*The
Annual Report
of the
California Energy
Company*

1988

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enough to get the volume of steam up to the surface.

"That \$30 million provided us with the money to go into a six-rig drilling program and really get on with field development."

To date, 320 megawatts of steam has been brought to the surface; the field is estimated to hold sufficient steam to drive 600 megawatts of generating capacity.

Other financial milestones of 1988 include the completion of financing packages from Credit Suisse for more than \$400 million, in the form of construction loans, project finance loans, and resource development loans.

"People ask me how a firm like California Energy Company could successfully raise that amount of money in such a short period," says former Touche Ross partner Richard Nishkian, now senior vice president and chief financial officer at California Energy. "I tell them, we have a good geothermal resource. We have

Dick Nishkian, Senior Vice President and Chief Financial Officer, wife Sunny Sue, and son, Gregory and his wife, Marilyn.

Assistant Treasurer, John Sylvia, his wife Shawn, and their children, Katharine and George Michael.

good employees who work hard. We have good contracts with Southern California Edison. We have an assured price for at least 10 years that enables us to pay off our loans in 10 years or less. Even if energy prices go way down – which isn't very likely – our debts are paid off by then, so our costs go way down, too.

"In sum, we have a good resource, good contracts, and a good management team. If you were a bank, wouldn't you loan to us, too?"

POWER MARKET PLANNING/FUTURE

While acknowledging the risks that are inherent in any business venture, California Energy's managers are confident of their Company's abilities and the potential of its assets.

"The main challenge facing this company," says Gary Lavering, vice president, management information systems and planning, "is the task of managing what we say we can manage.

Geothermal Energy And A CLEAN EN

Twenty-two years after the environmental movement first bore fruit in the form of the federal Air Quality Act of 1967 (followed by the 1970 creation of the Environmental Protection Agency and adoption of the more stringent Clean Air Amendments), the American public has lost little, if any, of its enthusiasm for a safe, clean environment.

Nearly two thirds of the population believes that "environmental improvements must be made regardless of cost," according to a summer 1988 New York Times poll, and public officials charged with the responsibility of carrying out these improvements are taking note.

"I don't care about cost-effectiveness or least cost alone," says Ted Hallock, who represents the state of Oregon on the Northwest Power Planning Council. We must also, he adds, "think about tomorrow."

For the electric utility industry, that means increasing pressure to find non-polluting sources of power such as geothermal energy.

THE "GREENHOUSE EFFECT"

High among the reasons behind this widespread support for environmental measures appears to be the public's concern over the "greenhouse" effect. A growing body of scientific evidence suggests that too much CO₂ in the atmosphere – a by-product of the burning of fossil fuels – will raise the average temperature of the earth, wreaking havoc with established socio-economic patterns. Not very far behind in the public's environmental consciousness are the two other high-profile air quality issues: acid rain (caused by sulfur and nitrogen oxide emissions) and destruction of ozone in the upper atmosphere.

We are in danger, the public is saying, of fouling our nest, and we want it to stop.

In one sense, air pollution is neither new nor the exclusive province of human activity. Volcanoes have spewed prodigious amounts of sulfur and nitrogen into the air for billions of years. The release of carbon dioxide is a natural part of the life cycle, as plant and

animal matter decays. Cattle and other livestock have turned carbon and hydrogen into ozone-damaging methane since the dawn of animal life.

But until the advent of the Industrial Age, nature was able to adjust these slow or intermittent fluctuations in the chemical composition of the air.

THE INDUSTRIAL AGE

Then humans started deliberately extracting energy from fossilized remains, when the Welsh started burning coal for heat more than 4,000 years ago. With the rise of the Industrial Age, our use of fossil fuels began a dramatic climb that continues today, as we learned to make steel furnaces, railroads, and, eventually, automobiles and electricity generators.

Scientists estimate the atmospheric concentration of carbon dioxide has grown from a pre-industrial-era level of 280 parts per million (ppm) to a current level of 340 ppm, a 21 percent increase in just over 200 years. Worse, they believe most of it has occurred in the 100 years since the advent of electricity generators, especially those powered by coal. While a 21 percent increase over two centuries may seem small at first glance, it is alarming to scientists used to measuring time in spans of millions of years.

In the United States, electric utility plants are responsible for more than one third (35 percent) of the CO₂ released into the atmosphere; transportation devices rank a close second (30 percent), followed by industrial and residential sources (25 and 11 percent respectively).

Coal remains the main source of energy of the modern industrialized world, and its use is growing, both in absolute numbers and in share of the energy total. In 1986, according to the Edison Electric Institute, 668 million tons of coal, a third again as much as in 1980, were used to generate more than 60 percent of all the electricity generated in America. Among the fossil fuels, natural gas is the second most-used by utilities, followed by oil.

America's Quest For

ENVIRONMENT

ENVIRONMENTAL CONTROLS

Since the creation of the Environmental Protection Agency nearly 20 years ago, substantial progress has been made in controlling the rate at which fossil fueled plants emit contaminants.

Scrubbers, catalytic converters, fluidized bed furnaces, and elaborate, complex synthetic fuel plants (that convert coal, oil shale, and other raw fuels to a gas) can be employed to eliminate most if not all of the noxious emissions – including sulfur, nitrogen, and carbon compounds as well as particulates – that come out of a modern power plant.

But each of these controls can add millions of dollars to the cost of a new plant; to retrofit all of the nation's existing power plants would cost billions. We need to explore other alternatives.

Conservation is one. In the decade or so following the oil crisis years of the mid-1970s, Americans responded to rising fuel costs by enacting numerous efficiencies, such as insulating homes and factories, switching to more efficient appliances and industrial processes, and being more conscious of energy use in general.

But conservation can only cut consumption so much. Once the insulation has been installed, once the hot water heater has been replaced, there can be no more cut-backs in energy use without a corresponding cut-back in comfort or prosperity. There may still be room for improvement, but that room is, nonetheless, finite.

Another alternative is to shift our energy reliance away from fossil fuels. A petition circulating in Washington state would limit the construction of fossil fuel plants in that state.

"Because the atmospheric emissions that plague fossil fuel furnaces are virtually nonexistent at a geothermal plant, geothermal energy is the fuel of the future."

ALTERNATIVE FUELS

But it is not enough to simply rule out one form of energy; we still need to find cleaner substitute fuels. Fortunately, they do exist, though not without certain caveats. Many experts believe that uranium, for all the nuclear industry's bad image at the present time, will someday – perhaps decades

from now – re-emerge as the fuel of choice. Other alternatives, such as solar, wind, and hydro, may be more immediately available, but each has other hurdles to overcome, including day-to-day reliability uncertainties due to weather.

Geothermal energy is one of the most promising alternatives, and the one most immediately available on a commercial scale. It can be tapped today economically, quickly, and incrementally as needed, without negative impact on the environment.

Since there is no combustion, there is no new formation of sulfur, nitrogen or carbon oxides. Modern injection systems are able to return to the underground reservoir virtually all of the liquids, solids, and gases that make up the geothermal brine. Because the atmospheric emissions that plague fossil fuel furnaces are virtually nonexistent at a geothermal plant, geothermal energy is the fuel of the future.

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

Results of Operations:

The following is Management's discussion and analysis of certain significant factors which have affected the Company's financial condition and results of operations during the period included in the accompanying statement of operations.

Net loss for the year ended December 31, 1988 (Fiscal 1988) was \$258,000 compared to \$386,000 for the eleven months ended December 31, 1987 (Fiscal 1987), the first year in which the Company's power plant at its Coso Project was in operation. Several factors contributed to the reduced loss, including the Project's increase in electric kilowatt-hour sales to 261,292,000 KWH in Fiscal 1988 from 83,209,000 KWH in Fiscal 1987, lower operating costs per KWH, and the effect of the loss from extinguishment of debt in Fiscal 1987. The increase in electric sales volumes resulted from the first Unit of the Navy I power plant (Navy I, Unit 1) operating all year in Fiscal 1988, compared to 135 days in Fiscal year 1987 and Navy I, Units 2 and 3 operating for 12 days at the end of Fiscal 1988. Navy I, Unit 1 commenced operations on August 19, 1987, Units 2 and 3 on December 20, 1988.

Sales of electricity increased 238% in 1988 to \$10.7 million from \$3.2 million due to increased production and an increase in the average price per KWH to 8.80 cents per KWH in Fiscal 1988 from 8.66 cents per KWH in Fiscal 1987. Electric sales represented 85 and 82% of total revenues respectively. Other revenues which consist primarily of interest income and management fees from the joint ventures increased 166% in Fiscal 1988.

Plant operations, general and administration costs increased 206% in Fiscal 1988 to \$6.8 million from \$2.2

million. Due to increased efficiency of the plant, cost per KWH decreased to 5.64 cents per KWH from 6.12 cents per KWH which represented 64.0% and 70.7% of electric revenue respectively. Depreciation and amortization, which was \$2.3 million in Fiscal 1988 compared to \$0.7 million in Fiscal 1987, decreased to 21.6% from 21.9% of electric sales revenue. Interest expense increased to \$3.6 million from \$1.1 million due to increased borrowing and floating rates which increased in Fiscal 1988. Interest expense represented 34.1% of electric sales in Fiscal 1988 compared to 33.9% in Fiscal 1987.

The \$0.2 million loss on extinguishment of debt in Fiscal 1987 related to redemption of \$1.6 million debentures. The remaining \$1.8 million of debentures converted into common stock in 1989. There was no loss on the conversion.

The Company has not incurred any income tax expense for any of the periods presented. In December 1987, the Financial Accounting Standards Board adopted FAS 96, Accounting for Income Taxes. The Company intends to retroactively adopt FAS 96 in 1989.

The year ended January 31, 1987 (Fiscal 1986) is not comparable to Fiscal 1988 or Fiscal 1987, as the Coso Project was not operational until August 19, 1987.

Inflation currently is not having a material impact on the financial statements of the Company, as the rate of inflation has slowed somewhat in recent years. Inflation is not expected to impact the Company's costs more adversely than its competitors. The Company's gross revenue for the first ten years of deliveries under the PURPA Contracts include escalation clauses.

Liquidity and Capital Resources:

Cash and short-term investments were \$7.0 million at December 31, 1988 as compared to \$2.5 million at December 31, 1987. The increase in cash resulted primarily from the issuance of the 12% Senior Notes with Additional Contingent Interest (the "Senior Notes"), net of proceeds used for exploration and development of the Coso Project. The Senior Notes, due in 1995, bear interest at the rate of 12% per annum, plus 10% of the Company's share of net cash flow (as defined) from the Coso Project commencing July 1, 1989 and terminating December 31, 1994. In accordance with the terms of the Senior Notes, the first three semi-annual interest payments aggregating approximately \$5.7 million are deferred and added to the principal balance. Interest payments commence March 1990.

In 1988, the Company entered into project finance loan agreements with Credit Suisse for eight turbine-generator units including construction phase financing. The loans provide funding for Units 2 and 3 of the Navy I

power plant, the BLM power plant of 3 units and Navy II power plant of 3 units. The Company's proportionate share of those loans is \$196.2 million of which \$75.6 million had been drawn down as of December 31, 1988. The plant loans are to be repaid over a nine to ten year period after completion of construction, with interest at variable rates ranging from 1% to 1.45% over LIBOR (London Interbank Offered Rate). The estimated cost to complete the power plants is \$112.6 million.

In management's opinion, the remaining \$120.6 million of the Credit Suisse financing, which includes contingencies, will provide the financing necessary to complete the entire Coso Project as currently contemplated.

The unsecured line of credit of \$2.5 million as of December 31, 1988 has been increased to \$5 million and a second unsecured line of credit with another bank of \$2.5 million has been added. In addition, the Company expects that a portion of the warrants outstanding will be exercised by the holders in 1989.

SELECTED FINANCIAL DATA

for the year ended December 31, 1988 and
for the eleven months ended December 31, 1987 and
for the three years ended January 31, 1987
(in thousands except per share data)

	Year Ended December 31, 1988	11 Months Ended December 31, 1987	Year Ended January 31,		
			1987	1986	1985
Sales of electricity	\$ 10,673	\$ 3,156			
Other income	1,845	693	\$ 22	\$ 25	\$ 78
Expenses	12,776	4,235	165	96	120
Net (loss)	(258)	(386)	(143)	(71)	(42)
Net (loss) per share*	(0.01)	(0.02)	(0.01)	(0.01)	(0.00)
Total assets	210,164	67,120	22,218	14,329	10,514
Total liabilities	181,277	39,515	8,344	833	553
Deferred income	2,268	1,507	1,281	1,049	773
Stockholders' equity	26,619	26,098	12,593	12,447	9,188

* Adjusted for three-for-two stock split.

CONSOLIDATED BALANCE SHEETS

as of December 31, 1988 and December 31, 1987
(dollars and shares in thousands, except per share amounts)

ASSETS	December 31	
	1988	1987
Cash and short-term investments	\$ 7,019	\$ 2,453
Restricted cash	820	2,060
Accounts receivable	1,464	664
Due from joint venturers	8,117	895
Geothermal power plant and development costs, net	183,103	57,860
Equipment, net	2,620	1,096
Deferred charges and other assets	7,021	2,092
Total assets	\$210,164	\$67,120

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:		
Short-term bank loan	\$ 1,920	—
Accounts payable	6,775	\$ 4,085
Amounts due to construction contractor	8,445	2,809
Other accrued liabilities	8,517	639
Production payments	1,624	1,533
Project finance loans	120,382	28,622
Senior notes	31,800	—
Convertible subordinated debentures	1,814	1,827
Total liabilities	181,277	39,515
Deferred income	2,268	1,507
Commitments and contingencies (Notes 3, 8, and 12).		
Stockholders' equity:		
Preferred stock—authorized 1,000 shares, no par value, issued none		
Common stock—authorized 50,000 shares, par value \$0.0675 per share, outstanding		
19,190 and 18,906 shares at December 31, 1988 and 1987, respectively	1,295	1,276
Additional paid-in capital	26,842	26,221
Accumulated deficit	(1,518)	(1,260)
Employee stock purchase notes and treasury stock	—	(139)
Total stockholders' equity	26,619	26,098
Total liabilities and stockholders' equity	\$210,164	\$67,120

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars and shares in thousands, except per share amounts)

	Year Ended December 31, 1988	11 Months Ended December 31, 1987	Year Ended January 31, 1987
Revenues:			
Sales of electricity	\$10,673	\$3,156	—
Interest and other income	1,845	693	\$ 22
Total revenues	12,518	3,849	22
Costs and expenses:			
Plant operations, general and administration,	6,832	2,230	165
Depreciation and amortization	2,306	692	—
Interest	3,638	1,069	—
Loss from extinguishment of debt	—	244	—
Total expenses	12,776	4,235	165
Net loss	\$ (258)	\$ (386)	\$ (143)
Loss per share	\$ (0.01)	\$ (0.02)	\$ (0.01)
Average number of shares outstanding	18,928	18,143	15,498

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

for the year ended December 31, 1988, the eleven months ended
December 31, 1987, and for the year ended January 31, 1987

(dollars and shares in thousands)

	Outstanding Common Shares	Common Stock	Additional Paid-In Capital	Deficit	Employee Notes and Treasury Stock	Total
Balance, January 31, 1986	15,499	\$1,046	\$12,343	\$ (731)	\$ (211)	\$12,447
Payment of employee notes					16	16
Proceeds from issuance of warrants			273			273
Net (loss)				(143)		(143)
Balance, January 31, 1987	15,499	1,046	12,616	(874)	(195)	12,593
Proceeds from issuance of common stock	3,408	230	13,579			13,809
Proceeds from issuance of warrants			26			26
Payment of employee notes					72	72
Acquisition of treasury stock	(1)				(16)	(16)
Net (loss)				(386)		(386)
Balance, December 31, 1987	18,906	1,276	26,221	(1,260)	(139)	26,098
Payment of employee notes					139	139
Proceeds from issuance of common stock	16	1	18			19
Proceeds from exercise of warrants	264	18	590			608
Conversion of debentures	4	—	13			13
Net (loss)				(258)		(258)
Balance, December 31, 1988	19,190	\$1,295	\$26,842	\$ (1,518)	\$ —	\$26,619

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

for the year ended December 31, 1988,
the eleven months ended December 31, 1987,
and for the year ended January 31, 1987
(dollars in thousands)

	Year Ended December 31, 1988	11 Months Ended December 31, 1987	Year Ended January 31, 1987
Cash flows provided by (used in) operating activities:			
Net loss	\$ (258)	\$ (386)	\$ (143)
Adjustments to reconcile net loss to net cash provided by operating activities:			
Depreciation and amortization	2,306	692	-
Amortization of deferred financing costs	156	95	-
Increase in accounts receivable	(800)	(664)	-
Increase in other assets	(997)	-	-
Increase in accounts payable and accrued liabilities	908	332	-
Increase in deferred income	761	226	232
Net cash flows provided by operating activities	2,076	295	89
Cash flows provided by (used in) investing activities:			
Capital expenditures relating to power plants	(87,280)	(27,522)	(1,199)
Exploration and development costs	(38,015)	(12,983)	(7,338)
Acquisition of other property and equipment, net	(1,999)	(1,057)	(21)
Increase in accounts payable and accrued liabilities	10,427	863	1,488
Increase in amounts due to construction contractor	5,636	2,809	-
Decrease (increase) in restricted cash	1,240	(2,060)	-
Other	(212)	-	-
Net cash flows (used in) investing activities	(110,203)	(39,950)	(7,070)
Cash flows provided by (used in) financing activities:			
Proceeds from sale of common stock	627	13,809	-
Proceeds from issuance of warrants to purchase common stock	-	26	273
Proceeds from issuance of convertible debentures	-	327	3,100
Proceeds from issuance of senior notes	30,000	-	-
Proceeds from project finance loans	92,842	31,048	2,736
Repayment of project finance loans	(1,082)	(4,694)	-
Production payment advances	-	1,533	-
Redemption of convertible debentures	-	(1,600)	-
(Increase) decrease in amounts due from joint venturers	(7,222)	(574)	2,459
Increase in short-term bank loan	1,920	-	-
(Decrease) increase in accounts payable and accrued liabilities	(767)	553	214
Deferred charges relating to debt financing	(3,855)	(989)	-
Other	230	967	(887)
Net cash flows provided by financing activities	112,693	40,406	7,895
Net increase in cash and cash equivalents	4,566	751	914
Cash and cash equivalents at beginning of period	2,453	1,702	788
Cash and cash equivalents at end of period	\$ 7,019	\$ 2,453	\$ 1,702

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollars in thousands)

1. BUSINESS:

California Energy Company, Inc. (the Company) was formed in 1971 and is engaged in the exploration and development of geothermal resources and conversion of such resources into electrical power for sale to electric utilities.

The Company has organized several partnerships and joint ventures (herein referred to as joint ventures) in order to explore, develop, and convert resources at the China Lake Naval Weapons Center at Coso Hot Springs, China Lake, California. Collectively, the projects undertaken by these partnerships and joint ventures are referred to as the Coso Project. The Company is the operator and holds interests between 46% and 50% in the partnerships and joint ventures after payout. Payout is achieved when a joint venture has returned the initial capital of the joint venturers. In addition, the Company is exploring geothermal resources in the Cascade Mountains of Northern California, Washington and Oregon (the Cascades).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Principles of Consolidation:

The consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries, and its proportionate share of the joint ventures in which it has invested. All significant inter-enterprise transactions and accounts have been eliminated.

Exploration and Development Costs:

The Company follows the full cost method of accounting for costs incurred in connection with the exploration and development of geothermal resources. All such costs, which include dry hole costs and the cost of drilling and equipping production wells, as well as directly attributable administrative costs and interest costs, are capitalized and amortized over their estimated useful lives when production commences. The estimated useful lives of production wells are ten years each; exploration costs and development costs, other than production wells, are amortized over the lives of the leases from the Navy and the U.S. Bureau of Land Management (BLM), as applicable. Rework costs of operating wells are charged to expense as incurred.

Fixed Assets and Depreciation:

The cost of major additions and betterments is capitalized, while replacements, maintenance, and repairs that do not improve or extend the life of the respective assets are expensed currently.

Depreciation of the operating power plant is computed on the straight-line method over its estimated useful life of thirty years.

Depreciation of furniture, fixtures, and equipment, which are recorded at cost, is computed on the straight-line method over the estimated useful lives of the related assets, which range from three to ten years.

Capitalization of Interest:

Prior to the commencement of operations, interest is capitalized on the costs of the plants and geothermal properties to the extent incurred. Interest capitalized for the year ended December 31, 1988, the eleven months ended December 31, 1987 and the year ended January 31, 1987 was approximately \$6,089, \$494 and \$676, respectively.

Deferred Charges:

Deferred financing costs are amortized over the term of the related financing. Loan fees are amortized using the implicit interest method; other deferred financing costs are amortized using the straight-line method. Capitalized interest and other deferred charges are amortized over ten years. Accumulated amortization at December 31, 1988 and 1987 was approximately \$474 and \$151, respectively.

Management Fee and Interest Revenue Recognition:

The Company charges the joint ventures management fees and interest on outstanding advances. Recognition of fees and interest relating to joint ventures in which the Company has invested is deferred until each joint venture commences operations (for fees and interest related to resource development) and with concurrent funding (for fees and interest related to the power plants). Revenue previously deferred is amortized over the lives of the related assets of the joint ventures when each joint venture becomes operational.

Net Loss Per Share:

Net loss per share is computed as net loss divided by the weighted average number of common shares outstanding. Options and warrants outstanding are excluded from the computation as they are antidilutive.

Cash Flows:

The statement of cash flows does not include noncash activities relating to interest added to the principal of the Senior Notes and capitalized as part of the exploration and development costs of \$1,800 in the year ended December 31, 1988, nor the capitalization of depreciation of equipment and amortization of deferred charges within exploration and development costs of \$423, \$150, and \$36 for the year ended December 31, 1988, the eleven months ended December 31, 1987 and the year ended January 31, 1987, respectively.

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Restricted cash is not considered a cash equivalent.

Change in Fiscal Year:

Effective January 1, 1987, the Company changed its fiscal year-end from January 31 to December 31.

3. GEOTHERMAL POWER PLANT AND DEVELOPMENT COSTS:

Geothermal power plant and development costs comprise the following:

	December 31	
	1988	1987
Coso Project:		
Power plant	\$ 70,983	\$26,961
Exploration and development costs	31,405	12,855
Total	102,388	39,816
Less accumulated depreciation and amortization	2,967	692
Net operating facilities	99,421	39,124
Construction in progress:		
Power plants	46,433	3,175
Exploration and development costs	27,992	8,944
Total Coso Project	173,846	51,243
Cascades geothermal exploration costs	9,257	6,617
Total	\$183,103	\$57,860

Operating Facilities:

The operating facilities comprise the Company's proportionate share of the assets of one of its joint ventures, Coso Finance Partners (CFP). The first turbine commenced delivery of firm power on August 19, 1987, and the second and third turbines commenced delivery of firm power on December 20, 1988. The facility (Navy I) is located on land owned by the U.S. Navy. Under the terms of the joint venture, profits and losses are allocated 46% to the Company after payout.

Construction in Progress:

BLM Plant:

The power plants under construction comprise the Company's proportionate share of the assets of one of its joint ventures, Coso Energy Developers (CED). Under the terms of CED's joint venture agreement, the Company's share of profits and losses before and after payout is approximately 40% and 48%, respectively, for the net 70MWe facility on lands leased from the U.S. Bureau of Land Management (the BLM plant). The

lands are leased under a ten-year geothermal lease agreement that can be extended until October 31, 2035, so long as geothermal resources continue to be produced in commercial quantities on these lands. The lease may be extended to 2075 at the option of the BLM. The BLM plant consists of two turbines at one site (BLM East), which are on line but had not yet commenced delivery of firm power as of December 31, 1988, and one turbine at another site (BLM West) which is expected to be completed by the summer of 1989.

Navy II Plant:

Exploration and development costs include the Company's proportionate share of CED's development of a further 80MWe power plant (Navy II) on the southern portion of the Navy lands. The Company has signed a turnkey construction contract with Mission Power Engineering Co. (MPE), a subsidiary of Southern California Edison (SCE), for the construction of the 80MWe power plant to be completed in 1989. All profits and losses and capital contributions for Navy II are divided equally.

The geothermal resources for all of the power plants have been confirmed and are under active development.

Cascades Geothermal Exploration Costs:

In the Cascades, the Company has acquired leasehold rights and has performed certain geological evaluations to determine the resource potential of the underlying properties. Recovery of these costs is ultimately dependent upon the Company's ability to prove geothermal reserves, obtain financing, gain access to high voltage transmission lines, and to sell the resultant electricity at favorable prices or, alternatively, to sell its leaseholds. However, in the opinion of management, the Company will be able to realize its exploration costs through the generation of electricity for sale.

Significant Customers:

All of the Company's sales of electricity from the Coso facility are to SCE and are under long-term power purchase contracts. Under the terms of these contracts, SCE pays firm prices for the energy portion of the contract, which escalate pursuant to the contracts at an average rate of 7.8% per year for the delivery of electricity for ten years, commencing with the initial delivery of electricity at firm power; thereafter, the energy payment adjusts to the actual avoided energy cost experienced by SCE at that time. The capacity payment, which initially represents approximately 25% of the Company's revenue, remains fixed during the entire period of the contract. In addition, the Company is eligible for bonus payments based on the amount by which the actual output exceeds the contract capacity of each power plant.

The Company has three contracts for terms of 20, 24, and 30 years, expiring in 2010, 2011, and 2019, respectively. Delivery of electricity by CFP commenced under the 24-year contract in 1987. Delivery of electricity at

firm power under the other two contracts is scheduled for 1989. In the event that the delivery of electricity does not commence by June 28, 1990, these contracts are subject to termination unless delayed by force majeure causes.

Navy Contract:

As referred to above, Navy I, Unit 1, is located on land owned by the U.S. Navy. Under the terms of a 30-year contract with the U.S. Navy to develop geothermal energy on its lands, the Company will pay the Navy a fee based on the difference between the amounts paid by the Navy to SCE for specified quantities of electricity and the price as determined under the Navy contract. In addition to this fee arrangement, the Company is required to pay the Navy \$11,600 on December 31, 2009, the date the contract expires. The Navy has the option to extend the contract to 2019. The payment is secured by funds placed on deposit monthly, which funds, plus accrued interest, will aggregate \$11,600. The monthly deposit is currently \$12. As of December 31, 1988, the balance of funds deposited approximated \$200, which amount is included in restricted cash and accrued liabilities.

The Navy I (Units 2 and 3) and Navy II power plants are on Navy lands, on which the Navy will receive a royalty based on electric sales revenue at the initial rate of 4% escalating to 20% by the end of the contract in December 2009. The BLM will be paid a royalty of 10% of the value of steam produced by the geothermal resource supplying the BLM plant.

4. EQUIPMENT:

Equipment is stated at cost, net of accumulated depreciation of \$710 and \$235 as of December 31, 1988 and 1987, respectively.

5. SHORT-TERM BANK LOAN:

Short-term borrowings under the Company's line of credit agreement at December 31, 1988 were \$1,920. The Company has established a line of credit aggregating \$2,500 at December 31, 1988 which expires in February 1990. Borrowings under this line of credit are at an interest rate of prime plus one-half. As of December 31, 1988, prime was 10.5%.

The maximum month-end borrowings during 1988 under the line of credit were \$1,920 and the average borrowing outstanding was \$597 at an average interest rate of 10.5%.

There were no lines of credit prior to 1988.

In December 1988, the Company received a commitment from another bank for an additional \$2,500 line of credit which became available in February 1989.

6. PRODUCTION PAYMENTS:

The Company has entered into a production payment agreement whereby \$1,624 was funded towards the cost of drilling wells. Under the terms of the agreement, the Company is obligated to pay up to 7.0% (after return of

capital) of the net cash flow (as defined in the agreement) from the first turbine generator set of CFP.

7. PROJECT FINANCE LOANS:

Project finance loans comprise the following:

	December 31	
	1988	1987
Term loans:		
Navy I bank term loan with interest at LIBOR (9 $\frac{1}{4}$ % as of December 31, 1988) plus 1.45%, due 1997	\$ 29,232	\$28,622
Navy I bank term loan with interest at LIBOR plus 3%, due 1998	8,352	—
BLM resource development term loan with interest at LIBOR plus 1.5% plus 1.4% of cash flow (as defined), due 1999	7,200	—
	<u>44,784</u>	<u>28,622</u>
Construction loans:		
Navy I bank construction loan with interest at LIBOR plus 1.25%, converting into term loan with interest at LIBOR plus 1.45%, due 1998	33,454	—
BLM bank construction loan with interest at LIBOR plus 1.25% converting into term loan with interest at LIBOR plus 1.45%, due 1999	42,144	—
	<u>75,598</u>	<u>—</u>
	<u>\$120,382</u>	<u>\$28,622</u>

The loans are collateralized by the power plants, the geothermal resources, and cash placed on deposit and are subject to certain financial and geothermal reserve covenants and require, inter alia, that all revenues be deposited into and disbursed from a project control account with Credit Suisse, that cash reserves in special cash accounts be maintained for well replacement and contingencies, that certain restrictions be placed on the sale of assets, and that the Company maintain 125% of the geothermal resources necessary to operate the plant at full capacity. The Company has entered into loan agreements with Credit Suisse to finance drilling and construction of the additional eight turbines. This financing aggregates approximately \$196,260, of which \$75,598 had been drawn down as of December 31, 1988. These loans automatically convert into nine- or ten-year term loans upon completion of construction.

Assuming the draw-down of the remaining \$120,662 of the construction loans and conversion into term loans, the annual maturities of project debt financing for the five years beginning January 1, 1989 will be as follows:

1989	\$ 3,016
1990	17,448
1991	18,952
1992	21,348
1993	24,236
Thereafter	<u>156,044</u>
	<u>\$241,044</u>

Warrants:

The Company has granted warrants in connection with various financing activities to purchase shares of common stock as follows:

	Warrants Outstanding		
	Shares	Option Price Per Share	Total
Balance, February 1, 1986	3,337,134	\$2.21 - \$4.12	\$ 8,006
Warrants granted	401,751	\$2.21 - \$2.56	1,025
Balance, January 31, 1987	3,738,885	\$2.21 - \$4.12	9,031
Warrants granted	337,207	\$2.56 - \$7.21	2,242
Balance, December 31, 1987	4,076,092	\$2.21 - \$7.21	11,273
Warrants exercised	(264,275)	\$2.21 - \$4.12	(608)
Balance, December 31, 1988	3,811,817	\$2.21 - \$7.21	\$10,665

The warrants are exercisable immediately; 319,500 of the warrants with an exercise price of \$4.12 expire within ten days of a Registration Statement covering the warrants that was filed with the Securities and Exchange Commission on January 18, 1989, being declared effective, and the remainder expire in 1991 and 1992.

Stock Splits:

On June 30, 1986, the shareholders approved a resolution to split the Common Stock of the Company 2-for-1. In January 1987, the shareholders approved a 2.7-for-1 reverse stock split, which changed the par value to \$0.0675 per share. In November 1988, the Company declared a 4% stock dividend and in January 1989, the Company declared a 50% stock split. All share amounts herein give effect to the stock splits, reverse stock split, and the stock dividend.

15. RECLASSIFICATIONS:

Certain reclassifications have been made to prior year financial statements in order for them to conform to the classifications used in Fiscal 1988.

16. QUARTERLY FINANCIAL DATA (unaudited):

Following is a summary of the Company's quarterly results of operations for the year ended December 31, 1988 and for the eleven months ended December 31, 1987:

	Three Months ended				Year Ended December 31, 1988
	March 31, 1988	June 30, 1988	September 30, 1988	December 31, 1988	
Revenue:					
Sales of electricity	\$2,060	\$2,188	\$3,701	\$2,724	\$10,673
Other income	240	449	352	804	1,845
Total revenue	2,300	2,637	4,053	3,528	12,518
Total costs and expenses	2,755	3,315	3,292	3,414	12,776
Net income (loss)	\$ (455)	\$ (678)	\$ 761	\$ 114	\$ (258)
Earnings (loss) per share	\$ (0.02)	\$ (0.04)	\$ 0.03	\$ 0.01	\$ (0.01)

	Three Months Ended			Two Months Ended December 31, 1987	Year Ended December 31, 1987
	April 30, 1987	July 31, 1987	October 31, 1987		
Revenue:					
Sales of electricity	—	—	\$1,371	\$1,785	\$3,156
Other income	\$ 52	\$ 222	132	287	693
Total revenue	52	222	1,503	2,072	3,849
Total costs and expenses	257	109	1,279	2,590	4,235
Net income (loss)	\$ (205)	\$ 113	\$ 224	\$ (518)	\$ (386)
Earnings (loss) per share	\$ (0.01)	\$ 0.01	\$ 0.01	\$ (0.03)	\$ (0.02)