	Current Position	Age at 12-31-85	Has Served in Current Position Since
D. L. Knauss*	Chairman of the Board, President and Chief Executive Officer	57	1983
R. E. King*	President - Electrical Group	62	1983
D. E. Wilson*	Vice President - Finance, Secretary and Chief Financial Officer	61	1974
C. W. Denny	Vice President - Operations	50	1985
D. S. Free	Treasurer and Assistant Secretary	48	1975
R. A. Hegeman	Vice President - Marketing	60	1983
E. A. Kemper	Vice President - Corporate Planning and Assistant Secretary	56	1982
W. W. Kurczewski	Vice President - General Counsel	42	1985
J. F. LaShorne	Controller, Chief Accounting Officer and Assistant Secretary	60	1975
G. E. Myers	Vice President - Electronic Components and Materials Group	45	1985
[illegible] E. Quentel III	Vice President - Engineering and Quality Assurance	58	1984
R. A. Sackett	Vice President - Operations	55	1985
J. M. Yetts	Vice President - Personnel Relations	56	1974
J. Vikmanis	Vice President - Electronic Systems Group	48	1985

*Indicates Director

None of the above executive officers has a family relationship with any other executive officer, any director or person chosen by the Registrant to become a director or executive officer. All of the executive officers except Mr. Knauss, Mr. Kurczewski, Mr. Myers and Mr. Vikmanis have been employed by the Company in their present or other managerial and executive capacities for more than five years. Prior to his employment by the Company, Mr. Knauss had been President of General Semiconductor Industries, Inc. (GSI) for over five years. GSI was acquired by Square D in January, 1981. For over five years, Mr. Kurczewski was employed by Estech, Inc., a subsidiary of Esmark, Inc. which is now owned by Beatrice Companies, Inc. He served in several positions as Vice President and director from 1982 to 1984, most recently Vice President - Law and Administration. Prior to serving as Vice President, he held the position of Assistant General Counsel. Mr. Myers had been employed with GSI for over five years prior to the acquisition of GSI by Square D. Mr. Myers had served in several positions with GSI, and held the position of Vice President - Transistor Products at the time of the acquisition. For over five years, Mr. Vikmanis was employed by Bendix Corporation. He served in several positions as Vice President from 1981 to 1984, most recently Vice President and General Manager - Material Handling and Robotics Division.

Executive Officers of the Registrant (Continued)

Officers are either elected by the Registrant's Board of Directors or appointed by the Registrant's Board of Directors or Chairman of the Board. Officers elected or appointed by the Board shall hold office at the pleasure of the Board. Officers appointed by the Chairman of the Board shall hold office at the pleasure of the Chairman of the Board. Any officer elected or appointed by the Board of Directors may be removed at any time, with or without cause, by the affirmative vote of a majority of the whole Board of Directors.

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

Square D Company's common stock is traded on the New York Stock Exchange. The high and low sales prices, on the Composite Tape, by quarter for 1985 and 1984 were:

	1985		1984	
	High	Low	High	Low
First Quarter	$ 43.625	$ 35.875	$ 41.500	$ 33.750
Second Quarter	40.375	35.500	39.000	31.125
Third Quarter	40.250	35.125	39.250	31.875
Fourth Quarter	43.125	35.125	40.875	35.625

A dividend of $.46 per share has been declared and paid in each quarter of 1985 and 1984. The number of shareholders of the Company's common stock as of January 31, 1986, was approximately 12,800. See Note H of Notes to Consolidated Financial Statements for information regarding dividend payment restrictions.

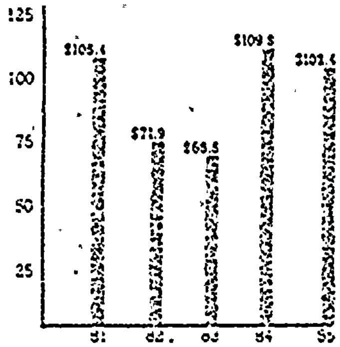
Item 6: SELECTED FINANCIAL DATA
(Amounts in thousands, except per share)

	1985	1984	1983	1982	1981
SUMMARY OF OPERATIONS					
Net sales	$1,348,114	$1,310,126	$1,093,931	$1,013,997	$1,107,361
Cost of products sold	894,036	852,571	737,865	706,970	721,674
Selling, administrative and general expenses	259,560	244,025	220,599	174,574	178,069
Non-operating income	12,893	12,716	18,482	6,348	12,512
Interest expense	24,363	28,467	24,341	19,315	18,331
Earnings from continuing operations before income taxes	182,548	197,779	129,608	119,486	201,799
Provision for income taxes	80,110	88,021	63,088	47,630	96,381
Earnings from continuing operations	102,438	109,758	66,520	71,856	105,418
Loss from discontinued operations, net of taxes	(15,250)	(3,605)	(3,609)	(156)	(1,736)
Net earnings	87,188	106,153	62,911	71,700	103,682
FINANCIAL INFORMATION					
Working capital	$ 253,225	$ 239,176	$ 212,885	$ 203,433	$ 219,773
Property, plant and equipment	473,503	418,729	393,128	356,654	338,258
Total assets	1,103,129	1,021,130	945,018	804,762	817,421
Long-term debt	134,954	170,304	176,326	109,099	100,542
Shareholders' equity	606,139	551,163	505,970	478,697	476,392
Capital expenditures	87,619	68,969	69,548	62,595	65,618
Depreciation and amortization from continuing operations	45,810	40,943	37,708	30,211	29,414
SHARE DATA					
Earnings per share:					
Continuing operations	$ 3.55	$ 3.83	$ 2.35	$ 2.61	$ 3.83
Discontinued operations	(.53)	(.12)	(.13)	-	(.06)
Net earnings	3.02	3.71	2.22	2.61	3.77
Weighted average shares outstanding	28,235	28,545	28,363	27,502	27,484
Cash dividends per share	$ 1.84	$ 1.84	$ 1.84	$ 1.84	$ 1.735
Shares outstanding at December 31	28,364	28,746	28,589	27,640	27,490
Shareholders' equity per share	$ 21.00	$ 19.17	$ 17.70	$ 17.32	$ 17.33
KEY FINANCIAL RELATIONSHIPS					
Gross profit from continuing operations	33.7%	34.9%	32.5%	30.3%	34.8%
Current ratio	2.0:1	2.0:1	2.0:1	2.2:1	2.1:1
Average debt to average equity	41.5%	41.8%	38.7%	32.2%	35.8%
Average long-term debt to average total capitalization	20.5%	22.8%	22.8%	20.0%	21.5%
Return from continuing operations on average equity	17.7%	20.6%	13.2%	15.1%	23.5%

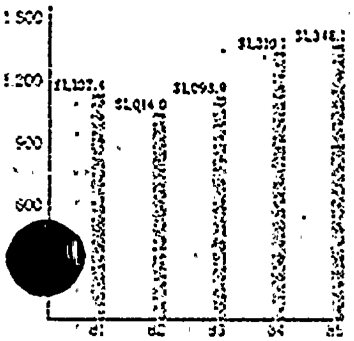
All financial and share data relating to earnings for the periods prior to 1985 have been restated for discontinued operations (Note C). Net earnings for 1982 include $2,260, or $.08 per share, for the adoption of SFAS No. 52 on Foreign Currency Translation. All financial data for 1981 have been restated for the pooling of interests transaction relating to the acquisition of Ircon.

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

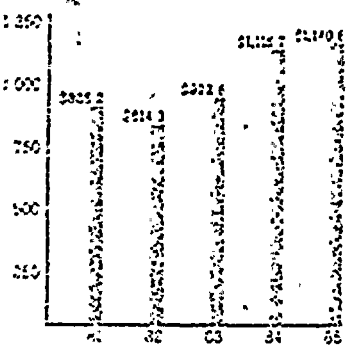
Earnings from Continuing Operations
in millions of dollars



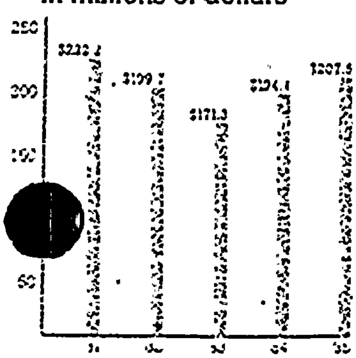
Consolidated Sales
in millions of dollars



United States Sales
in millions of dollars



International Sales
in millions of dollars



Results of Operations

Consolidated Results As part of an overall objective to focus on historically profitable operations, the Company announced in 1985 its intention to dispose of the Building Products Division. As a result, this division has been classified as a discontinued operation. Results of operations and related statistics for years prior to 1985, discussed below, have been restated to reflect continuing operations, unless otherwise stated. Additional information regarding discontinued operations is presented in Note C to the Consolidated Financial Statements.

The Company's net sales increased $38.0 million in 1985 to $1.348 billion from the previous record level of $1.310 billion in 1984 and the sales level of $1.094 billion in 1983. Earnings from continuing operations for 1985 declined 6.7 percent to $102.4 million from the record mark of $109.8 million achieved in 1984. Economic pressures of an overall recession within the electronics industry and highly competitive pricing within the electrical equipment markets restrained both sales and earnings in 1985. Earnings from continuing operations were further reduced by the impact of lower production levels despite cost reduction and expense control efforts. Net earnings of $87.2 million in 1985 included a reduction of $15.2 million, or fifty-three cents per share, attributable to discontinued operations. This reduction is the combination of a net provision for the loss on disposal of $11.5 million, or forty cents per share, recorded in the fourth quarter, and a current year loss from discontinued operations of $3.7 million, or thirteen cents per share. The loss from discontinued operations was $3.6 million in both 1984 and 1983. Net earnings in 1984 and 1983 were $106.2 million and $62.9 million, respectively.

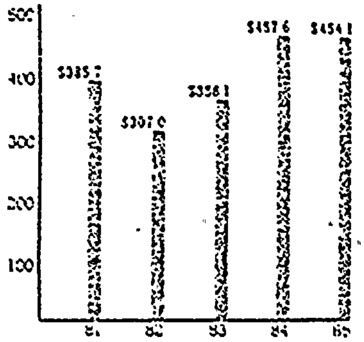
The United States operations reported an increase in net sales of $24.9 million in 1985. Net price increases of approximately $12.6 million and volume increases of approximately $8.0 million accounted for the majority of this increase. The remaining increase in sales resulted from the Company's 1984 acquisition. Increased volume of approximately $173.6 million and price increases of approximately $19.4 million accounted for the increase in sales from 1983 to 1984.

Net sales of the Company's international operations increased $13.1 million in 1985 and $23.2 million in 1984, an increase of 21.1 percent over the two year period. This growth rate is reflected in volume increases of approximately $19.4 million and $26.6 million in 1985 and 1984, respectively; and price increases of approximately $14.8 million in 1985 and $17.7 million in 1984. However, the strength of the U.S. dollar against foreign currencies resulted in lower exchange rates being used to translate the foreign currency amounts into U.S. dollars which reduced international sales by approximately $21.1 million in both 1985 and 1984.

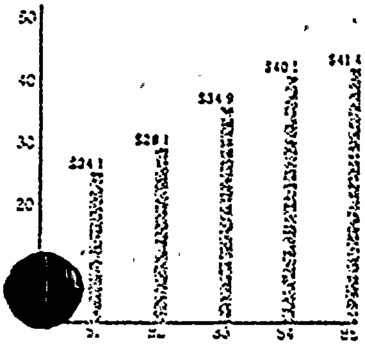
The gross profit margin attained in 1985 was 33.7 percent, compared to 34.9 percent in 1984 and 32.5 percent in 1983.

The Company's continued emphasis on the application of new technologies and new product development resulted in an increase in research and development expense of 3.4 percent over 1984 and 18.5 percent over 1983. The Company's commitment to research and development is reflected in the consistent relationship of research and development expense as a percent of sales. Research and development expense as a percent of sales was 3.1 percent in both 1985 and 1984 and 3.2 percent in 1983.

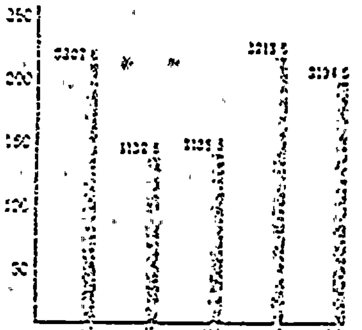
Gross Profit
in millions of dollars



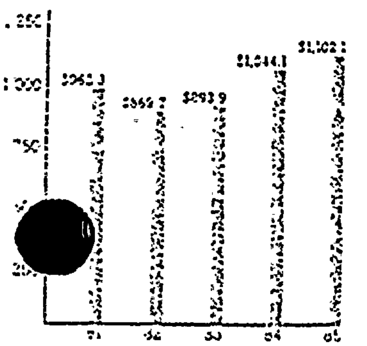
Research and Development
in millions of dollars



Operating Earnings
in millions of dollars



Electrical Sales
in millions of dollars



Selling, administrative and general expenses increased a moderate 6.4 percent in 1985, compared to an increase of 10.6 percent in 1984. Sales and marketing expenditures increased proportionately to the increase in sales in both years.

Non-operating income decreased $5.8 million from 1983 to 1984 and increased $.2 million from 1984 to 1985. Non-operating income in 1983 was higher than both 1984 and 1985 due to a gain on sale of property of $5.0 million in 1983.

Lower interest rates during 1985 were the major factor contributing to the decrease in interest expense of $3.6 million, or 12.7 percent from 1984.

The effective tax rate of 43.9 percent in 1985 was slightly lower than the effective tax rate of 44.5 percent in 1984, and 4.8 percentage points less than the 1983 rate of 48.7 percent. The variance between the 1985 and 1983 effective tax rates is due primarily to the effect of foreign translation adjustments caused by the Mexican peso devaluation in prior years.

The Company achieved a return on sales from continuing operations of 7.6 percent in 1985, 8.4 percent in 1984, and 6.1 percent in 1983. The reduction in return on sales from 1984 is due to the factors mentioned above.

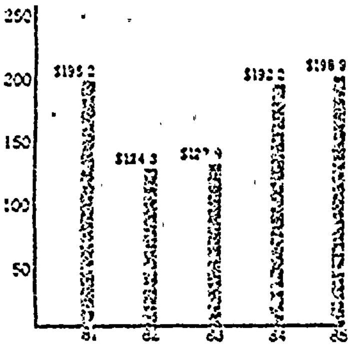
Electrical Equipment Segment The electrical equipment segment of the business experienced a year of moderate growth after a substantial gain in 1984. Current year sales increased $58.0 million compared to a 1984 increase of $150.2 million. Sales reported by the United States operations within this segment were $948.7 million in 1985 compared to $904.0 million in 1984 and $762.2 million in 1983. United States sales realized price increases in 1985 of approximately 1.8 percent, as severe price competition limited price increases. Sales volume of the United States operations increased approximately $24.2 million over 1984. The Company's 1984 acquisition contributed $4.3 million to 1985 sales.

International sales within this segment were $153.5 million, an increase of $13.4 million, or 9.5 percent, over 1984. Increased volume in local currencies of approximately $20.6 million and price increases of approximately $11.3 million were partially offset by the $18.5 million effect of lower exchange rates.

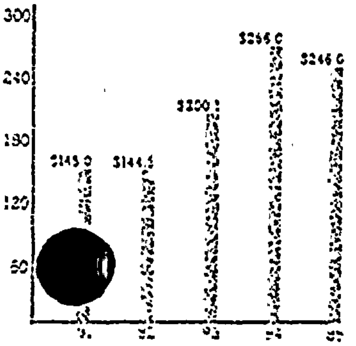
Expense controls and increased sales volume offset the negative income effect of competitive pressures within the marketplace and decreased production levels, as operating earnings of the electrical segment increased from $192.2 million in 1984 to $198.9 million in 1985. Selling, administrative and general expenses remained at approximately the same level as 1984. Operating earnings, as a percent of sales, were 18.0 percent in 1985 compared to 18.4 percent in 1984.

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

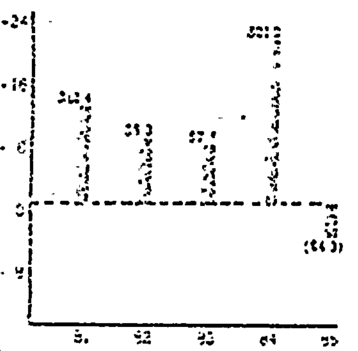
Electrical Operating Earnings
in millions of dollars



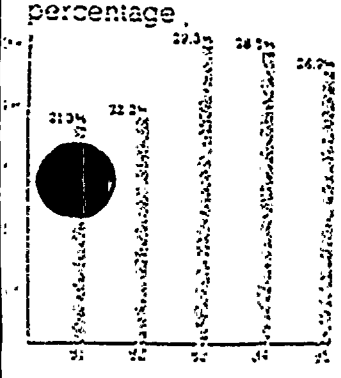
Electronic Sales
in millions of dollars



Electronic Operating Earnings
in millions of dollars



Total Debt to Total Capitalization
percentage



Electronic Products Segment The severe recession in the electronics industry depressed both sales and operating earnings of the electronic products segment in 1985. As a result, sales declined from the record level of $266.0 million in 1984 to $246.0 million in 1985, but remained above the 1983 level of $200.1 million. Decreased volume accounted for 86.3 percent of the total decrease in 1985 sales. The reduction in sales volume was the sharpest in the copper foil and semiconductor operations of the segment. However, the entire segment experienced intense price competition. The industry downturn had a much greater impact on the domestic markets than on the international markets, as international sales within the segment maintained approximately the same level as in 1984, despite lower exchange rates. The electronic segment accounted for 18.2 percent of 1985 consolidated sales, compared to 20.3 percent in 1984, and 18.3 percent in 1983.

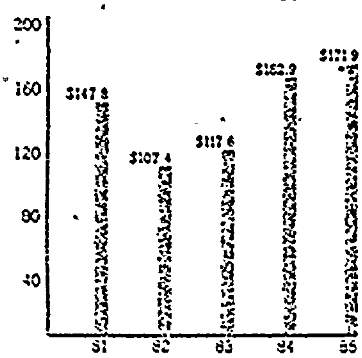
Lower production volume and increased selling, administrative and general expenses as a percentage of sales were the major reasons for the $4.3 million operating loss recorded by the electronic products segment in 1985. Operating earnings of the electronic segment were $21.2 million and $7.5 million in 1984 and 1983, respectively.

Financial Condition

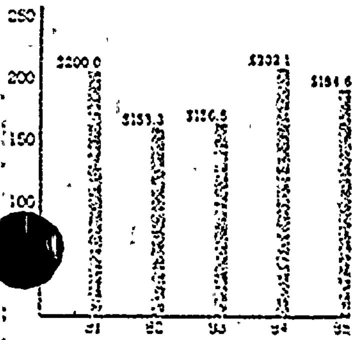
The Company's financial position continues to be strong with respect to both solvency and liquidity. On December 1, 1985, in order to take advantage of favorable market conditions, the Company sold the first public debt in its history, which was rated Aa/AA by principal rating agencies. This issue of $75.0 million of ten percent 10 year Notes was used by the Company to replace substantially all of its commercial paper outstanding, which prior to this debt issuance averaged $97.3 million in 1985. At December 31, 1985, commercial paper outstanding was $4.0 million. However, the average commercial paper outstanding during 1986 is anticipated to be in excess of the 1985 ending balance. At December 31, 1984, the Company had $88.3 million of commercial paper outstanding, of which $80.0 million was classified as long-term debt. The Company has the highest possible commercial paper rating of A1+/P1.

The Company's total debt outstanding at December 31, 1985 was relatively unchanged from 1984 year end. However, with the issuance of the long-term Notes, the Company's exposure to adverse changes in interest rates was considerably reduced. The ratio of total debt to total capitalization for 1985 was 26.9 percent, as compared to 28.3 percent in 1984, reflecting an increase in equity through earnings and relatively stable debt levels. The Company's working capital position remained strong, with a current ratio of 2.0 to 1 in each of the past three years

Funds Provided from Continuing Operations
in millions of dollars



Inventory
in millions of dollars



Funds provided from continuing operations were $171.9 million in 1985. The lower levels of inventory maintained by the Company in 1985 contributed to the increase in funds. Increased levels of receivables and prepaid expenses in 1985 reduced funds provided from operations.

Net trade receivables increased 8.4 percent in 1985, reflecting the steady growth in sales. The number of day's sales outstanding for total operations increased from 51.0 in 1984, to 53.2 in 1985, partially due to programs offering extended payment terms.

Prepaid expenses increased $30.9 million in 1985, almost entirely due to a $29.7 million prepayment to the Company's Group Health Insurance Trust.

Funds used for capital expenditures, excluding discontinued operations, totalled $86.4 million in 1985, an increase of 27.6 percent over 1984. Spending within the electronic products segment increased 58.9 percent from 1983 to 1985, to $34.6 million, reflecting the Company's expansion in this segment. The Company has projected a slight decrease in capital spending for 1986. As part of the Company's strategy, it continues to investigate acquisition candidates. Businesses acquired during the past three years are discussed in Note B to the Consolidated Financial Statements.

The Company has short-term lines of credit available from various financial institutions. At December 31, 1985, short-term credit lines available for use consisted of $110.5 million from domestic banks and $25.9 million from international banks. The Company also has $50.0 million available through revolving credit/term loan agreements. On December 31, 1985, no borrowings were outstanding under this agreement nor under the Company's short-term credit lines.

Effects of Inflation

Information on the effects of inflation on the Company's financial results is presented in the Supplementary Information on Changing Prices.

Item 8. Financial Statements and Supplementary Data

Financial statements listed in the index contained in Item 14(a) are filed in response to this Item.

Item 9. Disagreements on Accounting and Financial Disclosure

None

Item 10. Directors and Executive Officers of the Registrant

The information required by this Item is hereby incorporated by reference from the Company's definitive Proxy Statement for its 1986 Annual Meeting of Shareholders to be filed with the Commission within 120 days after the end of the fiscal year covered by this Annual Report.

Item 11. Executive Compensation

The information required by this Item is hereby incorporated by reference from the Company's definitive Proxy Statement for its 1986 Annual Meeting of Shareholders to be filed with the Commission within 120 days after the end of the fiscal year covered by this Annual Report.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information required by this Item is hereby incorporated by reference from the Company's definitive Proxy Statement for its 1986 Annual Meeting of Shareholders to be filed with the Commission within 120 days after the end of the fiscal year covered by this Annual Report.

Item 13. Certain Relationships and Related Transactions

The information required by this Item is hereby incorporated by reference from the Company's definitive Proxy Statement for its 1986 Annual Meeting of Shareholders to be filed with the Commission within 120 days after the end of the fiscal year covered by this Annual Report.

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) 1. Financial Statements

Report of Independent Accountants

Consolidated Statements of Net Earnings - years ended December 31, 1985, 1984 and 1983

Consolidated Balance Sheets - December 31, 1985 and 1984

Consolidated Statements of Changes in Financial Position - years ended December 31, 1985, 1984 and 1983

Consolidated Statements of Shareholders' Equity - years ended December 31, 1985, 1984 and 1983

Notes to Consolidated Financial Statements

Selected Quarterly Financial Data

Supplementary Information on Changing Prices

2. Financial Statement Schedules

Schedule V - Property, Plant and Equipment

Schedule VI - Accumulated Depreciation and Amortization of Property, Plant and Equipment

Schedule VIII - Valuation and Qualifying Accounts

Schedule IX - Short-Term Borrowings

All other schedules are omitted because they are inapplicable, not required under the instructions, or the information is included in the financial statements or notes thereto.

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K (Continued)

Separate financial statements for the Registrant's unconsolidated affiliated companies, accounted for by the equity method, have been omitted because they do not constitute significant subsidiaries.

3. EXHIBITS

Exhibit Number

3. (A) Restated Articles of Incorporation of Square D Company as amended to date [Incorporated by reference to Exhibit 3 to the 1980 Annual Report on Form 10-K (File No. 1-2188)]

3. (B) By-laws of Square D Company as amended to date [Incorporated by reference to Exhibit 19 of the Form 10-Q for the quarter ended September 30, 1984 (File No. 1-2188)]

4. (A) Credit Agreement with National Bank of Detroit, dated as of August 1, 1982 [Incorporated by reference to Exhibit 4(A) to the 1982 Annual Report on Form 10-K (File No. 1-2188)]

4. (B) Note Agreement dated November 1, 1974, as amended, re: 10 3/8% Senior Notes due 1999 [Incorporated by reference to Exhibit 4(B) to the 1984 Annual Report on Form 10-K (File No. 1-2188)]

4. (C) Note Agreement, dated December 1, 1978, re: 9.20% First Mortgage Notes [Incorporated by reference to Exhibit 4(C) to the 1980 Annual Report on Form 10-K (File No. 1-2188)]

4. (D) Indenture, dated as of December 1, 1985, between Square D Company and Continental Illinois National Bank and Trust Company of Chicago, as Trustee [Incorporated by reference to Exhibit 4.1 to Amendment No. 1 to Form S-3 Registration Statement No. 33-1615]

4. (E) First Supplemental Indenture, dated as of December 1, 1985, between Square D Company and Continental Illinois National Bank and Trust Company of Chicago, as Trustee [Incorporated by reference to Exhibit 4.2 to Amendment No. 1 to Form S-3 Registration Statement No. 33-1615]

4. (F) Miscellaneous long-term debt agreements with banks and other creditors*

4. (G) Miscellaneous industrial development bond long-term debt issues*

4. (H) Rights agreement, dated as of January 7, 1986, between Square D Company and Morgan Guaranty Trust Company of New York [Incorporated by reference to Exhibit 1 to the Current Report on Form 8-K for January 23, 1986]

10. (A) Square D Company's 1975 Employees' Stock Option Plan, as amended [Incorporated by reference to Exhibit 10(B) to the 1980 Annual Report on Form 10-K (File No. 1-2188)]

10. (B) Stock Appreciation Rights Plan [Incorporated by reference to Exhibit 1 of Square D Company's Registration Statement on Form S-8 (File No. 2-61469)]

10. (C) Corporate Incentive Compensation Plan, dated December 1, 1980 as amended to date

10. (D) Director's Retirement Income Program, dated September 8, 1982, as amended to date [Incorporated by reference to Exhibit 10(D) to the 1984 Annual Report on Form 10-K (File No. 1-2188)].

10. (E) Post-Retirement Life Insurance Coverage for Officers dated January 3, 1985 [Incorporated by reference to Exhibit 10(E) to the 1984 Annual Report on Form 10-K (File No. 1-2188)]

10. (F) 1985 Master Stock Compensation Plan dated January 3, 1985 [Incorporated by reference to Exhibit 10(F) to the 1984 Annual Report on Form 10-K (File No. 1-2188)]

10. (G) Employment agreement between Dalton L. Knauss and Square D Company [Incorporated by reference to Exhibit 10(G) to the 1983 Annual Report on Form 10-K (File No. 1-2188)]

10. (H) Supplemental Retirement Plan, dated January 3, 1985, as amended to date

11. Computation of Earnings Per Share

22. Subsidiaries of the Registrant

* These instruments are not being filed as exhibits herewith because none of the long-term debt instruments authorizes the issuance of debt in excess of ten percent of the total assets of Square D Company and its subsidiaries on a consolidated basis. Square D agrees to furnish a copy of each such agreement to the Securities and Exchange Commission upon request.

(b) 1. Reports on Form 8-K

No reports on Form 8-K were filed for the three months ended December 31, 1985.

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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.

SQUARE D COMPANY (Registrant)

By ______________________
D. L. Knauss
Chairman of the Board,
Chief Executive Officer
and Director (Principal
Executive Officer)

By ______________________
D. E. Wilson
Vice President - Finance,
Secretary, Chief Financial
Officer and Director
(Principal Financial
Officer)

By ______________________
J. F. LaShorne
Controller, Chief Accounting
Officer and Assistant Secretary
(Principal Accounting Officer)

DATE: March 10, 1986

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in their capacity as a Director of Square D on March 10, 1986.

Signature

M. L. Bessen

D. C. Clark

R. F. Froehlke

H. E. Hosley, Jr.

R. E. King

S. B. Lunar

D. B. Meeker

G. H. Moede, Jr.

F. J. Morgan

E. F. Mulligan

J. B. Schwemm

REPORT OF INDEPENDENT ACCOUNTANTS

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS
SQUARE D COMPANY
PALATINE, ILLINOIS

We have examined the consolidated balance sheets of Square D Company and subsidiaries as of December 31, 1985 and 1984, and the related consolidated statements of net earnings, shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Square D Company and subsidiaries at December 31, 1985 and 1984, and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Our examinations also comprehended the schedules listed in the Index at Item 14(a)2. In our opinion, such schedules, when considered in relation to the basic financial statements, present fairly in all material respects the information shown therein.

Chicago, Illinois

January 23, 1986

CONSENT OF INDEPENDENT ACCOUNTANTS

We consent to the incorporation by reference in the Registration Statements (Form S-8, File Nos. 2-78880, 2-83550 and 2-98402; Form S-3, File Nos. 2-88533 and 2-95987) of Square D Company of our report, dated January 23, 1986, on the examinations of the consolidated financial statements of Square D Company and subsidiaries as of December 31, 1985 and 1984 and for each of the three years in the period ended December 31, 1985 contained in the Annual Report on Form 10-K of Square D Company for the year ended December 31, 1985.

Chicago, Illinois

March 10, 1986

CONSOLIDATED STATEMENTS OF NET EARNINGS
(Amounts in thousands, except per share)

	Year Ended December 31 1985	1984	1983
Net Sales	$1,348,114	$1,310,126	$1,093,931
Costs and Expenses:			
Cost of products sold	894,036	852,571	737,865
Selling, administrative and general	259,560	244,025	220,599
Operating Earnings	194,518	213,530	135,467
Non-operating income (Note J)	12,893	12,716	18,482
Interest expense	(24,863)	(28,467)	(24,341)
Earnings from Continuing Operations before Income Taxes	182,548	197,779	129,608
Provision for Income Taxes (Note I)	80,110	88,021	63,088
Earnings from Continuing Operations	102,438	109,758	66,520
Discontinued Operations (Note C):			
Loss from operations, net of income tax benefit (1985 - $3,309; 1984 - $3,249; 1983 - $3,248)	(3,666)	(3,605)	(3,609)
Provision for loss on disposal, net of income tax benefit $11,584	(11,584)	-	-
Loss from Discontinued Operations	(15,250)	(3,605)	(3,609)
Net Earnings	$ 87,188	$ 106,153	$ 62,911
Earnings per share based on weighted average number of shares outstanding during the year:			
Continuing operations	$ 3.55	$ 3.83	$ 2.35
Discontinued operations	(.53)	(.12)	(.13)
Net earnings	$ 3.02	$ 3.71	$ 2.22
Weighted average number of common shares outstanding	28,835	28,645	28,363

See accompanying notes to consolidated financial statements

CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share)

	December 31 1985	December 31 1984
Assets		
Current Assets:		
Cash and cash equivalents (Note D)	$ 27,025	$ 35,768
Short-term investments	21,774	33,650
Receivables, less allowances (1985 - $10,640; 1984 - $8,352)	228,554	202,341
Inventories (Note E)	184,649	202,077
Insurance and other prepaid expenses	37,795	6,937
Total Current Assets	499,797	480,773
Investments in Affiliates	24,438	11,830
Property, Plant and Equipment, at cost:		
Land	25,243	23,028
Buildings and land improvements	234,647	213,597
Equipment	465,553	395,199
	725,443	631,824
Less accumulated depreciation	251,940	213,095
	473,503	418,729
Other Assets	13,734	15,058
Excess of Purchase Price Over Net Assets of Businesses Acquired	91,657	94,740
	$1,103,129	$1,021,130
Liabilities and Shareholders' Equity		
Current Liabilities:		
Short-term debt (Note H)	$ 25,627	$ 40,555
Current maturities of long-term debt	12,427	12,259
Accounts payable and accrued expenses (Note G)	173,887	166,743
Income taxes	15,546	7,638
Dividend payable	13,277	13,224
Deferred income taxes	5,803	1,178
Total Current Liabilities	246,572	241,597
Long-Term Debt (Note H)	184,954	170,304
Deferred Income Taxes	65,464	57,812
Minority Interest in Subsidiaries	-	254
Shareholders' Equity:		
Preferred stock, no par value, authorized 6,000,000 shares, none issued	-	-
Common stock, par value $1.66 2/3, authorized 50,000,000 shares, issued and outstanding 28,863,760 shares at December 31, 1985 (Notes H and K)	48,106	47,914
Additional paid-in capital	89,366	86,240
Retained earnings (Note H)	499,016	464,909
Cumulative translation adjustments	(30,349)	(47,900)
Total Shareholders' Equity	606,139	551,163
	$1,103,129	$1,021,130

See accompanying notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
(Dollars in thousands)

	Year Ended December 31 1985	1984	1983
Cash and Short-Term Investments at January 1	$ 69,418	$ 79,694	$ 46,642
Cash and Short-Term Investments Were Provided From (Used For):			
Operations:			
Net earnings from continuing operations	102,438	109,758	66,520
Add (deduct) items not affecting funds:			
Depreciation and amortization	45,810	40,943	37,708
Deferred income taxes	23,866	12,418	14,786
Minority interest	(254)	(191)	(1,386)
Funds provided from continuing operations	171,860	162,928	117,628
Loss from discontinued operations	(3,666)	(3,605)	(3,609)
Add (deduct) items not affecting funds:			
Depreciation and amortization	1,315	1,237	1,196
Deferred income taxes	(11,584)	-	-
Provision for loss on disposal of discontinued operations	(11,584)	-	-
Funds used for discontinued operations	(25,519)	(2,368)	(2,413)
Funds provided from earnings	146,341	160,560	115,215
Current Items:			
Receivables	(26,213)	(18,619)	(31,713)
Inventories	17,428	(45,574)	(3,149)
Insurance and other prepaid expenses	(30,858)	(238)	564
Accounts payable and accrued expenses	7,144	11,662	38,894
Income taxes	7,908	(2,318)	(706)
Effect of exchange rate changes on current items	4,474	(5,387)	(3,656)
Dividend payable	53	73	437
Net funds provided from operations	126,277	100,159	115,886
Dividends:			
Cash dividends	(53,081)	(52,744)	(52,374)
Investments:			
Capital expenditures	(87,619)	(68,969)	(69,548)
Purchase of businesses (Note B):			
Excess of purchase price over net assets acquired	-	(3,303)	(39,844)
Property, plant and equipment	-	(1,310)	(18,987)
(Increase) decrease in other investments	(9,249)	(3,533)	(1,325)
Net funds used for investments	(96,868)	(77,115)	(129,704)
Financing:			
Increase in long-term debt	76,942	7,318	69,450
Long-term debt assumed through purchase of businesses	-	1,976	12,193
Reductions in long-term debt	(62,279)	(16,515)	(11,927)
Increase (decrease) in short-term debt	(14,928)	20,823	2,603
Stock issued for acquired businesses	-	3,043	24,273
Common stock issued	3,318	2,779	2,652
Net funds provided from financing	3,053	19,424	99,244
Cash and Short-Term Investments at December 31	$ 48,799	$ 69,418	$ 79,694

See accompanying notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands, except per share)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Cumulative Translation Adjustments
	Shares	Amount			
Balance, January 1, 1983.......	27,639,987	$ 46,067	$ 55,340	$ 400,541	$ (23,251)
Issued in purchase acquisition (Note B).......	713,915	1,190	23,083		
Pooling adjustment (Note B)..	135,132	225	(180)	422	
Exercise of stock options....	54,047	90	918		
Conversion of subordinated notes......................	26,692	44	890		
Conversion of stock appreciation rights........	19,270	32	633		
Effect of foreign currency translation - net of taxes of $133....................					(10,611)
Net earnings..................				62,911	
Cash dividends ($1.84 per share)..........				(52,374)	
Balance, December 31, 1983.....	28,589,043	47,648	80,684	411,500	(33,862)
Issued in purchase acquisition (Note B).......	76,798	128	2,915		
Exercise of stock options....	25,326	43	711		
Conversion of subordinated notes......................	28,352	47	945		
Conversion of stock appreciation rights........	28,445	48	985		
Effect of foreign currency translation - net of taxes of $280....................					(14,038)
Net earnings..................				106,153	
Cash dividends ($1.84 per share)..........				(52,744)	
Balance, December 31, 1984.....	28,748,464	47,914	86,240	464,909	(47,900)
Issued restricted stock......	21,050	35	34		
Exercise of stock options....	21,145	35	450		
Conversion of subordinated notes......................	31,374	52	1,046		
Conversion of stock appreciation rights........	41,727	70	1,596		
Effect of foreign currency translation - net of taxes of $0......................					17,551
Net earnings..................				87,188	
Cash dividends ($1.84 per share)..........				(53,081)	
Balance, December 31, 1985.....	28,863,760	$ 48,106	$ 89,366	$ 499,016	$ (30,349)

See accompanying notes to consolidated financial statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Three Years Ended December 31, 1985

(Dollars in thousands, except per share)

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The financial statements include the accounts of the Company and all subsidiaries except a financing subsidiary which is accounted for by the equity method. Investments in unconsolidated affiliates are accounted for by the equity method. All significant intercompany accounts and transactions have been eliminated. The statements are based on years ended December 31, except international subsidiaries whose fiscal years end November 30.

Short-Term Investments

Short-term investments are carried at cost, which approximates market.

Inventories

Inventories are stated at the lower of cost or market. Cost of inventories is determined using the last-in, first-out (LIFO) method for substantially all domestic inventories. The first-in, first-out (FIFO) method is used for substantially all international inventories.

Property, Plant and Equipment

Depreciation of property, plant and equipment is provided on a straight-line basis over the estimated useful lives of the assets. Accelerated methods are used for income tax purposes.

Businesses Acquired

The excess of purchase price over net assets of businesses acquired is amortized on a straight-line basis over forty years.

Income Taxes

Deferred income taxes are provided on timing differences between financial and taxable earnings. Investment tax credits are recognized as a reduction of tax expense in the year in which the related assets are placed in service.

B. ACQUISITIONS

Accounted for as Purchases
During 1983, the Company acquired Topaz, Inc., a manufacturer of power conditioning equipment, for $31,890 in cash and $24,273 in shares of the Company's common stock (713,915 shares). Other acquisitions were made for an aggregate total of $1,303 in cash during 1983 and $2,495 in cash and $3,043 in shares of the Company's common stock (76,798 shares) during 1984. The combined sales and net earnings of these businesses for periods prior to the dates of acquisition were not material.

Accounted for as Pooling of Interests
In 1983, the Company acquired all of the outstanding stock of KB-Denver, Inc., a manufacturer of snap dome switches, in exchange for 135,132 shares of the Company's common stock. Results of operations preceeding the combination were not material, and the consolidated financial statements have not been restated to reflect this acquisition.

C. DISCONTINUED OPERATIONS

On October 23, 1985, the Company announced its intention to dispose of the Building Products Division. A provision of $11,584, net of deferred tax benefits of $11,584, has been made in the fourth quarter ended December 31, 1985, to reduce the carrying amount of assets of discontinued operations to their net realizable values and provide for other costs and expenses related to the disposal. Although the ultimate costs of this disposition cannot be fully determined, the provision for loss from discontinued operations is believed to be sufficient to cover costs related to the disposal including operating losses during the phase-out period. Operating losses were $658, net of tax benefit of $619, from the date of discontinuance to December 31, 1985.

Assets of discontinued operations at December 31, 1985 include current assets of $13,452 consisting primarily of inventories and non-current assets of $14,296 consisting of property, plant and equipment which have been reduced to their estimated net realizable values. Sales applicable to discontinued operations were $54,087, $55,378 and $50,206 in 1985, 1984 and 1983, respectively.

Management anticipates the disposal of the Building Products Division will be completed during 1986.

D. CASH AND CASH EQUIVALENTS

Cash and cash equivalents include:

	1985	1984
Cash in banks	$ 7,561	$ 16,068
Time deposits	19,464	19,700
	$ 27,025	$ 35,768

E. INVENTORIES

Inventories valued by the last-in, first-out (LIFO) method aggregated $93,059 and $109,015 at December 31, 1985 and 1984, respectively. If the first-in, first-out (FIFO) method had been used, inventories would have been $143,943 and $142,288 higher than reported in the accompanying consolidated balance sheets at December 31, 1985 and 1984, respectively.

Production levels were lowered during 1985 in order to reduce inventory levels. This reduction resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years as compared to the cost of 1985 purchases. The effect on net earnings was immaterial.

The application of generally accepted accounting principles in APB Opinion No. 16 requires the assignment of fair values to inventories acquired in a transaction accounted for by the purchase method. The financial reporting value of such inventories acquired during 1980 was $1,079 and $1,040 higher than the tax value at December 31, 1985 and 1984, respectively.

Inventories are maintained by element of cost and it is therefore not practical to determine major classes such as finished goods, work in process and raw materials.

F. LEASE COMMITMENTS

The Company rents various warehouse, office and manufacturing facilities and certain equipment, principally computers and vehicles, under lease arrangements classified as operating leases.

Future minimum rental payments under noncancelable operating leases with initial or remaining terms of one year or more as of December 31, 1985, are:

1986	$ 9,088
1987	5,833
1988	2,858
1989	1,852
1990	881
Remainder	1,606
	$22,118

G. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses include:

	1985	1984
Amounts owing for materials and expenses	$109,554	$115,382
Accrued wages and salaries	41,289	42,336
Reserve for discontinued operations	12,502	-
Payroll, property and miscellaneous taxes	10,542	9,025
	$173,887	$166,743

Long-term debt consists of:

	1985	1984
Senior Notes, 10%, due 1995	$ 75,000	$ -
Senior Notes, 10.375%	28,000	30,000
Commercial Paper	-	50,000
Industrial Revenue Bonds, 4.576% to 8.8%, due on various dates to 2006	36,525	37,440
First Mortgage Notes, 9.0% to 9.2%, due on various dates to 2009	12,061	12,247
Subordinated Convertible Notes, 9%, due 1992 (net of unamortized discount of $998 at 13%)	9,331	10,639
Payable to banks, average rate 9.2%, due on various dates to 2004	12,963	18,626
Other debt, average rate 10.4%, due on various dates to 2011	23,501	23,611
	197,381	182,563
Less current maturities	12,427	12,259
	$ 184,954	$ 170,304

The aggregate annual maturities of long-term debt for the years 1986 through 1990 are $12,427, $11,120, $10,971, $10,259, and $7,251, respectively.

The 10.375% Senior Note Agreement requires annual repayments of $2,000 through November 1, 1999. Under the terms of this agreement, the Company may pay dividends up to $20,000 plus the proceeds from the sale of stock and the consolidated net earnings for periods subsequent to December 31, 1973. At December 31, 1985, $457,803 of retained earnings was not restricted as to payment of dividends.

Industrial Revenue Bonds of $13,570 and the First Mortgage Notes are secured by the property and equipment acquired with the proceeds of the financings.

The Subordinated Convertible Notes are convertible at a rate of 28.57 shares for each one thousand dollars of principal and 295,102 shares of the Company's common stock have been reserved for the conversion.

The Company has revolving credit/term loan agreements with five of its principal banks. The agreements provide for up to $50,000 of revolving credit, through July 31, 1986, under a number of interest rate pricing options. On July 31, 1986, the Company may convert all or part of the outstanding balance into a term loan payable on July 31, 1990. The term loan will bear interest at a slightly higher rate than that paid under the revolving credit portion of the agreement and may involve a number of interest rate pricing options. The Company pays a 1/8% facility fee on the total credit. An additional 3/8% is paid on any amounts used, during the time such amounts are unused. Currently, only the 1/8% fee is payable. On December 31, 1985, no borrowings were outstanding under this agreement.

Short-term debt includes bank borrowings of $21,581 and $22,246 and commercial paper of $4,046 and $18,309 in 1985 and 1984, respectively.

The Company has additional unused short-term lines of credit which aggregated $136,394 at December 31, 1985. In connection with substantially all of these lines of credit, the Company has agreed to maintain unrestricted compensating balances or pay commitment fees ranging from 1/4% to 3/8%. At December 31, 1985, the unrestricted compensating balances were $3,665.

I. INCOME TAXES

Pre-tax income from continuing operations is as follows:

	1985	1984	1983
United States	$155,977	$170,347	$123,830
International	26,571	27,432	5,778
Total	$182,548	$197,779	$129,608

Income tax provisions for continuing operations are as follows:

	1985	1984	1983
Current:			
U.S. Federal	$ 39,850	$ 60,000	$ 37,704
International	6,944	5,233	3,692
State	8,243	10,051	6,788
	55,037	75,284	48,184
Deferred:			
U.S. Federal	20,540	7,358	10,545
International	1,687	4,441	3,277
State	2,846	938	1,082
	25,073	12,737	14,904
Total provision	$ 80,110	$ 88,021	$ 63,088

The U.S. deferred income tax provision includes the tax effect of the excess of accelerated depreciation over straight line depreciation used for financial reporting of $7,879, $7,108 and $5,614 in 1985, 1984 and 1983, respectively, and the tax effect of recording certain sales on the installment method of $410, $2,764 and $11,500 in 1985, 1984 and 1983, respectively, for U.S. federal income tax purposes. In addition, for 1985, the U.S. federal deferred tax provision includes $13,646 which is the tax effect of the prepayment to the Company's Group Health Insurance Trust. No other timing differences between financial and tax reporting were individually significant.

The differences between the statutory and effective tax rates on continuing operations are as follows:

	1985	1984	1983
U.S. Federal statutory rate	46.0%	46.0%	46.0%
State income taxes, less Federal benefit	3.6	3.2	3.4
Investment tax credit	(2.8)	(2.0)	(3.0)
Ireland export sales relief	(1.5)	(2.1)	(2.9)
Foreign translation-Mexico	.8	.4	5.4
Other	(2.2)	(1.0)	(.2)
	43.9%	44.5%	48.7%

No provisions have been made for possible international and U.S. income taxes payable on the distribution of approximately $92,244 of undistributed earnings which have been or will be reinvested abroad or are expected to be returned to the United States in tax-free distributions. Provisions for taxes have been made for all earnings which the Company presently plans to repatriate.

J. SUPPLEMENTARY EARNINGS STATEMENT INFORMATION

	1985	1984	1983
NON-OPERATING INCOME:			
Interest income	$ 9,421	$ 10,323	$ 7,558
Gain on sale of property	-	1,126	5,016
Other	3,472	1,267	5,908
TOTAL	$ 12,893	$ 12,716	$ 18,482
RESEARCH AND DEVELOPMENT	$ 41,394	$ 40,049	$ 34,941
MAINTENANCE AND REPAIRS	37,333	37,508	28,527
RENTS	16,893	16,739	15,491
ADVERTISING	16,654	15,269	12,066
FOREIGN CURRENCY TRANSACTION GAIN	2,628	466	4,183
CAPITALIZED INTEREST	1,465	1,395	2,104

The 1985 Master Stock Compensation Plan provides for the granting of options to purchase the Company's common stock at 100% of the fair market value of the common stock on the date of grant and the issuance of restricted stock to key employees. Options granted may be designated as incentive or nonstatutory stock options, and are exercisable, in whole or in part, at any time after the date of grant with a maximum term of ten years. Incentive stock options may not be exercised while a previously granted incentive stock option remains outstanding. The total number of shares subject to issuance under the Plan may not exceed 1,200,000, of which not more than 600,000 may be issued as restricted stock. During 1985, 21,050 shares of restricted stock were issued. At December 31, 1985, 1,178,950 shares of common stock were reserved for issuance under this Plan, of which not more than 578,950 shares may be issued as restricted stock. Compensation expense equal to the fair market value of the restricted stock on the date of issuance will be charged to expense over the periods of restriction.

The Company's Stock Appreciation Rights Plan entitles the holders to receive at the end of the grant period (from six months to five years) the increase in market value of the Company's common stock over the grant price during the designated period. The appreciation is recognized over the grant period and, upon maturity, will be paid one-half in cash and one-half in shares of the Company's common stock. There were 357,050 shares of common stock reserved at December 31, 1985. The appreciated value of these rights was $6,284 (equivalent to 73,500 shares of common stock). Compensation expense has been recorded reflecting changes in appreciated value. No further stock appreciation rights will be granted under this Plan and all outstanding rights will have been exercised or cancelled by 1988.

The Company has ceased granting options under the 1975 Employees' Stock Option Plan. Stock options previously granted, which expire at various dates through 1987, will not be affected.

Stock appreciation rights and stock option transactions relating to these plans are summarized as follows:

	Stock Appreciation Rights		Stock Options	
	Rights	Average Price Per Right *	Shares	Average Price Per Share
Outstanding, January 1, 1983	1,032,500	$ 25.97	79,800	$ 25.06
Granted	242,400	34.52	-	-
Exercised	(140,500)	25.00	(17,992)	25.06
Cancelled	(53,200)	26.35	(1,100)	25.86
Outstanding, December 31, 1983	1,081,300	27.99	[illegible]	25.05
Granted	-	-	-	-
Exercised	(157,200)	23.05	(19,441)	24.41
Cancelled	(7,700)	30.44	-	-
Outstanding, December 31, 1984	916,400	28.82	41,367	25.35
Granted	-	-	398,900	40.05
Exercised	(171,800)	20.42	(10,235)	23.73
Cancelled	(30,500)	30.95	(3,200)	38.38
Outstanding, December 31, 1985	714,100	30.75	426,832	39.02

*Average price per right is the equivalent of the price per share of common stock at the time of grant.

In addition, options to purchase 55 shares were outstanding at December 31, 1985, under stock option plans assumed by the Company in connection with the acquisition of certain subsidiaries. In the three years ended December 31, 1985, 55,647 options were exercised. At December 31, 1985, the outstanding options remain exercisable at an average price of $9.06. No additional options will be granted under these plans.

L. PENSION PLANS

The Company's domestic operations maintain several defined benefit pension plans, primarily noncontributory, covering substantially all employees for normal retirement benefits at age 65. The Company makes annual contributions to the plans equal to the amounts accrued for pension expense, including amortization of past service cost over thirty years.

Accumulated plan benefit information determined as of the most recent valuation date and plan net assets are shown below for the Company's domestic pension plans.

	January 1	
	1985	1984
Actuarial present value of accumulated plan benefits:		
Vested participants	$ 138,700	$ 135,700
Non-vested participants	12,800	14,200
	$ 151,500	$ 149,900
Net assets available for benefits	$ 178,600	$ 164,700

The assumed rate of return in determining the actuarial present value of accumulated plan benefits was 9% and 8% for January 1, 1985 and 1984, respectively.

The Company's international subsidiaries are not required to report under ERISA and do not otherwise determine the actuarial value of accumulated plan benefits or net assets available for benefits as calculated and shown above. The excess, if any, of vested benefits over fund assets is insignificant for these plans.

Total pension expense for all plans was $12,667, $15,720 and $17,399 for 1985, 1984 and 1983, respectively. Actuarial assumptions were revised in 1985 and 1984 principally to update the investment return and rates of pay increase to levels more reflective of current economic conditions. These and other minor assumption changes reduced pension expense by approximately $3,418 and $2,377 in 1985 and 1984, respectively.

M. POST-RETIREMENT BENEFITS

The Company provides health care and life insurance benefits for retired employees of substantially all of its domestic and certain international operations. Substantially all of the Company's employees may become eligible for those benefits if they reach normal retirement age while working for the Company. The cost of retiree health care is recognized as an expense when claims are paid. The cost of life insurance benefits is recognized as an expense as premiums are paid. These costs totaled $1,920 and $1,087 for 1985 and 1984, respectively.

N. SUBSEQUENT EVENT

In January, 1986, the Company declared a dividend distribution of one common stock purchase right on each share of the Company's common stock outstanding on January 21, 1986. Under certain conditions, each right may be exercised to buy one-half of one newly-issued share of the Company's common stock at an exercise price of $60 per one-half share. The right will be exercisable only if a person or group acquires 20% or more of the Company's common stock or announces a tender offer for 30% or more of the common stock. The rights, which do not have voting power, expire on January 21, 1996 and may be redeemed by the Company at a price of $.10 per right prior to the public announcement that 20% or more of the Company's shares have been accumulated by an individual or group.

If the Company is acquired in a merger or other business combination transaction or 50% or more of its assets or earning power are sold at any time after the rights become exercisable, the rights entitle a holder to buy a number of shares of common stock of the acquiring company having a market value of twice the exercise price of each right. If a 20% holder merges with the Company and the common stock is not exchanged in such merger, or engages in self-dealing transactions with the Company, each right not owned by such holder becomes exercisable for the number of shares of the Company having a market value of twice the exercise price of the right.

SEGMENT AND GEOGRAPHIC INFORMATION

The Company is engaged in the manufacture and sale of electrical equipment and electronic products and operates in virtually every major marketing area in the world. Major manufacturing plants are located throughout the United States and in Canada, Mexico, England, Ireland, West Germany, Italy, Spain, Luxembourg and Australia.

The electrical equipment segment includes the manufacture and sale of electrical products which are a part of the electrical system, primarily between the last utility point through the consumer's branch circuit. Components are identified by the electrical trade as switches; circuit breakers; panelboards; switchboards; switchgear; busway; transformers; motor starters; adjustable frequency motor controls; relays; pushbuttons; limit, pressure and vacuum switches; and control panels. Electrical products are marketed through the Company's own marketing organization and distributed through a system of strategically located warehouses. The majority of all sales are made directly to authorized electrical distributors who, in turn, market the products to electrical contractors, electrical utilities, large industrial plants and other classes of trade.

The electronic products segment includes the manufacture and sale of electrodeposited copper foil, semiconductor devices, power conditioning equipment, programmable controllers, infrared thermometers and pyrometers, electronic computerized control and data gathering systems, industrial assembly robots, emergency lighting devices, snap dome switches and other electronic devices. Electrodeposited copper foil is used in the manufacture of printed circuits for electronic and electrical applications. Copper foil is sold to laminators who bond the foil to various types of substrates, both rigid and flexible, which provide the surface upon which electronic components are mounted. Semiconductor devices are used in various electronic circuits and are used to control or divert the flow of electrical energy and find application in the telecommunications, computer, aerospace and automotive industries. Power conditioning equipment protects computers and other sensitive devices from errors and damage caused by disturbances on electrical power systems.

Sales between geographic areas and industry segments are based on prices approximating current market values. Certain reclassifications were made to 1984 and 1983 sales and operating earnings of the Company's industry segments to conform with the classifications used in the current year. Net sales of electrical equipment to a group of customers under common control were $149,000 in 1985, $141,000 in 1984 and $117,000 in 1983.

O. SEGMENT AND GEOGRAPHIC INFORMATION (Continued)

	Geographic Areas	International					Industry Segments		
	United States	Europe	Latin America	Other	Eliminations	Consolidated	Eliminations	Electrical Equipment	Electronic Products
For the Year Ended December 31, 1965:									
Net Sales to Unaffiliated Customers	$1,140,595	$ 112,044	$ 38,283	$ 57,189	$ -	$1,348,114	$ -	$1,102,125	$ 245,989
Intercompany Sales	41,955	24,533	400	218	(67,103)	-	(27,424)	4,105	23,319
Total Sales	$1,182,550	$ 136,577	$ 38,683	$ 57,407	$ (67,103)	$1,348,114	$ (27,424)	$1,106,230	$ 269,308
Operating Earnings	$ 165,893	$ 18,360	$ 8,992	$ 1,463	$ (190)	$ 194,518	$ (62)	$ 198,897	$ (4,317)
Non-Operating Income						12,893			
Interest Expense						(24,863)			
Earnings from Continuing Operations before Income Taxes						$ 182,548			
Identifiable Assets of Continuing Operations	$ 796,452	$ 195,148	$ 55,942	$ 49,886	$ (22,067)	$1,075,381	$ (472)	$ 700,917	$ 374,936
Assets of Discontinued Operations						27,748			
Total Assets						$1,103,129			
Depreciation and Amortization Expense*								$ 26,884	$ 18,926
Capital Expenditures*								$ 51,755	$ 34,603
For the Year Ended December 31, 1964:									
Net Sales to Unaffiliated Customers	$1,115,678	$ 107,921	$ 33,087	$ 53,440	$ -	$1,310,126	$ -	$1,044,081	$ 266,045
Intercompany Sales	40,739	27,500	26	192	(68,459)	-	(23,265)	3,930	19,335
Total Sales	$1,156,417	$ 135,421	$ 33,113	$ 53,632	$ (68,459)	$1,310,126	$ (23,265)	$1,048,011	$ 285,380
Operating Earnings	$ 180,193	$ 24,517	$ 6,276	$ 1,307	$ 1,237	$ 213,530	$ 137	$ 192,224	$ 21,169
Non-Operating Income						12,716			
Interest Expense						(28,467)			
Earnings from Continuing Operations before Income Taxes						$ 197,779			
Identifiable Assets of Continuing Operations	$ 725,388	$ 155,513	$ 59,201	$ 46,297	$ (6,826)	$ 979,573	$ (1,071)	$ 634,311	$ 346,333
Assets of Discontinued Operations						41,557			
Total Assets						$1,021,130			
Depreciation and Amortization Expense*								$ 24,173	$ 16,770
Capital Expenditures*								$ 37,213	$ 30,467
For the Year Ended December 31, 1963:									
Net Sales to Unaffiliated Customers	$ 922,638	$ 95,552	$ 29,874	$ 45,867	$ -	$1,093,931	$ -	$ 893,856	$ 200,075
Intercompany Sales	32,900	20,344	487	72	(53,803)	-	(16,825)	2,734	14,091
Total Sales	$ 955,538	$ 115,896	$ 30,361	$ 45,939	$ (53,803)	$1,093,931	$ (16,825)	$ 896,590	$ 214,166
Operating Earnings	$ 123,576	$ 16,923	$ (5,332)	$ (98)	$ 398	$ 135,467	$ 113	$ 127,858	$ 7,496
Non-Operating Income						18,482			
Interest Expense						(24,341)			
Earnings from Continuing Operations before Income Taxes						$ 129,608			
Identifiable Assets of Continuing Operations	$ 663,894	$ 145,613	$ 60,365	$ 41,844	$ (7,580)	$ 904,136	$ (1,164)	$ 574,980	$ 330,320
Assets of Discontinued Operations						40,882			
Total Assets						$ 945,018			
Depreciation and Amortization Expense*								$ 23,260	$ 14,448
Capital Expenditures*								$ 45,960	$ 21,779

* Depreciation and Amortization Expense and Capital Expenditures are reported for continuing operations only.

SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)
(Dollars in thousands, except per share)

Quarter Ended	Net Sales	Gross Profit	Earnings From Continuing Operations	Net Earnings	Earnings Per Share Continuing Operations	Earnings Per Share Net Earnings
1985						
March 31	$ 329,122	$ 112,490	$ 25,500	$ 24,759	$ .89	$ .86
June 30	335,772	110,703	23,391	22,352	.81	.78
September 30	347,074	115,472	25,986	24,660	.90	.85
December 31	336,146	115,413	27,561	15,417	.95	.53
1984						
March 31	$ 310,907	$ 109,123	$ 24,878	$ 24,341	$ .87	$ .85
June 30	324,277	113,180	26,514	25,936	.93	.91
September 30	365,163	135,857	38,672	37,670	1.35	1.31
December 31	309,779	99,395	19,694	18,206	.68	.64

All quarters prior to December 31, 1985, have been restated for the effect of discontinued operations (Note C).

SUPPLEMENTARY INFORMATION ON CHANGING PRICES (Unaudited)
(Dollars in thousands)

General Background

Financial statements have traditionally reported amounts reflecting historical costs which do not specifically measure the effect of inflation upon the business. The Statement of Financial Accounting Standards (SFAS) No. 33, as amended, requires the disclosure of financial information measuring the effect of changing prices.

The current cost method prescribed by the statement does not reflect fully all factors of inflation, and involves the use of assumptions and estimates. Therefore, the results shown are at best imprecise measurements of the effects of inflation and should be viewed in this context and not as precise indicators of the effects of inflation on, nor indicative of any future economic impact to the Company.

Current Cost

The objective of the current cost method is to reflect the current cost of the resources actually used in the Company's operations rather than the historical cost amounts expended to acquire the resources.

The current cost of property, plant and equipment was determined based on external price indexes closely related to the resources being measured. The same depreciation methods were used as included in the calculation of depreciation expense in the historical financial statements. The additional depreciation expense reduced earnings from continuing operations by $6,092.

Current prices for inventories and cost of sales are based on internally generated measurements of price changes and production costs. Substantially all of the Company's domestic operations account for inventories using the LIFO method of inventory accounting, under which current costs are charged to the results of operations for financial reporting.

Substantially all of the Company's international operations use the FIFO method of inventory accounting which values inventory at most recent costs and charges actual acquisition costs to the results of operations. The increase in cost of products sold when measured by the changes in specific prices in the local currencies of the Company's international operations is more than offset by a reduction due to lower exchange rates used to translate foreign currency amounts into U.S. dollars.

Review of Information Presented

In accordance with SFAS No. 33, the provision for income taxes has not been adjusted for inflation. The result is an increase in the effective tax rate from [illegible]3.9 percent, as reported in the primary financial statements, to 45.0 percent in the current cost calculations.

Three additional measurements affect the change in net assets during the year but are excluded from the adjusted earnings figures. The first measures the gain from decline in the purchasing power of monetary liabilities in excess of monetary assets. Monetary assets and liabilities are those which are fixed in amount without reference to future prices. Since the purchasing power of the dollar experienced a slight decline in 1985, a gain resulted from holding net monetary liabilities.

The second measurement is the excess of the increase in the general price level over the decrease in specific prices. The majority of the excess as reported relates to inventory. A substantial portion of the excess relating to inventory was due to the reduction of the carrying value of the inventory of discontinued operations to its net realizable value (Note C to the Consolidated Financial Statements). The remaining portion relates mostly to the decrease in the specific price index used to measure inventory. Earnings were not adjusted to reflect cost savings which would be associated with technological advancements and productivity improvements.

The third measurement is the aggregate foreign currency translation adjustment of nonmonetary assets on the current cost basis. In 1985, this adjustment increased net nonmonetary assets by $6,319.

Financial data in the five year comparison table shows the effect of adjusting historical amounts stated in terms of average 1985 dollars measured by the Consumer Price Index. Amounts for years prior to 1985 have been restated for the effect of the discontinued operations. Amounts for 1981 have not been restated for the change in foreign currency translation from SFAS No. 8 to No. 52 in 1982, because the primary financial statements were not restated for this change.

SUPPLEMENTARY INFORMATION ON CHANGING PRICES (Unaudited)

CONSOLIDATED STATEMENTS OF NET EARNINGS ADJUSTED FOR CHANGING PRICES
FOR THE YEAR ENDED DECEMBER 31, 1985
(Dollars in thousands, except per share)

	As Reported in the Primary Statements	Current Cost
Net Sales	$1,348,114	$1,348,114
Costs and Expenses:		
Cost of products sold (excluding depreciation)	858,213	856,646
Selling, administrative and general (excluding depreciation)	254,327	254,327
Depreciation expense	41,056	47,148
Operating Earnings	194,518	189,993
Non-operating income	12,893	12,893
Interest expense	(24,863)	(24,863)
Earnings from Continuing Operations before Income Taxes	182,548	178,023
Provision for Income Taxes	80,110	80,110
Earnings from Continuing Operations	$ 102,438	$ 97,913
Earnings Per Share from Continuing Operations	$ 3.55	$ 3.40
Effective tax rate	43.9%	45.0%
Gain from decline in purchasing power of net amounts owed		$ 7,992
Effect of increase in general price level of inventories and property, plant and equipment held during the year		$ 35,996
Effect of decrease in specific prices (current costs)*		(17,247)
Excess of increase in general price level over decrease in specific prices		$ 53,243
Foreign currency translation adjustment		$ 5,319
Net assets at year end	$ 606,139	$ 905,464

*At December 31, 1985, current cost of inventory was $329,997 and current cost of property, plant and equipment net of accumulated depreciation was $642,114.

SUPPLEMENTARY INFORMATION ON CHANGING PRICES (Unaudited)

FIVE YEAR COMPARISON OF SELECTED SUPPLEMENTARY
FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES
IN AVERAGE 1985 DOLLARS
(Dollars in thousands, except per share)

	1985	1984	1983	1982	1981
Net Sales	$1,348,114	$1,356,871	$1,181,182	$1,130,093	$1,310,28
Current Cost Information					
Earnings from continuing operations	97,913	97,728	49,235	62,283	110,57
Earnings per share from continuing operations	3.40	3.41	1.74	2.27	4.0
Net assets at year end	905,484	917,404	877,390	916,263	915,47
Excess of increase in general inflation over increase in current cost	53,243	884	15,759	2,895	28,46
Foreign currency translation adjustment	6,319	(6,396)	(3,497)	(8,887)	-
Other Information					
Gain in purchasing power of net amounts owed	7,592	7,287	5,526	5,066	11,64
Cash dividends per common share	1.84	1.91	1.99	2.05	2.0
Market price per common share at year end	42.07	40.21	42.45	37.31	33.9
Average Consumer Price Index	322.2	311.1	298.4	289.1	272.3

SQUARE D COMPANY AND SUBSIDIARIES

SCHEDULE V

SCHEDULE V - PROPERTY, PLANT AND EQUIPMENT

FOR THE THREE YEARS ENDED DECEMBER 31, 1985

(Dollars in thousands)

	Classification				
	Land	Buildings and Land Improvements	Equipment	Construction in Progress	Total
Balance, December 31, 1982	$ 14,592	$ 165,338	$ 291,635	$ 44,623	$516,188
Additions at cost	3,645	29,559	62,223	(6,618)	88,809
Retirements or sales	62	323	11,657	-	12,042
Translation adjustments	(310)	(2,705)	(4,455)	(92)	(7,562)
Other changes	-	(35)	35	-	-
Balance, December 31, 1983	17,865	191,834	337,781	37,913	585,393
Additions at cost	2,627	20,722	51,024	(4,094)	70,279
Retirements or sales	203	1,403	11,796	12	13,414
Translation adjustments	(199)	(2,926)	(7,002)	(307)	(10,434)
Other changes	-	(3)	(350)	353	-
Balance, December 31, 1984	20,090	208,224	369,657	33,853	631,824
Additions at cost	2,568	5,736	60,860	18,455	87,619
Retirements or sales	65	1,094	8,231	76	9,466
Translation adjustments	235	3,272	10,312	1,647	15,466
Other changes	389	1,649	(15)	(2,023)	-
Balance, December 31, 1985	$ 23,217	$ 217,787	$ 432,583	$ 51,856	$725,443

The estimated average useful lives of the principal classes of assets are as follows:

Buildings and land improvements	20 to 40 years
Equipment	5 to 12 years
Tools and dies	5 to 12 years

Cost and accumulated depreciation of assets sold or retired are eliminated from the accounts. The gain or loss on assets sold, abandoned or scrapped is reflected in earnings. The gain or loss on the trade-in of an asset is reflected in the cost of the new asset acquired.

Expenditures for maintenance and repairs are charged to earnings. Expenditures for betterments and major renewals are capitalized.

SQUARE D COMPANY AND SUBSIDIARIES

SCHEDULE VI - ACCUMULATED DEPRECIATION AND AMORTIZATION OF PROPERTY, PLANT AND EQUIPMENT

FOR THE THREE YEARS ENDED DECEMBER 31, 1985

(Dollars in thousands)

	Classification			
	Land	Buildings and Land Improvements	Equipment	Total
Balance, December 31, 1982	$ 30	$ 40,570	$118,934	$159,534
Charged to earnings	-	5,869	28,326	34,195
Retirements or sales	-	97	6,178	6,275
Translation adjustments	-	(166)	(24)	(190)
Other changes	-	-	1	1
Balance, December 31, 1983	30	46,176	141,059	187,265
Charged to earnings	-	6,406	31,439	37,845
Retirements or sales	-	666	8,778	9,444
Translation adjustments	-	(499)	(2,073)	(2,572)
Other changes	-	-	1	1
Balance, December 31, 1984	30	51,417	161,648	213,095
Charged to earnings	-	6,542	35,830	42,372
Retirements or sales	-	546	7,214	7,760
Translation adjustments	-	630	3,603	4,233
Other changes	-	3	(3)	-
Balance, December 31, 1985	$ 30	$ 58,046	$193,864	$251,940

SQUARE D COMPANY AND SUBSIDIARIES

SCHEDULE VIII - VALUATION AND QUALIFYING ACCOUNTS

FOR THE THREE YEARS ENDED DECEMBER 31, 1985

(Dollars in thousands)

Description	Balance at Beginning of Period	Additions		Deductions	Balance at Close of Period
		Charged to Earnings	Other (Note 1)	Accounts Written Off	
Allowances for losses, adjustments, and discounts on receivables:					
1983	$ 7,060	$ 1,961	$ 267	$ 1,416	$ 7,872
1984	$ 7,872	$ 2,417	$ 84	$ 2,021	$ 8,352
1985	$ 8,352	$ 6,481	$ -	$ 4,193	$ 10,640

Note: (1) Balance on books of acquired company at date of acquisition.

SQUARE D COMPANY AND SUBSIDIARIES

SCHEDULE IX - SHORT-TERM BORROWINGS

FOR THE THREE YEARS ENDED DECEMBER 31, 1985

(Dollars in thousands)

Category of Aggregate Short-Term Borrowings	Balance at End of Period	Weighted Average Interest Rate	Amount Outstanding During the Period Maximum	Amount Outstanding During the Period Average (Note 1)	Weighted Average Interest Rate During the Period (Note 2) (Note 3)
Bank borrowings:					
1983	$ 15,449	10.80%	$ 22,312	$ 16,496	10.40%
1984	$ 22,246	11.08%	$ 22,246	$ 16,836	10.25%
1985	$ 21,581	10.63%	$ 21,581	$ 19,064	11.70%
Commercial Paper:					
1983	$ 4,283	9.84%	$ 26,292	$ 7,581	9.24%
1984	$ 18,309	8.63%	$ 37,063	$ 23,311	10.59%
1985	$ 4,046	8.13%	$ 75,282	$ 43,705	8.23%

Note: (1) Average amount outstanding during the period is computed by dividing the total of month end outstanding principle balances by twelve.

(2) Average interest rate for bank borrowings for the year is computed by dividing the aggregate interest paid by average borrowings.

(3) Average interest rate for commercial paper for the year is computed by dividing the aggregate annualized interest by aggregate borrowings.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15 (d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarter Ended March 31, 1986 Commission File Number 1-2188

SQUARE D COMPANY
(Exact name of registrant as specified in its charter)

MICHIGAN
(State or other jurisdiction of incorporation or organization)

36-2440683
(I.R.S. Employer Identification No.)

14 outh Roselle Road, Palatine, Illinois
ddress of principal executive offices)

60067
(Zip Code)

Registrant's telephone number, including area code (312) 397-2600

Not Applicable
Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the registrant (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No ____

um f shares of common stock outstanding at April 30, 1986 -- 28,931,400

SQUARE D COMPANY AND SUBSIDIARIES

FORM 10-Q

MARCH 31, 1986

INDEX

PART I. - FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

SQUARE D COMPANY AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF NET EARNINGS - Unaudited
(Amounts in thousands, except per share)

	Three Months Ended March 31	
	1986	1985
Net Sales	$ 334,119	$ 329,122
Costs and Expenses:		
Cost of products sold	224,850	216,632
Selling, administrative and general	69,825	64,083
Operating Earnings	39,444	48,407
Non-operating income	3,953	3,351
Interest expense	(6,400)	(6,512)
Earnings from Continuing Operations before Income Taxes	36,997	45,246
Provision for Income Taxes	15,955	19,746
Earnings from Continuing Operations	21,042	25,500
Loss from Discontinued Operations	-	(741)
Net Earnings	$ 21,042	$ 24,759
Earnings per share based on weighted average number of shares outstanding:		
Continuing Operations	$ .73	$ .89
Discontinued Operations	-	(.03)
Net Earnings	$ .73	$ .86
Weighted average number of common shares outstanding	28,909	28,792
Cash dividends per common share	$ .46	$ .46

See notes to condensed consolidated financial statements.

SQUARE D COMPANY AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
Unaudited
(Amounts in thousands)

	March 31 1986	December 31 1985
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 25,362	$ 27,025
Short-term investments	21,964	21,774
Receivables - net	234,992	228,554
Inventories	179,450	184,649
Insurance and other prepaid expenses	39,418	37,795
Total Current Assets	501,186	499,797
Investments in Affiliates	26,187	24,438
Property, Plant and Equipment, at cost	754,645	725,443
Less accumulated depreciation	263,278	251,940
	491,367	473,503
Other Assets	13,890	13,734
Excess of Purchase Price Over Net Assets of Businesses Acquired	91,440	91,657
	$ 1,124,070	$ 1,103,129
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Short-term debt	$ 25,187	$ 25,627
Current maturities of long-term debt	10,310	12,427
Accounts payable and accrued expenses	175,039	173,887
Income taxes	18,096	15,546
Dividend payable	13,306	13,277
Deferred income taxes	6,154	5,808
Total Current Liabilities	248,092	246,572
Long-Term Debt	183,958	184,954
Deferred Income Taxes and Minority Interest	68,252	65,464
Shareholders' Equity:		
Capital stock	48,215	48,106
Additional paid-in capital	92,076	89,366
Retained earnings	506,751	499,016
Cumulative translation adjustments	(23,274)	(30,349)
Total Shareholders' Equity	623,768	606,139
	$ 1,124,070	$ 1,103,129

See notes to condensed consolidated financial statements.

SQUARE D COMPANY AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES
IN FINANCIAL POSITION - Unaudited
(Amounts in thousands)

	Three Months Ended March 31 1986	Three Months Ended March 31 1985
Cash and Short-Term Investments at January 1	$ 48,799	$ 69,418
Cash and Short-Term Investments Were Provided From (Used For):		
Operations:		
Earnings from continuing operations	21,042	25,500
Add (deduct) items not affecting funds:		
Depreciation and amortization	12,811	10,572
Deferred income taxes	3,134	1,314
Minority interest	-	(62)
Funds provided from continuing operations	36,987	37,324
Loss from discontinued operations	-	(741)
Add(deduct) items not affecting funds:		
Depreciation and amortization	-	337
Funds used for discontinued operations	-	(404)
Funds provided from earnings	36,987	36,920
Current Items:		
Receivables	(6,438)	(25,047)
Inventories	5,199	(3,128)
Insurance and other prepaid expenses	(1,623)	(1,884)
Accounts payable and accrued expenses	1,499	(2,972)
Income taxes	2,550	10,808
Effect of exchange rate changes on current items	811	(2,517)
Dividend payable	29	2
Net funds provided from operations	39,014	12,182
Dividends:		
Cash dividends	(13,307)	(13,226)
Investments:		
Capital expenditures	(26,354)	(13,424)
(Increase)decrease in other investments	(52)	2,006
Net funds used for investments	(26,406)	(11,418)
Financing:		
Increase in long-term debt	84	748
Reductions in long-term debt	(3,236)	(5,392)
Increase(decrease) in short-term debt	(440)	6,979
Common stock issued	2,818	2,821
Net funds provided from financing	(774)	5,156
Cash and Short-Term Investments at March 31	$ 47,326	$ 62,112

See notes to condensed consolidated financial statements.

SQUARE D COMPANY AND SUBSIDIARIES

NOTE TO CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS - Unaudited

NOTES:

1. Accounting Policies

The condensed consolidated financial statements have been prepared following the same accounting policies used in preparing the Company's 1985 Annual Report on Form 10-K. They have been prepared from the Company's books without audit and are subject to year-end adjustments. In the opinion of management, all adjustments which are necessary for a fair statement of the results for the periods presented have been reflected. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

2. Discontinued Operations

In the fourth quarter, 1985, the Company announced its intention to dispose of the Building Products Division. Results of operations for 1985 have been restated to reflect the discontinued operations.

SQUARE D COMPANY AND SUBSIDIARIES

ITEM 2 - MANAGEMENTS' DISCUSSION AND ANALYSIS

Results of Operations

In the fourth quarter, 1985, the Company announced its intention to dispose of the Building Products Division. As a result, this division has been classified as a discontinued operation. Results of operations for the period ended March 31, 1985, discussed below, have been restated to reflect continuing operations.

Consolidated net sales were $334.1 million for the first quarter of 1986, an increase of $5.0 million from the first quarter of 1985. Earnings from continuing operations for the periods ended March 31, 1986, and March 31, 1985, were $21.0 million and $25.5 million, respectively. In comparison to the first quarter of 1985, current year sales and earnings continued to be restrained by the weakness of the electronics industry and competitive pricing within the electrical equipment markets. Increased selling, administrative and general expenses as a percentage of sales in the first quarter of 1986, compared to the same period in 1985, also contributed to the reduced earnings level. In the first quarter of 1986, foreign exchange losses due to the weakening of the U.S. dollar against foreign currencies increased selling, administrative, and general expenses while in the first quarter of 1985, foreign exchange gains reduced selling, adminstrative and general expenses.

First quarter net sales of the U.S. operations decreased slightly to $278.9 million from $282.2 million in the first quarter of 1985. Net sales of the International operations increased $8.3 million, or 17.7 percent, from $46.9 million in the first quarter of 1985 to $55.2 million in the same period of 1986. Real growth and price increases, in local currencies, accounted for the majority of the increase. Sales also increased due to foreign exchange as a result of the weakening U.S. dollar against foreign currencies.

Net sa[illegible] in the electrical equipment segment of the business for the pe[illegible]d ended March 31, 1986, were $270.0 million, an increase of $8.7 million, or 3.3 percent over the same period in 1985. Operating earnings were $38.5 million and $46.3 million for the first quarter of 1986 and 1985, respectively. In 1986, the changing mix of business and continued competitive pressures on profit margins combined to restrict earnings. In 1985, earnings benefited from a favorable response by distributors to a special sales incentive program.

ITEM 2 - MANAGEMENTS' DISCUSSION AND ANALYSIS

Net sales in the electronic products segment for the first quarter of 1986 were $64.1 million compared to $67.8 million for the first quarter of 1985. Operating earnings for the same period were $.9 million and $2.1 million, respectively. Overall, current year results of the electronic segment continued to reflect the weakness of the semiconductor and computer industries. In comparison, the economic condition of the electronics industry was still relatively strong in the first three months of 1985. Certain reclassifications were made to 1985 sales and operating earnings of the Company's industry segments to conform with the classifications used in the current year. These reclassifications were not material.

Financial Condition

The Company continues to maintain a strong financial position with respect to both solvency and liquidity. The ratio of total debt to total capitalization at March 31, 1986, was 26.0 percent. The Company has not made any substantial changes to its line of credit agreements since December 31, 1985.

The Company's working capital position remains stable, with a current ratio of 2.0 to 1, unchanged from year end 1985. Net funds provided from continuing operations were $37.0 million at March 31, 1986. Funds were used primarily for capital expenditures and the quarterly dividend payment.

PART II. - OTHER INFORMATION

SQUARE D COMPANY AND SUBSIDIARIES

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

a. Not Applicable

b. Reports on Form 8-K

On January 23,1986 the company filed a current report on Form 8-K reporting the declaration of a dividend distribution of one common stock purchase right on each share of the Company's common stock outstanding on January 21, 1986.

SIGNATURE

SQUARE D COMPANY AND SUBSIDIARIES

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.

SQUARE D COMPANY
(Registrant)

By [signature]
J. F. LaShorne
Controller, Chief Accounting Officer and Assistant Secretary

Date May 12, 1986

END

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EXECUTED

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

ORIGINAL
L 45-411
9786

FORM 10-K

ANNUAL REPORT

RECD S.E.C.
SEP 27 1985
FEE 7

Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the fiscal year ended June 30, 1985

Commission file number 0-13082

Commercial Federal Corporation
(Exact name of registrant as specified in its charter)

Nebraska	47-0658852
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2120 South 72nd Street, Omaha, Nebraska	68124
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (402) 554-9200

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

SEP 30 1985

Title of each class

Common Stock, par value $.01 per share

Indicate by check mark whether the registrant has:

(1) filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports) YES X NO ____

100
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(2) been subject to such filing requirements for the past ninety days. YES X NO ____.

Based on the market value of the Registrant's common stock as of September 16, 1985, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $30,762,627. On such date [illegible] shares of the Registrant's Common Stock $.01 par v[illegible] [illegible]tanding.

DOCUMENTS IN[illegible]

1. Portions of Annual Report to Stockh[illegible] the Fiscal Year Ended June 30, 1985. (Parts I and II)

2. [illegible] of proxy statement for the 1985 annual meeting of Stockh[illegible]

Item 1. BUSINESS

Organization. Commercial Federal Corporation (the "Corporation"), a savings and loan holding company, incorporated in Nebraska, with corporate offices in Omaha, Nebraska, acquired 100% of the capital stock of Commercial Federal Savings and Loan Association (the "Association") on December 31, 1984 following completion of the Corporation's offering of common stock. The Association, organized in 1887, converted from a federal mutual association to a federal stock association on December 31, 1984 and issued its capital stock to the Corporation in exchange for 99% of the net offering proceeds. On June 30, 1985, the Association had assets of $2.6 billion and net worth of $65.3 million and operated 32 offices located throughout Nebraska. At June 30, 1985, the Association was the largest depository institution in Nebraska and ranked 71st among thrift institutions in the United States.

The Corporation has not engaged in any material operations to date. The assets of the Corporation consist of all of the shares of the Association's capital stock and one percent of the proceeds from the offering of common stock of the Corporation. The Corporation has no source of income other than from the Association and has had no expenses other than its organizational expenses.

The Corporation is a unitary, non-diversified, savings and loan holding company. The holding company structure provides the Corporation with the ability to expand and diversify the financial services offered beyond those currently offered through the Association and its "service corporation" subsidiaries. While the Corporation has no plans, arrangements, agreements, or understandings regarding diversification through acquisition or development into other businesses, the Board of Directors believes that the holding company structure offers significant advantages. As long as the Corporation remains a unitary savings and loan holding company, the Corporation may diversify its activities in such a manner as to include any activities allowed by regulation to a unitary savings and loan holding company. In pursuing such diversification, the Corporation will be required to raise additional capital. Currently, there are no plans to raise capital funds for the Corporation from outside sources other than 5% of the net proceeds to be raised in connection with the Company's proposed offering of one million shares of common stock. In addition, the Association's ability to pay dividends to the Corporation is significantly restricted. As a result, the Corporation's investments and activities will be limited until it can raise additional capital funds.

The Association is a financial intermediary which accepts deposits from the general public and reinvests such deposits, together with other borrowings, primarily in real estate loans secured by liens on residential and other real property and, to a lesser extent, in consumer loans. Primarily through its subsi-

aries, the Association engages in mortgage banking activities, l estate development, real estate syndication and equipment sing and provides real estate appraisal, insurance brokerage, securities brokerage and other financial services. The Association is regulated and supervised by the Federal Home Loan Bank Board ("FHLBB") and the Federal Savings and Loan Insurance Corporation ("FSLIC"). The Association is a member of the Federal Home Loan Bank System ("FHLBS") and its accounts are insured by the FSLIC up to applicable limits.

The Corporation's executive offices are located at 2120 South 72nd Street, Omaha, Nebraska 68124. Its telephone number is (402) 554-9200.

Lending Activities

Regulatory Developments. The Depository Institutions Deregulation and Monetary Control of 1980 ("Deregulation Act") and the Garn-St Germain Depository Institutions Act of 1982 ("Garn Act") have significantly expanded the powers of savings and loan associations. Prior to the enactment of the Deregulation Act, savings and loan associations were limited in their lending operations to loans on residential properties and investment in a limited range of federal securities and federally insured bank deposits for liquidity purposes. The Deregulation Act and Garn Act and implementing regulations have allowed savings and loan associations to lend and invest in areas previously reserved for commercial banks. In addition, the rcentage of assets which may be invested in nonresidential real tate loans has been increased from 20% to 40% and commercial eal estate loans are no longer required to be secured by first liens. Federal associations may generally invest up to 10% of assets in secured or unsecured loans for commercial, corporate, business or agricultural purposes. The Garn Act also permits federal associations to invest up to 30% of their assets in consumer loans and up to 10% of assets in tangible personal property in order to engage in equipment leasing.

General. The Association is utilizing these expanded lending authorities with several programs designed to improve the sensitivity of its loan portfolio to interest rate changes. First, it is aggressively marketing adjustable-rate residential mortgage loans, most of which it intends to retain for its own loan portfolio. Second, it has adopted a policy of selling in the secondary mortgage market substantially all long-term fixed-rate residential mortgage loans it originates. Third, the Association is placing increased emphasis on the origination of consumer and commercial real estate loans which have shorter maturities than residential real estate loans.

On July 1, 1983, the function of originating and servicing real estate loans, including responsibility for servicing the Association's existing loan portfolio, was transferred to CFS Mortgage Corporation ("CFS Mortgage"), a wholly owned mortgage

banking subsidiary of the Association. CFS Mortgage was formerly known as Tower Financial, Inc. Real estate loans are originated by CFS Mortgage through the efforts of its commissioned sales force, which maintains frequent contact with real estate agents in CFS Mortgage's market. Currently, CFS Mortgage originates residential and commercial real estate loans throughout Nebraska, and in Tulsa and Oklahoma City, Oklahoma, commercial real estate loans in Kansas City, Kansas and residential loans in Des Moines, Iowa and Kansas City, Missouri. In addition, CFS Mortgage has a 46% interest in American Western Mortgage Company, a Denver-based mortgage banking company.

All loans originated by CFS Mortgage are underwritten in accordance with the Association's standards, which are in compliance with FNMA and FHLMC standards. All adjustable-rate loans originated are immediately sold to the Association. Substantially all long-term fixed-rate real estate loans originated by CFS Mortgage are immediately packaged for sale in the secondary market with CFS Mortgage retaining the servicing at a fee of .25% to .50%.

The following table sets forth the composition of the Association's total loan portfolio by type of loans and type of security as of the dates indicated.

	At June 30,								
	1981		1982		1983		1984		19
	(Amounts in thousands)								
pe of Loan									
ntic [illegible] Loans	$1,045,659	77.2%	$1,035,082	75.8%	$1,053,874	66.6%	$1,570,041	72.0%	$1,534
ruc [illegible] Loans	33,291	2.5	13,083	1.0	32,796	2.1	59,914	2.8	67
VA Loans	226,596	16.7	227,502	16.7	226,857	14.3	208,399	9.6	200
& FHLMC and other tgage-Backed Securities	31,214	2.3	61,615	4.5	236,760	15.0	290,780	13.3	435
Improvement and Other sumer Loans	12,671	.9	19,382	1.4	26,744	1.7	45,240	2.1	55
gs Account Loans	4,725	.4	7,579	.6	4,246	.3	3,970	.2	4
tal	1,354,156	100.0%	1,364,243	100.0%	1,581,277	100.0%	2,178,344	100.0%	2,297
mortized Premiums and scounts	(3,854)		(6,934)		(14,798)		(79,323)		(69
ns in Process	(6,786)		(2,341)		(13,862)		(8,047)		(8
n Loss Reserve	--		(1,118)		(554)		(623)		
tal	$1,343,516		$1,353,850		$1,552,063		$2,090,351		$2,218
pe of Security									
ential:									
gle Family Units	$1,132,225	83.6%	$1,098,640	80.6%	$1,058,508	66.9%	$1,344,089	61.7%	$1,297
Family Units	41,501	3.1	39,575	2.9	36,236	2.3	28,494	1.3	24
er Dwelling Units	46,829	3.5	44,862	3.3	95,082	6.0	131,544	5.1	121
& FHLMC and other tgage-Backed Securities	31,214	2.3	61,615	4.5	236,760	15.0	290,780	13.3	435
	8,710	.6	6,032	.4	4,461	.3	45,090	2.1	34
rcial Properties	76,281	5.6	86,558	6.3	119,240	7.5	309,137	14.2	323
l Real Estate Loans	1,336,760	98.7	1,337,282	98.0	1,550,287	98.0	2,129,134	97.7	2,237
Improvement and Other sume [illegible] Loans	12,671	.9	19,382	1.4	26,744	1.7	45,240	2.1	55
gs [illegible] nt Loans	4,725	.4	7,579	.6	4,246	.3	3,970	.2	4
tal	1,354,156	100.0%	1,364,243	100.0%	1,581,277	100.0%	2,178,344	100.0%	2,297
mortized Premiums and scounts	(3,854)		(6,934)		(14,798)		(79,323)		(69
ns in Process	(6,786)		(2,341)		(13,862)		(8,047)		(8
n Loss Reserve	--		(1,118)		(554)		(623)		
tal	$1,343,516		$1,353,850		$1,552,063		$2,090,351		$2,218

The following table sets forth certain information at June 1985 regarding the dollar amount of loans maturing in the Association's portfolio based on the loan's contractual terms to maturity. Demand loans (loans having no stated schedule of repayments and no stated maturity) and overdrafts are reported as due in one year or less. The table does not include any estimate of prepayments. Principal reduction, including prepayments, of loans receivable amounted to $144.0 million, $247.1 million and $270.4 million for the three years ended June 30, 1983, 1984 and 1985, respectively.

Prepayments significantly shorten the average life of all mortgage loans. Thus, management believes that the following table will bear little resemblance to what the actual repayments of the loan portfolio will be.

	Due by June 30,			Due 4 through 5 years after June 30,	Due 6 through 10 years after June 30,	Due 11 through 15 years after June 30,	Due more than 15 years after June 30,
	1986	1987	1988	1985	1985	1985	1985
	(Amounts in thousands)						
tate Loans:							
e Family							
ed Rate........	$20,863	$22,985	$25,326	$ 58,666	$207,976	$339,326	$ 756,461
....	20,937	23,642	26,[illegible]16	62,596	122,248	193,513	289,088
	41,800	46,627	51,842	121,262	330,224	532,839	1,045,549
ction Loans....	50,082	17,126	--	--	--	--	--
provement, mer and gs Account	22,790	17,908	17,908	1,341	--	--	--

The following table sets forth the dollar amount of all loans due after one year from June 30, 1985 which have fixed interest rates and those which have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates
	(Amounts in thousands)	
At June 30, 1985:		
Real Estate Loans:		
Single Family..................	$1,410,740	$305,962
Other..........................	309,303	102,338
Construction Loans...............	17,126	--
Home Improvement, Consumer and Savings Account Loans......	37,157	--

Residential Loans. Historically, residential mortgage loans made by the Association were fixed-rate loans with maturities of generally 25 to 30 years. These loans were repayable in equal monthly installments of interest and principal. The Association retained in its portfolio substantially all of the loans it originated.

Significant changes in these historical practices began to occur within the past five years. These changes were accelerated when, effective August 1, 1981, the FHLBB authorized federal savings and loan associations to offer adjustable rate mortgages which are not subject to any limitation on interest rate adjustment over the life of the loan except for the requirement that such adjustments must be tied to movements in a national interest rate index. In 1981, the Association began the policy that long-term fixed-rate mortgage loans would be originated only if such loans are eligible for sale at a satisfactory yield in the secondary market, or if such loans represent the refinancing or replacement of existing lower-yielding loans then owned by the Association. At June 30, 1985, 76.6% of the Association's portfolio still consisted of long-term fixed-rate mortgage loans. This included $388.3 million of seasoned loans which had been purchased at a discount and funded with borrowings at a positive spread. Of the Association's loan portfolio at June 30, 1985, 62.3% consisted of fixed-rate first-mortgage loans made to home buyers on the security of single-family dwellings, including mortgage backed securities. See "Management's Discussion and Analysis - Asset/Liability Management." The Association holds in its portfolio mortgage-backed securities guaranteed by the Government National Mortgage Association ("GNMA") and participation certificates issued by the Federal Home Loan Mortgage Corporation ("FHLMC") which are classified as mortgage loans.

The Association offers three types of adjustable-rate mortgages all tied to U.S. Treasury bill rates with interest rates which can be adjusted every six months, one year or three years, respectively. Each loan has a maximum rate during the term of the loan. Fees charged on these loans range from 2.5% to 4% and are paid at closing.

Substantially all of the Association's conventional first mortgage loans include a "due-on-sale" clause which permits the Association to declare a loan immediately due and payable in the event, among other things, that the borrower sells or otherwise disposes of the property subject to the mortgage and the loan is not repaid. The Association's policy is to offer the new borrower a mortgage with an adjustable rate or one with an increased rate. The Association has not been enforcing due-on-sale clauses on adjustable-rate loans. Loans insured by the Federal Housing Authority (FHA) or partially guaranteed by the Veterans' Administration (VA) do not contain due-on-sale clauses.

Conventional residential loans originated by the Association are made up to 95% of the appraised value of the real property for dwellings of not more than four family units. All loans in excess of 80% of the appraised value require private mortgage insurance covering that portion of the loan in excess of 80% of the appraised value. The cost of this insurance is borne by the borrower.

The Association provides interim construction financing for single-family and multi-family dwellings. During fiscal 1984 and 1985, the Association originated approximately $19.6 million and $28.1 million, respectively, and purchased $41.4 million and $27.0 million, respectively, of such loans. Residential construction loans comprised the predominant portion of the Association's construction loans of $67.2 million as of June 30, 1985. Construction loans are typically made for periods of up to 18 months at rates tied to the prime rate, generally limited to 80% of the appraised value of the property upon completion. Construction loan funds are periodically disbursed as prespecified stages of completion are attained. The terms of the construction loans made by the Association require monthly interest payments with principal due upon completion or sale of the property. The Association usually does not grant long-term commitments to builders or other entities.

Commercial Real Estate and Land Acquisition and Development Loans. Commercial real estate loans and permanent loans secured by multi-family apartment projects with more than four dwelling units constituted approximately 19.4% of the Association's loan portfolio at June 30, 1985 and 5.7% of the total loans originated, purchased and refinanced during the year ended June 30, 1985. These loans are secured by various types of commercial properties including condominiums, shopping centers, warehouses and apartment buildings. While the majority of the commercial loans have been originated in Nebraska, an increasing percentage are being originated in Oklahoma through CFS Mortgage's two loan origination offices located in Oklahoma City and Tulsa.

As of June 30, 1985, the Association had approximately $34.9 million of land development loans, the predominant portion of which constituted funded participations in land acquisition and development loans and had commitments to fund approximately $1.7 million of such loans. These loans all mature by October 1985. The properties securing such loans are located nationwide and the lead lender is the same for each loan. The Association has the option to require the lead lender to buy back the Association's portion of these loans at specific dates. The Association generally has not taken majority equity positions in such loans.

Commercial real estate loans generally are made for terms of 12 years with a 30-year amortization schedule. Most of these loans are made at adjustable rates (adjusted the third and sixth years or the fourth and eighth years) which are tied to a U.S. Treasury Bill rate. This rate can be increased or decreased a

maximum of 1½ percentage points per adjustment period, but may not be reduced below the original note rate. The Association generally charges an origination fee of 2 to 2½% of the loan origination amount. Such loans, which are originated by CFS Mortgage, are immediately sold to the Association with CFS Mortgage retaining the servicing.

The Association also originates commercial construction loans which are solicited from qualified builders and developers. These loans are made up to 80% of the appraised value. Commercial construction loans have not constituted a significant portion of the Association's loan activity to date.

Loan Purchase and Sales. While the Association, like most other savings and loan associations, has historically relied on loan originations to replenish and build its loan portfolio, the purchase of loans and GNMA and FHLMC mortgage-backed securities has enabled the Association to generate an acceptable yield on its money during periods when loan demand is low. During the fiscal years ended June 30, 1983 and 1984, the Association purchased seasoned long-term fixed-rate real estate loans at deep discounts with aggregate unpaid principal balances of approximately $94.7 million and $358.4 million, respectively, and discounted values of approximately $74.4 million and $291.0 million, respectively, in order to increase the yield on, and to reduce the estimated remaining life of, its loan portfolio. Activity of this nature was not significant during the year ended June 30, 1985.

The Association through CFS Mortgage, has been actively engaged in selling loans and mortgage-backed securities which are packaged in the form of securities and sold in the secondary mortgage market. Most loans which are currently sold by the Association are originated with takeout commitments and are sold very soon after origination. It is the Association's current policy to sell, primarily through CFS Mortgage, in the secondary mortgage market almost all fixed-rate, long-term mortgage loans that it originates. All of these sales are made without recourse.

In connection with the sale of most of these loans, CFS Mortgage retains the servicing of the loans (i.e., collection of principal and interest payments) for which it receives a monthly fee of .25% to .50% per annum of the unpaid balance of each loan. As of June 30, 1985, CFS Mortgage was servicing loans and participations for others aggregating approximately $239.1 million after having sold in September 1984 loan servicing rights on approximately $63.1 million of loans serviced for others.

Set forth below is a table showing the Association's loan originations, purchases and sales for the periods indicated.

	Year Ended June 30,				
	1981	1982	1983	1984	1985
Loans Originated:					
Real Estate Loans(1):					
Construction Loans..........	$ 29,203	$ 4,673	$ 30,425	$ 19,605	$ 28,117
Loans on Existing Property..	176,908	61,430	72,129	166,720	144,654
Loans Refinanced............	16,297	4,745	22,561	28,691	9,754
Other Loans...................	4,928	15,377	14,547	29,823	60,962
Total Loans Originated....	$227,336	$86,225	$139,662	$244,839	$243,487
Loans Purchased:					
Real Estate Loans:					
Construction Loans..........	$ --	$ --	$ --	$ 41,422	$ 27,049
Conventional................	44,423	12,227	111,001	439,840	33,716
Insured and Guaranteed......	--	2,687	10,100	--	--
Mortgage-Backed Securities..	12,836	33,299	312,285	193,408	302,812
Other Loans...................	--	--	--	5,027	1,070
Total Loans Purchased.....	$ 57,259	$48,213	$433,386	$679,697	$364,647
Loans Sold:					
Whole Loans..................	$ 46,051	$12,397	$ 40,087	$ 60,895	$ 78,790
Participation Loans...........	15,731	27,705	75,250	--	50
Mortgage-Backed Securities....	--	--	116,321	80,988	127,941
Total Loans Sold..........	$ 61,782	$40,102	$231,658	$141,883	$206,781

(1) Includes insured and guaranteed loans of $25,833, $11,739, $41,051, $33,123 and $22,210 in the years ended June 30, 1981, 1982, 1983, 1984 and 1985, respectively.

Interest Rates and Loan Fees. Interest rates charged by the Association on its loans are primarily determined by secondary market yield requirements and competitive loan rates offered in its lending areas. Nebraska law provides that there is no interest rate limitation on any loan secured by real estate. Nebraska law does, however, impose various limitations on the interest rate which may be charged on installment and personal loans made to non-corporate borrowers. Generally, interest rates on these loans are limited to 19% per annum, although loans in excess of $25,000 are not subject to any interest rate limitation.

In additional to interest earned on loans, the Association receives loan origination fees. These fees are a percentage of the principal amount of the mortgage loan and are charged to the borrower and/or the seller by the Association for originating the loan. See Note A of Notes to Consolidated Financial Statements

for a discussion of how loan fee income is recognized under generally accepted accounting principles.

Consumer and Commercial Loans. Consistent with its efforts to restructure its loan portfolio to increase and to make such yields more responsive to changes in prevailing interest rates, the Association has recently increased its consumer loan dollar volume and anticipates a continual increase during fiscal 1986. During fiscal 1984 and 1985, the Association originated approximately $21.8 million and $36.7 million, respectively, of consumer loans. Federal regulations permit federal associations to make secured and unsecured consumer loans up to 30% of the Association's assets. In addition, a federal association has lending authority above the 30% category for certain consumer loans, such as home equity loans, property improvement loans, mobile home loans and savings account-secured loans. Most of the consumer loans originated by the Association are second mortgage loans. The Association also makes loans to depositors on the security of their savings accounts and offers loans secured by automobiles. The Association has recently offered commercial and corporate loans, which presently constitute an insignificant portion of the Association's total loan portfolio.

Loan Commitments. The Association negotiates standby commitments to real estate developers, real estate companies and qualified borrowers for the construction and purchase of residential real estate as well as commercial real estate. Such commitments are made on specified terms and conditions, including, in some cases, the payment of a non-refundable commitment fee ranging from 1.0% to 2.5% of the actual amount of committed funds. The commitments are for periods of up to 24 months with options for extensions. Such commitments are generally made at the prevailing market rate at the time of closing. As of June 30, 1985, the Association had issued commitments to fund loans and purchase mortgage-backed securities of $259.0 million, excluding undisbursed portions of loans in process. As of June 30, 1985, CFS Mortgage had purchased optional commitments totaling $20.2 million of loan production.

Scheduled Items. If a borrower fails to make required payments on a loan, the Association takes action to realize upon the security for the loan. If a delinquency cannot otherwise be cured, the Association commences foreclosure proceedings. On loans involving Nebraska real estate, a foreclosure sale will normally take place within approximately one year after commencement of the foreclosure proceedings. When a sale is held, the Association generally acquires title to the property. The property may then be sold for cash or with financing conforming to normal loan requirements, or it may be sold or financed with a "loan to facilitate" involving terms more favorable to the borrower than those permitted by applicable regulations for new loans.

To provide a measurement of the amount of an association's assets by loans and real estate involved in the delinquency cycle, the FHLBB has defined certain assets as "scheduled items" and has established certain ratios relating to such assets, the principal ratios being scheduled items to specified assets and scheduled items to total assets. In general, scheduled items include delinquent or "slow loans" (which in the case of FHA insured, VA guaranteed or federally insured student loans, include only 20% of the principal balance of such loans), real estate acquired as a result of foreclosure or by voluntary deed in lieu thereof, loans and contracts to facilitate the sale of such real estate and real estate previously held for investment or development where the loan does not conform to the lending requirements of the FHLBB and other investments which are in default. "Specified assets" consist principally of the balance due on conventional mortgage loans, 20% of the balance due of FHA insured or VA guaranteed loans, and investments in real estate.

Pursuant to FSLIC regulations, an association's regulatory net worth requirements are dependent in part upon its level of scheduled items. See "Regulation--Insurance of Accounts." In addition, an association with a ratio of scheduled items to specified assets exceeding 2.5% is required to give ten days notice to the district FHLB prior to the issuance of any securities evidencing "outstanding borrowings" (borrowings other than FHLB advances), during which period the supervisory agent may object to such issuance. A federally chartered thrift institution, such as the Association, also may not object to such issuance. A federally chartered thrift institution, such as the Association, also may not without prior approval of the FSLIC, make loans to its subsidiaries in excess of otherwise permissible investment limits if the institution's scheduled items exceed 2.5% of specified assets. The Association's scheduled items have consistently remained within regulatory limits.

The following table sets forth the amounts and categories of the Association's scheduled items and the ratio of such scheduled items to specified assets and to total assets at the dates indicated.

	At June 30,				
	1981	1982	1983	1984	1985
	(Amounts in thousands)				
ow loans(1)..................	$6,887	$13,435	$14,478	$15,234	$16,867
al estate owned(2)............	1,195	2,897	4,738	7,336	9,550
ans to facilitate(3)..........	995	1,038	1,020	1,010	959
Total scheduled items........	$9,077	$17,370	$20,236	$23,580	$27,376
tio of scheduled items to:					
Specified assets(4)..........	.77%	1.47%	1.70%	1.40%	1.51%
Total assets.................	.59	1.01	1.11	.97	1.04

(1) Generally refers to loans that are contractually delinquent (i.e., payments were due and unpaid for more than 60 to 90 days, depending upon the age of the loan, or tax payments were delinquent).

(2) Includes real estate acquired by the Association through foreclosure or voluntary deed and also real estate currently in process of foreclosure, but excludes real estate properties on which the loan is insured or guaranteed.

(3) Generally refers to loans secured by, and contracts for the sale of real estate owned by the Association or held by an FSLIC-insured institution for development or investment purposes where the unpaid principal balance exceeds applicable lending limitations or where the unexpired portion of the term exceeds 30 years.

(4) Specified assets are all assets of the Association except liquid assets (i.e., cash, U.S. government obligations, etc.), loans guaranteed in full by the U.S. government, FHLBB Stock, and other assets of this type.

The Association purchased a loan secured by an office building located in Midland, Texas (the All Rich project, see "Subsidiaries") in the amount of $1.4 million in December 1982 and the loan became delinquent in September 1983. In March 1984, the Association purchased this property by deed in lieu of foreclosure. This loan was a scheduled item at June 30, 1985. The property was last appraised in May 1985 for $1.7 million. The Association intends to sell the building when market conditions indicate that the time is appropriate and the loan will continue to be a scheduled item until disposition of the building.

The Association has a 16.1% participation interest in the amount of $5.0 million on a loan secured by a hotel being constructed at a ski resort in Crested Butte, Colorado. The Association and several other institutions including the FSLIC own the property which is under construction and expected to be completed by the end of the 1985 calendar year. The Association has established a 34% loss reserve on the funded amount of $4.0 million, in the amount of $1.4 million, which it believes is sufficient to cover any potential losses.

Investment Activities

The Association invests in fixed-income securities ranging from approximately 5% of assets, as generally required to meet liquidity regulations of the FHLBB, to approximately 18%, beyond which level the Association gradually loses its bad debt deduction for tax purposes under the "taxable income method." See "Federal and State Taxation."

As a member of the FHLBB, the Association is required to maintain an average daily balance of liquid assets (cash, certain domestic time deposits, certain domestic certificates of deposits, bankers' acceptances, specified government, state or federal agency obigations and prime-quality commercial paper) and an average daily balance of such liquid assets with maturities of one year or less equal to specified percentages of its net withdrawable savings plus short-term borrowings. Those percentages are currently 5% and 1%. The Association's general policy is to invest primarily in short-term liquid assets in compliance with these regulatory requirements. As of June 30, 1985, the Association had total liquid assets of approximately $144.4 million, and its liquidity and short term liquidity ratios were 8.24% and 5.10%, respectively. In addition, the Association held $5.0 million of investment securities at June 30, 1985 which would have qualified as liquid assets for regulatory purposes but for the fact that they had been pledged as security for short-term borrowings under repurchase agreements. See "Borrowings" and Notes D and J to the Notes to Consolidated Financial Statements.

The Association manages its investment portfolio for liquidity purposes primarily to meet anticipated and unanticipated cash flow needs, with preservation of principal being paramount. Management of this liquidity portfolio occasionally results in gains and losses from sale and reinvestment activities intended to enhance yields and/or shorten maturities within the parameters established by the Board of Directors.

Financial Futures Transactions

The Association has interest rate sensitive liabilities that exceed interest rate sensitive assets for repricing periods within 15 years, as do most thrift institutions. This imbalance subjects these institutions to interest rate risks such that rising rates will generally result in reduced earnings and declining rates in improved earnings. Many institutions have recently sought to reduce this imbalance by various means, including lengthening the maturities of liabilities, shortening the maturity and increasing the interest rate sensitivity of assets, hedging with financial futures and other strategies.

In order to hedge the interest rate risk on a portion of its fixed-rate loans, in March 1984, the Association entered into an interest rate swap for a notional principal amount of $25.0 million whereby the Association agreed for a two-year period to pay a fixed interest rate of 10.87% and receive a floating rate of interest equal to the three-month Treasury Bill yield. Through June 30, 1985, the Association had net interest expense of $462,000 from this contract. In accordance with present accounting for hedged transactions, the Association accounted for its net interest income or expense and has not recorded the notional principal amount.

In 1982 and 1983, the Association engaged in a financial futures hedging program to hedge the cost of funds paid on savings deposits. As of June 30, 1983, the Association had realized a net loss of $5.4 million in connection with its hedging activities. This loss was completely amortized by the end of fiscal year 1985. The general decline in market interest rates during fiscal 1983 caused these hedging losses, which were more than offset by the significant decline in the Association's liability costs. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Deposits

General. Deposits have traditionally been an important source of the Association's funds for use in lending and for other general business purposes. In addition to deposits, the Association derives funds from loan repayments, loan sales, FHLB advances, other borrowings and operations. Borrowings may be used on a short-term basis to compensate for reductions in deposits or deposit inflows at less than projected levels.

The Association offers a variety of rates and deposit programs within regulatory limitations to suit customer needs and to meet its requirements. Rates on deposits are priced based on investment opportunities and competitive rates available at other depository institutions.

The specific programs offered by the Association have changed over time as new instruments have been authorized. Historically, ceilings were imposed on the rates that financial institutions could offer for most types of accounts, and associations and savings banks were permitted to pay a slightly higer rate than most commercial banks on most types of accounts in order to attract funds for the housing market. Effective January 1, 1984, the Garn Act eliminated this interest rate differential. Effective October 1, 1983, the DIDC eliminated all remaining interest rate ceilings for accounts with maturity in excess of 31 days.

Pursuant to the Garn Act, the Association offers two Money Market Deposit accounts called Market Bonus Savings and Market Plus, deposit accounts competitive with money market mutual funds. These accounts have no maturity requirement, no regulatory interest rate ceiling and limited check-writing privileges. If the balance drops below $2,500, 5.25% is paid on the account until the balance again exceeds $2,500. The interest rate on the account may change daily but historically is adjusted weekly based on money market conditions. The Association began offering the Market Bonus Savings and Market Plus on December 14, 1982 and July 17, 1984, respectively, and at June 30, 1985 had approximately $182.5 million of such deposits or 13.4% of its deposit portfolio.

The decision by the federal financial regulatory authorities in June 1978 authorizing depository institutions to issue money market certificates was made primarily to allow these institutions to compete with government securities and other investments during periods of high interest rates. Money market certificates, together with the "small saver certificates" and the Money Market Deposit accounts, have been the primary sources of new deposits for the Association since their authorization. Since January 1979 the Association experienced a general shift of deposits from lower-rate passbook and certificate accounts to higher-rate six-month money market certificates, the 30-month small saver certificates and other market rate accounts. This redistribution of deposits, combined with periods of historically high interest rates, has significantly increased the Association's cost of funds. For example, the Association's cost of deposits increased from 6.9% during the year ended June 30, 1979 to 8.0% during 1980 to 9.4% during 1981 and to 11.2% during 1982, before decreasing to 10.73% during 1983, 9.95% during 1984 and 9.57% during 1985.

In November 1983, the Association implemented a checking account acquisition program to obtain low cost deposits and generate fee income. At June 30, 1985, a total of 34,878 accounts existed as a result of this program, of which 38% were accounts with a $5 monthly fee.

The Association has recently used brokered certificates of deposit as an alternative source of term deposits. As June 30, 1985 such certificates totaled $75.7 million which represented [illegible].6% of total deposits.

The Association offers certificate accounts with terms ranging from one month to 120 months which are not subject to federal interest rate controls. These deposits have increased substantially since the elimination of interest rate ceilings for these accounts in October 1983.

Since September 1984, the Association has offered and aggressively marketed a "Step-Up" savings certificate. The Step-Up certificate has a term of one year with a scheduled contractual increase in the interest rate paid on the certificate each month. The depositor is permitted to withdraw part or all of the principal and interest of the certificate every 30 days without the imposition of an early withdrawal penalty.

Passbook accounts continue to decline as a percentage of total deposits and in absolute terms. As of the date hereof, the Association is paying interest at the rate of 5.50% per annum on regular passbook accounts.

Substantially all of the Association's depositors are residents of the Association's primary market area, except for deposits solicited through brokers. The Association, through its subsidiaries, is also in the process of developing a national

etail accounts department for soliciting out-of-state deposits nitially through the use of direct mail.

The following table sets forth the deposit activity of the Association for the periods indicated.

	Year Ended June 30,				
	1981	1982	1983	1984	1985
	(Amounts In thousands)				
Deposits....................	$922,766	$1,242,250	$1,247,243	$1,452,335(1)(2)	$1,861,917(2)
Withdrawals..................	928,146	1,273,047	1,293,698	1,535,852(3)	1,885,634(3)
Net Deposit inflows (outflows)...............	(5,380)	(30,797)	(46,455)	(83,517)	(23,717)
Interest credited...........	77,196	97,985	102,520	92,261	80,304
Net increase in deposits....	$ 71,816	$ 67,188	$ 56,065	$ 8,744	$ 56,587

(1) Includes $47,745 of deposits gained from a branch sale transaction, consisting of two certificates of deposits of equal amounts included with one and two-year maturities, respectively.

(2) Includes brokered certificates of deposit of $30,380 and $69,245 in fiscal years 1984 and 1985, respectively.

(3) Includes $114,732 and $14,707 of deposits transferred with branch sale transactions in 1984 and 1985, respectively.

The following table sets forth the change in dollar amount of deposits in the various types of deposit accounts offered by the Association between the dates indicated. It reflects the movement of deposits from traditional deposit instruments, such as passbook accounts, into accounts yielding money market rates.

	At June 30, 1981		At June 30, 1982		
	Balance	% of Deposits	Balance	% of Deposits	Increase (Decrease)
	(Amounts in thousands)				
Passbook................	$ 213,252	18.2%	$ 192,792	15.6%	$(20,460)
NOW/Cashaction.........	16,221	1.4	21,328	1.7	5,107
Market Rate Savings and Super NOW........	--	--	--	--	--
Jumbo Certificates.....	24,973	2.1	22,429	1.8	(2,544)
Other Certificates.....	914,777	78.2	987,472	79.8	72,695
IRA/Keogh..............	1,037	.1	13,427	1.1	12,390
	$1,170,260	100.0%	$1,237,448	100.0%	$ 67,188

	At June 30, 1983			At June 30, 1984			At June 30, 1985		
	Balance	% of Deposits	Increase (Decrease)	Balance(1)	% of Deposits	Increase (Decrease)(1)	Balance(1)	% of Deposit	Increa (Decre
			(Amounts in table and notes in thousands)						
Passbook...	$ 135,000	10.4%	$(57,792)	$ 120,776	9.3%	$(14,224)	$ 112,034	8.2%	$ (8,
NOW/Cash-action...	31,160	2.4	9,832	33,595	2.6	2,435	45,138	3.3	11,
Market Rate Savings and Super NOW.......	202,333	15.6	202,333	183,039	14.0	(19,294)	182,470	13.4	(
Jumbo Certificates.....	29,695(2)	2.3	7,266	105,133(3)	8.1	75,438	93,280	6.9	(11,
Other Certificates.....	864,727	66.9	(122,745)	794,788	61.0	(69,939)	871,812	64.2	77,
IRA/Keogh..	30,598	2.4	17,171	64,926	5.0	34,328	54,110	4.0	(10,
	$1,293,513	100.0%	$ 56,065	$1,302,257	100.0%	$ 8,744	$1,358,844	100.0%	$ 56,

(1) Reflects $114,732 and $14,707 of deposits transferred with branch sale transactions in 1984 and 1985, respectively.

(2) Includes $14,900 of 9% certificates maturing in January 1995.

(3) Includes $47,745 of deposits gained from a branch sale transaction, consisting of two certificates of deposit of equal amounts with one and two year maturities, respectively.

The following table sets forth the Association's time deposits classified by rates as of the dates indicated.

Rate	At June 30, 1981	1982	1983	1984	1985
	(Amounts in thousands)				
6- 8%............	$190,573	$ 101,061	$ 62,871	$ 22,599	$ 65,673
8-10%............	68,461	57,932	479,945	242,571	515,669
10-12%............	51,371	86,193	71,241	570,121	398,418
12-14%............	259,988	536,099	95,704	55,818	38,331
14-16%............	293,422	181,516	147,535	73,693	1,093
Over 16%..........	--	60,527	67,724	45	18
Deposits of merged institutions....	76,972	--	--	--	--
	$940,787	$1,023,328	$925,020	$964,847	1,019,202

The following table sets forth the amount and maturities of the Association's time deposits at June 30, 1985.

Rate	Amounts Due: One Year or less	Over 1 up to 2 Years	Over 2 up to 3 years	Over 3 years	Total
	(Amounts in thousands)				
6- 8%............	$ 55,198	$ 6,319	$ 1,396	$ 2,760	$ 65,673
8-10%............	387,641	70,237	39,081	18,710	515,669
10-12%............	207,807	114,754	41,675	34,182	398,418
12-14%............	12,155	18,218	484	7,474	38,331
14-16%............	951	56	47	39	1,093
Over 16%..........	18	--	--	--	18
	$663,770	$209,584	$ 82,683	$63,165	$1,019,202

Customer Services

Management has updated its data processing equipment by recently adding new computer and branch terminal processing equipment to its branch operations in order to provide a cost-effective and efficient delivery of services to its customers. Additional software products relating to loan servicing, accounting, consumer lending and retail deposit activities have been updated to provide a wide range of correspondent services. As of September 1, 1985 there were 21 strategically located Automatic Teller Machines ("ATMs") in use. Commercial Federal has joined the Iowa Transfer System which being part of the CIRRUS Network will give the Association access to ATMs throughout the country.

The Association aggressively markets its telephone bill-paying system and checking accounts. It is the Association's objective to utilize these services and technology, rather than the rates paid on deposits, to attract and service customers to which it can cross market its numerous services on a cost-effective profitable basis.

Borrowings

In recent years, the Association has relied heavily upon borrowings, primarily advances from the FHLB of Topeka, as its primary source of new funds. Advances from the FHLB of Topeka are typically secured by the Association's stock in the FHLB of Topeka, a portion of the Association's first mortgage loans and mortgage-backed securities. The maximum amount of the line of credit which the FHLB of Topeka will advance for purposes other than meeting deposit withdrawals fluctuates from time to time in accordance with FHLBB policies. The Association is required to maintain an investment in FHLB stock equal to 5% of its outstanding advances and to pledge such stock as collateral for FHLB advances. As of June 30, 1985, pursuant to this requirement, the Association had pledged its FHLB stock in the amount of $35.2 million. In addition to this collateral requirement, the Association is required to pledge additional collateral which may be either unencumbered whole residential first mortgages with an unpaid principal amount equal to 170% of the Association's total outstanding FHLB advances or U.S. government or U.S. government agency guaranteed securities including mortgage-backed securities in an amount equal to 110% of the FHLB advances. Pursuant to this requirement, as of June 30, 1985, the Association had pledged whole first mortgage loans with unpaid principal balances of $1,153.5 million. As of June 30, 1985, the Association had $83.0 million of whole first mortgage loans and $144.5 million of mortgage-backed securities available to be pledged as collateral for additional FHLB advances. See "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources."

At June 30, 1985, rates and terms for FHLB advances varied from 7.90% for two months to 10.85% for 120 months. These rates vary from time to time in response to general economic conditions. At June 30, 1985, the Association had advances totaling $678.5 million from the FHLB of Topeka at interest rates ranging from 9.15% to 13.12% and at a weighted average rate of approximately 11.60%. See Note K to the Notes to Consolidated Financial Statements.

In December 1979, the Association sold $40.0 principal amount of 11.20% mortgage-backed bonds in an underwritten public offering. These bonds, which mature in December 1989, are secured by mortgages on owner-occupied single-family dwellings with unpaid principal balances of $79.6 million at June 30, 1985. See Note L to the Notes to Consolidated Financial Statements.

In December 1982 the Association borrowed the $23.1 million proceeds from a housing bond offering in Austin, Texas and issued a long-term note payable, the balance of which at June 30, 1985 was $19.6 million. In connection therewith, the Association made loans to developers for apartment construction at 1½ percentage points over the note payable rate. Further, the Association pledged as collateral otherwise unencumbered first mortgage loans with unpaid principal balances of $32.0 million at June 30, 1985. See Note L to the Notes to Consolidated Financial Statements.

In March 1983 the Association borrowed the $14.9 million proceeds from a housing bond offering in Lubbock, Texas in exchange for certificates of deposits. The Association made loans to the developer of three apartment complexes at 1½ percentage points over the certificate of deposit rate.

From time to time the Association borrows funds under repurchase agreements. Under a repurchase agreement, the Association sells securities (generally government securities and GNMA or FHLMC mortgage-backed securities) and agrees to buy them back at a specified price at a later date. Repurchase agreements are generally made for terms ranging from 30 days to one year, are subject to renewal, and are deemed to be borrowings collateralized by the securities sold. The purpose of these borrowings is to arbitrage these funds(i.e., the proceeds may be invested in money market instruments having maturity dates generally matching and rates exceeding the underlying repurchase obligation) and to provide funds for general business purposes. At June 30, 1985, the repurchase agreements, collateralized by approximately $292.8 million of securities aggregated $282.1 at an average rate of 8.70%. See Note J to the Notes to Consolidated Financial Statements.

Subsidiaries

The Association is permitted to invest an amount equal to 2% of its assets in its service corporations, with an additional investment of 1% of assets where such investment serves primarily for inner-city and community development purposes. Under such limitations, on June 30, 1985, the Association was authorized to invest up to approximately $76.2 million in the stock of, or loans to, service corporations (based upon the 3% limitation). In addition, federal associations meeting the regulatory net worth requirement and certain scheduled item tests may invest up to 50% of their regulatory net worth in conforming first mortgage loans to service corporations. By meeting these requirements and tests the Association at June 30, 1985 was permitted to make approximately $39.1 million of such conforming loans, for a total investment limitation of approximately $115.3 million. As of June 30, 1985 the net book value of the Association's investment in stock, unsecured loans, and conforming loans in its service corporations and their wholly owned subsidiaries was approximately $82.2 million.

Commercial Service Corporation. Commercial Service Corporation ("CSC") was formed in 1973. CSC's primary activity since 1979 has been real estate development. CSC sustained significant losses during fiscal years 1982 and 1983 in its two largest investments in real estate developments to date, Beacon Hill Landing and Turalee-On-The-Hill, both of which are located in Orange County, California. These investments were originally joint ventures with builders and involved the purchase of lots and the construction and sale of single-family residences. The final unit was sold in July 1985. CSC currently invests only in projects it owns 100% or through joint ventures with an experienced real estate development company. The profit and loss percentage and the equity investment percentage are negotiated between the parties and in most cases are not identical.

CSC is engaged in other activities through wholly owned or joint venture subsidiaries of its own. CSC owns 100% of Commercial Insurance Corporation, which is a general insurance agency. CSC also has a 65% ownership in Metro Title and Escrow Company, a title insurance agency. In addition, Com Fed Capital Corporation ("ComFed"), formerly Commercial Tax Sheltered Investments, Inc., a wholly owned subsidiary of CSC, was incorporated in late 1982 to form real estate syndications to purchase income properties, primarily apartment buildings. CF Realty Investors, Inc., a wholly owned subsidiary of CSC, was formed in 1983 to serve as the corporate general partner in the real estate limited partnerships to be formed by ComFed. In October 1983, ComFed closed its first real estate syndication in which it raised approximately $2.3 million and invested the proceeds in an apartment complex. In March 1984, ComFed completed another real estate syndication offering of approximately $1 million of limited partnership interests. In May and August 1985, ComFed closed separate real estate limited partnership syndications of $3.0 million and $1.8 million, respectively.

Set forth in the following table is certain information pertaining to CSC's real estate projects as of June 30, 1985. The Association has no outstanding loans or lending commitments on any of the following projects. However, a guarantee by the Association on one of the loans is noted below.

Project Name and Location	Description	CSC Profit/ Loss %	Total Estimated Project Cost	Date of Initial Investment	CSC's Investment at June 30, 1985	Net Equity Investment by Others	Loan Payable to Others
enner/Commercial orth, Worth, TX	Single-family residential lots	50%	$ 3,000,000	June 1985	$ 750,000	$750,000	$ --
dgefield(1) maha, NE	Single-family residential lots	25%	1,900,000	Nov. 1983	66,000	55,000	170,000
lla Niguel aguna Niguel, CA	Single-family residential homes	40%	10,100,000	Sept. 1984	295,000	96,000	4,951,000(2)
lla West ellevue, NE	Multi-family condominium conversion	100%	850,000	May 1985	656,000(3)	--	510,000
k Hills inc[illegible] NE	Single-family residential lots	100%	-- (4)	Oct. 1979	248,000	--	--
1 R[illegible](5) idland, TX	Commercial office building	100%	-- (5)	(5)	1,348,000	--	--
Total			$15,850,000		$3,363,000	$901,000	$5,631,000

(1) CSC is a limited partner.

(2) 50% of loan is guaranteed by the Association and 50% of loan is guaranteed by Ampac Properties.

(3) Includes the $510,000 listed in column "Loan Payable to Others."

(4) Project completed. Approximately 20 out of 127 developed lots are sold.

(5) Completed property that was transferred to CSC from the Association. Purchased by deed in lieu of foreclosure in March 1984 for $1,424,000. See "Business - Scheduled Items." Approximately 60% was leased at June 30, 1985.

In 1984, CSC formed a separate corporation, CHE, Inc., for the purpose of forming partnerships and operating luxury budget motel sites. The plan is to develop and operate over the next several years, with experienced motel developers, 10-15 motels franchised by two of the largest motel franchisors in the country, Hampton Inn, the luxury budget motel of Holiday Inn, and Quality Inn. As of June 30, 1985 CHE owned five motel sites including one motel under construction. In July 1985, CSC purchased another site for motel development at 72nd Street, Omaha, Nebraska for approximately $442,000. Set forth below are the details of the motel projects and CSC's related investments as of June 30, 1985. The Association has no outstanding loans or lending commitments on any of the following projects.

Location	CSC Profit /Loss %	Total Estimated Project Cost	Date of Initial Investment	CSC's Investment at June 30, 1985	Net Equity Investment by Others	Loans Payable to Others
orado Springs, CO(1)	50%	$ 3,600,000	June 1984	$ 307,000	$25,000	$3,200,000(1)
asota, FL (2)	75%	2,200,000	June 1985	319,000	--	--
hita Falls, TX(2)	50%	3,500,000	May 1985	247,000	--	--
enix, AZ(2)(3)	50%	5,300,000	June 1985	200,000	--	--
h S[illegible], Omaha, E(2[illegible]	50%	3,500,000	July 1984	419,000	--	--
Total:		$18,100,000		$1,492,000	$25,000	$3,200,000

(1) Motel under construction as of June 30, 1985 and expected to open in approximately October 1985. A franchise agreement for the motel has been signed with Hampton Inn. The construction loan is a non-recourse loan.

(2) Partnerships are in the formation stage, having recently acquired the site, and no construction has begun as of June 30, 1985.

(3) The partnership is in the formation stage. The investment amount represents a nonrefundable deposit for the purchase of the land. The purchase of the site was completed in August 1985.

CFS Mortgage Corporation. CFS Mortgage is a wholly owned subsidiary of the Association. All of the activities of the Association's real estate lending division were transferred to CFS Mortgage in June 1983. Commercial Federal has invested $4.0 million in capital in CFS Mortgage as of June 30, 1985. Substantially all of the adjustable-rate mortgages presently originated by CFS Mortgage are sold to the Association, while the fixed-rate mortgages originated by CFS Mortgage are sold to other investors and quasi-governmental agencies. CFS Mortgage has loan origination operations in Omaha, Lincoln and several major communities in Nebraska. It has also established origination offices in Tulsa and Oklahoma City, Oklahoma, Kansas City, Kansas, Kansas City, Missouri and Des Moines, Iowa and owns a 46% interest in a mortgage company located in Denver, Colorado. For further information regarding the activities of CFS Mortgage see "Business -- Lending Activities."

Commercial Marketing Inc. Commercial Marketing Inc., ("CMI") a wholly owned subsidiary of the Association, was formed in August 1984 for the purpose of purchasing Systems Marketing, Inc., ("SMI"), an equipment leasing firm based in Phoenix, Arizona with offices in Los Angeles and Chicago. In September 1984, CMI purchased 80% of the voting stock of SMI. To date, CMI has invested $6.6 million in SMI, which represents its only asset at June 30, 1985. The investment in SMI was accounted for under the purchase method of accounting and includes $3.4 million of "goodwill" that is being amortized on a straight-line basis over ten years. See Note C to the Notes to Consolidated Financial Statements regarding determination of the final purchase price. SMI currently has $2.0 million of 13% and $1.0 million of 14% cumulative non-voting preferred stock outstanding. See Note O of Notes to Consolidated Financial Statements for details on the terms of the preferred stock.

SMI, which was formed in 1971, is primarily engaged in the leasing of data processing equipment. Typically, SMI enters into leases with end users, purchases equipment for them, and finances the purchases, generally structuring the financing around sales of the equipment in sale and leaseback transactions to limited partnerships, individuals and corporations. Ultimately, when an end user's lease ends, SMI will seek to release or sell the equipment to realize its residual value. For the nine months ended May 31, 1985, the majority of the new lease originations consisted of operating leases as opposed to sales-type leases.

As of May 31, 1985, SMI's equipment lease portfolio consisted of 661 leases involving 145 different lessees. At June 30, 1985 CMI's consolidated assets were $122.4 million and stockholder's equity was $9.8 million. SMI had net income of $909,000 and $2.2 million for the fiscal years ended September 30, 1983 and 1984, respectively. CMI's consolidated net income for the year ended June 30, 1985, which includes SMI's results of operations from September 1, 1984 to May 31, 1985, was $3.2 million. The nature of SMI's business subjects it to the risks of changes in estimated residual values of equipment out on lease which constitutes the collateral underlying receivables for lease rentals. Residual values are reviewed and adjusted, if necessary, both quarterly and in the audited financial statements. Ultimately, residual values are realized through either sale or release of equipment at the end of existing lease

periods. See Note F of Notes to Consolidated Financial Statements for details of SMI's investments in financial contracts associated with its leasing operations.

CMI has retained the executive management of SMI. In connection therewith, CMI has entered into a three year employment agreement with Robert R. Russell, Chairman of the Board and Chief Executive Officer of SMI. Pursuant to this agreement, Mr. Russell is entitled to receive $150,000 per annum. Also, additional compensation, salary increases and other benefits may be granted at the discretion of the Corporation's Board of Directors. The agreement is terminable upon default by either party, and the agreement includes a standard non-competition clause which remains in effect for two years following the expiration or termination of the agreement provided Mr. Russell is paid his salary during the term of the agreement.

Tower Investments, Inc. Tower Investments, Inc. ("TII") generally serves as a repository for equity participations entered into by the Association, primarily through commercial real estate loans. In November 1983 TII entered into a management agreement to develop a townhouse project in Omaha, Nebraska. The project, which is planned for 134 townhomes, is being funded primarily by CFS Mortgage. It is anticipated that a total of $12.5 million of construction loans will be funded for the project over the estimated development period of four years. At June 30, 1985, the total investment in this project was $1.9 million.

Trampe and Associates Corporation. Trampe and Associates Corporation ("TAC") was formed by the Association in April 1982 for the purpose of purchasing an existing appraisal services business. TAC is involved in real estate appraisal services in Nebraska. TAC provides appraisal services for the Association and subsidiary lending operations, and also operates as an independent fee appraiser servicing other major mortgage lenders. The Association has $69,000 invested in TAC common stock which generates a nominal profit.

INVEST

The Association has entered the securities brokerage business through INVEST, a service of ISFA Corporation. The Association's involvement with the INVEST program is twofold. First, the Association's wholly owned subsidiary, CSC, has an equity interest in ISFA Holding Company, Ltd. which owns 100% of ISFA Corporation. CSC's investment is $325,000. Secondly, the Association is a participant in the INVEST program and has installed INVEST centers with registered representatives in three of its branch offices.

INVEST is a brokerage service which provides access to all major stock, bond, mutual fund, and option markets, as well as providing investment advice. ISFA Corporation, the registered broker-dealer, provides all support functions either independently or through affiliates such as Quick & Reilly, Value Line, and Standard & Poor's. The INVEST approach is different from major securities firms in that all the registered representatives are salaried and not paid a commission based on transaction volume. Additionally, INVEST effects transactions only on behalf of its customers and does not buy or sell for its own account nor does it underwrite securities.

Several of the Association's employees have been trained and registered with both the National Association of Securities Dealers, Inc. and the state of Nebraska. Commercial Federal ranked second in new account openings in calendar year 1984 among all INVEST subscribers.

Competition

The Association faces strong competition in the attraction of deposits and in the origination of real estate loans. Its most direct competition for savings deposits has come historically from other savings and loan associations and from commercial banks located in its primary market areas. The Association's primary market area for savings deposits includes Nebraska and western Iowa and, for loan originations, includes Nebraska, Colorado, Iowa, Kansas, Missouri and Oklahoma. Management believes that the Association's extensive branch network has enabled the Association to compete effectively for deposits and loans against commercial banks and other savings and loan associations. Commercial banks in Nebraska are currently subject to certain restrictions regarding branch banking. The Association, as the largest depository institution in Nebraska, has been able to attract savings deposits primarily by offering depositors a wide variety of deposit accounts, competitive rates of interest, convenient branch locations, tax-deferred retirement programs, a telephone bill paying service and a full range of financial services.

The Association's competition for real estate loans comes principally from other savings and loan associations, commercial banks, mortgage banking companies, insurance companies and other institutional lenders. The Association competes for loans principally through the interest rates and loan fees it charges and the efficiency and quality of the services it provides borrowers, real estate brokers, and home builders.

Legislation passed by the U.S. Congress since 1980 and regulations implementing these acts have significantly expanded the range of services which federal associations can offer the public. In addition, since 1978 the federal regulatory authorities, in part due to this legislation, have been deregulating the interest rate controls and other federal regulation of savings deposits. These changes, combined with high interest rates and an increasingly sophisticated savings public, have dramatically increased competition between savings and loan associations and other types of income investments (such as money market mutual funds, Treasury securities, municipal bonds, etc.) for savings dollars and increased competition with commercial banks in regard to loans, checking accounts, and other types of financial services. In addition, large conglomerates and securities firms are entering the market for financial services. Thus the Association, like other savings and loans, faces increased competition in the savings and lending services it offers and has to be innovative and knowledgeable about its market, as well as exert effective controls over its costs, in order to be competitive.

Employees

As of June 30, 1985, the Corporation and its wholly owned subsidiaries had 628 full-time employees and 141 part-time employees. The employees are not represented by a collective bargaining unit. The Corporation believes its employee relations are good.

Regulation

General. Federal savings and loan associations such as Commercial Federal are members of the FHLBS and have their savings deposits insured by the FSLIC. They are subject to extensive regulation by the FHLBB as chartering authority and operating head of the FSLIC. Mortgage lending activities and other investments must comply with various federal statutory and regulatory requirements. Associations must file reports with these governmental agencies about their activities and their financial condition. There are periodic FHLBB examinations to test compliance by an association with various regulatory requirements. This supervision and regulation is intended primarily for the protection of the depositors.

Federal Home Loan Bank System. Commercial Federal is a member of the FHLBS, which consists of 12 regional Federal Home Loan Banks subject to FHLBB supervision and regulation. The Federal Home Loan Banks provide a central credit facility primarily for member institutions. Commercial Federal, as a member of the FHLB of Topeka, is required to acquire and hold shares of capital stock in the FHLB in an amount at least equal to 1% of the aggregate principal amount of its unpaid residential mortgage loans, purchase contracts and similar obligations at the beginning of each year, or 5% of its advances (borrowings) from the FHLB of Topeka, whichever is greater. Commercial Federal is in compliance with this requirement with an investment in FHLB of Topeka stock at June 30, 1985 of $35.2 million.

In December 1984, the FHLMC, which is a quasi-governmental agency (see "Business -- Lending Activities -- Loan Purchases and Sales") distributed a stock dividend in the form of non-voting preferred stock to its members of the FHLBS. As a member of the FHLB of Topeka, Commercial Federal received a dividend of 63,599 shares of non-voting preferred stock which was taken into income in the amount of $1.6 million (net of applicable income taxes) during the year ended June 30, 1985 as an extraordinary income item.

As of June 30, 1985, the Association had advances totaling $678.5 million from the FHLB of Topeka. This line of credit may fluctuate from time to time in accordance with specified loan underwriting considerations determined by the FHLB of Topeka.

Member savings and loans associations are required to maintain an average daily balance of liquid assets (cash, certain time deposits, bankers' acceptance and specified United States government, state or federal agency obligations) equal to a monthly average of not less than a specified percentage of its net withdrawable savings deposits plus short-term borrowings. This liquidity requirement may be changed from time to time by the FHLB to any amount within the range of 4% to 10% depending upon economic conditions and the savings flows for members of the association, and is currently 5%. FHLBB regulations also require each member to maintain an average daily balance of short-term liquid assets at a specified percentage (currently 1%) of the total of its net withdrawable savings accounts and borrowings payable in one year or less. Monetary penalties may be imposed for failure to meet liquidity requirements. The liquidity of the Association at June 30, 1985 was 8.24% and exceeded the then applicable 5% liquidity requirement. Its short-term liquidity ratio at June 30, 1985 was 5.10%.

Insurance of Accounts. The Association's savings accounts are insured up to applicable limits by the FSLIC. As an insurer, the FSLIC issues regulations, conducts examinations and generally supervises the operations of its insured members. Any insured association which does not operate in accordance with or conform to FSLIC regulations, policies and directives may be sanctioned for non-compliance. For example, proceedings may be instituted against any insured association or any director, officer, or employee of such association who engages in unsafe and unsound practices, including the violation of applicable laws and regulations. The FSLIC has the authority to terminate insurance of accounts pursuant to procedures established for that purpose. If insurance of accounts is terminated by the FSLIC, the savings in the association subject to termination proceedings will continue to be insured by the FSLIC for a period of two years following the date of termination.

Prior to 1985, insured institutions such as the Association were required by the FSLIC to meet as of the close of each fiscal year a minimum level of net worth for regulatory purposes (calculated at the beginning of such fiscal year) equal to 3% of total liabilities, plus 2% of recourse liabilities and 20% of scheduled items. Institutions were permitted to calculate liabilities by averaging the past fiscal year with the preceding four fiscal years ("five-year averaging"). In addition, institutions that had not reached their twentieth anniversary of FSLIC insurance were permitted to phase in the regulatory net worth requirement by multiplying 3% of liabilities by a fraction in which the numerator was the number of consecutive years of insurance and the denominator was 20 ("20 year phase-in").

In January 1985 the FSLIC amended its regulations and changed significantly the rules for calculating regulatory net worth. The amended regulations eliminate, through a straight-line amortization over 5 years, both the authority to calculate the net worth requirement using five-year averaging (except for institutions having $100 million or less in assets that increase their liabilities at an annual rate not exceeding 15% and for institutions having more than $100 million in assets that increase their liabilities at an annual rate not exceeding 10% -- such institutions may continue using five-year averaging) and the use of the 20 year phase-in.

The amended regulations require institutions to calculate their minimum net worth requirement at the end of each calendar quarter rather than at the beginning of a fiscal year and to have the minimum necessary amount on each quarterly calculation date rather than at the end of the fiscal year. In addition, the amended regulations impose a net worth requirement equal to a percentage of any increase in liabilities measured from the close of business on the last day of the preceding year, with the amount of growth as follows: 3% of any liability growth if the institution grew at an annual rate of 15% or less; a graduated ratio from 3% to 5% of liability growth at an annual rate between 15% and 25%; and 5% of liability growth if the growth was at an annual rate in excess of 25%. Institutions with more than $100 million in assets must seek approval from the FSLIC's Principal Supervisory Agent to increase total liabilities during any two consecutive quarters at an annual rate in excess of 25%. Excess existing net worth can be used to meet these incremental increases. The new regulations permit an institution to reduce the amount of this net worth requirement to reflect an annual decrease in liabilities. Minimum regulatory net worth continues to include 2% of recourse liabilities and 20% of scheduled items and in addition includes an amount equal to 10% of certain direct investments (investments in subsidiaries, equity interests and real estate, and equity securities).

If an insured institution fails to meet the foregoing net worth requirement the FSLIC may require the association to take certain corrective actions. Sanctions imposed may include budgetary controls or a pledge of savings accounts by directors of the association, or both. At June 30, 1985 the Association's regulatory net worth was $78.3 million and exceeded the regulatory net worth requirement of $46.7 million by $31.6 million.

The annual premium charge for the FSLIC insurance is one-twelfth of one percent of the insured institution's total amount of savings deposits. The FSLIC can also assess additional premiums against each insured institution in any one year (up to one-eighth of one percent of the institution's total savings deposits) to meet losses and expenses of the FSLIC for the year.

The FSLIC assessed two special premiums on insured institutions each equal to 1/32 of 1% for the total amount of the accounts of insured members at each institution payable on March 31, 1985 and June 30, 1985, respectively. The FSLIC has stated that it may assess additional premiums of the same amount in subsequent quarters of 1985. The FSLIC is authorized by statute to make special premium assessments totaling up to one-eighth of 1% of the total amount of the accounts of insured members at each institution in any one year.

Savings and Loan Holding Company Regulations. The Corporation is a savings and loan holding company within the meaning of the National Housing Act, as amended by the Savings and Loan Holding Act Amendments of 1968 (the "National Housing Act"). As such, the Corporation is registered with the FSLIC and is subject to FSLIC regulations, examinations, supervision and reporting requirements. As a subsidiary of a savings and loan holding company, the Association is subject to certain restrictions in its dealings with the Corporation and with other companies affiliated with the Corporation and is also subject to regulatory requirements and provisions as a federal savings and loan association.

The National Housing Act prohibits a savings and loan holding company, without prior approval of the FSLIC, from (i) acquiring any other savings and loan association or savings and loan holding company or controlling the assets thereof or (ii) assuming debt or issuing, selling, renewing or guaranteeing debt securities aggregating in excess of 15% of its consolidated net worth at the end of the preceding year. A savings and loan holding company may not acquire as a separate subsidiary an insured institution outside of the state where the principal office of its subsidiary institution is located, except in the case of certain emergency thrift acquisitions approved by the FSLIC, under authority given the FSLIC in the Garn Act, which authority expires on October 15, 1985. Except with the prior approval of the FSLIC, no director or officer of a savings and loan holding company or person owning or controlling by proxy or otherwise more than 25% of such company's stock, may also serve as a director, officer or employee of or acquire control of, any insured association, other than a subsidiary association, or any other savings and loan holding company.

Pursuant to the National Housing Act, an association that is a subsidiary of a savings and loan holding company may not (i) invest its funds in securities or obligations of an affiliate, (ii) accept securities or obligations of an affiliate as collateral for loans, (iii) purchase securities or other assets or obligations under repurchase agreements from an affiliate, (iv) make (except in certain circumstances) any loan, discount or extension of credit to an affiliate or a third party on the security of any property acquired from an affiliate or with knowledge that the proceeds thereof are to be paid over to, or utilized for the benefit of an affiliate, (v) guarantee any loan or extension of credit to an affiliate or maintain compensating balances for same, and (vi) except with the prior approval of the FSLIC, engage in any transaction during a twelve-month period for an aggregate amount in excess of the lessor of $100,000 or .1% of an association's assets with an affiliate involving the purchase sale or lease of property or assets, or enter into any agreements or understandings for an aggregate amount in excess of the lessor of $100,000 or .1% of an association's assets whereby such affiliate will render management or advertising services, serve as a consultant, advisor or agent or render services of any other nature to the subsidiary association. A savings and loan holding company, its subsidiaries and any other company under common control are considered "affiliates" of the subsidiary association for purposes of the National Housing Act.

Should the Corporation acquire control of another FSLIC-insured savings and loan association other than through merger or other business combinations with the Association, it would thereupon become a multiple savings and loan holding company. Except where such acquisition is pursuant to the FSLIC's temporary authority to approve emergency thrift acquisitions, the activities of the Corporation and any of its subsidiaries (other than the Association or other FSLIC-insured subsidiary savings and loan associations) would thereafter be subject to further restrictions. No multiple savings and loan holding company or subsidiary thereof which is not an insured institution shall commence or continue for more than 180 days after becoming a multiple savings and loan holding company or subsidiary thereof, any business activity other than (i) furnishing or performing management services for a subsidiary insured institution, (ii) conducting an insurance agency or an escrow business, (iii) holding, managing or liquidating assets owned by or acquired from a subsidiary insured institution, (iv) holding or managing properties used or occupied by a subsidiary insured institution, (v) acting as trustee under deeds of trust or (vi) furnishing or performing such other services or engaging in such other activities as the FSLIC may approve or may prescribe by regulation as being a proper incident to the operations of insured institutions and not detrimental to the interests of savings account holders therein.

There are generally no restrictions on the activities of a unitary savings and loan holding company. However, any savings and loan holding company whose subsidiary insured institution fails to qualify as a "domestic building and loan association" under the Internal Revenue Code of 1954 (due to insufficient investment in qualifying assets such as residential mortgage loans) may not commence or continue for more than three years after such failure, directly or through its other subsidiaries, any business activity other than those described above for multiple savings and loan holding companies and their subsidiaries. At June 30, 1985, the Association's assets composition was in excess of that required to qualify the Association as a "domestic building and loan association."

Two bills were introduced in the session of Congress which ended in 1984, which had they been adopted, would have restricted the asset composition of FSLIC-insured subsidiaries of unitary savings and loan holding companies.

Senator Garn's bill (the "Garn bill"), as amended by the Senate Banking Committee, would have permitted a unitary savings and loan holding company to remain unrestricted in terms of its activities and affiliations provided that its subsidiary savings and loan association met a "qualified thrift lender" ("QTL") test. The Garn bill defined a QTL as an institution which has 60% or more of its assets invested in eligible assets although not more than 10% of the 60% could be comprised of liquid assets as required to be maintained under the Federal Home Loan Bank Act and half the dollar amount of residential mortgage loans originated and sold within 90 days. Eligible assets included residential mortgage loans and investments, i.e., mortgage-backed securities and real estate used in business. The Garn bill, had it been enacted, would have subjected savings and loan holding companies which failed to meet the QTL test to the restrictions on activities applicable to multiple savings and loan holding companies. In addition, the Garn bill would have amended the Federal Home Loan Bank Act to apply the 60% QTL asset test as an eligibility standard for Federal Home Loan Bank System advances.

Representative St Germain introduced a similar bill (the "St Germain bill"), pursuant to which unitary savings and loan holding companies would be required to conform to the list of restricted activities applicable to multiple savings and loan holding companies unless their subsidiaries met a 65% "qualified institution" test. The qualified institution test would be met when 65% of the institution's assets were comprised of residential mortgage loans and related investments for three out of four consecutive calendar quarters. Related investments would include investments in residential mortgage-backed securities, cash and obligations of the United States or a state, stock of any Federal Home Loan Bank, the business premises directly used by the institution, retail mobile home loans, home improvement

loans and investments in a service corporation in proportion to that corporation's qualifying assets. Compliance with the qualified institution test would have been required within four years of the bill's enactment. Institutions which already exceeded the 65% requirement or that reached that level after the date of enactment would not be able to drop below the 65% level. In addition, the St Germain bill, had it been enacted, would have prohibited "nonqualified institutions" from engaging in commercial lending activities and would also have prohibited federally insured nonqualified institutions from engaging in any activity not permissible for a federally chartered thrift association.

Neither the Garn Bill nor the St Germain Bill was enacted in the 1984 session of Congress but similar legislation has been introduced in the House of Representatives in 1985. The Corporation is unable to predict whether legislation will be enacted in the current session of Congress.

Federal Reserve Board Requirements. In 1980, Congress enacted legislation which imposes Federal Reserve Board reserve requirements (under "Regulation D") on all depository institutions, including savings and loan associations, that maintain transaction accounts or nonpersonal time deposits. NOW accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any nonpersonal time deposits at a savings and loan association. Under Regulation D, an association must establish reserves equal to 3% on the first $29.8 million of transaction accounts, and 12% on the remainder. The reserve requirement on nonpersonal time deposits with original maturities of less than 1-1/2 years is 3%. Although the reserve requirements on NOW accounts took effect immediately, the reserve requirements on other types of transaction accounts and on nonpersonal time deposits are subject to an eight year phase-in period. As of June 30, 1985, the Association met its reserve requirements.

Recent Legislation. As a federally chartered savings and loan association, the Association must comply with applicable provisions of federal law, as well as with rules and regulations promulgated by the FHLBB and the FSLIC. The Association derives its investment powers from these laws and regulations and must structure its lending policies and procedures so to comply with the various applicable provisions. The Deregulation Act and Garn Act have substantially expanded the lending and investment authority of federal associations.

The Garn Act provides among other things for (a) emergency regulatory authority to the federal financial regulatory agencies to assist troubled institutions (b) a program of financial assistance for FSLIC insured institutions which are experiencing financial difficulties, (c) authority of federally-chartered associations to hold demand accounts of persons or organizations

that have a business, corporate, commercial or agricultural loan relationship with the association, (d) an increase in permissible investment in non-residential real estate from 20% to 40% of an association's assets, (e) authorization for federally-chartered associations to invest up to 30% of their assets in consumer loans, up to 10% of their assets in tangible personnel property for leasing activities and up to 10% of their assets in commercial loans, (f) the phase-out by January 1, 1984, of rate differentials on savings deposits between savings and loan associations and commercial banks with no such differential thereafter and (g) the creation of money market deposit accounts competitive with money market funds.

Federal and State Taxation

Savings and loan associations are subject to the provisions of the Internal Revenue Code (the "Code") which subject corporations to an income tax equal to 46% of taxable income. However, associations such as Commercial Federal which meet certain definitional tests and other conditions prescribed by the Code, are allowed a tax bad debt deduction in computing taxable income for federal income tax purposes.

The Corporation, the Association and their respective subsidiaries intend to file consolidated federal and Nebraska income tax returns, which would have the effect of eliminating intercompany distributions, including dividends, in the computation of consolidated taxable income. Any income of the Corporation would not be subject to the tax bad debt deduction allowed the Association, whether or not consolidated tax returns are filed. The Association, however, must reduce its taxable income for purposes of computing its tax bad debt deduction under the percentage of taxable income method by its allocable share of loss attributable to the activities of other members of the consolidated group, if those members' activities are functionally related to the activities of the Association.

Savings and loan associations such as the Association which meet certain definitional tests and other conditions prescribed by the Internal Revenue Code of 1954, as amended (the "Code"), are allowed a bad debt reserve deduction which, with respect to qualifying real property loans, is based upon (1) actual loss experience, (2) a percentage of outstanding loan balances, or (3) a percentage of taxable income within certain adjustments before such deduction. The Association has generally elected to use the third method (the "taxable income method") of computing its bad debt reserve for federal income tax purposes. The Tax Reform Act of 1979 has gradually reduced the deduction available under the percentage of taxable income method to 40% of taxable income for fiscal 1980 and thereafter. The allowable deduction under the percentage of taxable income method is scaled downward in the event that less than 82% of the total dollar amount of the assets of an association qualifies within certain designated categories,

and there is no deduction in the event that less than 60 percent of the total dollar amount of the assets of an association falls within such categories. As of June 30, 1985 greater than 82% of the Association's total assets so qualified. The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") reduced the bad debt reserve deduction under the percentage of loans and the percentage of income method (second and third method) by 15% of the amount by which the otherwise allowable deduction exceeds the amount deductible on the basis of actual experience, for tax years beginning after December 31, 1982. The Tax Reform Act of 1984 will reduce the bad debt reserve deduction by 20% of such amount for tax years beginning after December 31, 1984. As a result, the maximum bad debt reserve deduction was effectively reduced to 34% for tax years beginning after December 31, 1982 and effectively reduced to 32% for tax years beginning after December 31, 1984.

The percentage of taxable income bad debt deduction with respect to qualifying real property loans, is available only to the extent that the increase to the bad debt reserve does not result in a balance that exceeds 6% of qualifying real property loans at the end of the year. The total bad debt reserve deduction is further limited to the amount by which 12% of savings accounts at year-end exceeds the sum of surplus, undivided profits and reserves at the beginning of the year. Neither of these limitations is expected to restrict the Association from making the maximum addition to its bad debt reserve.

In addition to the regular income tax to which the Association is subject, a minimum tax is imposed at a rate of 15% of (a) tax preference items, including the excess of the Association's tax bad debt deduction over the allowable deduction under the experience method, less (b) the greater of $10,000 or the Association's regular bad debt tax liability less certain credits. Under TEFRA, only 71.6% of the bad debt tax preference items subject to the minimum tax are included in the minimum tax base for tax years beginning after December 31, 1982. Under the Tax Reform Act of 1984, only 59.84% of the tax preference items subject to the minimum tax will be included in the minimum tax base for tax years beginning after December 31, 1984.

Earnings appropriated to a tax bad debt reserve are not available for payment of cash dividends or other distributions to the Corporation without payment of federal income taxes at the then current tax rate by the Association with respect to such distribution. The Corporation intends to make full use of the favorable tax treatment afforded to the Association and does not contemplate any action which would limit the Association's tax bad debt deduction or create federal tax liabilities. Retained earnings at June 30, 1985 include $23.3 million for which federal income taxes have not been provided.

On May 29, 1985 the President of the United States presented a tax reform proposal to Congress (the "1985 Proposal"). This proposal would make wide spread comprehensive changes on the taxation of individuals and corporations including thrift institutions. The 1985 Proposal would repeal the special provision which allows thrift institutions to compute a bad debt reserve. The 1985 Proposal would require that bad debt losses be deducted only as they become worthless. The 1985 Proposal would be effective for taxable years beginning on or after January 1, 1986 and would require a recapture of the bad debt reserves computed under the greater of the experience or percentage of eligible loans method. Such recapture would be taken into income ratably over ten years. Any existing excess bad debt reserves computed under the percentage of income method would not be recaptured. The repeal of the special bad debt reserve provisions may result in an increase in the Corporation's effective tax rate. Although the 1985 Proposal would retain the interest deduction on home mortgages on a taxpayer's principal residence, interest deductions on second home and investment real estate would be limited or eliminated. This may have an adverse effect on the real estate market and the lending activities of financial institutions. No reliable prediction can be made as to the likelihood of any such proposal being enacted into law.

The Association's income tax returns for 1980 through 1983 have recently been examined by the IRS. Although there has not yet been a full resolution of the issues raised by the IRS, management does not anticipate any material financial statement adjustments as a result of these examinations.

Nebraska imposes a corporate income tax on the Association which is computed based upon a percentage of federal taxable income subject to certain adjustments. This tax is imposed at the rate of 5.0% on the first $50,000 of federal taxable income and 7.0% on the amount over $50,000 for the year ended June 30, 1984. Comparable rates for the year ending June 30, 1985 are 4.75% on the first $50,000 of federal taxable income and 6.65% on any remainder.

Item 2. Properties

At June 30, 1985, the Association owned the building and land for 25 of its branch offices and owned the building, but leased the land for one other. Of the remaining 6 branches, 5 were leased and one was located in the corporate headquarters building. In addition, one location was being leased that was previously a branch office and one location was being leased that will be a mortgage loan office.

The following table sets forth the net book value of the Association's (savings and loan operations) office premises at June 30, 1985.

	(Amounts in thousands)
Offices located in:	
Omaha Area (17 offices).....................	$ 7,804
Lincoln Area (6 offices).....................	3,109
Norfolk Area (2 offices)....................	408
North Platte Area (2 offices)..............	407
Other Areas (5 offices)......................	1,500
	$13,228

On May 31, 1985, the Association sold its branch office located in Holdrege, Nebraska to another association. See Note U to the Notes to Consolidated Financial Statements.

The Association has received regulatory approval to construct a branch office located at 140th & West Center in Omaha, Nebraska. The Association currently owns the land and intends to invest approximately $500,000 to complete the branch facility.

At June 30, 1985, the total net book value of office properties and equipment owned by the Association was $36.0 million. See Note H to the Notes to Consolidated Financial Statements.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Corporation, the Association of any subsidiary is a party or to which any of their property is subject.

Item 4. Submission of Matters to Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended June 30, 1985.

PART II

Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters

The information contained under the section captioned "Quarterly Data" in the Corporation's Annual Report to Stockholders for the Fiscal Year Ended June 30, 1985 (the "Annual Report") is incorporated herein by reference.

Item 6. Selected Financial Data

The information contained in the table captioned "Selected Consolidated Financial Data and Other Items" in the Annual Report is incorporated herein by reference.

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

The information contained in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Annual Report is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data

The financial statements contained in the Annual Report are incorporated herein by reference.

Item 9. Disagreements on Accounting and Financial Disclosure

None

PART III

Item 10. Directors and Executive Officers of the Registrant

For information concerning the Board of Directors of the Corporation, the information contained under the section captioned "Proposal I -- Election of Directors" in the Corporation's definitive proxy statement for the Corporation's 1985 Annual Meeting of Stockholders (the "Proxy Statement") is incorporated herein by reference.

The executive officers of the Corporation are as follows:

Name	Age	Position
William A. Fitzgerald	47	President and Chief Executive Officer
Donald L. Schinzel	50	Senior Vice President
Gene R. Boba	45	Senior Vice President and Treasurer
Robert P. King	52	Senior Vice President
George A. Grieb	50	Senior Vice President
Robert M. Ames	42	Senior Vice President

The principal occupation of each executive officer of the Corporation for the last five years is set forth below.

William A. Fitzgerald has been with the Association for 30 years and has been President and Chief Executive Officer and a Director of the Association since 1975. Mr. Fitzgerald is also the President and Chief Executive Officer of the Corporation. Prior to 1975, he served as Chief Operating Officer, Chairman of the Loan Committee, and designed the Association's statewide diversification. He has served the thrift industry in leadership roles in several organizations on a national and local basis. He is a Past President of the Omaha Chamber of Commerce and served as General Chairman of the United Way of the Midlands Campaign. He currently serves on the Board of Creighton University, and College of Saint Mary and is a Governor of the Knights of Ak-Sar-Ben.

Donald L. Schinzel has been with the Association since 1956, and has, during that period, had management responsibility for many key areas of the Association, including accounting, data processing and electronic funds transfer. He is currently the Senior Vice President of the Corporate Development/Administration Division, and Secretary of the Association. Mr. Schinzel serves as Chairman of the Board of the Omaha/Council Bluffs YMCA, Vice Chairman of Lutheran Health Services and Chairman of the Board of the Health Affiliates, a subsidiary of Lutheran Health Services.

Gene R. Boba, Senior Vice President, Treasurer and Chief Financial Officer, joined the Association in December 1981. He has over 20 years of experience in the financial services industry. From 1979 to 1981, Mr. Boba was Vice President and Assistant Treasurer of the Federal Intermediate Credit Bank of Louisville, Kentucky, an agricultural banking company. He was Vice President of the Bond Department and Manager, Asset and Liability Committee of the Central National Bank of Chicago, Illinois from 1969 to 1978. Prior to that, Mr. Boba was associated with Dean Witter & Company in Chicago, Illinois, in corporate finance, investment banking, and brokerage functions.

Robert P. King, Senior Vice President of Information Services, joined Commercial Federal in June 1982, bringing 20 years of experience in the information services industry. His experience with IBM, Honeywell and international management led to a Vice President assignment with Blue Cross/Blue Shield, and a senior level assignment with Jefferson/Ward, a subsidiary of Montgomery Ward. Mr. King currently serves as a member of the Board of Bergan Mercy-Medata Corporation, a for-profit subsidiary of Bergan Mercy Hospital.

George A. Grieb, Senior Vice President, Retail Services Division, has served in various executive capacities with the Association since 1975. In his current position Mr. Grieb has primary responsibility for deposit acquisition and for fee income retail services. He oversees the Association's marketing, consumer lending, and customer service departments as well as the state-wide network of branch sales offices. Mr. Grieb has a broad background in commercial banking having spent 13 years with the National Bank of Detroit, and 5 years with the Omaha National Bank. He is a member of the Board of Directors of United Way of the Midlands; Junior Achievement of Omaha; Marion High School, Omaha; and Creighton Preparatory School, Omaha.

Robert H. Ames joined Commercial Federal in February 1984 as Senior Vice President of Diversification, and is responsible for the overall management and direction of the corporate diversification investment program which includes service corporation operations, acquisitions and new business ventures. Prior to that, from 1983 to 1984, he was an executive with Touche Ross & Co., an international accounting firm, and was responsible for providing tax and consulting services to clients in a wide range of businesses, including those of the banking industry. From 1966 to 1982 Mr. Ames was employed by Ernst & Whinney, an international accounting firm and from 1976 to 1982 he was the managing partner of their Omaha office. Mr. Ames is a member of the board of directors of Nodaway Valley Co. and the Omaha Community Foundation.

Item 11. Executive Compensation

The information contained under the section captioned "Management Remuneration" in the Proxy Statement is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Managment

The information required by this item is incorporated herein by reference to the section captioned "Proposal I -- Election of Directors" and "Voting Securities and Principal Holders Thereof" of the Proxy Statement.

PART IV

Item 13. Certain Relationships and Related Transactions

The information required by this item is incorporated herein by reference to the section captioned "Proposal I -- Election of Directors" and "Voting Securities and Principal Holders Thereof" of the Proxy Statement.

Item 14. Financial Statement Schedules and Reports on Form 8-K

1. Report of Independent Certified Public Accountants*

2. Commercial Federal Corporation*
   (a) Consolidated Statements of Condition at June 30, 1984 and 1985
   (b) Consolidated Statements of Operations for Each of the Three Years in the Period Ended June 30, 1985
   (c) Consolidated Statements of Stockholders' Equity for Each of the Three Years in the Period Ended June 30, 1985
   (d) Consolidated Statements of Changes in Financial Position for Each of the Three Years in the Period Ended June 30, 1985
   (e) Notes to Consolidated Financial Statements

   All schedules have been omitted as the required information is either inapplicable or included in the financial statements or related notes.

3. Exhibits
   (3)(a) Articles of Incorporation**
   (3)(b) Bylaws**
   (10) Employment Agreements**
   (11) Computation of Earnings Per Share
   (13) Annual Report to Stockholders for the Fiscal Year Ended June 30, 1985
   (22) Subsidiaries of the Registrant

4. No reports on Form 8-K have been filed during the last quarter of the fiscal year covered by this report.

*Incorporated by reference to the Annual Report to Stockholders for the Fiscal Year Ended June 30, 1985, attached as an exhibit hereto.

**These documents are incorporated by reference from the Registration Statement on Form S-1 (Registration No. 33-330).

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

COMMERCIAL FEDERAL CORPORATION

Date: September 26, 1985

By: William A. Fitzgerald
William A. Fitzgerald, Chief Executive Officer and Duly Authorized Representative

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: September 26, 1985

By: Gene R. Boba
Gene R. Boba
Principal Financial Officer

Date: September 26, 1985

By: Jeffrey A. Bainbridge
Jeffrey A. Bainbridge
Principal Accounting Officer

Date: September 26, 1985

By: William F. Fitzgerald
William F. Fitzgerald
Chairman of the Board

Date: September 26, 1985

By: William A. Fitzgerald
William A. Fitzgerald
Director

Date: September 26, 1985

By: Arthur W. Berry
Arthur W. Berry
Director

Date: September ___, 1985

By: ____________________
David S. Engelman
Director

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MAY 1 4 1986
DISCLOSURE INCORPORATED

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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NASDAQ

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FORM 10-Q

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107364

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended March 31, 1986 Commission File Number 0-13082

****

COMMERCIAL FEDERAL CORPORATION

****

14

Nebraska 47-0658852

2120 South 72nd Street
Omaha, Nebraska 68124
(402)554-9200

Indicate by check mark whether the Registrant (1) has filed all reports re[illegible]ired 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 Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

Indicate the number of shares out[illegible] of the issuer's classes of common stock, as of the latest p[illegible]

Class	Outstanding at May 12, 1986
[illegible] Par Value	[illegible],013,620 Shares

COMMERCIAL FEDERAL CORPORATION

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INDEX
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COMMERCIAL FEDERAL CORPORATION

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Amounts in Thousands)

ASSETS	March 31, 1986 (Unaudited)	June 30, 1985
Cash (including short-term investments)	$ 49,045	$ 38,169
Investment securities, at cost	196,463	144,955
Loans receivable	1,737,498	1,783,405
Mortgage-Backed Securities	828,256	441,323
Investment in financing contracts	137,924	112,208
Accrued interest receivable	31,858	26,322
Real estate	25,298	16,406
Premises and equipment	38,324	35,961
Prepaid expenses and other assets	41,144	27,515
TOTAL ASSETS	$3,085,810	$2,626,264

LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposit accounts	$1,704,309	$1,358,844
Short-term borrowings	307,497	295,475
Advances from Federal Home Loan Bank	709,195	678,514
Long-term debt	69,646	69,217
Notes payable and non-recourse discounted rentals on leases	84,796	69,421
Advance payments by borrowers for taxes and insurance	30,916	18,924
Accrued interest payable	41,962	26,793
Accounts payable and other liabilities	27,233	27,851
Deferred income	6,460	6,497
Deferred income taxes	6,461	6,461
Total Liabilities	2,988,475	2,557,997
Redeemable preferred stock of subsidiary	3,000	3,000
Stockholders' equity:		
Common stock, $.01 par value; 25,000,000 shares authorized, 6,012,279 and 4,012,517 shares issued and outstanding	40	27
Paid in capital	34,725	18,254
Retained earnings, substantially restricted	59,570	47,320
Net unrealized loss on marketable equity securities	-0-	(334)
Total Stockholders' Equity	94,335	65,267
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$3,085,810	$2,626,264

See notes to consolidated financial statements.

COMMERCIAL FEDERAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)
(Amounts in Thousands)

	Three Months Ended March 31, 1986	Three Months Ended March 31, 1985	Nine Months Ended March 31, 1986	Nine Months Ended March 31, 1985
Interest income:				
First mortgage loans and mortgage-backed securities	$66,398	$61,580	$193,570	$180,249
Other loans	2,984	2,604	7,881	6,927
Investment securities	4,207	4,071	12,308	16,322
Financing contracts	2,884	--	8,071	--
Total interest income	76,473	68,255	221,830	203,498
Interest expense:				
Deposit accounts	33,852	30,839	98,047	96,867
Short-term borrowings and other	5,958	6,576	18,920	22,227
FHLB advances and long-term debt	21,236	21,961	64,569	65,267
Notes and discounted lease rentals	2,553	--	6,910	--
Total interest expense	63,599	59,376	188,446	184,361
Net interest margin	12,874	8,879	33,384	19,137
Provision for loan losses	(769)	(411)	(1,756)	(1,011)
Net interest margin after provision for loan losses	12,105	8,468	31,628	18,126
Other income:				
Provision for loss on sale of real estate owned	(486)	(145)	(1,176)	(418)
Loan origination and servicing fees	1,419	974	5,011	4,025
Gain (loss) on sales of loans, mortgage-backed securities and loan servicing rights	1,066	(181)	4,344	2,010
Gain on sales of investment securities	2,086	148	3,306	1,262
Gain (loss) on sales of real estate acquired for investment including provision for loss	(1,036)	(322)	(1,353)	(197)
Gross profit on sales-type, brokerage and operating leases	3,086	--	7,395	--
Other operating income	2,859	3,398	7,493	8,882
Total other income	8,992	3,672	24,420	15,564
General and administrative expenses:				
Compensation, payroll taxes and fringe benefits	6,301	4,528	18,169	13,327
Rent and other occupancy expenses	1,995	1,873	5,682	5,270
FSLIC insurance premium	769	693	2,234	1,248
Advertising	827	510	1,725	1,436
Other operating expenses	3,624	1,713	9,002	5,769
Total general and administrative expenses	13,516	9,317	36,812	27,050
Income before income taxes and extraordinary items	7,581	3,023	19,236	6,640
Income tax provision	2,974	1,260	6,986	2,294
Income before extraordinary items	4,607	1,763	12,250	4,346
Extraordinary items, net of income taxes	--	--	--	1,391
Net income	$ 4,607	$ 1,763	$ 12,250	$ 5,737

See notes to consolidated financial statements.

COMMERCIAL FEDERAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31, 1986	Three Months Ended March 31, 1985	Nine Months Ended March 31, 1986	Nine Months Ended March 31, 1985
Earnings per common and common equivalent share:				
Income before extraordinary items	$ .75	$ .44	$2.36	$1.08
Extraordinary items	--	--	--	.35
Net income	$ .75	$ .44	$2.36	$1.43
Weighted Average Shares Outstanding	6,150,507	3,978,767	5,181,242	4,012,517
Earnings per common share - assuming full dilution:				
Income before extraordinary items	$ .75	$ .44	$2.34	$1.08
Extraordinary items	--	--	--	.35
Net income	$ .75	$ .44	$2.34	$1.43
Weighted Average Shares Outstanding	6,163,865	3,978,767	5,232,012	4,012,517

See notes to consolidated financial statements.

COMMERCIAL FEDERAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

(Unaudited)
(Amounts in Thousands)

	Nine Months Ended March 31, 1986	1985
Sources of funds:		
Net income before extraordinary items	$ 12,250	$ 4,346
Items not requiring (providing) funds:		
Interest credited to deposit accounts	57,119	59,947
Increase in accrued interest payable	14,740	11,144
Amortization of deferred discounts and fees	(7,127)	(7,528)
Provision for losses on loans, real estate owned, and real estate held for investment and under development	5,082	1,725
Increase in accrued interest receivable	(5,536)	(2,572)
Depreciation and amortization	2,574	2,155
Equity in earnings of subsidiary	--	(1,841)
Amortization of deferred losses on futures contracts	--	316
Funds provided from operations before extraordinary items	79,102	67,692
Sales of loans and mortgage-backed securities	359,887	102,294
Principal reduction of loans receivable and mortgage-backed securities	319,375	196,588
Increase in deposit accounts	198,408	61,957
Proceeds from FHLB advances	170,000	102,867
Deposits assumed in branch acquisition	89,938	--
Proceeds from sale of common stock	16,483	18,281
Increase in short-term borrowings	12,022	6,396
Increase in long-term debt	430	3,420
Extraordinary item - FHLMC dividend	--	1,650
	1,245,645	561,145
Applications of funds:		
Purchases of loans and mortgage-backed securities	735,957	246,046
Loans originated	280,247	193,621
Repayment of FHLB advances	139,319	49,812
Increase in investment securities	51,174	--
Other - net	17,731	13,779
Increase in investment in financing contracts in excess of notes payable and discounted rentals on leases	10,341	--
Decrease in deposit accounts	--	38,469
Extraordinary item - loss on early extinguishment of debt	--	259
	1,234,769	541,986
Increase in cash	$ 10,876	$ 19,159

See notes to consolidated financial statements.

COMMERCIAL FEDERAL CORPORATION

NOTES TO INTERIM UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 1986

A. BASIS OF CONSOLIDATION AND PRESENTATION:

The unaudited consolidated financial statements include the accounts of Commercial Federal Corporation (the Corporation) and its wholly-owned subsidiary, Commercial Federal Savings and Loan Association (the Association) and all of its subsidiaries. All significant intercompany items related to the consolidated subsidiaries have been eliminated. The results of Systems Marketing, Inc. (SMI), an 84.95% owned subsidiary, were recorded on an equity basis in the consolidated results of the Corporation on a one-quarter time lag for the periods ended March 31, 1985. The results of SMI for fiscal year 1986 are recorded on a consolidated basis on a one-month time lag.

The accompanying consolidated financial statements have not been examined by independent certified public accountants. However, in the opinion of management, all adjustments (consisting only of normal recurring accruals) necessary for a fair statement of financial condition, results of operations and changes in financial position for the periods presented have been included. The accounting policies followed by the Corporation and its subsidiaries are included in "Notes to the Consolidated Financial Statements - Three Years Ended June 30, 1985" included in Form 10-K Commission file number 0-13082 which are incorporated herein by reference. The results of operations for the three and nine month periods ended March 31, 1986 are not necessarily indicative of the results which may be expected for the entire fiscal year.

B. ADDITIONAL STOCK OFFERING:

On November 6, 1985, the Corporation completed a secondary stock offering which resulted in the issuance of 1,725,000 shares at $9.00 per share. On November 15, 1985, an additional 258,750 shares were issued to the underwriters to cover over-allotments of the secondary offering. Net proceeds of the secondary offering, after underwriting and offering expenses of $1,460,000, totaled $16,394,000. Approximately 95% of the net proceeds were used by the Corporation to purchase additional stock in the Association.

C. STOCK OPTION PLAN:

The Stock Option Plan, previously approved by the Board of Directors of the Corporation, was approved by the Corporation's stockholders at the November 19, 1985 annual stockholders' meeting.

As of March 31, 1986, the Corporation had granted options to purchase 254,229 shares at prices ranging from $5.67 to $9.58 per share, 37,491 of which have related stock appreciation rights. All options outstanding were exercisable at March 31, 1986. During the three and nine months ended March 31, 1986, 15,894 and 16,367 options, were exercised at average prices of $5.93 and $5.92 per share, respectively.

D. FSLIC SPECIAL ASSESSMENTS:

Starting with the quarter ended March 31, 1985, the Federal Home Loan Bank Board has assessed a special premium of one thirty-second of one percent on the quarter ending deposit base of individual savings institutions insured by the Federal Savings and Loan Corporation (FSLIC). Each quarter's assessment has been approximately $450,000.

E. RECLASSIFICATION OF PRIOR YEAR AMOUNTS:

Certain reclassifications have been made in the Corporation's financial statements for the prior fiscal year periods to conform to classifications used in the financial statements for the current fiscal year periods.

F. STOCK SPLIT:

At the close of the third quarter, the Corporation's Board of Directors declared a 3-for-2 stock split, in the form of a 50% stock dividend on the Corporation's outstanding common shares. The stock split will be distributed May 9, 1986, to shareholder's of record as of April 9, 1986. All share and per share information has been retroactively restated to reflect the stock split.

G. EARNINGS PER SHARE:

The Corporation's initial stock offering of 3,900,017 shares was on December 31, 1984. On January 28, 1985, an additional 112,500 shares were issued to the underwriters to cover over-allotments of the public offering.In computing earnings per share for the nine months ended March 31, 1985, the weighted number of shares used was 4,012,517, the same number of shares outstanding as of March 31, 1985.

Computation of income per common and common equivalent shares:

	Three Months Ended March 31, 1986	Three Months Ended March 31, 1985	Nine Months Ended March 31, 1986	Nine Months Ended March 31, 1985
Income available to common stock	$4,607,000	$1,763,000	$12,250,000	$5,737,000
Weighted average common shares outstanding	4,000,974	2,652,511	3,379,739	2,675,011
Add shares applicable to stock options using average market price	99,364	--	74,422	--
Average common and common equivalent shares outstanding	4,100,338	2,652,511	3,454,161	2,675,011
Stock split effect (1)	2,050,169	1,326,256	1,727,081	1,337,506
Total average common and common equivalent shares outstanding	6,150,507	3,978,767	5,181,242	4,012,517
Income per common & common equivalent share	$ .75	$ .44	$ 2.36	$ 1.43

Computation of income per common share assuming full dilution:

	Three Months Ended March 31, 1986	Three Months Ended March 31, 1985	Nine Months Ended March 31, 1986	Nine Months Ended March 31, 1985
Income available to common stock	$4,607,000	$1,763,000	$12,250,000	$5,737,000
Weighted average common shares outstanding	4,000,974	2,652,511	3,379,739	2,675,011
Add shares applicable to stock options using the period-end market price if higher than average market price	108,269	--	108,269	--
Average common and common equivalent shares assuming full dilution	4,109,243	2,652,511	3,488,008	2,675,011
Stock split effect (1)	2,054,622	1,326,256	1,744,004	1,337,506
Total average common and common equivalent shares assuming full dilution	6,163,865	3,978,767	5,232,012	4,012,517
Income per common share assuming full dilution	$ .75	$ .44	$ 2.34	$ 1.43

(1) See Note F to the Interim Unaudited Consolidated Financial Statements.

H. ACQUISITION OF SIERRA FEDERAL SAVINGS & LOAN:

During the quarter ended March 31, 1986, the Association acquired Denver-based Sierra Federal Savings and Loan Association from the FSLIC. In conjunction with this transaction, the Association assumed $89,9[illegible] of insured deposits in exchange for cash of $80,800,000. No assets or other obligations of Sierra Federal were acquired or assumed in this transaction. The $9.1 million of goodwill, representing the excess of deposits assumed over cash received, will be amortized on a straight-line basis over 10 years. The acquired Denver office is currently being operated as a branch of the Association.

Liquidity and Capital Resources:

The Association's liquidity position is monitored on a daily basis. The Association's current liquidity position provides flexibility for operational requirements, while exceeding minimums for regulatory purposes. Liquidity, which is the ratio of short-term liquid assets to net withdrawable savings deposits plus borrowings due in one year or less, was 9.48% at March 31, 1986 as compared to 8.24% at June 30, 1985.

As of March 31, 1986, the Association had issued commitments of $1,189.7 million, excluding undisbursed portions of loans in process, to fund loans and purchase mortgage-backed securities. Such commitments included $19.6 million of adjustable-rate commercial mortgage loans, $1.5 million of fixed rate commercial mortgage loans, $117.2 million of fixed-rate single-family mortgage loans, $8.4 million of adjustable-rate single-family mortgage loans and $1,043.0 million of mortgage-backed securities. The Association also had commitments to deliver mortgage-backed securities of approximately $145.0 million as of March 31, 1986. The mortgage-backed security purchase commitments of $1,043.0 million are spread over the next fifteen months, of which no month exceeds $156.0 million in settlements. At March 31, 1986, the Association had commitments from the FHLB for advances of $240.0 million. The Association can draw on these advances at any time through September 28, 1986. The Association expects to meet its additional funding requirements through the normal course of business, which includes brokered term certificates of deposit. The Association had $309.1 million of brokered term certificates of deposit outstanding as of March 31, 1986, as compared to $75.7 million at June 30, 1985.

Loan Activity - Loans receivable and mortgage-backed securities increased $341.0 million from June 30, 1985 to March 31, 1986. The 15.33% increase in loans receivable was due principally to: Adjustable-rate mortgage originations of $67.3 million; commercial real estate mortgage originations of $24.2 million; consumer loan originations of $60.2 million; GNMA and FHLMC mortgage-backed security purchases of $723.4 million; other loans purchased of $12.6 million; residential construction loan originations of $17.2 million; commercial construction loan originations of $10.9 million; and other fixed-rate originations of $100.5 million. Additionally, there were GNMA, FNMA, and FHLMC mortgage-backed security sales of $257.0 million, fixed-rate mortgage sales of $98.0 million, variable-rate mortgage sales of $1.8 million, consumer loan sales of $3.1 million and principal payoffs of $319.4 million.

Net Interest Margin:

The following table illustrates the quarterly change in net interest margin over the last five quarters ended March 31, 1986.

Quarter Ended	Net Interest Margin	Interest Rate Spread During The Quarter
March 31, 1985	$ 8,879,000	1.19%
June 30, 1985	10,063,000	1.52
September 30, 1985	9,575,000	1.58
December 31, 1985	10,935,000	1.79
March 31, 1986	12,874,000	1.72

Net Interest Margin (Cont'd):

Changes from period to period in net interest margin result from changes in interest rates on and balances of assets and liabilities. The following table presents the dollar amount of changes in interest income and expense for each major component of interest-earning assets and interest-bearing liabilities, respectively, and the amount of change in each attributable to (i) changes in rate (change in rate multiplied by old volume) and (ii) changes in volume, (change in volume multiplied by old rate). The net change attributable to changes in both volume and rate, which cannot be segregated, has been allocated proportionately to the change due to volume and the change due to rate.

	Three Months Ended March 31, 1986 Compared to 1985 Increase (Decrease)			Nine Months Ended March 31, 1986 Compared to 1985 Increase (Decrease)		
	(Amounts in Thousands)					
	Volume	Rate	Net	Volume	Rate	Net
Interest income on loans and mortgage-backed securities	$6,637	$(1,439)	$ 5,198	$17,735	$(3,460)	$14,275
Interest income on investments	430	(294)	136	(1,889)	(2,125)	(4,014)
Financing contracts			2,884			8,071
Total interest income	7,067	(1,733)	8,218	15,846	(5,585)	18,332
Interest expense on deposits	5,678	(2,665)	3,013	5,887	(4,707)	1,180
Interest expense on borrowings	(339)	(996)	(1,335)	752	(5,423)	(4,671)
Notes and discounted lease rentals			2,545			7,576
Total interest expense	5,339	(3,661)	4,223	6,639	(10,130)	4,085
Net interest margin	$1,728	$ 1,928	$ 3,995	$ 9,207	$ 4,545	$14,247

The following table presents the weighted average yields on interest earning assets and interest bearing liabilities during the three and nine month periods ended March 31, 1986 and 1985, and at March 31, 1986 and 1985.

	Three Months Ended March 31,		Nine Months Ended March 31,		At March 31,	
	1986	1985	1986	1985	1986	1985
Weighted Average Yield On:						
Loan and mortgage-backed security portfolio	11.28%	11.57%	11.33%	11.58%	11.21%	11.52%
Investments	8.54	9.67	9.06	10.54	8.28	9.80
Financing contracts	14.89	--	14.08	--	14.36	--
Total interest earnings assets	11.18	11.39	11.25	11.45	11.06	11.39
Weighted Average Effective Rate Paid On:						
Deposits	8.49	9.52	8.61	9.75	8.35	9.31
FHLB Advances and other borrowings	10.66	11.07	10.64	11.34	10.49	10.98
Notes and discounted lease rentals	13.42	--	12.71	--	12.97	--
Total interest bearing liabilities	9.46	10.20	9.53	10.44	9.29	10.06
Net Interest Rate Spread	1.72	1.19	1.72	1.01	1.77	1.33

Non-Interest Income and Expense:

Gain (loss) on sales of real estate acquired for investment including provision for loss: For the three and nine month periods ended March 31, 1986, the loss in this category relates primarily to an increase in the loss reserve on a $7.2 million investment in a ski resort in Crested Butte, Colorado. The Association has established a $2.7 million (38%) loss reserve on this property, which it believes is sufficient to cover any potential losses.

Gross profit on sales-type, brokerage and operating leases: This income category represents the gross profit on the leasing activities of SMI. See Note A to the Interim Unaudited Consolidated Financial Statements contained elsewhere herein.

Other operating income: In the year-ago nine month period ended March 31, 1985, other operating income included SMI equity basis earnings of $1.8 million (SMI earnings are consolidated for the current fiscal year periods) and a $1.1 million gain resulting from the disposition of a developmental loan. When the above items are excluded from the previous fiscal year activity, the current fiscal year periods reflect comparative increases resulting primarily from deposit account fees, brokerage and securities commissions and appraisal fees.

Compensation, payroll taxes and fringe benefits: Compensation increased principally due to bonuses, which are based on profitability, and the inclusion of SMI on a consolidated basis.

FSLIC insurance premium: See Note D to the Interim Unaudited Consolidated Financial Statements contained elsewhere herein.

Other operating expenses: Other operating expenses increased primarily from the inclusion of SMI on a consolidated basis.

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PART II. OTHER INFORMATION
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Item 1. Legal Proceedings

None

Item 2: Change in Securities

None

Item 3: Defaults Upon Senior Securities

Not Applicable

Item 4: Submission of Matters to a Vote of Security Holders

None

Item 5: Other Information

None

Item 6: Exhibits and Reports on Form 8-K

Form 8-K, dated February 28, 1986, was filed with the SEC on March 6, 1986. This filing covered the acquisition of certain liabilities of Sierra Federal Savings and Loan. See Note G to the Interim Unaudited Consolidated Financial Statements contained elsewhere herein.

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S I G N A T U R E

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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.

COMMERCIAL FEDERAL CORPORATION

Date: May 12, 1986

Gene R. Boba, Chief Financial Officer,
Treasurer and Duly Authorized Officer

END

U 982400 87198

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

357 EX 20

FORM 10-K

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

For the fiscal year ended December 31, 1985 Commission file no. 1-3562

UTILICORP UNITED INC.
(Exact name of registrant as specified in its charter)

Missouri	44-0541677
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
922 Walnut, Kansas City, Missouri	64199
(Address of principal executive offices)	(Zip Code)

APR 2 1986

Registrant's telephone number, including area code (816) 472-7329

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $1 par value	New York and Pacific Stock Exchanges
Preference Stock, no par value, $2.4375 Series	New York and Pacific Stock Exchanges
Preference Stock, no par value, $2.6125 Series	New York and Pacific Stock Exchanges
Preference Stock, no par value, $4.1250 Series	New York and Pacific Stock Exchanges

Securities registered pursuant to Section 12(g) of the Act:

None
(Title of Class)

Indicate by check mark whether the registrant (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___. State the aggregate market value of the voting stock held by nonaffiliates of the registrant.. $217,214,595 based on March 12, 1986, New York Stock Exchange closing price.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the close of the period covered by this report.

Class	Outstanding at March 12, 1986
Common Stock, $1 par value	8,194,841

The following documents, or parts thereof, are incorporated herein by reference:

Document	Where Incorporated
1985 Annual Report to Shareholders	Parts I, II and IV
1986 Proxy Statement	Part III

Page 1 of 357

Exhibit Index appears on Page 20

UTILICORP UNITED INC.
FORM 10-K
For the fiscal year ended December 31, 1985

TABLE OF CONTENTS

PART I

ITEM 1. BUSINESS

GENERAL

UtiliCorp United Inc. (the "Company"), formerly named Missouri Public Service Company, is a public utility company which supplies electric and gas utility service through its three operating divisions, Missouri Public Service, Peoples Natural Gas and Kansas Public Service. In addition, on September 23, 1985 the Company signed a definitive agreement to purchase the West Virginia electric distribution properties ("West Virginia Power") of Virginia Electric and Power Company for approximately $20 million. This acquisition is subject to certain conditions, including receipt of West Virginia regulatory approval of the acquisition and of certain rate requests. If completed, West Virginia Power will be an operational division of the Company serving approximately 22,000 customers in eight communities. The Company has its executive offices at 922 Walnut, P.O. Box 13287, Kansas City, Missouri, 64199, telephone number (816) 472-7329.

Missouri Public Service ("MPS"), formed under the laws of Missouri in 1950 to carry on the business of a predecessor company, is a public utility operating company engaged in supplying electric and gas utility service in west central and north central Missouri, including a portion of metropolitan Kansas City, Missouri. In 1985, 84% of MPS' revenues were derived from electric sales and 16% from gas sales. Executive offices of MPS are located at 10700 East 350 Highway, Kansas City, Missouri, 64138, telephone number (816) 353-5000.

Peoples Natural Gas ("PNG"), was acquired from InterNorth, Inc. on December 20, 1985 for approximately $231 million. In connection with the acquisition, the Company also paid $15 million to InterNorth, Inc. in consideration of a five-year noncompetition agreement. PNG was formed in 1930 as a subsidiary of Northern Natural Gas Company. In 1952, PNG became a division of Northern Natural Gas Company serving less than 100 communities in five states. PNG is now primarily engaged in the providing retail gas distribution services to over 299,000 customers in five states: Iowa, Minnesota, Nebraska, Colorado and Kansas. In addition, PNG serves a large industrial customer in Michigan and approximately 300 rural customers in South Dakota. PNG also operates a pipeline system for gathering, transporting and distributing gas primarily for end-use customers in central Kansas. Executive offices of PNG are located at 25 Main Place, Council Bluffs, Iowa, 51501, telephone number (712) 325-2091.

Kansas Public Service ("KPS") is engaged in providing retail gas distribution service in the city of Lawrence, Kansas. Executive offices of KPS are located at 110 East Ninth, Lawrence, Kansas, 66044, telephone number (913) 843-7844.

The purchase of PNG was accounted for as a purchase in accordance with generally accepted accounting principles and, as such, only 12 days of PNG's results appear in the Company's 1985 Financial Statements.

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Additional information with respect to the Company's acquisition of PNG appears in Note 2 of Notes to Consolidated Financial Statements on page 25 of the Company's 1985 Annual Report and is incorporated herein by reference.

The business of the Company is seasonal only to the extent that weather patterns may have an effect on revenues. The Company's electric revenues peak during the summer months and gas revenues peak during the winter months.

Segment information for the five years ended December 31, 1985, appearing on page 30 of the accompanying 1985 Annual Report to Shareholders is incorporated by reference in this Form 10-K Annual Report.

ELECTRIC OPERATIONS

General - MPS supplies electric service to approximately 145,000 customers in 28 counties within the State of Missouri. In 1985, MPS' largest source of electric revenues was from its residential customers, who accounted for 39% of KWH (kilowatt hour) sales. Commercial customers accounted for 26% of KWH sales, industrial customers 20% and other sales 15%. Two customers accounted for approximately 6% of MPS' electric revenues in 1985.

Capacity - The net aggregate generating capability of MPS' system is presently 910,000 kilowatts (see Item 2 Properties). Of this capability, 67%, or 614,000 kilowatts, represents base load coal-fired units. The remaining 33% represents gas or oil-fired peaking units.

On September 6, 1985 MPS' customer load peaked at 717,900 KW. At the time of peak, MPS had a capacity margin of 21.1%. The 1985 peak represented a 3% drop from the 1984 peak of 741,700 KW.

MPS does not foresee any significant expenditures for generating capacity additions until the early 1990's. Current purchased power contracts will enable MPS to maintain adequate reserve levels through 1991. MPS is currently pursuing additional purchased power arrangements to extend through the mid 1990's. Currently, Jeffrey Energy Center Unit #4 is being planned for completion in 1997. If completed, MPS will purchase an 8% undivided interest in Jeffrey Unit #4. It currently has an 8% interest in Jeffrey Units 1, 2 and 3.

Fuel - MPS' coal-fired units aggregate 614,000 KW of the total 910,000 KW capacity. Oil-fired units aggregate 211,000 KW and natural gas 85,000 KW. Set forth below is a table which shows actual fuel use for the last three years.

FUEL USAGE

	1983	1984	1985
Coal	99.6	99.6	99.9
Gas	.1	.2	.0
Oil	.3	.2	.1
	100%	100%	100%

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Presently MPS is receiving coal for the Sibley Generating Station pursuant to a contract with Southwestern Illinois Coal Corporation. The contract, which commenced in 1979, has an initial term of 10 years, with two five-year renewal options. The price per ton of coal is subject to escalation throughout the term of the contract. In December, 1985, MPS entered into a contract with the Union Pacific and Santa Fe Railroads providing for delivery of the coal to the Sibley Generating Station at a cost which is also subject to escalation. In 1984 and 1985 the average cost per ton delivered pursuant to the above contract was $37.66 and $38.44, respectively.

The coal requirements for the three units of the Jeffrey Energy Center, in which MPS has an 8% undivided interest, are supplied pursuant to a contract between KPL Gas Service Company and American Metal Climax, Inc. The contract provides for coal deliveries through December 31, 2013, with price and delivery cost subject to escalation. Effective January 1, 1986, an amendment to the contract was signed between KPL Gas Service Company and American Metal Climax, Inc. which reduced the price of coal by $.28 per ton, and reduced coal delivery quantities between 1988 and 1992. In 1984 and 1985 the average cost per ton delivered pursuant to the above contract was $23.97 and $21.32, respectively.

Gas purchased by MPS for use as fuel in its electric generating stations is supplied by the Northwest Central Pipeline Company ("Northwest Central") and KPL Gas Service Company under contracts calling for interruptible gas deliveries. Fuel oil for MPS' peaking installations is purchased in the open market for use primarily for emergencies and peaking generation.

During the years 1985 and 1984, MPS consumed 13,913 and 130,391 MCF of gas and 97,690 and 333,777 gallons of fuel oil, respectively, for the operation of its electric generating units. In the aggregate, such fuel accounted for less than 1 percent of MPS' generating requirements during the periods.

ENVIRONMENTAL MATTERS

Relevant to air and water quality as well as other environmental concerns, MPS is regulated at the federal, state, and local levels. Compliance with existing rules and regulations, and those which may be promulgated in the future, can result in considerable capital expenditure and operation and maintenance expenses. These costs can range from non-compliance penalties to expensive retrofit of pollution control equipment. The following summarizes MPS' involvement in the areas of air and water quality control as well as other environmental matters.

Air

Generating facilities in Missouri are subject to the air quality standards and emission limitations under the jurisdiction of the Missouri Air Conservation Commission ("MACC"). Presently, MPS believes that it is in compliance with all applicable MACC emission standards. On January 8, 1986 an annual inspection of the Sibley Generating Station was conducted by a MACC representative and it was determined to be in compliance with all applicable regulations.

The Jeffrey Energy Center ("JEC") is presently in compliance with air regulations promulgated by the State of Kansas and the Environmental Protection Agency. Federal emission standards which are applicable to the JEC units prohibit the emission of more than 1.2 pounds of sulfur dioxide per million BTU of heat input. Compliance with these emission standards is being achieved through the use of electrostatic precipitators, low sulfur coal, and flue gas desulphurization scrubbers.

Water

Clean water criteria under the Federal Water Pollution Control Act, as amended by the Clean Water Act of 1977, is administered by the Missouri Clean Water Commission. A National Pollutant Discharge Elimination System ("NPDES") permit was issued effective February 15, 1985 for the Sibley Generating Station. The NPDES permit serves as a federal discharge permit and as the state operating permit. In conjunction with this permit, a coal pile runoff treatment facility has been constructed at the Sibley plant.

EPA regulations in Kansas are administered by the Kansas Department of Health and Environment. Presently, the Jeffrey Energy Center is in compliance with existing water quality regulations.

Other Environmental Matters

MPS is currently engaged in an extensive replacement program of certain polychlorinated biphenyl ("PCB") equipment as required by Federal regulations promulgated on September 8, 1982 and July 25, 1985. PCB capacitors will be changed out by October 1, 1988 and PCB transformers in or near commercial buildings are scheduled to be replaced by October 1, 1990.

MPS, as of August 26, 1982, has been registered as a small quantity generator of hazardous waste, which does not require a permit for treatment, storage, or disposal.

COMPETITION

In the territory served by MPS, there are 17 municipally owned electric systems, 16 of which were in service prior to 1940. Eight of these systems purchase all or part of their power requirements from MPS. All municipalities served by MPS, as well as those not served but situated within the borders of its service territory, are empowered within specified limits to purchase or construct utility property. However, only one municipally-owned electric system (serving Osceola, Missouri, population 850) has been created in the service area of MPS in the past 40 years. In addition, there are 13 cooperatives providing electric service to approximately 50,000 customers in rural areas within MPS' service territory.

GAS OPERATIONS

The gas systems of MPS, PNG and KPS are not interconnected and each division operates on a "stand-alone" basis.

MISSOURI PUBLIC SERVICE

General - MPS supplies gas service to approximately 40,000 customers in west central and north central Missouri. In 1985, MPS' largest source of gas revenues was from its residential customers, who accounted for 48% of MCF (thousand cubic feet) sales. Industrial customers accounted for 28% of MCF sales, commercial customers 17 and other sales 7%. Two customers accounted for approximately 6% of MPS' gas revenues in 1985.

Supply - Approximately 77 percent of the natural gas for resale requirements of MPS are obtained from Northwest Central and 23 percent from Panhandle Eastern Pipe Line Company ("Panhandle Eastern"). Most of the Northwest Central contracts renew automatically for five-year terms, subject to termination by either party on 90 days notice prior to such expiration dates. The next expiration dates occur in 1987. The contract for gas supplied by Panhandle Eastern is subject to renewal in 1988. The contracts provide for rates as set forth in rate schedules filed with the Federal Energy Regulatory Commission ("FERC"). The cost of gas purchased by MPS from Northwest Central and Panhandle Eastern for the year ended December 31, 1985, totaled $18.4 million and $7.8 million respectively, resulting in an average cost of $2.79 and $4.03 respectively, per MCF. Increases and decreases in the cost of purchased gas for Missouri customers are passed on to MPS' customers through the purchased gas adjustment clause pursuant to rate schedules filed with the Public Service Commission of the State of Missouri.

MPS' gas purchase contracts call for interruptible gas deliveries. Interruptions in service are permitted in accordance with a Curtailment Priority Plan filed by Northwest Central with FERC which took effect July 1, 1980. Under the Curtailment Priority Plan, gas deliveries to meet MPS' requirements are subject to curtailments prior to certain other Northwest Central customers. The highest priority is for residential and small commercial customers including schools, hospitals and other similar institutions and the lowest priority being various commercial and industrial customers with alternate fuel capabilities. There were no curtailments in service to MPS during 1984 and 1985. Northwest Central projections through 1991 indicate that it does not expect any supply deficiency curtailments and curtailments due to operational causes (e.g., extreme weather and pipeline emergencies) are expected to be minimal.

Panhandle Eastern also has a Curtailment Priority Plan filed with FERC to which MPS is subject. There were no curtailments to interruptible customers in the area served by Panhandle Eastern during 1984 and 1985. Panhandle Eastern recently updated its twelve month forecast and indicated that it does not expect to involve any gas supply deficiency curtailments through December 31, 1986. Panhandle Eastern curtailments, if involved, would be borne by the Company's industrial customers that are served under interruptible rate schedules.

PEOPLES NATURAL GAS

General - PNG provides retail natural gas services to over 299,000 customers in approximately 288 communities in five states: Iowa, Minnesota, Nebraska, Colorado and Kansas. In addition, PNG serves a large industrial customer in Michigan and approximately 300 rural customers in South Dakota. PNG also operates a pipeline system for gathering, transporting and

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MPS is also subject to the jurisdiction of FERC with respect to sales of electricity for resale. PNG is subject, as an operating gas utility, to the jurisdiction of the Minnesota Public Utilities Commission, Iowa State Commerce Commission, Kansas Corporation Commission and the Colorado Public Utilities Commission. These commissions regulate rates, service and facilities, securities, classification of accounts, valuations of property and various other matters. There is no state regulatory body in Nebraska which has jurisdiction over utility operations. However, in Nebraska, municipalities which are served by PNG regulate rates and services therein. KPS has been regulated by the city of Lawrence, Kansas which has had jurisdiction over rates and services therein. With the acquisition of PNG, which also serves customers in Kansas, KPS will now come under the jurisdiction of the Kansas Corporation Commission. Set out below is a list of the rate cases pending by the Company:

Gas Rate Cases Pending:

STATE	FILED	AMOUNT REQUESTED	ROE REQUESTED	EFFECTIVE
Minnesota	3/86	$8,043,000	15.0%	5/86 (subject to refund)
Kansas	7/85	$3,700,000	16.5%	5/86 (final)

Electric Rate Cases Pending:

NONE

On October 9, 1985, FERC adopted broad, major changes to its rules and regulations which could significantly alter the natural gas production, transportation and distribution industries. As subsequently modified, the changes will, among other things, (1) require interstate pipelines that elect to transport gas for others under the new rules and regulations to provide transportation services to producers, distributors and all other shippers on a non-discriminatory basis; (2) encourage certain one time "buy-out" payments made by such pipelines to producers to extinguish future minimum payment or purchase obligations in gas purchase contracts; (3) provide an expedited certificate process for new services, facilities, and operations which could result in the bypass of local distribution companies, such as MPS, KPS and PN and (4) permit local distribution companies served by pipelines that elect to transport gas for others to reduce or eliminate (over five years) their leve of firm gas entitlements and related charges to reflect anticipated levels c demand. FERC has also proposed regulations to require a new rate structure for pipelines which would reserve older, cheaper gas supplies for existing customers and limit the ability of pipelines to average their more expensi deregulated gas with older, cheaper gas in order to compete for new custom and markets. Although the Company believes that the new rules and regulat may have beneficial effects on its operations, the Company also believes the rules and regulations could significantly increase competition for it industrial customers. The Company cannot determine, however, the specif effect of such rules and regulations on its gas operations, which will c on a number of factors including the actions of suppliers, competitors customers. In addition, such rules and regulations are subject to chal by various parties in FERC proceedings and in the federal courts.

EMPLOYEES

The Company had [illegible] employees at December 31, 1985. Collective Bargaining Agreements cover 534 of these employees.

EXECUTIVE OFFICERS OF THE REGISTRANT

Avis Green Tucker — Chairman of the Board of Directors. Age 70. Present position 4 years. Ms. Tucker has served on the Board of Directors since 1973.

[illegible] I. Owen — Vice-Chairman of the Board of Directors. Age 62. Present position 1 year. Mr. Owen is also the President and Chief Executive Officer of Missouri Public Service and has served in that capacity for 3 years. Prior to being President, Mr. Owen was Senior Vice President-Transmission and Distribution for 1 year.

Richard C. Green, Jr. — President and Chief Executive Officer. Age 31. Present position 1 year. Prior position was Executive Vice President of Missouri Public Service Company for 3 years. Prior to being Executive Vice President, Mr. Green was Director of Finance and Assistant Secretary for 1 year.

[illegible] F. Baker — Senior Vice President-Corporate Development. Age 59. Present position 1 year. Prior position was Senior Vice President for Missouri Public Service Company for 3 years. Prior to being Senior Vice President, Mr. Baker was Executive Vice President for 7 years.

[illegible] Muncaster — Senior Vice President-Public Affairs. Age 52. Present position 1/3 year. Mr. Muncaster came to UtiliCorp United Inc. from Hill and Knowlton, an international Public Relations firm where he was Senior Vice President for 10 years. At Hill and Knowlton Mr. Muncaster was in charge of corporate and financial relations of clients for the national division of Hill and Knowlton based in Chicago.

[illegible] J. Wolf — Vice President-Finance. Age 46. Present position 1 year. Prior position was Vice President and Treasurer of Missouri Public Service Company for 1 year. Prior to being Vice President, Mr. Wolf was Treasurer for 7 years.

[illegible] F. Franklin — Vice President-Engineering. Age 41. Present position 1 year. Prior position was Vice President-Engineering for Missouri Public Service Company for 1 year. Mr. Franklin was also Senior Director-Engineering and Construction for 2 years and Director of Distribution for 3 years.

[illegible] Claar	Vice President-Accounting. Age 34. Present position 1/2 year. Mr. Claar came to UtiliCorp United Inc. from Price Waterhouse where he was Audit Senior Manager for 4 years and Audit Manager for the 3 previous years. His principal duty as Audit Manager and Audit Senior Manager was to overview the execution of audit engagements for various clients.
[illegible] Sallee	Corporate Secretary. Age 38. Present position 1 year. Prior position was Assistant Secretary/Assistant Treasurer of Missouri Public Service Company for 7 years. Prior to being Assistant Secretary/Assistant Treasurer, Mr. Sallee was Assistant to the Treasurer for 2 years.
James W. McClymond	President of Peoples Natural Gas. Age 52. Present position 1 year. Prior position was Vice President-Administration with InterNorth, Inc. for 1 year and Vice President-Personnel and Organization for 7 years with InterNorth, Inc.
William C. Salome, III	President of Kansas Public Service. Age 56. Present position 8 years.

All officers are elected annually by the Board of Directors for a term of one year. There is no relationship between the executive officers of the Company, except that Avis G. Tucker is the aunt of Richard C. Green, Jr.

ITEM 2. PROPERTIES

The Company owns, through its divisions, an electric production, transmission and distribution system and gas transmission and distribution systems throughout its service territory.

ELECTRIC FACILITIES

Unit	Location	Year Installed	Unit Capability (KW Net)	Fuel
Sibley #1	Sibley, Missouri	1960	49,000	Coal
Sibley #2	Sibley, Missouri	1962	46,000	Coal
Sibley #3	Sibley, Missouri	1969	364,000	Coal
Ralph Green #3	Pleasant Hill, Missouri	1981	61,000	Gas
Jeffrey #1	Pottawatomie County, Kansas	1978	51,000*	Coal
Jeffrey #2	Pottawatomie County, Kansas	1980	52,000*	Coal
Jeffrey #3	Pottawatomie County, Kansas	1983	52,000*	Coal
Nevada #1	Nevada, Missouri	1974	19,000	Oil
Greenwood #1	Greenwood, Missouri	1975	48,000	Oil
Greenwood #2	Greenwood, Missouri	1975	48,000	Oil
Greenwood #3	Greenwood, Missouri	1977	48,000	Oil
Greenwood #4	Greenwood, Missouri	1979	48,000	Oil
KCI	Platte County, Missouri	1970	24,000	Gas
Total			910,000	

* Amounts shown are the 8% interest of MPS in the units capacity adjusted for line losses of approximately 2 MW per unit.

At December 31, 1985 MPS owned substations aggregating approximately 3,979,000 KVA, 57.96 miles of 345,000 volt transmission line, 290.64 miles of 161,000 volt transmission line, 499.23 miles of 69,000 volt transmission line, 439.03 miles of line operating at 34,500 volts and 4,716.65 overhead pole miles and 526.00 underground pole miles of distribution lines.

GAS PROPERTIES

PNG's natural gas compressor stations, as of December 31, 1985 are as follows:

Location	Date In Service	Type of Fuel	Total Station Horsepower
Chaney	51/66/80	Natural Gas	3108
Anadarko (Getty)	60	Natural Gas	674
Trenton	61/62	Natural Gas	1332
Rago (Spivey)	69/71/81	Natural Gas	1620
Sharon	84	Natural Gas	896
Burrton	65/73	Natural Gas	324
Fitzpatrick (Sterling)	81/80	Natural Gas	915

Location	Date In Service	Type of Fuel	Total Station Horsepower
Lauterback (Westerman)	72	Natural Gas	137
Graber	81	Natural Gas	140
Attica	84	Natural Gas	400
Flagler	66	Natural Gas	896
Murfin	80/76	Natural Gas	177
Ute Pass (Woodland Park)	62	Natural Gas	200

At December 31, 1985 PNG had 3,736 miles of gas gathering and transmission pipelines and 8,700 miles of distribution main located throughout its service territory.

At December 31, 1985 MPS had 193 miles of transmission pipeline and 660 miles of distribution main located throughout its service territory.

KPS had 271 miles of distribution main at December 31, 1985.

ITEM 3. LEGAL PROCEEDINGS

For legal proceedings pending, see page 27 of the accompanying 1985 Annual Report to Shareholders which is incorporated by reference in this Form 10-K Annual Report.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the fourth quarter of 1985, the Company solicited the consent of the holders of all series of the Company's preferred stock. The consent was for the purpose of obtaining a waiver from a provision in the Articles of Incorporation that precluded the Company from having outstanding short-term debt greater than 20% of the aggregate capital structure of the Company. The waiver was necessary for the Company to purchase PNG, which was acquired through the issue of short-term debt. A majority of the preferred holders consented to this waiver.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Information relating to market prices of common stock, number of security holders and dividends on page 33 of the Company's 1985 Annual Report to Shareholders is incorporated herein by reference.

Cash dividends on the Company's capital stock are restricted by the provisions in the Indenture securing the Company's First Mortgage Bonds and in the Company's Articles of Incorporation. Under the most restrictive of these provisions, the Company may not pay cash dividends in excess of the sum of $15.0 million plus (or minus in the case of a deficit) the net income of the Company for the period from January 1, 1982, to the date of such dividend distribution. None of the Company's retained earnings were restricted as to payment of cash dividends as of December 31, 1985.

ITEM 6. SELECTED FINANCIAL DATA

Five-year selected financial data on page 34 of the Company's 1985 Annual Report to Shareholders is incorporated herein by reference.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations on pages 16, 17 and 18 of the Company's 1985 Annual Report to Shareholders is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements, together with the report thereon of Price Waterhouse dated February 21, 1986, appearing on pages 19 to 33 of the accompanying 1985 Annual Report to Shareholders are incorporated by reference in this Form 10-K Annual Report.

ITEM 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

PART III

ITEMS 10, 11, 12 and 13. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT, EXECUTIVE COMPENSATION, SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT, AND CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding these items appears in the Company's definitive proxy statement for its annual meeting of shareholders to be held May 7, 1986, and is incorporated herein by reference. For information with respect to the executive officers of the registrant, see "Executive Officers of the Registrant" following Item 1 in Part I.

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PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

* Incorporated by reference from the indicated pages of the 1985 Annual Report to Shareholders

All other schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(3) List of Exhibits
Incorporated herein by reference to the Index to Exhibits.

(b) During the fourth quarter of 1985, a Form 8-K, dated December 31, 1985, was filed by the registrant which incorporated pro forma income statements as of December 31, 1984 and September 30, 1985, a pro forma balance sheet at September 30, 1985, and notes to pro forma condensed financial statements for the registrant and Peoples Natural Gas and financial statements of Peoples Natural Gas for the three years ended December 31, 1984 and interim period ending September 30, 1985 in accordance with Rule 3-05(b) of Regulation S-X.

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REPORT OF INDEPENDENT ACCOUNTANTS ON FINANCIAL STATEMENT SCHEDULES

To the Board of Directors
of UtiliCorp United Inc.

Our examinations of the consolidated financial statements referred to in our report dated February 21, 1986, appearing on page 33 of the 1985 Annual Report to Shareholders of UtiliCorp United Inc. (which report and consolidated financial statements are incorporated by reference in this Annual Report on Form 10-K) also included an examination of the Financial Statement Schedules listed in Item 14(a) of this Form 10-K. In our opinion, these Financial Statement Schedules present fairly the information set forth therein when read in conjunction with the related consolidated financial statements.

Price Waterhouse
Price Waterhouse

Kansas City, Missouri
February 21, 1986

CONSENT OF INDEPENDENT ACCOUNTANTS

We hereby consent to the incorporation by reference in the Prospectuses constituting part of the Registration Statements on Form S-3 (No. 2-95111 and No. 33-00138) and on Form S-8 (No. 2-22265 and No. 33-3338) of UtiliCorp United Inc. of our report dated February 21, 1986, appearing on page 33 of the Annual Report to Shareholders which is incorporated in this Annual Report on Form 10-K. We also consent to the incorporation by reference of our report on the Financial Statement Schedules, which appears above.

Price Waterhouse
Price Waterhouse

Kansas City, Missouri
March 20, 1986

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

UTILICORP UNITED INC.

By ______________________________
Richard C. Green, Jr.
President and Chief Executive Officer

Date March 26, 1986

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons, which include the Principal Executive Officer, the Principal Financial Officer, the Principal Accounting Officer and a majority of the Board of Directors on behalf of the Registrant and in the capacities and on the dates indicated.

March 26, 1986	President and Chief Executive Officer and Director (Principal Executive Officer)	Richard C. Green, Jr.
March 26, 1986	Vice President-Finance (Principal Financial Officer)	Dale J. Wolf
March 26, 1986	Senior Vice President and Director	John R. Baker
March 26, 1986	Vice President (Principal Accounting Officer)	Donald K. Claar
March 26, 1986	Director	Avis G. Tucker
March 26, 1986	Director	William I. Owen
March 26, 1986	Director	Raymond Rollins
March 26, 1986	Director	Robert F. Jackson
March 26, 1986	Director	Don R. Armacost

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

UTILICORP UNITED INC.

By ______________________________
Richard C. Green, Jr.
President and Chief Executive Officer

Date March 26, 1986

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UTILICORP UNITED INC.

By Richard C. Green, Jr.
Richard C. Green, Jr.
President and Chief Executive Officer

Date March 26, 1986

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March 26, 1986	Director	Raymond Rollins
March 26, 1986	Director	Robert F. Jackson
March 26, 1986	Director	Don R. Armacost

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UTILICORP UNITED INC.

SCHEDULE V -- UTILITY PLANT

FOR THE YEAR ENDED DECEMBER 31, 1985
(in thousands)

Column A	Column B	Column C	Column D	Column E	Column F	Column G
Classification	Balance December 31, 1984	Additions At Cost	Retirements or Sales	Other Changes Debit or (Credit) (Transfers)	Purchase of PNG	Balance December 31, 1985
ELECTRIC						
Intangibles	$ 6	$ -	$ 1	$ -	$ -	$ 5
Production	184,830	3,037	157	4	-	187,714
Transmission	54,846	4,559	395	(1)	-	59,009
Distribution	194,732	10,695	1,319	(16)	-	204,092
General	4,730	591	37	(31)	-	5,253
Total Electric	439,144	18,882	$1,909	(44)	-	456,073
GAS	36,796	3,032	533	(65)	253,653	292,883
COMMON	17,861	2,319	695	(18)	-	19,467
Total Utility Plant in Service	493,801	24,233	$3,137	(127)	253,653	768,423
CONSTRUCTION WORK IN PROGRESS	9,717	7,520	-	-	1,469	18,706
Total Utility Plant, at Original Cost	$503,518	$31,753	$3,137	$(127)	$255,122	$787,129

UTILICORP UNITED INC.

SCHEDULE V -- UTILITY PLANT

FOR THE YEAR ENDED DECEMBER 31, 1984
(in thousands)

Column A	Column B	Column C	Column D	Column E	Column F
Classification	Balance December 31, 1983	Additions At Cost	Retirements or Sales	Other Changes Debit or (Credit) (Transfers)	Balance December 31, 1984

UTILICORP UNITED INC.

SCHEDULE VI -- ACCUMULATED DEPRECIATION OF

UTILITY PLANT IN SERVICE

FOR THE YEAR ENDED DECEMBER 31, 1985
(in thousands)

Column A	Column B	Column C		Column D	Column E		Column F	Column G
		Additions		Deductions from Reserves				
Description	Balance December 31, 1984	Charged to Expense	Charged to Clearing Accounts	Property Retired	Salvage and Removal Costs, Net	Transfers and Other	Purchase of PNG	Balance December 31, 1985
Electric	$122,705	$13,810	$ -	$1,909	$ 719	$1	$ -	$133,836
Gas	13,930	1,179	-	534	249	4	94,824	109,146
Common	6,792	321	1,243	694	164	-	-	7,498
Total	$143,427	$15,310(a)	$1,243	$3,137	$1,132	$5	$94,824	$250,530

(a) This amount excludes $322 of depreciation relative to Peoples Natural Gas which is included in Column F for the purpose of this schedule.

UTILICORP UNITED INC.

SCHEDULE VI -- ACCUMULATED DEPRECIATION OF

UTILITY PLANT IN SERVICE

FOR THE YEAR ENDED DECEMBER 31, 1984
(in thousands)

Column A	Column B	Column C		Column D	Column E		Column F
		Additions		Deductions from Reserves			
Description	Balance December 31, 1983	Charged to Expense	Charged to Clearing Accounts	Property Retired	Salvage and Removal Costs, Net	Transfers and Other	Balance December 31, 1984
Electric	$111,391	$13,268	$ -	$1,287	$ 488	$179	$122,705
Gas	13,551	1,080	-	486	215	-	13,930
Common	6,521	244	866	980	(141)	-	6,792
Total	$131,463	$14,592	$866	$2,753	$ 562	$179	$143,427

UTILICORP UNITED INC.

SCHEDULE VI -- ACCUMULATED DEPRECIATION OF UTILITY PLANT IN SERVICE

FOR THE YEAR ENDED DECEMBER 31, 1983
(in thousands)

Column A	Column B	Column C		Column D	Column E		Column F
		Additions		Deductions from Reserves			
Description	Balance December 31, 1982	Charged to Expense	Charged to Clearing Accounts	Property Retired	Salvage and Removal Costs, Net	Transfers and Other	Balance December 31, 1983
Electric	$102,127	$12,399	$ -	$1,497	$233	$1,405	$111,391
Gas	13,088	993	-	370	158	2	13,551
Water	1,081	67	-	(11)	64	1,095	-
Common	6,156	187	791	657	(58)	14	6,521
Total	$122,452	$13,646	$791	$2,513	$397	$2,516	$131,463

UTILICORP UNITED INC.

SCHEDULE VIII -- VALUATION AND QUALIFYING ACCOUNTS

FOR THE YEAR ENDED DECEMBER 31, 1985

Column A	Column B	Column C	Column D	Column E	Column F
Description	Balance December 31, 1984	Purchase of Peoples Allowance Account	Additions Charged to Expense	Deductions from Reserves for Purposes for Which Created	Balance December 31, 1985
DEDUCTED FROM ASSETS TO WHICH APPLICABLE:					
Allowance for doubtful accounts	$891	$215	$179	$264	$1,021

UTILICORP UNITED INC.

SCHEDULE VIII -- VALUATION AND QUALIFYING ACCOUNTS

FOR THE YEAR ENDED DECEMBER 31, 1984
(in thousands)

Column A	Column B	Column C	Column D	Column E
Description	Balance December 31, 1983	Additions Charged to Expense	Deductions from Reserves for Purposes for Which Created	Balance December 31, 1984
DEDUCTED FROM ASSETS TO WHICH APPLICABLE:				
Allowance for doubtful accounts	$729	$552	$390	$891

SCHEDULE VIII -- VALUATION AND QUALIFYING ACCOUNTS

FOR THE YEAR ENDED DECEMBER 31, 1983
(in thousands)

Column A	Column B	Column C	Column D	Column E
Description	Balance December 31, 1982	Additions Charged to Expense	Deductions from Reserves for Purposes for Which Created	Balance December 31, 1983
DEDUCTED FROM ASSETS TO WHICH APPLICABLE:				
Allowance for doubtful accounts	$593	$843	$707	$729

UTILICORP UNITED INC.

SCHEDULE IX - SHORT-TERM BORROWINGS

FOR THE YEAR ENDED DECEMBER 31, 1985
(dollars in thousands)

Column A	Column B	Column C	Column D	Column E	Column F
Category of aggregate short-term borrowings	Balance at December 31	Weighted average interest rate	Maximum amount outstanding during the period	Average amount outstanding during the period(b)	Weighted average interest rate during the period(b)
Bank Borrowings	$230,800(a)	8.98%	$250,000	$ 8,728	9.25%
Commercial Paper	7,500	8.14%	19,500	10,110	8.15%

The Company borrows funds for corporate purposes through the sale of commercial paper and under line of credit agreements with banks. The commercial paper is generally sold for periods of 45 days or less, and short-term bank borrowings generally are arranged for periods of 30 to 90 days. In 1985, the Company acquired Peoples Natural Gas with the issuance of short-term debt. In connection with the line of credit agreements, a commitment fee of 3/8 of 1 percent on each line is required.

(a) Includes $100,000 of short-term debt permanently funded in 1986 which is included in Column B for the purpose of this schedule.
(b) Based upon daily balances outstanding.

UTILICORP UNITED INC.

SCHEDULE IX - SHORT-TERM BORROWINGS

FOR THE YEAR ENDED DECEMBER 31, 1983
(dollars in thousands)

Column A	Column B	Column C	Column D	Column E	Column F
Category of aggregate short-term borrowings	Balance at December 31	Weighted average interest rate	Maximum amount outstanding during the period	Average amount outstanding during the period(a)	Weighted average interest rate during the period(a)
Bank Borrowings	$ 500	10.00%	$ 600	$ 125	9.38%
Commercial Paper	3,000	9.63%	7,000	3,106	9.29%

The Company borrows funds for corporate purposes through the sale of commercial paper and under line of credit agreements with banks. The commercial paper is generally sold for periods of 45 days or less, and short-term bank borrowings generally are arranged for periods of 30 to 90 days. In connection with the line of credit agreements, a commitment fee of 3/8 of 1 percent on each line is required.

(a) Based upon daily balances outstanding.

UTILICORP UNITED INC.

SCHEDULE X - SUPPLEMENTARY INCOME STATEMENT

INFORMATION

FOR THE THREE YEARS ENDED DECEMBER 31, 1985
(in thousands)

	1985	1984	1983
TAXES, OTHER THAN INCOME TAXES:			
Property	$ 6,161	$ 5,991	$ 6,082
City occupational and franchise	9,839	9,892	9,396
Other	1,747	1,500	1,362
Total taxes, other than income taxes	$17,747	$17,383	$16,840

U982400 105147

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 1-3562 For Quarter Ended March 31, 1986

UTILICORP UNITED INC.
(Exact name of registrant as specified in its charter)

MISSOURI
(State or other jurisdiction of incorporation or organization)

44-0541877
(I.R.S. Employer Identification No.)

922 Walnut, Kansas City, Missouri
(Address of principal executive offices)

64199
(Zip code)

(816) 472-7329
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has 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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes X No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 12, 1986
Common Stock, $1 par value	8,194,659

PART I

UTILICORP UNITED INC.
CONSOLIDATED STATEMENT OF INCOME
(dollars in thousands except per share amounts)

	Three Months Ended March 31,	
	1986	1985
	(unaudited)	
Operating Revenues:		
Electric	$ 43,359	$ 43,183
Gas	159,687	20,962
Total operating revenues	203,046	64,145
Operating Expenses:		
Fuel used for generation	8,774	11,214
Power purchased	3,397	894
Gas purchased for resale	130,933	15,966
Other	19,536	7,760
Maintenance	5,103	4,496
Depreciation	7,258	3,780
Taxes--		
General taxes	6 770	4,632
Income taxes - currently payable	4,039	5,685
Deferred income taxes (net)	1,883	1,049
Investment tax credit (net)	791	263
Total operating expenses	188,484	55,739
Total operating income	14,562	8,406
Other Income:		
Allowance for equity funds used during construction	106	100
Other, including tax effect of non-operating items	762	(5)
Total other income, net	868	95
Income before interest charges	15,430	8,501
Interest Charges:		
Long-term debt	3,379	2,918
Short-term debt	3,403	264
Allowance for borrowed funds used during construction	(164)	(69)
Other	356	114
Total interest charges	6,974	3,227
Net Income	8,456	5,274
Preferred and preference dividend requirements	1,071	1,086
Earnings Available for Common Shares	$ 7,385	$ 4,188
Weighted Average Common Shares Outstanding*	8,183,195	7,229,765
Earnings Per Common Share*	$.90	$.58
Cash Dividends Per Common Share*	$.35	$.31

*After giving retroactive effect to stock dividends.

See accompanying notes to consolidated financial statements.

UTILICORP UNITED INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS

CAPITAL RESOURCES

For the three months ended March 31, 1986, cash generated internally increased to $57.7 million from $8.2 million for 1985. A majority of the increase is directly attributed to the collection of purchased accounts receivable of Peoples Natural Gas. The cash generated internally has enabled the Company to reduce its short-term debt by approximately $45 million in the first quarter.

On April 22, 1986, the Company filed a registration statement with the Securities and Exchange Commission for the sale of 850,000 shares of common stock. Net proceeds of this common stock offering will be used to reduce short-term debt incurred in connection with the acquisition of Peoples Natural Gas, as well as for other general corporate purposes.

OPERATING RESULTS

UtiliCorp United Inc. achieved record first quarter 1986 earnings per common share of 90 cents, a 55 percent increase over 58 cents per common share in the comparable 1985 period.

The first quarter results reflect the full impact of the operations of Peoples Natural Gas, acquired in December, 1985. Due to the winter heating season, the first quarter is traditionally strong for the Peoples division.

The inclusion of Peoples in the quarterly results caused substantial variances in operating revenues and operating expenses during the period. A discussion of other key factors affecting operating results follows.

OPERATING REVENUES

Shown below is an analysis of the major factors affecting revenues of the electric and gas operations of the Company in the first quarter of 1986 as compared to the same quarters in 1985 (in millions).

ELECTRIC	VARIATION
Change in customer mix	$(.5)
Change in usage per customer	(.5)
Change in customer levels	1.2
	$ .2

GAS	
Change in rates, including tracking changes	$(1.4)
Change in usage per customer	(1.7)
Change in customer levels (primarily due to Peoples)	141.8
	$ 138.7

The milder winter weather in 1986 affected the usage of both electricity and gas by the residential customer. The decline in usage of electricity by residential customers was partially offset by increased usage by large industrial customers.

UtiliCorp's various divisions are subject to regulation by certain federal, state, and city regulatory commissions. The Peoples Natural Gas division has filed for rate relief in Minnesota ($6.2 million) and will soon file in Iowa. In April, 1986, Peoples received regulatory approval to implement a $2.4 million rate increase to its Kansas customers.

OPERATING EXPENSES

The availability of excess electric generation in the midwest has continued in 1986 allowing utilities to purchase power at competitive rates. The Missouri Public Service division's principal generating unit was out of service for a portion of this quarter. These two factors enabled the division to shift its mix of internal generation and external purchases while reducing the total cost per KWH as compared to 1985. A contractual dispute related to the Jeffrey Energy Center was resolved in the first quarter of 1985 and resulted in a reduction of fuel expense of $1.6 million. These factors combined to decrease fuel expenses by $2.4 million from the first quarter of 1985 while purchased power increased by an offsetting amount.

While the Missouri Public Service and Kansas Public Service divisions experienced reductions in purchased gas expense as a result of lower supplier rates ($1.3 million) and weather ($1.6 million), the inclusion of gas purchases of the Peoples Natural Gas division ($117.8 million) produced an overall increase in purchased gas expense of $115.0 million.

The effective income tax rate in 1985 was affected by the accrual of additional federal income taxes related to prior years under examination by the Internal Revenue Service.

The inclusion of Peoples increased other operating expenses by $11.1 million. The majority of the additional increase was attributable to corporate and divisional payroll increases. Other variances in levels of operating expenses are primarily a result of the acquisition of Peoples.

INTEREST CHARGES

Increased levels of interest charges are a result of additional borrowings incurred for the acquisition of Peoples.

UTILICORP UNITED INC.
CONSOLIDATED BALANCE SHEET
(dollars in thousands)

	March 31, 1986 (unaudited)	December 31, 1985
UTILITY PLANT AND OTHER ASSETS		
UTILITY PLANT IN SERVICE:		
Electric	$479,056	$472,482
Gas	298,082	295,941
	777,138	768,423
Less-Accumulated depreciation	257,926	250,530
Net utility plant in service	519,212	517,893
CONSTRUCTION WORK IN PROGRESS	20,502	18,706
Total utility plant (net)	539,714	536,599
INVESTMENTS AND NONUTILITY PROPERTY	7,944	6,209
CURRENT ASSETS:		
Cash and temporary cash investments	23,983	19,146
Accounts receivable	87,465	94,160
Fuel, at average cost	17,901	14,847
Materials and supplies, at average cost	15,726	15,291
Prepayments and other	7,305	11,514
Total current assets	152,380	154,958
DEFERRED CHARGES	22,744	26,307
TOTAL UTILITY PLANT AND OTHER ASSETS	$722,782	$724,073
CAPITALIZATION AND LIABILITIES		
CAPITALIZATION:		
Common shareholders' equity	$172,054	$165,697
Preferred and preference stock	41,821	41,821
Long-term debt	226,272	226,276
Total capitalization (See Statement of Capitalization)	440,147	433,794
CURRENT LIABILITIES:		
Current maturities of long-term debt	1,900	1,901
Notes payable	86,614	130,824
Commercial paper	6,500	7,500
Accounts payable	54,597	36,882
Accrued taxes	18,551	10,918
Accrued interest	5,049	4,420
Customers' deposits	8,298	8,345
Other	20,107	10,445
Total current liabilities	201,616	211,235
DEFERRED CREDITS:		
Deferred income taxes	47,339	45,393
Investment tax credits	24,736	23,995
Other	8,944	9,656
Total deferred credits	81,019	79,044
COMMITMENTS AND CONTINGENCIES		
TOTAL CAPITALIZATION AND LIABILITIES	$722,782	$724,073

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CAPITALIZATION
(dollars in thousands)

	March 31, 1986 (unaudited)	December 31, 1985
COMMON SHAREHOLDERS' EQUITY:		
Common stock, par value $1 per share, authorized 15,000,000 shares, outstanding 8,194,841 shares (8,178,663 at December 31, 1985)	$ 8,195	$ 8,179
Premium on capital stock	104,173	101,046
Retained earnings	59,686	56,472
Total common shareholders' equity	172,054	165,697
PREFERRED AND PREFERENCE STOCK:		
Cumulative preferred stock, par value $100 per share, authorized 97,000 shares, outstanding-		
41,800 shares, 4.30% series	4,180	4,180
30,000 shares, 5.52% series	3,000	3,000
25,200 shares, 6.70% series	2,520	2,520
Less-8,910 shares of 6.70% series held as treasury stock, at cost	(879)	(879)
Preference stock, without par value, authorized 10,000,000 shares, outstanding-		
600,000 shares, $2.4375 series	15,000	15,000
400,000 shares, $2.6125 series	10,000	10,000
320,000 shares, $4.1250 series	8,000	8,000
Total preferred and preference stock	41,821	41,821
LONG-TERM DEBT (exclusive of current maturities):		
First mortgage bonds		
Series J, 4-3/4%, due February 1, 1987	5,000	5,000
Series K, 5-3/8%, due September 1, 1987	6,000	6,000
Series L, 4.90%, due April 1, 1989	10,000	10,000
Series M, 4-3/4%, due April 15, 1991	8,000	8,000
Series N, 6%, due March 15, 1997	8,000	8,000
Series O, 6-1/2%, due September 1, 1987	3,000	3,000
Series X, 7-7/8%, due April 15, 2002	5,000	5,000
Series Y, 7.95%, due April 1, 1998	11,100	11,100
Series AA, 9-1/4%, due September 1, 1996	6,660	6,660
Series CC, 8-5/8%, due April 1, 2003	13,000	13,000
Series DD, 10-3/8%, due September 15, 2004	9,200	9,200
Series FF, 16-3/8%, due October 28, 1991	25,000	25,000
Series HH, 10-1/4%, due March 15, 1998	100,000	-
Pledged in support of pollution control bonds:		
Series BB, 6.20%, due July 1, 2002	4,000	4,000
Series GG, floating rate, due November 1, 1995	5,000	5,000
Total first mortgage bonds	218,960	118,960
Other		
Notes	12	16
Standby credit and term loan	-	100,000
Pollution control bonds, Wamego, Kansas, floating rate, due November 15, 2014	7,300	7,300
Total long-term debt	226,272	226,276
TOTAL CAPITALIZATION	$440,147	$433,794

See accompanying notes to consolidated financial statements.

UTILICORP UNITED INC.
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
(dollars in thousands)

	Three Months Ended March 31, 1986	(unaudited)	Three Months Ended March 31, 1985
CASH GENERATED INTERNALLY:			
Net income	$ 8,456		$ 5,274
Depreciation and amortization	7,613		3,809
Deferred taxes and investment tax credits	2,674		1,312
Allowance for equity funds used during construction	(106)		(100)
Net decrease in working capital	43,007		1,267
Cash provided by operations	61,644		11,562
Cash dividends paid	(3,934)		(3,379)
Cash generated internally	57,710		8,183
INVESTMENT ACTIVITIES:			
Additions to utility plant	9,907		4,228
Allowance for equity funds used during construction	(106)		(100)
Cash used for investment activities	9,801		4,128
FINANCING ACTIVITIES:			
Issuance of common stock	424		379
Retirement of long-term debt	(5)		(24)
Other debt repayments, net	(45,210)		(6,200)
Cash used for financing activities	(44,791)		(5,845)
OTHER ACTIVITIES:			
Other sources, net	1,719		1,943
Cash provided by other activities	1,719		1,943
INCREASE IN CASH AND TEMPORARY CASH INVESTMENTS	$ 4,837		$ 153
NET DECREASE IN WORKING CAPITAL COMPONENTS:			
Accounts receivable	$ 6,695		$ 1,650
Fuel and materials	(3,489)		(938)
Accounts payable	17,715		(2,863)
Accrued taxes	7,633		1,940
Customer deposits	(47)		35
Other	14,500		1,443
Net decrease in working capital (excluding short-term debt and current maturities)	$ 43,007		$ 1,267

See accompanying notes to consolidated financial statements

UTILICORP UNITED INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(1) Summary of Significant Accounting Policies: These unaudited interim consolidated financial statements have been prepared in accordance with the accounting policies described in the consolidated financial statements and related notes included in the Company's 1985 Annual Report to Shareholders incorporated by reference in the Company's 1985 Form 10-K, other than accounting for certain maintenance costs described below. It is suggested that those consolidated financial statements be read in conjunction herewith. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the financial position of the Company and the results of its operations.

Due to estimates inherent in the accounting process, the accuracy of the amounts in the interim consolidated financial statements is in some respects dependent upon the facts that will exist and the procedures that will be implemented by the Company later in the fiscal year.

During the year the Company accrues for scheduled major maintenance expenses applicable to its generating units and other maintenance expenses consisting principally of the cost of trimming trees.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

For legal proceedings pending, see page 27 of the 1985 Annual Report to Shareholders which is incorporated by reference in the 1985 Form 10-K Annual Report.

Item 5. Other Information

The registrant has received approval from the Kansas Corporation Commission to implement a $2.4 million rate increase to Kansas customers of its Peoples Natural Gas division. The rates will become effective sometime in May, 1986.

Item 6. Exhibits and Reports on Form 8-K

(b) On January 2, 1986, a Form 8-K was filed by the registrant which incorporated pro forma income statements as of December 31, 1984 and September 30, 1985, a pro forma balance sheet at September 30, 1985, and notes to pro forma condensed financial statements for the registrant and Peoples Natural Gas and financial statements of Peoples Natural Gas for the three years ended December 31, 1984 and interim period ending September 30, 1985 in accordance with Rule 3-05(b) of Regulation S-X.

SIGNATURES

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

UtiliCorp United Inc.
(Registrant)

May 5, 1986
(Date)

/s/ Richard C. Green, Jr.
Richard C. Green, Jr.
President
(Chief Executive Officer)

/s/ Dale J. Wolf
Dale J. Wolf
Vice President-Finance
(Principal Financial Officer)

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