UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

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Arizona Public Service Company (APS), as Project Manager and Operating Agent of Palo Verde Nuclear Generating Station (PVNGS) Units 1, 2 and 3, submits this application on its behalf as a joint owner of PVNGS Unit 2 (Unit 2) and a licensee under Facility Operating License No. NPF-51 (the Unit 2 License) authorized to "possess" an interest in Unit 2, as distinguished from its licensed authority to "use and operate" Unit 2.

1. Relief Requested

APS proposes to refinance its construction financing for Unit 2 by entering into one or more sale and leaseback transactions relating to all or a portion of APS's 29.1% undivided ownership interest in Unit 2 with or without a portion of APS's undivided ownership interest in certain PVNGS common facilities (said interest in Unit 2 and any such portion of the common facilities being hereinafter collectively referred to as the Unit 2 Facilities).[1] The relief requested by this Application is the issuance of an order (i) consenting to the sale and leaseback transactions described in this Application and (ii) authorizing the Director of the Office of Nuclear Reactor Regulation to amend the Unit 2 License by adding a new paragraph, 2.B(6), substantially as follows:

> (6) Pursuant to an Order of the Nuclear Regulatory Commission dated _____ ___, 1986, Arizona Public Service Company (APS) is authorized to transfer and APS may transfer portions of its ownership share in Palo Verde Unit 2 to certain institutional investors and concurrently may lease back each such interest. The basic term of each lease will expire on or about January 15, 2016, subject to a right of renewal. The

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[1]APS will also sell an undivided interest in certain real property interests associated with the Unit 2 Facilities. APS will retain its entire 29.1% ownership interest in all so-called "section 1250 property" such as the administration building, the administration annex building, the technical support center and the visitor center. APS will also retain its entire ownership interest in all nuclear fuel and transmission facilities associated with PVNGS.

sale and leaseback transactions are subject to the representations and conditions set forth in the May 2, 1986 Application in Respect of Sale and Leaseback Transactions by Arizona Public Service Company and the Commission's Order of _____ ____, 1986, consenting to such transactions. Specifically, the lessors and anyone else who may acquire an interest under these transactions are prohibited from exercising directly or indirectly any control over the licensees of Palo Verde Unit 2. For purposes of this condition, the limitations in 10 CFR 50.81 "Creditor Regulations" as now in effect and as they may be subsequently amended are fully applicable to the lessors and any successor in interest to such lessors as long as the license for Palo Verde Unit 2 remains in effect. These transactions shall have no effect on the license for Palo Verde Unit 2 throughout the term of the license.

Further, the licensees are required to notify the Commission in writing (1) prior to any change in (i) the terms or conditions of any lease agreements executed as part of such transactions, (ii) the ANPP Participation Agreement or (iii) the existing insurance for Palo Verde Unit 2 maintained pursuant to 10 CFR Part 140 and 10 CFR 50.54(w) and (2) of any action by any lessor or others that may have an adverse effect on the safe operation of Palo Verde Unit 2.

This paragraph 2.B(6) will become effective as to any sale and leaseback transaction only upon receipt by the Office of Nuclear Reactor Regulation of supplemental information acceptable to such Office concerning the institutional investors which are parties to such transaction and the expiration of 10 days (or any shorter period permitted by such Office) without notice to APS of Commission objection to any such institutional investor.

2. Background

On October 18, 1985, APS filed on behalf of Public Service Company of New Mexico (PNM) an application (the PNM Unit 1 Application), which requested approval for PNM to sell and lease back all or a portion of PNM's 10.2 percent ownership

interest in PVNGS Unit 1 (Unit 1), and all or a proportionate share of one-third of PNM's 10.2 percent ownership interest in certain Palo Verde common facilities (collectively, the Unit 1 Facilities). On December 12, 1985, the Nuclear Regulatory Commission issued an Order[2] (i) consenting to sale and leaseback transactions with respect to PNM's interest in the Unit 1 Facilities and (ii) authorizing the Director of the Office of Nuclear Reactor Regulation to amend Facility Operating License NPF-41 (the Unit 1 License) to reflect PNM's position as lessee in respect of Unit 1. On December 26, 1985, the Unit 1 License was so amended.

As shown below, the transactions described in this Application are similar in all significant respects to the transactions entered into by PNM with respect to the Unit 1 Facilities. In addition, the relief requested in this Application by APS is the same relief as was granted to PNM by the Nuclear Regulatory Commission in its December 12, 1985 Order.[3]

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[2]Arizona Public Service Company (Palo Verde Unit 1), Docket No. STN-50-528, December 12, 1985 (hereinafter the "December 12, 1985 Order").

[3]Both PNM and El Paso Electric (EPE) have filed applications in this docket seeking authorizations to sell and lease back all or portions of their respective interests in Unit 2. Such applications are currently pending before the Nuclear Regulatory Commission.

This Application, however, does present a fact situation that differs from that presented by the PNM Unit 1 Application insofar as APS occupies two positions with respect to Unit 2: (i) the position of a joint owner licensed to "possess" Unit 2, and (ii) the position of a licensee authorized to "use and operate" Unit 2. On the other hand, PNM's position in the PNM Unit 1 Application was solely that of a joint owner licensed to "possess" Unit 1. The two positions occupied by APS in respect of this Application are no different than would be presented in an application in which the applicant is the sole owner of a facility and the licensed authority to "possess" the facility is not shared with any other entity.

As will be demonstrated, if the conditions which were imposed by the December 12, 1985 Order are applied as requested by this Application, then the fact that APS is the licensee authorized to "use and operate" Unit 2 is not material to the authorization of the conversion of its possessory rights in Unit 2 from a fee ownership interest to a leasehold interest.

3. Description of the Proposed Sale and Leaseback Transactions

APS proposes to sell to a grantor trust or trusts, the beneficiaries of which will be institutional equity investors (the Equity Investors), the Unit 2 Facilities, including without

limitation all or a corresponding proportion of APS's 29.1% generation entitlement share in Unit 2. Each such investor will enter into a trust agreement with The First National Bank of Boston (hereinafter, in such capacity, the Owner Trustee) who will take and hold title to the Unit 2 Facilities sold by APS. The Owner Trustee will in turn lease the Unit 2 Facilities (hereinafter, in such capacity, the Lessor) and assign the acquired generation entitlement share back to APS for a term of approximately 29-1/2 years for a stipulated basic rent.

At the time of this Application, the forms of documents relating to the proposed transactions have not been prepared. In light of such circumstances, the following description is offered as a summary of certain significant aspects of the transaction.

3.1. Sale of Unit 2.

APS proposes to refinance its construction financing for Unit 2 by entering into one or more sale and leaseback transactions relating to all or a portion of the Unit 2 Facilities. Each lease agreement will be with the Owner Trustee (in such capacity, the Lessor) acting for the related Equity Investor. Trusts formed by the Equity Investors will hold title to the respective purchased interests in the Unit 2 Facilities. The

Lessor will lease the Unit 2 Facilities to APS under separate leases (the Leases). If the sale and lease-back transactions are completed as to less than all of APS's interest in the Unit 2 Facilities, APS will retain an undivided interest in the Unit 2 Facilities.

It is typical in sale and leaseback transactions involving large investments to have multiple Equity Investors. Because of this structure, there will be multiple sets of documents (including the Leases) in substantially the same form, with one set for each of the Equity Investors.

Because discussions with potential Equity Investors have only recently been initiated, the identity of the actual Equity Investors who will participate in the proposed transactions is not yet known. Over the last several years, affiliates and subsidiaries of electric utilities (singly or in joint-venture with other equity investors and/or financial intermediaries) have become an increasingly important source of equity investment for sale and leaseback transactions of all types. Although it might seem anomalous that electric utilities would be involved both as lessee and, through an affiliate or subsidiary, as equity investor, this is not surprising

in view of the different financial situations of different utilities. Like other investors, some utilities are in the position of seeking tax-advantaged investments. APS and its financial advisors, The First Boston Corporation, believe that participation by such Equity Investors may be essential to the successful sale and leaseback by APS of its entire interest in the Unit 2 Facilities. Affiliates and subsidiaries of electric utilities would be purely passive investors and would have the same investment purpose as any other Equity Investor. Because participation by such entities in the proposed sale and leaseback transactions would have no effect whatsoever upon the operation of PVNGS, or the generation of electricity or transmission thereof, the presence of such entities as Equity Investors should have no impact on the requested relief.

In addition, if APS is unable to sell all of its interest in the Unit 2 Facilities to third-party Equity Investors, APS may consummate a sale and leaseback transaction for all or a portion of such unsold interest with an affiliate or subsidiary of APS on essentially the same terms as those involving unrelated Equity Investors except that certain provisions of certain agreements (for example, covenants

governing mergers by APS) may be suspended or otherwise modified for so long as the APS affiliate or subsidiary is the Equity Investor in such transaction. The provisions that may be suspended or otherwise modified will not be, either singly or in the aggregate, material to this Application, the supporting documents or the Commission's consideration of this Application.

3.2 Purchase Price.

The Unit 2 Facilities will be sold to the Lessors at a fair market price which may be in excess of $1.0 billion if all of APS's interest in the Unit 2 Facilities (including a portion of certain common facilities) is sold. Prior to the closing of the lease transactions, an appraisal will confirm that the purchase price is a reasonable estimate of fair market value. The appraisal, to be conducted by an appraiser selected by the Equity Investors, will also determine that, after approximately 31-1/2 years, the estimated remaining economic life of the Unit 2 Facilities will be long enough and their estimated value will be great enough to establish the Leases as "true leases" for Federal tax purposes.

3.3 Lease Term and Renewal Option.

The basic term of each of the Leases is expected to be approximately 29-1/2 years. APS will seek an option, at the end of the basic term, to renew each of the Leases for one or more relatively short, fixed-rent renewal term (e.g., 2 years) at a rental payment equal to a ratio of the original rent to be negotiated. The fixed-rent renewal period may be extended under limited circumstances, provided that the initial and any extended fixed-rent renewal period shall always be less than the period at which the Leases would not be treated as "true leases" for Federal tax purposes. Additionally, APS will seek from the Equity Investors the option, but no obligation, to continue renewing each of the Leases at fair market rentals for the remaining life of the Unit 2 Facilities.

3.4 Purchase Option

APS will have the option, but no obligation, at the end of the basic term and at the end of each renewal term to purchase the Unit 2 Facilities at their fair market value at that time.

3.5 Quiet Enjoyment; Rights of APS

During the term of the Leases, the Lessors will warrant that, so long as APS is in compliance with the terms of the Leases, APS's sole possession and use of, and rights with respect to, the Unit 2 Facilities shall not be interrupted by the Lessors or any person claiming through the Lessors. APS will be empowered with respect to the Unit 2 Facilities to be and act as the "Participant" under the ANPP Participation Agreement[4] with full and exclusive authority to exercise and perform all of the rights and duties of a Participant thereunder. Additionally, APS will retain the exclusive right to sell and dispose of the power and energy derived from its generation entitlement share in Unit 2 associated with the Unit 2 Facilities. APS will also reserve its right to serve as the Operating Agent of Unit 2 on behalf of all of ANPP Participants and as the sole licensee authorized to "use and operate" Unit 2 under the Unit 2 License.

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[4]See section 3.10 hereof.

3.6 Net Lease

The Leases will be "net leases" under which APS will be responsible for paying all taxes, insurance premiums, operating and maintenance costs, and all other similar costs associated with the Unit 2 Facilities (including obligations as the Participant in respect of the Unit 2 Facilities under the ANPP Participation Agreement).[5] The purpose of these provisions is to ensure that the Lessors are subject only to normal financing risks and not to operational risks or responsibilities.

3.7 Capital Improvements.

Any addition, betterment or enlargement of the Unit 2 Facilities, or replacement of units of property within the Unit 2 Facilities (Capital Improvements) will be APS's obligation under the Leases. Although the Lessor will be under no obligation to finance Capital Improvements, APS may, in the future, seek to finance Capital Improvements through sale and leaseback transactions.

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[5]See section 3.10 hereof.

3.8 Support Agreements.

APS and the Lessor will enter into support agreements which will provide the Lessor with such rights in parts of APS's interest in PVNGS not constituting Unit 2 Facilities as may be necessary to enable the Lessor and its successors and assigns to realize the residual values of its interests under the several sale and leaseback transactions as may be consummated. In particular, effective upon termination of each Lease (unless APS shall have exercised its option to purchase the Unit 2 Facilities subject to such Lease), certain rights in nuclear fuel, transmission facilities to the ANPP Switchyard and other retained common facilities and assets[6] will be made available to the Lessors for the remaining economic life of the Unit 2 Facilities to satisfy Internal Revenue Service guidelines for a "true lease" characterization, particularly with regard to negating any "limited use" characteristics of the Unit 2 Facilities.

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[6]For a description of the retained assets, see footnote 1 above.

3.9 Debt Matters

The Lessors will borrow approximately 70 percent to 80 percent of the purchase price of the Unit 2 Facilities from a funding corporation (the Funding Corporation) created for that purpose. The Funding Corporation, in turn, will borrow the debt portion of the purchase price by issuing publicly or privately placed debt that will be non-recourse to the Lessors and the Equity Investors. Such debt, which must be issued on terms acceptable to APS, will be indirectly secured by and be payable from the rentals due from APS under the Leases and may involve the pledge of a security interest in the Unit 2 Facilities. The debt will be structured to have principal and interest payments that correspond to the receipt of rental payments under the Leases and may involve pledge of a security interest in the Unit 2 Facilities. The debt will be issued in serial form, i.e., obligations with different maturities and principal amounts. Privately-placed interim financing may be required pending the issuance of such debt.

The details of the debt funding arrangements of the proposed sale and leaseback transaction will be fully described in the application of the Funding

Corporation expected to be filed with the Securities and Exchange Commission in May, 1986, requesting an order exempting such Corporation from the provisions of the Investment Company Act of 1940. A copy of the application will be provided to the Nuclear Regulatory Commission when available.

3.10 The ANPP Participation Agreement

The construction, operation and maintenance of PVNGS and the rights and duties of the joint owners of and participants in PVNGS are governed by the ANPP Participation Agreement dated August 23, 1973, as amended (the ANPP Participation Agreement). Under the ANPP Participation Agreement, APS, as agent for all of the ANPP Participants, has been appointed as the Project Manager responsible for the construction of PVNGS and as the Operating Agent responsible for the operation and maintenance of PVNGS. The ANPP Participation Agreement provides the delegations of authority to APS necessary to permit APS, as Project Manager and Operating Agent, to carry out such functions in a manner which complies with all laws, regulations, permits and licenses (including the Unit 2 License).

The ANPP Participation Agreement also establishes the rights and obligations of the ANPP Participants. One of the primary obligations assumed by the ANPP Participants under the ANPP Participation Agreement is the obligation to share the costs of construction, operation, maintenance, decommissioning and capital improvements of PVNGS, in accordance with their respective generation entitlement shares. So long as an ANPP Participant is not in default in its obligations under the ANPP Participation Agreement, such Participant is entitled to schedule power based on its generation entitlement share of the generating capability of such unit available at the time of such scheduling.

The ANPP Participation Agreement provides the ANPP Participants with oversight of PVNGS and the actions of APS, as Project Manager and Operating Agent, through participation in three standing committees: the Administrative Committee, the Engineering and Operating Committee and the Auditing Committee. Generally, all actions which each of the committees is authorized to take must be approved by the unanimous vote of all members entitled to vote on such committee.

Since each Participant is entitled to one vote and the unanimous vote of all Participants is required for all such actions, the roles played by the Participants in the oversight of PVNGS are equal irrespective of disparities in their respective joint participation interests. In the event any committee is unable to agree on any matter (with certain limited exceptions) which the committee is authorized to determine, the Project Manager/Operating Agent is authorized and obligated to take such action and expend such funds as in its discretion is necessary to the proper construction, operation and maintenance of PVNGS, pending resolution of such inability or failure to agree. Additionally, in the event of an operating emergency, the Operating Agent is authorized and obligated to take such action as it, in its sole discretion, may deem prudent and necessary.

Amendment No. 10 to the ANPP Participation Agreement permits the proposed sale and leaseback transactions, subject to the satisfaction of certain criteria. As with the transactions described in the PNM Unit 1 Application, the transactions described in this Application will meet such criteria. APS will request that the ANPP Administrative Committee make the

determinations necessary to permit consummation of the proposed transactions.

4. Conditions Precedent to the Transactions

The proposed transactions are subject to the following conditions precedent, in addition to others commonly associated with any financial transaction of this nature:

(a) The approval of the transactions by the Arizona Corporation Commission (ACC) as required by the laws of the State of Arizona, such approval to be in form and substance satisfactory to all parties to such transactions;

(b) Receipt of an order of the Federal Energy Regulatory Commission (FERC) or an opinion of counsel to APS specializing in FERC matters, satisfactory in form and substance to all parties to the transactions, to the effect that the Equity Investors and the Owner Trustee will not, as a result of their holding title to the Unit 2 Facilities, become "public utilities" as defined in section 203(a) of the Federal Power Act. APS's counsel specializing in FERC matters has determined that an application for an exemptive order from FERC, such as was obtained in respect of the

transactions described in the PNM Unit 1 Application,[7] will not be necessary since transactions of this nature have been ruled upon favorably on numerous occasions by FERC;

(c) The actions of the Nuclear Regulatory Commission requested in this Application; and

(d) The determinations required to be made in respect of the transactions by the ANPP Administrative Committee.

5. Schedule of the Sale and Leaseback Transactions

If the proposed sale and leaseback transactions are to include the economic benefit to APS of transferring to the Lessors the investment credit available with respect to Unit 2 (which results in lower annual rent payments), such transactions must be consummated within three months of the date on which Unit 2 is first synchronized (utilizing its nuclear steam supply system) with the main transmission grid, the latter date being the date on which Unit 2 is first "placed-in-service" for purposes of the investment credit under section 46 of the

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[7]A copy of the FERC Order in respect of the transactions described in the PNM Unit 1 Application is attached hereto as Exhibit A.

Internal Revenue Code. Under current schedules, first synchronization is expected to be completed about mid-May, 1986. If this schedule is met, sales of interests in the Unit 2 Facilities must occur not later than mid-August, 1986 in order to permit the Equity Investors to claim the investment credit with respect to the Unit 2 Facilities. If the proposed sale and leaseback transactions do not include any investment credits, the sales of interests in Unit 2 Facilities would, nevertheless, have to be consummated by mid-August, 1986, in order that such interests might qualify as "transition property" as defined in H.R.3838 (99th Congress) which would assure the availability of 10-year ACRS (Accelerated Cost Recovery System) depreciation.

To meet the projected deadline it is planned that preliminary conditional commitments will be obtained from the Equity Investors in a timely manner. The First National Bank of Boston has already committed to act as Owner Trustee. It is expected that approval of the proposed transactions by the ACC will also be obtained in a timely manner and that the proposed transactions will themselves be consummated by mid-August, 1986 (assuming synchronization in mid-May, 1986). The economic aspects of certain transactions may, however, require a closing prior to mid-August, 1986. Certain potential Equity Investors have tax years that end other than on December 31. If a potential Equity Investor's tax year ended on June 30, 1986, the

closing of a transaction prior to that date may yield more favorable tax benefits to the investor and a lower yearly rent obligation to APS, resulting in further savings to APS's ratepayers. APS may receive a proposal from such an Equity Investor which therefore requires an accelerated review of this Application.

To achieve a schedule accelerated to meet an early closing date, it is requested that:

(i) notice of this Application be published in the Federal Register at the earliest convenient date; and

(ii) the requested order and amendment to the Unit 2 License be issued and become effective at the earliest date convenient to the Commission.

6. Supporting Information

The general information respecting applicant APS required by 10 CFR 50.33 is provided by Exhibit B attached hereto. Copies of the 1985 Annual Reports of APS and AZP Group, Inc. (AZP), the parent company of APS, and the Annual Reports on Form 10-K for the fiscal year ended December 31, 1985, for both AZP Group, Inc. and APS are attached hereto as Exhibits C, D, E, and F respectively.

The general information respecting the Owner Trustee required by 10 CRR 50.33 is provided by Exhibit G attached hereto. Copies of the 1985 Annual Report of the Bank of Boston, the parent company of the Owner Trustee and Bank of Boston Corporation's Annual Report on Form 10-K for the fiscal year ended December 31, 1985, are included in Exhibit B attached to the Application in Respect of Sale and Leaseback Transactions by El Paso Electric Company, filed in this docket on April 16, 1986, and are incorporated herein by reference.

The Equity Investors have yet to be identified. Upon APS's accepting a proposal from a potential Equity Investor, APS will, as promptly as possible, provide to the Commission (i) the purchase price of the portion of the Unit 2 Facilities in respect of which each Equity Investor will make its initial commitment to invest and (ii) the most recent publicly-available annual and interim financial statements for such Equity Investor or its parent company.

7. Relationship between APS and AZP

The establishment of AZP Group, Inc. (AZP) as the parent company of APS resulted from a restructuring consummated on April 29, 1985. On such date all common stock previously issued by APS was deemed to be common stock issued by AZP, and

all common stock shareholders of APS became common stock shareholders of AZP and were no longer shareholders of APS. No exchange or transfer of common stock certificates then outstanding was required. On completion of the restructuring, AZP became the owner of all of the common stock of APS, but the ownership of outstanding APS preferred stock and debt securities was unaffected. APS retained ownership of all of its utility plant and of three of its wholly-owned subsidiaries: Bixco, APS Finance Company N.V. and APS Fuels Company. AZP purchased at book value the common stock of three other wholly-owned APS subsidiaries: Malapai Resources Company; Energy Development Company and El Dorado Investment Company. Accordingly, the reorganization did not result in any change in the net worth of APS or in its financial resources.

As can be seen from the AZP Annual Report for 1985 (Exhibit D attached hereto) the directors of AZP are also the directors of APS, and all of the officers of AZP are also officers of APS. Therefore, the corporate restructuring has not resulted in any change in the control of APS.

Also, APS continued to own its 29.1% interest in PVNGS and remained as a Participant of ANPP with all of the rights and obligations of an ANPP Participant under the ANPP Participation Agreement, including without limitation representation on each ANPP committee.

Finally, APS has remained as the Project Manager and Operating Agent of ANPP responsible for the construction, operation and maintenance of PVNGS, and, accordingly, the sole licensee authorized, pursuant to the Unit 2 License, to use and operate PVNGS Unit 2.

8. Responsibility for Management of Unit 2.

As a Participant owning (or leasing) an undivided 29.1% in PVNGS, APS has and will continue to have the same rights and obligations as any other Participant in ANPP [See Section 3.10 hereof]. As the Project Manager and Operating Agent of PVNGS, APS has a separate and distinct set of responsibilities, obligations and authorities which are not shared with or by any other Participant. This dichotomous relationship which APS has with respect to the Palo Verde project is dealt with explicitly in the ANPP Participation Agreement. It also is recognized in the Unit 2 License (and Facility Operating License No. NPF-41 for PVNGS Unit 1 as well) where in paragraph 2.B.(1) APS and each of the other Participants is authorized to "possess" PVNGS Unit 2 and APS alone is authorized to "use and operate" such unit.

Pursuant to (i) the provisions of the proposed Leases and the ANPP Participation Agreement and (ii) the conditions of the proposed amendment of the Unit 2 License, APS shall continue throughout the term of the Leases to have all of the rights and

obligations associated with the possession of Unit 2, and being a Participant in ANPP, all to the exclusion of the Lessor and any of its successors. APS will also continue to serve as the Operating Agent of Unit 2 responsible to the Participants and as the sole licensee responsible to the Nuclear Regulatory Commission for the use and operation of Unit 2, also to the exclusion of the Lessor and any of its successors.

The prohibitions imposed upon the Lessor by the proposed amendment against the exercise, directly or indirectly, of any control over the licensees of Unit 2 will apply equally to APS' licensed authorization of possession and to its licensed authorization to use and operate Unit 2. Similarly, the limitations in 10 CFR 50.81 "Creditor Regulations" will be fully applicable so that the Lessor and any of its successors may not assume any authority or responsibility in respect of Unit 2, whether possessory or operational in nature, without the express authorization of the Nuclear Regulatory Commission. As the proposed license amendment simply but explicitly states:

> "Specifically, the lessors and anyone also who may acquire an interest under these transactions are prohibited from exercising directly or indirectly any control over the licensees of Palo Verde Unit 2 . . . These transactions shall have no effect on the

license for Palo Verde Unit 2 throughout the term of the license."

Apart from the impediments imposed by the proposed license amendment and the inherent jurisdiction of the Nuclear Regulatory Commission over any transfer of authority to "use and operate" Unit 2, the ANPP Participation Agreement stands to prevent either APS or the Lessor unilaterally, or the both of them collectively, from passing control of Unit 2 from APS to the Lessor or any of its successors or assigns. First, the ANPP Participation Agreement by definition mandates that the Operating Agent must be a Participant in ANPP. Second, though APS has the right to resign as Operating Agent, neither APS nor the Lessor may designate the successor Operating Agent; this right rests solely upon the written agreement of all Participants. Third, the right of removal of APS as Operating Agent rests solely with the other ANPP Participants to the exclusion of the Lessor and its successors and assigns. Fourth, the designation of any Participant other than APS would require an amendment of the ANPP Participation Agreement, which, pursuant to the proposed license amendment, would require advance notice to the Nuclear Regulatory Commission.

Finally, it must be recognized that APS will retain substantial ownership interests in PVNGS. Its ownership interests in PVNGS Unit 1 will remain unaffected by its proposed sale

and leaseback transactions in respect of Unit 2. Moreover, in respect of Unit 2, it will retain ownership interests in property with substantial values: i.e., retained assets[8] and other common facilities. These retained interests, together with its entitlement to Unit 2 generation during the term of the Leases, provide ample incentives to APS to maintain its control over the operation of Unit 2 in accordance with the terms of the Unit 2 License.

9. Environmental Considerations

The proposed conveyances of the Unit 2 Facilities to the Owner Trustee and the lease of the Unit 2 Facilities to APS by the Lessors do not involve any design or physical change to Unit 2, any change in the transmission or other facilities associated with Unit 2, any change in types or amounts of effluents from Unit 2, any change in the potential for accidental releases from Unit 2 or any change in the authorized power level of Unit 2. Accordingly, the grant of the relief requested by this Application does not present an unreviewed environmental impact. Pursuant to 10 CFR 51.5(d)(4), no environmental impact statement, negative declaration or environmental impact appraisal need be prepared in connection with this Application.

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[8]See footnote 1 hereof.

10. Antitrust Considerations

As noted above,[9] affiliates and/or subsidiaries of electric utilities may be among the Equity Investors from which APS expects to receive proposals. These utilities may be in any geographic region of the country, including Arizona. These entities are an important potential source of equity investment for the sale and leasebacks of APS's interest in Unit 2. These entities, like any other Equity Investor, will not have, so long as the related Leases are in effect, any right to power or energy generated at PVNGS,[10] and such power and energy will be distributed in the manner as now set forth in the ANPP Participation Agreement as though no sale and leaseback transactions had been consummated. The transactions described in this Application do not present any unreviewed antitrust considerations not previously addressed in connection with issuance of the Unit 2 License.[11] To the extent that antitrust considerations could arise upon the termination of any lease, whether or not any Equity Investor is an affiliate or subsidiary of an electric utility, the restrictions imposed by the requested amendment to the Unit 2 License

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[9]See section 3.1 hereof.

[10]See section 3.5 hereof.

[11]Policy Paper SECY-85-367, pp. 9-10, fn. 7. See section 8 hereof.

will give the Commission an opportunity to make further determinations respecting any antitrust and other licensing concerns in light of the circumstances that may be relevant at the time of such termination.

In this connection APS concurs in and adopts the Memorandum in Respect of Antitrust Reviews submitted by counsel on behalf of PNM in support of its Application in Respect of Sale and Leaseback Transactions by PNM, filed February 14, 1986, relating to PVNGS Unit 2.

11. No Significant Hazards Consideration

The consummation of the proposed sale and leaseback transactions will not involve any increase in the probability or consequences of an accident previously evaluated, nor create the possibility of an accident that is new or that is different from any accident previously evaluated, nor involve any reduction in any margin of safety. Accordingly, the consummation of the transfers of the Unit 2 Facilities as contemplated by the proposed sale and leaseback transactions does not involve a "significant hazards consideration" within the meaning of that phrase as defined in 10 CFR 50.92. A similar determination was made by the Commission in connection with the PNM Unit 1 Application.

12. Foreign Ownership Considerations

Certain Equity Investors may be "owned," "controlled" or "dominated" by a foreign corporation within the meaning of Section 103d of the Atomic Energy Act. In Policy Paper SECY-85-367, the Staff took the position that, if a licensing requirement were not imposed on the Equity Investors, then the prohibition of Section 103d need not be addressed.[12] In its December 12, 1985 Order, the Commission concurred in the "no license" position. It is respectfully submitted, therefore, that possible foreign control of an Equity Investor should not prohibit the license amendment requested by this Application. This conclusion is only reinforced by the fact that the proposed transactions, like the previously approved PNM transactions, do not subject APS to the will of the Equity Investors or otherwise give the Equity Investors the power to direct APS's actions with respect to Unit 2.

13. Basis for Relief Requested

The sale and leaseback transactions described in this Application are the same in all respects material to the Commission's consideration of this Application as the transactions

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[12]Policy Paper SECY-85-367, pp. 9-10, fn. 7. See section 8 hereof.

described in the Unit 1 Application. In both cases, the basic term of each applicable lease agreement is in excess of 29 years, subject to certain renewal options, and is joined with a fair market value purchase option at the end of the basic lease term and each renewal term. All such lease agreements will provide that, so long as APS is in compliance with the terms of the lease agreements, APS's sole possession and use of, and rights with respect to the leased facilities, will not be interrupted by the Lessors or any person claiming through the Lessors. In addition, APS will be empowered with respect to the Unit 2 Facilities (whether or not subject to a sale and leaseback transaction) to be and act as the "Participant" under the ANPP Participation Agreement, which sets forth the rights and duties of each of the owners of PVNGS.[13]

Additionally, APS will retain the exclusive right to sell and dispose of its share of power and energy from PVNGS without limitation arising from any lease agreement. All such lease agreements are or will be "net leases" under which APS will be responsible for paying all taxes, insurance premiums, operating and maintenance costs, costs related to capital improvements and decommissioning and all other similar costs and expenses associated with APS's share of the leased facilities. Although

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[13]Policy Paper SECY-85-367, pp. 9-10, fn.7. See section 8 hereof.

provisions may be made for the Equity Investors to make a limited initial contribution toward decommissioning, such an approach would not diminish APS's primary and unconditional obligations with respect to decommissioning. Under each lease agreement APS will be obligated to make semi-annual lease payments to the Lessor which will repay and provide a return on each Equity Investor's investment in the Unit 2 Facilities and which will pay principal and interest on debt obligations issued to finance a portion of the purchase price of the Unit 2 Facilities.[14] The rights acquired by the Lessors, the Equity Investors and their respective successors and assigns in and to the Unit 2 Facilities may, in each case, be exercised only in compliance with and subject to the same requirements and restrictions as would apply to APS pursuant to the provisions of the applicable Commission license, the Atomic Energy Act and the Commission's regulations. Lastly, the Lessors and the Equity Investors will acknowledge that before taking possession of any part of PVNGS, they will be subject to applicable requirements concerning (i) the issuance of a license by the Commission authorizing such possession or (ii) the transfer of the Commission license authorizing APS to possess an interest in PVNGS upon application for transfer of such license filed pursuant to applicable law.

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[14]See Section 3.9 hereof.

This Application is motivated by the fact that Arizona ratepayers will experience substantial long-term savings both from the lower cost of debt capital made available thereby and from the lower revenue requirements inherent in the sale and leaseback transaction.[15]

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[15]See Policy Paper SECY-85-367, p.4.

WHEREFORE, APS requests that the Commission grant the relief requested in Section 1 hereof or in such other form and/or subject to such conditions in addition to those stated in such Section as the Commission may deem appropriate.

Respectfully submitted,

ARIZONA PUBLIC SERVICE COMPANY

By Edwin E. Van Brunt Jr.
Edwin E. Van Brunt, Jr.
Executive Vice President-
ANPP

Dated: May 2, 1986

STATE OF ARIZONA)
) ss.
County of Maricopa)

I, Edwin E. Van Brunt, Jr., represent that I am the Executive Vice President-ANPP, that the foregoing document has been signed by me on behalf of Arizona Public Service Company with full authority to do so, that I have read such document and know its contents, and that to the best of my knowledge and belief, the statements made therein are true.

By Edwin E. Van Brunt Jr.
Edwin E. Van Brunt, Jr.

Sworn before me this ____ day of April, 1986.

_____
Notary Public

My Commission Expires:

_____

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBITS

A. FERC Order - PNM Unit 1 Application

B. General Information Respecting Arizona Public Service Company Required by 10 CFR 50.33 (a)-(d)

C. 1985 Arizona Public Service Company Annual Report

D. 1985 AZP Group, Inc. Annual Report

E. AZP Group, Inc. Annual Report on Form 10-K for Fiscal Year Ending December 31, 1985

F. Arizona Public Service Company Annual Report on Form 10-K for Fiscal Year Ending December 31, 1985

G. General Information Respecting Owner Trustee Required by 10 CFR 50.33 (a)-(d)

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT A

FERC ORDER - PNM UNIT 1 APPLICATION

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

ELECTRIC RATES: Lease: Jurisdiction

Before Commissioners: Raymond J. O'Connor, Chairman;
A. G. Sousa, Charles G. Stalon,
Charles A. Trabandt and C. M. Naeve.

Public Service Company of New Mexico	))	Docket No. EL86-5-000

ORDER DISCLAIMING JURISDICTION

(Issued December 5, 1985)

On October 18, 1985, Public Service Company of New Mexico (PNM) filed a petition with the Commission requesting a disclaimer of jurisdiction with regard to a proposed sale and lease-back by PNM of its ownership interest in certain facilities.

More specifically, PNM requests a disclaimer of Commission jurisdiction, under section 203 of the Federal Power Act (FPA), over the sale of facilities claimed by PNM to be non-jurisdictional generating facilities. PNM also seeks a Commission order: (1) disclaiming jurisdiction over the proposed investors in, and lessors of, the PNM facilities which will be purchased and leased back solely for investment purposes, and which will continue to be controlled by PNM; and (2) determining that the investors and lessors will not, as a result of ownership of the facilities, or the lease-back of the facilities to PNM, become "public utilities" pursuant to section 201(e) of the FPA.

PNM's petition indicates that it now owns a 10.2% undivided interest in the Palo Verde Nuclear Generating Station (PVNGS), which consists of three 1,270 MW units. 1/ Only Unit No. 1 is now operational. Unit No. 2 is scheduled for firm power operation in the second quarter of 1986, and Unit No. 3 is scheduled for firm power operation in the second quarter of 1987.

1/ Other participants in PVNGS include: Arizona Public Service Company (29.1%); Salt River Project Agricultural Improvement and Power District (23.19%); and El Paso Electric Company (15.9%). The Department of Water and Power of the City of Los Angeles, California, will acquire a 5.7% interest from Salt River on the "Date of Firm Operation."

PNM is proposing to sell and lease back its 10.2% interest in Palo Verde Unit No. 1 and as much as one-third of its undivided 10.2% interest in the common facilities of PVNGS. 2/ According to the petition, the facilities proposed to be sold and leased back are exclusively nuclear generation and ancillary facilities and do not include any transformation or transmission equipment or facilities.

Notice of PNM's petition was published in the Federal Register, with comments due on or before November 4, 1985. No responses have been received by the Commission.

Proposed Transaction:

According to the information provided by PNM, Unit No. 1 was synchronized with PNM's main transmission grid on June 10, 1985. PNM has determined that certain benefits to it and its ratepayers can be achieved by the sale and lease-back of Unit No. 1. These benefits will be discussed below.

PNM proposes to sell only generation or generation-associated facilities. The facilities would be purchased by owner trustees who would be acting on behalf of institutional investors. The institutional investors would hold title to their shares of the purchased facility. The owner trustees would act for the investors and lease the facilities back to PNM under separate lease agreements on behalf of each institutional investor.

The facilities are to be sold to the lessors at a fair market price that is expected to result in no book gain or loss to PNM. If all of PNM's interest in Unit No. 1 and the related common facilities is sold, as proposed, the purchase price would be approximately $400,000,000.

The lessors, acting for the equity investors, would lease the property back to PNM pursuant to a "net lease" under which PNM would pay all taxes, insurance, operating and maintenance costs, and all other similar costs associated with the facilities. In addition, PNM would make semiannual lease payments to the lessors

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2/ The common facility systems are composed primarily of engineering safeguard systems such as cooling towers, radioactive waste treatment systems, emergency diesel-generator systems, communication systems, surveilance systems, and water treatment facilities.

which would repay and provide a return on the equity investors' capital investment and pay the principal and interest on the debt obligations issued to finance the purchase.

The lessors would borrow approximately 70-80% of the purchase price from a funding corporation formed for that purpose. The funding corporation would borrow the debt portion of the purchase price by issuing public debt that would be non-recourse to the lessors and the equity investors. The public debt must be issued on terms acceptable to PNM and would be indirectly secured by a security interest in the facilities and payable from the rentals due from PNM under the leases.

The basic lease term is anticipated to be 28.5 years with an option, but not an obligation, to renew each lease for a renewal term of approximately 2.5 years at a rental equal to 50% of the original rent. PNM will have an additional option to continue renewing the lease at fair market rentals for the remaining life of the facilities or to exercise an option to purchase the facilities at fair market value at the end of the basic lease term or any renewal period.

Any addition, betterment, or enlargement of the facilities, or replacement of units of property within the facilities (capital improvements) will be PNM's obligation under the leases. Such costs, through 1995, are estimated to be $55,000,000, but the total capital improvements during the term of the lesses are expected to be limited to approximately $200,000,000. PNM may, but is not obligated to, request the lessors to provide supplemental financing for the capital improvements. Concurrent with any supplemental financing, the lease payments would be adjusted to support the amortization of the additional debt and to preserve the equity investors' net economic return.

PNM also states that the lessors and PNM would enter into support agreements which would provide the equity investors with such rights as may be necessary for them to realize the residual value of their interests. More specifically, rights in real property 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. PNM would retain ownership of easements, rights-of-way, and other property referred to as "Section 1250 property." PNM also would retain ownership of the nuclear fuel and the electric transmission facilities associated with the generation. In the event of a total loss of the facilities, PNM 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.

PNM's petition recognizes possible changes in the Internal Revenue Code which may affect the proposed sale and lease-back. PNM, however, believes that if the sale and lease-back transactions are consummated and the terms of the leases commence in 1985, the rent and casualty values in the leases will reflect and retain the benefits of depreciation at rates allowed under current tax laws. However, adjustments to rent and casualty values are likely to be required by amendments affecting the tax characteristics of the equity investors' investment. Adjustment may be required to protect the equity investors' net ecomomic return in consequence of a reduction in the marginal Federal income tax rate. PNM 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, PNM would be required to re-purchase 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. PNM 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. PNM would have the right to make virtually all decisions regarding construction, modifications, and operations as if PNM remained the owner. Arizona Public Service Company will continue to be the operator of PVNGS through agreements with PNM and other utility-owners of PVNGS.

PNM 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 be reduced because the lessors would be able to finance a greater portion of the facilities with debt than PNM; in addition, accelerated depreciation for the facilities would provide greater current benefits to the equity investors than to PNM if PNM were to retain its ownership interest. Second, revenue requirements would be levelized over the life of

the facilities under the proposed transaction. PNM states that in the first full year of the leases, revenue requirements would be reduced by $40,000,000. PNM expects that the proposed sale and lease-backs will produce at least $140,000,000 of customer savings (in present worth) over the life of the facilities as compared to traditional ratemaking assumptions.

In requesting that the Commission find that the proposed transaction is not subject to jurisdiction under the FPA, PNM 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 and generation-related equipment 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 PNM, and the proposed financing mechanism would significantly reduce the present value of ratepayer revenue requirements associated with the facilities. According to the petition, none of the participants other than PNM is currently a public utility, and Commission jurisdiction over sales of electricity from the PVNGS would not be affected by the transaction.

Discussion

The basis for PNM'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 provides, in relevant part:

> The provisions of this subchapter 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 generation of electric energy . . . . (emphasis added).

Section 201(e) defines a "public utility" as "any person who owns or operates facilities subject to the jurisdiction of the Commission under this subchapter. . . ." 16 U.S.C. § 824(e) (1982). Section 203(a) of the FPA 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. (emphasis added).

We agree that the facilities, as described by PNM, represent only generating facilities or ancillary facilities which are not subject to our jurisdiction under section 201(b) of the FPA and, therefore, are not jurisdictional facilities for purposes of Commission approval within the meaning of section 203 of the FPA.

Any jurisdiction that might attach with respect to the lessors or equity investors after the proposed transfer of facilities would be based upon a finding that they were public utilities under the FPA. Such a finding might be grounded on the acquisition of facilities associated with jurisdictional sales for resale. However, we conclude that such a finding here is not compelled by applicable Commission precedent.

The Commission in Pacific Power and Light Company, 3 FERC ¶ 61,119 (1978), disclaimed jurisdiction over parties to a proposed leasing transaction similar to the present arrangement. That case involved a public utility which entered into an agreement to convey its interest in a generating unit to a construction company which, in turn, entered into a loan agreement with a number of banks to obtain financing. The construction company then conveyed the facility to a trust created to hold title to the facility for the benefit of the banks. The trust leased the facility back to the utility. The issue was whether the trust's or the banks' interests in the facilities constituted ownership as contemplated by section 201(e), thereby making those entities subject to the jurisdiction of the Commission as public utilities.

The Commission, in determining that neither the trust nor the banks were public utilities, said:

> Although the Parties through their respective interests in the Trust hold either equitable or legal title to the Facility they will not operate the Facility. Applicant represents that it will have complete control over the operation of the Facility, and that the Parties will have no voice in or dominion over such operation. The Parties will play a passive role in the generating and sale of power from the Facility.

> Secondly, none of the Parties are in the business of producing or selling electrical power and all have a principal business other than that of a public utility. The Parties are involved in the proposed transaction to obtain benefits from tax advantages accruing by virtue of the leverage lease arrangement.

The Commission found that it would be inconsistent with the intent of the FPA to label the banks or trustee as public utilities because they held mere equitable or legal title to facilities, and were clearly disassociated from the operation of the facilities and the sale of power. The lease arrangement was described as essentially a financing device which served to reduce the utility's cost of service and did not create in the trust or the banks the status of a "public utility." 3/

The same considerations are present in the instant proceeding; the sale and lease-back is merely a financing device reducing PNM's cost of service. Further, the lessors and the equity investors will not operate or control the facilities and they are not in the business of producing, selling, or transmitting electric power. Accordingly, we shall disclaim jurisdiction over the lessors and equity investors, as requested by PNM. We note, however, that this order makes no findings with respect to any jurisdictional rate or accounting issues applicable to PNM, except that, consistent with Pacific Power & Light Co., and the other orders cited herein, we shall require PNM to record any reacquisition of the plant on its books at original cost less depreciation.

The Commission orders:

(A) The sale of PNM's interest in the Palo Verde Nuclear Generating Unit No. 1 and related ancillary facilities as described in its application is not a jurisdictional transaction within the meaning of section 203 of the Federal Power Act.

(B) The lessors and equity investors, participating in the proposed sale and lease-back of facilities as set forth in PNM's application, will not become public utilities solely by virtue of such participation.

3/ The Commission recently applied the same rationale in United Illuminating Company, 29 FERC ¶ 61,270 (1984). See also Letter Orders issued in Carolina Power and Light Company, Docket No. E-8789 (July 14, 1974), and Chase Manhatten Service Corp., et al., Docket No. E-8870 (September 9, 1975).

(C). The foregoing disclamer of jurisdiction is without prejudice to the authority of this Commission or any other regulatory body with respect to rates, service, accounts, valuation, estimates or determinations of cost, or any other matter which is now pending or which may come before this Commission.

By the Commission.

(S E A L)

Kenneth F. Plumb

Kenneth F. Plumb,
Secretary.

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

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APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT B

GENERAL INFORMATION RESPECTING
ARIZONA PUBLIC SERVICE COMPANY
REQUIRED BY 10 CFR 50.33 (a)-(d)

General Information Concerning
Arizona Public Service Company
Required by 10 CFR 50.33

(a) Name of applicant:

Arizona Public Service Company (APS).

(b) Address of applicant:

411 North Central Avenue
P. O. Box 53900
Phoenix, Arizona 85072-3900.

(c) Description of business or occupation of applicant:

APS is a public utility engaged in the generation, transmission, distribution and sale of electricity in the State of Arizona.

(d) (1) Not applicable.

(2) Not applicable.

(3) (i) APS is an investor-owned corporation organized and existing under and by virtue of the laws of the State of Arizona. Its general offices are located at 411 North Central Avenue, Phoenix, Arizona.

(ii) The names of the directors and principal officers of APS are set forth in Exhibit C of the Application to which this document is attached.

(d) (4) APS is not acting as agent or representative of another person in respect of this application.

(e) Not applicable.

(f) Not applicable.

(g) Not applicable.

(h) Not applicable.

(i) The names and addresses of regulatory agencies which have jurisdiction over APS's rates and services are:

Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Federal Energy Regulatory Commission
825 North Capitol Street, NE
Washington, D. C. 20426

News publications which circulate in the area which the facility is located are:

The Arizona Republic
120 East Van Buren
Phoenix, Arizona 85004

The Phoenix Gazette
120 East Van Buren
Phoenix, Arizona 85004

Buckeye Valley News
P. O. Box 217
Buckeye, Arizona 85326

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT C

1985 ARIZONA PUBLIC SERVICE COMPANY
ANNUAL REPORT

1985 ANNUAL REPORT

ARIZONA PUBLIC SERVICE COMPANY

1886

Beginning Our Second Century of Service

1986

About the Company

Arizona Public Service Company is engaged principally in the generation and sale of electricity. APS, a successor to a series of small utility operations originating in 1886, was incorporated in 1920 under the laws of Arizona and has operated under its present name since 1952.

Our electric service reaches approximately 1,418,000 people, or about 45 percent of the state's population, in an area that includes all or part of 11 of Arizona's 15 counties.

All the shares of common stock of the Company are owned by AZP Group, Inc. ("AZP"). As a result of the restructuring, the holders of outstanding shares of Company common stock became instead the common shareholders of AZP on a share-for-share basis. The restructuring did not affect the Company's preferred stock or any of its outstanding debt securities, all of which remain obligations of the Company. As part of the restructuring, the Company sold and transferred to AZP all the capital stock of three of its non-utility subsidiaries: Malapai Resources Company, Energy Development Company, and El Dorado Investment Company. APS Finance Company N.V., Bixco, Inc., and APS Fuels Company remain as wholly-owned subsidiaries of the Company. The Company's Stock Purchase and Dividend Reinvestment Plan was assumed by AZP on the effective date of the restructuring.

Annual Report

This report is published to provide general information concerning the Company and not in connection with any sale, offer for sale, or solicitation of an offer to buy, any securities.

Annual Meeting of Stockholders

All stockholders are invited to attend the Company's sixty-sixth annual meeting. It will be held on Thursday, April 24, 1986 in the Grand Ballroom of the Phoenix Hilton, 111 North Central Avenue, Phoenix, Arizona. AZP (APS' parent corporation) will begin its Annual Meeting at 10:00 a.m., and immediately following will be the APS Annual Meeting.

APS Officers

O. Mark De Michele, 52, president and chief operating officer
Walter F. Ekstrom, 48, vice president, Electric Operations
Karl Eller, 57, chairman of the executive committee
David W. Ellis, 47, vice president, Research, Development and Alternative Energy Applications
Kathryn A. Forbes, 35, general auditor
Joseph A. Gelinas, 41, vice president, Employee Relations
B. Paul Hart, 62, vice president, Rates and Regulation
Jerry G. Haynes, 51, vice president, Nuclear Production
Russell D. Hulse, 59, vice president, Resources Planning
Jerry Human, 55, vice president, Customer Services, State Region
Charles D. Jarman, 50, vice president, Construction
Donald B. Karner, 34, vice president, Engineering
Sally F. Kur, 41, assistant secretary
Guy W. Lunt, Jr., 52, vice president, Customer Services, Metro Region
Jaron B. Norberg, 48, senior vice president and corporate counsel
John C. Ogden, 40, vice president, Customer and Administrative Services
William J. Post, 35, vice president and controller, Economic and Regulatory Planning
Shirley A. Richard, 39, vice president, Corporate Relations
Henry B. Sargent, Jr., 51, executive vice president and chief financial officer, Corporate Finance, Planning and Control
Keith L. Turley, 62, chairman and chief executive officer
Edwin E. Van Brunt, Jr., 54, executive vice president, Arizona Nuclear Power Project
Faye Widenmann, 37, secretary
Paul A. Williams II, 40, vice president and treasurer, Finance and Tax Services

(Age on Annual Meeting date, April 24, 1986)

To our APS Preferred Shareholders:

1985 was an important year in the history of Arizona Public Service Company. Our corporate structure changed last April when APS shareholders approved the formation of AZP Group, Inc., of which APS is now a part. Essentially, APS and three of its non-utility subsidiaries became subsidiaries of AZP. The primary purpose of the restructuring was to separate the non-utility operations from the utility operations giving us the opportunity to increase our earnings through non-regulated ventures.

This report will provide you with a comprehensive review of the financial posture of your company for 1985. Within a few weeks, you will also receive a copy of the AZP Annual Report which will give you a detailed look at AZP, including APS, for the past year.

1986 marks your company's 100th year in the utility business. We can look back with pride on our accomplishments and with your continued support we can look forward to a successful future.

Sincerely,

Keith L. Turley
Chairman of the Board and
Chief Executive Officer

ARIZONA PUBLIC SERVICE COMPANY
SELECTED CONSOLIDATED FINANCIAL DATA

	1985	1984	1983	1982	1981
	(Dollars in Thousands, Except Per Share Amounts)				
Electric Operating Revenues..	$ 1,174,502	$ 994,967	$ 871,875	$ 866,486	$ 730,788
Electric Operating Expenses:					
Operation and maintenance	447,985	358,665	349,150	349,975	311,479
Depreciation and amortization	99,221	87,494	83,707	79,676	70,988
Taxes*	320,312	285,548	185,606	173,736	98,597
Total	867,518	731,707	618,463	603,387	481,064
Operating Income	306,984	263,260	253,412	263,099	249,724
Other Income*	190,047	190,818	134,459	83,040	58,617
Interest Deductions - Net	171,608	156,508	118,819	117,838	106,073
Income from Continuing Operations	325,423	297,570	269,052	228,301	202,268
Income (Loss) from Discontinued Operations	—	(26,503)	(4,255)	2,742	(4,834)
Net Income	325,423	271,067	264,797	231,043	197,434
Preferred Dividend Requirements	44,412	48,375	43,741	34,816	26,786
Earnings for Common Stock..	$ 281,011	$ 222,692	$ 221,056	$ 196,227	$ 170,648
Total Assets	$ 5,251,327	$ 4,653,774	$ 4,386,312	$ 3,888,536	$ 3,396,790
Long-term Debt and Redeemable Preferred Stock.	$ 2,425,361	$ 1,967,486	$ 1,892,477	$ 1,610,486	$ 1,618,048
Common Stock Data:					
Book value per share	$ 25.42	$ 24.18	$ 23.78	$ 22.94	$ 22.13
Earnings (loss) per share (based on average shares outstanding):					
Continuing Operations	$ 3.96	$ 3.65	$ 3.53	$ 3.25	$ 3.36
Discontinued Operations	—	(0.39)	(0.07)	0.05	(0.10)
Total	$ 3.96	$ 3.26	$ 3.46	$ 3.30	$ 3.26
Dividends declared per share	$ 2.73	$ 2.60	$ 2.56	$ 2.40	$ 2.20
Shares of common					
—year-end	71,264,947	70,128,329	66,710,852	62,894,490	57,648,791
—average	71,031,228	68,308,131	63,865,210	59,549,685	52,289,259
Number of common shareholders	1**	124,274	127,387	120,623	119,825

* Federal and State income taxes are included in Taxes and in Other Income. Total income tax expense was as follows (in thousands): 1985, $165,279; 1984, $137,072; 1983, $93,930; 1982, $93,100; 1981, $19,876.

** See Note 2 of Notes to Consolidated Financial Statements for a description of the corporate restructuring.

OTHER FINANCIAL AND OPERATING STATISTICS

	1985	1984	1983	1982	1981
			(Thousands of Dollars)		
Capitalization:					
Common equity	$ 1,811,405	$ 1,695,923	$ 1,586,671	$ 1,442,639	$ 1,275,623
Non-redeemable preferred stock	218,561	218,561	218,561	168,561	118,561
Redeemable preferred stock	219,421	282,740	237,400	241,220	199,280
Long-term debt	2,205,940	1,684,746	1,655,077	1,369,266	1,418,768
Total	$ 4,455,327	$ 3,881,970	$ 3,697,709	$ 3,221,686	$ 3,012,232
Utility Plant—Gross	$ 5,712,507	$ 5,088,243	$ 4,761,265	$ 4,198,466	$ 3,688,270
Utility Plant—Net	$ 4,873,823	$ 4,344,083	$ 4,033,400	$ 3,551,949	$ 3,111,773
Number of Employees at Year-End	8,324	7,358	7,642	7,047	6,231
Average Wage per Hour	$ 14.48	$ 13.61	$ 13.11	$ 12.27	$ 11.20
Electric:					
Electric resources (kw)	3,570,800	3,425,900	3,528,400	3,532,900	3,634,300
Peak load (kw)	3,197,800	2,970,600	2,899,000	2,898,700	3,018,700
Electric sales—total (mwh)	13,971,314	13,054,987	12,753,542	12,950,727	13,387,998
Number of customers at year-end	521,567	499,751	468,768	449,244	438,853

OPERATING REVENUES

	1985	1984	1983	1982	1981
			(Thousands of Dollars)		
Electric					
Residential	$ 438,265	$ 378,536	$ 314,404	$ 294,498	$ 252,907
Commercial	401,439	343,971	296,364	286,262	238,975
Industrial	135,254	126,187	122,184	128,464	113,736
Irrigation	22,853	25,540	15,113	23,391	22,916
Other	97,728	86,394	90,118	92,490	81,565
Total	1,095,539	960,628	838,183	825,105	710,099
Transmission for others	16,602	13,023	12,555	11,104	9,173
Miscellaneous services	62,361	21,316	21,137	30,277	11,516
Total Operating Revenues	$ 1,174,502	$ 994,967	$ 871,875	$ 866,486	$ 730,788

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

Liquidity and Capital Resources

The Company has large capital requirements for its ongoing construction program and for the refunding of maturing securities. Its heavy reliance on external debt financing to meet those requirements is detailed in Notes 5 and 6 of Notes to Consolidated Financial Statements. The Company has a degree of flexibility in adjusting its construction program to its financing capability. However, that flexibility is limited, and the Company's long-term liquidity will depend on its access to the capital markets, which in turn will depend on sufficiency of the Company's rates to provide adequate coverages on its senior securities, and an adequate rate of return on common stock equity. Adequate earnings and coverages are critical to the maintenance of satisfactory credit ratings on the Company's senior securities, and, as calculated in accordance with the governing instruments, are prerequisite to the Company's legal ability to issue such securities.

See page 3 with respect to the Company's capitalization at December 31, 1985. The Company regards common stock equity as its most expensive form of permanent financing, but it intends to maintain that category at approximately the 40% level in order to support the credit ratings on its senior securities. If interest and dividend rates on new issues of long-term debt and preferred stock rise in the future, the Company's average cost of capital will rise accordingly.

See Note 7 of Notes to Consolidated Financial Statements with respect to short-term borrowings available to the Company (there being a statutory limitation on the amount of such borrowings that can be outstanding without consent from the ACC). Funds from operations after the payment of dividends have contributed only marginally to total sources of funds in the last few years (see Consolidated Statements of Changes in Financial Position). This situation is expected to continue to some degree until Palo Verde Unit 1 is fully included in rate base so as to give rise to additional cash earnings. The Company's retention of funds from operations has also been affected by its policy of increasing common stock dividends periodically.

On February 13, 1986, the date Unit 1 attained commercial operation as defined by the ACC, the Company ceased accruing AFC with respect to Unit 1 and the facilities common to all three Palo Verde units (the "Common Facilities"), currently totalling approximately $6 million per month. In addition, the Company began expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 1 and the Common Facilities, currently estimated at $5 million per month. Absent adequate and timely rate relief from the ACC, the Company expects these developments to adversely affect its earnings.

APS is seeking an accounting order from the ACC allowing the Common Facilities to be transferred to plant in service in three steps, each tied to the commercial operation date of each Palo Verde Unit, with the continuance of a carrying charge equivalent to AFC on any portion which has not been transferred to plant in service. If the ACC grants such accounting order, the Company would be able to accrue approximately $1 million of such carrying charge per month on each of the remaining two portions of the Common Facilities which have not been transferred to plant in service as a result of Palo Verde units 2 or 3 attaining commercial operation. In addition, the Company would be able to defer expensing the cost of owning its 29.1% share of each of the remaining two portions of the Common Facilities which have not yet been transferred to plant in service as a result of Palo Verde units 2 or 3 attaining commercial operation, each portion currently totalling approximately $.3 million per month.

APS has also requested the ACC to issue an accounting order which would allow the Company to defer expensing the cost of Unit 2 and to continue the accrual of a carrying charge equivalent to AFC from the commencement of the commercial operation of Unit 2 until the date on which the Company is allowed to recover these costs. If the ACC does not grant the requested accounting order relating to Unit 2, when Unit 2 achieves commercial operation (currently scheduled for the third quarter of 1986) the Company will cease accruing AFC (and will not be able to accrue an equivalent carrying charge) which respect to Unit 2, currently totalling approximately $6 million per month. In addition, the

Company will begin expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 2 currently estimated at $3 million per month. If the ACC does not grant the requested accounting order with respect to Unit 2 or grant adequate and timely rate relief with respect to Unit 2, the Company expects its earnings to be adversely affected.

Operating Results

Total operating revenues reflect the effects of rate increases and adjustment clauses on prices of units sold. Operating revenues also reflect volume changes in unit sales. The foregoing factors contributed to annual increases in electric revenues over the preceding calendar year as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Energy related:			
Volume increases (1)	$ 71,169	$ 29,216	$13,438
Price increases (decrease) (2)	63,742	93,229	(360)
Non-energy related:			
Revenue increases (decrease) (3)	44,624	647	(7,689)
Net increase	$179,535	$123,092	$ 5,389

(1) Calculated by summing the products derived by multiplying the year-to-year increases in units sold in each customer class by the weighted average of the applicable rate levels in effect for the prior year.

(2) Calculated by summing the products derived by multiplying the year-to-year increases in the weighted average of rate levels in each customer class times the applicable number of units sold in the current year. Relative contributions by rate increases and by effects of the Company's fuel adjustment clauses vary according to the timing of general rate proceedings and the extent to which accumulated effects of the adjustment clauses are incorporated in new rates.

(3) Includes revenues for miscellaneous service and transmission for others.

The increase in volume-related electric revenues in 1985 was primarily due to higher sales in the residential and commercial classes. These sales increases were mainly the result of customer growth and the warmer weather conditions experienced during the summer of 1985. In addition, there were increased industrial sales to the copper industry. Unit sales of electricity increased in 1984 primarily due to customer growth in the residential and commercial classes and more humid weather conditions, partially offset by decreased industrial and resale sales. The increase in unit sales of electricity in 1983 was primarily due to customer growth in the residential and commercial classes partially offset by decreased retail and resale irrigation usage resulting from the U.S. Government's Payment-In-Kind Program. Conservation efforts by customers in response to higher energy costs have affected unit sales, are expected to continue to do so, and are being aided by the Company's own load-management programs. The year-to-year changes in non-energy related electric revenues reflect changes in capacity sold to other utilities.

Although unit fuel costs have continued to rise, the Company's cost of fuel per kilowatt-hour generated has been tempered by the large portion of coal in the fuel mix. See Note 1d of Notes to Consolidated Financial Statements with respect to the treatment of increased unit fuel costs and the increase in the Company's deferred fuel account. In 1985, increases in fuel expenses were primarily due to increased gas generation. In 1984, the slight increase in fuel expenses reflects increases in the unit costs of fuel for generation partially offset by an improved fuel mix and high capacity factors at the Company's coal-fired plants.

Variations in purchased power and interchange-net reflect varying degrees of availability of relatively low-priced power from other sources including energy available from testing of the Company's nuclear generating unit, the needs of the Company to augment its own generating sources from time to time, and the Company's ability to sell energy to neighboring utilities. In 1985, an

increase in purchased power and interchange-net was primarily due to increased purchased power requirements and reduced interchange sales to other utilities. This increase was largely offset by the accounting treatment for the Company's fuel and purchased power expense (See Note 1d of Notes to Consolidated Financial Statements). The increase in purchased power and interchange-net expense in 1984 was primarily due to the accounting treatment for fuel and purchased power which was largely offset by increased interchange sales to other utilities.

See "Effects of Inflation" below in regard to maintenance expense, which is also a function of the size of the Company's utility plant and is affected by the timing of major overhauls. The increase in operations excluding fuel expense in 1985 was due in large part to increased payroll, associated expenses related to customer growth, and an addition to the reserve for uncollectibles resulting from an unpaid note.

Depreciation and amortization expenses and ad valorem taxes increase with the size of the Company's utility plant. See Note 12 of Notes to Consolidated Financial Statements for both ad valorem and sales taxes (the latter being a function of operating revenues), which are the principal components of other taxes.

The increases in income taxes and deferred income taxes in 1985 and 1984 were largely a result of the Company's compliance with an ACC accounting order, effective October 1, 1983, the aggregate effect of which was to require the company to normalize substantially all income tax timing differences (see Note 1f of Notes to Consolidated Financial Statements).

The aggregate amount of AFC, shown as other income and a credit to interest deductions, is primarily a function of the amount of construction work in progress during any given period and ceases to accrue on those portions of construction work in progress that are included in rate base. See Note 1e of Notes to Consolidated Financial Statements for changes in rates of AFC.

The increase in interest on long-term debt in recent years reflects large amounts of new borrowings at relatively high interest rates. See "Liquidity and Capital Resources" above and Note 6 of Notes to Consolidated Financial Statements. The decrease in interest on short-term borrowings in 1985 resulted primarily from decreased borrowings, but includes the effects of lower interest rates.

Consolidated net income represents a composite of cash and non-cash items (see Consolidated Statements of Changes in Financial Position) and, in part, reflect accounting practices unique to regulated public utilities.

As described in Note 13 of Notes to Consolidated Financial Statements, the Company sold its gas distribution system, effective November 1, 1984. Accordingly, 1983's statement of income has been reclassified to report separately this discontinued operation.

Effects of Inflation

In contrast to the analysis of increases in operating revenues in the table at the beginning of "Operating Results", it is sometimes difficult, in the case of operation and maintenance expenses, to distinguish between effects of volume increases and rises in unit costs (which, for purposes of this discussion, are all attributed to inflationary pressures).

Certain inflationary effects, such as those on costs of generating fuel, are passed through to customers pursuant to rate adjustment procedures. Nevertheless, the Company attempts to minimize such effects by means that include increasing the availability of its coal-fired units to result in a more economical fuel mix. This increase has been achieved by an intensive maintenance program, the cost of which is not covered by the adjustment clauses. There are a number of other major expense items that are also beyond the scope of the adjustment clauses. Inflationary pressures on these items have given rise to a significant earnings attrition between general rate increases.

See Note 15 of Notes to Consolidated Financial Statements for perspectives on other effects of inflation.

ACCOUNTANTS' OPINION

Arizona Public Service Company:

We have examined the consolidated balance sheets of Arizona Public Service Company and its subsidiaries as of December 31, 1985 and 1984 and the related consolidated statements of income, retained earnings 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, such consolidated financial statements present fairly the financial position of Arizona Public Service Company and its 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.

DELOITTE HASKINS & SELLS

Phoenix, Arizona
February 20, 1986

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
Utility Plant (Notes 6 and 8):		
Electric plant in service	$2,929,926	$2,747,464
Construction work in progress	2,742,139	2,304,306
Plant held for future use	40,442	36,473
Total Utility Plant	5,712,507	5,088,243
Less accumulated depreciation and amortization	838,684	744,160
Utility Plant—net	4,873,823	4,344,083
Investments and Other Assets:		
Investments in and receivables from affiliates	16,513	61,693
Other investments and notes receivable	5,991	5,588
Total Investments and Other Assets	22,504	67,281
Current Assets:		
Cash	7,871	7,565
Special deposits and working funds	3,342	3,339
Accounts receivable:		
Service customers	84,533	70,560
Other	43,415	35,329
Allowance for doubtful accounts	(1,395)	(1,434)
Materials and supplies (at average cost)	41,525	42,942
Fuel (at average cost)	30,433	30,163
Deferred fuel (Note 3)	74,335	927
Other	3,873	6,036
Total Current Assets	287,932	195,427
Deferred Debits:		
Unamortized gas exploration costs	10,417	12,967
Unamortized debt issue costs	16,705	13,931
Other	39,946	20,085
Total Deferred Debits	67,068	46,983
Total	$5,251,327	$4,653,774

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED BALANCE SHEETS

LIABILITIES

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
Capitalization (Notes 2, 4, 5 and 6):		
Common stock	$ 178,162	$ 175,321
Premiums and expenses—net	1,040,909	1,015,188
Retained earnings	592,334	505,414
Common stock equity	1,811,405	1,695,923
Non-redeemable preferred stock	218,561	218,561
Redeemable preferred stock	219,421	282,740
Long-term debt less current maturities	2,205,940	1,684,746
Total Capitalization	4,455,327	3,881,970
Current Liabilities:		
Notes payable	—	1,800
Commercial paper	18,000	158,000
Current maturities of long-term debt (Note 6)	17,456	70,890
Accounts payable	87,113	68,090
Accrued taxes	52,976	49,348
Accrued interest	72,678	55,906
Accrued dividends	3,566	4,143
Other	26,069	32,405
Total Current Liabilities	277,858	440,582
Deferred Credits and Other:		
Deferred income taxes	230,553	110,821
Deferred investment tax credit	174,503	138,120
Unamortized credit related to sale of tax benefits (Note 9)	43,645	45,333
Customers' advances for construction	23,991	21,351
Other	45,450	15,597
Total Deferred Credits and Other	518,142	331,222
Commitments and Contingencies (Notes 3 and 11)		
Total	$5,251,327	$4,653,774

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	1985	1984	1983
	(Dollars in Thousands, Except Per Share Amounts)		
Electric Operating Revenues	$ 1,174,502	$ 994,967	$ 871,875
Fuel Expenses:			
Fuel for electric generation	219,575	186,276	185,504
Purchased power and interchange - net	16,789	6,647	6,454
Total	236,364	192,923	191,958
Operating Revenues Less Fuel Expenses	938,138	802,044	679,917
Other Operating Expenses:			
Operations excluding fuel expenses	122,751	97,535	94,511
Maintenance	88,870	68,207	62,681
Depreciation and amortization	99,221	87,494	83,707
Income taxes (Note 9)	216,036	191,100	103,186
Other taxes (Note 12)	104,276	94,448	82,420
Total	631,154	538,784	426,505
Operating Income	306,984	263,260	253,412
Other Income (Deductions):			
Allowance for equity funds used during construction	143,612	134,359	121,390
Income taxes (Note 9)	50,757	54,028	9,256
Other - net	(4,322)	2,431	3,813
Total	190,047	190,818	134,459
Income Before Interest Deductions	497,031	454,078	387,871
Interest Deductions:			
Interest on long-term debt	209,220	191,079	170,830
Interest on short-term borrowings	6,951	12,281	11,430
Debt discount, premium and expense	3,613	2,465	1,959
Allowance for borrowed funds used during construction	(48,176)	(49,317)	(65,400)
Total	171,608	156,508	118,819
Income From Continuing Operations	325,423	297,570	269,052
Loss From Disposal and Operation of Discontinued Gas System, Net of Tax (Note 13)	—	(26,503)	(4,255)
Net Income	325,423	271,067	264,797
Preferred Dividend Requirements	44,412	48,375	43,741
Earnings for Common Stock	$ 281,011	$ 222,692	$ 221,056
Average Common Shares Outstanding	71,031,228	68,308,131	63,865,210
Per Share of Common Stock:			
Earnings (Loss) (based on average shares outstanding):			
Continuing operations	$ 3.96	$ 3.65	$ 3.53
Discontinued operations	—	(0.39)	(0.07)
Total	$ 3.96	$ 3.26	$ 3.46
Dividends declared	$ 2.73	$ 2.60	$ 2.56

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Retained earnings at beginning of year	$505,414	$459,962	$401,723
Add—Net income	325,423	271,067	264,797
Total	830,837	731,029	666,520
Deduct—Dividends:			
Common stock (Notes 4 and 5)	194,091	177,240	162,817
Preferred stock (see below)	44,412	48,375	43,741
Total	238,503	225,615	206,558
Retained earnings at end of year	$592,334	$505,414	$459,962
Dividends on preferred stock:			
$1.10 preferred	$ 172	$ 172	$ 172
$2.50 preferred	258	258	258
$2.36 preferred	94	94	94
$4.35 preferred	326	326	326
Serial preferred:			
$2.40 Series A	576	576	576
$2.625 Series C	630	630	630
$2.275 Series D	455	455	455
$3.25 Series E	1,040	1,040	1,040
$8.50 Series G	96	401	500
$10.00 Series H	1,459	3,147	3,307
$10.70 Series I	2,300	2,595	2,875
$8.32 Series J	4,160	4,160	4,160
$8.80 Series K	3,407	5,280	5,280
$9.70 Series L	4,656	4,656	4,656
$11.95 Series M	1,235	2,330	2,330
$12.90 Series N	4,773	4,773	4,773
$3.58 Series O	7,160	7,160	7,160
Adjustable Rate Series P	1,250	1,250	1,250
Adjustable Rate Series Q	4,615	5,223	3,899
$11.50 Series R	5,750	3,849	—
Total	$ 44,412	$ 48,375	$ 43,741

See Consolidated Statements of Income for dividends per share of common stock.

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Source of Funds:			
Funds from operations:			
Continuing operations:			
Income from continuing operations	$ 325,423	$297,570	$269,052
Principal non-fund charges (credits) to income:			
Depreciation and amortization	99,221	87,494	83,707
Allowance for equity funds used during construction	(143,612)	(134,359)	(121,390)
Deferred income taxes—net	106,158	43,464	27,033
Deferred investment tax credit—net	36,383	56,002	29,960
Other	31,361	(385)	4,967
Total funds from continuing operations	454,934	349,786	293,329
Funds from discontinued gas system-net	—	(3,093)	5,116
Total funds from operations	454,934	346,693	298,445
Funds from external sources:			
Proceeds from sale of gas system	—	114,657	—
Common stock	28,562	63,800	86,918
Preferred stock	—	50,000	48,875
Long-term debt	745,030	264,179	419,126
Investments and other assets	44,777	13,299	4,955
Other items—net	(160)	(3,916)	4,141
Total funds from external sources	818,209	502,019	564,015
Total source of funds	$1,273,143	$848,712	$862,460
Application of Funds:			
Funds used for capital expenditures:			
Continuing operations	$ 494,105	$377,278	$425,130
Discontinued operations	—	31,657	29,724
Short-term borrowings—net	141,800	(73,492)	3,308
Repayment of long-term debt	275,421	275,833	185,653
Redemption of redeemable preferred stock	63,319	4,660	3,820
Dividends on preferred and common stock	238,503	225,615	206,558
Increase in working capital*	59,995	7,161	8,267
Total application of funds	$1,273,143	$848,712	$862,460
Increase (Decrease) in Working Capital*:			
Cash	$ 309	$(25,704)	$ 24,801
Accounts receivable	22,098	(2,216)	(950)
Materials, supplies and fuel	(1,147)	(1,420)	(2,760)
Deferred fuel and other assets	71,245	(4,191)	(2,048)
Accounts payable and accrued expenses	(38,846)	32,881	(23,904)
Other liabilities	6,336	7,811	13,128
Net increase	$ 59,995	$ 7,161	$ 8,267

*Excluding short-term borrowings—net and current maturities of long-term debt.

See Notes to Consolidated Financial Statements.

1. Summary of Significant Accounting Policies.

a. System of accounts— The accounting records of Arizona Public Service Company (the "Company") are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission ("FERC").

b. Consolidation— The consolidated financial statements include the accounts of the Company and those of its wholly-owned subsidiaries, APS Finance Company N.V. ("Finance"), organized to serve as a financing corporation to raise funds outside the United States of America, and APS Fuels Company, organized to manage investments in certain fuel resources. All significant intercompany balances and transactions have been eliminated.

c. Plant and depreciation— Property is stated at original cost as defined for regulatory purposes. The cost of additions to utility plant and replacements of retirement units is capitalized. Replacements of minor items of property are charged to expense as incurred. In addition to direct costs, capitalized items include the present value of certain future lease payments (see Note 6), research and development expenditures pertaining to construction projects, indirect charges for engineering, supervision, transportation and similar costs, and an allowance for funds used during construction. Costs of depreciable units of plant retired are eliminated from plant accounts and such costs plus removal expenses less salvage are charged to accumulated depreciation. Contributions in aid of construction are credited to plant cost.

Depreciation on utility property is provided on a straight-line basis at rates authorized by the Arizona Corporation Commission ("ACC") annually. The applicable rates for 1983 through 1985 ranged from 2.86% to 9.86% for electric plant.

d. Revenues and fuel costs— Operating revenues are recognized when billed on a monthly cycle billing basis. Retail rate schedules include adjustment clauses which permit recovery of costs of certain fuel and purchased power. Regulatory hearings are held periodically to adjust the rates applicable under fuel adjustment clauses to more nearly match actual fuel costs. Temporary net under- or over-recoveries of costs resulting from application of the adjustment clauses are recognized as a deferred fuel asset or liability, respectively, with an offsetting amount recognized in purchased power and interchange—net expense. See Note 3 for a discussion of current rate matters relating to such clauses.

e. Allowance for funds used during construction— In accordance with the regulatory accounting practice prescribed by the FERC and the ACC, the Company capitalizes an allowance for the cost of funds used to finance its construction program ("AFC"). AFC, which does not represent current cash earnings, is defined as the net cost during the period of construction of borrowed funds and a reasonable rate of return on equity funds so used. The calculated amount is capitalized as a part of the cost of utility plant.

AFC has been calculated using composite rates of 12.75% in 1985 and 1984 and 13% in 1983. In July 1983 the Company began compounding AFC semi-annually and, in October 1983, recording the borrowed funds portion on a "net of tax" basis through charges to income taxes—operating expense and credits to income taxes—other income. AFC ceases to accrue on those portions of construction work in progress allowed in rate base which was approximately $460,000,000 at December 31, 1985 for ACC purposes.

f. Income taxes— The Company uses accelerated depreciation methods for income tax purposes. As prescribed by the ACC, deferred income taxes are provided for certain timing differences arising from the recording, for income tax and financial reporting purposes, of depreciation of property placed in service after January 1, 1977. In October 1983 the Company, in accordance with an ACC order, began deferring amounts equal to the change in income taxes arising from substantially all other timing differences. Prior to October 1983, such differences were reflected currently in income.

At December 31, 1985 the Company had flowed through to income currently approximately $271,600,000 of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

In 1982 the Company, in compliance with an ACC order, began deferring amounts equal to the reduction in Federal income taxes arising from investment tax credits and amortizing these amounts to other income over the estimated life of the related assets. Before 1982 such amounts were flowed through income currently.

g. Research and development costs— The Company expenses research and development costs on a current basis, except that costs which may result in additions to utility plant are deferred for subsequent inclusion in plant or to be written off if the applicable project is abandoned.

h. Gas exploration costs— The excess of costs over sales proceeds of the Company's discontinued gas exploration program has been deferred to be recovered, without interest, over a ten-year period pursuant to an order of the ACC, from certain classes of customers. A portion of such amount is now to be remitted to the Company by Southwest Gas Corporation as a result of the sale of the gas distribution system in 1984. See Note 13.

i. Discontinued operations—As described in Note 13, the Company sold its gas distribution system effective November 1, 1984. Accordingly, 1983's statement of income has been reclassified to report separately this discontinued operation.

2. Corporate Restructuring.

On April 18, 1985, the Company's shareholders approved a plan for corporate restructuring to provide financial and organizational flexibility by separating regulated utility operations from other activities. Effective April 29, 1985, APS became a subsidiary of a holding company, AZP Group, Inc. ("AZP").

As part of the restructuring, the Company sold to AZP, at book value, $34,703,000, the common stock of three of its wholly-owned subsidiaries, Malapai Resources Company, Energy Development Company and El Dorado Investment Company. Prior to the sale the results of operations and net assets of these subsidiaries were included in Other income — net and Investments in and receivables from affiliates.

The corporate restructuring had no effect on the ownership of preferred stock or on debt securities.

3. Rate Matters.

In 1984, a committee comprised of representatives from each of the state utility regulatory commissions having primary jurisdiction over the rates of the various regulated participants in the Arizona Nuclear Power Project commissioned a study to determine whether sufficient evidence exists to warrant a prudency audit of costs incurred for construction. In September, 1985, the committee concluded that an audit should be performed relating to $3.12 billion of material and labor costs, of which the Company's share is approximately $900 million, as well as financing and certain indirect costs related to the project. The prudency audit is expected to begin in 1986 with recommendations expected in late 1986 or 1987. Any amounts subsequently deemed by the ACC imprudently spent and not allowed in rate base would be written off. Although the Company is unable to predict the final outcome of this matter, management believes, based on current information, that overall the Palo Verde Nuclear Generating Station (Palo Verde) was constructed in a prudent manner.

On February 11, 1986 hearings commenced concerning costs deferred by the Company through the operation of its purchased power and fuel adjustment clause. In August, 1985 the ACC granted a rate increase sufficient only to limit the increase in the accumulated balance of such costs and agreed to hear testimony in connection with the accumulated balance (approximately $74 million at

December 31, 1985) in early 1986. To date no order has been received. Management believes that any ultimate disallowance of such cost should not be material to the Company's operation or financial position.

As an incentive to complete construction and commence operation of Palo Verde, the ACC in a November, 1984 order, placed a cap on total construction costs. The cap was set at $2.86 billion. Amounts expended in excess of the cap are presumed to be imprudent under the commissions order. The most recent estimate of the Company's share of total Palo Verde construction costs is $2.76 billion.

On May 24, 1985, the Company filed with the ACC a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 1. Unit 1 commenced commercial operation on February 13, 1986, and the Company began incurring such costs at that time. Also requested was an accounting order allowing the deferral until 1987 of the costs of commercial operation of Palo Verde Unit 2 which is expected to commence commercial operation in the third quarter of 1986. A hearing on this request has been scheduled for March 27, 1986.

On December 18, 1985, the Company filed a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 2. As requested by the ACC, the Company proposed as an alternative to a one step increase, and subject to certain conditions precedent, that the costs of commercial operation of Unit 2 be phased in over a period of years. The hearing date for the Unit 2 phase of the case has been set for September 26, 1986.

4. Common and Non-Redeemable Preferred Stock.

The balances at December 31, 1985 and 1984 of common stock and of preferred stock, which is not redeemable except pursuant to call by the Company at its option, are shown below.

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding at December 31,			Outstanding at December 31,		
	Authorized	1985	1984	Per Share	1985	1984	
					(Thousands of Dollars)		
Common Stock	100,000,000	71,264,947(b)	70,128,329	$ 2.50	$178,162	$175,321	—
Non-Redeemable Preferred Stock (cumulative):							
$1.10 preferred	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000						
$2.40 Series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 Series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 Series D		200,000	200,000	50.00	10,000	10,000	50.50
$3.25 Series E		320,000	320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(c)						
$8.32 Series J		500,000	500,000	100.00	50,000	50,000	(d)
Adjustable rate Series Q		500,000	500,000	100.00	50,000	50,000	(e)
Serial preferred	10,000,000						
$3.58 Series O		2,000,000	2,000,000	25.00	50,000	50,000	(f)
Total		4,374,199	4,374,199		$218,561	$218,561	

(a) In each case plus accrued dividends.

(b) As a result of the corporate restructuring described in Note 2, these shares are now held by AZP.

(c) This authorization also covers outstanding redeemable preferred shares shown in Note 5, as well as the non-redeemable shares indicated above.

(d) At $105.50 through August 31, 1987; at $103.00 through August 31, 1992; and at $101.00 thereafter.

(e) Bears dividends at a rate, adjusted on a quarterly basis, 2% below the rate borne by certain United States Treasury Securities, but in no event less than 6% per annum, or greater than 12% per annum. Redeemable on or after March 1, 1988 at the option of the Company at $103.00 through February 28, 1993; and at $100.00 thereafter.

(f) Not redeemable prior to June 1, 1987 through certain refunding operations that would result in a lower rate of cost to the Company than the dividend rate on the shares to be redeemed; otherwise at $28.58 through May 31, 1987; at $27.39 through May 31, 1992; at $26.19 through May 31, 1997; and at $25.00 thereafter.

The holders of preferred stock are entitled to one vote for each share held of record. Special requirements for favorable votes of holders of preferred stock, voting by the classes respectively prescribed for the several purposes, pertain to (i) certain conversions or exchanges of outstanding preferred stock, (ii) the authorization of any stock ranking prior to the preferred stock, (iii) making any change in the terms and provisions of preferred stock that would adversely affect the rights and preferences of the holders thereof, (iv) the issuance of any additional shares of preferred stock except under prescribed circumstances or (v) a merger, consolidation or sale of substantially all the assets of the Company. The foregoing voting rights attach to both redeemable and non-redeemable preferred stock, as do the rights that would arise out of dividend arrearages as discussed in Note 5.

Common and non-redeemable preferred stock sales and changes in premiums and expenses during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

	Common Stock		Non-Redeemable Preferred Stock (cumulative)		Premiums and Expenses Net*
Description	Number of Shares	Par Value Amount	Number of Shares	Par Value Amount	
Balance, December 31, 1982	62,894,490	$157,236	3,874,199	$168,561	$883,680
Common Stock	3,816,362	9,541	—	—	77,557
Non-Redeemable Preferred Stock, Adjustable Rate Series Q	—	—	500,000	50,000	(1,305)
Balance, December 31, 1983	66,710,852	166,777	4,374,199	218,561	959,932
Common Stock	3,417,477	8,544	—	—	55,256
Balance, December 31, 1984	70,128,329	175,321	4,374,199	218,561	1,015,188
Common Stock	1,136,618	2,841	—	—	25,721
Balance, December 31, 1985	71,264,947	$178,162	4,374,199	$218,561	$1,040,909

*Premiums and expenses — net also includes those of redeemable preferred stock issues (see Note 5).

5. Redeemable Preferred Stock.

The balances at December 31, 1985 and 1984 of preferred stock which is redeemable at the option of the holders or pursuant to sinking fund obligations, in addition to being callable by the Company, are shown below.

	Number of Shares Outstanding at December 31,		Par Value			
			Per Share	Outstanding at December 31,		Call Price Per Share(a)
	1985	1984		1985	1984	
				(Thousands of Dollars)		
Redeemable Preferred Stock (cumulative) serial preferred: (b)						
$8.50 Series G	—	38,400	$100.00	$ —	$ 3,840	
$10.00 Series H	104,677	304,000	100.00	10,468	30,400	(c)
$10.70 Series I	209,934	240,000	100.00	20,993	24,000	(d)
$8.80 Series K	344,600	600,000	100.00	34,460	60,000	(e)
$9.70 Series L	480,000	480,000	100.00	48,000	48,000	(f)
$11.95 Series M	85,000	195,000	100.00	8,500	19,500	(g)
$12.90 Series N	370,000	370,000	100.00	37,000	37,000	(h)
Adjustable Rate Series P	100,000	100,000	100.00	10,000	10,000	(i)
$11.50 Series R	500,000	500,000	100.00	50,000	50,000	(j)
Total	2,194,211	2,827,400		$219,421	$282,740	

(a) In each case plus accrued dividends.

(b) See Note 4 for authorized number of shares.

(c) Redeemable at $106.12 through September 1, 1986, and thereafter declining by $0.36 per year to par after September 1, 2002. Applicable sinking fund provisions require the redemption of 16,000 shares at par annually (representing annual payments of $1,600,000).

(d) Redeemable at $103.00 through November 30, 1990, and at $101.00 thereafter. Applicable sinking fund provisions require the redemption of 15,000 shares at par annually (representing annual payments of $1,500,000). The Company may, but is not required to, redeem an additional 15,000 shares at par on December 1 in any year.

(e) Redeemable at $106.00 through February 28, 1989; at $103.00 through February 28, 1994; and thereafter declining in steps to $101.00. Applicable sinking fund provisions require the redemption of 22,500 shares at par annually commencing March 1, 1986 (representing annual payments of $2,250,000). The Company may, but is not required to, redeem an additional 22,500 shares at par on March 1 in any year beginning in 1986. At December 31, 1985, the Company had met the 1986 sinking fund requirement.

(f) Redeemable at the option of the Company at $104.31 through February 28, 1986, declining by $1.08 per year to $101.07 after March 1, 1989. Applicable sinking fund provisions require the redemption of 96,000 shares at par annually commencing March 1, 1986 (representing annual payments of $9,600,000).

(g) Redeemable on or after May 1, 1986 at the option of the Company at $101.99 through April 30, 1987; and thereafter at par. All shares then outstanding are required to be redeemed on May 1, 1988 at par.

(h) Redeemable after June 1, 1992 at the option of the Company at $106.11 through June 1, 1993, declining by $0.68 per year to $100.00 after June 1, 2002. Applicable sinking fund provisions require the redemption between 1988 and 2002 of all shares according to a predetermined schedule.

(i) Bears a dividend of $12.50 per share through December 1, 1987 and a dividend thereafter to be fixed by a formula related to the average prime interest rate in 1987. Redeemable at par on or after December 1, 1987 at the option of the Company. Applicable sinking fund provisions require the redemption of 20,000 shares at par each December 1 beginning in 1988 (representing annual payments of $2,000,000). All shares then outstanding are required to be redeemed on December 1, 1992.

(j) Redeemable after June 1, 1994 at the option of the Company at $105.45, declining each year by a predetermined amount to $100.00 after June 1, 2004. Applicable sinking fund provisions require the redemption between 1990 and 2004 of all shares according to a predetermined schedule.

If there were to be any arrearage in dividends on any of its preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock (each such dividend being cumulative and of equal ranking with other such dividends, and each such requirement being cumulative and of equal ranking with other such requirements), the Company could not pay dividends on its common stock or acquire any shares thereof for consideration. If any such dividend arrearage was to equal six or more quarterly dividends, the holders of preferred stock, in addition to their other voting rights and voting by the classes prescribed for this purpose, could elect a total of six directors (all series of serial preferred stock, regardless of par value and whether redeemable or non-redeemable, comprising one such class and being entitled to elect two of the six directors). See Note 4 in regard to other voting rights of holders of preferred stock.

The combined aggregate amount of redemption requirements for the above issues each year through 1990 are as follows: $12,700,000 in 1986, $14,950,000 in 1987, $39,040,000 in 1988, $19,540,000 in 1989, and $22,975,000 in 1990.

Redeemable preferred stock transactions during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

Description	Number of Shares	Par Value Amount
Balance, December 31, 1982	2,412,200	$241,220
Retirements:		
$8.50 Series G	(7,200)	(720)
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1983	2,374,000	237,400
$11.50 Series R	500,000	50,000
Retirements:		
$8.50 Series G	(15,600)	(1,560)
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1984	2,827,400	282,740
Retirements:		
$8.50 Series G	(38,400)	(3,840)
$10.00 Series H	(199,323)	(19,932)
$10.70 Series I	(30,066)	(3,007)
$8.80 Series K	(255,400)	(25,540)
$11.95 Series M	(110,000)	(11,000)
Balance, December 31, 1985	2,194,211	$219,421

6. Long-Term Debt.

Details of long-term debt outstanding at December 31, 1985 and 1984 are as follows:

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
First mortgage bonds:		
Maturing through 1990:		
10.375% due February 1, 1985	$ —	$ 60,250
Less securities held by trustee	—	(16,127)
5.125% due October 1, 1987	15,000	15,000
4.7% due March 1, 1989	20,000	20,000
Maturing 1991 through 1995 - 4.40% to 15%	325,000	200,000
Maturing 1996 through 2000 - 6.25% to 12.875%	269,977	272,977
Maturing 2001 through 2005 - 6.20% to 9.95%	185,000	185,000
Maturing 2006 through 2010 - 6% to 12.125%	202,000	152,000
Maturing 2011 through 2015 - 12.75% to 13.5%	450,000	200,000
Unamortized discount and premium	(2,413)	(1,965)
Total first mortgage bonds	1,464,564	1,087,135
Various issues of pollution control indebtedness due primarily December 15, 1985	—	105,000
Less securities held by Trustee	—	(11,269)
Pollution control indebtedness due August 2, 2009 (a)	106,980	—
Less securities held by trustee (b)	(1,572)	—
Pollution control indebtedness due December 1, 2009 (c)	147,000	147,000
Less securities held by trustee (b)	(15,071)	(23,252)
Pollution control indebtedness due May 1, 2013 (c)	65,750	65,750
Pollution control indebtedness due May 1, 2014 (d)	55,200	55,200
Pollution control indebtedness due February 1, 2015 (e)	49,400	—
Less securities held by Trustee (b)	(2,444)	—
Unsecured notes payable due 1987 (f)	70,000	70,000
16.25% guaranteed debentures due July 15, 1988 (g)	—	50,000
16.25% guaranteed debentures due February 1, 1989 (g)	75,000	75,000
16% guaranteed debentures due February 15, 1989 (g)	25,000	25,000
11.75% guaranteed debentures due January 15, 1990 (g)	60,000	60,000
12.5% Debentures due February 15, 1992	75,000	—
Capitalized lease obligation (h)	46,907	48,472
Other	1,975	2,380
Unamortized discount	(293)	(780)
Total long-term debt	2,223,396	1,755,636
Less current maturities:		
Pollution control indebtedness due December 15, 1985, net of securities held by trustee	—	65,949
Sinking fund requirements on first mortgage bonds	15,333	3,000
Capitalized lease obligation	1,685	1,565
Other	438	376
Total current maturities	17,456	70,890
Total long-term debt less current maturities	$2,205,940	$1,684,746

(a) Adjustable-rate annual tender pollution control revenue refunding bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest at 6% through July 31, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(b) Representing pollution control funds deposited with a revenue bond trustee and to be disbursed as needed to pay the costs of acquiring, constructing, reconstructing, improving, maintaining, equipping or furnishing the facilities financed.

(c) Consisting of borrowings from a governmental authority which has funded that amount through issuance of a series of par value demand bonds supported by a long-term irrevocable letter of credit issued by a bank. These bonds bear interest at such rate, determined weekly, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(d) On May 15, 1985 the Company borrowed from a governmental authority the proceeds of a $55,200,000 issue of adjustable-rate annual tender pollution control revenue refunding bonds for the purpose of refunding $55,200,000 in aggregate principal amount of previously issued pollution control bonds due April 1, 1986. The new issue is supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest rate at 6% through April 30, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates as nearly as possible, their par value.

(e) Adjustable-rate annual tender pollution control revenue bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest through January 31, 1986 at 6.5% and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(f) Consisting of two long-term bank loans of $50,000,000 and $20,000,000. The principal amounts of such loans bear interest, at the Company's option, at one or more of the following annual interest rates: (a) in the case of the first loan, 102% of the Prime Rate or, in the case of the second loan, the Prime Rate plus ¼%, (b) the CD Rate plus ⅝%, or (c) the Eurodollar Rate plus ½%.

(g) Representing debentures issued by Finance, the payment of principal and interest has been unconditionally guaranteed by the Company. The 11.75% debentures due January 15, 1990 are redeemable at the option of Finance at 101½% from January 15, 1987 through January 14, 1988, then at 100¾% through January 15, 1989, and thereafter at 100%. The 16.25% debentures due February 1, 1989 and 16% debentures due February 15, 1989 were redeemed on February 1 and 15, 1986, respectively, with the proceeds of a $100,000,000 issue of first mortgage bonds. The debentures were redeemed at 101% plus accrued interest. The new bonds bear interest at 11% and are due January 15, 2016.

The 16.25% debentures due July 1988 were redeemed on July 15, 1985 at 101½% plus accrued interest.

(h) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) on a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semi-annual payments of $2,582,000 through June 2001, and includes renewal and purchase options based on fair market value. This plant is included in plant in service at its original cost of $54,405,000; accumulated depreciation at December 31, 1985 was $21,401,000.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1990 are as follows: 1986, $17,456,000; 1987, $102,620,000; 1988, $17,795,000; 1989, $37,985,000; and 1990, $78,193,000. For sinking fund requirements and redemptions at the option of the holders of redeemable preferred stock, see Note 5.

Substantially all utility plant, other than nuclear fuel, transportation equipment and the combined cycle plant mentioned above, is subject to the lien of the first mortgage bonds. The indenture respecting the first mortgage bonds includes provisions which would restrict the payment of dividends on common stock under certain conditions which did not exist at December 31, 1985.

7. Lines of Credit and Compensating Balances.

The Company's lines of credit at December 31, 1985 and 1984 are summarized below. No amounts were outstanding under the lines at December 31, 1985 or 1984.

	1985	1984
	(Thousands of Dollars)	
Commercial paper backup lines:		
Domestic banks	$125,000	$125,000
Foreign banks	50,000	50,000
Other domestic bank lines	245,000(a)	245,000(a)
Total	$420,000	$420,000

(a) Including $200,000,000 available under a credit agreement between the Company and various banks which carries a commitment fee of ¼% per annum.

The commitment fees for the commercial paper backup lines with domestic banks were ⅜% per annum in 1985 and 1984. Compensating balances required (but which were not legally restricted) for the other domestic banks lines (exclusive of the credit agreement referred to in (a) above) were generally 7½% of the lines plus 5% of borrowings in 1985 and 1984.

Under the foreign bank lines, commitment fees were payable at ¼% per annum in 1985 and 1984. The interest rate on borrowings under these facilities was approximately ½% per annum over the applicable Eurodollar Rate in effect from time to time.

By statute the Company's short-term borrowings cannot exceed 7% of total capitalization without the consent of the ACC.

8. Jointly-Owned Facilities.

At December 31, 1985, the Company owned the following interests in jointly-owned electric generating and transmission facilities (dollars in thousands):

	Percent owned by Company	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Generating Facilities:					
Arizona Nuclear Power Project (ANPP) - Units 1, 2 and 3	29.1%	$ —	$ —	$ —	$2,407,231
Four Corners Steam Generating Plant - Units 4 and 5	15.0%	118,897	20,791	98,106	1,499
Navajo Steam Generating Plant - Units 1, 2 and 3	14.0%	119,295	37,994	81,301	1,009
Transmission Facilities:					
ANPP Transmission System	35.8%(a)	7,398	791	6,607	48,337
Navajo Southern Transmission System	31.4%(b)	28,198	9,027	19,171	93
Palo Verde-Yuma 500KV System	23.9%(c)	16,255	550	15,705	1,915
Total		$290,043	$69,153	$220,890	$2,460,084

(a) Weighted average of interests varying from 34.6% to 43.95%.

(b) Weighted average of interests varying from 14% to 100%.

(c) Weighted average of interests varying from 11% to 100%.

The foregoing dollar amounts correlate to the Company's percentage interest in each facility. The Company's share of related operating and maintenance expenses is included in operating expenses.

9. Income Tax Expense.

The components of income tax expense—continuing operations for each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Currently payable:			
Federal	$ 10,095	$ 14,578	$14,224
State	10,664	16,340	10,742
Other	2,861	3,606	2,870
Total current	23,620	34,524	27,836
Deferred:			
Depreciation—net	57,273	26,276	22,571
Taxes, pension costs and other—net	49,690	18,367	5,627
Investment tax credit—net	36,383	59,592	39,583
Total deferred	143,346	104,235	67,781
Amortization of tax benefits sold	(1,687)	(1,687)	(1,687)
Total	$165,279	$137,072	$93,930

In 1981 the Company sold to another corporation certain federal income tax benefits in exchange for cash. The Company, pursuant to an order of the ACC, has recorded the proceeds of the sale as a deferred credit and is amortizing the amount of such proceeds on a straight-line basis over approximately 30 years.

Following is a summary of the difference between income tax expense—continuing operations and the amount obtained by multiplying income before income taxes by the statutory federal income tax rate.

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Federal income tax expense at statutory rate	$225,723	$199,935	$166,972
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	16,431	14,165	10,213
Allowance for funds used during construction	(88,222)	(84,491)	(83,799)
Investment tax credit amortization	(2,955)	(2,827)	(1,970)
Taxes, pension costs and other items capitalized	—	—	(6,640)
State income tax—net of Federal income tax benefit	11,815	11,172	7,070
Other	2,487	(882)	2,084
Total provision for Federal and state income tax expense	$165,279	$137,072	$ 93,930

At December 31, 1985 the Company had approximately $11,000,000 of investment tax credit carryforwards which will expire through 2000.

10. Pension Plan and Other Benefits.

The Company's pension plan, a defined benefit plan, covers virtually all employees. Pension cost, including administrative cost, for 1985, 1984, and 1983 was $15,458,000, $16,370,000, and $15,248,000, respectively, of which approximately $5,081,000, $6,512,000, and $6,871,000, respectively, was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

The following is a summary of plan data as of the most recent benefit information date:

	January 1,	
	1985	1984
	(Thousands of Dollars)	
Actuarial present value of accumulated plan benefits:		
Vested	$127,018	$115,984
Non-vested	11,885	10,499
Total	$138,903	$126,483
Net assets available for benefits	$193,235	$182,577

The actuarial present value (assuming a rate of return of 9.00%) of accumulated plan benefits presented above has not been calculated with reference to the effects of projected inflation, whereas such effects are considered by the Company with reference to the adequacy of plan assets; accordingly, the Company considers the utility of the comparison suggested to be extremely limited.

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for active and retired employees. Life insurance benefits are provided through an insurance company whereas health care costs are paid as expenses are incurred under a self-insured plan. The cost of providing those benefits in 1985 for 1,091 retirees and 8,362 active employees was

$1,086,000 and $13,423,000, respectively, of which approximately $5,825,000 was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

Under the AZP Group, Inc. Stock Option and Incentive Plan approved by the Company's shareholders on April 18, 1985, non-qualified and incentive stock options (ISO) and restricted stock awards may be granted to officers and key employees of AZP and subsidiaries, including APS, for up to 3,000,000 shares of common stock. The plan also provides for the granting of stock appreciation rights, performance shares, dividend equivalents or any combination of the foregoing. In 1985, approximately 15,000 restricted shares, 15,000 ISOs, and 15,000 dividend equivalents were awarded under the Plan.

11. Commitments and Contingencies.

Nuclear Insurance

The Price-Anderson Act ("Act") currently limits the public liability claims that could arise from a nuclear incident to a maximum amount of $650,000,000 for each licensed nuclear facility. Private insurance for this exposure has been purchased by the participants in the Palo Verde Nuclear Generating Station ("Participants"), including the Company in the maximum available amount, presently $160,000,000, with the balance to be provided by secondary financial protection required by the Nuclear Regulatory Commission (NRC). Under the agreement with the NRC, the Company could be assessed retrospective premium adjustments of up to $3,000,000 per year in the event of nuclear incidents involving any licensed reactor in the United States.

Property damage coverage is provided for losses up to $500,000,000 at Palo Verde. Decontamination liability and property damage insurance in excess of the primary $500,000,000 layer has also been purchased. These policies are primarily provided through mutual insurance companies owned by utilities with nuclear facilities. If losses at any nuclear facility covered by the arrangement were to exceed the accumulated funds available for these insurance programs, the Company could be assessed retrospective premium adjustments of up to approximately $3,500,000 per year.

The Act is scheduled to expire in August 1987 and Congress is currently considering several alternatives. The Company is unable to predict Congress' ultimate action and what effect such action may have on the Company's liability.

Litigation

The Company is a party to various claims, legal actions and complaints arising in the ordinary course of business, including a lawsuit seeking to invalidate the Company's contract with various municipalities for the purchase of effluent to be used as cooling water for Palo Verde. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the operations or financial position of the Company.

Purchase Commitments

The Company has significant purchase commitments in connection with the continuing construction program. Construction expenditures in 1986 have been estimated at $372,000,000.

12. Supplementary Income Statement Information.

Other taxes charged to operations during each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Ad valorem	$ 45,554	$42,581	$44,691
Sales	51,438	45,495	32,169
Other	7,284	6,372	5,560
Total other taxes	$104,276	$94,448	$82,420

13. Discontinued Operations.

Effective November 1, 1984 (the "Closing Date") the Company sold its gas distribution system to Southwest Gas Corporation ("Southwest"). The sale resulted in a non-recurring loss of approximately $26,470,000, net of an income tax benefit of $7,094,000, (approximately $0.39 per average share of common stock) in 1984.

The Company agreed to fund a portion of the costs associated with the accelerated replacement of certain gas pipe included in the gas distribution system acquired by Southwest by purchasing, under certain conditions, up to $50,000,000 in aggregate par value of cumulative preference stock (the "Stock") to be issued by Southwest. Any such purchases would be made by the Company within approximately three years following the Closing Date. As of December 31, 1985, no such purchases had been made. The Stock would yield an annual dividend of between 3% and 16% (payable quarterly) based on a formula relating to the operating performance of the gas distribution system. The Stock is also redeemable by Southwest, at its option, on any dividend payment date (at the issue price plus accrued dividends), but must be redeemed no later than seven years after the issuance date as to any issue.

Revenues from the Company's discontinued gas operations for 1984 and 1983 were $174,728,000 and $202,134,000, respectively.

14. Selected Quarterly Financial Data (Unaudited).

Quarter	Revenue from Continuing Operations	Income from Continuing Operations	Income (loss) from Discontinued Operations	Net Income	Earnings for Common Stock	Earnings (loss) per share of common stock: Continuing Operations	Earnings (loss) per share of common stock: Discontinued Operations
	(Dollars in Thousands, Except Per Share Amounts)						
1985							
First	$243,552	$ 59,019	$ —	$ 59,019	$ 46,921	$0.67	$ —
Second	276,697	73,185	—	73,185	62,443	0.88	—
Third	368,129	114,473	—	114,473	103,641	1.45	—
Fourth	286,124	78,746	—	78,746	68,006	0.95	—
1984							
First	203,937	51,324	1,397	52,721	41,598	0.60	0.02
Second	236,712	61,889	(185)	61,704	49,600	0.73	—
Third	311,845	103,118	(1,028)	102,090	89,456	1.32	(0.02)
Fourth	242,473	81,239	(26,687)	54,552	42,038	0.99	(0.39)

15. Supplementary Information to Disclose the Effects of Changing Prices (Unaudited).

The following supplementary information is furnished pursuant to Statement No. 33 as amended by Statement No. 82 of the Financial Accounting Standards Board for the purpose of illustrating the effects of changing prices in an inflationary environment. It offers some perspectives of approximated effects of inflation, and is not intended as precise measurements of those effects.

The Company and other public utilities similarly situated are subject to rate-making procedures which, by law and practice, in large part utilize the historical cost of utility plant in the determination of the allowed recovery (through depreciation) of the investment therein and return thereon. This precludes or restricts a rate-making response to the effects of realizing such recovery and return in inflated dollars, compared to those in which the investment was made. The first table below presents an approximate measurement of those effects from the perspective of that portion of the investment, which was not reflected in 1985 depreciation or in the Company's return, and which is therefore not "recoverable".

For these presentations, "current cost" amounts were calculated by applying certain indices (or ratios derived therefrom) to certain historical or other amounts. The primary index was the Handy Whitman Index of Public Utility Construction Costs (a preliminary estimate of which was used for the last half of 1985), although the Consumer Price Index was used for construction work in progress. The Company believes that the Handy Whitman Index is the more accurate of the two in estimating the prices it would incur to duplicate at various times its utility plant in service at the indicated dates. Over the period from 1981 through 1985 the Consumer Price Index rose faster than the Handy Whitman Index.

Electric depreciation expense for 1985 was recalculated by applying the Company's composite depreciation rate to depreciable base determined by indexing certain appraised values from the times of appraisal. The amount by which the expense so recalculated exceeds that shown on the Company's 1985 Consolidated Statement of Income appears as an adjustment to income from continuing operations.

The sum of the depreciation adjustment and the figure shown lower as the "reduction to net recoverable cost" was derived through application of 1985 increases in the Consumer Price Index to historical costs of the Company's utility plant.

The Company did not make adjustments to asset values, or related consolidated income statement amounts, other than those discussed above in regard to utility plant and depreciation thereon. Fuel inventories and fuel expenses are, in effect, monetary items, due to applicable rate-making procedures which include adjustment clauses. In accordance with Statement No. 33, as amended by Statement No. 82, income taxes were not adjusted.

As contrasted to the assumed net value losses which, in the presentation below, are associated with the holding of assets committed to a regulated business, there is an assumed "holding gain" associated with borrowings that will be repaid with inflated dollars. The 1985 decline in the purchasing power of net amounts owed by the Company (measured by the Consumer Price Index) appears to result in a "net" difference between the assumed holding losses and gain.

Inferences which, in the case of some industries, may be drawn from information in the nature of that presented below as to the adequacy of future cash flows in relation to future plant replacement requirements are believed by the Company to be less valid in the case of public utilites which, like itself, should be able to establish rates to cover increased costs of new plant. However, the information may provide some indication of the expanded capital structure that will be required for making plant replacements and additions with inflated dollars.

ARIZONA PUBLIC SERVICE COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

INCOME FROM OPERATIONS ADJUSTED FOR CHANGING PRICES FOR THE YEAR ENDED DECEMBER 31, 1985

	Current Cost Average 1985 Dollars (Dollars in Thousands, Except Per Share Amounts)
Income from continuing operations as reported in Consolidated Statements of Income	$325,423
Adjustment to restate depreciation expense	(78,431)
Income from continuing operations (excluding reduction to net recoverable cost)	$246,992
Income from continuing operations per common share (after preferred stock dividend requirements and excluding reduction to net recoverable cost)	$2.85
Increase in specific prices (current cost) of utility plant held during the year (a)	$168,637
Reduction to net recoverable cost	(7,981)
Effect of increase in general price level	(251,888)
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	(91,232)
Gain from decline in purchasing power of net amounts owed	45,772
Net	$ (45,460)

(a) At December 31, 1985, Current Cost of Utility Plant—net was $7,140,611.

ARIZONA PUBLIC SERVICE COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECT OF CHANGING PRICES

	Year Ended December 31,				
	1985	1984	1983	1982	1981
	(Average 1985 Dollars in Thousands, Except Per Share Amounts)				
Electric operating revenues	$1,174,502	$1,030,467	$ 941,414	$ 965,693	$ 864,390
Current cost information					
Income from continuing operations (excluding reduction to net recoverable cost)	$ 246,992	$ 230,583	$ 210,929	$ 176,336	$ 163,711
Income from continuing operations per common share (after dividend requirements on preferred stock and excluding reduction to net recoverable cost)	$ 2.85	$ 2.64	$ 2.56	$ 2.31	$ 2.52
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	$ (91,232)	$ (86,837)	$ (68,252)	$ (56,669)	$ (208,236)
Net assets at year-end at net recoverable cost*	$1,997,725	$1,955,140	$1,916,460	$1,775,405	$1,595,758
Reduction to net recoverable cost	$ 7,981	$ 38,216	$ 44,362	$ 33,376	$ 205,988
General information					
Gain from decline in purchasing power of net amounts owed	$ 45,772	$ 93,149	$ 85,460	$ 79,686	$ 171,052
Cash dividends declared per common share	$ 2.73	$ 2.69	$ 2.77	$ 2.68	$ 2.60
Average consumer price index	322.2	311.1	298.4	289.1	272.4

* Consisting of common stock equity and non-redeemable preferred stock.

Shareholder Information

Stock Listing

The $10.70 cumulative preferred stock, Series I (Symbol ARP+); the $3.58 cumulative preferred stock, Series O (Symbol ARPO); and the adjustable cumulative preferred stock, Series Q (Symbol ARPQ), which ended the year at $2.075, are listed for trading on the New York Stock Exchange. The common stock of the Company is held by AZP and as a result is not listed for trading on any stock exchange. Prior to April 29, 1985 the Company's common stock was publicly held and was traded on the New York and Pacific Stock Exchanges. At the close of business on April 28, 1985 the Company's common stock was held by 123,776 shareholders.

The chart below sets forth the common stock price ranges for the four quarters of 1984 and for the first two quarters of 1985. The second quarter common stock price ranges for 1985 reflect the price ranges to April 29, 1985, the date on which AZP became the sole shareholder of the Company's common stock. The chart below also sets forth the dividends per share paid on the Company's common stock for each of the four quarters for 1984 and 1985.

Common Stock Price Ranges and Dividends

1985	High	Low	Dividend Per Share
1st Quarter	22⅞	20⅝	$.65
2nd Quarter	24⅞	22¼	.68
3rd Quarter	—	—	.69
4th Quarter	—	—	.71
1984			
1st Quarter	21	18	$.65
2nd Quarter	18¼	14½	.65
3rd Quarter	20⅜	16	.65
4th Quarter	22⅝	19¼	.65

Transfer Agent

First Interstate Bank of Arizona, N.A.
Corporate Trust Operations
Dept. 958, P.O. Box 29715
Phoenix, Arizona 85038
(602) 271-1620

Registrars

First Interstate Bank of Arizona, N.A.
Phoenix, Arizona

The Valley National Bank of Arizona,
Phoenix, Arizona

General Counsel

Snell & Wilmer, Phoenix, Arizona

Auditors

Deloitte Haskins & Sells,
Phoenix, Arizona

AZP Stock Purchase and Dividend Reinvestment Plan

A Prospectus describing this plan is available upon request. Write: Office of the Secretary, Sta. 1891, at the address below.

Form 10-K

A copy of our Annual Report to the Securities and Exchange Commission, Form 10-K, will be available after March 31, 1986, without charge, upon written request of shareholders. Write: Office of the Secretary, Sta. 1891, at the address below.

Statistical Report

A detailed Statistical Report for Financial Analysis 1975-1985 will be available by mid-April on request. Write: Office of the Treasurer, Sta. 1820, at the address below.

MAILING ADDRESS:

P.O. Box 53999
Phoenix, Arizona 85072-3999

APS DIRECTORS

Joe Acosta, 62, founder, Acosta, Cordova & Pittman, C.P.A.s, P.A., Phoenix, Arizona

Dino DeConcini, 52, attorney at law, Phoenix, Arizona

* O. Mark De Michele, 52, president and chief operating officer of APS, executive vice president of AZP, Phoenix, Arizona

* Karl Eller, 57, chairman of the board, The Circle K Corporation, Phoenix, Arizona

* William T. Garland, 69, president of Garland Land Co. (land development), Sedona, Arizona

Pamela Grant, 47, chairman of the board and chief executive officer, Goldwaters, Division of Associated Dry Goods (general mercantile), Scottsdale, Arizona

Jack M. Morgan, 62, attorney at law and state senator, Farmington, New Mexico

Marvin R. Morrison, 62, farmer, cattle feeder and dairyman, Morrison Brothers Ranch, Higley, Arizona

+ John R. Norton III, 57, former president, J. R. Norton Co. (agricultural production), Phoenix, Arizona

John J. Rhodes, 69, former member of the U.S. House of Representatives and counsel in the law firm of Hunton & Williams, Washington, D.C.

Henry B. Sargent, Jr., 51, executive vice president and chief financial officer of APS, executive vice president, treasurer and chief financial officer of AZP, Phoenix, Arizona

Wilma W. Schwada, 59, civic leader and homemaker, Phoenix, Arizona

James P. Simmons, 61, chairman of the board and president, United Bank of Arizona and United Bancorp of Arizona, Phoenix, Arizona

* Richard Snell, 55, chairman of the board and president, Ramada Inns, Inc., Phoenix, Arizona

* Donald N. Soldwedel, 61, president, Western Newspapers, Inc., Yuma, Arizona

* Maurice R. Tanner, 64, chairman of the board and chief executive officer, The Tanner Companies (construction and materials supply), Phoenix, Arizona

* Keith L. Turley, 62, chairman of the board and chief executive officer of APS; chairman of the board and president of AZP, Phoenix, Arizona

* Douglas J. Wall, 59, member of the law firm of Mangum Wall Stoops & Warden, Flagstaff, Arizona

Morrison F. Warren, 62, professor emeritus of education, Arizona State University, Tempe, Arizona

Ben F. Williams, Jr., 56, mayor of the City of Douglas and attorney at law, Douglas, Arizona

Thomas G. Woods, Jr., 59, formerly executive vice president for the Arizona Nuclear Power Project (Retired 2/85), Phoenix, Arizona

(Age on Annual Meeting date, April 24, 1986)

* Member of Executive Committee

+ Mr. Norton was reelected to the board on February 20, 1986, effective March 1, 1986. He had resigned from the board in May 1985 to accept a position as acting U.S. Deputy Secretary of Agriculture.

Each is also a member of the AZP board of directors

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

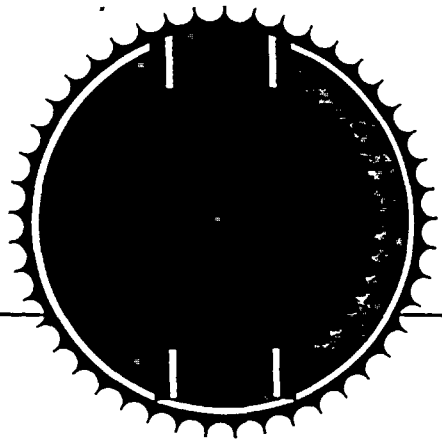
In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT D

1985 AZP GROUP, INC. ANNUAL REPORT

"Every company faces challenges. Through the 100 years we have served in Arizona we have been responsive to those challenges. Now, as AZP Group, Inc., we are even better positioned to meet the future. We have reason to be optimistic, but our success will take a team effort; it will require that extra dedication and hard work that characterize all great companies."



ABOUT OUR COMPANY

AZP Group, Inc. is a holding company created in April 1985, but its roots stretch back to 1886, when an enterprising pioneer established one of the West's first electric and gas utilities. Today, as we celebrate the centennial of our utility business, we are improving our corporate strength and increasing our growth potential through the development of our non-utility subsidiaries.

Successor to a series of small utility operations, AZP's largest subsidiary, Arizona Public Service Company, was incorporated in 1920 under the laws of Arizona and has operated under its present name since 1952. APS electric service now reaches approximately 1,418,000 people, or about 45 percent of the state's population, in an area that includes all or part of 11 of Arizona's 15 counties.

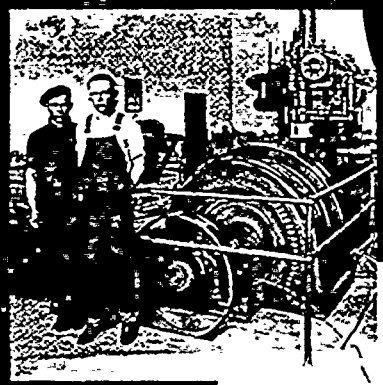
AZP's three other subsidiaries, Malapai Resources Company, Energy Development Company, Inc., and El Dorado Investment Company, were acquired from APS upon creation of the holding company structure. The restructuring is part of a long-standing commitment to build a stronger future for our company, our customers, our employees, and our shareholders.

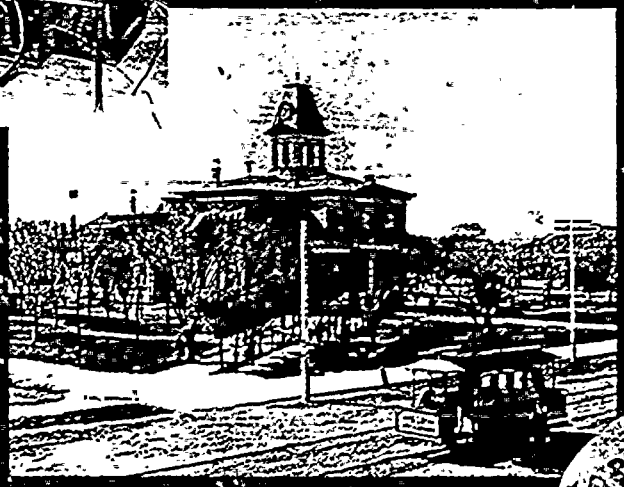
ANNUAL REPORT

This report is published to provide general information concerning the company and not in connection with any sale, offer for sale, or solicitation of an offer to buy, any securities.

ANNUAL MEETING OF STOCKHOLDERS

All stockholders are invited to attend the company's annual meeting. It will be held at 10 a.m. Thursday, April 24, 1986 in the Grand Ballroom of the Phoenix Hilton, 111 North Central Avenue, Phoenix, Arizona.





HIGHLIGHTS 1985

	1985	1984	1983
Property and Plant:			
Total utility plant, year-end	$5,712,507,000	$5,088,243,000	$4,761,265,000
Funds used for capital expenditures	$ 494,105,000	$ 408,935,000	$ 454,854,000
Sales and Customers:			
Operating revenues—continuing electric operations	$1,174,502,000	$ 994,967,000	$ 871,875,000
Operating revenues—discontinued gas operations	$ —	$ 174,728,000	$ 202,134,000
Total electric sales (mwh)	13,971,314	13,054,987	12,753,542
Electric customers, year-end	521,567	499,751	468,768
Income, Earnings, Dividends:			
Operating income	$ 306,984,000	$ 263,260,000	$ 253,412,000
Net income*	$ 279,549,000	$ 222,692,000	$ 221,056,000
Average common shares outstanding	72,126,618	68,308,131	63,865,210
Earnings (loss) (based on average shares outstanding)			
Continuing operations	$ 3.88	$ 3.65	$ 3.53
Discontinued operations	—	(0.39)	(0.07)
Total	$ 3.88	$ 3.26	$ 3.46
Dividends declared per share of common stock	$ 2.69	$ 2.60	$ 2.56
Common shareholders	119,944	124,274	127,387
Employees, year-end	8,324	7,358	7,642

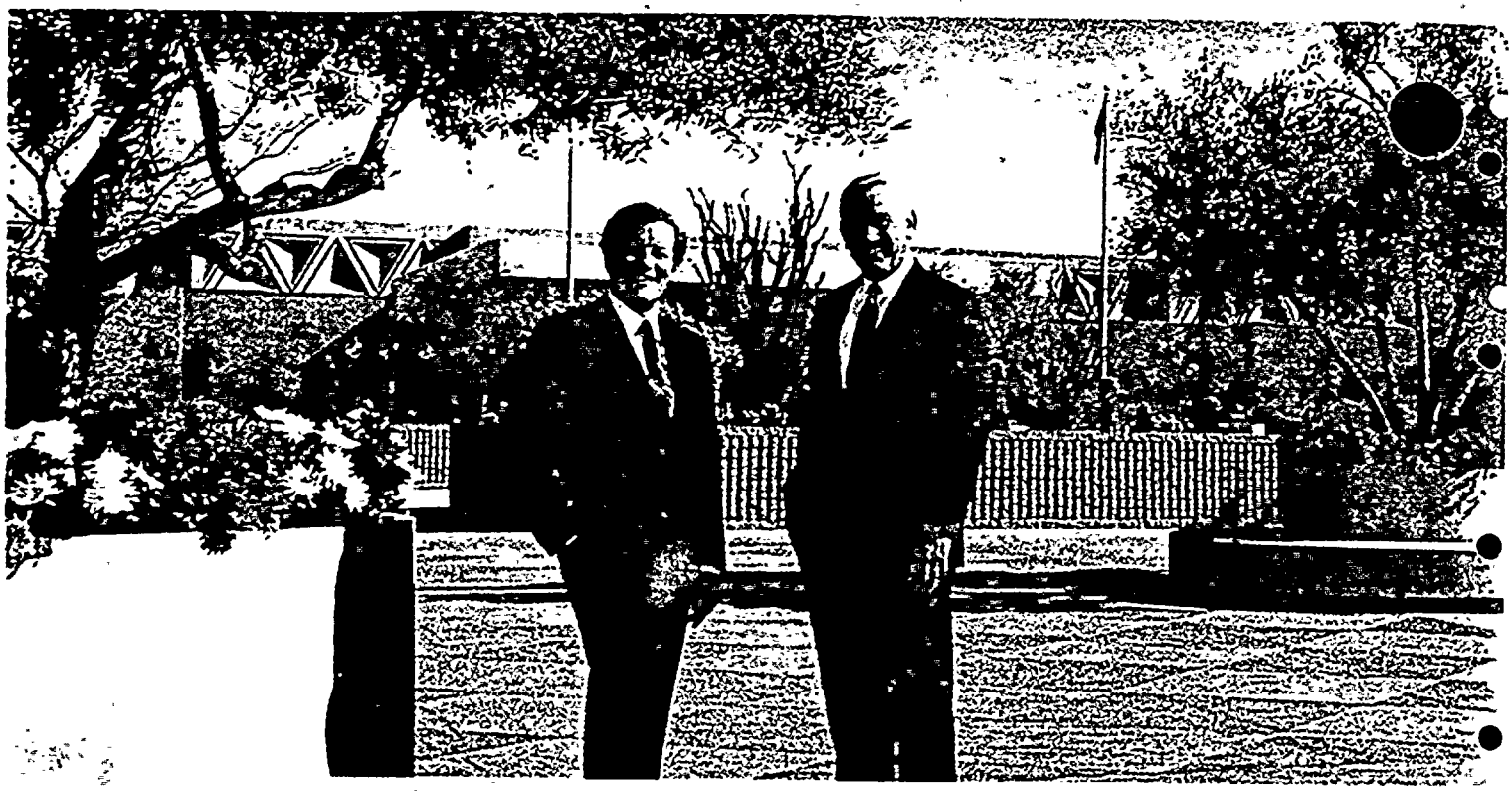
*Restated to give effect to corporate restructuring (See Note 2 to Consolidated Financial Statements).

COMMON STOCK PRICE RANGES

(Symbol: AZP)

1985	High	Low	Dividend Per Share
1st Quarter	22⅞	20⅝	$.65
2nd Quarter	28⅛	22¼	.68
3rd Quarter	28⅛	22⅝	.68
4th Quarter	27⅜	22¾	.68
1984			
1st Quarter	21	18	$.65
2nd Quarter	18¼	14½	.65
3rd Quarter	20⅜	16	.65
4th Quarter	22⅝	19¼	.65

1886 Beginning Our Second Century of Service 1986



TO OUR SHAREHOLDERS:

1985 was a demanding year, yet one that proved successful for our company. We achieved the best financial results in our history, boosting earnings to a record $3.88 per share. This enabled us to increase your dividend to a rate of $2.72 per share on an annualized basis.

Contributing to our success in 1985 were a much-needed electric rate increase; growth in both electric sales and the number of customers served; a continuing successful effort to hold the line on operating expenses; and our ability to take advantage of today's lower interest rates.

But if there is a word that best summarizes 1985 it is "change." We changed from a combination gas and electric to an electric-only utility. We became a nuclear energy supplier, as the Palo Verde Nuclear Generating Station began the transition from a project under construction to a major operating facility. And we changed, too, in our corporate structure, as we became AZP Group, Inc., of which APS is now a part.

Change is nothing new for our company. We celebrate our centennial anniversary in 1986 recalling that we have changed and adjusted and adapted continually through our first 100 years of existence. Now, as we begin our second century we are changing again, and charting exciting new directions for our progress.

The creation of AZP has separated our regulated utility operations from our non-utility activities. It signals a stronger emphasis on non-utility subsidiaries, and our intention to create a more profitable operation overall.

APS must continue to invest new dollars in order to meet the growth that is ahead; and it must rely on fair regulation to ensure our investors an adequate return.

At the same time, we can now look to other business lines for contributions to corporate growth that will provide even greater assurance fo our shareholders.

Since you approved the creation of AZP Group, Inc. at our Annual Meeting in 1985, you have expressed growing interest in the activity of our subsidiaries. Many of your questions were answered at regional shareholder meetings held this past year.

In essence, our plan is to further develop our non-utility subsidiaries, while continuing our primary emphasis on the provision of reliable and efficient electric service in Arizona.

In the short-run, investments in our non-regulated subsidiaries will come primarily from your investments in our dividend reinvestment plan. Although reinvested dividends can no longer be deducted for federal income tax purposes, many shareholders continue to benefit from participation in the AZP dividend reinvestment plan. We hope that you, too, will increase your invest through continued participation.

Meanwhile, we will continue to apply the cash generated by APS to that company's construction program. Fortunately, this construction is winding down, thanks to the progress at Palo Verde and our plans to forestall building any major new generating plants until at least the year 2000.

You can read about our progress at Arizona's first nuclear generating station elsewhere in this report, but most significant is the fact that we *need* our share of Palo Verde electricity.

The anticipated commercial operation of the Palo Verde units can help improve our long-term financial outlook; however, should we receive no rate relief in 1986, our earnings will certainly decrease. Palo Verde's change from construction to operational status means we must begin charging each unit's expenses against current income, rather than continuing to accumulate and capitalize project costs as we did during construction.

We had hoped to have rates in effect now to cover such charges. But because of regulatory delays, discussed later in this report, that hasn't happened.

Nevertheless, for 1986 our cash flow has improved and your dividend is secure, even though we may not receive rate relief in the near future. To help maintain our financial strength until reasonable rates are approved, we have drastically reduced budgeted operating expenses.

We expect 1986 to be a tough year financially. But looking beyond, we can see things becoming brighter. With three Palo Verde units in operation, with the approval of adequate rates, and with our subsidiaries actively generating income, we should see a very positive improvement in our earnings picture.

The fact is that every company faces challenges. Through the 100 years we have served in Arizona we have been responsive to those challenges. Now, as AZP Group, Inc., we are even better positioned to meet the future.

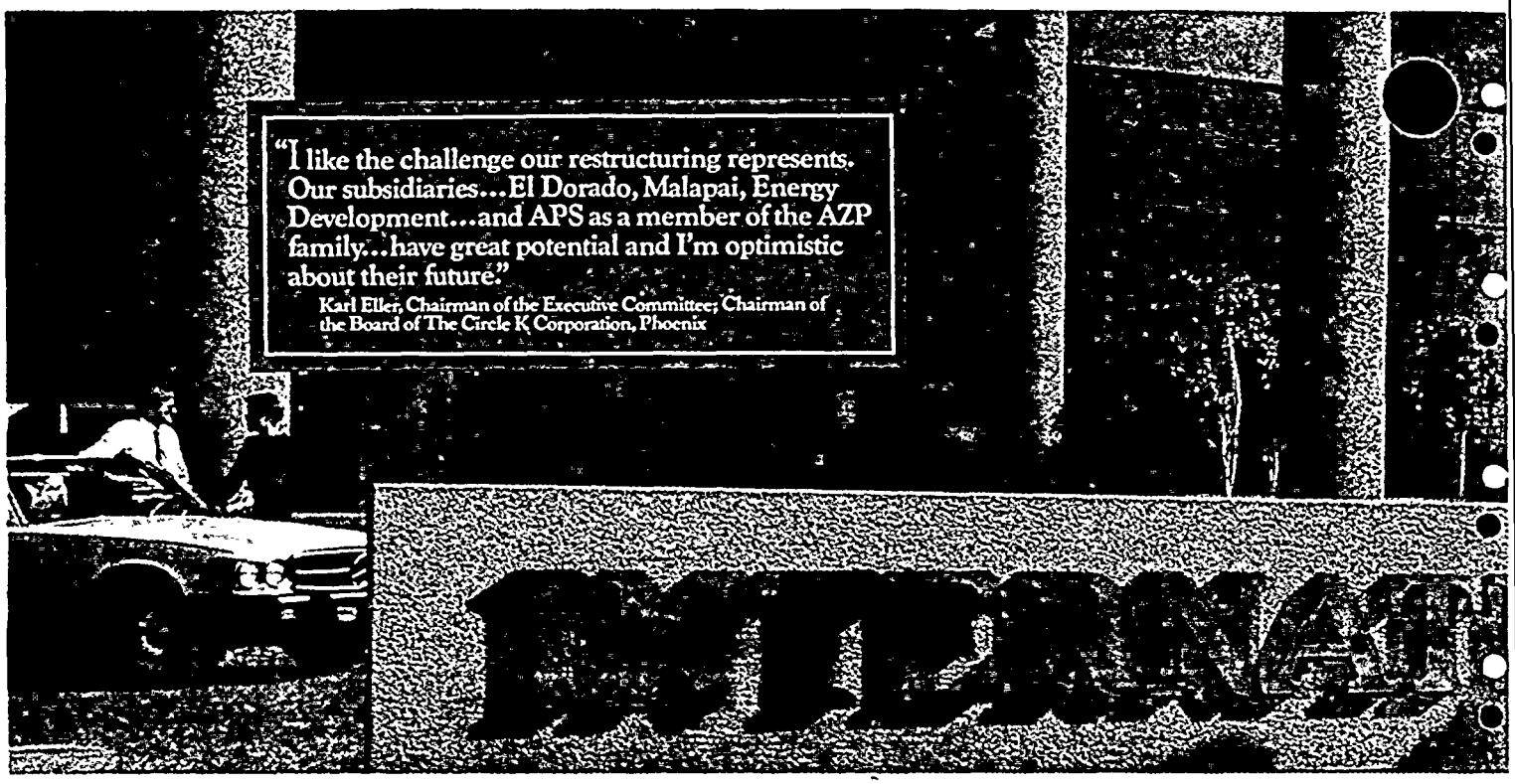
We have reason to be optimistic, but our success will take a team effort; it will require that extra dedication and hard work that characterize all great companies.

Ours is a great company, and we believe that, with the continued support of our employees and shareholders, we can make the years ahead the most successful in our history.

Keith L. Turley
Chairman of the Board
and President

O. Mark De Michele
Executive Vice President, AZP,
and President and Chief Operating
Officer, APS

1886 Beginning Our Second Century of Service 1986



THE YEAR IN REVIEW

We see the past 100 years as a prelude to the century ahead . . . a future brightened by a corporate restructuring that will enhance our long-term earnings potential.

In 1985, our 100th year, the AZP board of directors increased the quarterly dividend rate from 65¢ per share for the first quarter of the year to 68¢ per share for all following quarters. As one indicator of our financial health, return of capital for 1985 was zero, meaning that all dividends will be subject to federal income taxes.

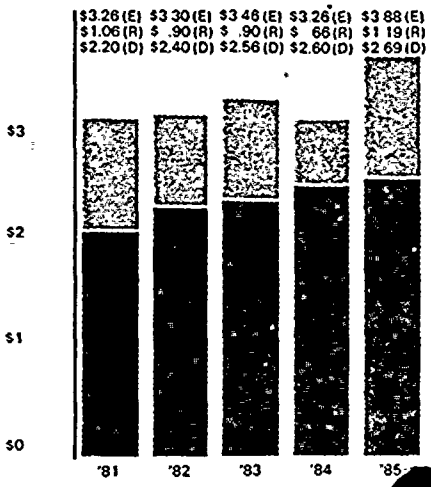
APS electric revenues topped a record $1 billion in 1985, pushing AZP's earnings to $3.88 per share, up from $3.65 per share earned by APS in 1984. (Net 1984 earnings were actually shown as $3.26 per share after accounting for a loss on the sale of our gas properties.)

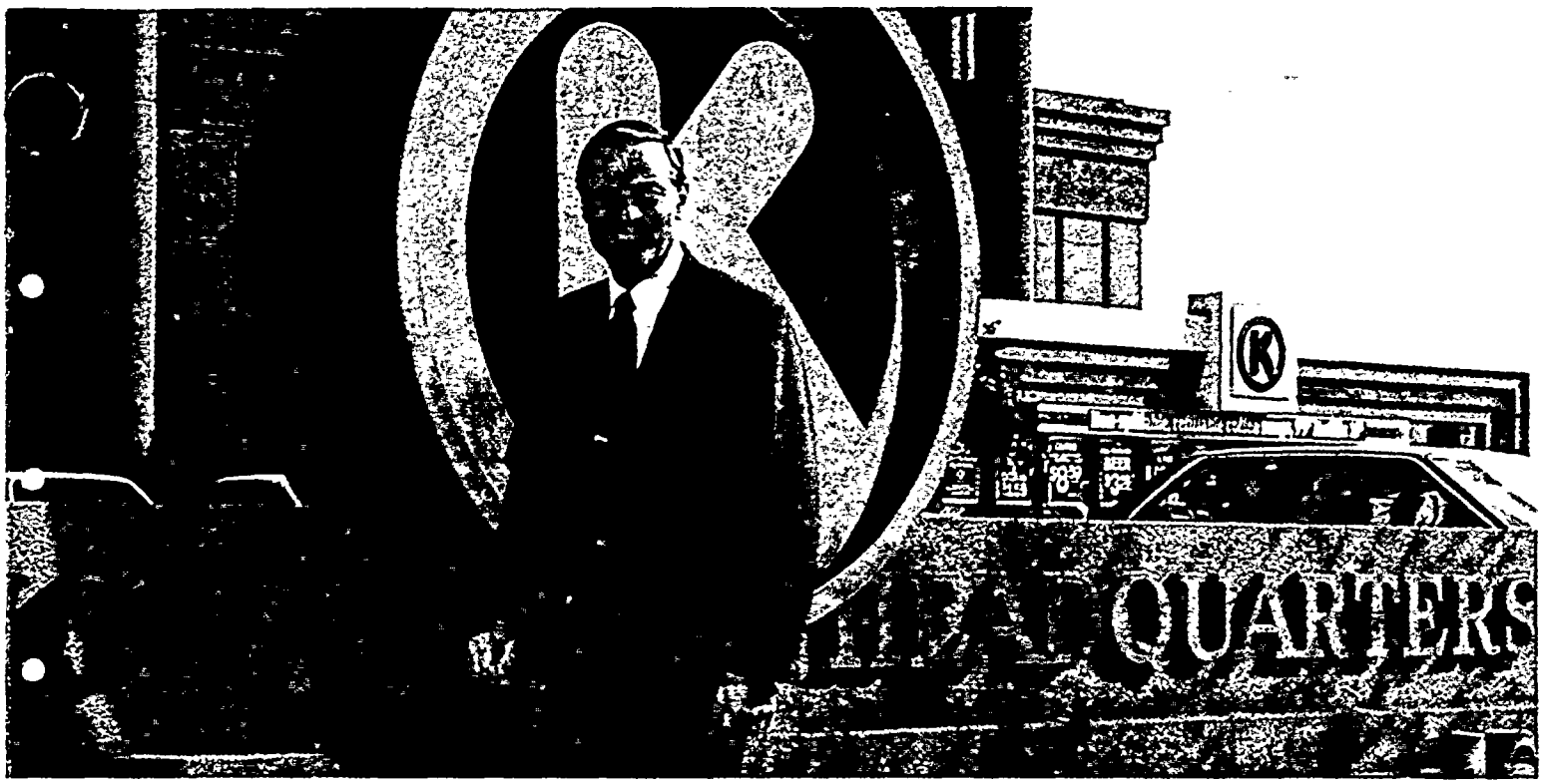
These higher earnings were enhanced significantly by their improved quality. Approximately 31 percent of our 1985 earnings consisted of cash, compared to 26 percent in 1984 and only 15 percent in 1983.

Return on equity also improved, reaching 15.9 percent, while net cash flow as a percentage of capitalization was 2.2 percent. Meanwhile, APS' pre-tax interest coverage reached 3.2 times in 1985, a significant improvement over previous years and a goal the company had set some 10 years ago.

We're still far below our long-term goal set for internal cash generation, with the 1985 figure up only slightly from the year before, to 22 percent of AZP capital requirements. We will continue working for improvement, and the greatest positive impac should occur as more of Palo Ve costs are included in rate base and "paper" earnings are replaced by cash earnings.

Earnings, Reinvested Earnings, and Dividends Per Average Share of Common Stock





Our non-utility subsidiaries are not expected to have a positive impact on the AZP financial picture for several years. Though they contributed little to overall earnings in 1985, we have laid the foundation for their success. As discussed later in this report, business plans have been developed that provide the potential for each subsidiary to contribute at least 10 percent of AZP's earnings within the next 5 to 10 years.

Meanwhile, the electric utility business continues to dominate our performance, with investment, earnings and cash flow primarily driven by the requirements and performance of APS.

Our dividend policy will also remain utility-driven.

Arizona has consistently been one of the fastest-growing states in the nation and that pace will continue. Our moderate climate and desirable lifestyle are obvious attractions, and a stable and reliable supply of electricity is vital to sustaining our healthy growth.

During 1985, more than 70,000 new citizens moved to our state, approximately 80,000 new housing permits were issued, and some 54,000 new jobs were created. We added about 21,800 new electric customers in 1985, and are preparing for increases of about 20,000 annually through 1995.

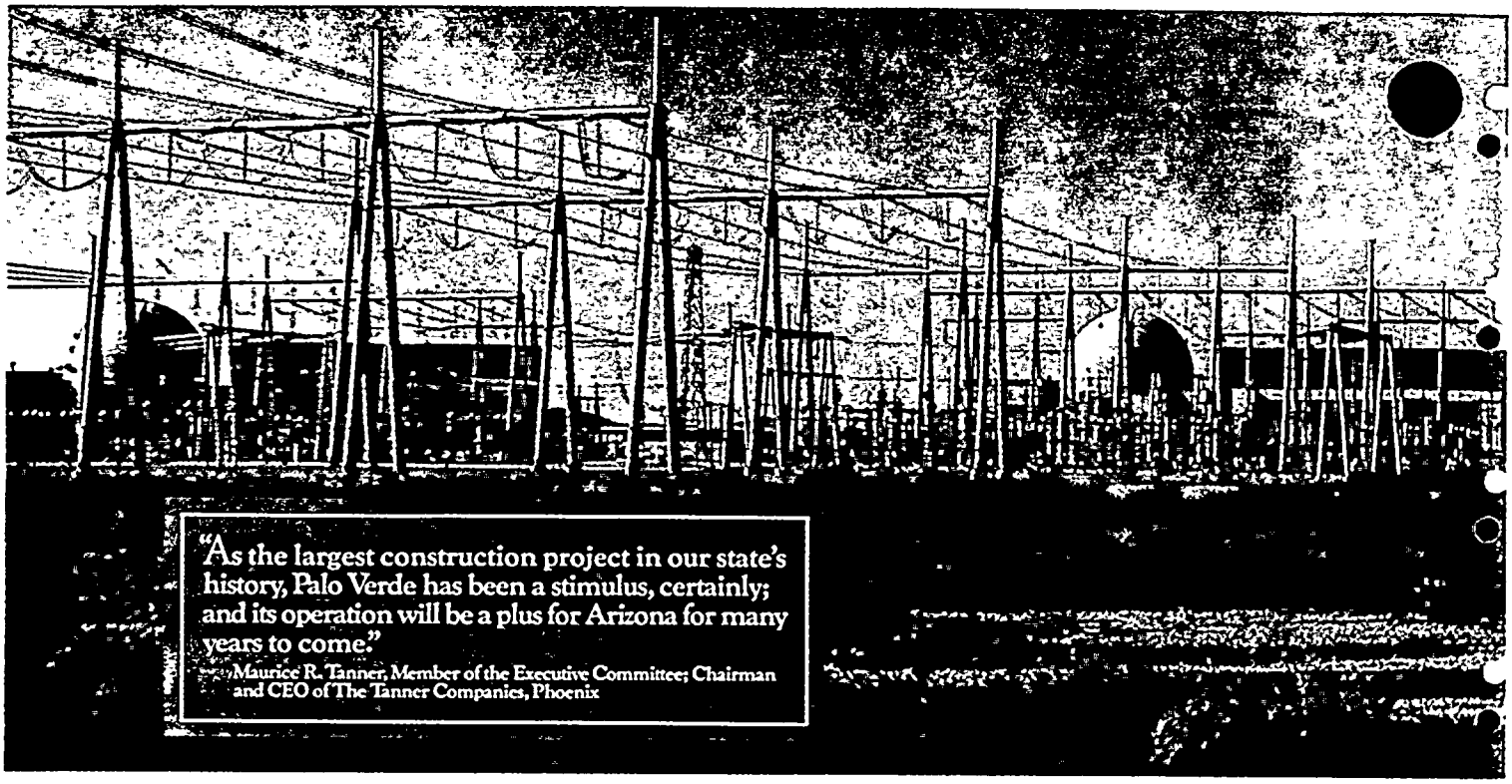
Our peak demand increased by 7.6 percent in 1985, to nearly 3,200 megawatts. With continued increases of about 3 percent per year, we expect demand to reach 4,300 megawatts by 1995.

Electric sales rose by 7 percent in 1985, and will continue to grow.

Stock Purchase and Dividend Reinvestment Plan

Many shareholders have asked about the tax provisions of AZP's dividend reinvestment plan. Previously, utility shareholders had been allowed to deduct a portion of their dividends for income tax purposes, provided those dividends were reinvested in new stock. Although Congress has not extended this special tax treatment for 1986, you may still continue to reinvest your dividends and thus build a stronger stock position.

1886 Beginning Our Second Century of Service 1986

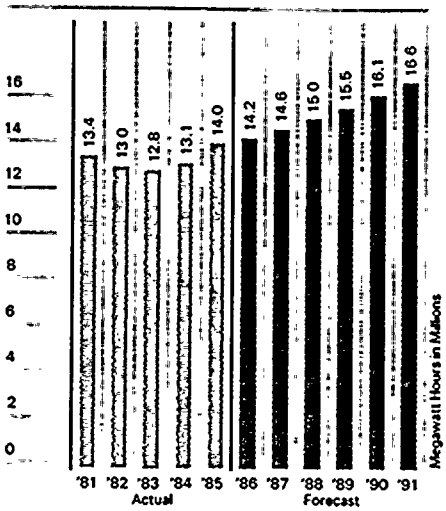


From a high of 14 million megawatt-hours in 1985, we expect to see total sales reach 19.4 million megawatt-hours by 1995.

It's clear that Arizona needs the power that the Palo Verde Nuclear Generating Station will provide. And Arizonans have been using Palo Verde Unit 1-generated electricity to heat and cool their homes and provide light and power since June 1985 — months before the unit met the Arizona Corporation Commission (ACC) definition of commercial operation in February 1986.

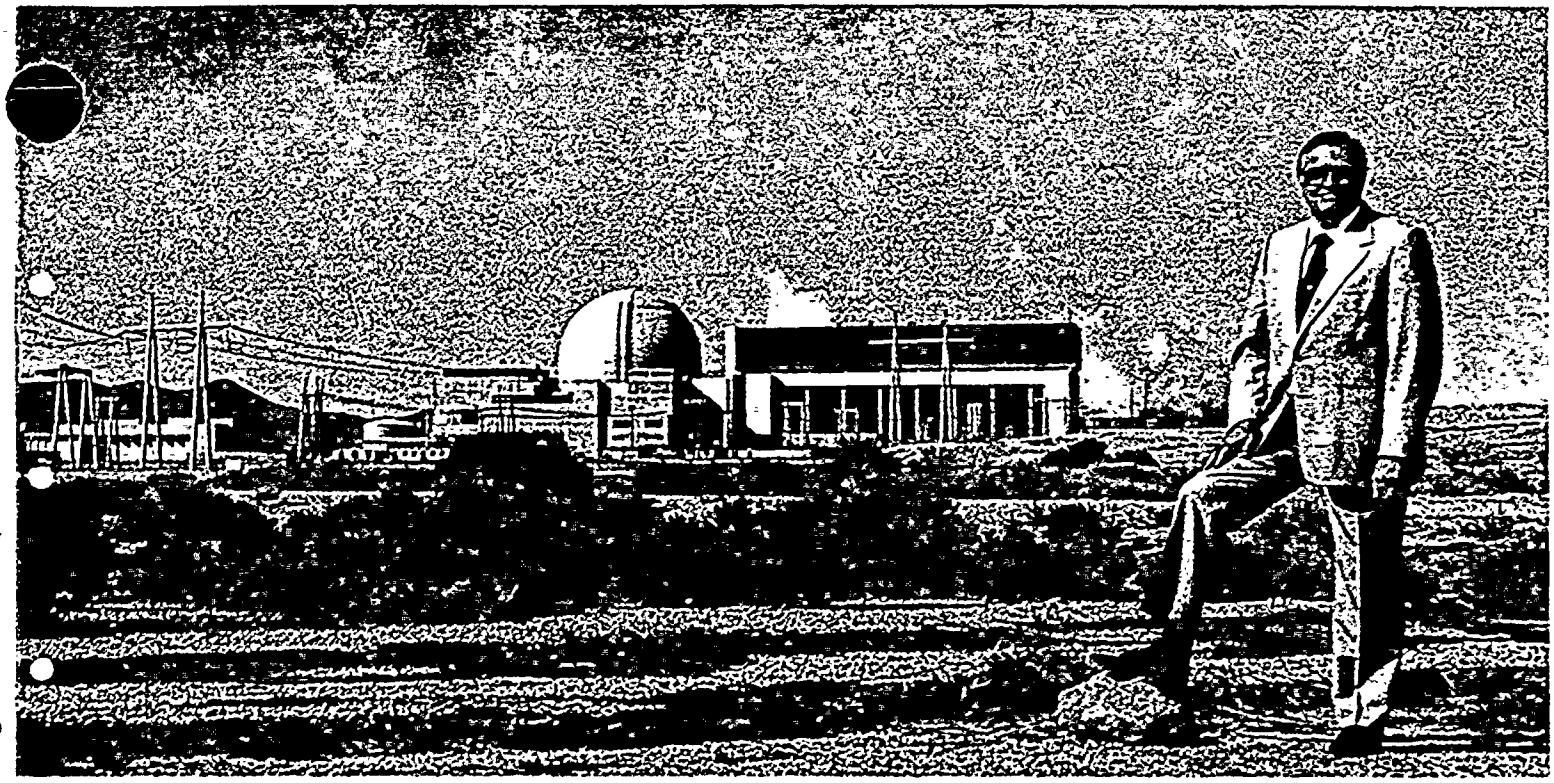
We were fortunate in having that power available for our customers during the unit's year-long program of start-up testing, necessary to satisfy the stringent requirements of the Nuclear Regulatory Commission, as well as the ACC. Last year, with Palo Verde not yet on line, we had to buy power to meet our customers' demands.

Total Electric Sales



Palo Verde Unit 1 entered commercial operation in February 1986. During testing in mid-1985, one member of the Nuclear Regulatory Commission called it "the plant of the future." Here in the growing Southwest we're calling Palo Verde the plant *for* the future.

Arizona is just one of four states whose citizens will directly benefit from Palo Verde. Utilities in Texas, New Mexico and California which have invested in Palo Verde are also counting on the plant to help meet the energy needs of their customers . . . well into the years ahead.



We committed ourselves from the start to build one of the most reliable, safe and efficient plants in the country. On December 31, 1984, the NRC granted an operating license for Unit 1; fuel was loaded in the first month of 1985; and, on June 10, 1985, we generated Palo Verde's first electricity.

A recent revision in testing schedules has pushed commercial operation dates of units 2 and 3 to the third quarters of 1986 and 1987, respectively, though the new schedule is not expected to increase Palo Verde's construction costs. With financing costs included, the total cost of APS' share of the plant is $2.76 billion, of which we had spent $2.4 billion by year-end 1985.

In managing the Arizona Nuclear Power Project we've had to make some tough decisions in the interests of our project partners, our shareholders and our customers. A prudency audit ordered by regulators from four states involved in the Palo Verde project should bear out the wisdom of those decisions.

A preliminary report released late last November outlined the scope of the audit and narrowed the areas to be studied, though the audit itself probably won't be completed before late 1986.

Our company's long-term prospects look strong, though in the current year we don't expect to see the same kind of success we realized in 1985.

Ironically, the factors that will help improve our long-term financial outlook — the transition of Palo Verde units 1 and 2 to operating plants — may result in decreased earnings in 1986.

Arizona Nuclear Power Project Ownership

Arizona Public Service Company—29.1%
Salt River Project—17.49%
Public Service Company of New Mexico—10.2%
El Paso Electric Company—15.8%
Southern California Edison—15.8%
Southern California Public Power Authority—5.91%
Los Angeles Department of Water Power—5.7%

1886 Beginning Our Second Century of Service 1986

The reason is simple. While Palo Verde was under construction and not included in our rates, finance costs were accumulated and capitalized under the procedure called Allowance for Funds Used During Construction (AFC), and construction costs were also capitalized. Now, with Unit 1 in commercial operation, we must charge all its expenses, including operating costs and depreciation, against current income.

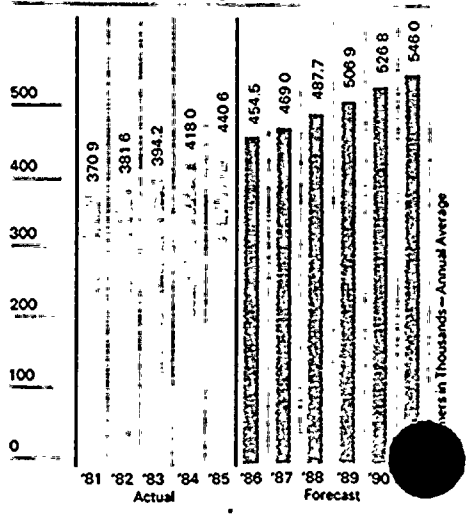
With adequate rates, we would earn revenue enough to cover these charges; AFC "paper" earnings would be replaced by cash. But because of regulatory delays (discussed later in this report), those rates haven't been granted. The problem will be compounded when Unit 2 enters commercial operation later this year.

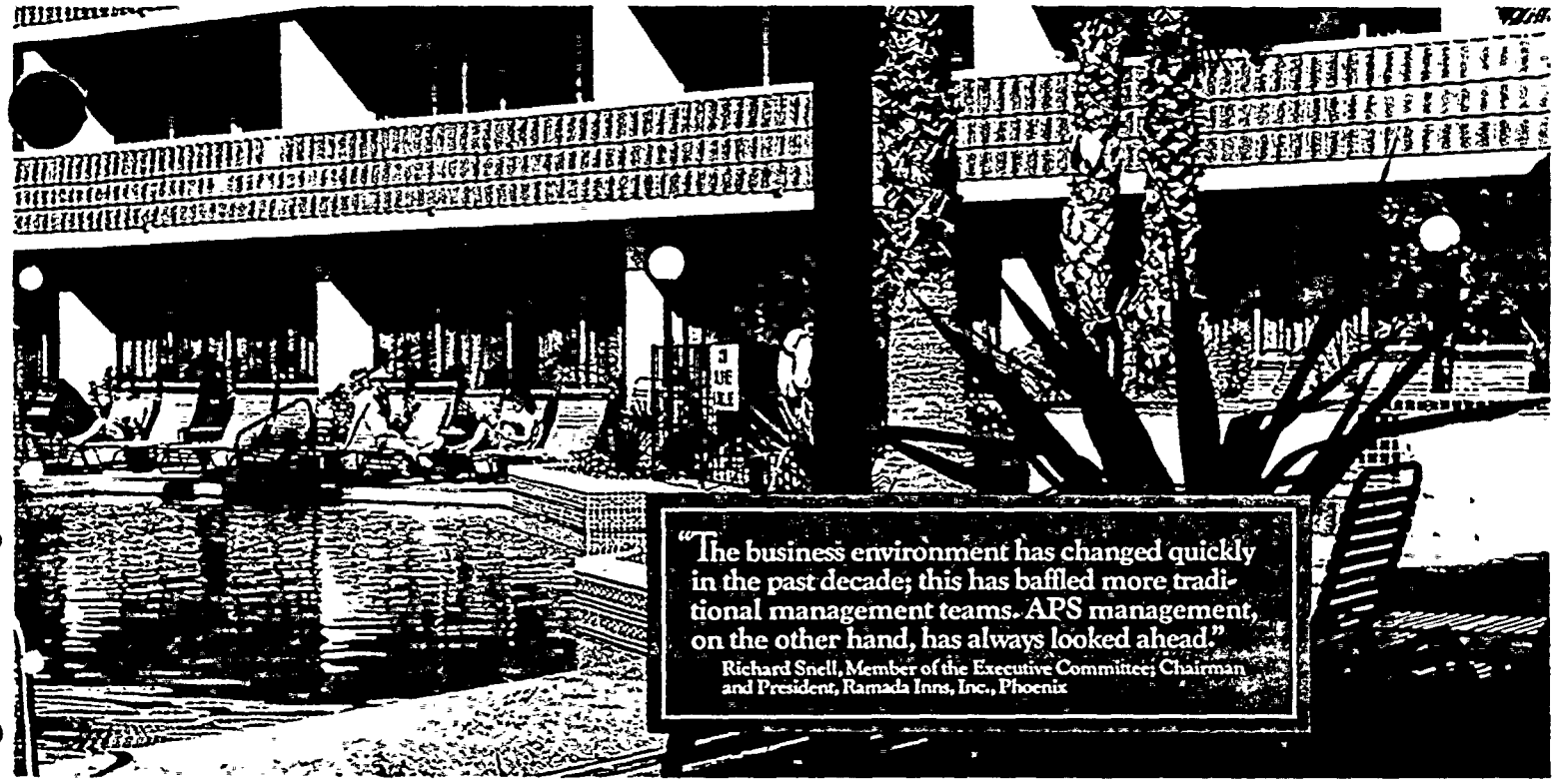
Two new commissioners were elected to the ACC in January 1985, and a third was appointed by the governor to fill the remaining seat, vacated by a resignation in October. Thus a completely new panel of commissioners will be deliberating during 1986 on our Palo Verde-related rate requests. (Further complicating the situation is the fact that two seats, including that of the current ACC chairman, will be up for election in November 1986.)

In May 1985 we filed a request for new rates that would reflect the balance of Unit 1 costs. Approval of our $78.2-million request would have resulted in an 8.6 percent rate increase, effective at the time the unit went into commercial operation.

Additionally, approval would mean that you and others who have provided funds for the u[illegible] construction could begin receiv[illegible] a meaningful return on your investment. But hearings on our request were not scheduled until March 1986, with no chance of receiving a decision that would be

Customer Growth Expectations

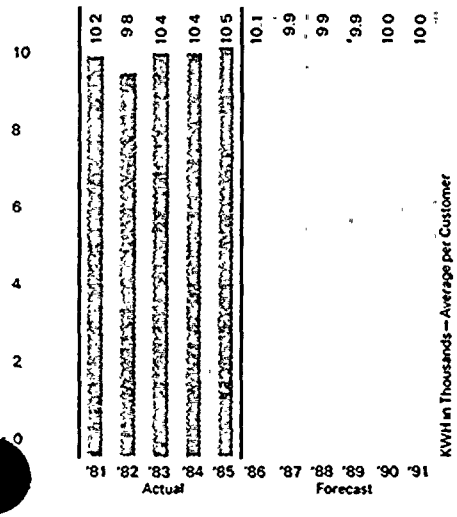




effective when the unit went into commercial operation.

Meanwhile, progress on units 2 and 3 has continued and Unit 2, scheduled to enter commercial operation in the third quarter of 1986, must also be folded into rates.

Customer Use Trends—Residential Electric



Bringing new generating units into rates today can have a sizable impact on customers' budgets. So in December 1985 we filed a rate increase request for Palo Verde Unit 2 that we believe will balance the concerns of investors and consumers.

Our filing asks for three annual increases, of about 6 percent each, beginning in 1987. Compounded, the increases would total 19.6 percent, but phasing them in on an "installment plan" basis would keep annual increases at about the anticipated level of inflation.

To provide the ACC with some flexibility in setting new rates, we also filed an alternate request, asking that our entire interest in Unit 2 be placed in the rate base as soon as it goes into commercial operation. Approval of this request would produce an annual revenue increase of about $194 million, from a single overall rate increase of 19.36 percent, to cover immediately our costs in the unit.

Implementation of the phase-in plan is contingent on the ACC's treatment of the Unit 1 case pending, and its approval of an accounting order (requested in our May 1985 filing) that would allow us to defer Unit 2 costs until we are allowed to recover these costs.

In the last half of 1986 we expect to file a similar phase-in

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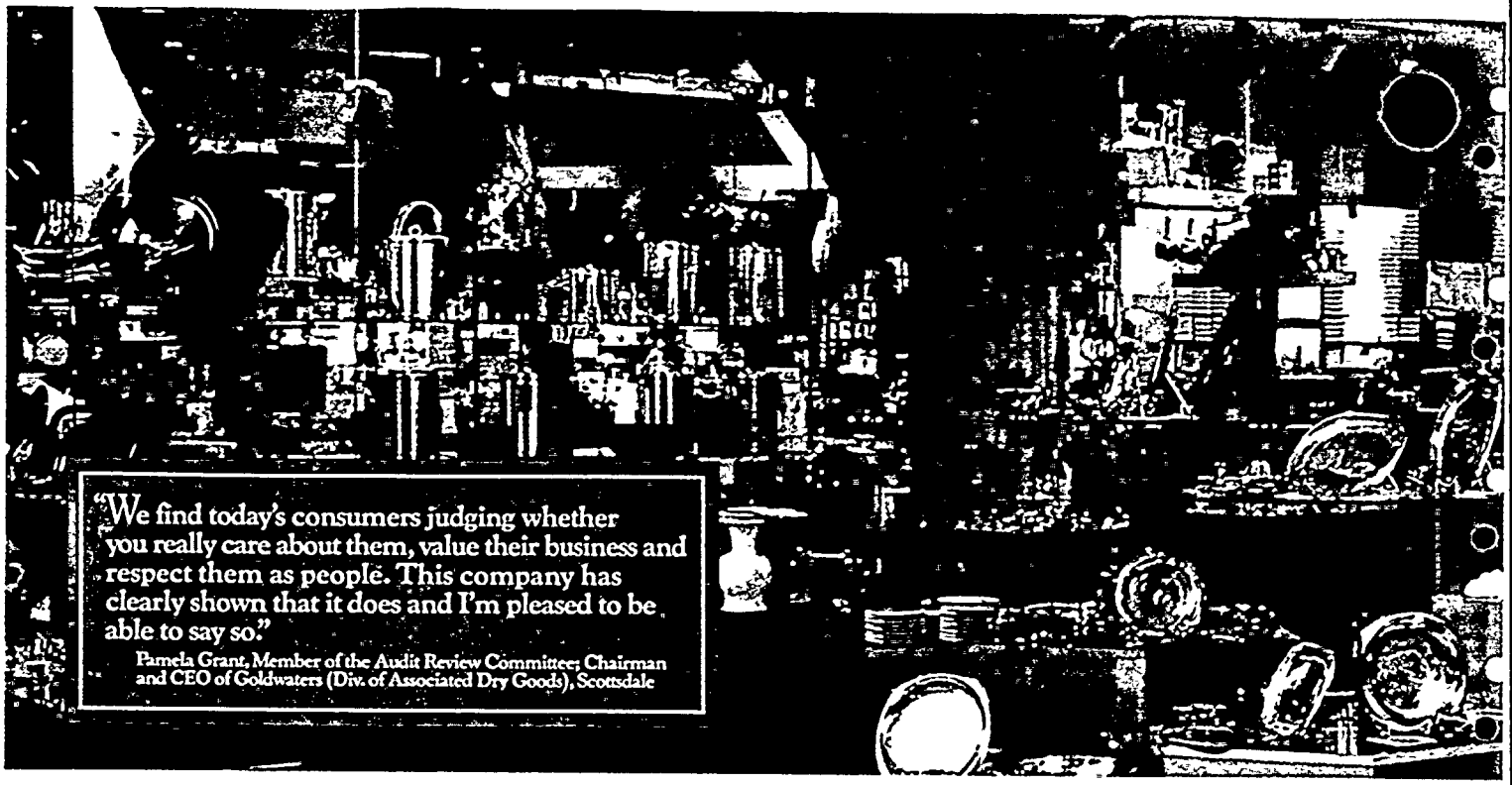


"We find today's consumers judging whether you really care about them, value their business and respect them as people. This company has clearly shown that it does and I'm pleased to be able to say so."

Pamela Grant, Member of the Audit Review Committee; Chairman and CEO of Goldwaters (Div. of Associated Dry Goods), Scottsdale

plan for Palo Verde Unit 3, asking for rate increases averaging about 6 percent annually. Again, these figures are contingent on prior rate treatment, and the results of the prudency audit, discussed earlier, that could affect the amount recovered from all three Palo Verde units.

Meanwhile, we are awaiting results from a February 1986 hearing which dealt with several issues left unresolved in an earlier purchased power and fuel adjustment decision. Among these was our contention that an increase of four mills per kilowatt-hour, granted by the ACC last August, was insufficient.

In other matters, the Federal Energy Regulatory Commission accepted agreements allowing APS to increase wholesale revenues by approximately $6 million. The increase took effect in February 1985.

The control of operating expenses is a major, ongoing effort throughout our APS operations. But because of the uncertainties of our present rate situation as Palo Verde makes the transition to commercial operation, we have drastically cut 1986 budgeted expenses across the board. In addition, we have deferred a number of essential programs, until we are assured of adequate rates that will cover their cost.

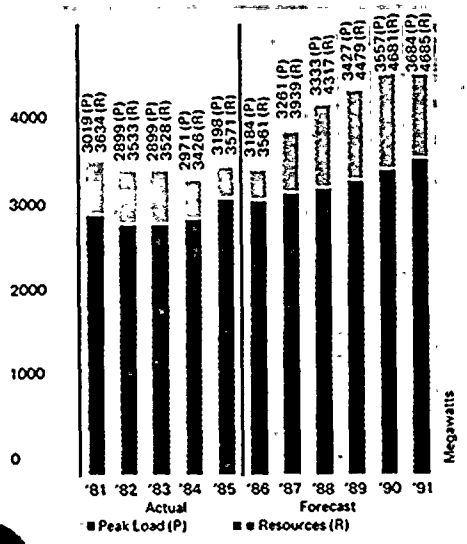
We're evaluating the sale and lease back of some of our office buildings, and the sale of land holdings that are not now in productive use. We have reduced marketing programs and advertising; we'll defer dues and corporate memberships in many industry and business organizations; and we have frozen the salaries of officers and senior managers. These and other cuts or deferrals will save millions of dollars over the next 12 months.

In our efforts to reduce costs, however, we have been very conscious of the need to maintain quality standards throughout our operations; and we have been careful to avoid cutting programs that enhance our ability to serve our customers.

Our load management programs, for example, are based on a "win-win" philosophy in that they

benefit both company and customer: they help lower our costs while providing our customers opportunities to control their electric bills.

Peak Load and Electric Resources



Since our load-management effort began in the late-1970s, we have reduced our 1995 projected peak demand by a total of 628 megawatts. Our goal is to make more productive, round-the-clock use of our existing generating facilities and to hold down the seasonal peak energy demands which strain the limits of our resources.

In 1985 we actively promoted the use of heat pumps and other high-efficiency appliances, and offered customers interest-free, no money-down loans for the purchase and installation of approved load-controlling products.

Programs being directed to commercial and industrial customers encourage installation of sophisticated energy management systems such as advanced thermal storage, which chills and stores water at night, then recirculates it for cooling during daytime peak-demand hours. This program alone is expected to shave about 100 megawatts off of our peak demand by 1995.

Response to all of these programs has been enthusiastic. Our customers have expressed their preference for clean, efficient electric energy, and we have provided them with the tools, information and programs to help them get the best value for their energy dollars.

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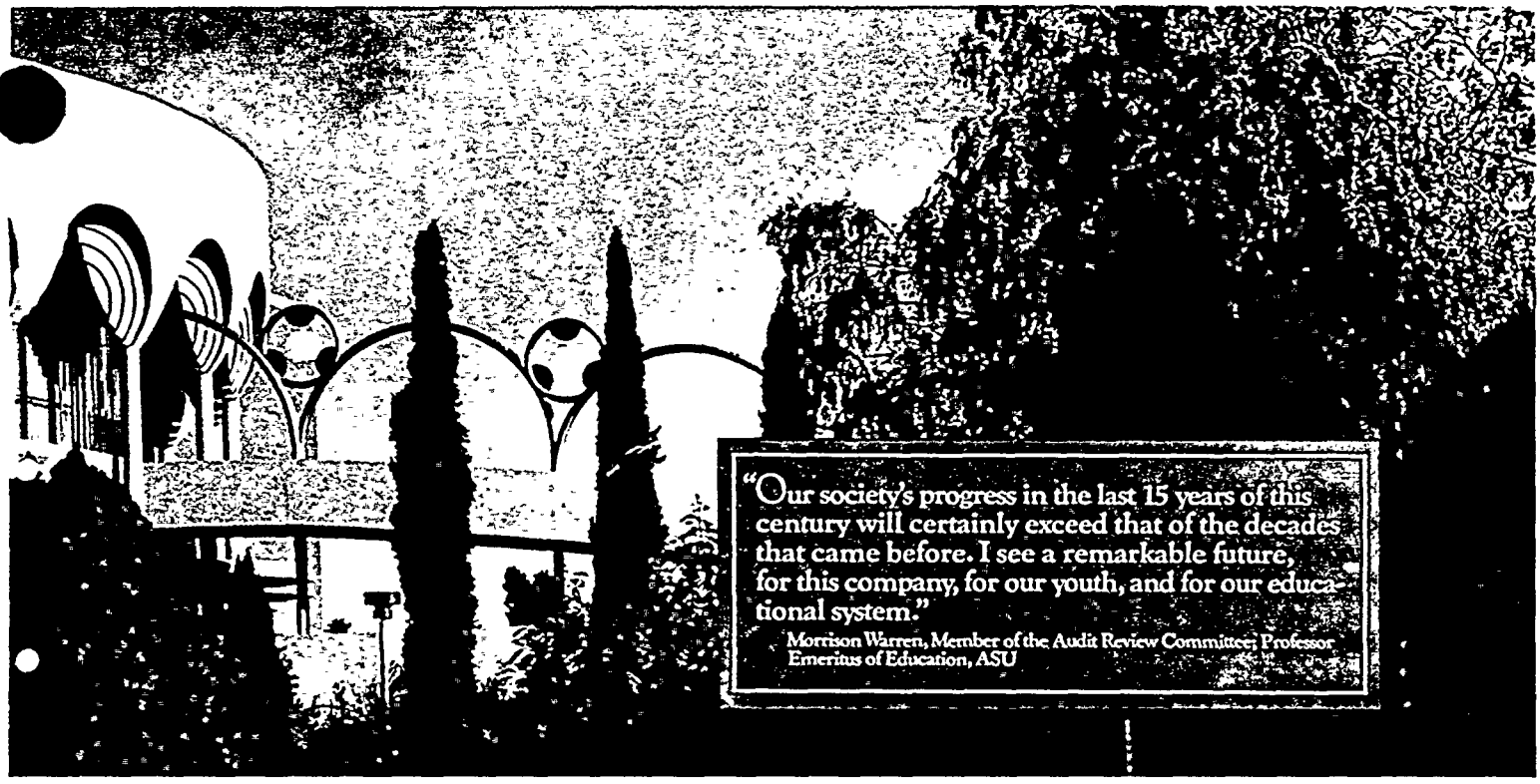
As a single-energy utility, we're competing more actively against several suppliers of natural gas. Early in 1985 we launched a series of programs designed to preserve electricity's share of the new-home market. In addition to working with builders and developers, we held educational seminars for real estate agents and targeted advertising and other programs directly to homebuyers.

We also began a program to increase the quality of our service and improve customer satisfaction with that service. One element, an up-graded, computer-based customer information system, went on line in April. The system puts more account information at our fingertips while reducing paperwork and improving data accuracy. It has been a big help in meeting the demands of today's consumer, who is much more aware of the value of products and services bought.

We believe that, if we are to keep our company living, working and growing, we must join in partnerships with those with whom we work and serve. This belief, which demands that we include in our business considerations many segments of our society, will continue to influence our efforts well into the future.

We have established a consumer advisory panel to help ensure that we are responsive to the needs and opinions of our customers; we are working with legislators to establish a lifeline program for low-income customers; we are contributing to a variety of cultural, educational, social and economic development activities; and we are encouraging and rewarding employee involvement in the communities we serve.

We also have made the commitment to further develop the human resources within our company. A new quality circle program that helps increase upward communication while improving our productivity has gained enthusiastic support throughout the company. Employees also continue to participate in a program which rewards them for submitting innovative ideas for cost savings or operational improvements. This program saved APS more than $2 million in 1985.



Our employees are working more safely, too. During 1985, time lost due to injury was cut in half from the previous year's mark, and the total number of injuries was reduced by 32 percent.

These kinds of efforts have inspired "Arizona People Serving You," a slogan introduced in early 1985 that emphasizes APS' corporate and employee strengths, our commitment to service, and our shared concern for Arizona's future.

Another long-standing philosophy at APS is our commitment to provide the best possible service at a fair and reasonable cost. The completion of Palo Verde is one way we're keeping that commitment. But beyond its ability to provide abundant electric energy, Palo Verde represents a real economic boost to Arizona.

A report published late in 1985 by Wharton Econometric Forecasting Associates says, in short, that Palo Verde is *good* for our state. Perhaps the largest contributing factor stems from the fact that Palo Verde is jointly-owned, built by seven Southwestern utilities serving customers in four states. Thus, while more than half of Palo Verde's costs are borne by those outside our state, Arizona enjoys the benefits of the project's construction and operating employment, wages, purchases of materials and supplies, tax payments and more.

But even with our share of Palo Verde's energy and the recapture of our Cholla 4 coal-fired unit — whose output is currently being sold to another utility — we will need additional generating capacity in the years ahead. Fortunately, with these major generating sources available, we will be able to pursue a more flexible approach to supplying tomorrow's energy.

And because cost is a significant factor, we will be looking to those energy sources that can help us avoid the need for major construction until after the turn of the

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century. That means development of technologies that offer shorter lead times, fewer risks and lower costs than are associated with conventional power plants. These may include trash-to-energy conversion, co-generation, thermal storage, and the development of additional hydroelectric power.

We'll also seek third-party financing of new generating units or regional transmission tie-lines.

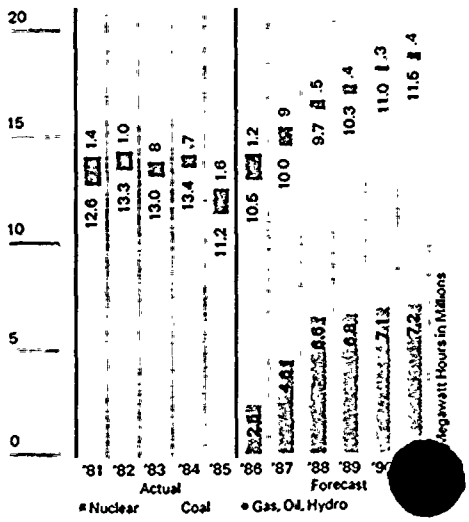
Meanwhile, we continue to lead the development of advanced solar technology with projects such as our 225-kilowatt solar photovoltaic facility at Sky Harbor International Airport, an experimental photovoltaic home located in the southwestern section of our state, and a new photovoltaic test facility to be located adjacent to our Ocotillo Generating Plant east of Phoenix.

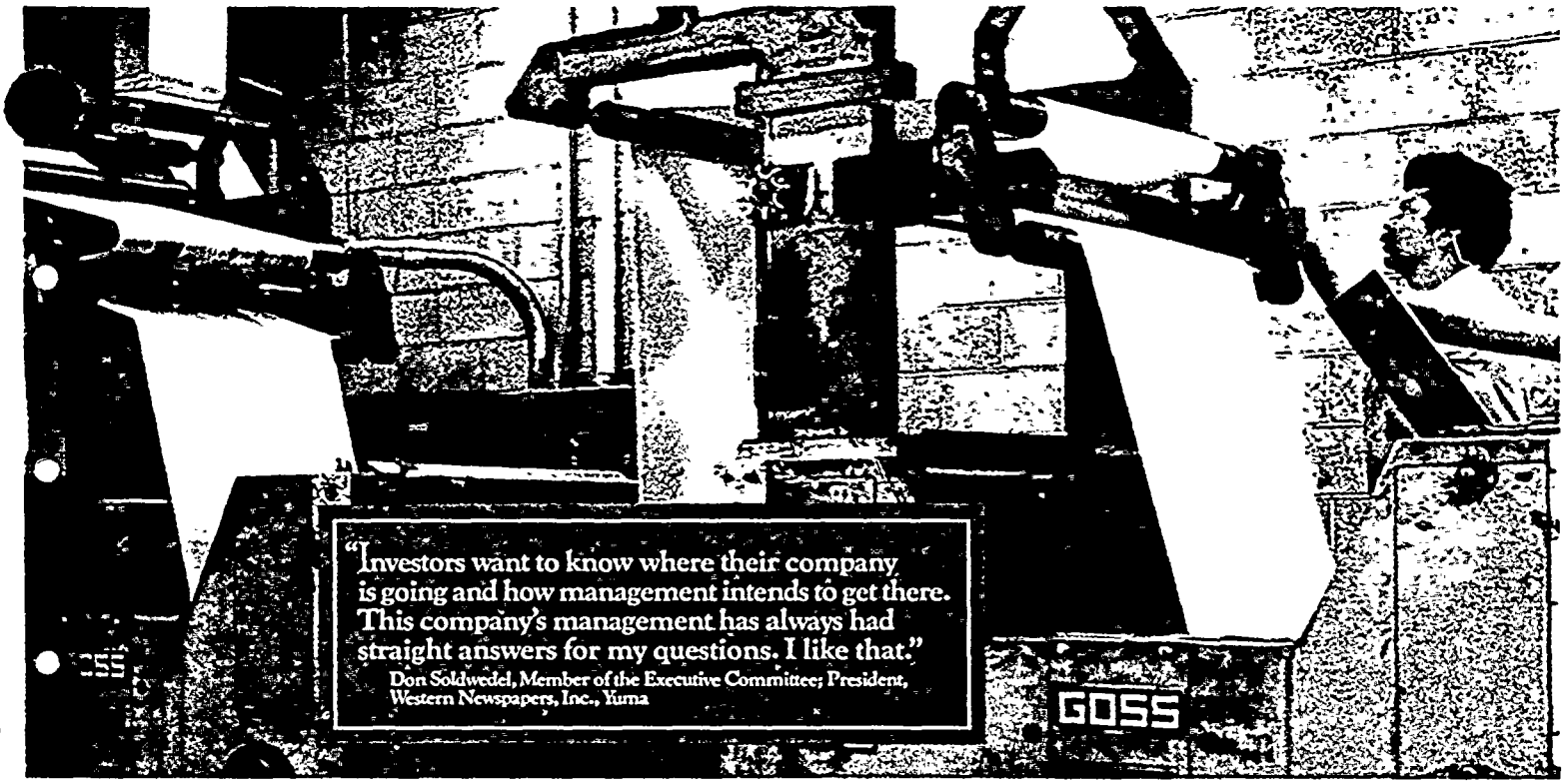
We work constantly to keep our system efficient and productive

We're working hard to get the most out of our existing power plants that were built at yesterday's lower construction costs. Our focus is on two major coal-fired plants: Four Corners, jointly owned with several western utilities; and Cholla, wholly owned by APS. These economical plants — together with our share of another coal-fired plant, Navajo — met 73.5 percent of our customers' energy requirements in 1985, while only about 10 percent was generated with more expensive gas and oil.

We have steadily increased the availability of these baseload units. In 1984 our coal-fired equivalent availability reached an all-time

Generation Fuel Mix Trend



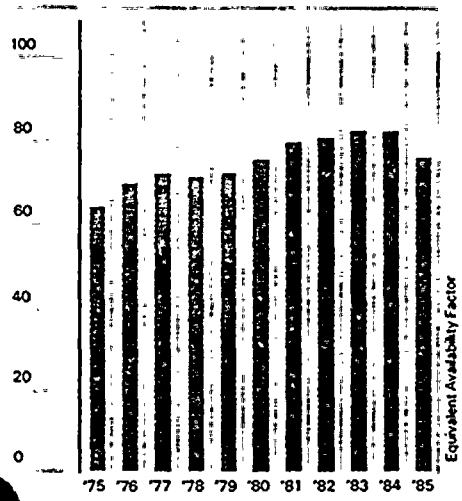


"Investors want to know where their company is going and how management intends to get there. This company's management has always had straight answers for my questions. I like that."

Don Soldwedel, Member of the Executive Committee; President, Western Newspapers, Inc., Yuma

high of 82.5 percent, though that figure was reduced to 76 percent in 1985. The drop was due largely to several major planned overhauls, and an extensive reheat steam line inspection of both Four Corners units 4 and 5, triggered by a serious accident at Southern California Edison's Mohave Power Plant.

Power Plant Performance—Total Coal Base



In March 1986 we will begin a $49 million project to replace obsolete coal pulverizers at Four Corners. This will reduce both planned and unplanned downtime.

We're also working to minimize substation and transmission system outages. Since 1982 we have nearly doubled the manhours devoted to maintaining lines and substations, we've increased system inspections, and have employed computers to more effectively schedule and track maintenance.

Portions of a new computer-based energy management system — to monitor and control the generation, transmission and distribution of our entire system — began operating early in 1985. The balance will be completed in 1986.

For all of these reasons, our construction requirements are going to be much lower in the future than they have been in the past few years. Over the last five years our construction budget has averaged nearly $400 million per year, but we see this figure declining to less than $300 million per year, on average, for the next five years.

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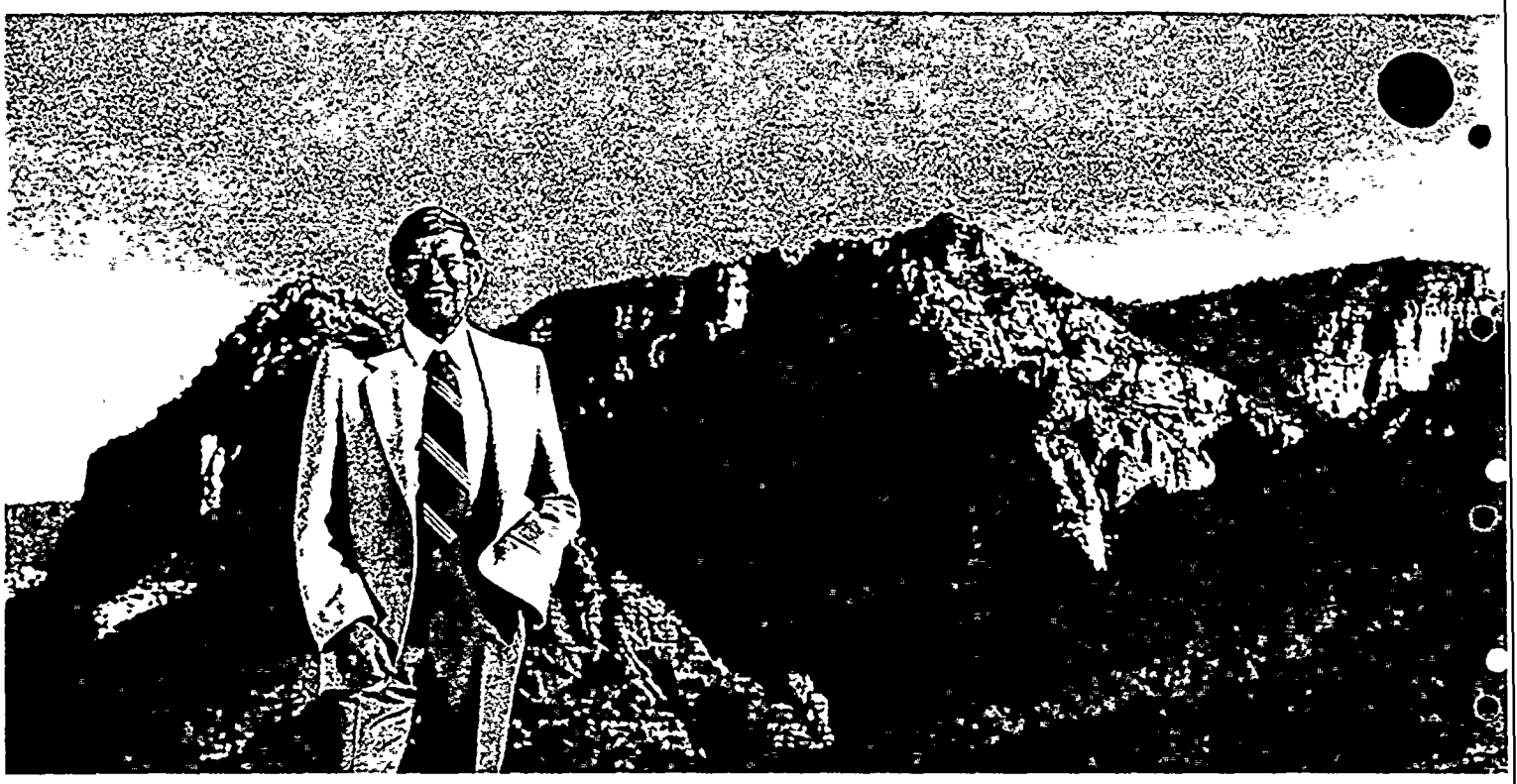


Lower interest rates, a positive revenue ruling from the Internal Revenue Service, and the ability to access a variety of financial markets contributed to a strong balance sheet in 1985.

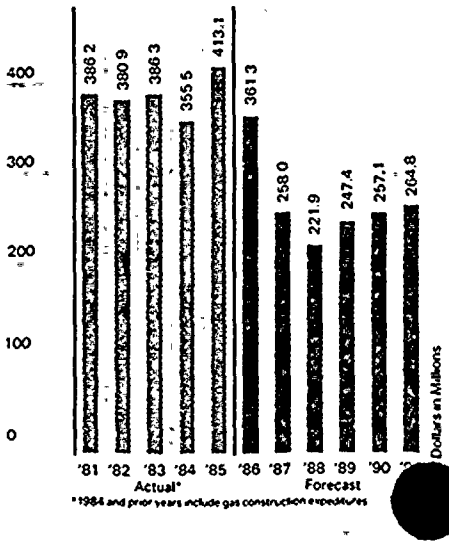
We saved more than $4 million in interest during the year by restructuring outstanding debt at lower interest rates and lengthened maturity schedules. The high-coupon issues refunded were a $50 million, 16.25 percent Eurobond and a $60 million pollution control bond.

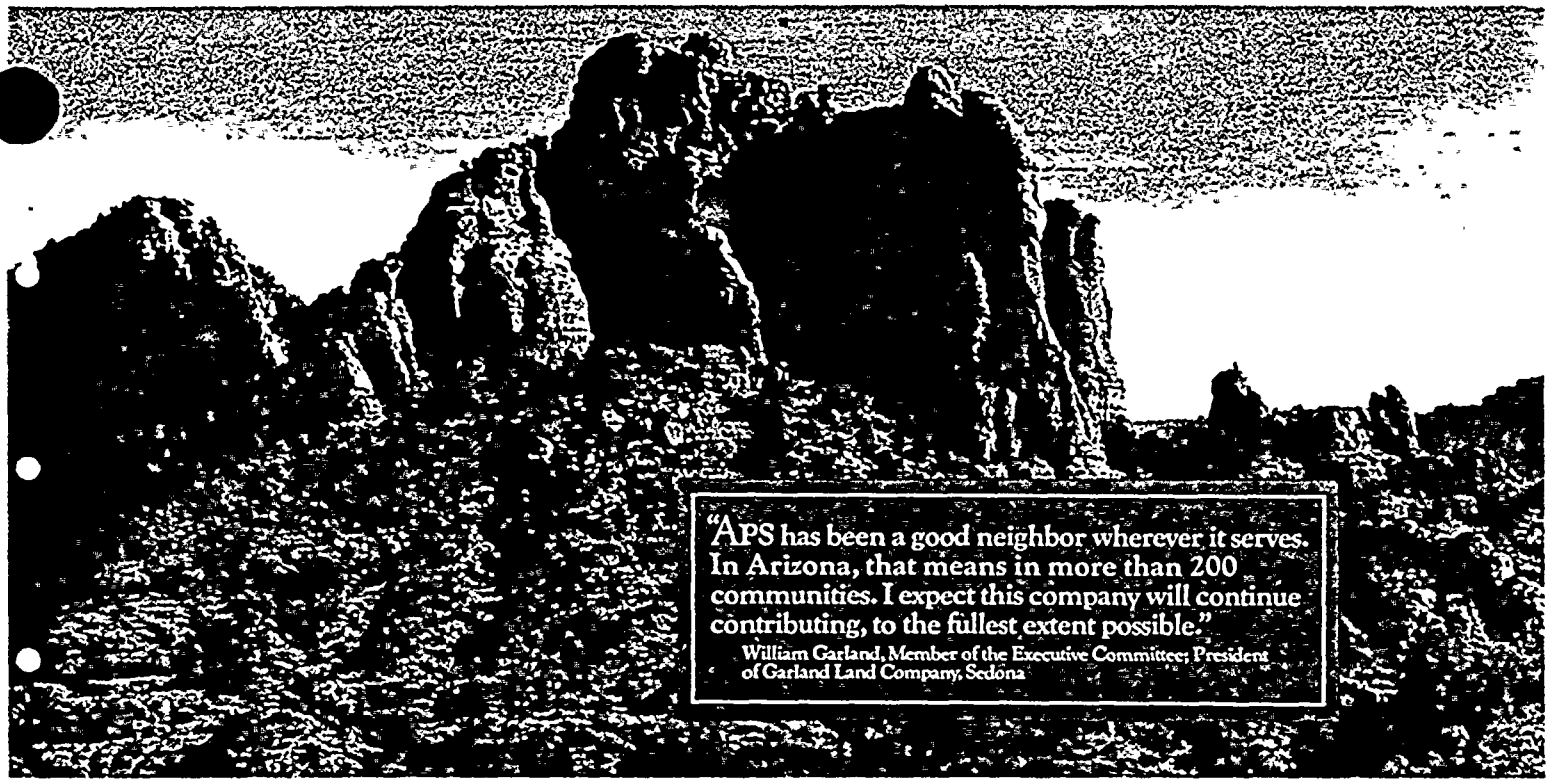
Later in the year, we received a favorable IRS ruling regarding the tax exempt status of $107 million in Palo Verde pollution control bonds. Those 6 percent bonds were used to refund several series of short-term bonds issued in 1984.

The most recent transaction involved the early redemption of a $75 million Eurobond, priced at 16.25 percent and a $25 million Eurobond, priced at 16 percent. Both Eurobonds were called in February 1986 at a slight premium. Proceeds to call the issues were raised through the sale of $100 million in 30-year first mortgage bonds issued in January 1986 at a coupon of 11 percent. This refunding alone will save us $5 million per year in interest.

APS was one of the few Triple B utilities able to enter the Eurobond Market within the last two years, and 1985 marked the first

Construction Expenditures (Excl. AFC)



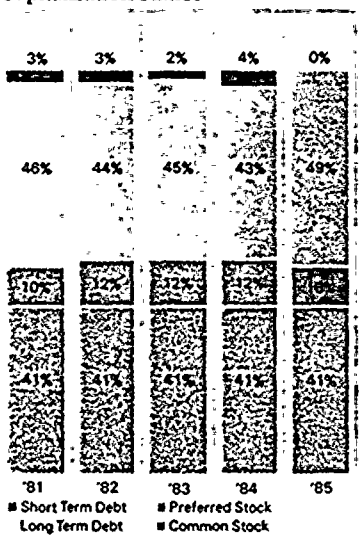


time in several years that APS issued any 30-year bonds.

Debt financing for the year, listed in order of issue date, included: a $125 million, 10-year domestic first mortgage bond at 12 percent; a $75 million, 7-year Eurobond at 12.5 percent; a $50 million 22-year first mortgage bond at 13.25 percent; a $150 million, 30-year first mortgage bond at 11.5 percent; and another $100 million, 30-year first mortgage bond at 11.5 percent.

Plans for 1986 include a $200 million credit facility to finance nuclear fuel inventory, and another bond issue later in the year.

Capitalization Ratios



Summary of 1985 Financings (APS)

Debt	Amount ($ Million)	Rate	Month Issued	Maturity Date
First Mortgage Bonds	$125.0	12%	January	1995
First Mortgage Bonds	$ 50.0	13¼%	May	2007
First Mortgage Bonds	$150.0	11½%	June	2015
First Mortgage Bonds	$100.0	11½%	November	2015
Eurobonds	$ 75.0	12½%	February	1992
Pollution Control Bonds	$ 49.4	Adjustable	January	2015
Pollution Control Bonds	$ 55.2	Adjustable	May	2014
Pollution Control Bonds	$107.0	Adjustable	September	2009

Despite APS' high financing requirements over the past few years, our objective has been to establish a capital structure of at least 40 percent common equity and less than 50 percent debt, with the balance consisting of preferred stock. At year's end we had a common equity ratio of over 41 percent, and a total debt ratio of only 49 percent.

AZP's dividend reinvestment plan should continue to provide sufficient equity to maintain this capital structure and, assuming reasonable regulatory treatment, we have no plans for any further public stock offerings in the foreseeable future.

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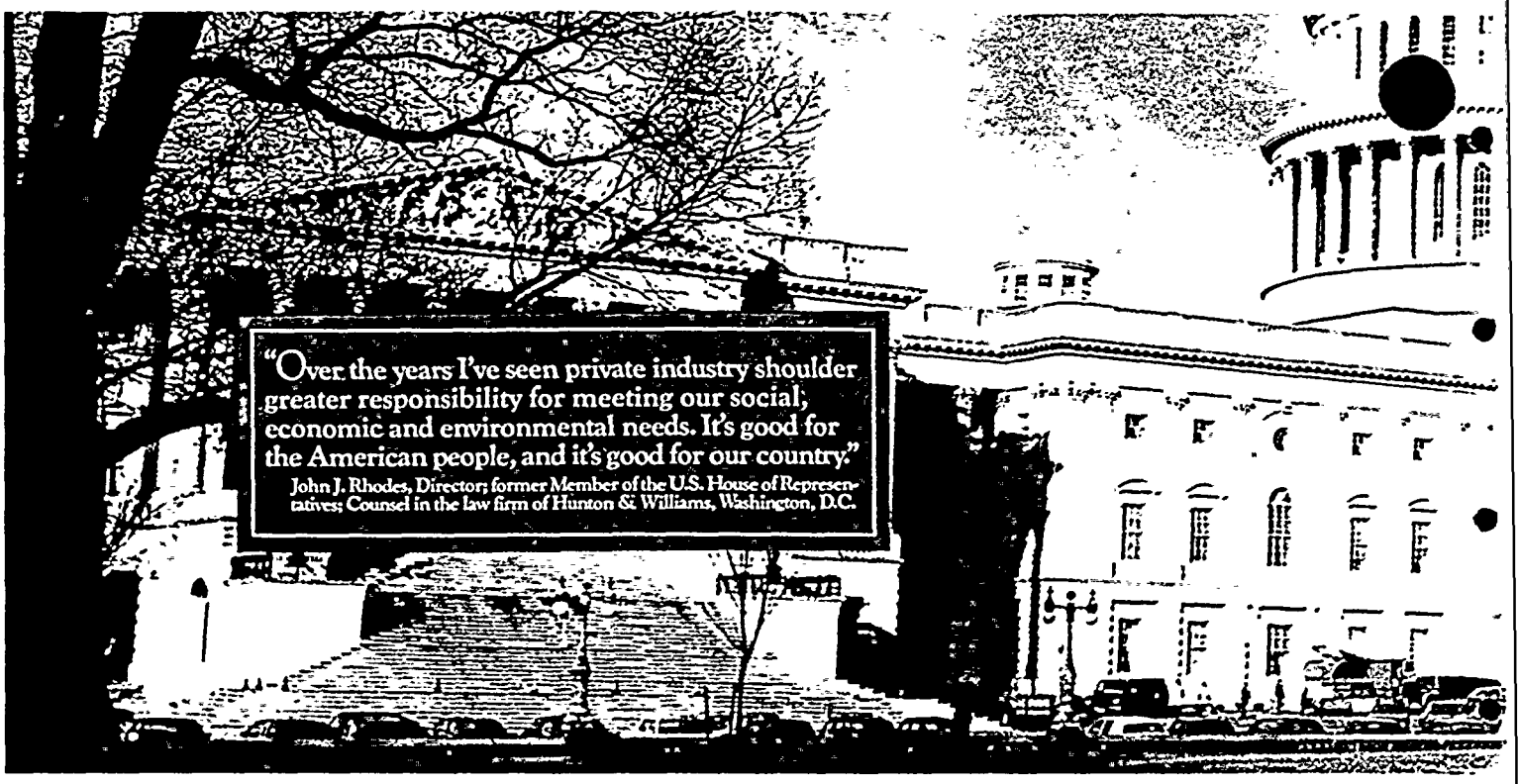

AZP GROUP, INC.

With the creation of AZP Group Inc. and the restructuring of our subsidiaries under the AZP parent company, we now have the opportunity to increase our earnings through non-regulated ventures.

The restructuring became official in April 1985 as AZP became the holding company for APS and three of its former non-utility related subsidiaries: Malapai Resources Company, Energy Development Company, Inc., and El Dorado Investment Company.

A primary goal in restructuring was to increase financial and operating flexibility by separating regulated and non-regulated businesses. This was largely completed in December 1985 when AZP paid off all notes owed APS for the purchase of the three non-regulated subsidiaries.

Future investments in the AZP dividend reinvestment plan will be allocated to the non-regulated subsidiaries, and possibly to APS. Allocations will be made so that each non-regulated subsidiary has the potential to contribute at least 10 percent of AZP's earnings within the next 5 to 10 years.

Since the restructuring, our emphasis has been on formulating long-term business strategies, developing and approving operating plans and budgets, and recruiting and hiring appropriate management personnel to direct our non-utility businesses.

MALAPAI RESOURCES COMPANY

Malapai Resources was formed in 1959 to locate and develop fuel reserves. It assumed its present name in 1981, and has since acquired investments in uranium properties.

Malapai's assets have increased by about 18 percent since the restructuring. This results from the buy out in late-1985 of the remaining interest in the Christensen Ranch uranium properties in Wyoming — representing uranium reserves of at least 32 million pounds — from Phelps Dodge's Western Nuclear Inc. subsidiary.

Malapai has secured contracts for the sale of uranium and is now preparing for commercial production of uranium during the late 1980s.

ENERGY DEVELOPMENT COMPANY (EDC)

EDC originated as an APS subsidiary in the 1960s and took on its present form after merging with two other APS subsidiaries in

1972. It is primarily involved in joint-venture real estate development and property sales.

EDC plans to invest in a real estate portfolio consisting of a balanced mix of development and income properties. Targets for investment include high quality projects throughout the country, with emphasis on the high-growth sunbelt region.

Financial analysis shows EDC as a high growth business with the potential to become a very profitable operation. Year-end 1985 assets totaled about $7 million, and the subsidiary is expected to produce positive net income in 1986.

EL DORADO INVESTMENT COMPANY

The El Dorado Investment Company was formed in 1983 for the purpose of making equity investments in other companies. Initial investments have included nuclear fuel-related ventures and investments in diversified funds.

El Dorado currently has assets of $22 million and it is earning some interest income. Its primary business focus is to become a major venture capital firm which is national in scope.

You have responded with enthusiasm to our efforts to improve communications between AZP management and its shareholders.

During 1985, company officers met with shareholders in Arizona, California, Texas, Massachusetts and Connecticut; 1986 meetings will be held in New York, Maryland, Colorado, Florida and Southern California. The theme of these meetings has been our commitment to maintain the security of dividends and increase AZP's long-term earnings potential.

Arizona shareholders are also getting a first-hand look at Palo Verde during special tours of the plant. The first tour was held in December 1985, and more tours are planned for early 1986.

Shareholders too far away to visit the plant can learn more about it and other company developments by calling our toll-free number, 1-800-457-2983. Representatives are available to answer questions about individual accounts or the company in general.

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FINANCIAL DATA 1985

SELECTED CONSOLIDATED FINANCIAL DATA

	1985	1984	1983	1982	1981
	(Dollars in Thousands, Except Per Share Amounts)				
Electric Operating Revenues	$ 1,174,502	$ 994,967	$ 871,875	$ 866,486	$ 730,788
Electric Operating Expenses:					
Operation and maintenance	447,985	358,665	349,150	349,975	311,479
Depreciation and amortization	99,221	87,494	83,707	79,676	70,988
Taxes[1]	320,312	285,548	185,606	173,736	98,597
Total	867,518	731,707	618,463	603,387	481,064
Operating Income	306,984	263,260	253,412	263,099	249,724
Other Income[1]	188,585	190,818	134,459	83,040	58,617
Interest and Other Deductions[2]	216,020	204,883	162,560	152,654	132,859
Income from Continuing Operations[2]	279,549	249,195	225,311	193,485	175,482
Income (Loss) from Discontinued Operations	—	(26,503)	(4,255)	2,742	(4,834)
Net Income[2]	$ 279,549	$ 222,692	$ 221,056	$ 196,227	$ 170,648
Total Assets	$ 5,324,945	$ 4,653,774	$ 4,386,312	$ 3,888,536	$ 3,396,790
Long-term Debt and Redeemable Preferred Stock of APS	$ 2,425,361	$ 1,967,486	$ 1,892,477	$ 1,610,486	$ 1,618,048
Common Stock Data:					
Book value per share	$ 25.36	$ 24.18	$ 23.78	$ 22.94	$ 22.13
Earnings (loss) per share (based on average shares outstanding):					
Continuing Operations	$ 3.88	$ 3.65	$ 3.53	$ 3.25	$ 3.36
Discontinued Operations	—	(0.39)	(0.07)	0.05	(0.10)
Total	$ 3.88	$ 3.26	$ 3.46	$ 3.30	$ 3.26
Dividends declared per share	$ 2.69	$ 2.60	$ 2.56	$ 2.40	$ 2.20
Shares of common					
—year-end	74,346,118	70,128,329	66,710,852	62,894,490	57,648,791
—average	72,126,618	68,308,131	63,865,210	59,549,685	52,289,259
Number of common shareholders	119,944	124,274	127,387	120,623	119,825

[1] Federal and State income taxes are included in Taxes and in Other Income.
Total income tax expense was as follows (in thousands): 1985, $164,360; 1984, $137,072; 1983, $93,930; 1982, $93,100; 1981, $19,876.

[2] Restated to give effect to corporate restructuring (See Note 2 to Consolidated Financial Statements).

OTHER FINANCIAL AND OPERATING STATISTICS

	1985	1984	1983	1982	1981
			(Thousands of Dollars)		
Capitalization:					
Common equity	$ 1,885,495	$ 1,695,923	$ 1,586,671	$ 1,442,639	$ 1,275,623
Non-redeemable preferred stock of APS	218,561	218,561	218,561	168,561	118,561
Redeemable preferred stock of APS	219,421	282,740	237,400	241,220	199,280
Long-term debt of APS	2,205,940	1,684,746	1,655,077	1,369,266	1,418,768
Total	$ 4,529,417	$ 3,881,970	$ 3,697,709	$ 3,221,686	$ 3,012,232
Utility Plant—Gross	$ 5,712,507	$ 5,088,243	$ 4,761,265	$ 4,198,466	$ 3,688,270
Utility Plant—Net	$ 4,873,823	$ 4,344,083	$ 4,033,400	$ 3,551,949	$ 3,111,773
Number of Employees at Year-End	8,324	7,358	7,642	7,047	6,231
Average Wage per Hour	$ 14.48	$ 13.61	$ 13.11	$ 12.27	$ 11.20
Electric:					
Electric resources (kw)	3,570,800	3,425,900	3,528,400	3,532,900	3,634,300
Peak load (kw)	3,197,800	2,970,600	2,899,000	2,898,700	3,018,700
Electric sales—total (mwh)	13,971,314	13,054,987	12,753,542	12,950,727	13,387,998
Number of customers at year-end	521,567	499,751	468,768	449,244	438,853

OPERATING REVENUES

	1985	1984	1983	1982	1981
			(Thousands of Dollars)		
Electric					
Residential	$ 438,265	$378,536	$314,404	$294,498	$252,907
Commercial	401,439	343,971	296,364	286,262	238,975
Industrial	135,254	126,187	122,184	128,464	113,736
Irrigation	22,853	25,540	15,113	23,391	22,916
Other	97,728	86,394	90,118	92,490	81,565
Total	1,095,539	960,628	838,183	825,105	710,099
Transmission for others	16,602	13,023	12,555	11,104	9,173
Miscellaneous services	62,361	21,316	21,137	30,277	11,516
Total Operating Revenues	$1,174,502	$994,967	$871,875	$866,486	$730,788

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Liquidity and Capital Resources

The primary factor in AZP's current liquidity and capital resources is APS' ability to fund its capital requirements. Consequently, the following discussion will address APS' liquidity and capital resources.

APS' large capital requirements for its on-going construction program and for the refunding of maturing securities, and its heavy reliance on external financing to meet those requirements, are discussed earlier in this report and in Notes 5 and 6 of Notes to Consolidated Financial Statements. APS has a degree of flexibility in adjusting its construction program to its financing capability. However, that flexibility is limited, and APS' long-term liquidity will depend on its access to the capital markets, which in turn will depend on sufficiency of APS' rates to provide adequate coverages on its senior securities and an adequate rate of return on common stock equity. Adequate earnings and coverages are critical to the maintenance of satisfactory credit ratings on APS' senior securities, and, as calculated in accordance with the governing instruments, are prerequisite to APS' legal ability to issue such securities.

See page 22 with respect to AZP's capital structure at December 31, 1985. Its target structure consists of no more than 50% debt (including current maturities and short-term obligations) and 40% common stock equity, with the balance consisting of preferred stock. AZP regards common stock equity as its most expensive form of permanent financing, but it intends to maintain that category at approximately the 40% level in order to support the credit ratings on APS' senior securities. If interest and dividend rates on new issues of long-term debt and preferred stock rise in the future, APS' average cost of capital will rise accordingly.

See Note 7 of Notes to Consolidated Financial Statements with respect to short-term borrowings available to APS (there being a statutory limitation on the amount of such borrowings that APS can have outstanding without consent from the ACC). Funds from operations after the payment of dividends have contributed only marginally to total sources of funds in the last few years (see Consolidated Statements of Changes in Financial Position). This situation is expected to continue to some degree until Palo Verde Unit 1 is fully included in rate base so as to give rise to additional cash earnings. APS' retention of funds from operations has also been affected by its policy of increasing common stock dividends periodically.

On February 13, 1986, the date Unit 1 attained commercial operation as defined by the ACC, APS ceased accruing AFC with respect to Unit 1 and the facilities common to all three Palo Verde units (the "Common Facilities"), currently totalling approximately $6 million per month. In addition, APS began expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 1 and the Common Facilities, currently estimated at $5 million per month. Absent adequate and timely rate relief from the ACC, APS expects these developments to adversely affect its earnings.

APS is seeking an accounting order from the ACC allowing the Common Facilities to be transferred to plant in service in three steps, each tied to the commercial operation date of each Palo Verde Unit, with the continuance of a carrying charge equivalent to AFC on any portion which has not been transferred to plant in service. If the ACC grants such accounting order, APS would be able to accrue approximately $1 million of such carrying charge per month on each of the remaining two portions of the Common Facilities which have not been transferred to plant in service as a result of Palo Verde Units 2 or 3 attaining commercial operation. In addition, APS would be able to defer expensing the cost of owning its 29.1% share of each of the remaining two portions of the Common Facilities which have not yet been transferred to plant in service as a result of Palo Verde Units 2 or 3 attaining commercial operation, each portion currently totalling approximately $.3 million per month.

APS has also requested the ACC to issue an accounting order which would allow APS to defer expensing the cost of Unit 2 and to continue the accrual of a carrying charge equivalent to AFC from the commencement of the commercial operation of Unit 2 until the date on which APS is allowed to recover these costs. If the ACC does not grant the requested accounting order relating to Unit 2, when Unit 2 achieves commercial operation (currently scheduled for the third quarter of 1986) APS will cease accruing AFC (and will not be able to accrue an equivalent carrying charge) with respect to Unit 2, currently totalling approximately $6 million per month. In addition, APS will begin expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 2, currently estimated at $3 million per month. If the ACC does not grant the requested accounting order with respect to Unit 2 or grant adequate and timely rate relief with respect to Unit 2, APS expects its earnings to be adversely affected.

Operating Results

The Company's subsidiaries, other than APS, are not considered material to an understanding of the Company's operating results. Consequently the following discussion will address only APS' operating results.

Total operating revenues reflect the effects of rate increases and adjustment clauses (see Note 1c of Notes to Consolidated Financial Statements) on prices of units sold. Operating revenues also reflect the volume changes in unit sales shown on page 22. The foregoing factors contributed to annual increases in electric revenues over the preceding calendar year as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Energy related:			
Volume increases (1)	$ 71,169	$ 29,216	$ 13,438
Price increases (decrease) (2)	63,742	93,229	(360)
Non-energy related:			
Revenue increases (decrease) (3)	44,624	647	(7,689)
Net increase	$179,535	$123,092	$ 5,389

(1) Calculated by summing the products derived by multiplying the year-to-year increases in units sold in each customer class by the weighted average of the applicable rate levels in effect for the prior year.
(2) Calculated by summing the products derived by the year-to-year increases in the weighted average of rate levels in each customer class times the applicable number of units sold in the current year. Relative contributions by rate increases and by effects of APS' fuel adjustment clauses vary according to the timing of general rate proceedings and the extent to which accumulated effects of the adjustment clauses are incorporated in new rates.
(3) Includes revenues for miscellaneous service and transmission for others.

The increase in volume-related electric revenues in 1985 was primarily due to higher sales in the residential and commercial classes. These sales increases were mainly the result of customer growth and the warmer weather conditions experienced during the summer of 1985. In addition, there were increased industrial sales to the copper industry. Unit sales of electricity increased in 1984 primarily due to customer growth in the residential and commercial classes and more humid weather conditions, partially offset by decreased industrial and resale sales. The increase in unit sales of electricity in 1983 was primarily due to customer growth in the residential and commercial classes partially offset by decreased retail and resale irrigation usage resulting from the U.S. Government's Payment-In-Kind Program. Conservation efforts by customers in response to higher energy costs have affected unit sales, are expected to continue to do so, and are being aided by APS' own load-management programs. The year-to-year changes in non-energy relat electric revenues reflect changes in the capacity sold to other utilities.

Although unit fuel costs have continued to rise, APS' cost of fuel per kilowatt-hour generated has been tempered by the large portion of coal in the fuel mix. See Note 1c of Notes to Consolidated Financial Statements with respect to the treatment of increased unit fuel costs and the increase in APS' deferred fuel account. In 1985, increases in fuel expenses were primarily due to increased gas generation. In 1984, the slight increases in fuel expenses reflects increases in the unit costs of fuel for generation partially offset by an improved fuel mix and high capacity factors at APS' coal-fired plants.

Variations in purchased power and interchange-net reflect varying degrees of availability of relatively low-priced power from other sources including energy available from testing of APS' nuclear generating unit, the need for APS to augment its own generating sources from time to time, and APS' ability to sell energy to neighboring utilities. In 1985, an increase in purchased power and interchange-net was primarily due to increased purchased power requirements and reduced interchange sales to other utilities. This increase was largely offset by the accounting treatment for APS' fuel and purchased power expense (discussed in Note 1c of Notes to Consolidated Financial Statements). The increase in p chased power and interchange-net expense in 1984 was primarily due to accounting treatment for fuel and purchased power which was largely offset by increased interchange sales to other utilities.

See "Effects of Inflation" below in regard to maintenance expense, which is also a function of the size of APS' utility plant and is affected by the timing of major overhauls. The increase in operations excluding fuel expense in 1985 was due in large part to increased payroll, associated expenses related to customer growth, and an addition to the reserve for uncollectibles resulting from an unpaid note.

Depreciation and amortization expenses and ad valorem taxes increase with the size of APS' utility plant. See Note 12 of Notes to Consolidated Financial Statements for both ad valorem and sales taxes (the latter being a function of operating revenues), which are the principal components of other taxes.

The increases in income taxes and deferred income taxes in 1985 and 1984 were largely a result of APS' compliance with an ACC accounting order, effective October 1, 1983, the aggregate effect of which was to require APS to normalize substantially all income tax timing differences (see Note 1e of Notes to Consolidated Financial Statements).

The aggregate amount of AFC, shown as other income and a credit to interest deductions, is primarily a function

of the amount of construction work in progress during any given period and ceases to accrue on those portions of construction work in progress that are included in rate base. See Note 1d of Notes to Consolidated Financial Statements for changes in rates of AFC. See "Liquidity and Capital Resources" above with respect to the non-cash aspect of AFC.

The increase in interest on long-term debt in both 1985 and 1984 reflects large amounts of new borrowings. See "Liquidity and Capital Resources" above and Note 6 of Notes to Consolidated Financial Statements. The decrease in interest on short-term borrowings in 1985 resulted primarily from decreased borrowings. The increase in 1984 was due primarily to increased borrowings over the previous years.

Consolidated net income represents a composite of cash and non-cash items (see Consolidated Statements of Changes in Financial Position) and, in part, reflect accounting practices unique to regulated public utilities.

As described in Note 13 of Notes to Consolidated Financial Statements, APS sold its gas distribution system, effective November 1, 1984. Accordingly, 1983's Consolidated Statement of Income has been reclassified to report separately this discontinued operation.

Effects of Inflation

In contrast to the analysis of increases in operating revenues in the table at the beginning of "Operating Results" above, it is sometimes difficult, in the case of operation and maintenance expenses, to distinguish between effects of volume increases and rises in unit costs (which, for purposes of this discussion, are all attributed to inflationary pressures).

Certain inflationary effects, such as those on costs of generating fuel, are passed through to customers pursuant to rate adjustment procedures (see Note 1c of Notes to Consolidated Financial Statements). Nevertheless, APS attempts to minimize such effects by means that include increasing the availability of its coal-fired units to result in a more economical fuel mix. This increase has been achieved by an intensive maintenance program, the cost of which is not covered by the adjustment clauses. There are a number of other major expense items that are also beyond the scope of the adjustment clauses. Inflationary pressures on these items have given rise to a significant earnings attrition between general rate increases. See earlier discussion with respect to APS' most recent rate filings.

See Note 15 of Notes to Consolidated Financial Statements for perspectives on other effects of inflation.

ACCOUNTANTS' OPINION

AZP Group, Inc.:

We have examined the consolidated balance sheets of AZP Group, Inc. and its subsidiaries as of December 31, 1985 and 1984 and the related consolidated statements of income and retained earnings and of 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, such consolidated financial statements present fairly the financial position of AZP Group, Inc. and its 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.

Deloitte Haskins & Sells

Phoenix, Arizona
February 20, 1986

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

	Year Ended December 31,		
	1985	1984	1983
	(Dollars in Thousands, Except Per Share Amounts)		
Electric Operating Revenues	$ 1,174,502	$ 994,967	$ 871,875
Fuel Expenses:			
Fuel for electric generation	219,575	186,276	185,504
Purchased power and interchange—net	16,789	6,647	6,454
Total	236,364	192,923	191,958
Operating Revenues Less Fuel Expenses	938,138	802,044	679,917
Other Operating Expenses:			
Operations excluding fuel expenses	122,751	97,535	94,511
Maintenance	88,870	68,207	62,681
Depreciation and amortization	99,221	87,494	83,707
Income taxes (Note 9)	216,036	191,100	103,186
Other taxes (Note 12)	104,276	94,448	82,420
Total	631,154	538,784	426,505
Operating Income	306,984	263,260	253,412
Other Income (Deductions):			
Allowance for equity funds used during construction	143,612	134,359	121,390
Income taxes (Note 9)	51,676	54,028	9,256
Other—net	(6,703)	2,431	3,813
Total	188,585	190,818	134,459
Income Before Interest And Other Deductions	495,569	454,078	387,871
Interest And Other Deductions:			
Interest on long-term debt	209,220	191,079	170,8[illegible]
Interest on short-term borrowings	6,951	12,281	11,430
Debt discount, premium and expense	3,613	2,465	1,959
Allowance for borrowed funds used during construction	(48,176)	(49,317)	(65,400)
Preferred stock dividend requirements of APS (Note 2)	44,412	48,375	43,741
Total	216,020	204,883	162,560
Income From Continuing Operations	279,549	249,195	225,311
Loss From Disposal and Operation of Discontinued Gas System, Net of Tax (Note 13)	—	(26,503)	(4,255)
Net Income (Note 2)	279,549	222,692	221,056
Retained Earnings At Beginning Of Year	505,414	459,962	401,723
Deduct:			
Common stock dividends (Notes 4 and 5)	194,091	177,240	162,817
Retained Earnings At End Of Year	$ 590,872	$ 505,414	$ 459,962
Average Common Shares Outstanding	72,126,618	68,308,131	63,865,210
Per Share of Common Stock:			
Earnings (Loss) (based on average shares outstanding):			
Continuing operations	$ 3.88	$ 3.65	$ 3.53
Discontinued operations	—	(0.39)	(0.07)
Total	$ 3.88	$ 3.26	$ 3.46
Dividends declared	$ 2.69	$ 2.60	$ 2.56

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Source of Funds:			
Funds from operations:			
Continuing operations:			
Income from continuing operations	$ 279,549	$249,195	$225,311
Principal non-fund charges (credits) to income:			
Depreciation and amortization	99,221	87,494	83,707
Allowance for equity funds used during construction	(143,612)	(134,359)	(121,390)
Deferred income taxes—net	106,158	43,464	27,033
Deferred investment tax credit—net	36,383	56,002	29,960
Other	31,361	(385)	4,967
Total funds from continuing operations	409,060	301,411	249,588
Funds from discontinued gas system—net	—	(3,093)	5,116
Total funds from operations	409,060	298,318	254,704
Funds from external sources:			
Proceeds from sale of gas system	—	114,657	—
Common stock	104,114	63,800	86,918
Preferred stock of APS	—	50,000	48,875
Long-term debt of APS	745,030	264,179	419,126
Other items—net	(1,616)	(3,916)	4,141
Total funds from external sources	847,528	488,720	559,060
Total source of funds	$1,256,588	$787,038	$813,764
Application of Funds:			
Funds used for capital expenditures:			
Continuing operations	$ 494,105	$377,278	$425,130
Discontinued operations	—	31,657	29,724
Investments and other assets	22,976	(13,299)	(4,955)
Short-term borrowings—net	141,800	(73,492)	3,308
Repayment of long-term debt of APS	275,421	275,833	185,653
Redemption of redeemable preferred stock of APS	63,319	4,660	3,820
Dividends on common stock	194,091	177,240	162,817
Increase in working capital*	64,876	7,161	8,267
Total application of funds	$1,256,588	$787,038	$813,764
Increase (Decrease) in Working Capital*:			
Cash and temporary cash investments	$ 4,876	$ (25,704)	$ 24,801
Accounts receivable	21,940	(2,216)	(950)
Materials, supplies and fuel	(1,147)	(1,420)	(2,760)
Deferred fuel and other assets	71,245	(4,191)	(2,048)
Accounts payable and accrued expenses	(38,174)	32,881	(23,904)
Other liabilities	6,136	7,811	13,128
Net increase	$ 64,876	$ 7,161	$ 8,267

*Excluding short-term borrowings—net and current maturities of long-term debt.

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

Assets	December 31, 1985	1984
	(Thousands of Dollars)	
Utility Plant (Notes 6 and 8):		
Electric plant in service	$2,929,926	$2,747,464
Construction work in progress	2,742,139	2,304,306
Plant held for future use	40,442	36,473
Total Utility Plant	5,712,507	5,088,243
Less accumulated depreciation and amortization	838,684	744,160
Utility Plant—net	4,873,823	4,344,083
Investments and Other Assets:		
Investments in and receivables from subsidiaries	84,253	61,693
Other investments and notes receivable	6,004	5,588
Total Investments and Other Assets	90,257	67,281
Current Assets:		
Cash	7,338	7,565
Temporary cash investments	5,100	—
Special deposits and working funds	3,342	3,339
Accounts receivable:		
Service customers	84,533	70,560
Other	43,257	35[illegible]
Allowance for doubtful accounts	(1,395)	(1[illegible]
Materials and supplies (at average cost)	41,525	42,942
Fuel (at average cost)	30,433	30,163
Deferred fuel	74,335	927
Other	3,873	6,036
Total Current Assets	292,341	195,427
Deferred Debits:		
Unamortized gas exploration costs	10,417	12,967
Unamortized debt issue costs	16,705	13,931
Other	41,402	20,085
Total Deferred Debits	68,524	46,983
Total	$5,324,945	$4,653,774

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

Liabilities	December 31, 1985	1984
	(Thousands of Dollars)	
Capitalization (Notes 2, 4, 5 and 6):		
Common stock, no par value, authorized 100,000,000 shares; issued & outstanding 74,346,118 in 1985 and 70,128,329 in 1984	$1,294,623	$1,190,509
Retained earnings	590,872	505,414
Common stock equity	1,885,495	1,695,923
Non-redeemable preferred stock of APS	218,561	218,561
Redeemable preferred stock of APS	219,421	282,740
Long-term debt of APS less current maturities	2,205,940	1,684,746
Total Capitalization	4,529,417	3,881,970
Current Liabilities:		
Notes payable	—	1,800
Commercial paper	18,000	158,000
Current maturities of long-term debt (Note 6)	17,456	70,890
Accounts payable	87,121	68,090
Accrued taxes	52,296	49,348
Accrued interest	72,678	55,906
Accrued dividends of APS	3,566	4,143
Other	26,269	32,405
Total Current Liabilities	277,386	440,582
Deferred Credits and Other:		
Deferred income taxes	230,553	110,821
Deferred investment tax credit	174,503	138,120
Unamortized credit related to sale of tax benefits (Note 9)	43,645	45,333
Customers' advances for construction	23,991	21,351
Other	45,450	15,597
Total Deferred Credits and Other	518,142	331,222
Commitments and Contingencies (Notes 3 and 11)		
Total	$5,324,945	$4,653,774

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies.

a. Consolidation—The consolidated financial statements of AZP Group, Inc. (the "Company" or "AZP") include the accounts of AZP and its principal subsidiary, Arizona Public Service Company ("APS") and those of APS' wholly-owned subsidiaries, APS Finance Company N.V. ("Finance"), organized to serve as a financing corporation to raise funds outside the United States of America, and APS Fuels Company, organized to manage investments in certain fuel resources. All significant intercompany balances and transactions have been eliminated. Other AZP subsidiaries, which are shown on the equity basis, are not considered material for financial reporting purposes.

b. Plant and depreciation—Utility property is stated at original cost as defined for regulatory purposes. The cost of additions to utility plant and replacements of retirement units is capitalized. Replacements of minor items of property are charged to expense as incurred. In addition to direct costs, capitalized items include the present value of certain future lease payments (see Note 6), research and development expenditures pertaining to construction projects, indirect charges for engineering, supervision, transportation and similar costs, and an allowance for funds used during construction. Costs of depreciable units of plant retired are eliminated from plant accounts and such costs plus removal expenses less salvage are charged to accumulated depreciation. Contributions in aid of construction are credited to plant cost.

Depreciation on utility property is provided on a straight-line basis at rates authorized by the Arizona Corporation Commission ("ACC") annually. The applicable rates for 1983 through 1985 ranged from 2.86% to 9.86% for electric plant.

c. Revenues and fuel costs—Operating revenues are recognized when billed on a monthly cycle billing basis. Retail rate schedules include adjustment clauses which permit recovery of costs of certain fuel and purchased power. Regulatory hearings are held periodically to adjust the rates applicable under fuel adjustment clauses to more nearly match actual fuel costs. Temporary net under- or over-recoveries of costs resulting from application of the adjustment clauses are recognized as a deferred fuel asset or liability, respectively, with an offsetting amount recognized in purchased power and interchange—net expense. See Note 3 for a discussion of current rate matters related to such clauses.

d. Allowance for funds used during construction—In accordance with the regulatory accounting practice prescribed by the FERC and the ACC, APS capitalizes an allowance for the cost of funds used to finance its construction program ("AFC"). AFC, which does not represent current cash earnings, is defined as the net cost during the period of construction of borrowed funds and a reasonable rate of return on equity funds so used. The calculated amount is capitalized as a part of the cost of utility plant.

AFC has been calculated using composite rates of 12.75% in 1985 and 1984 and 13% in 1983. In July 1983 APS began compounding AFC semi-annually and, in October 1983, recording the borrowed funds portion on a "net of tax" basis through charges to income taxes—operating expense and credits to income taxes—other income. AFC ceases to accrue on those portions of construction work in progress allowed in rate base.

e. Income taxes—APS uses accelerated depreciation methods for income tax purposes. As prescribed by the ACC, deferred income taxes are provided for certain timing differences arising from the recording, for income tax and financial reporting purposes, of depreciation of property placed in service after January 1, 1977. In October 1983 in accordance with an ACC order, APS began deferring amounts equal to the change in income taxes arising from substantially all other timing differences. Prior to October 1983, such differences were reflected currently in income. At December 31, 1985 APS had flowed to income currently approximately $271,600,000 of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

In 1982 APS, in compliance with an ACC order, began deferring amounts equal to the reduction in Federal income taxes arising from investment tax credits and amortizing these amounts to other income over the estimated life of the related assets. Before 1982 such amounts were flowed through income currently.

f. Research and development costs—Research and development costs are expensed on a current basis, except that costs which may result in additions to utility plant are deferred for subsequent inclusion in plant or to be written off if the applicable project is abandoned.

g. Gas exploration costs—The excess of costs over sales proceeds of APS' discontinued gas exploration program has been deferred to be recovered, without interest, over a ten-year period pursuant to an order of the ACC, from

certain classes of customers. A portion of such amount is now being remitted to APS by Southwest Gas Corporation as a result of the sale of the gas distribution system in 1984. See Note 13.

h. Discontinued operations—As described in Note 13, APS sold its gas distribution system, effective November 1, 1984. Accordingly, 1983's statement of income has been reclassified to report separately this discontinued operation.

2. Corporate Restructuring.

On April 18, 1985, APS' shareholders approved a plan for corporate restructuring to provide financial and organizational flexibility by separating regulated utility operations from other activities. Effective April 29, 1985, APS became a subsidiary of AZP.

As part of the restructuring, APS sold to AZP, at book value, the common stock of three of APS' wholly-owned subsidiaries: Malapai Resources Company, Energy Development Company and El Dorado Investment Company.

The accompanying consolidated financial statements have given effect to the restructuring for all periods presented. Accordingly, the preferred dividend requirements of APS are classified as Interest and Other Deductions. Except for this change, the restructuring had no material effect on the historical financial statements. The corporate restructuring also had no effect on the ownership of APS preferred stock or on APS debt securities.

3. Rate Matters.

In 1984, a committee comprised of representatives from each of the state utility regulatory commissions having primary jurisdiction over the rates of the various regulated participants in the Arizona Nuclear Power Project commissioned a study to determine whether sufficient evidence exists to warrant a prudency audit of costs incurred for construction. In September, 1985, the committee concluded that an audit should be performed relating to $3.12 billion of material and labor costs, of which APS' share is approximately $900 million, as well as financing and certain indirect costs related to the project. The prudency audit is expected to begin in 1986 with recommendations expected in late 1986 or 1987. Any amounts subsequently deemed by the ACC imprudently spent and not allowed in rate base would be written off. Although the Company is unable to predict the final outcome of this matter, management believes, based on current information, that overall the Palo Verde Nuclear Generating Station (Palo Verde) was constructed in a prudent manner.

On February 11, 1986, hearings commenced concerning costs deferred by APS through the operation of its purchased power and fuel adjustment clause. In August, 1985, the ACC granted a rate increase sufficient only to limit the increase in the accumulated balance of such costs and agreed to hear testimony in connection with the accumulated balance (approximately $74 million at December 31, 1985) in early 1986. To date no order has been received. Management believes that any ultimate disallowance of such cost should not be material to the Company's operation or financial position.

As an incentive to complete construction and commence operation of Palo Verde, the ACC in a November, 1984 order, placed a cap on total construction costs. The cap was set at $2.86 billion. Amounts expended in excess of the cap are presumed to be imprudent under the Commission's order. The most recent estimate of APS' share of total Palo Verde construction costs is $2.76 billion.

On May 24, 1985, APS filed with the ACC a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 1. Unit 1 commenced commercial operation on February 13, 1986, and APS began incurring such costs at that time. Also requested was an accounting order allowing the deferral until 1987 of the costs of commercial operation of Palo Verde Unit 2 which is expected to commence commercial operation in the third quarter of 1986. A hearing on this request has been scheduled for March 27, 1986.

On December 18, 1985, APS filed a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 2. As requested by the ACC, APS proposed as an alternative to a one step increase, and subject to certain conditions precedent, that the costs of commercial operation of Unit 2 be phased in over a period of years. The hearing date for the Unit 2 phase of the case has been set for September 26, 1986.

4. Non-Redeemable Preferred Stock of APS and Common Stock of AZP.

The balances at December 31, 1985 and 1984 of preferred stock of APS which is not redeemable except pursuant to call by APS at its option, are shown below.

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding at December 31,			Outstanding at December 31,		
	Authorized	1985	1984	Per Share	1985	1984	
					(Thousands of Dollars)		
Non-Redeemable Preferred Stock of APS (cumulative):							
$1.10 preferred	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000						
$2.40 Series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 Series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 Series D		200,000	200,000	50.00	10,000	10,000	50.50
$3.25 Series E		320,000	320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(b)						
$8.32 Series J		500,000	500,000	100.00	50,000	50,000	(c)
Adjustable rate series Q.....		500,000	500,000	100.00	50,000	50,000	(d)
Serial preferred	10,000,000						
$3.58 Series O		2,000,000	2,000,000	25.00	50,000	50,000	(e)
Total		4,374,199	4,374,199		$218,561	$218,561	

(a) In each case plus accrued dividends.

(b) This authorization also covers outstanding redeemable preferred shares shown in Note 5, as well as the non-redeemable shares indicated above.

(c) At $105.50 through August 31, 1987; at $103.00 through August 31, 1992; and at $101.00 thereafter.

(d) Bears dividends at a rate, adjusted on a quarterly basis, 2% below the rate borne by certain United States Treasury Securities, but in no event less than 6% per annum, or greater than 12% per annum. Redeemable on or after March 1, 1988 at the option of APS at $103.00 through February 28, 1993; and at $100.00 thereafter.

(e) Not redeemable prior to June 1, 1987 through certain refunding operations that would result in a lower rate of cost to APS than the dividend rate on the shares to be redeemed; otherwise at $28.58 through May 31, 1987; at $27.39 through May 31, 1992; at $26.19 through May 31, 1997; and at $25.00 thereafter.

The holders of preferred stock of APS are entitled to one vote for each share held. Special requirements for favorable votes of holders of preferred stock, voting by the classes respectively prescribed for the several purposes, pertain to (i) certain conversions or exchanges of outstanding preferred stock, (ii) the authorization of any stock ranking prior to the preferred stock, (iii) making any change in the terms and provisions of preferred stock that would adversely affect the rights and preferences of the holders thereof, (iv) the issuance of any additional shares of preferred stock except under prescribed circumstances or (v) a merger, consolidation or sale of substantially all the assets of APS. The foregoing voting rights attach to both redeemable and non-redeemable preferred stock, as do the rights that would arise out of dividend arrearages as discussed in Note 5.

Sales of common stock of AZP and non-redeemable preferred stock of APS during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

Description	Common Stock* Number of Shares	Common Stock* Amount**	Non-Redeemable Preferred Stock of APS (cumulative) Number of Shares	Non-Redeemable Preferred Stock of APS (cumulative) Par Value Amount
Balance, December 31, 1982	62,894,490	$1,040,916	3,874,199	$168,561
Common Stock	3,816,362	85,793	—	—
Non-Redeemable Preferred Stock, Adjustable Rate Series Q	—	—	500,000	50,000
Balance, December 31, 1983	66,710,852	1,126,709	4,374,199	218,561
Common Stock	3,417,477	63,800	—	—
Balance, December 31, 1984	70,128,329	1,190,509	4,374,199	218,561
Common Stock	4,217,789	104,114	—	—
Balance, December 31, 1985	74,346,118	$1,294,623	4,374,199	$218,561

*Common stock of APS prior to April 29, 1985, See Note 2 regarding corporate restructuring.
**Includes premiums and expenses of preferred stock issues.

The Company has a stock purchase and dividend reinvestment plan whereby newly issued shares of its common stock may be purchased at market on the applicable dates by any participant in the plan. APS has an employee savings plan under which the investment of certain funds contributed by participating employees could, and its own contributions (pursuant to provisions calling for the matching of employee contributions on certain terms or provisions pursuant to which limited federal tax credits can be obtained by reason of voluntary contributions) would, involve the issuance of new shares of AZP common stock. Contributions made by APS to its employee retirement plan may also involve one or more such issuances.

5. Redeemable Preferred Stock of APS.

The balances at December 31, 1985 and 1984 of preferred stock of APS which is redeemable at the option of the holders or pursuant to sinking fund obligations, in addition to being callable by APS, are shown below.

	Number of Shares Outstanding at December 31, 1985	Number of Shares Outstanding at December 31, 1984	Par Value Per Share	Par Value Outstanding at December 31, 1985	Par Value Outstanding at December 31, 1984	Call Price Per Share(a)
				(Thousands of Dollars)		
Redeemable Preferred Stock (cumulative)						
Serial preferred: (b)						
$8.50 Series G	—	38,400	$100.00	$ —	$ 3,840	
$10 Series H	104,677	304,000	100.00	10,468	30,400	(c)
$10.70 Series I	209,934	240,000	100.00	20,993	24,000	(d)
$8.80 Series K	344,600	600,000	100.00	34,460	60,000	(e)
$9.70 Series L	480,000	480,000	100.00	48,000	48,000	(f)
$11.95 Series M	85,000	195,000	100.00	8,500	19,500	(g)
$12.90 Series N	370,000	370,000	100.00	37,000	37,000	(h)
Adjustable Rate Series P	100,000	100,000	100.00	10,000	10,000	(i)
$11.50 Series R	500,000	500,000	100.00	50,000	50,000	(j)
Total	2,194,211	2,827,400		$219,421	$282,740	

(a) In each case plus accrued dividends.

(b) See Note 4 for authorized number of shares.

(c) Redeemable at $106.12 through September 1, 1986, and thereafter declining by $0.36 per year to par after September 1, 2002. Applicable sinking fund provisions require the redemption of 16,000 shares at par annually (representing annual payments of $1,600,000).

(d) Redeemable at $103.00 through November 30, 1990, and at $101.00 thereafter. Applicable sinking fund provisions require the redemption of 15,000 shares at par annually (representing annual payments of $1,500,000). APS may, but is not required to, redeem an additional 15,000 shares at par on December 1 in any year.

(e) Redeemable at $106.00 through February 28, 1989; at $103.00 through February 28, 1994; and thereafter declining in steps to $101.00. Applicable sinking fund provisions require the redemption of 22,500 shares at par annually commencing March 1, 1986 (representing annual payments of $2,250,000). APS may, but is not required to, redeem an additional 22,500 shares at par on March 1 in any year beginning in 1986. At December 31, 1985, APS had met the 1986 sinking fund requirement.

(f) Redeemable at the option of APS at $104.31 through February 28, 1986, declining by $1.08 per year to $101.07 after March 1, 1989. Applicable sinking fund provisions require the redemption of 96,000 shares at par annually commencing March 1, 1986 (representing annual payments of $9,600,000).

(g) Redeemable on or after May 1, 1986 at the option of APS at $101.99 through April 30, 1987; and thereafter at par. All shares then outstanding are required to be redeemed on May 1, 1988 at par.

(h) Redeemable after June 1, 1992 at the option of APS at $106.11 through June 1, 1993, declining by $0.68 per year to $100.00 after June 1, 2002. Applicable sinking fund provisions require the redemption between 1988 and 2002 of all shares according to a predetermined schedule.

(i) Bears a dividend of $12.50 per share through December 1, 1987 and a dividend thereafter to be fixed by a formula related to the average prime interest rate in 1987. Redeemable at par on or after December 1, 1987 at the option of APS. Applicable sinking fund provisions require the redemption of 20,000 shares at par each December 1 beginning in 1988 (representing annual payments of $2,000,000). All shares then outstanding are required to be redeemed on December 1, 1992.

(j) Redeemable after June 1, 1994 at the option of APS at $105.45, declining each year by a predetermined amount to $100.00 after June 1, 2004. Applicable sinking fund provisions require the redemption between 1990 and 2004 of all shares according to a predetermined schedule.

If there were to be any arrearage in dividends on any of its preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock (each such dividend being cumulative and of equal ranking with other such dividends, and each such requirement being cumulative and of equal ranking with other such requirements), APS could not pay dividends on its common stock or acquire any shares thereof for consideration. If any such dividend arrearage was to equal six or more quarterly dividends, the holders of preferred stock, in addition to their other voting rights and voting by the classes prescribed for this purpose, could elect a total of six directors (all series of serial preferred stock, regardless of par value and whether redeemable or non-redeemable, comprising one such class and being entitled to elect two of the six directors). See Note 4 in regard to other voting rights of holders of preferred stock.

The combined aggregate amount of redemption requirements for the above issues each year through 1990 are as follows: $12,700,000 in 1986, $14,950,000 in 1987, $39,040,000 in 1988, and $19,540,000 in 1989 and $22,975,000 in 1990.

Redeemable preferred stock transactions of APS during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

Description	Number of Shares	Par Value Amount
Balance, December 31, 1982....	2,412,200	$ 241,220
Retirements:		
$8.50 Series G	(7,200)	(720)
$10 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1983....	2,374,000	237,400
$11.50 Series R	500,000	50,000
Retirements:		
$8.50 Series G	(15,600)	(1,560)
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1984....	2,827,400	282,740
Retirements:		
$8.50 Series G	(38,400)	(3,840)
$10.00 Series H	(199,323)	(19,932)
$10.70 Series I	(30,066)	(3,007)
$8.80 Series K	(255,400)	(25,540)
$11.95 Series M	(110,000)	(11,000)
Balance December 31, 1985....	2,194,211	$ 219,421

6. Long-Term Debt of APS.

Details of long-term debt outstanding at December 31, 1985 and 1984 are as follows:

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
First mortgage bonds:		
Maturing through 1990:		
10.375% due February 1, 1985	$ —	$60,250
Less securities held by trustee	—	(16,127)
5.125% due October 1, 1987	15,000	15,000
4.7% due March 1, 1989	20,000	20,000
Maturing 1991 through 1995—4.40% to 15%	325,000	200,000
Maturing 1996 through 2000—6.25% to 12.875%	269,977	272,977
Maturing 2001 through 2005—6.20% to 9.95%	185,000	185,000
Maturing 2006 through 2010—6% to 12.125%	202,000	152,000
Maturing 2011 through 2015—12.75% to 13.5%	450,000	200,000
Unamortized discount & premium	(2,413)	(1,965)
Total first mortgage bonds	1,464,564	1,087,135
Various issues of pollution control indebtedness primarily due December 15, 1985	—	105,000
Less securities held by trustee	—	(11,269)
Pollution control indebtedness due August 1, 2009 (a)	106,980	—
Less securities held by trustee (b)	(1,572)	—
Pollution control indebtedness due December 1, 2009 (c)	147,000	147,000
Less securities held by trustee (b)	(15,071)	(23,252)
Pollution control indebtedness due May 1, 2013 (c)	65,750	65,750
Pollution control indebtedness due May 1, 2014 (d)	55,200	55,200
Pollution control indebtedness due February 1, 2015 (e)	49,400	—
Less securities held by trustee (b)	(2,444)	—
Unsecured notes payable due 1987 (f)	70,000	70,000
16.25% guaranteed debentures due July 15, 1988 (g)	—	50,000
16.25% guaranteed debentures due February 1, 1989 (g)	75,000	75,000
16% guaranteed debentures due February 15, 1989 (g)	25,000	25,000
11.75% guaranteed debentures due January 15, 1990 (g)	60,000	60,000
12.5% debentures due February 15, 1992	75,000	—
Capitalized lease obligation (h)	46,907	48,472
Other	1,975	2,380
Unamortized discount	(293)	(780)
Total long-term debt	2,223,396	1,755,636
Less current maturities:		
Pollution control indebtedness due December 15, 1985 net of securities held by trustee	—	65,949
Sinking fund requirements on first mortgage bonds	15,333	3,000
Capitalized lease obligation (h)	1,685	1,565
Other	438	376
Total current maturities	17,456	70,890
Total long-term debt less current maturities	$2,205,940	$1,684,746

(a) Adjustable-rate annual tender pollution control revenue refunding bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest at 6% through July 31, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(b) Representing pollution control funds deposited with a revenue bond trustee and to be disbursed as needed to pay the costs of acquiring, constructing, reconstructing, improving, maintaining, equipping or furnishing the facilities financed.

(c) Consisting of borrowings from a governmental authority which has funded that amount through issuance of a series of par value demand bonds supported by a long-term irrevocable letter of credit issued by a bank. These bonds bear interest at such rate, determined weekly, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(d) Adjustable-rate annual tender pollution control revenue refunding bonds are supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest rate at 6% through April 30, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(e) Adjustable-rate annual tender pollution control revenue bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest through January 31, 1986 at 6.5% and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(f) Consisting of two long-term bank loans of $50,000,000 and $20,000,000. The principal amounts of such loans bear interest, at APS' option, at one or more of the following annual interest rates: (a) in the case of the first loan, 102% of the Prime Rate or, in the case of the second loan, the Prime Rate plus ¼%, (b) the CD Rate plus ⅝%, or (c) the Eurodollar Rate plus ½%.

(g) Representing debentures issued by Finance, the payment of principal and interest has been unconditionally guaranteed by APS. The 11¾% debentures due January 15, 1990 are redeemable at the option of Finance at 101½% from January 15, 1987 through January 14, 1988, then at 100¾% through January 15, 1989, and thereafter at 100%. The 16.25% debentures due February 1, 1989 and 16% debentures due February 15, 1989 were redeemed on February 1 and 15, 1986, respectively, with the proceeds of a $100,000,000 issue of first mortgage bonds. The debentures were redeemed at 101% plus accrued interest. The new bonds bear interest at 11.0% and are due January 15, 2016. The 16¼% debentures due July 15, 1988 were redeemed on July 15, 1985 at 101½% plus accrued interest.

(h) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) on a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semi-annual payments of $2,582,000 through June 2001, and includes renewal and purchase options based on fair market value. This plant is included in plant in service at its original cost of $54,405,000; accumulated depreciation at December 31, 1985 was $21,401,000.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1990 are as follows: 1986, $17,456,000; 1987, $102,620,000; 1988, $17,795,000; 1989, $37,985,000; and 1990, $78,193,000. For sinking fund requirements and redemptions at the option of the holders of redeemable preferred stock, see Note 5.

Substantially all utility plant, other than nuclear fuel, transportation equipment and the combined cycle plant mentioned above, is subject to the lien of the first mortgage bonds. The first mortgage bond indenture includes provisions which would restrict the payment of dividends on APS common stock under certain conditions which did not exist at December 31, 1985.

7. Lines of Credit and Compensating Balances.

APS' lines of credit at December 31, 1985 and 1984 are summarized below. No amounts were outstanding under the lines at December 31, 1985 or 1984.

	1985	1984
	(Thousands of Dollars)	
Commercial paper backup lines:		
Domestic banks	$125,000	$125,000
Foreign banks	50,000	50,000
Other domestic bank lines	245,000(a)	245,000(a)
Total	$420,000	$420,000

(a) Including $200,000,000 available under a credit agreement between APS and various banks which carries a commitment fee of ¼% per annum.

The commitment fees for the commercial paper backup lines with domestic banks were ⅜% per annum in 1985 and 1984. Compensating balances required (but which were not legally restricted) for the other domestic bank lines (exclusive of the credit agreement referred to in (a) above) were generally 7½% of the lines plus 5% of borrowings in 1985 and 1984.

Under the foreign bank lines, commitment fees were payable at ¼% per annum in 1985 and 1984. The interest rate on borrowings under these facilities was approximately ½% per annum over the applicable Eurodollar Rate in effect from time to time.

By statute, APS' short-term borrowings cannot exceed 7% of total capitalization without the consent of the ACC.

8. Jointly-Owned Facilities.

At December 31, 1985, APS owned the following interests in jointly-owned electric generating and transmission facilities (dollars in thousands):

	Percent owned by APS	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Generating Facilities:					
Arizona Nuclear Power Project (ANPP)—Units 1, 2 and 3	29.1%	$ –	$ –	$ –	$2,407,231
Four Corners Steam Generating Plant—Units 4 and 5	15.0%	118,897	20,791	98,106	1,499
Navajo Steam Generating Plant—Units 1, 2 and 3	14.0%	119,295	37,994	81,301	1,009
Transmission Facilities:					
ANPP Transmission System	35.8%(a)	7,398	791	6,607	48,337
Navajo Southern Transmission System	31.4%(b)	28,198	9,027	19,171	93
Palo Verde-Yuma 500KV System....	23.9%(c)	16,255	550	15,705	1,915
Total		$290,043	$69,153	$220,890	$2,460,084

(a) Weighted average of interests varying from 34.6% to 43.95%.
(b) Weighted average of interests varying from 14% to 100%.
(c) Weighted average of interests varying from 11% to 100%.

The foregoing dollar amounts correlate to APS' percentage interest in each facility. APS' share of related operating and maintenance expenses is included in operating expenses.

9. Income Tax Expense.

The components of income tax expense—continuing operations for each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Currently payable:			
Federal	$ 9,242	$ 14,578	$14,224
State	10,598	16,340	10,742
Other	2,861	3,606	2,870
Total current	22,701	34,524	27,836
Deferred:			
Depreciation—net	57,273	26,276	22,571
Taxes, pension costs and other—net	49,690	18,367	5,627
Investment tax credit—net	36,383	59,592	39,583
Total deferred	143,346	104,235	67,781
Amortization of tax benefits sold	(1,687)	(1,687)	(1,687)
Total	$164,360	$137,072	$93,930

In 1981 APS sold to another corporation certain federal income tax benefits in exchange for cash. APS, pursuant to an order of the ACC, has recorded the proceeds of the sale as a deferred credit and is amortizing the amount of such proceeds on a straight-line basis over approximately 30 years.

Following is a summary of the difference between income tax expense—continuing operations and the amount obtained by multiplying income before income taxes and preferred stock dividend requirements of APS by the statutory federal income tax rate.

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Federal income tax expense at statutory rate	$224,628	$199,935	$166,972
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	16,431	14,165	10,213
Allowance for funds used during construction	(88,222)	(84,491)	(83,799)
Investment tax credit amortization	(2,955)	(2,827)	(1,970)
Taxes, pension costs and other items capitalized	—	—	(6,640)
State income tax —net of federal income tax benefit	11,780	11,172	7,070
Other	2,698	(882)	2,084
Total provision for federal and state income tax	$164,360	$137,072	$ 93,930

At December 31, 1985 the Company had approximately $11,000,000 of investment tax credit carryforwards which will expire through 2000.

10. Pension Plan and Other Benefits.

APS' pension plan, a defined benefit plan, covers virtually all employees. Pension cost, including administrati cost for 1985, 1984, and 1983 was $15,458,000, $16,370,000, and $15,248,000, respectively, of which approximately $5,081,000, $6,512,000, and $6,871,000, respectively, was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

The following is a summary of plan data as of the most recent benefit information date:

	January 1,	
	1985	1984
	(Thousands of Dollars)	
Actuarial present value of accumulated plan benefits:		
Vested	$127,018	$115,984
Non-vested	11,885	10,499
Total	$138,903	$126,483
Net assets available for benefits	$193,235	$182,577

The actuarial present value (assuming a rate of return of 9.00%) of accumulated plan benefits presented above has not been calculated with reference to the effects of projected inflation, whereas such effects are considered by APS with reference to the adequacy of plan assets; accordingly, APS considers the utility of the comparison suggested to be extremely limited.

In addition to providing pension benefits, APS provides certain health care and life insurance benefits for active and retired employees. Life insurance benefits are provided through an insurance company whereas health care costs are paid as expenses are incurred under a self-insured plan. The cost of providing those benefits in 1985 for 1,091 retirees and 8,362 active employees was $1,086,000 and $13,423,000, respectively, of which approximately $5,825,000 was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

Under the AZP Group, Inc. Stock Option and Incentive Plan approved by the Company's shareholders on April 18, 1985, non-qualified and incentive stock options (ISO) and restricted stock awards may be granted to officers and key employees of the Company and subsidiaries for up to 3,000,000 shares of AZP common stock. The plan also provides for the granting of stock appreciation rights, performance shares, dividend equivalents or any combination of the foregoing. In 1985 approximately 15,000 restricted shares, 15,000 ISOs and 15,000 dividend equivalents were awarded under the plan.

11. Commitments and Contingencies.

Nuclear Insurance—The Price-Anderson Act ("Act") currently limits public liability claims that could arise from a nuclear incident to a maximum amount of $650,000,000 for each licensed nuclear facility. Private insurance for this exposure has been purchased by the participants (including APS) in the Palo Verde Nuclear Generating Station ("Participants") in the maximum available amount, presently $160,000,000, with the balance to be provided by secondary financial protection required by the Nuclear Regulatory Commission (NRC). Under the agreement with the NRC, the Participants could be assessed retrospective premium adjustments of which APS' share is approximately $3,000,000 per year, in the event of nuclear incidents involving any licensed reactor in the United States.

Property damage coverage is provided for losses up to $500,000,000 at Palo Verde. Decontamination liability and property damage insurance in excess of the primary $500,000,000 layer has also been purchased. These policies are primarily provided through mutual insurance companies owned by utilities with nuclear facilities. If losses at any nuclear facility covered by the arrangement were to exceed the accumulated funds available for these insurance programs, APS could be assessed retrospective premium adjustments of up to $3,500,000.

The Act is scheduled to expire in August 1987 and Congress is currently considering several proposals. The Company is unable to predict Congress' ultimate action and what effect such action may have on APS' liability.

Litigation—APS is a party to various claims, legal actions and complaints, including a lawsuit seeking to invalidate APS' contract with various municipalities for the purchase of effluent to be used as cooling water for Palo Verde. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the operations or financial position of APS.

Purchase Commitments—APS has significant purchase commitments in connection with the continuing construction program. Construction expenditures in 1986 have been estimated at $372,000,000.

12. Supplementary Income Statement Information.

Other taxes charged to operations during each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Ad valorem	$ 45,554	$42,581	$44,691
Sales	51,438	45,495	32,169
Other	7,284	6,372	5,560
Total other taxes	$104,276	$94,448	$82,420

13. Discontinued Operations.

Effective November 1, 1984 (the "Closing Date") APS sold its gas distribution system to Southwest Gas Corporation ("Southwest"). The sale resulted in a non-recurring loss of approximately $26,470,000, net of an income tax benefit of $7,094,000, (approximately $0.39 per average share of common stock) in 1984.

APS agreed to fund a portion of the costs associated with the accelerated replacement of certain gas pipe included in the gas distribution system acquired by Southwest by purchasing, under certain conditions, up to $50,000,000 in aggregate par value of cumulative preference stock (the "Stock") to be issued by Southwest. Any such purchases would be made by APS within approximately three years following the Closing Date. As of December 31, 1985, no such purchases had been made. The Stock would yield an annual dividend of between 3% and 16% (payable quarterly) based on a formula relating to the operating performance of the gas distribution system. The Stock is also redeemable by Southwest, at its option, on any dividend payment date (at the issue price plus accrued dividends), but must be redeemed no later than seven years after the issuance date as to any issue.

Revenues from APS' discontinued gas operations for 1984 and 1983 were $174,728,000 and $202,134,000, respectively.

14. Selected Quarterly Financial Data (Unaudited).

Condensed consolidated quarterly financial information for 1985 and 1984, as restated to give effect to the restructuring, is as follows:

	Revenue from Continuing Operations	Income from Continuing Operations	Income (loss) from Discontinued Operations	Net Income	Earnings (loss) per share of common stock	
					Continuing Operations	Discontinued Operations
Quarter	(Dollars in Thousands, Except Per Share Amounts)					
1985						
First	$243,552	$ 46,921	$ –	$ 46,921	$0.67	$ –
Second	276,697	61,712	–	61,712	0.86	–
Third	368,129	102,679	–	102,679	1.41	–
Fourth	286,124	68,237	–	68,237	0.92	–
1984						
First	203,937	40,201	1,397	41,598	0.60	0.02
Second	236,712	49,785	(185)	49,600	0.73	–
Third	311,845	90,484	(1,028)	89,456	1.32	(0.02)
Fourth	242,473	68,725	(26,687)	42,038	0.99	(0.39)

15. Supplementary Information to Disclose the Effects of Changing Prices (Unaudited).

The following supplementary information is furnished pursuant to Statement No. 33 as amended by Statement No. 82 of the Financial Accounting Standards Board for the purpose of illustrating the effects of changing prices in an inflationary environment. It offers some perspectives of approximated effects of inflation, and is not intended as precise measurements of those effects.

APS and other public utilities similarly situated are subject to rate-making procedures which, by law and practice, in large part utilize the historical cost of utility plant in the determination of the allowed recovery (through depreciation) of the investment therein and return thereon. This precludes or restricts a rate-making response to the effects of realizing such recovery and return in inflated dollars, compared to those in which the investment was made. The first table below presents an approximate measurement of those effects from the perspective of that portion of the investment, which was not reflected in 1985 depreciation or in the Company's return, and which is therefore not "recoverable."

For these presentations, "current cost" amounts were calculated by applying certain indices (or ratios derived therefrom) to certain historical or other amounts. The primary index was the Handy Whitman Index of Public Utility Construction Costs (a preliminary estimate of which was used for the last half of 1985), although the Consumer Price Index was used for construction work in progress. The Company believes that the Handy Whitman Index is the more accurate of the two in estimating the prices it would incur to duplicate at various times its utility plant in service at the indicated dates. Over the period from 1981 through 1985 the Consumer Price Index rose faster than the Handy Whitman Index.

Electric depreciation expense for 1985 was recalculated by applying the Company's composite depreciation rate to depreciable base determined by indexing certain appraised values from the times of appraisal. The amount by which the expense so recalculated exceeds that shown on the Company's 1985 Consolidated Statement of Income appears as an adjustment to income from continuing operations.

The sum of the depreciation adjustment and the figure shown lower as the "reduction to net recoverable cost" was derived through application of 1985 increases in the Consumer Price Index to historical costs of APS' utility plant.

The Company did not make adjustments to asset values, or related consolidated income statement amounts, other than those discussed above in regard to utility plant and depreciation thereon. Fuel inventories and fuel expenses are, in effect, monetary items, due to applicable rate-making procedures which include adjustment clauses. In accordance with Statement No. 33, as amended by Statement No. 82, income taxes were not adjusted.

As contrasted to the assumed net value losses which, in the presentation below, are associated with the holding of assets committed to a regulated business, there is an assumed "holding gain" associated with borrowings that will be repaid with inflated dollars. The 1985 decline in the purchasing power of net amounts owed by the Company (measured by the Consumer Price Index) appears to result in a "net" difference between the assumed holding losses and gain.

Inferences which, in the case of some industries, may be drawn from information in the nature of that presented below as to the adequacy of future cash flows in relation

to future plant replacement requirements are believed by the Company to be less valid in the case of public utilities which, like itself, should be able to establish rates to cover increased costs of new plant. However, the information may provide some indication of the expanded capital structure that will be required for making plant replacements and additions with inflated dollars.

Income From Operations Adjusted for Changing Prices for the Year Ended December 31, 1985

	Current Cost Average 1985 Dollars
	(Dollars in Thousands, Except Per Share Amounts)
Income from continuing operations as reported in Consolidated Statements of Income	$ 279,549
Adjustment to restate depreciation expense	(78,431)
Income from continuing operations (excluding reduction to net recoverable cost)	$ 201,118
Income from continuing operations per common share (excluding reduction to net recoverable cost)	$ 2.79
Increase in specific prices (current cost) of utility plant held during the year (a)	$ 168,637
Reduction to net recoverable cost	(7,981)
Effect of increase in general price level	(251,888)
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	(91,232)
Gain from decline in purchasing power of net amounts owed	45,036
Net	$ (46,196)

(a) At December 31, 1985, Current Cost of Utility Plant—net was $7,140,611.

Five Year Comparison of Selected Supplementary Financial Data Adjusted for Effect of Changing Prices

	Year Ended December 31,				
	1985	1984	1983	1982	1981
	(Average 1985 Dollars in Thousands, Except Per Share Amounts)				
Electric operating revenues	$1,174,502	$1,030,467	$ 941,414	$ 965,693	$ 864,390
Current cost information					
Income from continuing operations (excluding reduction to net recoverable cost)	$ 201,118	$ 180,482	$ 163,699	$ 137,533	$ 132,027
Income from continuing operations per common share (excluding reduction to net recoverable cost)	$ 2.79	$ 2.64	$ 2.56	$ 2.31	$ 2.52
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	$ (91,232)	$ (86,837)	$ (68,252)	$ (56,669)	$ (208,236)
Net assets at year-end at net recoverable cost*	$2,070,638	$1,955,140	$1,916,460	$1,775,405	$1,595,758
Reduction to net recoverable cost	$ (7,981)	$ 38,216	$ 44,362	$ 33,376	$ 205,988
General information					
Gain from decline in purchasing power of net amounts owed	$ 45,036	$ 93,149	$ 85,460	$ 79,686	$ 171,052
Cash dividends declared per common share	$ 2.69	$ 2.69	$ 2.77	$ 2.68	$ 2.60
Market price per common share at year-end	$ 27.25	$ 22.78	$ 20.57	$ 26.87	$ 22.17
Average consumer price index	322.2	311.1	298.4	289.1	272.4

*Consisting of common stock equity and non-redeemable preferred stock.

AZP/APS DIRECTORS

†Joe Acosta, 62, founder, Acosta, Cordova & Pittman, C.P.A.s, P.A., Phoenix, Arizona

Dino DeConcini, 52, attorney at law, Phoenix, Arizona

*O. Mark De Michele, 52, president and chief operating officer of APS; executive vice president of AZP, Phoenix, Arizona

*Karl Eller, 57, chairman of the board, The Circle K Corporation, Phoenix, Arizona

*William T. Garland, 69, president of Garland Land Co. (land development), Sedona, Arizona

†Pamela Grant, 47, chairman and chief executive officer, Goldwaters, Division of Associated Dry Goods (general mercantile), Scottsdale, Arizona

†Jack M. Morgan, 62, attorney at law and state senator, Farmington, New Mexico

Marvin R. Morrison, 62, farmer, cattle feeder and dairyman, Morrison Brothers Ranch, Higley, Arizona

John R. Norton III, 57, former president, J. R. Norton Co. (agricultural production), Phoenix, Arizona**

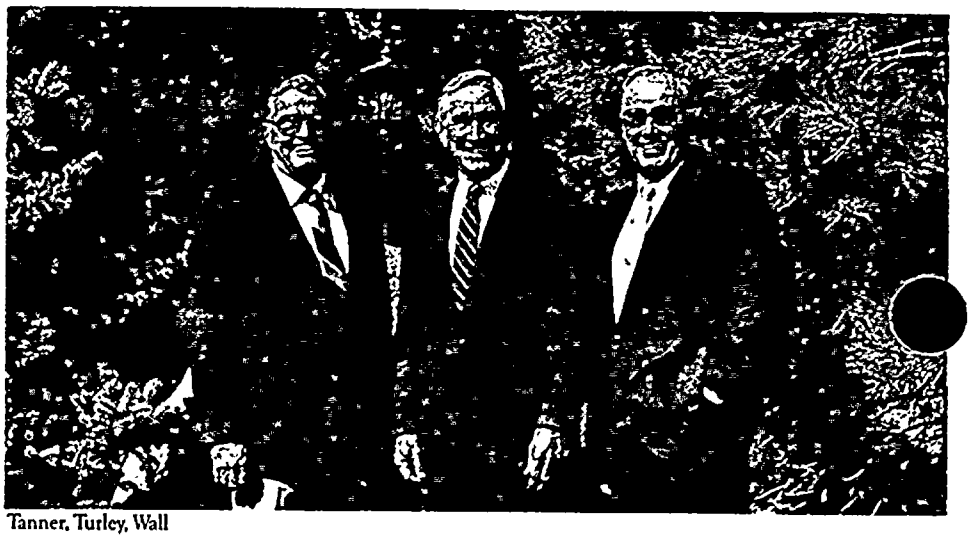
John J. Rhodes, 69, former member of the U.S. House of Representatives and counsel in the law firm of Hunton & Williams, Washington, D.C.

Henry B. Sargent, Jr., 51, executive vice president and chief financial officer of APS; executive vice president, treasurer and chief financial officer of AZP, Phoenix, Arizona

Wilma W. Schwada, 59, civic leader and homemaker, Phoenix, Arizona

**Mr. Norton (not pictured) was reelected to the board on February 20, 1986, effective March 1, 1986. He had resigned from the board in May 1985 to accept a position as acting U.S. Deputy Secretary of Agriculture.

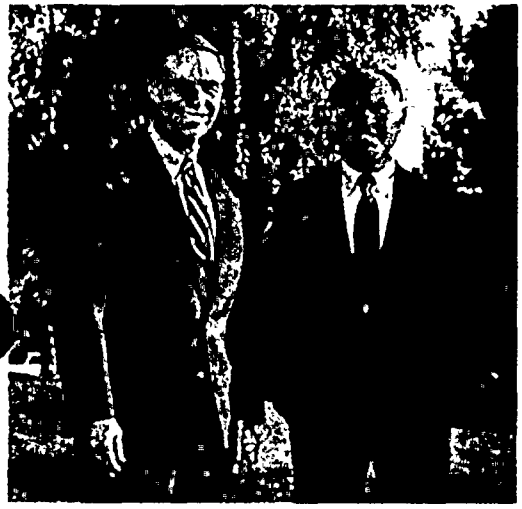
Morrison, Sargent, Grant, Simmons



Tanner, Turley, Wall

Rhodes, De Michele, Garland

Williams, Schwada, Morgan, Acosta



Eller, Snell

DeConcini

Soldwedel, Warren, Woods

James P. Simmons, 61, chairman of the board and president, United Bank of Arizona and United Bancorp of Arizona, Phoenix, Arizona

*Richard Snell, 55, chairman of the board and president, Ramada Inns, Inc., Phoenix, Arizona

*Donald N. Soldwedel, 61, president, Western Newspapers, Inc., Yuma, Arizona

*Maurice R. Tanner, 64, chairman of the board and chief executive officer, The Tanner Companies (construction and materials supply), Phoenix, Arizona

*Keith L. Turley, 62, chairman of the board and chief executive officer of APS; chairman of the board and president of AZP, Phoenix, Arizona

*†Douglas J. Wall, 59, member of the law firm of Mangum Wall Stoops & Warden, Flagstaff, Arizona

†Morrison F. Warren, 62, professor emeritus of education, Arizona State University, Tempe, Arizona

†Ben F. Williams, Jr., 56, mayor of the City of Douglas and attorney at law, Douglas, Arizona

Thomas G. Woods, Jr., 59, formerly executive vice president for the Arizona Nuclear Power Project (Ret. 2/85), Phoenix, Arizona

*Member of Executive Committee
†Member of Audit Review Committee
(Age on Annual Meeting date, April 24, 1986)

1886 Beginning Our Second Century of Service 1986

AZP GROUP, INC.

Officers

Keith L. Turley, chairman of the board and president
O. Mark De Michele, executive vice president
Henry B. Sargent, Jr., executive vice president, treasurer and chief financial officer
Jaron B. Norberg, senior vice president and corporate counsel
Kathryn A. Forbes, general auditor
Faye Widenmann, secretary
Sally F. Kur, assistant secretary

AZP GROUP, INC. SUBSIDIARIES

EL DORADO INVESTMENT COMPANY

Officers

Henry B. Sargent, Jr., president and chief executive officer
Paul A. Williams II, treasurer and assistant secretary
Faye Widenmann, secretary and assistant treasurer
Sally F. Kur, assistant secretary

Directors

Keith L. Turley, chairman
Henry B. Sargent, Jr.
Karl Eller
Maurice R. Tanner

ENERGY DEVELOPMENT COMPANY

Officers

Keith L. Turley, chairman, president and chief executive officer
Henry B. Sargent, Jr., vice president
Paul A. Williams II, treasurer and assistant secretary
Faye Widenmann, secretary and assistant treasurer
Sally F. Kur, assistant secretary

Directors

Henry B. Sargent, Jr.
James P. Simmons
Donald N. Soldwedel
Keith L. Turley
Eugene L. Thomas, executive vice president, The Arizona Bank

MALAPAI RESOURCES COMPANY

Officers

Keith L. Turley, chairman, president and chief executive officer
Myron K. Beck, vice president and manager of development
Henry B. Sargent, Jr., vice president
Paul A. Williams II, treasurer and assistant secretary
Faye Widenmann, secretary and assistant treasurer
Sally F. Kur, assistant secretary

Directors

William T. Garland
Henry B. Sargent, Jr.
Keith L. Turley
Douglas J. Wall

ARIZONA PUBLIC SERVICE COMPANY

Officers

O. Mark De Michele, president and chief operating officer
Walter F. Ekstrom, vice president, Electric Operations
Karl Eller, chairman of the executive committee
David W. Ellis, vice president, Research, Development and Alternative Energy Applications
Kathryn A. Forbes, general auditor
Joseph A. Gelinas, vice president, Employee Relations
B. Paul Hart, vice president, Rates and Regulation
Jerry G. Haynes, vice president, Nuclear Production
Russell D. Hulse, vice president, Resources Planning
Jerry Human, vice president, Customer Services, State Region
Charles D. Jarman, vice president, Construction
Donald B. Karner, vice president, Engineering
Sally F. Kur, assistant secretary
Guy W. Lunt, Jr., vice president, Customer Services, Metro Region
Jaron B. Norberg, senior vice president and corporate coun
John C. Ogden, vice president, Customer and Administrative Services
William J. Post, vice president and controller, Economic and Regulatory Planning
Shirley A. Richard, vice president, Corporate Relations
Henry B. Sargent, Jr., executive vice president and chief financial officer, Corporate Finance Planning and Control
Keith L. Turley, chairman and chief executive officer
Edwin E. Van Brunt, Jr., executive vice president, Arizona Nuclear Power Project
Faye Widenmann, secretary
Paul A. Williams II, vice president and treasurer, Finance and Tax Services

SHAREHOLDER INFORMATION

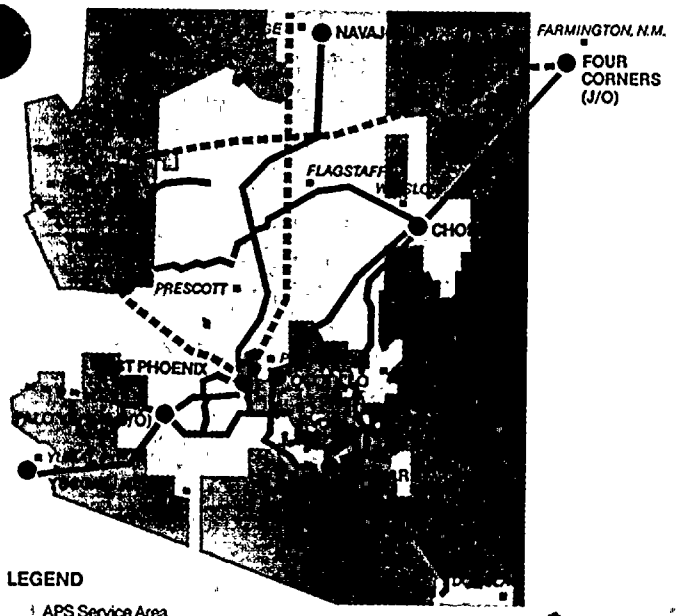
STOCKLISTING (SYMBOL: AZP)

Common stock of the company is listed for trading on the New York Stock Exchange and on the Pacific Stock Exchange.

TRANSFER AGENTS/REGISTRARS

First Interstate Bank of Arizona, N.A.
Corporate Trust Operations
Dept. 958, P.O. Box 29715
Phoenix, Arizona 85038
(602) 271-1620

The First National Bank of Boston
Shareholder Relations
P.O. Box 644
Boston, Massachusetts 02102
(617) 929-6498



GENERAL COUNSEL

Snell & Wilmer, Phoenix, Arizona

AUDITORS

Deloitte Haskins & Sells
Phoenix, Arizona

STOCK PURCHASE AND DIVIDEND REINVESTMENT PLAN

A Prospectus describing this plan is available upon request. Write: Office of the Secretary, Sta. 1892, at the address below.

FORM 10-K

A copy of our Annual Report to the Securities and Exchange Commission, Form 10-K, will be available after March 31, 1986, without charge, upon written request of shareholders. Write: Office of the Secretary, Sta. 1892, at the address below.

STATISTICAL REPORT

A detailed Statistical Report for Financial Analysis 1975-1985 will be available by mid-April on request. Write: Office of the Treasurer, Sta. 1820, at the address below.

MAILING ADDRESS:

P.O. Box 53900
Phoenix, Arizona 85072-3900

Toll-free Telephone Numbers:
Arizona 1-800-621-9093
Nationwide 1-800-457-2983

1886 Beginning Our Second Century of Service 1986

AZP
GROUP
INC.

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT E

AZP GROUP, INC. ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDING
DECEMBER 31, 1985

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

For the fiscal year ended December 31, 1985 Commission File Number 1-8962

AZP Group, Inc.

(Exact name of registrant as specified in its charter)

ARIZONA (State or other jurisdiction of incorporation or organization)	86-0512431 (I.R.S. Employer Identification No.)
411 North Central Avenue, P.O. Box 53900 Phoenix, Arizona 85072-3900 (Address of principal executive offices, including zip code)	(602) 250-3033 (Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, No Par Value	New York Stock Exchange Pacific Stock Exchange

Title of Each Class of Voting Stock	Shares Outstanding as of March 25, 1986	Aggregate Market Value of Shares Held by Non-affiliates as of March 25, 1986
Common Stock, No Par Value	75,360,646	$2,201,978,000(a)

(a) Computed by reference to the closing price on the composite tape on March 25, 1986, as reported by the Wall Street Journal.

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 ___

Documents Incorporated By Reference

Portions of the registrant's definitive proxy statement relating to its annual meeting of shareholders on April 24, 1986, are incorporated by reference into Parts I and III hereof.

TABLE OF CONTENTS

PART I

ITEM 1. BUSINESS

The Company

AZP Group, Inc. (the "Company") was incorporated in 1985 under the laws of the State of Arizona and is engaged in the acquisition and holding of securities of corporations for investment purposes. The principal executive offices of the Company are located at 411 North Central Avenue, Phoenix, Arizona 85004 (telephone 602-250-1000).

Effective April 29, 1985, the Company became the holder of all of the outstanding shares of the common stock of Arizona Public Service Company ("APS") pursuant to a corporate restructuring plan approved by the shareholders of APS on April 18, 1985. As a result of the restructuring, the holders of outstanding shares of APS common stock became the common shareholders of the Company on a share-for-share basis. The restructuring did not affect APS' preferred stock or any of its outstanding debt securities, all of which remain obligations of APS. As part of the restructuring, APS sold to the Company, at book value of $34,703,000, all of the capital stock of three of its non-utility subsidiaries: Malapai Resources Company, SunCor Development Company (formerly Energy Development Company), and El Dorado Investment Company. APS Finance Company N.V., Bixco, Inc., and APS Fuels Company remain as wholly-owned subsidiaries of APS. See Note 2 of Notes to Consolidated Financial Statements in Item 8 with respect to the corporate restructuring.

In conjunction with the restructuring, APS' Stock Purchase and Dividend Reinvestment Plan was assumed and continued by the Company on April 29, 1985, so that the Company's shareholders and APS' preferred shareholders may reinvest dividends in shares of Company common stock. APS' Employees' Retirement Plan and the Savings Plan for Employees of APS (collectively, the "APS Employee Plans") were also amended as of April 29, 1985, to provide for the issuance or purchase of Company common stock in lieu of APS common stock.

Funds to meet the Company's dividend requirements and equity contributions to its subsidiaries are provided primarily by dividend payments from APS and from the sale of the Company's common stock. The Company currently expects to raise approximately $50 million during 1986 from the issuance of its common stock through the AZP Stock Purchase and Dividend Reinvestment Plan, the APS Employee Plans, and the Savings Plan for Union Employees of APS. Changes, if any, in the Company's anticipated capital requirements could result in the sale of additional securities in 1986.

The Company currently conducts no business other than investing in its subsidiaries and owns no properties other than the common stock of its subsidiaries, including APS. The Company and its subsidiaries are currently exempt from registration under the Public Utility Holding Company Act of 1935 (the "Holding Company Act"). There may be limits on the extent to which the Company can diversify beyond energy-related fields without affecting its exempt status. However, the Company has no present intention of becoming a registered holding company subject to regulation under the Holding Company Act.

The Company and its subsidiaries employed approximately 8,320 persons as of December 31, 1985. Substantially all of these employees were employees of APS and employees assigned to joint projects of APS where APS serves as project manager.

Capital Structure

The capital structure of the Company (which, for this purpose, includes short-term borrowings and current maturities of long-term debt) as of December 31, 1985, is tabulated below.

	Amount (Thousands of Dollars)	Percentage
Long-Term Debt Less Current Maturities:		
First mortgage bonds	$1,449,231	
Other	756,709	
Total long-term debt less current maturities	2,205,940	48.3%
Non-Redeemable Preferred Stock of APS	218,561	4.8
Redeemable Preferred Stock of APS	219,421	4.8
Common Stock Equity:		
Common stock, no par value, 100,000,000 shares authorized; 74,346,118 shares outstanding	1,294,623	
Retained earnings	590,872	
Total common stock equity	1,885,495	41.3
Total capitalization	4,529,417	
Current Maturities of Long-Term Debt	17,456	.4
Short-Term Borrowings	18,000	.4
Total	$4,564,873	100.0%

See Notes 4, 5, and 6 of Notes to Consolidated Financial Statements in Item 8.

Subsequent to December 31, 1985, APS issued $100,000,000 of 11% Series First Mortgage Bonds due January 15, 2016, to fund the redemption by APS Finance Company N.V. of $75,000,000 of 16¼% guaranteed debentures due February 1, 1989, and $25,000,000 of 16% guaranteed debentures due February 15, 1989. APS issued $100,000,000 of its 9¼% Series First Mortgage Bonds due March 1, 1996, to purchase approximately $80,000,000 of its $100,000,000 15% Series First Mortgage Bonds due June 15, 1994, at 123.23% of their principal amount plus accrued interest. In addition, on March 26, 1986, APS filed a registration statement with the Securities and Exchange Commission relating to $350,000,000 of its first mortgage bonds to be issued at such times as market conditions suggest.

BUSINESS OF ARIZONA PUBLIC SERVICE COMPANY

The following is a discussion of the business of APS, which accounts for substantially all of the assets, revenues, and earnings of the Company. In the near future, the Company's non-utility subsidiaries are not expected to have a material impact on the Company's financial results.

Service Territory of APS

APS' service territory includes all or part of 11 of Arizona's 15 counties. It is estimated by APS that its electricity service reaches approximately 1,418,000 persons, or about 45% of the population of Arizona (which was approximately 3,150,500 in 1985 as compared to approximately 2,286,000 in 1975). During 1985, no single purchaser or user of energy accounted for more than 3% of total electric revenues.

Certain territory adjacent to or within areas served by APS is served by other investor-owned utilities (notably Tucson Electric Power Company serving electricity in the Tucson area and Southwest Gas Corporation serving gas throughout the state) and a number of cooperatives, municipalities, electric districts, and similar types of governmental organizations (principally the Salt River Project Agricultural Improvement and Power District serving electricity in various areas in ar

around Phoenix). Effective November 1, 1984, APS sold its gas distribution system. APS expects increased competition in the future from entities offering alternative sources of energy, particularly natural gas.

Industry Problems

The utility industry continues to experience a number of problems. Depending on the circumstances of a particular utility, these may include (i) difficulties in obtaining rates sufficient to provide an adequate return on invested capital; (ii) difficulties in meeting government imposed environmental requirements; (iii) increasing costs of fuel, wages, and materials; (iv) the necessity to make substantial capital outlays during protracted construction periods for larger and more complex generating units; (v) the uncertainty regarding the rate of actual and projected energy demand growth; (vi) increased reliance on volatile capital markets and periodically limited availability of both equity and debt capital; and (vii) controversies over the safety and use of nuclear power.

In APS' case, although increases in retail rates approved during 1984 improved APS' 1985 financial performance, long-term financial improvement, as well as betterment of APS' fixed income securities ratings (which were downgraded in 1983) will be contingent upon the timely granting of additional increases in retail rates. See "Rates—State" in this Item.

The impact on APS of other utility industry problems are discussed in this Item under "Environmental Requirements" and "Generating Fuel". Also see "Water Supply for APS" in this Item with respect to certain problems specific to APS and other southwestern utilities.

Business Segments

Effective November 1, 1984, APS sold its gas distribution system. See the Company's "Consolidated Statements of Income and Retained Earnings" and Note 13 of Notes to Consolidated Financial Statements in Item 8 for financial information regarding discontinued operations.

Rates

State. The Arizona Corporation Commission (the "ACC") has regulatory authority over APS in matters relating to retail electric rates and the issuance of securities. In November 1984, the ACC approved an increase in annual retail electric rates of approximately $43.5 million (5.0%), which became effective in February 1985. The order also adopted an "operating incentive plan" for APS under which APS will be rewarded or penalized for meeting or failing to meet specified operating efficiency levels at the Four Corners Plant ("Four Corners") and Palo Verde Unit 1 ("Unit 1"). The rewards and penalties will be related to the additional fuel costs avoided or incurred as a result of operating efficiency. If the operating efficiency levels fall within certain limits, APS is neither rewarded or penalized.

Rewards or penalties (in dollars per kilowatt hour) that may result from this operating incentive plan will be collected through a "Performance Incentive Adjustment Clause" in APS' rate schedules. Application of the operating incentive plan for Four Corners was effective January 1, 1985. As a result of the operation of Four Corners in 1985, APS will neither be rewarded nor penalized under the operating incentive plan. With respect to Unit 1, since commercial operation only recently commenced on February 13, 1986, APS expects that rate adjustments under this clause will initially be implemented in May 1987.

Finally, the order set a construction cost limit of $2.86 billion for APS' share of Palo Verde, with any amounts expended above that figure to be construed as imprudently incurred for rate-making purposes (although no presumption of prudence will attach to expenditures made up to such limit). Taking into consideration the revised Palo Verde schedule discussed in Item 2, APS' current estimate of its Palo Verde cost is approximately $2.76 billion.

In May 1985, APS filed a request with the ACC for a $78.2 million (8.6%) increase in annual retail electric rates premised upon Unit 1 being fully included in APS' rate base (the "Unit 1 Rate Case"). APS also requested an accounting/rate-making order to defer certain costs and accrue certain

carrying charges relating to Palo Verde Unit 2 ("Unit 2") for the period of time between Unit 2 goin into commercial operation and new rates going into effect to cover the cost of Unit 2. The reque included information on a potential phase-in of rates for Palo Verde Units 2 and 3. The ACC has divided the Unit 1 Rate Case into three phases. The "Phase I" hearings concerning APS' purchased power and fuel adjustment mechanism (see below) were completed on March 7, 1986, and the ACC has not rendered a decision. The "Phase II" hearings concerning APS' proposed increase in retail electric rates began on March 27, 1986. The "Phase III" hearings concerning APS' requested accounting/rate-making order for Unit 2 are scheduled to begin following the completion of the Phase II hearings.

On August 22, 1985, the ACC issued an order allowing an increase in APS' purchased power and fuel adjustment mechanism of $.004 per kilowatt hour effective September 1, 1985. APS had requested an increase of $.007 per kilowatt hour in the purchased power and fuel adjustment mechanism to compensate for the under-collection, since April of 1983, of APS' increased fuel costs in excess of amounts currently being collected. The ACC order stated that the increase will remain effective until additional issues can be addressed in the Unit 1 Rate Case. Under-collected purchased power and fuel costs were approximately $74 million at December 31, 1985.

On December 18, 1985, APS filed an application with the ACC for a $193.9 million (19.36%) increase in annual retail electric rates, to be effective on the date Unit 2 is placed in service (the "Unit 2 Rate Case"). As an alternative proposal, APS recommended a series of three 6.15% base rate increases to take effect on January 1, 1987, 1988, and 1989 to phase in the costs of Unit 2 on the condition that the ACC grants APS' request for the rate increase and accounting/rate-making order requested in the Unit 1 Rate Case. On December 30, 1985, the ACC instructed APS to resubmit all schedules relating to the Unit 2 Rate Case on or before April 30, 1986, so as to reflect a calendar 1985 test year. Hearings concerning APS' Unit 2 Rate Case are scheduled to begin September 26, 1986.

On February 13, 1986, the date Unit 1 attained commercial operation as defined by the AC APS ceased accruing allowance for funds used during construction ("AFC") with respect to Unit 1 and the facilities common to all three Palo Verde Units (the "Common Facilities") in the amount of approximately $6 million per month. In addition, APS began expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 1 and the Common Facilities, currently totalling approximately $5 million per month. Absent adequate and timely rate relief from the ACC, APS expects these developments to adversely affect its earnings.

As part of the Unit 1 Rate Case, APS is seeking an accounting/rate-making order from the ACC allowing the Common Facilities to be transferred to plant in service in three equal increments, each tied to the commercial operation date of a Palo Verde unit, with the continuance of a carrying charge equivalent to AFC on any portion which has not been transferred to plant in service. If the ACC grants such accounting/rate-making order, APS would be able to accrue approximately $1 million of such carrying charge per month on each of the remaining two portions of the Common Facilities which have not been transferred to plant in service. In addition, APS would be able to defer expensing the cost of owning, operating, and maintaining its 29.1% share of the remaining two portions of the Common Facilities, with such expenses currently totalling approximately $.3 million per month for each such portion.

As discussed above, APS has requested the ACC to issue an accounting/rate-making order allowing APS to defer expensing the cost of Unit 2 and to continue the accrual of a carrying charge equivalent to AFC from the commencement of the commercial operation of Unit 2 until APS is allowed to recover the costs of Unit 2 in rates. If the ACC does not grant APS' requested accounting/rate-making order relating to Unit 2, when Unit 2 achieves commercial operation (currently scheduled for the third quarter of 1986) APS will cease accruing AFC with respect to Unit 2, currently totalling approximately $6 million per month. In addition, APS will begin expensing the cost of owning, operating, and maintaining its share of Unit 2, currently estimated at $3 million p

month. If the ACC does not grant the requested accounting/rate-making order with respect to Unit 2 or grant adequate and timely rate relief with respect to Unit 2, APS expects its earnings to be adversely affected.

In 1984 the utility regulatory bodies of Arizona, California, New Mexico, and Texas formed the Four State Monitoring Committee (the "Committee") to oversee an independent construction audit of Palo Verde to determine the prudency of Palo Verde construction costs. On November 27, 1985, the Committee released a "Phase I Report" prepared by outside consultants in connection with this construction audit. The Phase I Report identifies certain areas in which the consultants recommend further study. Among these areas are the construction costs, engineering costs, system planning study, and project management. The Phase I Report estimates that the "direct construction costs" of Palo Verde will total approximately $5.9 billion. Approximately $3.12 billion of this amount, of which APS' share is approximately $900 million, will be subject to further study. In addition, the Phase I Report recommends a review of the AFC costs associated with Palo Verde as well as other indirect costs.

The Phase I Report does not express an opinion regarding the reasonableness of specific actions related to Palo Verde. Rather, it is intended to define subsequent detailed studies which may include recommendations regarding the reasonableness of such actions. The issue of the reasonableness of specific actions related to Palo Verde may relate to the extent to which APS may recover Palo Verde's costs from its customers. The next phase of the prudency audit began in March 1986, with recommendations expected in late 1986 or 1987. Any amounts ultimately deemed by the ACC to have been imprudently spent and not allowed in APS' rate base would be written off by APS. Although APS is unable to predict the final outcome of this matter, management believes that overall Palo Verde was constructed in a prudent manner.

Federal. APS' rates for wholesale power sales and transmission services are subject to regulation by the Federal Energy Regulatory Commission ("FERC"). During 1985, approximately 8% of APS' electric operating revenues resulted from such sales and charges.

Pursuant to recent decisions by the United States Court of Appeals, the FERC's previous procedure for establishing the effective date of rate increases in connection with certain previous FERC rate cases involving APS has been repealed. As a result, the FERC has ordered APS to refund approximately $2.5 million (excluding interest) in revenues collected from some of its wholesale customers based upon the previous effective dates for such rate increases. APS had provided for all of these revenues at December 31, 1985.

Adjustment Clauses. Adjustment clauses in APS' retail rate schedules are intended to pass through to its retail customers changes in the costs of its generating fuel, purchased power, and the rates of excise taxes. In the case of excise taxes, adjustments are relatively prompt. In the case of generating fuel and purchased power, APS is operating under a format that may require a hearing by the ACC after experienced or projected under- or over-recoveries of fuel and purchased power costs by APS from its retail customers through prevailing rates have accumulated to a certain amount per kilowatt hour.

This format at times has resulted, as it did at December 31, 1985, in under-recovered balances arising from increased fuel expenses. Those amounts, which are to be recovered by APS over time from retail customers through operation of the adjustment format, account for the "Deferred fuel" asset in the Company's consolidated balance sheets for that date on which such under-recovered balances occurred (see Consolidated Financial Statements in Item 8) and for much of the fluctuation in "Purchased power and interchange—net" expense in the Consolidated Statements of Income and Retained Earnings (see Note 1d of Notes to Consolidated Financial Statements in Item 8). See "Rates—State" in this Item for additional information on APS' purchased power and fuel adjustment mechanism.

For wholesale transactions regulated by the FERC, fuel adjustment clauses result in adjustment for changes in the actual cost of fuel for generation and in the fuel component of purchased power expense.

Construction and Financing Programs of APS

Construction expenditures, including expenditures for environmental control facilities, for the years 1986 through 1988 have been estimated as follows:

(Millions of Dollars)

By Year		By Major Facilities	
1986	$386	Electric generation	$337
1987	258	Electric transmission	104
1988	226	Electric distribution	295
	$870	General facilities	134
			$870

The foregoing amounts include expenditures for nuclear fuel and start-up and preoperating costs, but omit all AFC and capitalized property taxes. They were derived in the course of APS' ongoing review process, and, as they reflect the sale of APS' gas operations (see "Business Segments" in this Item), may differ from those contained in other reports. The estimates are subject to periodic revision to reflect further changes in APS' plans (which may result from extraneous developments, such as adverse rate orders or governmental regulations), updated scheduling, unanticipated inflation, and other factors. During the years 1983 through 1985 APS incurred approximately $1,103 million in electric construction expenditures and approximately $621 million in additional electric capitalized items.

In addition to funds required for capital expenditures in 1986, 1987, and 1988, refunding obligations of senior securities and installment obligations, including certain anticipated early redemptions, are expected to total up to $297 million for 1986 and $118 million and $57 million for the years 1987 and 1988, respectively. External financing was required for substantially all of APS' total capital requirements in 1985 and will be required for nearly half of such requirements in the 1986-1988 period, assuming that internally generated funds remaining after dividend payments are augmented by adequate rate increases during the period.

In 1985 APS provided for its external capital requirements through issuances of first mortgage bonds, an issuance of European debentures, and pollution control financings (including draw-downs of previously committed funds). In addition, until April 29, 1985, the effective date of the corporate restructuring, APS provided for a portion of its external capital requirements through the issuance of common stock pursuant to its stock purchase and dividend reinvestment plan and certain employee benefit plans. Effective April 29, 1985, the Company assumed APS' stock purchase and dividend reinvestment plan, which was amended (along with other employee benefit plans) to provide for the issuance or purchase of the Company's common stock in place of APS common stock. See "The Company" in this Item. In January 1986, APS issued $100 million in 30-year 11% first mortgage bonds. The proceeds were applied to the redemption of outstanding European debentures issued by APS' wholly-owned finance subsidiary. In March 1986, APS issued $100 million in 10-year 9¼% first mortgage bonds. Substantially all of the proceeds were applied to purchase approximately $80 million of APS' $100 million 15% Series First Mortgage Bonds due 1994 at 123.23% of their principal amount plus accrued interest. Also in 1986, at such times as market conditions suggest, APS plans to issue in private and public sales up to an additional $300 million in other long-term debt (inclusive of any refunding, redemption, repayment, or retirement of outstanding indebtedness), any or all of which may take the form of secured debt (presumably first mortgage bonds). During 1986 APS also expects to issue or incur up to $200 million in additional debt to finance its nuclear fuel program in connection with the operation of Palo Verde. See "Properties of APS" in this Item.

Provisions in APS' mortgage bond indenture and articles of incorporation restrict it from issuing additional first mortgage bonds or preferred stock, respectively, unless its earnings (as defined) cov

by at least the prescribed number of times the amount of interest (as to bonds) and the amount of interest plus preferred stock dividend requirements (as to preferred stock) on the securities to be outstanding after completion of the new issue. Operation of the latter such provision has at times in the past limited APS' ability to issue preferred stock. As calculated in accordance with the applicable document, assuming 11½% as the rate of interest on new bonds and dividend requirement on new preferred stock that might have been issued on December 31, 1985, and treating the issuance of $100,000,000 of 11% series first mortgage bonds and $100,000,000 of 9¼% series first mortgage bonds as though consummated on that date, the coverage afforded by earnings (as defined) for the twelve months ended on that date would have allowed the issuance of either $1,303,000,000 in aggregate principal amount of additional first mortgage bonds (as compared to approximately $1,016,000,000 in bonds issuable on the basis of net "property additions") or $239,000,000 in aggregate par value of additional preferred stock. Minimum required coverages are 2.0 for bonds and 1.5 for preferred stock. Coverages afforded by earnings (as defined) were as follows:

	Year Ended December 31,		
	1985	1984	1983
Bonds	4.17	4.99	3.93
Preferred Stock	1.75	1.79	1.58

By statute, APS' short-term borrowings may not exceed 7% of its total capitalization without the consent of the ACC. Such borrowings are an important source of funds, particularly between permanent financings, and the statute could from time to time limit APS' financing flexibility. However, APS' own general policy relating to short-term borrowings is consistent with that of the statute.

Environmental Requirements for APS

APS' operations are subject to stringent environmental protection measures imposed under federal and state laws and regulations, some of which have required substantial expenditures for pollution control technology. The Four Corners Plant, which is older than most of APS' other coal-fired units, has been particularly affected by such measures, and installation of retrofit particulate and sulfur dioxide control equipment has been required at an approximate direct construction cost to APS totaling $65,070,000 for its 15% share of Units 4 and 5. It has also been necessary to obtain variances or stipulations for certain aspects of that plant's operation. The initial variances were granted because state authorities found that emissions from the plant did not cause violation of air quality standards and that there was no reasonably available technology that would allow the plant to meet existing emissions limitations. Certain variances relating to the emission of nitrogen dioxides by Unit 3 expired on May 13, 1984, and with respect to Units 4 and 5, on May 13, 1985. APS filed timely petitions for further variances for such units with the New Mexico Environmental Improvement Board through May 13, 1987, and applicable regulations provide for stays of enforcement pending final determinations with respect to such petitions. The outcome of such petitions cannot currently be predicted. Other state permits, relating to surface and groundwater standards, contain various compliance dates and schedules which largely appear (though not beyond question) to be attainable.

The Federal Clean Air Act Amendments of 1977 may require installation of "the best available retrofit technology" on existing services located near certain federally protected areas in which visibility is an important attribute. The Four Corners Plant is one such source. The installation is to occur as expeditiously as practicable, and in any event, within approximately five years after revision of the applicable state implementation plan. The full significance of the visibility provisions to the Four Corners Plant and the Company's other coal-fired plants is difficult to predict pending finalization of state and federal implementing regulations.

Problems of interpreting and complying with the various measures described above and the evolution of new measures (including any measures which are intended to address the "acid rain"

problems afflicting other utilities but which could impact APS as well) require continuing involvement of APS in proceedings before the United States Congress, state legislatures, federal and state regulatory agencies, and the courts. APS cannot accurately predict the financial and operational impacts resulting from revisions to existing laws.

Generating Fuel

Coal, gas, and oil contributions to total net generation of electricity by APS in 1985, 1984, and 1983 and the average cost to APS of those fuels (per million BTU), were as follows:

	Coal		Gas		Oil		All Fuels
	Percent of Generation	Average Cost	Percent of Generation	Average Cost	Percent of Generation	Average Cost	Average Cost
1985	87.7	$1.2292	11.5	$3.7478	0.8	$5.0480	$1.5859
1984	94.6	1.0263	5.1	4.0741	0.3	4.9379	1.2206
1983	93.8	1.0070	5.4	4.1591	0.8	4.6005	1.2380

APS believes that the Four Corners, Navajo, and Cholla Plants have sufficient reserves of low sulfur coal (the sulfur content of which is currently running at 0.8%, 0.5% and 0.5%, respectively) committed to those plants to continue operating them for their useful lives. Prices paid for coal supplied from reserves dedicated under the existing contracts have been escalating pursuant to applicable contract clauses. In addition, major price changes from time to time result from contract renegotiation.

In April 1985, the United States Supreme Court affirmed a decision of the United States Court of Appeals for the Ninth Circuit, thereby upholding the authority of the Navajo Tribe (the "Tribe") to impose taxes on non-Indian businesses pursuant to certain possessory interest and business activity tax resolutions adopted by the Navajo Tribal Council in 1978. As a result, APS is liable for the payment of Navajo taxes, either directly or indirectly, through its fuel supply agreements with its coal suppliers, effective as of the 1978 date of enactment of the taxing resolutions, except to the extent that APS or its coal suppliers are relieved from payment by virtue of tax waiver or tax forgiveness provisions contained in certain lease agreements.

The plant site lease agreements for the Navajo and Four Corners Plants (each of which is located within the Navajo Reservation) contain provisions whereby the Tribe agreed not to impose certain taxes directly or indirectly on APS' ownership or operation of each plant or on the coal supplier to each plant (each of which conducts at least a portion of its mining operation within the Navajo Reservation). APS is uncertain, however, whether the tax waiver provisions in the Four Corners plant site lease agreement would allow APS to prevail in nullifying the attempt by the Tribe to impose the possessory interest tax against the coal supplier to that plant (see below).

Effective April 25, 1985, the coal lease agreement between the Tribe and the coal supplier to the Four Corners Plant was amended. In that amendment, the Tribe forgave all business activities taxes and possessory interest taxes that may have accrued against the Four Corners Plant participants and their coal supplier before April 25, 1985. Accordingly, notwithstanding the uncertainty as to the scope of the tax waiver provisions in the plant site lease agreement, the amendment to the coal lease agreement forgives the portion of the possessory interest tax that may have accrued against the coal supplier between 1978 and the effective date of the amendment.

Notwithstanding the 1985 amendment to the coal lease agreement, the Navajo Tax Commission has assessed the coal supplier to the Four Corners Plant for possessory interest taxes accruing prior to April 25, 1985, the effective date of that amendment. The coal supplier has commenced administrative proceedings to contest these assessments. APS does not believe that the position adopted by the Tribe is meritorious.

The Tribe has also assessed a possessory interest tax on the coal supplier to the Four Corners Plant for the period beginning April 25, 1985. Pending the resolution of the issue of whether the Four Corners plant site lease agreement contains a waiver for the imposition of this tax, the tax will be paid into escrow by the coal supplier pursuant to provisions in the amendments to its lease. APS

share of the possessory interest tax sought to be imposed against the coal supplier is approximately $1.9 million per year. The dispute will initially be heard by the Secretary of the Interior; however, the funds paid into escrow will not be released until the matter is decided by a federal court.

The 1985 amendment to the coal lease agreement also increased royalty payments to the Tribe in return for certain contractual and other concessions including, among others, an amendment to the plant site lease agreement providing for a formula for pricing rights-of-way for future transmission lines, a pricing formula for a supply of water in the event the participants' water resources are reduced as a result of certain adjudication currently pending in the New Mexico state courts, and an additional area for coal ash disposal, equipment storage, and construction lay-down. The Company estimates that the additional royalties will increase APS' Four Corners coal costs by approximately $5 million per year. See also "Water Supply for APS" in this Item with respect to pending litigation involving water resources.

One of the leases between the coal supplier to the Navajo Plant and the Tribe contains a provision permitting a "reasonable adjustment" to the royalties payable to the Tribe in 1984 and at ten year intervals thereafter, such reasonable adjustment to be made by the Secretary of the Interior or his delegated representative. The Secretary of the Interior designated the Area Director of the Navajo Tribal Agency of the Bureau of Indian Affairs ("Area Director") as his representative. In June 1984 the Area Director notified the coal supplier to the Navajo Plant that, pursuant to the lease agreement, the royalties payable to the Tribe would increase to 20% of the gross value of the coal, as determined in accordance with federal regulations governing the leasing of federal coal reserves, effective in August 1984. The coal supplier and the participants in the Navajo Plant have appealed the decision of the Area Director to the Commissioner of Indian Affairs as both untimely and, therefore, of no effect, and unreasonable in amount, if timely. The matter is still pending before the Commissioner of Indian Affairs. If the Area Director's decision is upheld in whole or in part, the increased royalties will accrue from August 1984. Any increase in the royalties payable under this lease will be passed through to the participants in the Navajo Plant, including APS, which owns 15% of the plant. If the royalties are increased to 20% of the gross value of the coal, the royalties would increase from thirty cents per ton, which is presently being paid, to approximately $4.00 per ton, or approximately $2.4 million per year. However, the standard federal royalty on coal from leased lands owned by the federal government is 12½% of gross value, which would be approximately $2.50 per ton in royalties, or an increase of approximately $1.4 million per year. APS cannot predict the outcome of the appeal.

APS purchases coal for its Cholla Plant (located outside the Navajo reservation) from a coal supplier that conducts its mining operations partially within the Navajo Reservation. As a result of the Supreme Court decision referred to above, on July 23, 1985, the coal supplier to the Cholla Plant agreed to pay the Navajo Tribe approximately $11 million as settlement of the tax liability that had accrued against the coal supplier between 1978 and July 23, 1985. APS' share of such settlement is approximately $6 million, of which $2.7 million was paid in 1985 and $3.3 million will be due on July 25, 1986. APS expects these taxes to increase its Cholla costs by approximately $4.5 million each year after 1986. In connection with this tax settlement, the coal supplier and the Tribe also agreed to an increase in future royalty payments by the coal supplier to the Tribe. APS expects these increased royalties to increase its Cholla coal costs by 6% of the gross value of the coal per year through July 25, 1989 and by 12½% per year thereafter.

The coal supplier to the Cholla Plant also conducts mining operations on federal land under leases with the Bureau of Land Management (the "Bureau"). The pricing terms of the leases were subject to renegotiation on April 1, 1981, at which time the Bureau agreed to renew the leases for an additional ten year period but at a substantially higher royalty level. In June 1985 the coal supplier paid the Bureau under protest the increased royalties that had accrued since April 1, 1981, in the amount of $10.1 million. APS' share of such royalites is approximately $6 million. The coal supplier has filed suit against the Bureau in the United States District Court of New Mexico challenging several provisions of the leases, including the royalty level.

APS is not providing a reserve for the 1978 Tribal taxes in its financial statements and h obtained an order from the ACC that should allow APS to recover from its retail customers t amount of such taxes that are allocable to them to the extent payment thereof is ultimately required.

See also "Water Supply for APS" in this Item, with respect to additional matters involving questions as to the rights of Indian tribes.

The principal source of APS' gas for generating fuel is El Paso Natural Gas Company ("El Paso") pursuant to a contract with a primary term expiring at the end of 1987. Although substantial amounts of boiler gas have been made available to it by El Paso, APS intends to purchase sizeable quantities of natural gas on the spot market at prices below El Paso's. APS expects that limited and, in the long run, decreasing amounts of boiler gas will be available to it from El Paso and other sources. In light of that expectation, APS plans to reduce its reliance on boiler gas to the extent possible.

APS burned a total of 230,000 barrels of residual and diesel fuel oil in 1983, 75,000 barrels in 1984, 200,000 barrels in 1985, and now estimates its 1986 oil requirements at 70,000 barrels. Large supplies of boiler gas, the start-up of additional coal-fired capacity, and the availability of purchased power have allowed APS to substantially reduce its reliance on oil as compared to the 1970's. APS' oil requirements are particularly sensitive to its supplies of boiler gas.

The fuel cycle for Palo Verde is comprised of the following stages: (1) the mining and milling of uranium ore to produce uranium concentrates, (2) the conversion of uranium concentrates to uranium hexafluoride, (3) the enrichment of uranium hexafluoride, (4) the fabrication of fuel assemblies, (5) the utilization of fuel assemblies in reactors, and (6) the storage of spent fuel and the disposal or (if future circumstances permit) the reprocessing thereof. Arrangements have been made to insure that Palo Verde's requirements of materials and services for each stage of the fuel cycle will be available as needed over an extended period.

Uranium concentrates in inventory and available under contracts with Energy Fuels Explorati Company, Pathfinder Mines Corporation, and other sources should meet Palo Verde's operational requirements through 1998 and beyond that year if options to purchase uranium concentrates under the fabrication contract with Westinghouse Electric Corporation (discussed below) are exercised. Options provided under the above contracts will permit the purchase of a portion of Palo Verde's uranium concentrate requirements on the spot market without penalty if the spot market purchase becomes economical. Uranium hexaflouride in storage and to be obtained through 1992 under a conversion service contract with Allied Corporation will meet Palo Verde's operational requirements for uranium hexaflouride through 1992. Existing contracts for fabrication services with Combustion Engineering, Inc. and Westinghouse Electric Corporation will provide fuel assembly services for each of the Palo Verde units for at least the first two years of operation and approximately the next fifteen years of operation of each unit, respectively.

The participants in Palo Verde, including APS have an enrichment services contract with the United States Department of Energy ("DOE") that obligates DOE to furnish the enrichment services required throughout the life of each of the Palo Verde units. In September 1985, the United States District Court for the District of Colorado held that the form of the utility services contract used by DOE in its negotiations with utilities, including the one with the Palo Verde participants, is null and void. DOE has appealed the decision and has publically announced that pending the final resolution of the appeal, it will continue to treat the enrichment services contracts, including the Palo Verde contract, as valid.

Pursuant to the Nuclear Waste Policy Act of 1982 (the "Act"), DOE is obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by all domestic power reactors. The Nuclear Regulatory Commission ("NRC") pursuant to the Act, also requires operators of nuclear power reactors to enter into spent fuel disposal contracts with DOE. The Company, on its own behalf and on behalf of the other Palo Verde participants, has executed a spent fuel disposal contract with DOE. The Act also obligates DOE to develop the facilities necessary f

the disposal of all spent fuel generated and to be generated by domestic power reactors and to have the first such facility in operation by 1998 under prescribed procedures. Such development is currently in progress. Spent fuel storage facilties at Palo Verde have sufficient capacity to store all fuel expected to be discharged from normal operation of all of the Palo Verde units during a period extending beyond the year 2000.

Increases in generating fuel costs historically have been passed through by APS to its customers under adjustment clauses filed with the ACC and the FERC. See "Rates—Adjustment Clauses" in this Item. However, APS cannot be certain of being able to do so in regard to future costs, such as those arising out of increased royalties payable by APS' coal suppliers to the Navajo or Hopi Tribes. Any specific exercise of pass-through procedures at any time in effect could be contested and possibly denied in whole or in part by the ACC or the FERC. Moreover, rate increases in any form are resulting in customer resistance in the form of decreased energy usage that may retard future growth of unit sales.

Palo Verde Liability and Insurance Matters

The Palo Verde participants currently have insured against public liability claims resulting from nuclear energy hazards to the full $655 million limit on liability under Federal law (such law being commonly referred to as the "Price-Anderson Act"). The maximum available private insurance of $160 million has been purchased, and the remaining $495 million has been provided through a mandatory industry-wide retrospective assessment program, under which the Palo Verde participants collectively could be assessed up to $5 million for each Palo Verde unit licensed by the NRC (of which APS' share would be 29.1%) in the event the total liability arising from any nuclear incident involving any licensed facility in the nation exceeds the $160 million private insurance. In the event of more than one incident, the potential $5 million assessment per licensed unit would apply to each incident, subject to a maximum assessment in any year of $10 million per licensed unit (of which APS' share would be 29.1%) for all incidents. The insureds under the liability insurance include Palo Verde participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard." Such nuclear liability insurance coverage does not apply to damage to the plant facilities.

To cover possible damage to the Palo Verde facilities, the Palo Verde participants maintain nuclear property damage and decontamination insurance in the aggregate amount of $1.135 billion. APS has also secured insurance against the increased cost of generation or purchased power resulting from the accidental outage of a nuclear unit. APS will be insured, after a 26-week deductible period, for up to $1.24 million per week for its share of Units 1 and 2 (and Unit 3 when it is placed in service) for 52 weeks and up to 50% of such weekly amount for an additional 52 weeks.

In addition to the above-described policies of insurance, the Palo Verde participants are parties to an indemnity agreement with the NRC. This agreement contains an undertaking by the NRC to indemnify the Palo Verde participants "from public liability arising from nuclear incidents which is in excess of the level of financial protection required of" the Palo Verde participants but not in excess of $560 million. The indemnity agreement is not currently operative and will remain inoperative unless or until the level of financial protection (*i.e.*, the aggregate amount of primary and secondary levels of liability protection) required of the Palo Verde participants falls below $560 million.

The authority of the NRC under the Price-Anderson Act to enter into indemnity agreements covering new nuclear facilities not now in operation or under construction will expire on August 1, 1987. This limited expiration of authority, if not modified by Congress, would have no effect upon the financial protection and indemnity agreements in effect for plants now in operation or under construction, such as Palo Verde. Nonetheless, this expiration date has served as a catalyst for proposals to amend the Price-Anderson Act in a variety of ways. Some would simply extend the indemnity authority for an additional ten years in order to preserve the viability of the nuclear option for future expansion of the nation's generating capacity. However, other proposals, if adopted, could apply to existing plants now licensed for operation, such as Units 1 and 2, by eliminating or altering

the limitation of liability or by increasing the maximum amount of retrospective annual premium which could be assessed. Several bills to extend the expiring provisions and to amend or eliminate other provisions of the Price-Anderson Act have been offered in both the Senate and the House of Representatives. The response of Congress to these proposals cannot be predicted, nor is it certain that Congress will act in the near future.

Water Supply for APS

Assured supplies of water are important both to APS (for its generating plants) and to its customers. However, conflicting claims to limited amounts of water in the Southwest have resulted in numerous court actions in recent years.

Both groundwater and surface water in areas important to APS' operation have been the subject of inquiries, claims, and legal proceedings which will require a number of years to resolve. APS has been named along with a number of defendants in three lawsuits brought in the United States District Court for the District of Arizona by or on behalf of Indian tribes regarding the pumping of groundwater near Indian reservations. APS has also been joined as one of a number of defendants in a proceeding before a state court in New Mexico to adjudicate rights to a stream system from which water for the Four Corners Plant is derived. See "Generating Fuel" in this Item for additional information regarding the water supply for the Four Corners Plant.

In connection with the construction and operation of Palo Verde, APS has entered into contracts with certain municipalities granting APS the right to purchase effluent for cooling purposes at Palo Verde and other future generating units. The validity of APS' primary effluent contract has been challenged in a suit filed by the Salt River Pima-Maricopa Indian Community (the "Community") against the Department of the Interior (the federal agency alleged to have jurisdiction over the use of such effluent) and additional defendants, including APS. The portion of the action challenging the effluent contract has been stayed while the Community litigates its claims against the Department of the Interior and other defendants for wrongful exclusion from the Salt River Project Improvement and Power District, a federal reclamation project.

In November 1982, certain operators of farms located in the vicinity of the Palo Verde site filed a lawsuit in Maricopa County Superior Court claiming prior rights to effluent to be delivered to Palo Verde under the primary and secondary effluent contracts. In December 1983, an owner of land in the river basin from which the effluent to be received under the primary contract is alleged to be derived filed a complaint in the United States District Court for the District of Arizona challenging the primary effluent contract. This action was dismissed in November 1985. That dismissal has been appealed to the United States Court of Appeals for the Ninth Circuit. APS joined with another Palo Verde participant in bringing an action in an Arizona state court against the plaintiffs in the two foregoing lawsuits, seeking a declaratory judgment as to rights to effluent under Arizona law. Such declaratory judgment action was consolidated in the Arizona state court with the lawsuit filed in November 1982. In October 1985, the state court ruled in favor of the Palo Verde participants in these consolidated lawsuits, holding that the effluent contracts are neither void, unenforceable, nor enjoinable for the reasons raised in the consolidated lawsuits by the parties adverse to the Palo Verde participants (the "Adverse Parties"). The Adverse Parties have appealed that decision to the Arizona Court of Appeals. APS and certain Palo Verde participants have cross-appealed.

On November 22, 1985, several municipalities which are parties to the primary effluent contract filed an action in Maricopa County Superior Court against certain of the Adverse Parties seeking a declaration that the primary effluent contract is valid notwithstanding claims asserted by those Adverse Parties that approval of the effluent contract exceeded the municipalities' legal authority and that the effluent contract violates the laws and public policy of Arizona. APS was named as an indispensable party. APS has answered the municipalities' complaint, alleging that there is no controversy because the Adverse Parties' claims are barred by applicable legal and equitable principles and alternatively seeking a declaration of the validity of the effluent contract. All parties have moved for summary judgment. A hearing on those motions is scheduled for April 21, 1986. On March 2

1986, the Adverse Parties in that suit sought leave to amend their answer to assert numerous counterclaims and join additional parties as counterdefendants, including the Company and the other Palo Verde participants. The proposed counterclaims allege that the primary effluent contract is invalid because it violates Arizona municipal law, Arizona water law, certain water supply agreements involving the municipalities, and various other provisions of state law. The Company will respond to the proposed amendment in a timely manner.

Although the foregoing matters remain subject to further evaluation, APS expects that the described litigation will not have a materially adverse impact on the completion, licensing, or operation of the Palo Verde units.

APS anticipates that existing water supplies in certain parts of Arizona will be augmented by Colorado River water upon completion of the Central Arizona Project (now scheduled to deliver water to Phoenix by mid-year 1986). Although APS has been granted an allocation of this water by the Secretary of the Interior, it expects that reasonably priced water will remain in short supply in Arizona as well as in the Four Corners region of New Mexico, that uncertainties in applicable water law as applied to pertinent facts and circumstances may persist for some time, and that its own highly visible status as a large consumer (along with that of other utilities, particularly those from out of state) may attract conflicting claims to present water supplies and objections to new plants. Nevertheless, APS believes that acceptable supplies will be available to its generating units now in operation or under construction throughout their useful lives.

Indian Matters

In August 1985, the Navajo Tribal Council adopted the Navajo Preference in Employment Act ("Employment Act") relating to requirements for preference in hiring, promotion, retention, and training of Navajos by companies and their contractors conducting business on or near the Navajo reservation. APS and the Chairman of the Navajo Nation, with authorization of the Advisory Committee of the Navajo Tribal Council, entered into a letter agreement in March 1985 ("Letter Agreement") regarding Indian employment preference at the Four Corners Plant. The Letter Agreement provides, among other things, that qualifications for employment and promotion shall be determined by APS. APS and the Tribe disagree on the interpretation of the Employment Act and whether the Employment Act or the Letter Agreement control future employment relations. The Employment Act, if binding on APS, could seriously impair APS' present ability to hire and promote the most qualified employees at the Four Corners Plant. APS cannot currently predict the outcome of this matter.

See also "Generating Fuel" and "Water Supply for APS," both in this Item, with respect to additional matters involving questions as to the rights of Indian tribes.

ITEM 2. PROPERTIES OF APS

APS' present generating facilities have an accredited capacity aggregating 3,640,370 kw comprised as follows:

	Capacity
Coal:	
Units 1, 2 and 3 at Four Corners, aggregating	560,000kw
15% owned Units 4 and 5 at Four Corners, representing	221,700
Units 1, 2, 3 and 4 at the Cholla Plant, aggregating	946,000(1)
14% owned Units 1, 2 and 3 at the Navajo Plant, representing	315,000
	2,042,700kw
Gas or Oil:	
Five steam units divided among the Saguaro (2) Ocotillo (2) and Yucca (1) Plants, aggregating	468,400kw
Eleven turbine units, aggregating	500,600
Three combined cycle units, aggregating	253,500
	1,222,500kw
Nuclear:	
29.1% owned Unit 1 at Palo Verde, representing	369,570kw
Other	5,600kw

(1) APS has agreed to sell varying amounts (up to 350,000 kw) of this capacity to another utility during the next five years.

The highest one-hour demand on its electric system which APS experienced in 1985 was 3,197,800 kw recorded on July 12, 1985, compared to a high of 2,970,600 kw experienced on August 30, 1984. Taking into account additional capacity then available to it under power purchase contracts as well as its own generating capacity, APS' capability of meeting system demand on July 12, 1985, computed in accordance with accepted industry practices, amounted to 3,570,800 kw for a reserve margin of 12.9%. The power actually available to APS from its resources fluctuates from time to time as a consequence of unit unavailability (because of shutdown for scheduled or unscheduled maintenance) and other technical problems. APS' own sources actually operable at the time of the July 12, 1985, peak demand were 1.2% less than those required.

Substantial capital expenditures for environmental protection measures have been and may be required to keep the Four Corners Plant, and possibly the Navajo Plant, in operation. See "Environmental Requirements" in Item 1. Both of those plants, along with certain of APS' transmission lines and all of its contracted coal sources, are located on Indian reservations. See "Generating Fuel" and "Indian Matters" in Item 1 and the sections cross-referenced therein with respect to the assertion of taxing and regulatory authority by the Navajo Tribe which will increase the cost of certain of APS' operations.

The receipt of a facility operating license for Palo Verde Unit 2 later than previously anticipated, combined with other factors, resulted in the announcement on January 14, 1986 of delays in the commercial operation dates of Palo Verde Units 2 and 3. APS' most recent projections indicate that Palo Verde Units 2 and 3 will achieve commercial operation during the third quarters of 1986 and 1987, respectively. Units 2 and 3 had been previously scheduled to achieve commercial operation during the second quarters of 1986 and 1987, respectively. Nuclear fuel loading was completed at Unit 1 on January 11, 1985, and that unit attained commercial operation on February 13, 1986. Unit 2 completed its fuel loading on December 16, 1985, and Unit 3 fuel loading is scheduled for the first quarter of 1987. The new schedule is not expected to increase APS' direct cost for its share of Palo Verde but is expected to increase APS' AFC for Units 2 and 3. The construction costs in the table below reflect the updated schedule announced in January 1986. However, various other factors m

affect the accuracy of the estimates shown as well as their comparability to other published estimates (which may have been prepared as of other review dates). Actual completion dates, unexpected inflationary pressures, and compliance with any additional governmental procedures and regulations could cause final costs to vary substantially from these and any later estimates, as could changes in APS' plans and changes of plans of other participants.

Type of Facility and Scheduled Completion Date	Nameplate Capacity or Equivalent	Estimated Construction Expenditures (Thousands of Dollars)(1)	Estimated Construction Expenditures Per Kilowatt(1)
Nuclear:			
29.1% owned Units 1 (1986), 2 (1986) and 3 (1987) of the Palo Verde Nuclear Generating Station, representing.....	1,109,000kw	$1,333,000(2)	$1,202

(1) Excluding expenditures for related transmission facilities, fuel, and fuel sources.
(2) Including $1,252,584,000 spent through December 31, 1985.

In addition to the construction expenditures shown in the table, APS capitalizes AFC, property taxes, start-up and pre-operating costs (including start-up power costs), and test energy credits associated with the foregoing facilities. Making certain assumptions (some of which differ from those involved in prior estimates) as to future interest rates, termination dates of AFC accruals, and other factors, APS has estimated that the addition of these associated costs to construction expenditures will bring its total installed cost for the three Palo Verde units to approximately $2,500 per kw. See "Rates-State" in Item 1 for a discussion of the construction limit imposed by the ACC for APS' share of Palo Verde cost.

APS' construction plans are susceptible to changes in forecasts of future demand on its electric system and in its ability to finance its construction program. Changes in the timing of forecasted increases in demand and other factors occurring since the commencement of construction of Unit 4 of the Cholla Plant caused APS to enter into agreements to temporarily sell up to 350,000 kw of that unit's generating capacity through 1990. Although its plans are subject to change, APS does not presently intend to construct any new major generating units, other than Palo Verde, until the end of the century. An important factor affecting APS' ability to delay the construction of new major generating units is a continuing effort to upgrade and improve the reliability of existing generating stations. APS is also looking to develop additional interties with neighboring utilities, to review reserve margins and reliability indices, to expand the size and scope of its load management program, and to explore cogeneration and third-party financed facilities.

Operation of each of the three Palo Verde units following its completion requires the obtaining of a low and full power operating license from the NRC. Facility operating licenses for Units 1 and 2 were granted by the NRC to APS and the other participants in Palo Verde in December 1984, and December 1985, respectively. The licenses, valid for a period of 40 years from the date of issuance, authorize APS, as operating agent for Palo Verde, to operate Units 1 and 2 at full power. Pending completion satisfactory to the NRC of certain tests and other items, however, the license for Unit 2 restricts operation of such unit to power levels not to exceed 5% of full power without specific NRC approval. Similar restrictions in the Unit 1 license were removed by the NRC in May 1985, and Unit 1 was placed in commercial operation in February 1986.

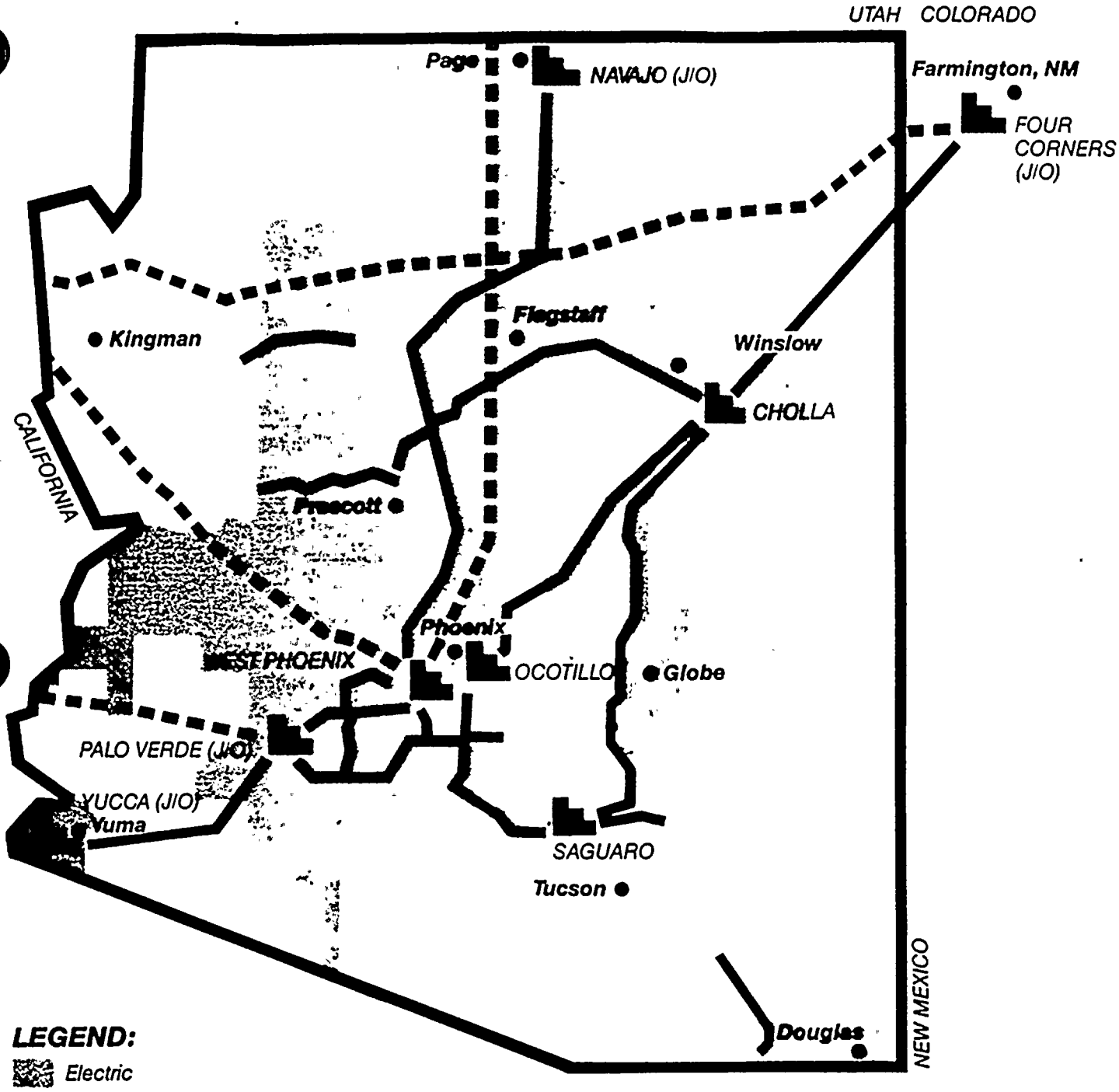
See also "Rates—State," "Water Supply for APS," and "Generating Fuel" in Item 1 with respect to matters having possible impact on the operation of Palo Verde.

In addition to that available from its own generating capacity, APS purchases electricity from other utilities under various arrangements. The most important of these is a long-term contract with Salt River Project Agricultural Improvement and Power District which may be canceled by the

District on three years' notice and which requires the District to make available, and APS to pay for certain amounts of electricity that are based in large part on customer demand within certain area now served by APS pursuant to a related territorial agreement. APS believes that the prices payable by it under the contract are fair to both parties. The generating capacity available to APS pursuant to the contract is currently 255,000 kw. In 1985 APS received 898,689 mwh of energy under the contract and paid approximately $45 million for capacity availability and energy received.

On January 25, 1985, the residents of the City of Page, Arizona ("Page") voted to acquire APS' electrical distribution system in and around the area of Page and to operate the acquired system as a municipal system. APS serves approximately 2,500 customers in the Page area. Page has filed a condemnation action to establish the value of the system and to acquire immediate possession. The exact property Page will ultimately acquire is unclear at this time and APS' preliminary estimate of the value of the system varies substantially from that of Page. The parties have stipulated that Page may take immediate possession of the system upon posting a bond intended to protect APS during the period of possession prior to trial. The trial is currently scheduled to begin in June 1986. APS cannot currently predict the outcome of this matter or the extent to which other municipalities may take similar action.

See Note 6 of Notes to Consolidated Financial Statements in Item 8 with respect to property of APS not held in fee or held subject to any major encumbrance.



LEGEND:

Electric

Major APS Power Plants (JIO = Joint Ownership)

Principal APS Transmission Lines

Transmission Lines Operated for Others

ITEM 3. LEGAL PROCEEDINGS

See "Rates," "Environmental Requirements," "Generating Fuel," "Water Supply for APS," and "Indian Matters," all in Item 1, and Item 2 in regard to pending or threatened litigation and other disputes involving APS.

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

No matter was submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report, through the solicitation of proxies or otherwise.

SUPPLEMENTAL ITEM. EXECUTIVE OFFICERS OF THE REGISTRANT

The Company's executive officers are as follows:

Name	Age at March 3, 1986	Position(s) at February 28, 1986
Keith L. Turley	62	Chairman of the Board of Directors and President
O. Mark De Michele	51	Executive Vice President and Director
Henry B. Sargent, Jr.	51	Executive Vice President, Treasurer, Chief Financial Officer, and Director
Jaron B. Norberg	48	Senior Vice President and Corporate Counsel
Faye Widenmann	37	Secretary
Kathryn A. Forbes	35	General Auditor
Sally F. Kur	41	Assistant Secretary

The executive officers of the Company are elected no less often than annually and may be removed by the Board of Directors at any time. The terms served by the named officers in their current positions and the principal occupations (in addition to those stated in the table and exclusive of directorships) of such officers have been as follows:

Mr. Turley was appointed Chairman of the Board and President of the Company in April 1985. Mr. Turley was appointed President of APS (a position he held until September 1982) and Chief Executive Officer of APS in 1974 and was appointed Chairman of the Board of Directors of APS in February 1981.

Mr. De Michele was elected Executive Vice President of the Company in April 1985. He has been President of APS since September 1982, and became Chief Operating Officer the following month. Previously he had occupied the positions of Executive Vice President for Customer, Employee and Corporate Relations of APS (since September 1981) and Vice President, Corporate-Relations of APS (April 1978 to September 1981).

Mr. Sargent has served in his current office with the Company since April 1985. He has been Executive Vice President and Chief Financial Officer of APS since September 1981. Before that date he was Vice President, Finance of APS.

Mr. Norberg was elected Senior Vice President and Corporate Counsel of the Company in 1985. He has been Senior Vice President and Corporate Counsel to APS since March 1982, prior to which time he had been a partner in the law firm of Snell & Wilmer.

Ms. Forbes was elected to her present position with the Company in 1985. She has been General Auditor of APS since March 1984 after serving as manager of the Audit Services Department since January 1982. Before that time she served as Internal Audit Supervisor (June 1980 to January 1982), Contract Audit Administrator (June 1979 to June 1980), and Senior Internal Auditor (November 1977 to June 1979).

Ms. Widemann was elected Secretary of the Company in 1985. She has been the Secretary of APS since December 1982. She previously held the following positions with APS: Manager of General Corporate Services (since March 1982) and Public Affairs Representative (March 1978 to June 1980).

Ms. Kur was elected Assistant Secretary to the Company in 1985. She has been the Assistant Secretary of APS since May 1985 and previously held the following positions with APS: Manager, General Corporate Services and Senior Writer.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCK HOLDER MATTERS

The Company's common stock is traded on the New York and Pacific Stock Exchanges. Prior to April 29, 1985, the Company's common stock was held solely by APS and was not listed for trading on any stock exchange.

The chart below sets forth the common stock price range on the composite tape, as reported in The Wall Street Journal, for the last three quarters of 1985. The second quarter common stock price ranges reflect the price ranges from April 29, 1985, the date on which the Company's common stock became publicly held. The chart also sets forth the dividends per share paid for the Company's common stock for the last three quarters of 1985.

Year		High	Low	Dividends
1985:	First Quarter	—	—	$ —
	Second Quarter	28-1/8	22-1/2	.68
	Third Quarter	28-1/8	22-5/8	.68
	Fourth Quarter	27-3/8	22-3/4	.68

Future dividends will depend on earnings and cash requirements of the Company and other factors. The holders of common stock are entitled to dividends when and as declared out of funds legally available therefor. See Notes 5 and 6 of Notes to Consolidated Financial Statements in Item 8 for restrictions on retained earnings available for the payment of dividends by APS to the Company. These restrictions could affect the Company's ability to pay dividends.

The number of record holders of the Company's common stock as of March 3, 1986 was 118,244. The closing price of the common stock on the composite tape on March 25, 1986, as reported in The Wall Street Journal, was 29¼.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

	Year Ended December 31,				
	1985	1984	1983	1982	1981
	(Thousands of Dollars, Except Per Share Data)				
Revenue from continuing operations	$1,174,502	$ 994,967	$ 871,875	$ 866,486	$ 730,788
Operating income from continuing operations	$ 306,984	$ 263,260	$ 253,412	$ 263,099	$ 249,724
Net income*	$ 279,549	$ 222,692	$ 221,056	$ 196,227	$ 170,648
Per share of common stock:					
Earnings (loss) (based on average shares outstanding)					
Continuing operations	$ 3.88	$ 3.65	$ 3.53	$ 3.25	$ 3.36
Discontinued operations	—	(0.39)	(0.07)	0.05	(0.10)
Total	$ 3.88	$ 3.26	$ 3.46	$ 3.30	$ 3.26
Dividends declared	$ 2.69	$ 2.60	$ 2.56	$ 2.40	$ 2.20
Total assets	$5,324,945	$4,653,774	$4,386,312	$3,888,536	$3,396,790
Long-term debt less current maturities and redeemable preferred stock	$2,425,361	$1,967,486	$1,892,477	$1,610,486	$1,618,048

*Restated to give effect to corporate restructuring (see Note 2 of Notes to Consolidated Financial Statements in Item 8).

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Liquidity and Capital Resources

The primary factor in the Company's current liquidity and capital resources is APS' ability to fund its capital requirements. Consequently, the following discussion will address APS' liquidity and capital resources.

APS' large capital requirements for its ongoing construction program and for the refunding of maturing securities, and its heavy reliance on external financing to meet those requirements, are discussed in "Construction and Financing Programs of APS" and in "Properties of APS" in Item 2. APS has a degree of flexibility in adjusting its construction program to its financing capability. However, that flexibility is limited and APS' long-term liquidity will depend on its access to the capital markets which in turn will depend on sufficiency of APS' rates to provide adequate coverages on its senior securities and an adequate rate of return on common stock equity. Adequate earnings and coverages are critical to the maintenance of satisfactory credit ratings on APS' senior securities and, as calculated in accordance with the governing instruments, are prerequisite to APS' legal ability to issue such securities.

See "Capital Structure" in Item 1 with respect to the Company's capital structure at December 31, 1985. Its target structure consists of no more than 50% debt (including current maturities and short-term obligations) and 40% common stock equity, with the balance consisting of preferred stock. AZP regards common stock equity as its most expensive form of permanent financing, but it intends to maintain that category at approximately the 40% level in order to support the credit ratings on APS' senior securities. If interest and dividend rates on new issues of long-term debt and preferred stock rise in the future, APS' average cost of capital will rise accordingly.

See "Construction and Financing Programs of APS" in Item 1 and Note 7 of Notes to Consolidated Financial Statements in Item 8 with respect to short-term borrowings available to APS (there being a statutory limitation on the amount of such borrowings that APS can have outstanding without consent from the ACC). Funds from operations after the payment of dividends have contributed only marginally to total sources of funds in the last few years (see "Industry Problems" and "Construction and Financing Programs of APS" in Item 1). This situation is expected to continue to some degree until Unit 1 is fully included in rate base so as to give rise to additional cash earnings. APS' retention of funds from operations has also been affected by its policy of increasing common stock dividends periodically (see Item 6).

On February 13, 1986, the date Unit 1 attained commercial operation as defined by the ACC, APS ceased accruing AFC with respect to Unit 1 and the facilities common to all three Palo Verde units (the "Common Facilities"), currently totalling approximately $6 million per month. In addition, APS began expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 1 and the Common Facilities, currently estimated at $5 million per month. Absent adequate and timely rate relief from the ACC, APS expects these developments to adversely affect is earnings.

As part of the Unit 1 Rate Case, APS is seeking an accounting/rate-making order from the ACC allowing the Common Facilities to be transferred to plant in service in three equal increments, each tied to the commercial operation date of a Palo Verde unit, with the continuance of a carrying charge equivalent to AFC on any portion which has not been transferred to plant in service. If the ACC grants such accounting/rate-making order, APS would be able to accrue approximately $1 million of such carrying charge per month on each of the remaining two portions of the Common Facilities which have not been transferred to plant in service. In addition, APS would be able to defer expensing the cost of owning, operating, and maintaining its 29.1% share of each of the remaining two portions of the Common Facilities, with such expenses currently totalling approximately $.3 million in expenses per month for each such portion.

APS has also requested that the ACC issue an accounting/rate-making order which would allo APS to defer expensing the cost of Unit 2 and continue the accrual of a carrying charge equivalent AFC from the commencement of the commercial operation of Unit 2 until APS is allowed to recover the cost of Unit 2 in rates. If the ACC does not grant the requested accounting/rate-making order relating to Unit 2, when Unit 2 achieves commercial operation (currently scheduled for the third quarter of 1986) APS will cease accruing AFC with respect to Unit 2, currently totalling approximately $6 million per month. In addition, APS will begin expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 2, currently estimated at $3 million per month. If the ACC does not grant the requested accounting/rate-making order with respect to Unit 2 or grant adequate and timely rate relief with respect to Unit 2, APS expects its earnings to be adversely affected.

Operating Results

The Company's subsidiaries, other than APS, are not considered material to an understanding of the Company's operating results. Consequently the following discussion will address only APS' operating results.

Total operating revenues reflect the effects of rate increases and adjustment clauses (see "Rates" in Item 1 and Note 1c of Notes to Consolidated Financial Statements) on prices of units sold. Operating revenues also reflect the volume changes in unit sales shown in "Operating Statistics" in this Item. The foregoing factors contributed to annual increases in electric revenues over the preceding calendar year as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Energy related:			
Volume increases (decreases) (1)	$ 71,169	$ 29,216	$ 13,438
Price increases (decreases) (2)	63,742	93,229	(360)
Non-energy related:			
Revenue increases (decreases) (3)	44,624	647	(7,689)
Net increase	$179,535	$123,092	$ 5,389

(1) Calculated by summing the products derived by multiplying the year-to-year increases in units sold in each customer class by the weighted average of the applicable rate levels in effect for the prior year.

(2) Calculated by summing the products derived by the year-to-year increases in the weighted average of rate levels in each customer class times the applicable number of units sold in the current year. Relative contributions by rate increases and by effects of APS' fuel adjustment clauses vary according to the timing of general rate proceedings and the extent to which accumulated effects of the adjustment clauses are incorporated in new rates.

(3) Includes revenues for miscellaneous service and transmission for others.

The increase in volume-related electric revenues in 1985 was primarily due to higher sales in the residential and commercial classes. These sales increases were mainly the result of customer growth and the warmer weather conditions experienced during the summer of 1985. In addition, there were increased industrial sales to the copper industry. Unit sales of electricity increased in 1984 primarily due to customer growth in the residential and commercial classes and more humid weather conditions, partially offset by decreased industrial and resale sales. The increase in unit sales of electricity in 1983 was primarily due to customer growth in the residential and commercial classes partially offset by descreased retail and resale irrigation usage resulting from the U.S. Government's Payment-in-Kind Program. Conservation efforts by customers in response to higher energy costs hav

affected unit sales, are expected to continue to do so, and are being aided by the Company's own load-management programs. The year-to-year changes in non-energy related electric revenues reflect changes in capacity sold to other utilities (see "Properties of APS" in Item 2).

Although unit fuel costs have continued to rise, APS' cost of fuel per kilowatt-hour generated has been tempered by the large portion of coal in the fuel mix. See "Rates—Adjustment Clauses" in Item 1 and Note 1c of Notes to Consolidated Financial Statements in Item 8 with respect to the pass-through treatment of increased unit fuel costs and the increase in APS' deferred fuel account. In 1985, increases in fuel expenses were primarily due to increased gas generation. In 1984, the slight increases in fuel expenses reflects increases in the unit costs of fuel for generation partially offset by an improved fuel mix and high capacity factors at APS' coal-fired plants.

Variations in purchased power and interchange-net reflect varying degrees of availability of relatively low-priced power from other sources including energy available from testing of APS' nuclear generating unit, the need for APS to augment its own generating sources from time to time, and APS' ability to sell energy to neighboring utilities. In 1985, an increase in purchased power and interchange-net was primarily due to increased purchased power requirements and reduced interchange sales to other utilities. This increase was largely offset by the accounting treatment for APS' fuel and purchased power expense (See Note 1c of Notes to Consolidated Financial Statements in Item 8). The increase in purchased power and interchange-net expense in 1984 was primarily due to accounting treatment for fuel and purchased power which was largely offset by increased interchange sales to other utilities.

See "Effects of Inflation" in this Item in regard to maintenance expense, which is a function of the size of the Company's utility plant and is affected by the timing of major overhauls. The increase in operations excluding fuel expense in 1985 was due in large part to increased payroll, associated expenses related to customer growth, and an addition to the reserve for uncollectibles resulting from an unpaid note.

Depreciation and amortization expenses and ad valorem taxes increase with the size of APS' utility plant. See Note 12 of Notes to Consolidated Financial Statement in Item 8 for both ad valorem and sales taxes (the latter being a function of operating revenues), which are the principal components of other taxes.

The increases in income taxes and deferred income taxes in 1985 and 1984 were largely a result of APS' compliance with an ACC accounting order, effective October 1, 1983, the aggregate effect of which was to require APS to normalize substantially all income tax timing differences (see Note 1e of Notes to Consolidated Financial Statements in Item 8).

The aggregate amount of AFC, shown as other income and a credit to interest deductions, is primarily a function of the amount of construction work in progress during any given period and ceases to accrue on those portions of construction work in progress that are included in rate base. See Note 1d of Notes to Consolidated Financial Statements in Item 8 for changes in rates of AFC. See "Liquidity and Capital Resources" in this Item with respect to the non-cash aspect of AFC.

The increase in interest on long-term debt in both 1985 and 1984 reflects large amounts of new borrowings. See "Liquidity and Capital Resources" in this Item and Note 6 of Notes to Consolidated Financial Statements in Item 8. The decrease in interest on short-term borrowings in 1985 resulted primarily from decreased borrowings. The increase in 1984 was due primarily to increased borrowings over the previous years.

Consolidated net income represents a composite of cash and non-cash items (see the Consolidated Statements of Changes in Financial Position in Item 8) and, in part, reflect accounting practices unique to regulated public utilities.

APS sold its gas distribution system, effective November 1, 1984. Accordingly, 1983's Consolidated Statement of Income and Retained Earnings has been reclassified to report separately this discontinued operation. See Note 13 of Notes to Consolidated Financial Statements, in Item 8.

Effects of Inflation

In contrast to the analysis of increases in operating revenues in the table at the beginning of "Operating Results" of this Item, it is sometimes difficult, in the case of operation and maintenance expenses, to distinguish between effects of volume increases and rises in unit costs (which, for purposes of this discussion, are all attributed to inflationary pressures).

Certain inflationary effects, such as those on costs of generating fuel, are passed through to customers pursuant to rate adjustment procedures (see "Rates—Adjustment Clauses" in Item 1). Nevertheless, APS attempts to minimize such effects by means that include increasing the availability of its coal-fired units to result in a more economical fuel mix. This increase has been achieved by an intensive maintenance program, the cost of which is not covered by the adjustment clauses. There are a number of other major expense items that are also beyond the scope of the adjustment clauses. Inflationary pressures on these items have given rise to a significant earnings attrition between general rate increases. See "Rates" in Item 1 with respect to APS' most recent rate filings.

See Note 15 of Notes to Consolidated Financial Statements in Item 8 for perspectives on other effects of inflation.

Operating Statistics

	Year Ended December 31,		
	1985	1984	1983
Electric Operations:			
Number of Customers (end of period):			
Residential	456,071	436,119	407,340
Commercial	61,110	58,810	56,470
Industrial	1,948	2,007	2,047
Irrigation	1,669	1,766	1,850
Other	769	1,049	1,061
Total Customers	521,567	499,751	468,768
Electric Sales (MWH):			
Residential	4,626,153	4,328,332	4,082,505
Commercial	4,867,856	4,495,954	4,195,225
Industrial	2,343,212	2,133,938	2,388,634
Irrigation	346,765	422,520	279,420
Other	1,787,328	1,674,243	1,807,758
Total Electric Sales	13,971,314	13,054,987	12,753,542
Operating Revenues (000):			
Residential	$ 438,265	$378,536	$314,404
Commercial	401,439	343,971	296,364
Industrial	135,254	126,187	122,184
Irrigation	22,853	25,540	15,113
Other	87,728	86,394	90,118
Total	1,095,539	960,628	838,183
Transmission for Others	16,602	13,023	12,555
Miscellaneous Services	62,361	21,316	21,137
Total Electric Operating Revenues	$1,174,502	$994,967	$871,875
Revenue Per KWH (Cents):			
Residential	9.47¢	8.75¢	7.70¢
Commercial	8.25¢	7.65¢	7.06¢
Industrial	5.77¢	5.91¢	5.12¢
Costs Per KWH Generated (Cents):			
Fuel	1.72¢	1.32¢	1.34¢
Total Electric Operating Expense	6.78¢	5.19¢	4.47¢
Annual KWH Per Average Residential Customer*	10,499	10,355	10,357

*Total units sold divided by average number of customers.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTAL CONSOLIDATED SCHEDULES

See Note 14 of Notes to Consolidated Financial Statements for the selected quarterly financial data required to be presented in this Item.

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

AZP Group, Inc:

We have examined the consolidated financial statements and supplemental consolidated schedules of AZP Group, Inc. and its subsidiaries as of December 31, 1985 and 1984 and for each of the three years in the period ended December 31, 1985, listed in the accompanying index. 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, such consolidated financial statements present fairly the financial position of AZP Group, Inc. and its 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. Also, in our opinion, such supplemental consolidated schedules, when considered in relation to the basic consolidated financial statements, present fairly in all material respects the information shown therein.

DELOITTE HASKINS & SELLS

Phoenix, Arizona
February 20, 1986

AZP GROUP, INC.

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

	Year Ended December 31,		
	1985	1984	1983
	(Dollars in Thousands, Except Per Share Amounts)		
Electric Operating Revenues	$ 1,174,502	$ 994,967	$ 871,875
Fuel Expenses:			
Fuel for electric generation	219,575	186,276	185,504
Purchased power and interchange - net	16,789	6,647	6,454
Total	236,364	192,923	191,958
Operating Revenues Less Fuel Expenses	938,138	802,044	679,917
Other Operating Expenses:			
Operations excluding fuel expenses	122,751	97,535	94,511
Maintenance	88,870	68,207	62,681
Depreciation and amortization	99,221	87,494	83,707
Income taxes (Note 9)	216,036	191,100	103,186
Other taxes (Note 12)	104,276	94,448	82,420
Total	631,154	538,784	426,505
Operating Income	306,984	263,260	253,412
Other Income (Deductions):			
Allowance for equity funds used during construction	143,612	134,359	121,390
Income taxes (Note 9)	51,676	54,028	9,256
Other - net	(6,703)	2,431	3,813
Total	188,585	190,818	134,459
Income Before Interest And Other Deductions	495,569	454,078	387,871
Interest And Other Deductions:			
Interest on long-term debt	209,220	191,079	170,830
Interest on short-term borrowings	6,951	12,281	11,430
Debt discount, premium and expense	3,613	2,465	1,959
Allowance for borrowed funds used during construction	(48,176)	(49,317)	(65,400)
Preferred stock dividend requirements of APS (Note 2)	44,412	48,375	43,741
Total	216,020	204,883	162,560
Income From Continuing Operations	279,549	249,195	225,311
Loss From Disposal and Operation of Discontinued Gas System Net of Tax (Note 13)	—	(26,503)	(4,255)
Net Income (Note 2)	279,549	222,692	221,056
Retained Earnings At Beginning Of Year	505,414	459,962	401,723
Deduct:			
Common stock dividends (Notes 4 and 5)	194,091	177,240	162,817
Retained Earnings At End Of Year	$ 590,872	$ 505,414	$ 459,962
Average Common Shares Outstanding	72,126,618	68,308,131	63,865,210
Per Share of Common Stock:			
Earnings (Loss) (based on average shares outstanding):			
Continuing operations	$ 3.88	$ 3.65	$ 3.53
Discontinued operations	—	(0.39)	(0.07)
Total	$ 3.88	$ 3.26	$ 3.46
Dividends declared	$ 2.69	$ 2.60	$ 2.56

See Notes to Consolidated Financial Statements.

AZP GROUP, INC.

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
Utility Plant (Notes 6 and 8):		
Electric plant in service	$2,929,926	$2,747,464
Construction work in progress	2,742,139	2,304,306
Plant held for future use	40,442	36,473
Total Utility Plant	5,712,507	5,088,243
Less accumulated depreciation and amortization	838,684	744,160
Utility Plant—net	4,873,823	4,344,083
Investments and Other Assets:		
Investments in and receivables from subsidiaries	84,253	61,693
Other investments and notes receivable	6,004	5,588
Total Investments and Other Assets	90,257	67,281
Current Assets:		
Cash	7,338	7,565
Temporary cash investments	5,100	—
Special deposits and working funds	3,342	3,339
Accounts receivable:		
Service customers	84,533	70,560
Other	43,257	35,329
Allowance for doubtful accounts	(1,395)	(1,434)
Materials and supplies (at average cost)	41,525	42,942
Fuel (at average cost)	30,433	30,163
Deferred fuel	74,335	927
Other	3,873	6,036
Total Current Assets	292,341	195,427
Deferred Debits:		
Unamortized gas exploration costs	10,417	12,967
Unamortized debt issue costs	16,705	13,931
Other	41,402	20,085
Total Deferred Debits	68,524	46,983
Total	$5,324,945	$4,653,774

See Notes to Consolidated Financial Statements.

AZP GROUP, INC.

CONSOLIDATED BALANCE SHEETS

LIABILITIES

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
Capitalization (Notes 2, 4, 5 and 6):		
Common stock, no par value, authorized 100,000,000 shares: issued & outstanding 74,346,118 in 1985 and 70,128,329 in 1984	$1,294,623	$1,190,509
Retained earnings	590,872	505,414
Common stock equity	1,885,495	1,695,923
Non-redeemable preferred stock of APS	218,561	218,561
Redeemable preferred stock of APS	219,421	282,740
Long-term debt less current maturities	2,205,940	1,684,746
Total Capitalization	4,529,417	3,881,970
Current Liabilities:		
Notes payable	—	1,800
Commercial paper	18,000	158,000
Current maturities of long-term debt (Note 6)	17,456	70,890
Accounts payable	87,121	68,090
Accrued taxes	52,296	49,348
Accrued interest	72,678	55,906
Accrued dividends of APS	3,566	4,143
Other	26,269	32,405
Total Current Liabilities	277,386	440,582
Deferred Credits and Other:		
Deferred income taxes	230,553	110,821
Deferred investment tax credit	174,503	138,120
Unamortized credit related to sale of tax benefits (Note 9)	43,645	45,333
Customers' advances for construction	23,991	21,351
Other	45,450	15,597
Total Deferred Credits and Other	518,142	331,222
Commitments (Notes 3 and 11)		
Total	$5,324,945	$4,653,774

AZP GROUP, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Source of Funds:			
Funds from operations:			
Continuing operations:			
Income from continuing operations	$ 279,549	$249,195	$225,311
Principal non-fund charges (credits) to income:			
Depreciation and amortization	99,221	87,494	83,707
Allowance for equity funds used during construction	(143,612)	(134,359)	(121,390)
Deferred income taxes—net	106,158	43,464	27,033
Deferred investment tax credit—net	36,383	56,002	29,960
Other	31,361	(385)	4,967
Total funds from continuing operations	409,060	301,411	249,588
Funds from discontinued gas system—net	—	(3,093)	5,116
Total funds from operations	409,060	298,318	254,704
Funds from external sources:			
Proceeds from sale of gas system	—	114,657	—
Common stock	104,114	63,800	86,918
Preferred stock of APS	—	50,000	48,875
Long-term debt of APS	745,030	264,179	419,126
Other items—net	(1,616)	(3,916)	4,141
Total funds from external sources	847,528	488,720	559,060
Total source of funds	$1,256,588	$787,038	$813,764
Application of Funds:			
Funds used for capital expenditures:			
Continuing operations	$ 494,105	$377,278	$425,130
Discontinued operations	—	31,657	29,724
Investments and other assets	22,976	(13,299)	(4,955)
Short-term borrowings—net	141,800	(73,492)	3,308
Repayment of long-term debt of APS	275,421	275,833	185,653
Redemption of redeemable preferred stock of APS	63,319	4,660	3,820
Dividends on common stock	194,091	177,240	162,817
Increase in working capital*	64,876	7,161	8,267
Total application of funds	$1,256,588	$787,038	$813,764
Increase (Decrease) in Working Capital*:			
Cash and temporary cash investments	$ 4,876	$(25,704)	$ 24,801
Accounts receivable	21,940	(2,216)	(950)
Materials, supplies and fuel	(1,147)	(1,420)	(2,760)
Deferred fuel and other assets	71,245	(4,191)	(2,048)
Accounts payable and accrued expenses	(38,174)	32,881	(23,904)
Other liabilities	6,136	7,811	13,128
Net increase	$ 64,876	$ 7,161	$ 8,267

*Excluding short-term borrowings—net and current maturities of long-term debt.

See Notes to Consolidated Financial Statements.

1. Summary of Significant Accounting Policies.

a. Consolidation—The consolidated financial statements of AZP Group, Inc. (the "Company" or "AZP") include the accounts of AZP and its principal subsidiary, Arizona Public Service Company ("APS") and those of APS' wholly-owned subsidiaries, APS Finance Company N.V. ("Finance"), organized to serve as a financing corporation to raise funds outside the United States of America, and APS Fuels Company, organized to manage investments in certain fuel resources. All significant intercompany balances and transactions have been eliminated. Other AZP subsidiaries, which are shown on the equity basis, are not considered material for financial reporting purposes.

b. Plant and depreciation—Utility property is stated at original cost as defined for regulatory purposes. The cost of additions to utility plant and replacements of retirement units is capitalized. Replacements of minor items of property are charged to expense as incurred. In addition to direct costs, capitalized items include the present value of certain future lease payments (see Note 6), research and development expenditures pertaining to construction projects, indirect charges for engineering, supervision, transportation and similar costs, and an allowance for funds used during construction. Costs of depreciable units of plant retired are eliminated from plant accounts and such costs plus removal expenses less salvage are charged to accumulated depreciation. Contributions in aid of construction are credited to plant cost.

Depreciation on utility property is provided on a straight-line basis at rates authorized by the Arizona Corporation Commission ("ACC") annually. The applicable rates for 1983 through 1985 ranged from 2.86% to 9.86% for electric plant.

c. Revenues and fuel costs—Operating revenues are recognized when billed on a monthly cycle billing basis. Retail rate schedules include adjustment clauses which permit recovery of costs of certain fuel and purchased power. Regulatory hearings are held periodically to adjust the rates applicable under fuel adjustment clauses to more nearly match actual fuel costs. Temporary net under- or over-recoveries of costs resulting from application of the adjustment clauses are recognized as a deferred fuel asset or liability, respectively, with an offsetting amount recognized in purchased power and interchange—net expense. See Note 3 for a discussion of current rate matters related to such clauses.

d. Allowance for funds used during construction—In accordance with the regulatory accounting practice prescribed by the FERC and the ACC, APS capitalizes an allowance for the cost of funds used to finance its construction program ("AFC"). AFC, which does not represent current cash earnings, is defined as the net cost during the period of construction of borrowed funds, and a reasonable rate of return on equity funds so used. The calculated amount is capitalized as a part of the cost of utility plant.

AFC has been calculated using composite rates of 12.75% in 1985 and 1984 and 13.0% in 1983. In July 1983 APS began compounding AFC semi-annually and, in October 1983, recording the borrowed funds portion on a "net of tax" basis through charges to income taxes—operating expense and credits to income taxes—other income. AFC ceases to accrue on those portions of construction work in progress allowed in rate base which, for ACC purposes, was approximately $460,000,000 at December 31, 1985.

e. Income taxes—APS uses accelerated depreciation methods for income tax purposes. As prescribed by the ACC, deferred income taxes are provided for certain timing differences arising from the recording, for income tax and financial reporting purposes, of depreciation of property placed in service after January 1, 1977. In October 1983, in accordance with an ACC order, APS began deferring amounts equal to the change in income taxes arising from substantially all other timing differences. Prior to October 1983, such differences were reflected currently in income. At December 31, 1985 APS had flowed to income currently approximately $271,600,000 of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

In 1982 APS, in compliance with an ACC order, began deferring amounts equal to the reduction in Federal income taxes arising from investment tax credits and amortizing these amounts to other income over the estimated life of the related assets. Before 1982 such amounts were flowed through income currently.

f. Research and development costs—Research and development costs are expensed on a current basis, except that costs which may result in additions to utility plant are deferred for subsequent inclusion in plant or to be written off if the applicable project is abandoned.

g. Gas exploration costs—The excess of costs over sales proceeds of APS' discontinued gas exploration program has been deferred to be recovered, without interest, over a ten-year period pursuant to an order of the ACC, from certain classes of customers. A portion of such amount is now being remitted to APS by Southwest Gas Corporation as a result of the sale of the gas distribution system in 1984. See Note 13.

h. Discontinued operations—As described in Note 13, APS sold its gas distribution system, effective November 1, 1984. Accordingly, 1983's statement of income has been reclassified to report separately this discontinued operation.

2. Corporate Restructuring.

On April 18, 1985, APS' shareholders approved a plan for corporate restructuring to provide financial and organizational flexibility by separating regulated utility operations from other activities. Effective April 29, 1985, APS became a subsidiary of AZP.

As part of the restructuring, APS sold to AZP, at book value, the common stock of three of APS' wholly-owned subsidiaries: Malapai Resources Company, Energy Development Company and El Dorado Investment Company.

The accompanying consolidated financial statements have given effect to the restructuring for all periods presented. Accordingly, the preferred dividend requirements of APS are classified as Interest and Other Deductions. Except for this change, the restructuring had no material effect on the historical financial statements. The corporate restructuring also had no effect on the ownership of APS preferred stock or on APS debt securities.

3. Rate Matters.

In 1984, a committee comprised of representatives from each of the state utility regulatory commissions having primary jurisdiction over the rates of the various regulated participants in the Arizona Nuclear Power Project commissioned a study to determine whether sufficient evidence exists to warrant a prudency audit of costs incurred for construction. In September, 1985, the committee concluded that an audit should be performed relating to $3.12 billion of material and labor costs, of which APS' share is approximately $900 million, as well as financing and certain indirect costs related to the project. The prudency audit is expected to begin in 1986 with recommendations expected in late 1986 or 1987. Any amounts subsequently deemed by the ACC imprudently spent and not allowed

in rate base would be written off. Although the Company is unable to predict the final outcome of this matter, management believes, based on current information, that overall the Palo Verde Nuclear Generating Station (Palo Verde) was constructed in a prudent manner.

On February 11, 1986 hearings commenced concerning costs deferred by APS through the operation of its purchased power and fuel adjustment clause. In August, 1985 the ACC granted a rate increase sufficient only to limit the increase in the accumulated balance of such costs and agreed to hear testimony in connection with the accumulated balance (approximately $74 million at December 31, 1985). To date no order has been received. Management believes that any ultimate disallowance of such cost should not be material to the Company's operation or financial position.

As an incentive to complete construction and commence operation of Palo Verde, the ACC in a November, 1984 order, placed a cap on the total construction costs. The cap was set at $2.86 billion. Amounts expended in excess of the cap are presumed to be imprudent under the Commission's order. The most recent estimate of APS' share of total Palo Verde construction costs is $2.76 billion.

On May 24, 1985, APS filed with the ACC a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 1. Unit 1 commenced commercial operation on February 13, 1986 and APS began incurring such costs at that time. Also requested was an accounting order allowing the deferral until 1987 of the costs of commercial operation of Palo Verde Unit 2 which is expected to commence commercial operation in the third quarter of 1986. A hearing on this request has been scheduled for March 27, 1986.

On December 18, 1985, APS filed a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 2. As requested by the ACC, APS proposed as an alternative to a one step increase, and subject to certain conditions precedent, that the costs of commercial operation of Unit 2 be phased in over a period of years. The hearing date for the Unit 2 phase of the case has been set for September 26, 1986.

4. Non-Redeemable Preferred Stock of APS and Common Stock of AZP.

The balances at December 31, 1985 and 1984 of preferred stock of APS which is not redeemable except pursuant to call by APS at its option, are shown below.

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding at December 31,			Outstanding at December 31,		
	Authorized	1985	1984	Per Share	1985	1984	
					(Thousands of Dollars)		
Non-Redeemable Preferred Stock of APS (cumulative):							
$1.10 preferred	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000						
$2.40 Series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 Series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 Series D		200,000	200,000	50.00	10,000	10,000	50.50
$3.25 Series E		320,000	320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(b)						
$8.32 Series J		500,000	500,000	100.00	50,000	50,000	(c)
Adjustable rate series Q		500,000	500,000	100.00	50,000	50,000	(d)
Serial preferred	10,000,000						
$3.58 Series O		2,000,000	2,000,000	25.00	50,000	50,000	(e)
Total		4,374,199	4,374,199		$218,561	$218,561	

(a) In each case plus accrued dividends.

(b) This authorization also covers outstanding redeemable preferred shares shown in Note 5, as well as the non-redeemable shares indicated above.

(c) At $105.50 through August 31, 1987; at $103.00 through August 31, 1992; and at $101.00 thereafter.

(d) Bears dividends at a rate, adjusted on a quarterly basis, 2% below the rate borne by certain United States Treasury Securities, but in no event less than 6% per annum, or greater than 12% per annum. Redeemable on or after March 1, 1988 at the option of the APS at $103.00 through February 28, 1993; and at $100.00 thereafter.

(e) Not redeemable prior to June 1, 1987 through certain refunding operations that would result in a lower rate of cost to APS than the dividend rate on the shares to be redeemed; otherwise at $28.58 through May 31, 1987; at $27.39 through May 31, 1992; at $26.19 through May 31, 1997; and at $25.00 thereafter.

The holders of preferred stock of APS are entitled to one vote for each share held. Special requirements for favorable votes of holders of preferred stock, voting by the classes respectively prescribed for the several purposes, pertain to (i) certain conversions or exchanges of outstanding preferred stock, (ii) the authorization of any stock ranking prior to the preferred stock, (iii) making any change in the terms and provisions of preferred stock that would adversely affect the rights and preferences of the holders thereof, (iv) the issuance of any additional shares of preferred stock except under prescribed circumstances or (v) a merger, consolidation or sale of substantially all the assets of APS. The foregoing voting rights attach to both redeemable and non-redeemable preferred stock, as do the rights that would arise out of dividend arrearages as discussed in Note 5.

Sales of common stock of AZP and non-redeemable preferred stock of APS during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

	Common Stock*		Non-Redeemable Preferred Stock of APS (cumulative)	
Description	Number of Shares	Amount**	Number of Shares	Par Value Amount
Balance, December 31, 1982	62,894,490	$1,040,916	3,874,199	$168,561
Common Stock	3,816,362	85,793	—	—
Non-Redeemable Preferred Stock, Adjustable Rate Series Q	—	—	500,000	50,000
Balance, December 31, 1983	66,710,852	1,126,709	4,374,199	218,561
Common Stock	3,417,477	63,800	—	—
Balance, December 31, 1984	70,128,329	1,190,509	4,374,199	218,561
Common Stock	4,217,789	104,114	—	—
Balance, December 31, 1985	74,346,118	$1,294,623	4,374,199	$218,561

*Common stock of APS prior to April 29, 1985, See Note 2 regarding corporate restructuring.

**Includes premiums and expenses of preferred stock issues.

The Company has a stock purchase and dividend reinvestment plan whereby newly issued shares of its common stock may be purchased at market on the applicable dates by any participant in the plan. APS has an employee savings plan under which the investment of certain funds contributed by participating employees could, and its own contributions (pursuant to provisions calling for the matching of employee contributions on certain terms or provisions pursuant to which limited federal tax credits can be obtained by reason of voluntary contributions) would, involve the issuance of new shares of AZP common stock. Contributions made by APS to its employee retirement plan may also involve one or more such issuances.

5. Redeemable Preferred Stock of APS.

The balances at December 31, 1985 and 1984 of preferred stock of APS which is redeemable at the option of the holders or pursuant to sinking fund obligations, in addition to being callable by APS, are shown below.

	Number of Shares Outstanding at December 31,		Par Value			
			Per	Outstanding at December 31,		Call Price
	1985	1984	Share	1985	1984	Per Share(a)
				(Thousands of Dollars)		
Redeemable Preferred Stock (cumulative) serial preferred: (b)						
$8.50 Series G	—	38,400	$100.00	$ —	$ 3,840	
$10 Series H	104,677	304,000	100.00	10,468	30,400	(c)
$10.70 Series I	209,934	240,000	100.00	20,993	24,000	(d)
$8.80 Series K	344,600	600,000	100.00	34,460	60,000	(e)
$9.70 Series L	480,000	480,000	100.00	48,000	48,000	(f)
$11.95 Series M	85,000	195,000	100.00	8,500	19,500	(g)
$12.90 Series N	370,000	370,000	100.00	37,000	37,000	(h)
Adjustable Rate Series P	100,000	100,000	100.00	10,000	10,000	(i)
$11.50 Series R	500,000	500,000	100.00	50,000	50,000	(j)
Total	2,194,211	2,827,400		$219,421	$282,740	

(a) In each case plus accrued dividends.

(b) See Note 4 for authorized number of shares.

(c) Redeemable at $106.12 through September 1, 1986, and thereafter declining by $0.36 per year to par after September 1, 2002. Applicable sinking fund provisions require the redemption of 16,000 shares at par annually (representing annual payments of $1,600,000).

(d) Redeemable at $103.00 through November 30, 1990, and at $101.00 thereafter. Applicable sinking fund provisions require the redemption of 15,000 shares at par annually (representing annual payments of $1,500,000). APS may, but is not required to, redeem an additional 15,000 shares at par on December 1 in any year.

(e) Redeemable at $106.00 through February 28, 1989; at $103.00 through February 28, 1994; and thereafter declining in steps to $101.00. Applicable sinking fund provisions require the redemption of 22,500 shares at par annually commencing March 1, 1986 (representing annual payments of $2,250,000). APS may, but is not required to, redeem an additional 22,500 shares at par on March 1 in any year beginning in 1986. At December 31, 1985, APS had met the 1986 sinking fund requirement.

(f) Redeemable at the option of APS at $104.31 through February 28, 1986, declining by $1.08 per year to $101.07 after March 1, 1989. Applicable sinking fund provisions require the redemption of 96,000 shares at par annually commencing March 1, 1986 (representing annual payments of $9,600,000).

(g) Redeemable on or after May 1, 1986 at the option of APS at $101.99 through April 30, 1987; and thereafter at par. All shares then outstanding are required to be redeemed on May 1, 1988 at par.

(h) Redeemable after June 1, 1992 at the option of APS at $106.11 through June 1, 1993, declining by $0.68 per year to $100.00 after June 1, 2002. Applicable sinking fund provisions require the redemption between 1988 and 2002 of all shares according to a predetermined schedule.

(i) Bears a dividend of $12.50 per share through December 1, 1987 and a dividend thereafter to be fixed by a formula related to the average prime interest rate in 1987. Redeemable at par on or after December 1, 1987 at the option of APS. Applicable sinking fund provisions require the redemption of 20,000 shares at par each December 1 beginning in 1988 (representing annual payments of $2,000,000). All shares then outstanding are required to be redeemed on December 1, 1992.

(j) Redeemable after June 1, 1994 at the option of APS at $105.45, declining each year by a predetermined amount to $100.00 after June 1, 2004. Applicable sinking fund provisions require the redemption between 1990 and 2004 of all shares according to a predetermined schedule.

If there were to be any arrearage in dividends on any of its preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock (each such dividend being cumulative and of equal ranking with other such dividends, and each such requirement being cumulative and of equal ranking with other such requirements), APS could not pay dividends on its common stock or acquire any shares thereof for consideration. If any such dividend arrearage was to equal six or more quarterly dividends, the holders of preferred stock, in addition to their other voting rights and voting by the classes prescribed for this purpose, could elect a total of six directors (all series of serial preferred stock, regardless of par value and whether redeemable or non-redeemable, comprising one such class and being entitled to elect two of the six directors). See Note 4 in regard to other voting rights of holders of preferred stock.

The combined aggregate amount of redemption requirements for the above issues each year through 1990 are as follows: $12,700,000 in 1986, $14,950,000 in 1987, $39,040,000 in 1988, and $19,540,000 in 1989 and $22,975,000 in 1990.

Redeemable preferred stock transactions of APS during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

Description	Number of Shares	Par Value Amount
Balance, December 31, 1982	2,412,200	$241,220
Retirements:		
$8.50 Series G	(7,200)	(720)
$10 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1983	2,374,000	237,400
$11.50 Series R	500,000	50,000
Retirements:		
$8.50 Series G	(15,600)	(1,560)
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1984	2,827,400	282,740
Retirements:		
$8.50 Series G	(38,400)	(3,840)
$10.00 Series H	(199,323)	(19,932)
$10.70 Series I	(30,066)	(3,007)
$8.80 Series K	(255,400)	(25,540)
$11.95 Series M	(110,000)	(11,000)
Balance, December 31, 1985	2,194,211	$219,421

6. Long-Term Debt.

Details of long-term debt outstanding at December 31, 1985 and 1984 are as follows:

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
First mortgage bonds:		
Maturing through 1990:		
10.375% due February 1, 1985	$ —	$ 60,250
Less securities held by trustee	—	(16,127)
5.125% due October 1, 1987	15,000	15,000
4.7% due March 1, 1989	20,000	20,000
Maturing 1991 through 1995—4.40% to 15%	325,000	200,000
Maturing 1996 through 2000—6.25% to 12.875%	269,977	272,977
Maturing 2001 through 2005—6.20% to 9.95%	185,000	185,000
Maturing 2006 through 2010—6% to 12.125%	202,000	152,000
Maturing 2011 through 2015—12.75% to 13.5%	450,000	200,000
Unamortized discount & premium	(2,413)	(1,965)
Total first mortgage bonds	1,464,564	1,087,135
Various issues of pollution control indebtedness primarily due December 15, 1985	—	105,000
Less securities held by trustee	—	(11,269)
Pollution control indebtedness due August 1, 2009(a)	106,980	—
Less securities held by trustee(b)	(1,572)	—
Pollution control indebtedness due December 1, 2009(c)	147,000	147,00[illegible]
Less securities held by trustee(b)	(15,071)	(23,2[illegible]
Pollution control indebtedness due May 1, 2013(c)	65,750	65,750
Pollution control indebtedness due May 1, 2014(d)	55,200	55,200
Pollution control indebtedness due February 1, 2015(e)	49,400	—
Less securities held by trustee(b)	(2,444)	—
Unsecured notes payable due 1987(f)	70,000	70,000
16.25% guaranteed debentures due July 15, 1988(g)	—	50,000
16.25% guaranteed debentures due February 1, 1989(g)	75,000	75,000
16% guaranteed debentures due February 15, 1989(g)	25,000	25,000
11.75% guaranteed debentures due January 15, 1990(g)	60,000	60,000
12.5% debentures due February 15, 1992	75,000	—
Capitalized lease obligation(h)	46,907	48,472
Other	1,975	2,380
Unamortized discount	(293)	(780)
Total long-term debt	2,223,396	1,755,636
Less current maturities:		
Pollution control indebtedness due December 15, 1985 net of securities held by trustee	—	65,949
Sinking fund requirements on first mortgage bonds	15,333	3,000
Capitalized lease obligation(h)	1,685	1,565
Other	438	376
Total current maturities	17,456	70,890
Total long-term debt less current maturities	$2,205,940	$1,684,746

(a) Adjustable-rate annual tender pollution control revenue refunding bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest at 6% through July 31, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(b) Representing pollution control funds deposited with a revenue bond trustee and to be disbursed as needed to pay the costs of acquiring, constructing, reconstructing, improving, maintaining, equipping or furnishing the facilities financed.

(c) Consisting of borrowings from a governmental authority which has funded that amount through issuance of a series of par value demand bonds supported by a long-term irrevocable letter of credit issued by a bank. These bonds bear interest at such rate, determined weekly, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(d) Adjustable-rate annual tender pollution control revenue refunding bonds are supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest rate at 6% through April 30, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(e) Adjustable-rate annual tender pollution control revenue bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest through January 31, 1986 at 6.5% and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(f) Consisting of two long-term bank loans of $50,000,000 and $20,000,000. The principal amounts of such loans bear interest, at APS' option, at one or more of the following annual interest rates: (a) in the case of the first loan, 102% of the Prime Rate or, in the case of the second loan, the Prime Rate plus ¼%, (b) the CD Rate plus ⅝%, or (c) the Eurodollar Rate plus ½%.

(g) Representing debentures issued by Finance, the payment of principal and interest has been unconditionally guaranteed by APS. The 11¾% debentures due January 15, 1990 are redeemable at the option of Finance at 101½% from January 15, 1987 through January 14, 1988, then at 100¾% through January 15, 1989, and thereafter at 100%. The 16.25% debentures due February 1, 1989 and 16% debentures due February 15, 1989 were redeemed on February 1 and 15, 1986, respectively, with the proceeds of a $100,000,000 issue of first mortgage bonds. The debentures were redeemed at 101% plus accrued interest. The new bonds bear interest at 11.0% and are due January 15, 2016. The 16¼% debentures due July 15, 1988 were redeemed on July 15, 1985 at 101½% plus accrued interest.

(h) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) on a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semi-annual payments of $2,582,000 through June 2001, and includes renewal and purchase options based on fair market value. This plant is included in plant in service at its original cost of $54,405,000; accumulated depreciation at December 31, 1985 was $21,401,000.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1990 are as follows: 1986, $17,456,000; 1987, $102,620,000; 1988, $17,795,000; 1989, $37,985,000; and 1990, $78,193,000. For sinking fund requirements and redemptions at the option of the holders of redeemable preferred stock, see Note 5.

Substantially all utility plant, other than nuclear fuel, transportation equipment and the combined cycle plant mentioned above, is subject to the lien of the first mortgage bonds. The first mortgage bond indenture includes provisions which would restrict the payment of dividends on APS common stock under certain conditions which did not exist at December 31, 1985.

7. Lines of Credit and Compensating Balances.

APS' lines of credit at December 31, 1985 and 1984 are summarized below. No amounts were outstanding under the lines at December 31, 1985 or 1984.

	1985	1984
	(Thousands of Dollars)	
Commercial paper backup lines:		
Domestic banks	$125,000	$125,000
Foreign banks	50,000	50,000
Other domestic bank lines	245,000(a)	245,000(a)
Total	$420,000	$420,000

(a) Including $200,000,000 available under a credit agreement between APS and various banks which carries a commitment fee of ¼% per annum.

The commitment fees for the commercial paper backup lines with domestic banks were ⅜% per annum in 1985 and 1984. Compensating balances required (but which were not legally restricted) for the other domestic banks lines (exclusive of the credit agreement referred to in (a) above) were generally 7½% of the lines plus 5% of borrowings in 1985 and 1984.

Under the foreign bank lines, commitment fees were payable at ¼% per annum in 1985 and 1984. The interest rate on borrowings under these facilities was approximately ½% per annum over the applicable Eurodollar Rate in effect from time to time.

By statute APS' short-term borrowings cannot exceed 7% of total capitalization without the consent of the ACC.

8. Jointly-Owned Facilities.

At December 31, 1985, APS owned the following interests in jointly-owned electric generating and transmission facilities (dollars in thousands):

	Percent owned by APS	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Generating Facilities:					
Arizona Nuclear Power Project (ANPP) - Units 1, 2 and 3	29.1%	$ —	$ —	$ —	$2,407,231
Four Corners Steam Generating Plant - Units 4 and 5	15.0%	118,897	20,791	98,106	1,499
Navajo Steam Generating Plant - Units 1, 2 and 3	14.0%	119,295	37,994	81,301	1,009
Transmission Facilities:					
ANPP Transmission System	35.8%(a)	7,398	791	6,607	48,337
Navajo Southern Transmission System	31.4%(b)	28,198	9,027	19,171	93
Palo Verde-Yuma 500KV System	23.9%(c)	16,255	550	15,705	1,915
Total		$290,043	$69,153	$220,890	$2,460,084

(a) Weighted average of interests varying from 34.6% to 43.95%.

(b) Weighted average of interests varying from 14% to 100%.

(c) Weighted average of interests varying from 11% to 100%.

The foregoing dollar amounts correlate to APS' percentage interest in each facility. APS' share of related operating and maintenance expenses is included in operating expenses.

9. Income Tax Expense.

The components of income tax expense—continuing operations for each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Currently payable:			
Federal	$ 9,242	$ 14,578	$14,224
State	10,598	16,340	10,742
Other	2,861	3,606	2,870
Total current	22,701	34,524	27,836
Deferred:			
Depreciation—net	57,273	26,276	22,571
Taxes, pension costs and other—net	49,690	18,367	5,627
Investment tax credit—net	36,383	59,592	39,583
Total deferred	143,346	104,235	67,781
Amortization of tax benefits sold	(1,687)	(1,687)	(1,687)
Total	$164,360	$137,072	$93,930

In 1981 APS sold to another corporation certain federal income tax benefits in exchange for cash. APS, pursuant to an order of the ACC, has recorded the proceeds of the sale as a deferred credit and is amortizing the amount of such proceeds on a straight-line basis over approximately 30 years.

Following is a summary of the difference between income tax expense—continuing operations and the amount obtained by multiplying income before income taxes and preferred stock dividend requirements of APS by the statutory federal income tax rate.

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Federal income tax expense at statutory rate	$224,628	$199,935	$166,972
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	16,431	14,165	10,213
Allowance for funds used during construction	(88,222)	(84,491)	(83,799)
Investment tax credit amortization	(2,955)	(2,827)	(1,970)
Taxes, pension costs and other items capitalized	—	—	(6,640)
State income tax—net of federal income tax benefit	11,780	11,172	7,070
Other	2,698	(882)	2,084
Total provision for federal and state income tax	$164,360	$137,072	$ 93,930

At December 31, 1985 the Company had approximately $11,000,000 of investment tax credit carryforwards which will expire through 2000.

10. Pension Plan and Other Benefits.

APS' pension plan, a defined benefit plan, covers virtually all employees. Pension cost, including administrative cost for 1985, 1984, and 1983 was $15,458,000, $16,370,000, and $15,248,000, respectively, of which approximately $5,081,000, $6,512,000, and $6,871,000, respectively, was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

The following is a summary of plan data as of the most recent benefit information date:

	January 1,	
	1985	1984
	(Thousands of Dollars)	
Actuarial present value of accumulated plan benefits:		
Vested	$127,018	$115,984
Non-vested	11,885	10,499
Total	$138,903	$126,483
Net assets available for benefits	$193,235	$182,577

The actuarial present value (assuming a rate of return of 9.00%) of accumulated plan benefits presented above has not been calculated with reference to the effects of projected inflation, whereas such effects are considered by APS with reference to the adequacy of plan assets; accordingly, APS considers the utility of the comparison suggested to be extremely limited.

In addition to providing pension benefits, APS provides certain health care and life insurance benefits for active and retired employees. Life insurance benefits are provided through an insurance company whereas health care costs are paid as expenses are incurred under a self-insured plan. The cost of providing those benefits in 1985 for 1,091 retirees and 8,362 active employees was $1,086,000 and $13,423,000, respectively, of which approximately $5,825,000 was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

Under the AZP Group, Inc. Stock Option and Incentive Plan approved by the Company's shareholders on April 18, 1985, non-qualified and incentive stock options (ISO) and restricted stock awards may be granted to officers and key employees of the Company and subsidiaries for up to 3,000,000 shares of AZP common stock. The plan also provides for the granting of stock appreciation rights, performance shares, dividend equivalents or any combination of the foregoing. In 1985, approximately 15,000 restricted shares, 15,000 ISOs and 15,000 dividend equivalents were awarded under the plan.

11. Commitments and Contingencies:

Nuclear Insurance—The Price-Anderson Act ("Act") currently limits public liability claims that could arise from a nuclear incident to a maximum amount of $655,000,000 for each licensed nuclear facility. Private insurance for this exposure has been purchased by the participants (including APS) in the Palo Verde Nuclear Generating Station in the maximum available amount, presently $160,000,000, with the balance to be provided by secondary financial protection required by the Nuclear Regulatory Commission ("NRC"). Under the agreement with the NRC, APS could be assessed retrospective premium adjustments of up to $3,000,000 per year in the event of nuclear incidents involving any licensed reactor in the United States.

Property damage coverage is provided for losses up to $500,000,000 at Palo Verde. Decontamination liability and property damage insurance in excess of the primary $500,000,000 layer has also been purchased. These policies are primarily provided through mutual insurance companies owned by utilities with nuclear facilities. If losses at any nuclear facility covered by the arrangement were to exceed the accumulated funds available for these insurance programs, APS could be assessed retrospective premium adjustments of up to $3,500,000.

The Act is scheduled to expire in August 1987 and Congress is currently considering several alternatives. The Company is unable to predict Congress' ultimate action and what effect such action may have on APS' liability.

Litigation—APS is a party to various claims, legal actions, and complaints, including a lawsuit seeking to invalidate APS' contract with various municipalities for the purchase of effluent to be used as cooling water for Palo Verde. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the operations or financial position of APS.

Purchase Commitments—APS has significant purchase commitments in connection with the continuing construction program. Construction expenditures in 1986 have been estimated at $372,000,000.

12. Supplementary Income Statement Information.

Other taxes charged to operations during each of the three years in the period ended December 31, 1985 are as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Ad valorem	$ 45,554	$42,581	$44,691
Sales	51,446	45,495	32,169
Other	7,276	6,372	5,560
Total other taxes	$104,276	$94,448	$82,420

13. Discontinued Operations.

Effective November 1, 1984 (the "Closing Date") APS sold its gas distribution system to Southwest Gas Corporation ("Southwest"). The sale resulted in a non-recurring loss of approximately $26,470,000, net of an income tax benefit of $7,094,000, (approximately $0.39 per average share of common stock) in 1984.

APS agreed to fund a portion of the costs associated with the accelerated replacement of certain gas pipe included in the gas distribution system acquired by Southwest by purchasing, under certain conditions, up to $50,000,000 in aggregate par value of cumulative preference stock (the "Stock") to be issued by Southwest. Any such purchases would be made by APS within approximately three years following the Closing Date. As of December 31, 1985, no such purchases had been made. The Stock would yield an annual dividend of between 3% and 16% (payable quarterly) based on a formula relating to the operating performance of the gas distribution system. The Stock is also redeemable by Southwest, at its option, on any dividend payment date (at the issue price plus accrued dividends), but must be redeemed no later than seven years after the issuance date as to any issue.

Revenues from APS' discontinued gas operations for 1984, and 1983 were $174,728,000, and $202,134,000, respectively.

14. Selected Quarterly Financial Data (Unaudited).

Condensed consolidated quarterly financial information for 1985 and 1984, as restated to give effect to the restructuring, is as follows:

Quarter	Revenue from Continuing Operations	Income from Continuing Operations	Income (loss) from Discontinued Operations	Net Income	Earnings (loss) per share of common stock: Continuing Operations	Earnings (loss) per share of common stock: Discontinued Operations
	(Dollars in Thousands, Except Per Share Amounts)					
1985						
First	$243,552	$ 46,921	$ —	$ 46,921	$0.67	$ —
Second	276,697	61,712	—	61,712	0.86	—
Third	368,129	102,679	—	102,679	1.41	—
Fourth	286,124	68,237	—	68,237	0.92	—
1984						
First	203,937	40,201	1,397	41,598	0.60	0.02
Second	236,712	49,785	(185)	49,600	0.73	—
Third	311,845	90,484	(1,028)	89,456	1.32	(0.02)
Fourth	242,473	68,725	(26,687)	42,038	0.99	(0.39)

15. Supplementary Information to Disclose the Effects of Changing Prices (Unaudited).

The following supplementary information is furnished pursuant to Statement No. 33 as amended by Statement No. 82 of the Financial Accounting Standards Board for the purpose of illustrating the effects of changing prices in an inflationary environment. It offers some perspectives of approximated effects of inflation, and is not intended as precise measurements of those effects.

APS and other public utilities similarly situated are subject to rate-making procedures which, by law and practice, in large part utilize the historical cost of utility plant in the determination of the allowed recovery (through depreciation) of the investment therein and return thereon. This precludes or restricts a rate-making response to the effects of realizing such recovery and return in inflated dollars, compared to those in which the investment was made. The first table below presents an approximate measurement of those effects from the perspective of that portion of the investment, which was not reflected in 1985 depreciation or in the Company's return, and which is therefore not "recoverable."

For these presentations, "current cost" amounts were calculated by applying certain indices (or ratios derived therefrom) to certain historical or other amounts. The primary index was the Handy Whitman Index of Public Utility Construction Costs (a preliminary estimate of which was used for the last half of 1985), although the Consumer Price Index was used for construction work in progress. The Company believes that the Handy Whitman Index is the more accurate of the two in estimating the prices it would incur to duplicate at various times its utility plant in service at the indicated dates. Over the period from 1981 through 1985 the Consumer Price Index rose faster than the Handy Whitman Index.

Electric depreciation expense for 1985 was recalculated by applying the Company's composite depreciation rate to depreciable base determined by indexing certain appraised values from the times of appraisal. The amount by which the expense so recalculated exceeds that shown on the Company's 1985 Consolidated Statement of Income appears as an adjustment to income from continuing operations.

The sum of the depreciation adjustment and the figure shown lower as the "reduction to net recoverable cost" was derived through application of 1985 increases in the Consumer Price Index to historical costs of APS' utility plant.

The Company did not make adjustments to asset values, or related consolidated income statement amounts, other than those discussed above in regard to utility plant and depreciation thereon. Fuel inventories and fuel expenses are, in effect, monetary items, due to applicable rate-making procedures which include adjustment clauses. In accordance with Statement Nos'. 33, as amended by Statement No. 82, income taxes were not adjusted.

As contrasted to the assumed net value losses which, in the presentation below, are associated with the holding of assets committed to a regulated business, there is an assumed "holding gain" associated with borrowings that will be repaid with inflated dollars. The 1985 decline in the purchasing power of net amounts owed by the Company (measured by the Consumer Price Index) appears to result in a "net" difference between the assumed holding losses and gain.

Inferences which, in the case of some industries, may be drawn from information in the nature of that presented below as to the adequacy of future cash flows in relation to future plant replacement requirements are believed by the Company to be less valid in the case of public utilites which, like itself, should be able to establish rates to cover increased costs of new plant. However, the information may provide some indication of the expanded capital structure that will be required for making plant replacements and additions with inflated dollars.

AZP GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
INCOME FROM OPERATIONS ADJUSTED FOR CHANGING PRICES
FOR THE YEAR ENDED DECEMBER 31, 1985

	Current Cost Average 1985 Dollars (Dollars in Thousands, Except Per Share Amounts)
Income from continuing operations as reported in Consolidated Statements of Income	$279,549
Adjustment to restate depreciation expense	(78,431)
Income from continuing operations (excluding reduction to net recoverable cost)	$201,118
Income from continuing operations per common share (excluding reduction to net recoverable cost)	$2.79
Increase in specific prices (current cost) of utility plant held during the year (a)	$168,637
Reduction to net recoverable cost	(7,981)
Effect of increase in general price level	(251,888)
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	(91,232)
Gain from decline in purchasing power of net amounts owed	45,036
Net	$(46,196)

(a) At December 31, 1985, Current Cost of Utility Plant—net was $7,140,611.

AZP GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECT OF CHANGING PRICES

	Year Ended December 31,				
	1985	1984	1983	1982	1981
	(Average 1985 Dollars in Thousands, Except Per Share Amounts)				
Electric operating revenues	$1,174,502	$1,030,467	$ 941,414	$ 965,693	$ 864,390
Current cost information					
Income from continuing operations (excluding reduction to net recoverable cost)	$ 201,118	$ 180,482	$ 163,699	$ 137,533	$ 132,027
Income from continuing operations per common share (excluding reduction to net recoverable cost)	$ 2.79	$ 2.64	$ 2.56	$ 2.31	$ 2.52
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	$ (91,232)	$ (86,837)	$ (68,252)	$ (56,669)	$ (208.236)
Net assets at year-end at net recoverable cost*	$2,070,638	$1,955,140	$1,916,460	$1,775,405	$1,595,758
Reduction to net recoverable cost	$ (7,981)	$ 38,216	$ 44,362	$ 33,376	$ 205,988
General information					
Gain from decline in purchasing power of net amounts owed	$ 45,036	$ 93,149	$ 85,460	$ 79,686	$ 171,052
Cash dividends declared per common share	$ 2.69	$ 2.69	$ 2.77	$ 2.68	$ 2.60
Market price per common share at year-end	$ 27.25	$ 22.78	$ 20.57	$ 26.87	$ 22.17
Average consumer price index	322.2	311.1	298.4	289.1	272.4

* Consisting of common stock equity and non-redeemable preferred stock.

AZP GROUP, INC.

SCHEDULE V — PROPERTY, PLANT, AND EQUIPMENT
YEAR ENDED DECEMBER 31, 1985 (a)

Column A Classification	Column B Balance At Beginning Of Period	Column C Additions At Cost	Column D Retirements	Column E Other Changes —Add (Deduct) —Describe	Column F Balance at End Of Period
	(Thousands of Dollars)				
Utility Plant:					
Electric Plant In Service:					
Intangible	$ 13,774	$ 28,161	$ 1,498	$ 6	$ 40,443
Steam Production	1,245,935	18,236	692	(50)	1,263,429
Hydraulic Production	244	3	—	—	247
Other Production	123,992	1,498	15	—	125,475
Transmission	445,853	6,590	965	(119)	451,359
Distribution	771,222	102,680	7,811	1,010	867,101
General	146,444	39,055	4,373	746	181,872
Total Electric Plant In Service	2,747,464	196,223	15,354	1,593(b)	2,929,926
Nuclear Fuel	135,144	33,637	—	—	168,781
Construction Work In Progress	2,169,162	605,276	—	(201,080)(c)	2,573,358
Utility Plant Held For Future Use	36,473	3,036	—	933(b)	40,442
Total Utility Plant	$5,088,243	$838,172	$15,354	$(198,554)	$5,712,507
Non-Utility Plant	$ 3,759	$ 1,994	$ —	$ (2,418)(b)	$ 3,335

(a) Depreciation is provided on a straight-line basis at rates authorized by the ACC annually; for 1985 those rates were from 2.86% to 9.86%

(b) Transfers between plant accounts.

(c) Transfers to plant in service.

AZP GROUP, INC.

SCHEDULE V — PROPERTY, PLANT, AND EQUIPMENT
YEAR ENDED DECEMBER 31, 1984 (a)

Column A Classification	Column B Balance At Beginning Of Period	Column C Additions At Cost	Column D Retirements	Column E Other Changes —Add (Deduct) —Describe	Column F Balance at End Of Period
	(Thousands of Dollars)				
Utility Plant:					
Electric Plant In Service:					
Intangible	$ 2,344	$ 317	$ 1	$ 11,114	$ 13,774
Steam Production	1,190,550	57,529	2,245	101	1,245,935
Hydraulic Production	243	1	—	—	244
Other Production	123,723	377	120	12	123,992
Transmission	422,991	23,561	22	(677)	445,853
Distribution	682,939	92,140	4,980	1,123	771,222
General	53,336	6,304	1,321	88,125	146,444
Total Electric Plant In Service	2,476,126	180,229	8,689	99,798 (c)	2,747,464
Gas Plant In Service:					
Intangible	427	301	—	(728)	—
Distribution	163,561	26,274	3,390	(186,445)	—
General	10,050	2,356	311	(12,095)	—
Total Gas Plant In Service	174,038	28,931	3,701	(199,268)(b)	—
Common Plant In Service:					
Intangible	10,914	226	—	(11,140)	—
General	79,663	10,073	1,033	(88,703)	—
Total Common Plant In Service	90,577	10,299	1,033	(99,843)(c)	—
Total Utility Plant In Service	2,740,741	219,459	13,423	(199,313)	2,747,464
Nuclear Fuel	113,488	21,656	—	—	135,144
Construction Work In Progress	1,872,564	521,890	—	(225,292)(d)	2,169,162
Utility Plant Held For Future Use	34,472	1,974	—	27 (e)	36,473
Total Utility Plant	$4,761,265	$764,979	$13,423	$(424,578)	$5,088,243
Non-Utility Plant	$ 3,642	$ (218)	$ —	$ 335 (d)	$ 3,759

(a) Depreciation is provided on a straight-line basis at rates authorized by the ACC annually; for 1984, those rates were from 3.07% to 4.16% for electric plant, 3.49% for gas plant and from 2.86% to 9.60% for common and general plant.

(b) Reflects the sale of gas plant to Southwest Gas Corporation.

(c) Reflects the reclassification of Common Plant to Electric Plant.

(d) Primarily transfers to plant in service.

(e) Transfers between plant accounts.

AZP GROUP, INC.

SCHEDULE V — PROPERTY, PLANT, AND EQUIPMENT
YEAR ENDED DECEMBER 31, 1983 (a)

Column A Classification	Column B Balance At Beginning Of Period	Column C Additions At Cost	Column D Retirements	Column E Other Changes —Add (Deduct) —Describe	Column F Balance at End of Period
	(Thousands of Dollars)				
Utility Plant:					
Electric Plant In Service:					
Intangible	$ 2,003	$ 342	$ 1	$ —	$ 2,344
Steam Production	1,190,413	19,986	6,694	(13,155)	1,190,550
Hydraulic Production	242	1	—	—	243
Other Production	119,337	4,519	133	—	123,723
Transmission	418,240	6,765	1,557	(457)	422,991
Distribution	622,478	65,385	5,170	246	682,939
General	49,927	5,198	1,508	(281)	53,336
Total Electric Plant In Service	2,402,640	102,196	15,063	(13,647)	2,476,126
Gas Plant In Service:					
Intangible	379	99	51	—	427
Distribution	143,199	22,739	2,377	—	163,561
General	7,833	2,311	94	—	10,050
Total Gas Plant In Service	151,411	25,149	2,522	—	174,038
Common Plant In Service:					
Intangible	10,363	721	170	—	10,914
General	74,768	5,200	845	540	79,663
Total Common Plant In Service	85,131	5,921	1,015	540	90,577
Total Utility Plant In Service	2,639,182	133,266	18,600	(13,107)(b)	2,740,741
Nuclear Fuel	72,663	40,825	—	—	113,488
Construction Work In Progress	1,466,790	540,886	—	(135,112)(c)	1,872,564
Utility Plant Held For Future Use	19,831	1,037	—	13,604 (b)	34,472
Total Utility Plant	$4,198,466	$716,014	$18,600	$(134,615)	$4,761,265
Non-Utility Plant	$ 3,359	$ 780	$ —	$ (497)(c)	$ 3,642

(a) Depreciation is provided on a straight-line basis at rates authorized by the ACC annually; for 1983, those rates were from 3.07% to 4.16% for electric plant, 3.49% for gas plant and from 2.86% to 9.60% for common and general plant.

(b) Transfers from plant in service.

(c) Transfers to plant in service.

AZP GROUP, INC.

SCHEDULE VI — ACCUMULATED DEPRECIATION, DEPLETION AND AMORTIZATION OF PROPERTY, PLANT, AND EQUIPMENT YEAR ENDED DECEMBER 31, 1985

Column A Description	Column B Balance At Beginning Of Period	Column C Additions Charged to Costs and Expenses	Column D Retirements	Column E Other Changes—Add (Deduct)—Describe(a)	Column F Balance at End of Period
	(Thousands of Dollars)				
Accumulated Depreciation and Amortization of Utility Plant:					
Electric Plant in Service:					
Steam Production	$297,650	$ 42,941	$ 692	$ 347	$340,246
Other Production	47,754	8,778	15	(18)	56,499
Transmission	130,315	13,617	965	1,025	143,992
Distribution	192,977	26,867	7,811	(561)	211,472
General	62,932	16,159	5,871	521	73,741
Total Electric Plant in Service	731,628	108,362	15,354	1,314	825,950
Plant Held For Future Use:					
Steam Production	12,085	—	—	202(b)	12,287
Transmission	447	—	—	—	447
Total Plant Held For Future Use	12,532	—	—	202(b)	12,734
Total	$744,160	$108,362	$15,354	$1,516	$838,684
Accumulated Depreciation of Non-Utility Property	$ 172	$ 8	$ —	$ —	$ 180

(a) Includes removal and salvage—net.

(b) Transfers from plant in service.

AZP GROUP, INC.

SCHEDULE VI — ACCUMULATED DEPRECIATION, DEPLETION AND AMORTIZATION OF PROPERTY, PLANT, AND EQUIPMENT YEAR ENDED DECEMBER 31, 1984

Column A Description	Column B Balance At Beginning Of Period	Column C Additions Charged To Costs and Expenses	Column D Retirements	Column E Other Changes—Add (Deduct)—Describe(a)	Column F Balance at End of Period
	(Thousands of Dollars)				
Accumulated Depreciation and Amortization of Utility Plant:					
Electric Plant in Service:					
Steam Production	$259,549	$40,675	$ 2,245	$ (329)	$297,650
Other Production	42,711	5,159	120	4	47,754
Transmission	117,174	13,166	22	(3)	130,315
Distribution	173,810	23,687	4,980	460	192,977
General	26,456	4,440	1,322	33,358	62,932
Total Electric Plant in Service	619,700	87,127	8,689	33,490 (c)	731,628
Gas Plant in Service:					
Distribution	62,853	5,059	3,390	(64,522)	—
General	4,950	833	311	(5,472)	—
Total Gas Plant in Service	67,803	5,892	3,701	(69,994)(b)	—
Common Plant in Service:					
General	27,830	6,061	1,033	(32,858)(c)	—
Total Plant in Service	715,333	99,080	13,423	(69,362)	731,628
Plant Held For Future Use:					
Steam Production	12,085	—	—	—	12,085
Transmission	447	—	—	—	447
Total Plant Held For Future Use	12,532	—	—	—	12,532
Total	$727,865	$99,080	$13,423	$ (69,362)	$744,160
Accumulated Depreciation of Non-Utility Property	$ 149	$ 23	$ —	$ —	$ 172

(a) Includes removal and salvage—net.

(b) Reflects sale of gas plant to Southwest Gas Corporation.

(c) Reflects reclassification of Common Plant to Electric Plant.

AZP GROUP, INC.

SCHEDULE VI — ACCUMULATED DEPRECIATION, DEPLETION AND AMORTIZATION OF PROPERTY, PLANT, AND EQUIPMENT YEAR ENDED DECEMBER 31, 1983

Column A Description	Column B Balance at Beginning of Period	Column C Additions Charged To Costs and Expenses	Column D Retirements	Column E Other Changes—Add (Deduct)—Describe*	Column F Balance at End of Period
	(Thousands of Dollars)				
Accumulated Depreciation and Amortization of Utility Plant:					
Electric Plant in Service:					
Steam Production	$233,712	$40,273	$ 6,670	$ (7,766)	$259,549
Other Production	37,384	5,061	133	399	42,711
Transmission	106,347	12,744	1,578	(339)	117,174
Distribution	157,426	21,276	5,157	265	173,810
General	23,586	3,827	1,492	535	26,456
Total Electric Plant in Service	558,455	83,181	15,030	(6,906)	619,700
Gas Plant in Service:					
Distribution	60,969	5,302	2,467	(951)	62,853
General	4,270	728	92	44	4,950
Total Gas Plant in Service	65,239	6,030	2,559	(907)	67,803
Common Plant in Service—General	22,823	5,921	1,027	113	27,830
Total Plant in Service	646,517	95,132	18,616	(7,700)	715,333
Plant Held For Future Use:					
Steam Production	—	—	12	12,097	12,085
Transmission	—	—	—	447	447
Total Plant Held For Future Use	—	—	12	12,544	12,532
Total	$646,517	$95,132	$18,628	$ 4,844	$727,865
Accumulated Depreciation of Non-Utility Property	$ 142	$ 7	$ —	$ —	$ 149

* Removal and salvage—net.

AZP GROUP, INC.

SCHEDULE IX — SHORT-TERM BORROWINGS

Column A Category of aggregate short-term borrowings	Column B Balance at end of period	Column C Weighted average interest rate at end of period	Column D Maximum amount outstanding during the period	Column E (a) Average amount outstanding during the period	Column F (b) Weighted average interest rate during the period
	(Thousands of Dollars)				
	YEAR ENDED DECEMBER 31, 1985				
Bank Borrowings	$ —	— %	$ 1,893	$ 1,345	6.52%
Commercial Paper	18,000	8.31(c)	155,125	37,426	8.32(c)
	YEAR ENDED DECEMBER 31, 1984				
Bank Borrowings	$ 1,800	6.9875%	$116,817	$82,586	8.34%
Commercial Paper	158,000	8.69(c)	158,000	29,717	9.90(c)
	YEAR ENDED DECEMBER 31, 1983				
Bank Borrowings	$86,308	8.22%	$ 86,308	$46,732	9.71%
Commercial Paper	—	—	150,000	40,808	9.57(c)

(a) Average daily balance during the period.

(b) Total applicable interest paid in the period divided by average daily balance.

(c) Does not include commitment fees on backup lines of credit in support of commercial paper. See Note 7 of Notes to Consolidated Financial Statements.

ITEM 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

The information regarding executive officers called for by Item 10, "Directors and Executive Officers of the Registrant," is furnished under the caption "Executive Officers of the Registrant" in Part I of this report. The other information called for by Item 10, as well as that called for by Item 11, "Executive Compensation," and Item 13, "Certain Relationships and Related Transactions," is hereby incorporated by reference from pages 6 through 14 of the Company's definitive proxy statement, relating to its annual meeting of stockholders to be held on April 24, 1986, as filed with the Securities and Exchange Commission on March 21, 1986.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS, AND MANAGEMENT

As of March 3, 1986, the Company's records and information supplied by the owners indicated that each of the directors of the Company and the officers and directors of the Company as a group beneficially owned the numbers of shares of the Company's common stock set forth in the table below. Shares beneficially owned by all officers and directors as a group in all cases constitute less than .1% of the class of the shares so owned.

Name of Beneficial Owner	Title of Class	Number of Shares Owned*
Joe Acosta	Common	1,345
Dino DeConcini	Common	695
O. Mark De Michele	Common	5,616
Karl Eller	Common	1,109
William T. Garland	Common	3,470
Pamela Grant	Common	800
Jack M. Morgan	Common	189
Marvin R. Morrison	Common	4,226
John R. Norton III	Common	15,000
John J. Rhodes	Common	2,349
Henry B. Sargent, Jr.	Common	7,006
Wilma W. Schwada	Common	919
James P. Simmons	Common	100
Richard Snell	Common	5,738
Donald N. Soldwedel	Common	3,596
Maurice R. Tanner	Common	1,500
Keith L. Turley	Common	14,420
Douglas J. Wall	Common	1,841
Morrison F. Warren	Common	271
Ben F. Williams, Jr.	Common	1,426
Thomas G. Woods, Jr.	Common	2,000
All Officers and Directors as a Group (25 individuals)	Common	79,359

* Including shares of Common Stock as to which voting or investment power is shared with others as follows. Mr. Acosta — 1,345, Mr. De Concini — 474, Mr. Garland — 1,845, Ms. Grant — 800, Mr. Morrison — 4,226, Mr. Norton — 15,000, Mr. Rhodes — 2,349, Ms. Schwada — 919, Mr. Soldwedel — 3,596, Mr. Tanner — 1,500, Mr. Turley — 2,583, Mr. Wall — 1,841, Mr. Williams — 100, Mr. Woods — 2,000 and all officers and directors as a group — 39,976.

PART IV

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

Financial Statements and Schedules

See the Index to Consolidated Financial Statements and Supplemental Consolidated Schedules on page 27.

Exhibits Filed

Exhibit No.	*Description*
11.1	Computation of per share earnings for the year ended December 31, 1985.
24.1	Consent of Deloitte Haskins & Sells.
28.1	Notice and Proxy Statement of the Company relating to its 1986 Annual Meeting of Shareholders.

In addition to those Exhibits shown above, the Company hereby incorporates the following Exhibits pursuant to Exchange Act Rule 12b-32 and Regulation §201.24 by reference to the filings set forth below:

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
3.1	Articles of Incorporation	3.1 to Form S-14 Registration Statement	2-96386	3-13-85
3.2	Bylaws	3.2 to Form S-14 Registration Statement	2-96386	3-13-85
4.1	Mortgage and Deed of Trust Relating to APS' First Mortgage Bonds, together with twenty-seven indentures supplemental thereto	4.1 to Form S-3 Registration Statement	2-84605	7-6-83
	Twenty-ninth Supplemental Indenture	4.2 to Form S-3 Registration Statement No. 2-86955 by means of October 13, 1983 Form 8-K Report	1-4473	10-14-83
	Thirtieth Supplemental Indenture	4.4 to Form S-3 Registration Statement No. 2-86955 by means of June 14, 1984 Form 8-K Report	1-4473	6-15-84

Exhibit No.	Description	Originally Filed as Exhibit:	File No.	Date Effective
	Thirty-first Supplemental Indenture	4.4 to Form S-3 Registration Statements (Nos. 2-86955 and 2-95340) by means of January 24, 1985 Form 8-K Report	1-4473	1-25-85
	Thirty-second Supplemental Indenture	4.7 to Form S-3 Registration Statement	2-97956	3-29-85
	Thirty-third Supplemental Indenture	4.5 to Form S-3 Registration Statement Nos. 2-95340 and 2-97956 by means of June 6, 1985 Form 8-K Report	1-4473	6-7-85
	Thirty-fourth Supplemental Indenture	4.1 to Form S-3 Registration Statement by means of Post-Effective Amendment No. 2	2-99739	11-21-85
	Thirty-fifth Supplemental Indenture	4.1 to Form S-3 Registration Statement No. 33-2297 by means of January 22, 1986 Form 8-K Report	1-4473	1-23-86
	Thirty-sixth Supplemental Indenture	4.1 to Form S-3 Registration Statement No. 33-3354 by means of February 24, 1986 Form 8-K Report	1-4473	2-25-86
4.2	Agreement, dated August 11, 1983, relating to the filing of instruments defining the rights of holders of long-term debt not in excess of 10% of APS' total assets	10.14 to June 1983 Form 10-Q Report	1-4473	8-15-83
10.1	Indenture of Lease with Navajo Tribe of Indians, Four Corners Plant	5.01 to Form S-7 Registration Statement	2-59644	9-1-77
10.2	Supplemental and Additional Indenture of Lease, including amendments and supplements to original lease with Navajo Tribe of Indians, Four Corners Plant	5.02 to Form S-7 Registration Statement	2-59644	9-1-77

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effecti*
10.3	Amendment and Supplement No. 1 to Supplemental and Additional Indenture of Lease, Four Corners, dated April 25, 1985	10.36 to Registration Statement on Form 8-B of AZP Group, Inc.	1-8962	7-25-85
10.4	Indenture of Lease, Navajo Units 1, 2 and 3	5(g) to Form S-7 Registration Statement	2-36505	3-23-70
10.5	Application and Grant of multi-party rights-of-way and easements, Four Corners Plant	5.04 to Form S-7 Registration Statement	2-59644	9-1-77
10.6	Application and Amendment No. 1 to Grant of multi-party rights-of-way and easements, Four Corners Power Plant Site, dated April 25, 1985	10.37 to Registration Statement on Form 8-B of AZP Group, Inc.	1-8962	7-25-85
10.7	Application and Grant of Company rights-of-way and easements, Four Corners Plant	5.05 to Form S-7 Registration Statement	2-59644	9-1-77
10.8	Application and Amendment No. 1 to Grant of Arizona Public Service Company rights-of-way and easements, Four Corners Power Plant Site, dated April 25, 1985	10.38 to Registration Statement on Form 8-B of AZP Group, Inc.	1-8962	7-25-85
10.9	Application and Grant of rights-of-way and easements, Navajo Plant	5(h) to Form S-7 Registration Statement	2-36505	3-23-70
10.10	Nuclear Fuel Contract with Combustion Engineering, Inc., ANPP	5(y) to Form S-7 Registration Statement, including an amendment filed as Exhibit 10.34 to 1982 10-K Report	1-4473	5-28-74 2-25-83
10.11	Reload Fuel Contract with Westinghouse Corporation for supply of nuclear fuel, ANPP	5(gg) to Form S-7 Registration Statement including an amendment filed as Exhibit 20.5 to 1981 Form 10-K Report	2-52443 1-4473	12-18-74 3-26-82

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
10.12	Agreement for Conversion Services with Allied Chemical Corporation, ANPP	21 to 1975 Form 12-K Report including an amendment filed as Exhibit 20.7 to 1981 Form 10-K Report	1-4473 1-4473	4-16-76 3-26-82
10.13	Water Service Contract Assignment with the United States Department of Interior, Bureau of Reclamation, Navajo Plant	5(l) to Form S-7 Registration Statement	2-39442	3-16-71
10.14	Uranium Concentrates Sales Agreement with Energy Fuels Exploration Company, ANPP	20.8 to 1981 Form 10-K Report including a supplement filed as Exhibit 10.38 to 1983 Form 10-K Report	1-4473 1-4473	3-26-82 3-29-84
10.15	Agreement No. 13904 (Option and Purchase of Effluent) with Cities of Phoenix, Glendale, Mesa, Scottsdale and Tempe, Town of Youngtown and Salt River Project Agricultural Improvement and Power District	20.10 to 1981 Form 10-K Report	1-4473	3-26-82
10.16	Agreement for the Sale and Purchase of Wastewater Effluent with City of Tolleson and Salt River Agricultural Improvement and Power District	20.11 to 1981 Form 10-K Report, including an amendment filed as Exhibit 20.12 to 1981 10-K Report	1-4473 1-4473	3-26-82 3-26-82
10.17	Loan Agreement between the Company and Bankers Trust Company	19.2 to September 1982 10-Q Report	1-4473	10-29-82
10.18	Term Credit Agreement between the Company and Bank of America National Trust and Savings Association	19.3 to September 1982 10-Q Report	1-4473	10-29-82

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effecti*
10.19	Agreement relating to the filing of instruments defining the rights of holders of long-term debt not in excess of 10% of APS' total assets	19.1 to 1982 Form 10-K Report	1-4473	2-25-83
10.20	Gas Sales Agreement dated March 1, 1983 with El Paso Natural Gas Company	10.1 to June 1983 Form 10-Q Report, including an amendment filed as Exhibit 10.2 to June 1983 Form 10-Q Report	1-4473 1-4473	8-15-83 8-15-83
10.21	Supplemental Agreement of Settlement, dated June 2, 1980, with Salt River Agricultural Improvement and Power District, Southern California Edison Company, Public Service Company of New Mexico, El Paso Electric Company, Arizona Electric Power Cooperative, Inc. and the United States Department of Energy ("DOE"), ANPP	10.11 to June 1983 Form 10-Q Report	1-4473	8-15-83
10.22	Agreement for Delivery of Natural UF_6, dated June 2, 1980, between Arizona Public Service Company, Salt River Agricultural Improvement and Power District, Southern California Edison Company, Public Service Company of New Mexico, El Paso Electric Company, Arizona Electric Power Cooperative, Inc., and DOE, ANPP	10.12 to June 1983 Form 10-Q Report	1-4473	8-15-83
10.23	Agreement in Principle, dated October 20, 1983, with Southwest Gas Corporation, relating to the proposed sale of gas distribution system	10.1 to September 1983 Form 10-Q Report including supplements, amendments and modifications filed as Exhibit 10.2 to September 1984 Form 10-Q Report	1-4473 1-4473	11-8-83 11-14-84
10.24	Uranium Concentrates Sales Agreement, dated December 1, 1983 with Energy Fuels Exploration Company, ANPP	10.39 to 1983 Form 10-K Report	1-4473	3-29-84

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
10.25	Uranium Concentrates Sales Agreement, dated December 1, 1983 with Pathfinder Mines Corporation, ANPP	10.40 to 1983 Form 10-K Report	1-4473	3-29-84
10.26	Deferred Compensation Plan, as restated, effective January 1, 1984 and incorporating the first through fifth amendments	10.41 to 1983 Form 10-K Report	1-4473	3-29-84
10.27	Directors' Deferred Compensation Plan, as restated, effective October 1, 1983	10.42 to 1983 Form 10-K Report	1-4473	3-29-84
10.28	Executive Incentive Compensation Plan, as restated, effective January 1, 1983	10.43 to 1983 Form 10-K Report	1-4473	3-29-84
10.29	Credit Agreement, dated May 15, 1984, among the Company, Citibank, N.A., and the Banks	10.1 to June 1984 Form 10-Q Report	1-4473	8-13-84
10.30	Letter Agreement, dated October 30, 1984 with Southwest Gas Corporation ("Southwest") relating to APS' purchase, under certain conditions, of cumulative preference stock to be issued by Southwest to fund a portion of the costs associated with the replacement of certain gas pipe in the gas distribution system acquired by Southwest from APS	10.3 to September 1984 Form 10-Q Report	1-4473	11-14-84

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effecti*
10.31	Contract, dated July 21, 1984, with DOE providing for the disposal of nuclear fuel and/or high-level radioactive waste, ANPP	10.31 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85
10.32	Supplemental Agreement of Settlement, dated November 15, 1984 with DOE, ANPP	10.32 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85
10.33	Uranium Enrichment Services Contract, dated November 15, 1984 with DOE, ANPP	10.33 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85
10.34	Agreement, dated January 1, 1985 with El Paso Natural Gas Company amending Gas Sales Agreement dated March 1, 1983	10.34 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85

Reports on Form 8-K

During the quarter ended December 31, 1985, and the period ended March 27, 1986, the Company filed, on the dates indicated, the following Reports on Form 8-K:

Report filed November 19, 1985, relating to (1) a motion filed by the Residential Utility Consumer Office ("RUCO") requesting emergency adoption of a new Arizona Corporation Commission (the "ACC") rule to require public service corporations to prove by a preponderance of the evidence that their investments were prudent, and (2) an attempt to file a counterclaim in the consolidated state court lawsuits by the plaintiff in the United States District Court of Arizona lawsuit involving an effluent contract.

Report filed November 25, 1985, relating to (1) the United States District Court of Arizona dismissal of the lawsuit asserting claims relating to the primary contract involving effluent for cooling purposes at the Palo Verde Nuclear Generating Station, and (2) a declaratory judgment action in the Superior Court of Maricopa County, Arizona brought by the municipalities who are parties to the primary effluent contract.

Report filed December 12, 1985, relating to (1) the release of an audit report by the utility regulatory bodies which identified certain areas in which consultants recommended further study, (2) the granting of a facility operating license for Palo Verde Unit 2, (3) the issuance of an order by the ACC changing certain hearing dates, (4) the request by APS of certain orders from the ACC pertaining to accounting matters, and (5) an amendment to the counterclaim in Superior Court of Maricopa County asserting alternative claims.

Report filed January 20, 1986, relating to (1) delays in the projected commercial operation dates of Palo Verde Units 2 and 3, (2) the impact on the Company if the ACC does not grant the requested accounting/rate-making order relating to Unit 2, (3) the court order upholding the ACC's order purporting to subject AZP and its subsidiaries, including the Company, to certain reporting requirements, (4) the ACC's refusal to grant a motion by RUCO involving the emergency rate reduction application filed by RUCO, and (5) the ACC's refusal to grant a motion by RUCO involving a requested emergency adoption of a new ACC rule to require public service corporations to prove by a preponderance of the evidence that their investments were prudent.

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.

AZP GROUP, INC.
(Registrant)

Date: March 27, 1986

/s/ KEITH L. TURLEY
(Keith L. Turley, Chairman of the Board of Directors and President)

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.

Signature	*Title*	*Date*
/s/ KEITH L. TURLEY (Keith L. Turley, Chairman of the Board of Directors and President)	Principal Executive Officer and Director	March 27, 1986
/s/ O. MARK DE MICHELE (O. Mark De Michele, Executive Vice President)	Executive Vice President and Director	March 27, 1986
/s/ H. B. SARGENT, JR. (H. B. Sargent, Jr., Executive Vice President, Treasurer and Chief Financial Officer)	Principal Financial Officer, Principal Accounting Officer and Director	March 27, 1986
/s/ JOE ACOSTA (Joe Acosta)	Directors	March 27, 1986
/s/ DINO DECONCINI (Dino DeConcini)		
/s/ KARL ELLER (Karl Eller)		
/s/ WILLIAM T. GARLAND (William T. Garland)		
/s/ PAMELA GRANT (Pamela Grant)		

Signature	Title	Date
/s/ JACK M. MORGAN (Jack M. Morgan)	Directors	March 27, 1986
/s/ MARVIN R. MORRISON (Marvin R. Morrison)		
/s/ JOHN R. NORTON III (John R. Norton III)		
/s/ JOHN J. RHODES (John J. Rhodes)		
/s/ WILMA W. SCHWADA (Wilma W. Schwada)		
/s/ JAMES P. SIMMONS (James P. Simmons)		
/s/ RICHARD SNELL (Richard Snell)		
/s/ DONALD N. SOLDWEDEL (Donald N. Soldwedel)		
/s/ MAURICE R. TANNER (Maurice R. Tanner)		
/s/ DOUGLAS J. WALL (Douglas J. Wall)		
/s/ MORRISON F. WARREN (Morrison F. Warren)		
/s/ BEN F. WILLIAMS, JR. (Ben F. Williams, Jr.)		
/s/ THOMAS G. WOODS, JR. (Thomas G. Woods, Jr.)		

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT F

ARIZONA PUBLIC SERVICE COMPANY
ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDING
DECEMBER 31, 1985

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

For the fiscal year ended December 31, 1985 Commission File Number 1-4473

Arizona Public Service Company

(Exact name of registrant as specified in its charter)

ARIZONA
(State or other jurisdiction of incorporation or organization)

86-0011170
(I.R.S. Employer Identification No.)

411 North Central Avenue, P.O. Box 53999
Phoenix, Arizona 85072-3999
(Address of principal executive offices, including zip code)

(602) 250-1000
(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
$10.70 Cumulative Preferred Stock, Series I, $100 Par Value $3.58 Cumulative Preferred Stock, Series O, $25 Par Value Adjustable Rate Cumulative Preferred Stock, Series Q, $100 Par Value	New York Stock Exchange
First Mortgage Bonds: 10.625% Series Due 2000 7.45 % Series Due 2002 12.125% Series Due 2009	New York Stock Exchange

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

Cumulative Preferred Stock
(Title of class)

(See Notes 4 and 5 of Notes to Consolidated Financial Statements for dividend rates, series designations (if any) and par values)

Title of Each Class of Voting Stock	Shares Outstanding as of March 21, 1986	Aggregate Market Value of Shares Held by Non-affiliates as of March 21, 1986
Cumulative Preferred Stock	6,472,410	$402,189,000(a)

(a) Computed, with respect to shares listed on the New York Stock Exchange, by reference to the closing price on the composite tape on March 21, 1986, as reported by the Wall Street Journal, and with respect to nonlisted shares, by determining the yield on listed shares and assuming a market value for nonlisted shares which would result in that same yield.

As of March 21, 1986, there were issued and outstanding 71,264,947 shares of the registrant's common stock, $2.50 par value, all of which were held beneficially and of record, by AZP Group, Inc.

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 ___

Documents Incorporated By Reference

Portions of the registrant's definitive proxy statement relating to its annual meeting of shareholders on April 24, 1986, are incorporated by reference into Parts I and III hereof.

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

For the fiscal year ended December 31, 1985 Commission File Number 1-4473

Arizona Public Service Company

(Exact name of registrant as specified in its charter)

ARIZONA (State or other jurisdiction of incorporation or organization)	86-0011170 (I.R.S. Employer Identification No.)
411 North Central Avenue, P.O. Box 53999 Phoenix, Arizona 85072-3999 (Address of principal executive offices, including zip code)	(602) 250-1000 (Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
$10.70 Cumulative Preferred Stock, Series I, $100 Par Value $3.58 Cumulative Preferred Stock, Series O, $25 Par Value Adjustable Rate Cumulative Preferred Stock, Series Q, $100 Par Value	New York Stock Exchange
First Mortgage Bonds: 10.625% Series Due 2000 7.45 % Series Due 2002 12.125% Series Due 2009	New York Stock Exchange

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

Cumulative Preferred Stock
(Title of class)

(See Notes 4 and 5 of Notes to Consolidated Financial Statements for dividend rates, series designations (if any) and par values)

Title of Each Class of Voting Stock	Shares Outstanding as of March 21, 1986	Aggregate Market Value of Shares Held by Non-affiliates as of March 21, 1986
Cumulative Preferred Stock	6,472,410	$402,189,000(a)

(a) Computed, with respect to shares listed on the New York Stock Exchange, by reference to the closing price on the composite tape on March 21, 1986, as reported by the Wall Street Journal, and with respect to nonlisted shares, by determining the yield on listed shares and assuming a market value for nonlisted shares which would result in that same yield.

As of March 21, 1986, there were issued and outstanding 71,264,947 shares of the registrant's common stock, $2.50 par value, all of which were held beneficially and of record, by AZP Group, Inc.

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___

Documents Incorporated By Reference

Portions of the registrant's definitive proxy statement relating to its annual meeting of shareholders on April 24, 1986, are incorporated by reference into Parts I and III hereof.

TABLE OF CONTENTS

PART I

ITEM 1. BUSINESS

The Company

Arizona Public Service Company (the "Company") was incorporated in 1920 under the laws of Arizona and is engaged principally in serving electricity in the State of Arizona. The principal executive offices of the Company are located at 411 North Central Avenue, Phoenix, Arizona 85072-3999 (telephone 602-250-1000). The Company currently employs approximately 8,320 persons, which includes employees assigned to joint projects where the Company is project manager.

The Company's service territory includes all or part of 11 of Arizona's 15 counties. It is estimated by the Company that its electricity service reaches approximately 1,418,000 persons, or about 45% of the population of Arizona (which was approximately 3,150,500 in 1985 as compared to approximately 2,286,000 in 1975). During 1985 no single purchaser or user of energy accounted for more than 3% of total electric revenues.

Certain territory adjacent to or within areas served by the Company is served by other investor-owned utilities (notably Tucson Electric Power Company serving electricity in the Tucson area and Southwest Gas Corporation serving gas throughout the state) and a number of cooperatives, municipalities, electric districts, and similar types of governmental organizations (principally the Salt River Project Agricultural Improvement and Power District serving electricity in various areas in and around Phoenix). Effective November 1, 1984 the Company sold its gas distribution system. The Company expects increased competition in the future from entities offering alternative sources of energy, particularly natural gas.

All of the outstanding shares of common stock of the Company are owned by AZP Group, Inc. ("AZP"), which became the Company's corporate parent, effective April 29, 1985, pursuant to a corporate restructuring plan approved by the Company's shareholders on April 18, 1985. As a result of the restructuring, the holders of outstanding shares of Company common stock became instead the common shareholders of AZP on a share-for-share basis. The restructuring did not affect the Company's preferred stock or any of its outstanding debt securities, all of which remain obligations of the Company. As part of the restructuring, the Company sold to AZP, at book value of $34,703,000, all of the capital stock of three of its non-utility subsidiaries: Malapai Resources Company, Energy Development Company, and El Dorado Investment Company. APS Finance Company N.V., Bixco, Inc., and APS Fuels Company remain as wholly-owned subsidiaries of the Company. See Note 2 of Notes to Consolidated Financial Statements in Item 8 with respect to the corporate restructuring.

In conjunction with the restructuring, the Company's Stock Purchase and Dividend Reinvestment Plan was assumed and continued by AZP on April 29, 1985, so that AZP common shareholders and APS preferred shareholders may reinvest dividends in shares of AZP common stock. The Company's Employees' Retirement Plan and The Savings Plan for Employees of the Company were also amended as of April 29, 1985 to provide for the issuance or purchase of AZP common stock in lieu of Company common stock.

Industry and Company Problems

The utility industry continues to experience a number of problems. Depending on the circumstances of a particular utility, these may include (i) difficulties in obtaining rates sufficient to provide an adequate return on invested capital; (ii) difficulties in meeting government imposed environmental requirements; (iii) increasing costs of fuel, wages, and materials; (iv) the necessity to make substantial capital outlays during protracted construction periods for larger and more complex generating units; (v) the uncertainty regarding the rate of actual and projected energy demand growth; (vi) increased reliance on volatile capital markets and periodically limited availability of both equity and debt capital; and (vii) controversies over the safety and use of nuclear power.

In the Company's case, although increases in retail rates approved during 1984 improved the Company's 1985 financial performance, long-term financial improvement, as well as betterment of the Company's fixed income securities ratings, which were downgraded in 1983, will be contingent upon the timely granting of additional increases in retail rates. See "Rates—State" in this Item.

The impact on the Company of other utility industry problems are discussed in this Item under "Environmental Requirements" and "Generating Fuel". Also see "Water Supply" in this Item with respect to certain problems specific to the Company and other southwestern utilities.

Business Segments

Effective November 1, 1984, the Company sold its gas distribution system. See the Company's "Consolidated Statements of Income" and Note 13 of Notes to Consolidated Financial Statements in Item 8 for financial information regarding discontinued operations.

Capital Structure

The capital structure of the Company (which, for this purpose, includes short-term borrowings and current maturities of long-term debt) as of December 31, 1985 is tabulated below.

	Amount (Thousands of Dollars)	Percentage
Long-Term Debt Less Current Maturities:		
First mortgage bonds	$1,449,231	
Other	756,709	
Total long-term debt less current maturities	2,205,940	49.1%
Non-Redeemable Preferred Stock	218,561	4.9
Redeemable Preferred Stock	219,421	4.9
Common Stock Equity:		
Common stock, $2.50 par value, 100,000,000 shares authorized; 71,264,947 shares outstanding	178,162	
Premiums and expenses	1,040,909	
Retained earnings	592,334	
Total common stock equity	1,811,405	40.3
Total capitalization	4,455,327	
Current Maturities of Long-Term Debt	17,456	0.4
Short-Term Borrowings	18,000	0.4
Total	$4,490,783	100.0%

See Notes 4, 5, and 6 of Notes to Consolidated Financial Statements in Item 8.

Subsequent to December 31, 1985, the Company issued $100,000,000 of 11% Series First Mortgage Bonds due January 15, 2016, to fund the redemption by APS Finance Company N.V. of $75,000,000 of 16¼% guaranteed debentures due February 1, 1989, and $25,000,000 of 16% guaranteed debentures due February 15, 1989. In addition, the Company issued $100,000,000 of its 9¼% Series First Mortgage Bonds due March 1, 1996, to purchase a portion of its $100,000,000 15% Series First Mortgage Bonds due June 15, 1994.

Rates

State. The Arizona Corporation Commission (the "ACC") has regulatory authority over the Company in matters relating to retail electric rates and the issuance of securities. In November 1984, the ACC approved an increase in annual retail electric rates of approximately $43.5 million (5.0%), which became effective in February 1985. The order also adopted an "operating incentive plan" for the Company under which the Company will be rewarded or penalized for meeting or failing to meet specified operating efficiency levels at the Four Corners Plant ("Four Corners") and Palo Verde Unit

1 ("Unit 1"). The rewards and penalties will be related to the additional fuel costs avoided or incurred as a result of operating efficiency. If the operating efficiency levels fall within certain limits, the Company is neither rewarded or penalized.

Rewards or penalties (in dollars per kilowatt hour) that may result from this operating incentive plan will be collected through a "Performance Incentive Adjustment Clause" in the Company's rate schedules. Application of the operating incentive plan for Four Corners was effective January 1, 1985. As a result of the operation of Four Corners in 1985, the Company will neither be rewarded nor penalized under the operating incentive plan. With respect to Unit 1, since commercial operation only recently commenced on February 13, 1986, the Company expects that rate adjustments under this clause will initially be implemented in May 1987.

Finally, the order set a construction cost limit of $2.86 billion for the Company's share of Palo Verde, with any amounts expended above that figure to be construed as imprudently incurred for rate-making purposes (although no presumption of prudence will attach to expenditures made up to such limit). Taking into consideration the revised Palo Verde schedule discussed in Item 2, the Company's current estimate of its Palo Verde cost is approximately $2.76 billion.

In May 1985, the Company filed a request with the ACC for a $78.2 million (8.6%) increase in annual retail electric rates premised upon Unit 1 being fully included in the Company's rate base (the "Unit 1 Rate Case"). The Company also requested an accounting/rate-making order to defer certain costs and accrue certain carrying charges relating to Palo Verde Unit 2 ("Unit 2") for the period of time between Unit 2 going into commercial operation and new rates going into effect to cover the cost of Unit 2. The request included information on a potential phase-in of rates for Palo Verde Units 2 and 3. The ACC has divided the Unit 1 Rate Case into three phases. The "Phase I" hearings concerning the Company's purchased power and fuel adjustment mechanism (see below) were completed on March 7, 1986, and the ACC has not rendered a decision. The "Phase II" hearings concerning the Company's proposed increase in retail electric rates are scheduled to begin on March 27, 1986. The "Phase III" hearings concerning the Company's requested accounting/rate-making order for Unit 2 are scheduled to begin following the completion of the Phase II hearings.

On August 22, 1985, the ACC issued an order allowing an increase in the Company's purchased power and fuel adjustment mechanism of $.004 per kilowatt hour effective September 1, 1985. The Company had requested an increase of $.007 per kilowatt hour in the purchased power and fuel adjustment mechanism to compensate for the under-collection, since April of 1983, of the Company's increased fuel costs in excess of amounts currently being collected. The ACC order stated that the increase will remain effective until additional issues can be addressed in the Unit 1 Rate Case. Under-collected purchased power and fuel costs were approximately $74 million at December 31, 1985.

On December 18, 1985, the Company filed an application with the ACC for a $193.9 million (19.36%) increase in annual retail electric rates, to be effective on the date Unit 2 is placed in service (the "Unit 2 Rate Case"). As an alternative proposal, the Company recommended a series of three 6.15% base rate increases to take effect on January 1, 1987, 1988, and 1989 to phase in the costs of Unit 2 on the condition that the ACC grants the Company's request for the rate increase and accounting/rate-making order requested in the Unit 1 Rate Case. On December 30, 1985, the ACC instructed the Company to resubmit all schedules relating to the Unit 2 Rate Case on or before April 30, 1986, so as to reflect a calendar 1985 test year. Hearings concerning the Company's Unit 2 Rate Case are scheduled to begin September 26, 1986.

On February 13, 1986, the date Unit 1 attained commercial operation as defined by the ACC, the Company ceased accruing allowance for funds used during construction ("AFC") with respect to Unit 1 and the facilities common to all three Palo Verde Units (the "Common Facilities") in the amount of approximately $6 million per month. In addition, the Company began expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 1 and the Common Facilities, currently totalling approximately $5 million per month. Absent adequate and timely rate relief from the ACC, the Company expects these developments to adversely affect its earnings.

As part of the Unit 1 Rate Case the Company is seeking an accounting/rate-making order from the ACC allowing the Common Facilities to be transferred to plant in service in three equal increments, each tied to the commercial operation date of a Palo Verde unit, with the continuance of a carrying charge equivalent to AFC on any portion which has not been transferred to plant in service. If the ACC grants such accounting order, the Company would be able to accrue approximately $1 million of such carrying charge per month on each of the remaining two portions of the Common Facilities which have not been transferred to plant in service. In addition, the Company would be able to defer expensing the cost of owning, operating, and maintaining its 29.1% share of the remaining two portions of the Common Facilities, with such expenses currently totalling approximately $.3 million per month for each such portion.

As discussed above, the Company has requested the ACC to issue an accounting/rate-making order allowing the Company to defer expensing the cost of Unit 2 and to continue the accrual of a carrying charge equivalent to AFC from the commencement of the commercial operation of Unit 2 until the Company is allowed to recover the costs of Unit 2 in rates. If the ACC does not grant the Company's requested accounting/rate-making order relating to Unit 2, when Unit 2 achieves commercial operation (currently scheduled for the third quarter of 1986) the Company will cease accruing AFC with respect to Unit 2, currently totalling approximately $6 million per month. In addition, the Company will begin expensing the cost of owning, operating, and maintaining its share of Unit 2, currently estimated at $3 million per month. If the ACC does not grant the requested accounting/rate-making order with respect to Unit 2 or grant adequate and timely rate relief with respect to Unit 2, the Company expects its earnings to be adversely affected.

In 1984 the utility regulatory bodies of Arizona, California, New Mexico, and Texas formed the Four State Monitoring Committee (the "Committee") to oversee an independent construction audit of Palo Verde to determine the prudency of Palo Verde construction costs. On November 27, 1985, the Committee released a "Phase I Report" prepared by outside consultants in connection with this construction audit. The Phase I Report identifies certain areas in which the consultants recommend further study. Among these areas are the construction costs, engineering costs, system planning studies and project management. The Phase I Report estimates that the "direct construction costs" of Palo Verde will total approximately $5.9 billion. Approximately $3.12 billion of this amount, of which the Company's share is approximately $900 million, will be subject to further study. In addition, the Phase I Report recommends a review of the AFC costs associated with Palo Verde as well as other indirect costs.

The Phase I Report does not express an opinion regarding the reasonableness of specific actions related to Palo Verde. Rather, it is intended to define subsequent detailed studies which may include recommendations regarding the reasonableness of such actions. The issue of the reasonableness of specific actions related to Palo Verde may relate to the extent to which the Company may recover Palo Verde's costs from its customers. The next phase of the prudency audit began in March 1986, with recommendations expected in late 1986 or 1987. Any amounts ultimately deemed by the ACC to have been imprudently spent and not allowed in the Company's rate base would be written off by the Company. Although the Company is unable to predict the final outcome of this matter, management believes that overall Palo Verde was constructed in a prudent manner.

Federal. The Company's rates for wholesale power sales and transmission services are subject to regulation by the Federal Energy Regulatory Commission ("FERC"). During 1985, approximately 8% of the Company's electric operating revenues resulted from such sales and charges.

Pursuant to recent decisions by the United States Court of Appeals, the FERC's previous procedure for establishing the effective date of rate increases in connection with certain previous FERC rate cases involving the Company has been repealed. As a result, the FERC has ordered the Company to refund approximately $2.5 million (excluding interest) in revenues collected from some of its wholesale customers based upon the previous effective dates for such rate increases. The Company had provided for all of these revenues at December 31, 1985.

Adjustment Clauses. Adjustment clauses in the Company's retail rate schedules are intended to pass through to its retail customers changes in the costs of its generating fuel, purchased power, and the rates of excise taxes. In the case of excise taxes, adjustments are relatively prompt. In the case of generating fuel and purchased power, the Company is operating under a format that may require a hearing by the ACC after experienced or projected under- or over-recoveries of fuel and purchased power costs by the Company from its retail customers through prevailing rates have accumulated to a certain amount per kilowatt hour.

This format at times has resulted, as it did at December 31, 1985, in under-recovered balances arising from increased fuel expenses. Those amounts, which are to be recovered by the Company over time from retail customers through operation of the adjustment format, account for the "Deferred fuel" asset in the Company's consolidated balance sheets for that date on which such under-recovered balances occurred (see Consolidated Financial Statements in Item 8) and for much of the fluctuation in "Purchased power and interchange—net" expense in the consolidated statements of income (see Note 1d of Notes to Consolidated Financial Statements in Item 8). See "Rates—State" in this Item for additional information on the Company's purchased power and fuel adjustment mechanism.

For wholesale transactions regulated by the FERC, fuel adjustment clauses result in adjustments for changes in the actual cost of fuel for generation and in the fuel component of purchased power expense.

Construction and Financing Programs

Construction expenditures, including expenditures for environmental control facilities, for the years 1986 through 1988 have been estimated as follows:

(Millions of Dollars)

By Year		By Major Facilities	
1986	$386	Electric generation	$337
1987	258	Electric transmission	104
1988	226	Electric distribution	295
	$870	General facilities	134
			$870

The foregoing amounts include expenditures for nuclear fuel and start-up and preoperating costs, but omit all AFC and capitalized property taxes. They were derived in the course of the Company's ongoing review process, and, as they reflect the sale of the Company's gas operations (see "Business Segments" in this Item), may differ from those contained in other reports. The estimates are subject to periodic revision to reflect further changes in the Company's plans (which may result from extraneous developments, such as adverse rate orders or governmental regulations), updated scheduling, unanticipated inflation, and other factors. During the years 1983 through 1985 the Company incurred approximately $1,103 million in electric construction expenditures and approximately $621 million in additional electric capitalized items.

In addition to funds required for capital expenditures in 1986, 1987, and 1988, refunding obligations of senior securities and installment obligations, including certain anticipated early redemptions, are expected to total up to $297 million for 1986 and $118 million and $57 million for the years 1987 and 1988, respectively. External financing was required for substantially all of the Company's total capital requirements in 1985 and will be required for nearly half of such requirements in the 1986-1988 period, assuming that internally generated funds remaining after dividend payments are augmented by adequate rate increases during the period.

In 1985 the Company provided for its external capital requirements through issuances of first mortgage bonds, an issuance of European debentures, and pollution control financings (including draw-downs of previously committed funds). In addition, until April 29, 1985, the effective date of the corporate restructuring, the Company provided for a portion of its external capital requirements through the issuance of common stock pursuant to its stock purchase and dividend reinvestment plan and certain employee benefit plans. Effective April 29, 1985, AZP assumed the Company's stock

purchase and dividend reinvestment plan, which was amended (along with other employee benefit plans) to provide for the issuance or purchase of AZP common stock in place of Company common stock. See "The Company" in this Item. In January 1986, the Company issued $100 million in 30-year 11% first mortgage bonds. The proceeds were applied to the redemption of outstanding European debentures issued by the Company's wholly-owned finance subsidiary. In March 1986, the Company issued $100 million in 10-year 9¼% first mortgage bonds. Substantially all of the proceeds were applied to purchase approximately $80 million of the Company's $100 million 15% Series First Mortgage Bonds due 1994 at 123.23% of their principal amount plus accrued interest. Also in 1986, at such times as market conditions suggest, the Company plans to issue in private and public sales up to an additional $300 million in other long-term debt (inclusive of any refunding, redemption, repayment, or retirement of outstanding indebtedness), any or all of which may take the form of secured debt (presumably first mortgage bonds). During 1986 the Company also expects to issue or incur up to $200 million in additional debt to finance its nuclear fuel program in connection with the operation of Palo Verde. See "Properties" in this Item.

Provisions in the Company's mortgage bond indenture and articles of incorporation restrict it from issuing additional first mortgage bonds or preferred stock, respectively, unless its earnings (as defined) cover by at least the prescribed number of times the amount of interest (as to bonds) and the amount of interest plus preferred stock dividend requirements (as to preferred stock) on the securities to be outstanding after completion of the new issue. Operation of the latter such provision has at times in the past limited the Company's ability to issue preferred stock. As calculated in accordance with the applicable document, assuming 11½% as the rate of interest on new bonds and dividend requirement on new preferred stock that might have been issued on December 31, 1985 and treating the issuance of $100,000,000 of 11% series first mortgage bonds and $100,000,000 of 9¼% series first mortgage bonds as though consummated on that date, the coverage afforded by earnings (as defined) for the twelve months ended on that date would have allowed the issuance of either $1,303,000,000 in aggregate principal amount of additional first mortgage bonds (as compared to approximately $1,015,000,000 in bonds issuable on the basis of net "property additions") or $239,000,000 in aggregate par value of additional preferred stock. Minimum required coverages are 2.0 for bonds and 1.5 for preferred stock. Coverages afforded by earnings (as defined) were as follows:

	Year Ended December 31,		
	1985	1984	1983
Bonds	4.17	4.99	3.93
Preferred Stock	1.75	1.79	1.58

By statute, the Company's short-term borrowings may not exceed 7% of its total capitalization without the consent of the ACC. Such borrowings are an important source of funds, particularly between permanent financings, and the statute could from time to time limit the Company's financing flexibility. However, the Company's own general policy relating to short-term borrowings is consistent with that of the statute.

Environmental Requirements

The Company's operations are subject to stringent environmental protection measures imposed under federal and state laws and regulations, some of which have required substantial expenditures for pollution control technology. The Four Corners Plant, which is older than most of the Company's other coal-fired units, has been particularly affected by such measures, and installation of retrofit particulate and sulfur dioxide control equipment has been required at an approximate direct construction cost to the Company totaling $65,070,000 for its 15% share of Units 4 and 5. It has also been necessary to obtain variances or stipulations for certain aspects of that plant's operation. The initial variances were granted because state authorities found that emissions from the plant did not cause violation of air quality standards and that there was no reasonably available technology that would allow the plant to meet existing emissions limitations. Certain variances relating to the emission of nitrogen dioxides by Unit 3 expired on May 13, 1984, and with respect to Units 4 and 5,

on May 13, 1985. The Company filed timely petitions for further variances for such units with the New Mexico Environmental Improvement Board through May 13, 1987, and applicable regulations provide for stays of enforcement pending final determinations with respect to such petitions. The outcome of such petitions cannot currently be predicted. Other state permits, relating to surface and groundwater standards, contain various compliance dates and schedules which largely appear (though not beyond question) to be attainable.

The Federal Clean Air Act Amendments of 1977 may require installation of "the best available retrofit technology" on existing sources located near certain federally protected areas in which visibility is an important attribute. The Four Corners Plant is one such source. The installation is to occur as expeditiously as practicable, and in any event, within approximately five years after revision of the applicable state implementation plan. The full significance of the visibility provisions to the Four Corners Plant and the Company's other coal-fired plants is difficult to predict pending finalization of state and federal implementing regulations.

Problems of interpreting and complying with the various measures described above and the evolution of new measures (including any measures which are intended to address the "acid rain" problems afflicting other utilities but which could impact the Company as well) require continuing involvement of the Company in proceedings before the United States Congress, state legislatures, federal and state regulatory agencies, and the courts. The Company cannot accurately predict the financial and operational impacts resulting from revisions to existing laws.

Generating Fuel

Coal, gas, and oil contributions to total net generation of electricity by the Company in 1985, 1984, and 1983 and the average cost to the Company of those fuels (per million BTU), were as follows:

	Coal		Gas		Oil		All Fuels
	Percent of Generation	Average Cost	Percent of Generation	Average Cost	Percent of Generation	Average Cost	Average Cost
1985	87.7	$1.2292	11.5	$3.7478	0.8	$5.0480	$1.5859
1984	94.6	1.0263	5.1	4.0741	0.3	4.9379	1.2206
1983	93.8	1.0070	5.4	4.1591	0.8	4.6005	1.2380

The Company believes that the Four Corners, Navajo, and Cholla Plants have sufficient reserves of low sulfur coal (the sulfur content of which is currently running at 0.8%, 0.5% and 0.5%, respectively) committed to those plants to continue operating them for their useful lives. Prices paid for coal supplied from reserves dedicated under the existing contracts have been escalating pursuant to applicable contract clauses. In addition, major price changes from time to time result from contract renegotiation.

In April 1985, the United States Supreme Court affirmed a decision of the United States Court of Appeals for the Ninth Circuit, thereby upholding the authority of the Navajo Tribe (the "Tribe") to impose taxes on non-Indian businesses pursuant to certain possessory interest and business activity tax resolutions adopted by the Navajo Tribal Council in 1978. As a result, the Company is liable for the payment of Navajo taxes, either directly or indirectly, through its fuel supply agreements with its coal suppliers, effective as of the 1978 date of enactment of the taxing resolutions, except to the extent that the Company or its coal suppliers are relieved from payment by virtue of tax waiver or tax forgiveness provisions contained in certain lease agreements.

The plant site lease agreements for the Navajo and Four Corners Plants (each of which is located within the Navajo Reservation) contain provisions whereby the Tribe agreed not to impose certain taxes directly or indirectly on the Company's ownership or operation of each plant or on the coal supplier to each plant (each of which conducts at least a portion of its mining operation within the Navajo Reservation). The Company is uncertain, however, whether the tax waiver provisions in the Four Corners plant site lease agreement would allow the Company to prevail in nullifying the attempt by the Tribe to impose the possessory interest tax against the coal supplier to that plant (see below).

Effective April 25, 1985, the coal lease agreement between the Tribe and the coal supplier to the Four Corners Plant was amended. In that amendment, the Tribe forgave all business activities taxes

and possessory interest taxes that may have accrued against the Four Corners Plant participants and their coal supplier before April 25, 1985. Accordingly, notwithstanding the uncertainty as to the scope of the tax waiver provisions in the plant site lease agreement, the amendment to the coal lease agreement forgives the portion of the possessory interest tax that may have accrued against the coal supplier between 1978 and the effective date of the amendment.

Notwithstanding the 1985 amendment to the coal lease agreement, the Navajo Tax Commission has assessed the coal supplier to the Four Corners Plant for possessory interest taxes accruing prior to April 25, 1985, the effective date of that amendment. The coal supplier has commenced administrative proceedings to contest these assessments. The Company does not believe that the position adopted by the Tribe is meritorious.

The Tribe has also assessed a possessory interest tax on the coal supplier to the Four Corners Plant for the period beginning April 25, 1985. Pending the resolution of the issue of whether the Four Corners plant site lease agreement contains a waiver for the imposition of this tax, the tax will be paid into escrow by the coal supplier pursuant to provisions in the amendments to its lease. The Company's share of the possessory interest tax sought to be imposed against the coal supplier is approximately $1.9 million per year. The dispute will initially be heard by the Secretary of the Interior; however, the funds paid into escrow will not be released until the matter is decided by a federal court.

The 1985 amendment to the coal lease agreement also increased royalty payments to the Tribe in return for certain contractual and other concessions including, among others, an amendment to the plant site lease agreement providing for a formula for pricing rights-of-way for future transmission lines, a pricing formula for a supply of water in the event the participants' water resources are reduced as a result of certain adjudication currently pending in the New Mexico state courts, and an additional area for coal ash disposal, equipment storage, and construction lay-down. The Company estimates that the additional royalties will increase the Company's Four Corners coal costs by approximately $5 million per year. See also "Water Supply" in this Item with respect to pending litigation involving water resources.

One of the leases between the coal supplier to the Navajo Plant and the Tribe contains a provision permitting a "reasonable adjustment" to the royalties payable to the Tribe in 1984 and at ten year intervals thereafter, such reasonable adjustment to be made by the Secretary of the Interior or his delegated representative. The Secretary of the Interior designated the Area Director of the Navajo Tribal Agency of the Bureau of Indian Affairs ("Area Director") as his representative. In June 1984 the Area Director notified the coal supplier to the Navajo Plant that, pursuant to the lease agreement, the royalties payable to the Tribe would increase to 20% of the gross value of the coal, as determined in accordance with federal regulations governing the leasing of federal coal reserves, effective in August 1984. The coal supplier and the participants in the Navajo Plant have appealed the decision of the Area Director to the Commissioner of Indian Affairs as both untimely and, therefore, of no effect, and unreasonable in amount, if timely. The matter is still pending before the Commissioner of Indian Affairs. If the Area Director's decision is upheld in whole or in part, the increased royalties will accrue from August 1984. Any increase in the royalties payable under this lease will be passed through to the participants in the Navajo Plant, including the Company, which owns 15% of the plant. If the royalties are increased to 20% of the gross value of the coal, the royalties would increase from thirty cents per ton, which is presently being paid, to approximately $4.00 per ton, or approximately $2.4 million per year. However, the standard federal royalty on coal from leased lands owned by the federal government is 12½% of gross value, which would be approximately $2.50 per ton in royalties, or an increase of approximately $1.4 million per year. The Company cannot predict the outcome of the appeal.

The Company purchases coal for its Cholla Plant (located outside the Navajo reservation) from a coal supplier that conducts its mining operations partially within the Navajo Reservation. As a result of the Supreme Court decision referred to above, on July 23, 1985, the coal supplier to the Cholla Plant agreed to pay the Navajo Tribe approximately $11 million as settlement of the tax liability that

had accrued against the coal supplier between 1978 and July 23, 1985. The Company's share of such settlement is approximately $6 million, of which $2.7 million was paid in 1985 and $3.3 million will be due on July 25, 1986. The Company expects these taxes to increase its Cholla costs by approximately $4.5 million each year after 1986. In connection with this tax settlement, the coal supplier and the Tribe also agreed to an increase in future royalty payments by the coal supplier to the Tribe. The Company expects these increased royalties to increase its Cholla coal costs by 6% of the gross value of the coal per year through July 25, 1989 and by 12½% per year thereafter.

The coal supplier to the Cholla Plant also conducts mining operations on federal land under leases with the Bureau of Land Management (the "Bureau"). The pricing terms of the leases were subject to renegotiation on April 1, 1981, at which time the Bureau agreed to renew the leases for an additional ten year period but at a substantially higher royalty level. In June 1985, the coal supplier paid the Bureau under protest the increased royalties that had accrued since April 1, 1981, in the amount of $10.1 million. The Company's share of such royalites is approximately $6 million. The coal supplier has filed suit against the Bureau in the United States District Court of New Mexico challenging several provisions of the leases, including the royalty level.

The Company is not providing a reserve for the 1978 Tribal taxes in its financial statements and has obtained an order from the ACC that should allow the Company to recover from its retail customers the amount of such taxes that are allocable to them to the extent payment thereof is ultimately required.

See also "Water Supply" in this Item, with respect to additional matters involving questions as to the rights of Indian tribes.

The principal source of the Company's gas for generating fuel is El Paso Natural Gas Company ("El Paso") pursuant to a contract with a primary term expiring at the end of 1987. Although substantial amounts of boiler gas have been made available to it by El Paso, the Company intends to purchase sizeable quantities of natural gas on the spot market at prices below El Paso's. The Company expects that limited and, in the long run, decreasing amounts of boiler gas will be available to it from El Paso and other sources. In light of that expectation, the Company plans to reduce its reliance on boiler gas to the extent possible.

The Company burned a total of 230,000 barrels of residual and diesel fuel oil in 1983, 75,000 barrels in 1984, 200,000 barrels in 1985, and now estimates its 1986 oil requirements at 70,000 barrels. Large supplies of boiler gas, the start-up of additional coal-fired capacity, and the availability of purchased power have allowed the Company to substantially reduce its reliance on oil as compared to the 1970's. The Company's oil requirements are particularly sensitive to its supplies of boiler gas.

The fuel cycle for Palo Verde is comprised of the following stages: (1) the mining and milling of uranium ore to produce uranium concentrates, (2) the conversion of uranium concentrates to uranium hexafluoride, (3) the enrichment of uranium hexafluoride, (4) the fabrication of fuel assemblies, (5) the utilization of fuel assemblies in reactors, and (6) the storage of spent fuel and the disposal or (if future circumstances permit) the reprocessing thereof. Arrangements have been made to insure that Palo Verde's requirements of materials and services for each stage of the fuel cycle will be available as needed over an extended period.

Uranium concentrates in inventory and available under contracts with Energy Fuels Exploration Company, Pathfinder Mines Corporation, and other sources should meet Palo Verde's operational requirements through 1998 and beyond that year if options to purchase uranium concentrates under the fabrication contract with Westinghouse Electric Corporation (discussed below) are exercised. Options provided under the above contracts will permit the purchase of a portion of Palo Verde's uranium concentrate requirements on the spot market without penalty if the spot market purchase becomes economical. Uranium hexaflouride in storage and to be obtained through 1992 under a conversion service contract with Allied Corporation will meet Palo Verde's operational requirements for uranium hexaflouride through 1992. Existing contracts for fabrication services with Combustion

Engineering, Inc. and Westinghouse Electric Corporation will provide fuel assembly services for each of the Palo Verde units for at least the first two years of operation and approximately the next fifteen years of operation of each unit, respectively.

The participants in Palo Verde, including the Company, have an enrichment services contract with the United States Department of Energy ("DOE") that obligates DOE to furnish the enrichment services required throughout the life of each of the Palo Verde units. In September 1985, the United States District Court for the District of Colorado held that the form of the utility services contract used by DOE in its negotiations with utilities, including the one with the Palo Verde participants, is null and void. DOE has appealed the decision and has publicly announced that pending the final resolution of the appeal, it will continue to treat the enrichment services contracts, including the Palo Verde contract, as valid.

Pursuant to the Nuclear Waste Policy Act of 1982 (the "Act"), DOE is obligated to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by all domestic power reactors. The Nuclear Regulatory Commission ("NRC") pursuant to the Act, also requires operators of nuclear power reactors to enter into spent fuel disposal contracts with DOE. The Company, on its own behalf and on behalf of the other Palo Verde participants, has executed a spent fuel disposal contract with DOE. The Act also obligates DOE to develop the facilities necessary for the disposal of all spent fuel generated and to be generated by domestic power reactors and to have the first such facility in operation by 1998 under prescribed procedures. Such development is currently in progress. Spent fuel storage facilities at Palo Verde have sufficient capacity to store all fuel expected to be discharged from normal operation of all of the Palo Verde units during a period extending beyond the year 2000.

Increases in generating fuel costs historically have been passed through by the Company to its customers under adjustment clauses filed with the ACC and the FERC. See "Rates—Adjustment Clauses" in this Item. However, the Company cannot be certain of being able to do so in regard to future costs, such as those arising out of increased royalties payable by the Company's coal suppliers to the Navajo or Hopi Tribes. Any specific exercise of pass-through procedures at any time in effect could be contested and possibly denied in whole or in part by the ACC or the FERC. Moreover, rate increases in any form are resulting in customer resistance in the form of decreased energy usage that may retard future growth of unit sales.

Palo Verde Liability and Insurance Matters

The Palo Verde participants currently have insured against public liability claims resulting from nuclear energy hazards to the full $655 million limit on liability under Federal law (such law being commonly referred to as the "Price-Anderson Act"). The maximum available private insurance of $160 million has been purchased, and the remaining $495 million has been provided through a mandatory industry-wide retrospective assessment program, under which the Palo Verde participants collectively could be assessed up to $5 million for each Palo Verde unit licensed by the NRC (of which the Company's share would be 29.1%) in the event the total liability arising from any nuclear incident involving any licensed facility in the nation exceeds the $160 million private insurance. In the event of more than one incident, the potential $5 million assessment per licensed unit would apply to each incident, subject to a maximum assessment in any year of $10 million per licensed unit (of which the Company's share would be 29.1%) for all incidents. The insureds under the liability insurance include Palo Verde participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard." Such nuclear liability insurance coverage does not apply to damage to the plant facilities.

To cover possible damage to the Palo Verde facilities, the Palo Verde participants maintain nuclear property damage and decontamination insurance in the aggregate amount of $1.135 billion. The Company has also secured insurance against the increased cost of generation or purchased power resulting from the accidental outage of a nuclear unit. The Company will be insured, after a 26-week deductible period, for up to $1.24 million per week for its share of Units 1 and 2 (and Unit 3 when it is placed in service) for 52 weeks and up to 50% of such weekly amount for an additional 52 weeks.

In addition to the above-described policies of insurance, the Palo Verde participants are parties to an indemnity agreement with the NRC. This agreement contains an undertaking by the NRC to indemnify the Palo Verde participants "from public liability arising from nuclear incidents which is in excess of the level of financial protection required of" the Palo Verde participants but not in excess of $560 million. The indemnity agreement is not currently operative and will remain inoperative unless or until the level of financial protection (*i.e.*, the aggregate amount of primary and secondary levels of liability protection) required of the Palo Verde participants falls below $560 million.

The authority of the NRC under the Price-Anderson Act to enter into indemnity agreements covering new nuclear facilities not now in operation or under construction will expire on August 1, 1987. This limited expiration of authority, if not modified by Congress, would have no effect upon the financial protection and indemnity agreements in effect for plants now in operation or under construction, such as Palo Verde. Nonetheless, this expiration date has served as a catalyst for proposals to amend the Price-Anderson Act in a variety of ways. Some would simply extend the indemnity authority for an additional ten years in order to preserve the viability of the nuclear option for future expansion of the nation's generating capacity. However, other proposals, if adopted, could apply to existing plants now licensed for operation, such as Units 1 and 2, by eliminating or altering the limitation of liability or by increasing the maximum amount of retrospective annual premiums which could be assessed. Several bills to extend the expiring provisions and to amend or eliminate other provisions of the Price-Anderson Act have been offered in both the Senate and the House of Representatives. The response of Congress to these proposals cannot be predicted, nor is it certain that Congress will act in the near future.

Water Supply

Assured supplies of water are important both to the Company (for its generating plants) and to its customers. However, conflicting claims to limited amounts of water in the Southwest have resulted in numerous court actions in recent years.

Both groundwater and surface water in areas important to the Company's operation have been the subject of inquiries, claims, and legal proceedings which will require a number of years to resolve. The Company has been named along with a number of defendants in three lawsuits brought in the United States District Court for the District of Arizona by or on behalf of Indian tribes regarding the pumping of groundwater near Indian reservations. The Company has also been joined as one of a number of defendants in a proceeding before a state court in New Mexico to adjudicate rights to a stream system from which water for the Four Corners Plant is derived. See "Generating Fuel" in this Item for additional information regarding the water supply for the Four Corners Plant.

In connection with the construction and operation of Palo Verde, the Company has entered into contracts with certain municipalities granting the Company the right to purchase effluent for cooling purposes at Palo Verde and other future generating units. The validity of the Company's primary effluent contract has been challenged in a suit filed by the Salt River Pima-Maricopa Indian Community (the "Community") against the Department of the Interior (the federal agency alleged to have jurisdiction over the use of such effluent) and additional defendants, including the Company. The portion of the action challenging the effluent contract has been stayed while the Community litigates its claims against the Department of the Interior and other defendants for wrongful exclusion from the Salt River Project Improvement and Power District, a federal reclamation project.

In November 1982, certain operators of farms located in the vicinity of the Palo Verde site filed a lawsuit in Maricopa County Superior Court claiming prior rights to effluent to be delivered to Palo Verde under the primary and secondary effluent contracts. In December 1983, an owner of land in the river basin from which the effluent to be received under the primary contract is alleged to be derived filed a complaint in the United States District Court for the District of Arizona challenging the primary effluent contract. This action was dismissed in November 1985. That dismissal has been appealed to the United States Court of Appeals for the Ninth Circuit. The Company joined with another Palo Verde participant in bringing an action in an Arizona state court against the plaintiffs

in the two foregoing lawsuits, seeking a declaratory judgment as to rights to effluent under Arizona law. Such declaratory judgment action was consolidated in the Arizona state court with the laws filed in November 1982. In October 1985, the state court ruled in favor of the Palo Verde participa in these consolidated lawsuits, holding that the effluent contracts are neither void, unenforceable, no enjoinable for the reasons raised in the consolidated lawsuits by the parties adverse to the Palo Verde participants (the "Adverse Parties"). The Adverse Parties have appealed that decision to the Arizona Court of Appeals. The Company and certain Palo Verde participants have cross-appealed.

On November 22, 1985, several municipalities which are parties to the primary effluent contract filed an action in Maricopa County Superior Court against certain of the Adverse Parties seeking a declaration that the primary effluent contract is valid notwithstanding claims asserted by those Adverse Parties that approval of the effluent contract exceeded the municipalities' legal authority and that the contract violates the laws and public policy of Arizona. The Company was named as an indispensable party. The Company has answered the municipalities' complaint, alleging that there is no controversy because the Adverse Parties' claims are barred by applicable legal and equitable principles and alternatively seeking a declaration of the validity of the effluent contract. All parties have moved for summary judgment. A hearing on those motions is scheduled for April 21, 1986. On March 20, 1986, the Adverse Parties in that suit sought leave to amend their answer to assert numerous counterclaims and join additional parties as counterdefendants, including the Company and the other Palo Verde participants. The proposed counterclaims allege that the primary effluent contract is invalid because it violates Arizona municipal law, Arizona water law, certain water supply agreements involving the municipalities, and various other provisions of state law. The Company will respond to the proposed amendment in a timely manner.

Although the foregoing matters remain subject to further evaluation, the Company expects that the described litigation will not have a materially adverse impact on the completion, licensing, or operation of the Palo Verde units.

The Company anticipates that existing water supplies in certain parts of Arizona will b augmented by Colorado River water upon completion of the Central Arizona Project (now schedule to deliver water to Phoenix by mid-year 1986). Although the Company has been granted an allocation of this water by the Secretary of the Interior, it expects that reasonably priced water will remain in short supply in Arizona as well as in the Four Corners region of New Mexico, that uncertainties in applicable water law as applied to pertinent facts and circumstances may persist for some time, and that its own highly visible status as a large consumer (along with that of other utilities, particularly those from out of state) may attract conflicting claims to present water supplies and objections to new plants. Nevertheless, the Company believes that acceptable supplies will be available to its generating units now in operation or under construction throughout their useful lives.

Indian Matters

In August 1985 the Navajo Tribal Council adopted the Navajo Preference in Employment Act ("Employment Act") relating to requirements for preference in hiring, promotion, retention, and training of Navajos by companies and their contractors conducting business on or near the Navajo reservation. The Company and the Chairman of the Navajo Nation, with authorization of the Advisory Committee of the Navajo Tribal Council, entered into a letter agreement in March 1985 ("Letter Agreement") regarding Indian employment preference at the Four Corners Plant. The Letter Agreement provides, among other things, that qualifications for employment and promotion shall be determined by the Company. The Company and the Tribe disagree on the interpretation of the Employment Act and whether the Employment Act or the Letter Agreement control future employment relations. The Employment Act, if binding on the Company, could seriously impair the Company's present ability to hire and promote the most qualified employees at the Four Corners Plant. The Company cannot currently predict the outcome of this matter.

See also "Generating Fuel" and "Water Supply", both in this Item, with respect to additional matters involving questions as to the rights of Indian tribes.

ITEM 2. PROPERTIES

The Company's present generating facilities have an accredited capacity aggregating 3,640,370 kw, comprised as follows:

	Capacity
Coal:	
Units 1, 2 and 3 at Four Corners, aggregating	560,000kw
15% owned Units 4 and 5 at Four Corners, representing	221,700
Units 1, 2, 3 and 4 at the Cholla Plant, aggregating	946,000(1)
14% owned Units 1, 2 and 3 at the Navajo Plant, representing	315,000
	2,042,700kw
Gas or Oil:	
Five steam units divided among the Saguaro (2) Ocotillo (2) and Yucca (1) Plants, aggregating	468,400kw
Eleven turbine units, aggregating	500,600
Three combined cycle units, aggregating	253,500
	1,222,500kw
Nuclear:	
29.1% owned Unit 1 at Palo Verde, representing	369,570kw
Other	5,600kw

(1) The Company has agreed to sell varying amounts (up to 350,000 kw) of this capacity to another utility during the next five years.

The highest one-hour demand on its electric system which the Company experienced in 1985 was 3,197,800 kw recorded on July 12, 1985, compared to a high of 2,970,600 kw experienced on August 30, 1984. Taking into account additional capacity then available to it under power purchase contracts as well as its own generating capacity, the Company's capability of meeting system demand on July 12, 1985, computed in accordance with accepted industry practices, amounted to 3,570,800 kw for a reserve margin of 12.9%. The power actually available to the Company from its resources fluctuates from time to time as a consequence of unit unavailability (because of shutdown for scheduled or unscheduled maintenance) and other technical problems. The Company's own sources actually operable at the time of the July 12, 1985, peak demand were 1.2% less than those required.

Substantial capital expenditures for environmental protection measures have been and may be required to keep the Four Corners Plant, and possibly the Navajo Plant, in operation. See "Environmental Requirements" in Item 1. Both of those plants, along with certain of the Company's transmission lines and all of its contracted coal sources, are located on Indian reservations. See "Generating Fuel" and "Indian Matters" in Item 1 and the sections cross-referenced therein with respect to the assertion of taxing and regulatory authority by the Navajo Tribe which will increase the cost of certain of the Company's operations.

The receipt of a facility operating license for Palo Verde Unit 2 later than previously anticipated, combined with other factors, resulted in the announcement on January 14, 1986 of delays in the commercial operation dates of Palo Verde Units 2 and 3. The Company's most recent projections indicate that Palo Verde Units 2 and 3 will achieve commercial operation during the third quarters of 1986 and 1987, respectively. Units 2 and 3 had been previously scheduled to achieve commercial operation during the second quarters of 1986 and 1987, respectively. Nuclear fuel loading was completed at Unit 1 on January 11, 1985, and that unit attained commercial operation on February 13, 1986. Unit 2 completed its fuel loading on December 16, 1985, and Unit 3 fuel loading is scheduled for the first quarter of 1987. The new schedule is not expected to increase the Company's direct cost for its share of Palo Verde but is expected to increase the Company's AFC for Units 2 and 3. The construction costs in the table below reflect the updated schedule announced in January 1986.

However, various other factors may affect the accuracy of the estimates shown as well as their comparability to other published estimates (which may have been prepared as of other review dat Actual completion dates, unexpected inflationary pressures, and compliance with any additio governmental procedures and regulations could cause final costs to vary substantially from these and any later estimates, as could changes in the Company's plans and changes of plans of other participants.

Type of Facility and Scheduled Completion Date	Nameplate Capacity or Equivalent	Estimated Construction Expenditures (Thousands of Dollars)(1)	Estimated Construction Expenditures Per Kilowatt(1)
Nuclear:			
29.1% owned Units 1 (1986), 2 (1986) and 3 (1987) of the Palo Verde Nuclear Generating Station, representing.....	1,109,000kw	$1,333,000(2)	$1,202

(1) Excluding expenditures for related transmission facilities, fuel, and fuel sources.

(2) Including $1,252,584,000 spent through December 31, 1985.

In addition to the construction expenditures shown in the table, the Company capitalizes AFC, property taxes, start-up and pre-operating costs (including start-up power costs), and test energy credits associated with the foregoing facilities. Making certain assumptions (some of which differ from those involved in prior estimates) as to future interest rates, termination dates of AFC accruals, and other factors, the Company has estimated that the addition of these associated costs to construction expenditures will bring its total installed cost for the three Palo Verde units to approximately $2,500 per kw. See "Rates-State" in Item 1 for a discussion of the construction limit imposed by the ACC for the Company's share of Palo Verde cost.

The Company's construction plans are susceptible to changes in forecasts of future demand on its electric system and in its ability to finance its construction program. Changes in the timing of forecasted increases in demand and other factors occurring since the commencement of construction of Unit 4 of the Cholla Plant caused the Company to enter into agreements to temporarily sell up to 350,000 kw of that unit's generating capacity through 1990. Although its plans are subject to change, the Company does not presently intend to construct any new major generating units, other than Palo Verde, until the end of the century. An important factor affecting the Company's ability to delay the construction of new major generating units is a continuing effort to upgrade and improve the reliability of existing generating stations. The Company is also looking to develop additional interties with neighboring utilities, to review reserve margins and reliability indices, to expand the size and scope of its load management program, and to explore cogeneration and third-party financed facilities.

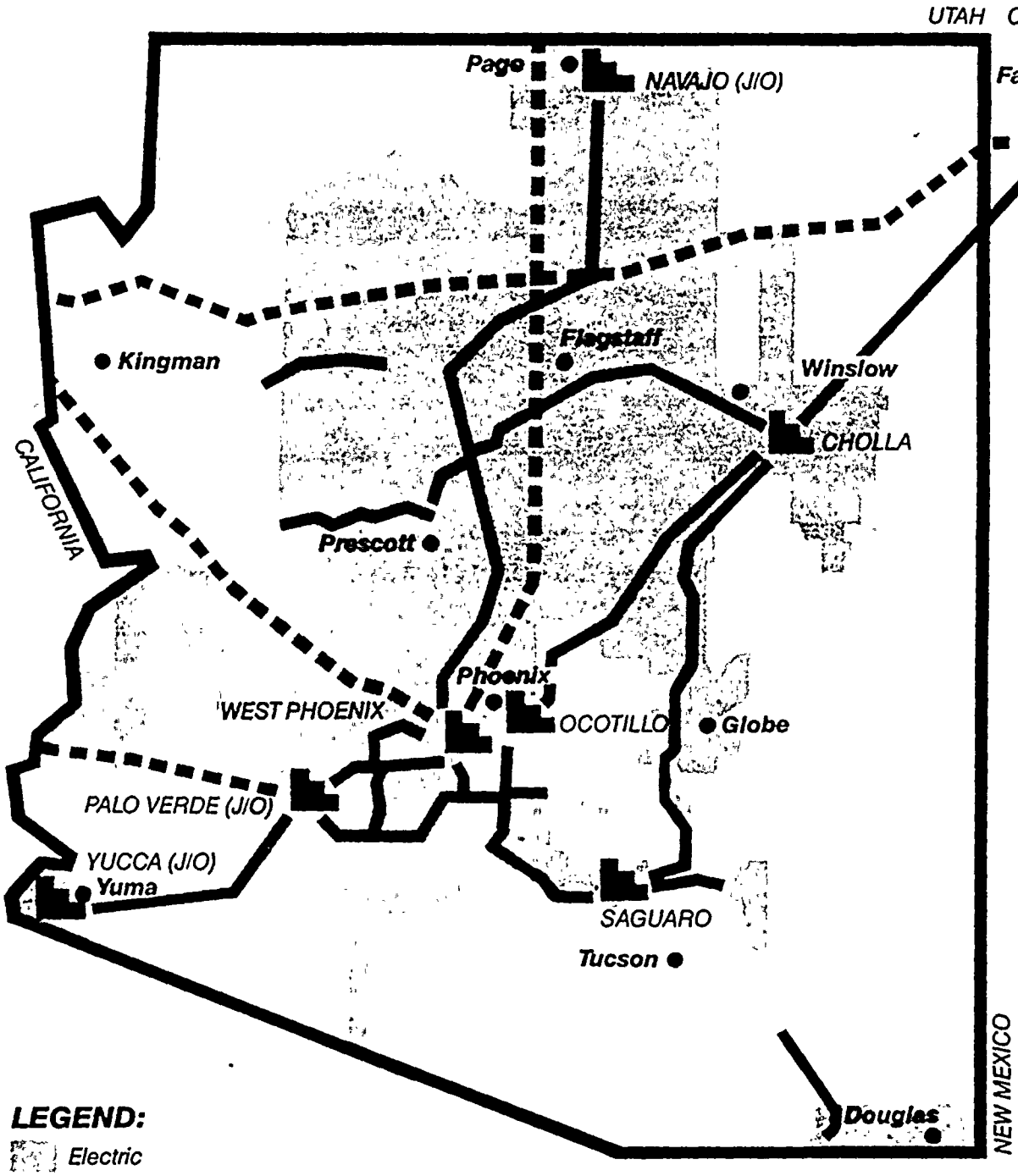
Operation of each of the three Palo Verde units following its completion requires the obtaining of a low and full power operating license from the NRC. Facility operating licenses for Units 1 and 2 were granted by the NRC to the Company and the other participants in Palo Verde in December 1984, and December 1985, respectively. The licenses, valid for a period of 40 years from the date of issuance, authorize the Company, as operating agent for Palo Verde, to operate Units 1 and 2 at full power. Pending completion satisfactory to the NRC of certain tests and other items, however, the license for Unit 2 restricts operation of such unit to power levels not to exceed 5% of full power without specific NRC approval. Similar restrictions in the Unit 1 license were removed by the NRC in May 1985, and Unit 1 was placed in commercial operation in February 1986.

See also "Rates—State," "Water Supply," and "Generating Fuel" in Item 1 with respect to matters having possible impact on the operation of Palo Verde.

In addition to that available from its own generating capacity, the Company purchases electricity from other utilities under various arrangements. The most important of these is a long-term contract with Salt River Project Agricultural Improvement and Power District which may be canceled by the District on three years' notice and which requires the District to make available, and the Company to pay for, certain amounts of electricity that are based in large part on customer demand within certain areas now served by the Company pursuant to a related territorial agreement. The Company believes that the prices payable by it under the contract are fair to both parties. The generating capacity available to the Company pursuant to the contract is currently 255,000 kw. In 1985 the Company received 898,689 mwh of energy under the contract and paid approximately $45 million for capacity availability and energy received.

On January 25, 1985, the residents of the City of Page, Arizona ("Page") voted to acquire the Company's electrical distribution system in and around the area of Page and to operate the acquired system as a municipal system. The Company serves approximately 2,500 customers in the Page area. Page has filed a condemnation action to establish the value of the system and to acquire immediate possession. The exact property Page will ultimately acquire is unclear at this time and the Company's preliminary estimate of the value of the system varies substantially from that of Page. The parties have stipulated that Page may take immediate possession of the system upon posting a bond intended to protect the Company during the period of possession prior to trial. The trial is currently scheduled to begin in June 1986. The Company cannot currently predict the outcome of this matter or the extent to which other municipalities may take similar action.

See Note 6 of Notes to Consolidated Financial Statements in Item 8 with respect to property of the Company not held in fee or held subject to any major encumbrance.



LEGEND:

Electric

Major APS Power Plants (J/O = Joint Ownership)

Principal APS Transmission Lines

Transmission Lines Operated for Others

ITEM 3. LEGAL PROCEEDINGS

See "Rates," "Environmental Requirements," "Generating Fuel," "Water Supply," and "Indian Matters," all in Item 1, and Item 2 in regard to pending or threatened litigation and other disputes.

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

No matter was submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report, through the solicitation of proxies or otherwise.

SUPPLEMENTAL ITEM. EXECUTIVE OFFICERS OF THE REGISTRANT

The Company's executive officers are as follows:

Name	Age at March 3, 1986	Position(s) at February 28, 1986
Keith L. Turley	62	Chairman of the Board of Directors and Chief Executive Officer(1)
Karl Eller	57	Chairman of the Executive Committee of the Board of Directors(1)
O. Mark De Michele	51	President and Chief Operating Officer(1)
Henry B. Sargent, Jr.	51	Executive Vice President and Chief Financial Officer(1)
Edwin E. Van Brunt, Jr.	54	Executive Vice President, Arizona Nuclear Power Project
Jaron B. Norberg	48	Senior Vice President and Corporate Counsel
Walter F. Ekstrom	48	Vice President, Electric Operations
David W. Ellis	47	Vice President, Research, Development and Alternative Energy Applications
Joseph A. Gelinas	41	Vice President, Employee Relations
B. Paul Hart	61	Vice President, Rates and Regulation
Jerry G. Haynes	51	Vice President, Nuclear Production
Russell D. Hulse	58	Vice President, Resources Planning
Jerry P. Human	55	Vice President, Customer Services-State Region
Charles D. Jarman	50	Vice President, Construction
Donald B. Karner	34	Vice President, Engineering
Guy W. Lunt	52	Vice President, Customer Services-Metro Region
John C. Ogden	40	Vice President, Customer and Administrative Services
William J. Post	35	Vice President and Controller
Shirley A. Richard	38	Vice President, Corporate Relations
Paul A. Williams II	39	Vice President and Treasurer
Faye Widenmann	37	Secretary
Kathryn A. Forbes	35	General Auditor
Sally F. Kur	41	Assistant Secretary

(1)Member of the Board of Directors.

The executive officers of the Company are elected no less often than annually and may be removed by the Board of Directors at any time. The terms served by the named officers in their current positions and the principal occupations (in addition to those stated in the table and exclusive of directorships) of such officers for the past five years have been as follows:

Mr. Turley was appointed President (a position he held until September 1982) and Chief Executive Officer in 1974 and was appointed Chairman of the Board of Directors in February 1981.

In July 1983, Mr. Eller became Chairman of the Board and Chief Executive Officer of The Circle K Corporation and in October 1982 he became President of The Karl Eller Company (consulting firm to the media) and resigned as President of Columbia Pictures Communications (advertising media), a position he assumed in 1981. He also served as Chairman of the Board of Directors of Red River Resources, Inc. (diversified investments) from January 1980 until January 1985. During portions of 1980 and in January 1981 he served as President of both Eller Media Company and Charter Media Company (advertising media).

Mr. De Michele was elected President in September 1982 and became Chief Operating Officer the following month. Previously, he had occupied the positions of Executive Vice President for Customer, Employee and Corporate Relations (since September 1981) and Vice President, Corporate Relations (April 1978 to September 1981).

Mr. Sargent has served in his current office since September 1981. Before that date, he was Vice President, Finance.

Mr. Van Brunt assumed his present position upon the retirement of Thomas G. Woods Jr., effective as of March 1, 1985. Mr. Van Brunt served as Vice President, Nuclear Production since January 1984 and prior to that time was Vice President, Nuclear Projects Management, from November 1978 to January 1984. Mr. Woods will remain on the Company's Board of Directors.

Mr. Norberg was elected to his position in March 1982, prior to which time he had been a partner in the law firm of Snell & Wilmer.

Mr. Ekstrom was elected to his present position in October 1982. Prior to that time he had served in a variety of engineering and management functions in the Company's Power Production operations, including Manager of Fossil Generation (September 1977 to September 1982).

Mr. Ellis was elected to his present position in November 1984. He had previously held the position of Vice President Gas Operations (June 1982 to November 1984) also served the Company in a variety of engineering and customer service management positions, including Manager of Gas Operations (October 1981 to June 1982).

Mr. Gelinas was elected to his present position in May 1979. He joined the Company as Director of Employee Relations in April 1978.

Mr. Hart was elected to his present position in October 1982, after serving as Manager of Rates and Property Evaluation.

Mr. Haynes was elected to his present position on July 8, 1985. Prior to that time he was employed by Southern California Edison.

Messrs. Hulse, Human and Jarman were elected to their present positions in 1973, 1974 and 1978, respectively, with Mr. Jarman assuming the post of Vice President Construction in December 1985.

Mr. Karner was elected to his present position in December 1985. Before such election he had held the position as Assistant Vice President for Nuclear Production (February 1984 to November 1985) and Plant Manager at the Four Corners Power Plant (since March 1981).

Mr. Lunt was elected to his present position in July 1984. Before that date he became the State Region manager in September 1982 and a Division manager since 1976.

Mr. Ogden was elected to his present office in October 1982. Before that time he served in capacities including Vice President and Controller (September 1981 to October 1982) and Vice President, Administration and Economic Planning (July 1978 to September 1981).

Mr. Post was elected to his present position in April 1985 after serving as Controller since December 1982. He had previously held the positions of Manager of Accounting and Control (October 1982 to November 1982) and Manager of Budgets and Forecasts (August 1978 to September 1982).

Ms. Richard was elected to her present position in May 1984. Prior to that time she served as Director of Corporate Communications at Adolph Coors Co.

Mr. Williams has served as Treasurer since September 1981 and was made a Vice President in September 1983. He joined the Company in November 1980 as Manager of Financial Planning and Analysis. Before that time he was employed by San Diego Gas & Electric Company (electric generation and natural gas distribution) in various capacities, including Manager of Financial Planning (February 1978 to November 1980).

Ms. Widenmann was elected to her present position in June 1983 after serving as Assistant Secretary since December 1982. She had previously held the positions of Manager of General Corporate Services (since March 1982) and Public Affairs Representative (March 1978 to March 1982).

Ms. Forbes was elected to her present position in March 1984 after serving as Manager of the Audit Services Department since January 1982. Before that time she served as Internal Audit Supervisor (June 1980 to January 1982), Contract Audit Administrator (June 1979 to June 1980) and Senior Internal Auditor (November 1977 to June 1979).

Ms. Kur was elected to her present position in May 1985 after serving as Manager of Securities Administration since November 1984. She had previously held the position of Manager, General Corporate Services since September 1983 and Senior writer since April 1981.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock is held solely by AZP and as a result is not listed for trading on any stock exchange. Prior to April 29, 1985 the Company's common stock was publicly held and was traded on the New York and Pacific Stock Exchanges. At the close of business on April 28, 1985 the Company's common stock was held by 123,776 shareholders.

The chart below sets forth the common stock price ranges for the four quarters of 1984 and for the first two quarters of 1985. The second quarter common stock price ranges for 1985 reflect the price ranges to April 29, 1985, the date on which AZP became the sole shareholder of the Company's common stock. The chart below also sets forth the dividends per share paid on the Company's common stock for each of the four quarters for 1984 and 1985.

Common Stock Price Ranges and Dividends

1985	High	Low	Dividend Per Share
1st Quarter	22⅞	20⅝	$.65
2nd Quarter	24⅞	22¼	.68
3rd Quarter	—	—	.69
4th Quarter	—	—	.71
1984			
1st Quarter	21	18	$.65
2nd Quarter	18¼	14½	.65
3rd Quarter	20⅜	16	.65
4th Quarter	22⅝	19¼	.65

After payment or setting aside for payment of cumulative dividends and mandatory sinking fund requirements, where applicable, on all outstanding issues of preferred stock, the holders of common stock are entitled to dividends when and as declared out of funds legally available therefore. See Notes 5 and 6 of Notes to Consolidated Financial Statements in Item 8 for restrictions on retained earnings available for the payment of dividends.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

	Year Ended December 31,				
	1985	1984	1983	1982	1981
	(Thousands of Dollars, Except Per Share Data)				
Revenue from continuing operations	$1,174,502	$ 994,967	$ 871,875	$ 866,486	$ 730,788
Operating income from continuing operations	$ 306,984	$ 263,260	$ 253,412	$ 263,099	$ 249,724
Net income	$ 325,423	$ 271,067	$ 264,797	$ 231,043	$ 197,434
Per share of common stock:					
Earnings (loss) (based on average shares outstanding)					
Continuing operations	$ 3.96	$ 3.65	$ 3.53	$ 3.25	$ 3.36
Discontinued operations	—	(0.39)	(0.07)	0.05	(0.10)
Total	$ 3.96	$ 3.26	$ 3.46	$ 3.30	$ 3.26
Dividends declared	$ 2.73	$ 2.60	$ 2.56	$ 2.40	$ 2.20
Total assets	$5,251,327	$4,653,774	$4,386,312	$3,888,536	$3,396,790
Long-term debt less current maturities and redeemable preferred stock	$2,425,361	$1,967,486	$1,892,477	$1,610,486	$1,618,048

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Liquidity and Capital Resources

The Company has large capital requirements for its ongoing construction program and for the refunding of maturing securities. Its heavy reliance on external debt financing to meet those requirements are discussed in "Construction and Financing Programs" in Item 1 and in "Properties" in Item 2. The Company has a degree of flexibility in adjusting its construction program to its financing capability. However, that flexibility is limited, and the Company's long-term liquidity will depend on its access to the capital markets, which in turn will depend on sufficiency of the Company's rates to provide adequate coverages on its senior securities, and an adequate rate of return on its common stock equity. Adequate earnings and coverage are critical to the maintenance of satisfactory credit ratings on the Company's senior securities and, as calculated in accordance with the governing instruments, are prerequisite to the Company's legal ability to issue such securities.

See "Capital Structure" in Item 1 with respect to the Company's capital structure at December 31, 1985. The Company regards common stock equity as its most expensive form of permanent financing, but it intends to maintain that category at approximately the 40% level in order to support the credit ratings on its senior securities. If interest and dividend rates on new issues of long-term debt and preferred stock rise in the future, the Company's average cost of capital will rise accordingly.

See "Construction and Financing Programs" in Item 1 and Note 7 of Notes to Consolidated Financial Statements in Item 8 with respect to short-term borrowings available to the Company (there being a statutory limitation on the amount of such borrowings that can be outstanding without consent from the ACC). Funds from operations after the payment of dividends have contributed only marginally to total sources of funds in the last few years (see "Industry and Company Problems" and "Construction and Financing Programs" in Item 1). This situation is expected to continue to some degree until Unit 1 is fully included in rate base so as to give rise to additional cash earnings. The Company's retention of funds from operations has also been affected by the Company's policy of increasing common stock dividends periodically (see Item 6).

On February 13, 1986, the date Unit 1 attained commercial operation as defined by the ACC, the Company ceased accruing AFC with respect to Unit 1 and the facilities common to all three Palo Verde units (the "Common Facilities"), currently totalling approximately $6 million per month. In addition, the Company began expensing the cost of owning, operating, and maintaining its 29.1% share of Unit 1 and the Common Facilities, currently estimated at $5 million per month. Absent adequate and timely rate relief from the ACC, the Company expects these developments to adversely affects its earnings.

As part of the Unit 1 Rate Case the Company is seeking an accounting/rate-making order from the ACC allowing the Common Facilities to be transferred to plant in service in three equal increments, each tied to the commercial operation date of a Palo Verde unit, with the continuance of a carrying charge equivalent to AFC on any portion which has not been transferred to plant in service. If the ACC grants such accounting/rate-making order, the Company would be able to accrue approximately $1 million of such carrying charge per month on each of the remaining two portions of the Common Facilities which have not been transferred to plant in service. In addition, the Company would be able to defer expensing the cost of owning, operating, and maintaining its 29.1% share of the remaining two portions of the Common Facilities, with such expenses currently totalling approximately $.3 million per month for each such portion.

As discussed above, the Company has requested the ACC to issue an accounting/rate-making order allowing the Company to defer expensing the cost of Unit 2 and to continue the accrual of a carrying charge equivalent to AFC from the commencement of the commercial operation of Unit 2 until the Company is allowed to recover the costs of Unit 2 in rates. If the ACC does not grant the Company's requested accounting/rate-making order relating to Unit 2, when Unit 2 achieves commercial operation (currently scheduled for the third quarter of 1986) the Company will cease accruing AFC with respect to

Unit 2, currently totalling approximately $6 million per month. In addition, the Company will begin expensing the cost of owning, operating, and maintaining its share of Unit 2, currently estimated at [illegible] million per month. If the ACC does not grant the requested accounting/rate-making order with respect [illegible] Unit 2 or grant adequate and timely rate relief with respect to Unit 2, the Company expects its earnings to be adversely affected.

Operating Results

Total operating revenues reflect the effects of rate increases and adjustment clauses (see "Rates" in Item 1) on prices of units sold. Operating revenues also reflect the volume changes in unit sales shown in "Operating Statistics" in this Item. The foregoing factors contributed to annual increases in electric revenues over the preceding calendar year as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Energy related:			
Volume increases (decreases) (1)	$ 71,169	$ 29,216	$ 13,438
Price increases (decreases) (2)	63,742	93,229	(360)
Non-energy related:			
Revenue increases (decreases) (3)	44,624	647	(7,689)
Net increase	$179,535	$123,092	$ 5,389

(1) Calculated by summing the products derived by multiplying the year-to-year increases in units sold in each customer class by the weighted average of the applicable rate levels in effect for the prior year.

(2) Calculated by summing the products derived by multiplying the year-to-year increases [illegible] the weighted average of rate levels in each customer class times the applicable number [illegible] units sold in the current year. Relative contributions by rate increases and by effects of the Company's adjustment clauses vary according to the timing of general rate proceedings and the extent to which accumulated effects of the adjustment clauses are incorporated in new rates.

(3) Includes revenues for miscellaneous service and transmission for others.

The increase in volume-related electric revenues in 1985 was primarily due to higher sales in the residential and commercial classes. These sales increases were mainly the result of customer growth and the warmer weather conditions experienced during the summer of 1985. In addition, there were increased industrial sales to the copper industry. Unit sales of electricity increased in 1984 primarily due to customer growth in the residential and commercial classes and more humid weather conditions, partially offset by decreased industrial and resale sales. The increase in unit sales of electricity in 1983 was primarily due to customer growth in the residential and commercial classes partially offset by decreased retail and resale irrigation usage resulting from the U.S. Government's Payment-In-Kind Program. Conservation efforts by customers in response to higher energy costs have affected unit sales, are expected to continue to do so, and are being aided by the Company's own load-management programs. The year-to-year changes in non-energy related electric revenues reflect changes in capacity sold to other utilities (see "Properties" in Item 2).

Although unit fuel costs have continued to rise, the Company's cost of fuel per kilowatt-hour generated has been tempered by the large portion of coal in the fuel mix. See "Rates-Adjustment Clauses" in Item 1 with respect to the pass-through treatment of increased unit fuel costs and the increase in the Company's deferred fuel account. In 1985, increases in fuel expenses were primarily

due to increased gas generation. In 1984, the slight increases in fuel expenses reflect increases in the unit costs of fuel for generation partially offset by an improved fuel mix and high capacity factors at the Company's coal-fired plants.

Variations in purchased power and interchange-net reflect varying degrees of availability of relatively low-priced power from other sources including energy available from testing of the Company's nuclear generating unit, the needs of the Company to augment its own generating sources from time to time, and the Company's ability to sell energy to neighboring utilities. In 1985, an increase in purchased power and interchange-net was primarily due to increased purchased power requirements and reduced interchange sales to other utilities. This increase was largely offset by the accounting treatment for the Company's fuel and purchased power expense (discussed in "Rates-Adjustment Clauses" in Item 1 and in Note 1d of Notes to Consolidated Financial Statements in Item 8). The increase in purchased power and interchange-net expense in 1984 was primarily due to the accounting treatment for fuel and purchased power which was largely offset by increased interchange sales to other utilities.

See "Effects of Inflation" in this Item in regard to maintenance expense, which is also a function of the size of the Company's utility plant and is affected by the timing of major overhauls. The increase in operations excluding fuel expense in 1985 was due in large part to increased payroll, associated expenses related to customer growth, and an addition to the reserve for uncollectibles resulting from an unpaid note.

Depreciation and amortization expenses and ad valorem taxes increase with the size of the Company's utility plant. See Note 12 of Notes to Consolidated Financial Statements for both ad valorem and sales taxes (the latter being a function of operating revenues), which are the principal components of other taxes.

The increases in income taxes and deferred income taxes in 1985 and 1984 were largely a result of the Company's compliance with an ACC accounting order, effective October 1, 1983, the aggregate effect of which was to require the Company to normalize substantially all income tax timing differences (see Note 1f of Notes to Consolidated Financial Statements).

The aggregate amount of AFC, shown as other income and a credit to interest deductions, is primarily a function of the amount of construction work in progress during any given period and ceases to accrue on those portions of construction work in progress that are included in rate base. In addition, AFC ceases to accrue on those generating facilities transferred to plant in service. See Note 1e of Notes to Consolidated Financial Satements for changes in rates of AFC. See "Liquidity and Capital Resources" above with respect to the non-cash aspect of AFC.

The increase in interest on long-term debt in recent years reflects large amounts of new borrowings at relatively high interest rates. See "Liquidity and Capital Resources" above and Note 6 of Notes to Consolidated Financial Statements. The decrease in interest on short-term borrowings in 1985 resulted primarily from decreased borrowings, but includes the effects of lower interest rates.

Consolidated net income represents a composite of cash and non-cash items (see Consolidated Statements of Changes in Financial Position) and, in part, reflect accounting practices unique to regulated public utilities.

As described in Note 13 of Notes to Consolidated Financial Statements, the Company sold its gas distribution system, effective November 1, 1984. Accordingly, 1983's statement of income has been reclassified to report separately this discontinued operation.

Effects of Inflation

In contrast to the analysis of increases in operating revenues in the table at the beginning of "Operating Results" of this Item, it is sometimes difficult, in the case of operation and maintenance expenses, to distinguish between effects of volume increases and rises in unit costs (which, for purposes of this discussion, are all attributed to inflationary pressures).

Certain inflationary effects, such as those on costs of generating fuel, are passed through to customers pursuant to rate adjustment procedures (see "Rates—Adjustment Clauses" in Item 1). Nevertheless, the Company attempts to minimize such effects by means that include increasing the availability of its coal-fired units to result in a more economical fuel mix. This increase has been achieved by an intensive maintenance program, the cost of which is not covered by the adjustment clauses. There are a number of other major expense items that are also beyond the scope of the adjustment clauses. Inflationary pressures on these items have given rise to a significant earnings attrition between general rate increases. See "Rates" in Item 1 with respect to the Company's most recent rate filings.

See Note 15 of Notes to Consolidated Financial Statements in Item 8 for perspectives on other effects of inflation.

Operating Statistics

	Year Ended December 31,		
	1985	1984	1983
Electric Operations:			
Number of Customers (end of period):			
Residential	456,071	436,119	407,340
Commercial	61,110	58,810	56,470
Industrial	1,948	2,007	2,047
Irrigation	1,669	1,766	1,850
Other	769	1,049	1,061
Total Customers	521,567	499,751	468,768
Electric Sales (MWH):			
Residential	4,626,153	4,328,332	4,082,505
Commercial	4,867,856	4,495,954	4,195,225
Industrial	2,343,212	2,133,938	2,388,634
Irrigation	346,765	422,520	279,420
Other	1,787,328	1,674,243	1,807,758
Total Electric Sales	13,971,314	13,054,987	12,753,542
Operating Revenues (000):			
Residential	$ 438,265	$378,536	$314,404
Commercial	401,439	343,971	296,364
Industrial	135,254	126,187	122,184
Irrigation	22,853	25,540	15,113
Other	97,728	86,394	90,118
Total	1,095,539	960,628	838,183
Transmission for Others	16,602	13,023	12,555
Miscellaneous Services	62,361	21,316	21,137
Total Electric Operating Revenues	$1,174,502	$994,967	$871,875
Revenue Per KWH (Cents):			
Residential	9.47¢	8.75¢	7.70¢
Commercial	8.25¢	7.65¢	7.06¢
Industrial	5.77¢	5.91¢	5.12¢
Costs Per KWH Generated (Cents):			
Fuel	1.72¢	1.32¢	1.34¢
Total Electric Operating Expense	6.78¢	5.19¢	4.47¢
Annual KWH Per Average Residential Customer*	10,499	10,355	10,357

*Total units sold divided by average number of customers.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTAL CONSOLIDATED SCHEDULES

See Note 14 of Notes to Consolidated Financial Statements for the selected quarterly financial data required to be presented in this Item.

OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Arizona Public Service Company:

We have examined the consolidated financial statements and supplemental consolidated schedules of Arizona Public Service Company and its subsidiaries as of December 31, 1985 and 1984 and for each of the three years in the period ended December 31, 1985, listed in the accompanying index. 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, such consolidated financial statements present fairly the financial position of Arizona Public Service Company and its 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. Also, in our opinion, such supplemental consolidated schedules, when considered in relation to the basic consolidated financial statements, present fairly in all material respects the information shown therein.

DELOITTE HASKINS & SELLS

Phoenix, Arizona
February 20, 1986

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	1985	1984	1983
	(Dollars in Thousands, Except Per Share Amounts)		
Electric Operating Revenues	$ 1,174,502	$ 994,967	$ 871,875
Fuel Expenses:			
Fuel for electric generation	219,575	186,276	185,504
Purchased power and interchange - net	16,789	6,647	6,454
Total	236,364	192,923	191,958
Operating Revenues Less Fuel Expenses	938,138	802,044	679,917
Other Operating Expenses:			
Operations excluding fuel expenses	122,751	97,535	94,511
Maintenance	88,870	68,207	62,681
Depreciation and amortization	99,221	87,494	83,707
Income taxes (Note 9)	216,036	191,100	103,186
Other taxes (Note 12)	104,276	94,448	82,420
Total	631,154	538,784	426,505
Operating Income	306,984	263,260	253,412
Other Income (Deductions):			
Allowance for equity funds used during construction	143,612	134,359	121,390
Income taxes (Note 9)	50,757	54,028	9,256
Other - net	(4,322)	2,431	3,813
Total	190,047	190,818	134,459
Income Before Interest Deductions	497,031	454,078	387,871
Interest Deductions:			
Interest on long-term debt	209,220	191,079	170,830
Interest on short-term borrowings	6,951	12,281	11,430
Debt discount, premium and expense	3,613	2,465	1,959
Allowance for borrowed funds used during construction	(48,176)	(49,317)	(65,400)
Total	171,608	156,508	118,819
Income From Continuing Operations	325,423	297,570	269,052
Loss From Disposal and Operation of Discontinued Gas System, Net of Tax (Note 13)	—	(26,503)	(4,255)
Net Income	325,423	271,067	264,797
Preferred Dividend Requirements	44,412	48,375	43,741
Earnings for Common Stock	$ 281,011	$ 222,692	$ 221,056
Average Common Shares Outstanding	71,031,228	68,308,131	63,865,210
Per Share of Common Stock:			
Earnings (Loss) (based on average shares outstanding):			
Continuing operations	$ 3.96	$ 3.65	$ 3.53
Discontinued operations	—	(0.39)	(0.07)
Total	$ 3.96	$ 3.26	$ 3.46
Dividends declared	$ 2.73	$ 2.60	$ 2.56

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
Utility Plant (Notes 6 and 8):		
Electric plant in service	$2,929,926	$2,747,464
Construction work in progress	2,742,139	2,304,306
Plant held for future use	40,442	36,473
Total Utility Plant	5,712,507	5,088,243
Less accumulated depreciation and amortization	838,684	744,160
Utility Plant—net	4,873,823	4,344,083
Investments and Other Assets:		
Investments in and receivables from affiliates	16,513	61,693
Other investments and notes receivable	5,991	5,588
Total Investments and Other Assets	22,504	67,281
Current Assets:		
Cash	7,871	7,565
Special deposits and working funds	3,342	3,339
Accounts receivable:		
Service customers	84,533	70,560
Other	43,415	35,329
Allowance for doubtful accounts	(1,395)	(1,434)
Materials and supplies (at average cost)	41,525	42,942
Fuel (at average cost)	30,433	30,1[illegible]
Deferred fuel (Note 3)	74,335	9[illegible]
Other	3,873	6,036
Total Current Assets	287,932	195,427
Deferred Debits:		
Unamortized gas exploration costs	10,417	12,967
Unamortized debt issue costs	16,705	13,931
Other	39,946	20,085
Total Deferred Debits	67,068	46,983
Total	$5,251,327	$4,653,774

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED BALANCE SHEETS

LIABILITIES

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
Capitalization (Notes 2, 4, 5 and 6):		
Common stock	$ 178,162	$ 175,321
Premiums and expenses—net	1,040,909	1,015,188
Retained earnings	592,334	505,414
Common stock equity	1,811,405	1,695,923
Non-redeemable preferred stock	218,561	218,561
Redeemable preferred stock	219,421	282,740
Long-term debt less current maturities	2,205,940	1,684,746
Total Capitalization	4,455,327	3,881,970
Current Liabilities:		
Notes payable	—	1,800
Commercial paper	18,000	158,000
Current maturities of long-term debt (Note 6)	17,456	70,890
Accounts payable	87,113	68,090
Accrued taxes	52,976	49,348
Accrued interest	72,678	55,906
Accrued dividends	3,566	4,143
Other	26,069	32,405
Total Current Liabilities	277,858	440,582
Deferred Credits and Other:		
Deferred income taxes	230,553	110,821
Deferred investment tax credit	174,503	138,120
Unamortized credit related to sale of tax benefits (Note 9)	43,645	45,333
Customers' advances for construction	23,991	21,351
Other	45,450	15,597
Total Deferred Credits and Other	518,142	331,222
Commitments and Contingencies (Notes 3 and 11)		
Total	$5,251,327	$4,653,774

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Retained earnings at beginning of year	$505,414	$459,962	$401,723
Add—Net income	325,423	271,067	264,797
Total	830,837	731,029	666,520
Deduct—Dividends:			
Common stock (Notes 4 and 5)	194,091	177,240	162,817
Preferred stock (see below)	44,412	48,375	43,741
Total	238,503	225,615	206,558
Retained earnings at end of year	$592,334	$505,414	$459,962
Dividends on preferred stock:			
$1.10 preferred	$ 172	$ 172	$ 172
$2.50 preferred	258	258	258
$2.36 preferred	94	94	94
$4.35 preferred	326	326	326
Serial preferred:			
$2.40 Series A	576	576	576
$2.625 Series C	630	630	630
$2.275 Series D	455	455	455
$3.25 Series E	1,040	1,040	1,040
$8.50 Series G	96	401	500
$10.00 Series H	1,459	3,147	3,307
$10.70 Series I	2,300	2,595	2,875
$8.32 Series J	4,160	4,160	4,160
$8.80 Series K	3,407	5,280	5,280
$9.70 Series L	4,656	4,656	4,656
$11.95 Series M	1,235	2,330	2,330
$12.90 Series N	4,773	4,773	4,773
$3.58 Series O	7,160	7,160	7,160
Adjustable Rate Series P	1,250	1,250	1,250
Adjustable Rate Series Q	4,615	5,223	3,899
$11.50 Series R	5,750	3,849	—
Total	$ 44,412	$ 48,375	$ 43,741

See Consolidated Statements of Income for dividends per share of common stock.

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Source of Funds:			
Funds from operations:			
Continuing operations:			
Income from continuing operations	$ 325,423	$297,570	$269,052
Principal non-fund charges (credits) to income:			
Depreciation and amortization	99,221	87,494	83,707
Allowance for equity funds used during construction	(143,612)	(134,359)	(121,390)
Deferred income taxes—net	106,158	43,464	27,033
Deferred investment tax credit—net	36,383	56,002	29,960
Other	31,361	(385)	4,967
Total funds from continuing operations	454,934	349,786	293,329
Funds from discontinued gas system-net	—	(3,093)	5,116
Total funds from operations	454,934	346,693	298,445
Funds from external sources:			
Proceeds from sale of gas system	—	114,657	—
Common stock	28,562	63,800	86,918
Preferred stock	—	50,000	48,875
Long-term debt	745,030	264,179	419,126
Investments and other assets	44,777	13,299	4,955
Other items—net	(160)	(3,916)	4,141
Total funds from external sources	818,209	502,019	564,015
Total source of funds	$1,273,143	$848,712	$862,460
Application of Funds:			
Funds used for capital expenditures:			
Continuing operations	$ 494,105	$377,278	$425,130
Discontinued operations	—	31,657	29,724
Short-term borrowings—net	141,800	(73,492)	3,308
Repayment of long-term debt	275,421	275,833	185,653
Redemption of redeemable preferred stock	63,319	4,660	3,820
Dividends on preferred and common stock	238,503	225,615	206,558
Increase in working capital*	59,995	7,161	8,267
Total application of funds	$1,273,143	$848,712	$862,460
Increase (Decrease) in Working Capital*:			
Cash	$ 309	$(25,704)	$ 24,801
Accounts receivable	22,098	(2,216)	(950)
Materials, supplies and fuel	(1,147)	(1,420)	(2,760)
Deferred fuel and other assets	71,245	(4,191)	(2,048)
Accounts payable and accrued expenses	(38,846)	32,881	(23,904)
Other liabilities	6,336	7,811	13,128
Net increase	$ 59,995	$ 7,161	$ 8,267

*Excluding short-term borrowings—net and current maturities of long-term debt.

See Notes to Consolidated Financial Statements.

1. Summary of Significant Accounting Policies.

a. System of accounts— The accounting records of Arizona Public Service Company (the "Company") are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission ("FERC").

b. Consolidation— The consolidated financial statements include the accounts of the Company and those of its wholly-owned subsidiaries, APS Finance Company N.V. ("Finance"), organized to serve as a financing corporation to raise funds outside the United States of America, and APS Fuels Company, organized to manage investments in certain fuel resources. All significant intercompany balances and transactions have been eliminated.

c. Plant and depreciation— Property is stated at original cost as defined for regulatory purposes. The cost of additions to utility plant and replacements of retirement units is capitalized. Replacements of minor items of property are charged to expense as incurred. In addition to direct costs, capitalized items include the present value of certain future lease payments (see Note 6), research and development expenditures pertaining to construction projects, indirect charges for engineering, supervision, transportation and similar costs, and an allowance for funds used during construction. Costs of depreciable units of plant retired are eliminated from plant accounts and such costs plus removal expenses less salvage are charged to accumulated depreciation. Contributions in aid of construction are credited to plant cost.

Depreciation on utility property is provided on a straight-line basis at rates authorized by the Arizona Corporation Commission ("ACC") annually. The applicable rates for 1983 through 1985 ranged from 2.86% to 9.86% for electric plant.

d. Revenues and fuel costs— Operating revenues are recognized when billed on a monthly cycle billing basis. Retail rate schedules include adjustment clauses which permit recovery of costs of certain fuel and purchased power. Regulatory hearings are held periodically to adjust the rates applicable under fuel adjustment clauses to more nearly match actual fuel costs. Temporary net under- or over-recoveries of costs resulting from application of the adjustment clauses are recognized as a deferred fuel asset or liability, respectively, with an offsetting amount recognized in purchased power and interchange—net expense. See Note 3 for a discussion of current rate matters relating to such clauses.

e. Allowance for funds used during construction— In accordance with the regulatory accounting practice prescribed by the FERC and the ACC, the Company capitalizes an allowance for the cost of funds used to finance its construction program ("AFC"). AFC, which does not represent current cash earnings, is defined as the net cost during the period of construction of borrowed funds and a reasonable rate of return on equity funds so used. The calculated amount is capitalized as a part of the cost of utility plant.

AFC has been calculated using composite rates of 12.75% in 1985 and 1984 and 13% in 1983. In July 1983 the Company began compounding AFC semi-annually and, in October 1983, recording the borrowed funds portion on a "net of tax" basis through charges to income taxes—operating expense and credits to income taxes—other income. AFC ceases to accrue on those portions of construction work in progress allowed in rate base which, for ACC purposes, was approximately $460,000,000 at December 31, 1985.

f. Income taxes— The Company uses accelerated depreciation methods for income tax purposes. As prescribed by the ACC, deferred income taxes are provided for certain timing differences arising from the recording, for income tax and financial reporting purposes, of depreciation of property placed in service after January 1, 1977. In October 1983 the Company, in accordance with an ACC order, began deferring amounts equal to the change in income taxes arising from substantially all other timing differences. Prior to October 1983, such differences were reflected currently in income.

At December 31, 1985 the Company had flowed through to income currently approximately $271,600,000 of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

In 1982 the Company, in compliance with an ACC order, began deferring amounts equal to the reduction in Federal income taxes arising from investment tax credits and amortizing these amounts to other income over the estimated life of the related assets. Before 1982 such amounts were flowed through income currently.

g. Research and development costs— The Company expenses research and development costs on a current basis, except that costs which may result in additions to utility plant are deferred for subsequent inclusion in plant or to be written off if the applicable project is abandoned.

h. Gas exploration costs— The excess of costs over sales proceeds of the Company's discontinued gas exploration program has been deferred to be recovered, without interest, over a ten-year period pursuant to an order of the ACC, from certain classes of customers. A portion of such amount is now to be remitted to the Company by Southwest Gas Corporation as a result of the sale of the gas distribution system in 1984. See Note 13.

i. Discontinued operations—As described in Note 13, the Company sold its gas distribution system effective November 1, 1984. Accordingly, 1983's statement of income has been reclassified to report separately this discontinued operation.

2. Corporate Restructuring.

On April 18, 1985, the Company's shareholders approved a plan for corporate restructuring to provide financial and organizational flexibility by separating regulated utility operations from other activities. Effective April 29, 1985, APS became a subsidiary of a holding company, AZP Group, Inc. ("AZP").

As part of the restructuring, the Company sold to AZP, at book value, $34,703,000, the common stock of three of its wholly-owned subsidiaries, Malapai Resources Company, Energy Development Company and El Dorado Investment Company. Prior to the sale the results of operations and net assets of these subsidiaries were included in Other income — net and Investments in and receivables from affiliates.

The corporate restructuring had no effect on the ownership of preferred stock or on debt securities.

3. Rate Matters.

In 1984, a committee comprised of representatives from each of the state utility regulatory commissions having primary jurisdiction over the rates of the various regulated participants in the Arizona Nuclear Power Project commissioned a study to determine whether sufficient evidence exists to warrant a prudency audit of costs incurred for construction. In September, 1985, the committee concluded that an audit should be performed relating to $3.12 billion of material and labor costs, of which the Company's share is approximately $900 million, as well as financing and certain indirect costs related to the project. The prudency audit is expected to begin in 1986 with recommendations expected in late 1986 or 1987. Any amounts subsequently deemed by the ACC imprudently spent and not allowed in rate base would be written off. Although the Company is unable to predict the final outcome of this matter, management believes, based on current information, that overall the Palo Verde Nuclear Generating Station (Palo Verde) was constructed in a prudent manner.

On February 11, 1986 hearings commenced concerning costs deferred by the Company through the operation of its purchased power and fuel adjustment clause. In August, 1985 the ACC granted a rate increase sufficient only to limit the increase in the accumulated balance of such costs and agreed to hear testimony in connection with the accumulated balance (approximately $74 million at

December 31, 1985). The hearings concluded on March 7, 1986, however, to date no order has been received. Management believes that any ultimate disallowance of such cost should not be material to the Company's operation or financial position.

As an incentive to complete construction and commence operation of Palo Verde, the ACC in a November, 1984 order, placed a cap on total construction costs. The cap was set at $2.86 billion. Amounts expended in excess of the cap are presumed to be imprudent under the commissions order. The most recent estimate of the Company's share of total Palo Verde construction costs is $2.76 billion.

On May 24, 1985, the Company filed with the ACC a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 1. Unit 1 commenced commercial operation on February 13, 1986, and the Company began incurring such costs at that time. Also requested was an accounting order allowing the deferral until 1987 of the costs of commercial operation of Palo Verde Unit 2 which is expected to commence commercial operation in the third quarter of 1986. A hearing on this request has been scheduled for March 27, 1986.

On December 18, 1985, the Company filed a request for a rate increase sufficient to recover its share of the costs of commercial operation of Palo Verde Unit 2. As requested by the ACC, the Company proposed as an alternative to a one step increase, and subject to certain conditions precedent, that the costs of commercial operation of Unit 2 be phased in over a period of years. The hearing date for the Unit 2 phase of the case has been set for September 26, 1986.

4. Common and Non-Redeemable Preferred Stock.

The balances at December 31, 1985 and 1984 of common stock and of preferred stock, which is not redeemable except pursuant to call by the Company at its option, are shown below.

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding at December 31,			Outstanding at December 31,		
	Authorized	1985	1984	Per Share	1985	1984	
					(Thousands of Dollars)		
Common Stock	100,000,000	71,264,947(b)	70,128,329	$ 2.50	$178,162	$175,321	—
Non-Redeemable Preferred Stock (cumulative):							
$1.10 preferred	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000						
$2.40 Series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 Series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 Series D		200,000	200,000	50.00	10,000	10,000	50.50
$3.25 Series E		320,000	320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(c)						
$8.32 Series J		500,000	500,000	100.00	50,000	50,000	(d)
Adjustable rate Series Q		500,000	500,000	100.00	50,000	50,000	(e)
Serial preferred	10,000,000						
$3.58 Series O		2,000,000	2,000,000	25.00	50,000	50,000	(f)
Total		4,374,199	4,374,199		$218,561	$218,561	

(a) In each case plus accrued dividends.

(b) As a result of the corporate restructuring described in Note 2, these shares are now held by AZP.

(c) This authorization also covers outstanding redeemable preferred shares shown in Note 5, as well as the non-redeemable shares indicated above.

(d) At $105.50 through August 31, 1987; at $103.00 through August 31, 1992; and at $101.00 thereafter.

(e) Bears dividends at a rate, adjusted on a quarterly basis, 2% below the rate borne by certain United States Treasury Securities, but in no event less than 6% per annum, or greater than 12% per annum. Redeemable on or after March 1, 1988 at the option of the Company at $103.00 through February 28, 1993; and at $100.00 thereafter.

(f) Not redeemable prior to June 1, 1987 through certain refunding operations that would result in a lower rate of cost to the Company than the dividend rate on the shares to be redeemed; otherwise at $28.58 through May 31, 1987; at $27.39 through May 31, 1992; at $26.19 through May 31, 1997; and at $25.00 thereafter.

The holders of preferred stock are entitled to one vote for each share held of record. Special requirements for favorable votes of holders of preferred stock, voting by the classes respectively prescribed for the several purposes, pertain to (i) certain conversions or exchanges of outstanding preferred stock, (ii) the authorization of any stock ranking prior to the preferred stock, (iii) making any change in the terms and provisions of preferred stock that would adversely affect the rights and preferences of the holders thereof, (iv) the issuance of any additional shares of preferred stock except under prescribed circumstances or (v) a merger, consolidation or sale of substantially all the assets of the Company. The foregoing voting rights attach to both redeemable and non-redeemable preferred stock, as do the rights that would arise out of dividend arrearages as discussed in Note 5.

Common and non-redeemable preferred stock sales and changes in premiums and expenses during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

	Common Stock		Non-Redeemable Preferred Stock (cumulative)		Premiums and Expenses Net*
Description	Number of Shares	Par Value Amount	Number of Shares	Par Value Amount	
Balance, December 31, 1982	62,894,490	$157,236	3,874,199	$168,561	$883,680
Common Stock	3,816,362	9,541	—	—	77,557
Non-Redeemable Preferred Stock, Adjustable Rate Series Q	—	—	500,000	50,000	(1,305)
Balance, December 31, 1983	66,710,852	166,777	4,374,199	218,561	959,932
Common Stock	3,417,477	8,544	—	—	55,256
Balance, December 31, 1984	70,128,329	175,321	4,374,199	218,561	1,015,188
Common Stock	1,136,618	2,841	—	—	25,721
Balance, December 31, 1985	71,264,947	$178,162	4,374,199	$218,561	$1,040,909

*Premiums and expenses — net also includes those of redeemable preferred stock issues (see Note 5).

5. Redeemable Preferred Stock.

The balances at December 31, 1985 and 1984 of preferred stock which is redeemable at the option of the holders or pursuant to sinking fund obligations, in addition to being callable by the Company, are shown below.

	Number of Shares Outstanding at December 31,		Par Value Per Share	Par Value Outstanding at December 31,		Call Price Per Share(a)
	1985	1984		1985	1984	
				(Thousands of Dollars)		
Redeemable Preferred Stock (cumulative) serial preferred: (b)						
$8.50 Series G	—	38,400	$100.00	$ —	$ 3,840	
$10.00 Series H	104,677	304,000	100.00	10,468	30,400	(c)
$10.70 Series I	209,934	240,000	100.00	20,993	24,000	(d)
$8.80 Series K	344,600	600,000	100.00	34,460	60,000	(e)
$9.70 Series L	480,000	480,000	100.00	48,000	48,000	(f)
$11.95 Series M	85,000	195,000	100.00	8,500	19,500	(g)
$12.90 Series N	370,000	370,000	100.00	37,000	37,000	(h)
Adjustable Rate Series P	100,000	100,000	100.00	10,000	10,000	(i)
$11.50 Series R	500,000	500,000	100.00	50,000	50,000	(j)
Total	2,194,211	2,827,400		$219,421	$282,740	

(a) In each case plus accrued dividends.

(b) See Note 4 for authorized number of shares.

(c) Redeemable at $106.12 through September 1, 1986, and thereafter declining by $0.36 per year to par after September 1, 2002. Applicable sinking fund provisions require the redemption of 16,000 shares at par annually (representing annual payments of $1,600,000).

(d) Redeemable at $103.00 through November 30, 1990, and at $101.00 thereafter. Applicable sinking fund provisions require the redemption of 15,000 shares at par annually (representing annual payments of $1,500,000). The Company may, but is not required to, redeem an additional 15,000 shares at par on December 1 in any year.

(e) Redeemable at $106.00 through February 28, 1989; at $103.00 through February 28, 1994; and thereafter declining in steps to $101.00. Applicable sinking fund provisions require the redemption of 22,500 shares at par annually commencing March 1, 1986 (representing annual payments of $2,250,000). The Company may, but is not required to, redeem an additional 22,500 shares at par on March 1 in any year beginning in 1986. At December 31, 1985, the Company had met the 1986 sinking fund requirement.

(f) Redeemable at the option of the Company at $104.31 through February 28, 1986, declining by $1.08 per year to $101.07 after March 1, 1989. Applicable sinking fund provisions require the redemption of 96,000 shares at par annually commencing March 1, 1986 (representing annual payments of $9,600,000).

(g) Redeemable on or after May 1, 1986 at the option of the Company at $101.99 through April 30, 1987; and thereafter at par. All shares then outstanding are required to be redeemed on May 1, 1988 at par.

(h) Redeemable after June 1, 1992 at the option of the Company at $106.11 through June 1, 1993, declining by $0.68 per year to $100.00 after June 1, 2002. Applicable sinking fund provisions require the redemption between 1988 and 2002 of all shares according to a predetermined schedule.

(i) Bears a dividend of $12.50 per share through December 1, 1987 and a dividend thereafter to be fixed by a formula related to the average prime interest rate in 1987. Redeemable at par on or after December 1, 1987 at the option of the Company. Applicable sinking fund provisions require the redemption of 20,000 shares at par each December 1 beginning in 1988 (representing annual payments of $2,000,000). All shares then outstanding are required to be redeemed on December 1, 1992.

(j) Redeemable after June 1, 1994 at the option of the Company at $105.45, declining each year by a predetermined amount to $100.00 after June 1, 2004. Applicable sinking fund provisions require the redemption between 1990 and 2004 of all shares according to a predetermined schedule.

If there were to be any arrearage in dividends on any of its preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock (each such dividend being cumulative and of equal ranking with other such dividends, and each such requirement being cumulative and of equal ranking with other such requirements), the Company could not pay dividends on its common stock or acquire any shares thereof for consideration. If any such dividend arrearage was to equal six or more quarterly dividends, the holders of preferred stock, in addition to their other voting rights and voting by the classes prescribed for this purpose, could elect a total of six directors (all series of serial preferred stock, regardless of par value and whether redeemable or non-redeemable, comprising one such class and being entitled to elect two of the six directors). See Note 4 in regard to other voting rights of holders of preferred stock.

The combined aggregate amount of redemption requirements for the above issues each year through 1990 are as follows: $12,700,000 in 1986, $14,950,000 in 1987, $39,040,000 in 1988, $19,540,000 in 1989, and $22,975,000 in 1990.

Redeemable preferred stock transactions during each of the three years in the period ended December 31, 1985 were as follows (dollars in thousands):

Description	Number of Shares	Par Value Amount
Balance, December 31, 1982	2,412,200	$241,220
Retirements:		
$8.50 Series G	(7,200)	(720)
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1983	2,374,000	237,400
$11.50 Series R	500,000	50,000
Retirements:		
$8.50 Series G	(15,600)	(1,560)
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(15,000)	(1,500)
Balance, December 31, 1984	2,827,400	282,740
Retirements:		
$8.50 Series G	(38,400)	(3,840)
$10.00 Series H	(199,323)	(19,932)
$10.70 Series I	(30,066)	(3,007)
$8.80 Series K	(255,400)	(25,540)
$11.95 Series M	(110,000)	(11,000)
Balance, December 31, 1985	2,194,211	$219,421

6. Long-Term Debt.

Details of long-term debt outstanding at December 31, 1985 and 1984 are as follows:

	December 31, 1985	December 31, 1984
	(Thousands of Dollars)	
First mortgage bonds:		
Maturing through 1990:		
10.375% due February 1, 1985	$ —	$ 60,250
Less securities held by trustee	—	(16,127)
5.125% due October 1, 1987	15,000	15,000
4.7% due March 1, 1989	20,000	20,000
Maturing 1991 through 1995 - 4.40% to 15%	325,000	200,000
Maturing 1996 through 2000 - 6.25% to 12.875%	269,977	272,977
Maturing 2001 through 2005 - 6.20% to 9.95%	185,000	185,000
Maturing 2006 through 2010 - 6% to 12.125%	202,000	152,000
Maturing 2011 through 2015 - 12.75% to 13.5%	450,000	200,000
Unamortized discount and premium	(2,413)	(1,965)
Total first mortgage bonds	1,464,564	1,087,135
Various issues of pollution control indebtedness due primarily December 15, 1985	—	105,000
Less securities held by Trustee	—	(11,269)
Pollution control indebtedness due August 2, 2009 (a)	106,980	—
Less securities held by trustee (b)	(1,572)	—
Pollution control indebtedness due December 1, 2009 (c)	147,000	147,000
Less securities held by trustee (b)	(15,071)	(23,252)
Pollution control indebtedness due May 1, 2013 (c)	65,750	65,750
Pollution control indebtedness due May 1, 2014 (d)	55,200	55,200
Pollution control indebtedness due February 1, 2015 (e)	49,400	—
Less securities held by Trustee (b)	(2,444)	—
Unsecured notes payable due 1987 (f)	70,000	70,000
16.25% guaranteed debentures due July 15, 1988 (g)	—	50,000
16.25% guaranteed debentures due February 1, 1989 (g)	75,000	75,000
16% guaranteed debentures due February 15, 1989 (g)	25,000	25,000
11.75% guaranteed debentures due January 15, 1990 (g)	60,000	60,000
12.5% Debentures due February 15, 1992	75,000	—
Capitalized lease obligation (h)	46,907	48,472
Other	1,975	2,380
Unamortized discount	(293)	(780)
Total long-term debt	2,223,396	1,755,636
Less current maturities:		
Pollution control indebtedness due December 15, 1985, net of securities held by trustee	—	65,949
Sinking fund requirements on first mortgage bonds	15,333	3,000
Capitalized lease obligation	1,685	1,565
Other	438	376
Total current maturities	17,456	70,890
Total long-term debt less current maturities	$2,205,940	$1,684,746

(a) Adjustable-rate annual tender pollution control revenue refunding bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest at 6% through July 31, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(b) Representing pollution control funds deposited with a revenue bond trustee and to be disbursed as needed to pay the costs of acquiring, constructing, reconstructing, improving, maintaining, equipping or furnishing the facilities financed.

(c) Consisting of borrowings from a governmental authority which has funded that amount through issuance of a series of par value demand bonds supported by a long-term irrevocable letter of credit issued by a bank. These bonds bear interest at such rate, determined weekly, as will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(d) On May 15, 1985 the Company borrowed from a governmental authority the proceeds of a $55,200,000 issue of adjustable-rate annual tender pollution control revenue refunding bonds for the purpose of refunding $55,200,000 in aggregate principal amount of previously issued pollution control bonds due April 1, 1986. The new issue is supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest rate at 6% through April 30, 1986 and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates as nearly as possible, their par value.

(e) Adjustable-rate annual tender pollution control revenue bonds supported by a long-term irrevocable letter of credit issued by a bank. The bonds bear interest through January 31, 1986 at 6.5% and thereafter at such rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(f) Consisting of two long-term bank loans of $50,000,000 and $20,000,000. The principal amounts of such loans bear interest, at the Company's option, at one or more of the following annual interest rates: (a) in the case of the first loan, 102% of the Prime Rate or, in the case of the second loan, the Prime Rate plus ¼%, (b) the CD Rate plus ⅝%, or (c) the Eurodollar Rate plus ½%.

(g) Representing debentures issued by Finance, the payment of principal and interest has been unconditionally guaranteed by the Company. The 11.75% debentures due January 15, 1990 are redeemable at the option of Finance at 101½% from January 15, 1987 through January 14, 1988, then at 100¾% through January 15, 1989, and thereafter at 100%. The 16.25% debentures due February 1, 1989 and 16% debentures due February 15, 1989 were redeemed on February 1 and 15, 1986, respectively, with the proceeds of a $100,000,000 issue of first mortgage bonds. The debentures were redeemed at 101% plus accrued interest. The new bonds bear interest at 11% and are due January 15, 2016.

The 16.25% debentures due July 1988 were redeemed on July 15, 1985 at 101½% plus accrued interest.

(h) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) on a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semi-annual payments of $2,582,000 through June 2001, and includes renewal and purchase options based on fair market value. This plant is included in plant in service at its original cost of $54,405,000; accumulated depreciation at December 31, 1985 was $21,401,000.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1990 are as follows: 1986, $17,456,000; 1987, $102,620,000; 1988, $17,795,000; 1989, $37,985,000; and 1990, $78,193,000. For sinking fund requirements and redemptions at the option of the holders of redeemable preferred stock, see Note 5.

Substantially all utility plant, other than nuclear fuel, transportation equipment and the combined cycle plant mentioned above, is subject to the lien of the first mortgage bonds. The indenture respecting the first mortgage bonds includes provisions which would restrict the payment of dividends on common stock under certain conditions which did not exist at December 31, 1985.

7. Lines of Credit and Compensating Balances.

The Company's lines of credit at December 31, 1985 and 1984 are summarized below. No amounts were outstanding under the lines at December 31, 1985 or 1984.

	1985	1984
	(Thousands of Dollars)	
Commercial paper backup lines:		
Domestic banks	$125,000	$125,000
Foreign banks	50,000	50,000
Other domestic bank lines	245,000(a)	245,000(a)
Total	$420,000	$420,000

(a) Including $200,000,000 available under a credit agreement between the Company and various banks which carries a commitment fee of ¼% per annum.

The commitment fees for the commercial paper backup lines with domestic banks were ⅜% per annum in 1985 and 1984. Compensating balances required (but which were not legally restricted) for the other domestic banks lines (exclusive of the credit agreement referred to in (a) above) were generally 7½% of the lines plus 5% of borrowings in 1985 and 1984.

Under the foreign bank lines, commitment fees were payable at ¼% per annum in 1985 and 1984. The interest rate on borrowings under these facilities was approximately ½% per annum over the applicable Eurodollar Rate in effect from time to time.

By statute the Company's short-term borrowings cannot exceed 7% of total capitalization without the consent of the ACC.

8. Jointly-Owned Facilities.

At December 31, 1985, the Company owned the following interests in jointly-owned electric generating and transmission facilities (dollars in thousands):

	Percent owned by Company	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Generating Facilities:					
Arizona Nuclear Power Project (ANPP) - Units 1, 2 and 3	29.1%	$ —	$ —	$ —	$2,407,231
Four Corners Steam Generating Plant - Units 4 and 5	15.0%	118,897	20,791	98,106	1,499
Navajo Steam Generating Plant - Units 1, 2 and 3	14.0%	119,295	37,994	81,301	1,009
Transmission Facilities:					
ANPP Transmission System	35.8%(a)	7,398	791	6,607	48,337
Navajo Southern Transmission System	31.4%(b)	28,198	9,027	19,171	93
Palo Verde-Yuma 500KV System	23.9%(c)	16,255	550	15,705	1,915
Total		$290,043	$69,153	$220,890	$2,460,084

(a) Weighted average of interests varying from 34.6% to 43.95%.

(b) Weighted average of interests varying from 14% to 100%.

(c) Weighted average of interests varying from 11% to 100%.

The foregoing dollar amounts correlate to the Company's percentage interest in each facility. The Company's share of related operating and maintenance expenses is included in operating expenses.

9. Income Tax Expense.

The components of income tax expense—continuing operations for each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Currently payable:			
Federal	$ 10,095	$ 14,578	$14,224
State	10,664	16,340	10,742
Other	2,861	3,606	2,870
Total current	23,620	34,524	27,836
Deferred:			
Depreciation—net	57,273	26,276	22,571
Taxes, pension costs and other—net	49,690	18,367	5,627
Investment tax credit—net	36,383	59,592	39,583
Total deferred	143,346	104,235	67,781
Amortization of tax benefits sold	(1,687)	(1,687)	(1,687)
Total	$165,279	$137,072	$93,930

In 1981 the Company sold to another corporation certain federal income tax benefits in exchange for cash. The Company, pursuant to an order of the ACC, has recorded the proceeds of the sale as a deferred credit and is amortizing the amount of such proceeds on a straight-line basis over approximately 30 years.

Following is a summary of the difference between income tax expense—continuing operations and the amount obtained by multiplying income before income taxes by the statutory federal income tax rate.

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Federal income tax expense at statutory rate	$225,723	$199,935	$166,972
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	16,431	14,165	10,213
Allowance for funds used during construction	(88,222)	(84,491)	(83,799)
Investment tax credit amortization	(2,955)	(2,827)	(1,970)
Taxes, pension costs and other items capitalized	—	—	(6,640)
State income tax—net of Federal income tax benefit	11,815	11,172	7,070
Other	2,487	(882)	2,084
Total provision for Federal and state income tax expense	$165,279	$137,072	$ 93,930

At December 31, 1985 the Company had approximately $11,000,000 of investment tax credit carryforwards which will expire through 2000.

10. Pension Plan and Other Benefits.

The Company's pension plan, a defined benefit plan, covers virtually all employees. Pension cost, including administrative cost, for 1985, 1984, and 1983 was $15,458,000, $16,370,000, and $15,248,000, respectively, of which approximately $5,081,000, $6,512,000, and $6,871,000, respectively, was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

The following is a summary of plan data as of the most recent benefit information date:

	January 1,	
	1985	1984
	(Thousands of Dollars)	
Actuarial present value of accumulated plan benefits:		
Vested	$127,018	$115,984
Non-vested	11,885	10,499
Total	$138,903	$126,483
Net assets available for benefits	$193,235	$182,577

The actuarial present value (assuming a rate of return of 9.00%) of accumulated plan benefits presented above has not been calculated with reference to the effects of projected inflation, whereas such effects are considered by the Company with reference to the adequacy of plan assets; accordingly, the Company considers the utility of the comparison suggested to be extremely limited.

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for active and retired employees. Life insurance benefits are provided through an insurance company whereas health care costs are paid as expenses are incurred under a self-insured plan. The cost of providing those benefits in 1985 for 1,091 retirees and 8,362 active employees was

$1,086,000 and $13,423,000, respectively, of which approximately $5,825,000 was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly owned facilities.

Under the AZP Group, Inc. Stock Option and Incentive Plan approved by the Company's shareholders on April 18, 1985, non-qualified and incentive stock options (ISO) and restricted stock awards may be granted to officers and key employees of AZP and subsidiaries, including APS, for up to 3,000,000 shares of common stock. The plan also provides for the granting of stock appreciation rights, performance shares, dividend equivalents or any combination of the foregoing. In 1985, approximately 15,000 restricted shares, 15,000 ISOs, and 15,000 dividend equivalents were awarded under the Plan.

11. Commitments and Contingencies.

Nuclear Insurance—The Price-Anderson Act ("Act") currently limits the public liability claims that could arise from a nuclear incident to a maximum amount of $655,000,000 for each licensed nuclear facility. Private insurance for this exposure has been purchased by the participants in the Palo Verde Nuclear Generating Station, including the Company, in the maximum available amount, presently $160,000,000, with the balance to be provided by secondary financial protection required by the Nuclear Regulatory Commission ("NRC"). Under the agreement with the NRC, the Company could be assessed retrospective premium adjustments of up to $3,000,000 per year in the event of nuclear incidents involving any licensed reactor in the United States.

Property damage coverage is provided for losses up to $500,000,000 at Palo Verde. Decontamination liability and property damage insurance in excess of the primary $500,000,000 lay has also been purchased. These policies are primarily provided through mutual insurance compan owned by utilities with nuclear facilities. If losses at any nuclear facility covered by the arrangement were to exceed the accumulated funds available for these insurance programs, the Company could be assessed retrospective premium adjustments of up to approximately $3,500,000 per year.

The Act is scheduled to expire in August 1987 and Congress is currently considering several alternatives. The Company is unable to predict Congress' ultimate action and what effect such action may have on the Company's liability.

Litigation—The Company is a party to various claims, legal actions and complaints arising in the ordinary course of business, including a lawsuit seeking to invalidate the Company's contract with various municipalities for the purchase of effluent to be used as cooling water for Palo Verde. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the operations or financial position of the Company.

Purchase Commitments—The Company has significant purchase commitments in connection with the continuing construction program. Construction expenditures in 1986 have been estimated at $372,000,000.

12. Supplementary Income Statement Information.

Other taxes charged to operations during each of the three years in the period ended December 31, 1985 were as follows:

	Year Ended December 31,		
	1985	1984	1983
	(Thousands of Dollars)		
Ad valorem	$ 45,554	$42,581	$44,691
Sales	51,438	45,495	32,169
Other	7,284	6,372	5,560
Total other taxes	$104,276	$94,448	$82,420

13. Discontinued Operations.

Effective November 1, 1984 (the "Closing Date") the Company sold its gas distribution system to Southwest Gas Corporation ("Southwest"). The sale resulted in a non-recurring loss of approximately $26,470,000, net of an income tax benefit of $7,094,000, (approximately $0.39 per average share of common stock) in 1984.

The Company agreed to fund a portion of the costs associated with the accelerated replacement of certain gas pipe included in the gas distribution system acquired by Southwest by purchasing, under certain conditions, up to $50,000,000 in aggregate par value of cumulative preference stock (the "Stock") to be issued by Southwest. Any such purchases would be made by the Company within approximately three years following the Closing Date. As of December 31, 1985, no such purchases had been made. The Stock would yield an annual dividend of between 3% and 16% (payable quarterly) based on a formula relating to the operating performance of the gas distribution system. The Stock is also redeemable by Southwest, at its option, on any dividend payment date (at the issue price plus accrued dividends), but must be redeemed no later than seven years after the issuance date as to any issue.

Revenues from the Company's discontinued gas operations for 1984 and 1983 were $174,728,000 and $202,134,000, respectively.

14. Selected Quarterly Financial Data (Unaudited).

Quarter	Revenue from Continuing Operations	Income from Continuing Operations	Income (loss) from Discontinued Operations	Net Income	Earnings for Common Stock	Earnings (loss) per share of common stock: Continuing Operations	Earnings (loss) per share of common stock: Discontinued Operations
	(Dollars in Thousands, Except Per Share Amounts)						
1985							
First	$243,552	$ 59,019	$ —	$ 59,019	$ 46,921	$0.67	$ —
Second	276,697	73,185	—	73,185	62,443	0.88	—
Third	368,129	114,473	—	114,473	103,641	1.45	—
Fourth	286,124	78,746	—	78,746	68,006	0.95	—
1984							
First	203,937	51,324	1,397	52,721	41,598	0.60	0.02
Second	236,712	61,889	(185)	61,704	49,600	0.73	—
Third	311,845	103,118	(1,028)	102,090	89,456	1.32	(0.02)
Fourth	242,473	81,239	(26,687)	54,552	42,038	0.99	(0.39)

15. Supplementary Information to Disclose the Effects of Changing Prices (Unaudited).

The following supplementary information is furnished pursuant to Statement No. 33 as amended by Statement No. 82 of the Financial Accounting Standards Board for the purpose of illustrating the effects of changing prices in an inflationary environment. It offers some perspectives of approximated effects of inflation, and is not intended as precise measurements of those effects.

The Company and other public utilities similarly situated are subject to rate-making procedures which, by law and practice, in large part utilize the historical cost of utility plant in the determination of the allowed recovery (through depreciation) of the investment therein and return thereon. This precludes or restricts a rate-making response to the effects of realizing such recovery and return in inflated dollars, compared to those in which the investment was made. The first table below presents an approximate measurement of those effects from the perspective of that portion of the investment, which was not reflected in 1985 depreciation or in the Company's return, and which is therefore not "recoverable".

For these presentations, "current cost" amounts were calculated by applying certain indices (or ratios derived therefrom) to certain historical or other amounts. The primary index was the Handy Whitman Index of Public Utility Construction Costs (a preliminary estimate of which was used for the last half of 1985), although the Consumer Price Index was used for construction work in progress. The Company believes that the Handy Whitman Index is the more accurate of the two in estimating the prices it would incur to duplicate at various times its utility plant in service at the indicated dates. Over the period from 1981 through 1985 the Consumer Price Index rose faster than the Handy Whitman Index.

Electric depreciation expense for 1985 was recalculated by applying the Company's composite depreciation rate to depreciable base determined by indexing certain appraised values from the time of appraisal. The amount by which the expense so recalculated exceeds that shown on the Company's 1985 Consolidated Statement of Income appears as an adjustment to income from continuing operations.

The sum of the depreciation adjustment and the figure shown lower as the "reduction to net recoverable cost" was derived through application of 1985 increases in the Consumer Price Index to historical costs of the Company's utility plant.

The Company did not make adjustments to asset values, or related consolidated income statement amounts, other than those discussed above in regard to utility plant and depreciation thereon. Fuel inventories and fuel expenses are, in effect, monetary items, due to applicable rate-making procedures which include adjustment clauses. In accordance with Statement No. 33, as amended by Statement No. 82, income taxes were not adjusted.

As contrasted to the assumed net value losses which, in the presentation below, are associated with the holding of assets committed to a regulated business, there is an assumed "holding gain" associated with borrowings that will be repaid with inflated dollars. The 1985 decline in the purchasing power of net amounts owed by the Company (measured by the Consumer Price Index) appears to result in a "net" difference between the assumed holding losses and gain.

Inferences which, in the case of some industries, may be drawn from information in the nature of that presented below as to the adequacy of future cash flows in relation to future plant replacement requirements are believed by the Company to be less valid in the case of public utilites which, like itself, should be able to establish rates to cover increased costs of new plant. However, the information may provide some indication of the expanded capital structure that will be required for making plant replacements and additions with inflated dollars.

INCOME FROM OPERATIONS ADJUSTED FOR CHANGING PRICES FOR THE YEAR ENDED DECEMBER 31, 1985

	Current Cost Average 1985 Dollars (Dollars in Thousands, Except Per Share Amounts)
Income from continuing operations as reported in Consolidated Statements of Income	$325,423
Adjustment to restate depreciation expense	(78,431)
Income from continuing operations (excluding reduction to net recoverable cost)	$246,992
Income from continuing operations per common share (after preferred stock dividend requirements and excluding reduction to net recoverable cost)	$2.85
Increase in specific prices (current cost) of utility plant held during the year (a)	$168,637
Reduction to net recoverable cost	(7,981)
Effect of increase in general price level	(251,888)
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	(91,232)
Gain from decline in purchasing power of net amounts owed	45,772
Net	$ (45,460)

(a) At December 31, 1985, Current Cost of Utility Plant—net was $7,140,611.

ARIZONA PUBLIC SERVICE COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECT OF CHANGING PRICES

	Year Ended December 31,				
	1985	1984	1983	1982	1981
	(Average 1985 Dollars in Thousands, Except Per Share Amounts				
Electric operating revenues	$1,174,502	$1,030,467	$ 941,414	$ 965,693	$ 864,39
Current cost information					
Income from continuing operations (excluding reduction to net recoverable cost)	$ 246,992	$ 230,583	$ 210,929	$ 176,336	$ 163,71
Income from continuing operations per common share (after dividend requirements on preferred stock and excluding reduction to net recoverable cost)	$ 2.85	$ 2.64	$ 2.56	$ 2.31	$ 2.5
Excess of increase in general price level over increase in specific prices after reduction to net recoverable cost	$ (91,232)	$ (86,837)	$ (68,252)	$ (56,669)	$ (208,23
Net assets at year-end at net recoverable cost*	$1,997,725	$1,955,140	$1,916,460	$1,775,405	$1,595,75
Reduction to net recoverable cost	$ 7,981	$ 38,216	$ 44,362	$ 33,376	$ 205,98
General information					
Gain from decline in purchasing power of net amounts owed	$ 45,772	$ 93,149	$ 85,460	$ 79,686	$ 171,05
Cash dividends declared per common share	$ 2.73	$ 2.69	$ 2.77	$ 2.68	$
Average consumer price index	322.2	311.1	298.4	289.1	272.

* Consisting of common stock equity and non-redeemable preferred stock.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE V — PROPERTY, PLANT AND EQUIPMENT
YEAR ENDED DECEMBER 31, 1985 (a)

Column A Classification	Column B Balance At Beginning Of Period	Column C Additions At Cost	Column D Retirements	Column E Other Changes —Add (Deduct) —Describe	Column F Balance at End Of Period
	(Thousands of Dollars)				
Utility Plant:					
Electric Plant In Service:					
Intangible	$ 13,774	$ 28,161	$ 1,498	$ 6	$ 40,443
Steam Production	1,245,935	18,236	692	(50)	1,263,429
Hydraulic Production	244	3	—	—	247
Other Production	123,992	1,498	15	—	125,475
Transmission	445,853	6,590	965	(119)	451,359
Distribution	771,222	102,680	7,811	1,010	867,101
General	146,444	39,055	4,373	746	181,872
Total Electric Plant In Service	2,747,464	196,223	15,354	1,593(b)	2,929,926
Nuclear Fuel	135,144	33,637	—	—	168,781
Construction Work In Progress	2,169,162	605,276	—	(201,080)(c)	2,573,358
Utility Plant Held For Future Use	36,473	3,036	—	933(b)	40,442
Total Utility Plant	$5,088,243	$838,172	$15,354	$ (198,554)	$5,712,507
Non-Utility Plant	$ 3,759	$ 1,994	$ —	$ (2,418)(b)	$ 3,335

(a) Depreciation is provided on a straight-line basis at rates authorized by the ACC annually; for 1985 those rates were from 2.86% to 9.86%.

(b) Transfers between plant accounts.

(c) Transfers to plant in service.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE V — PROPERTY, PLANT AND EQUIPMENT
YEAR ENDED DECEMBER 31, 1984 (a)

Column A Classification	Column B Balance At Beginning Of Period	Column C Additions At Cost	Column D Retirements	Column E Other Changes —Add (Deduct) —Describe	Column F Balance at End Of Period
	(Thousands of Dollars)				
Utility Plant:					
Electric Plant In Service:					
Intangible	$ 2,344	$ 317	$ 1	$ 11,114	$ 13,774
Steam Production	1,190,550	57,529	2,245	101	1,245,935
Hydraulic Production	243	1	—	—	244
Other Production	123,723	377	120	12	123,992
Transmission	422,991	23,561	22	(677)	445,853
Distribution	682,939	92,140	4,980	1,123	771,222
General	53,336	6,304	1,321	88,125	146,444
Total Electric Plant In Service	2,476,126	180,229	8,689	99,798 (c)	2,747,464
Gas Plant In Service:					
Intangible	427	301	—	(728)	—
Distribution	163,561	26,274	3,390	(186,445)	—
General	10,050	2,356	311	(12,095)	—
Total Gas Plant In Service	174,038	28,931	3,701	(199,268)(b)	—
Common Plant In Service:					
Intangible	10,914	226	—	(11,140)	—
General	79,663	10,073	1,033	(88,703)	—
Total Common Plant In Service	90,577	10,299	1,033	(99,843)(c)	—
Total Utility Plant In Service	2,740,741	219,459	13,423	(199,313)	2,747,464
Nuclear Fuel	113,488	21,656	—	—	135,144
Construction Work In Progress	1,872,564	521,890	—	(225,292)(d)	2,169,162
Utility Plant Held For Future Use	34,472	1,974	—	27 (e)	36,473
Total Utility Plant	$4,761,265	$764,979	$13,423	$(424,578)	$5,088,243
Non-Utility Plant	$ 3,642	$ (218)	$ —	$ 335 (d)	$ 3,759

(a) Depreciation is provided on a straight-line basis at rates authorized by the ACC annually; for 1984, those rates were from 3.07% to 4.16% for electric plant, 3.49% for gas plant and from 2.86% to 9.60% for common and general plant.

(b) Reflects the sale of gas plant to Southwest Gas Corporation.

(c) Reflects the reclassification of Common Plant to Electric Plant.

(d) Primarily transfers to plant in service.

(e) Transfers between plant accounts.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE V — PROPERTY, PLANT AND EQUIPMENT
YEAR ENDED DECEMBER 31, 1983 (a)

Column A Classification	Column B Balance At Beginning Of Period	Column C Additions At Cost	Column D Retirements	Column E Other Changes —Add (Deduct) —Describe	Column F Balance at End of Period
	(Thousands of Dollars)				
Utility Plant:					
Electric Plant In Service:					
Intangible	$ 2,003	$ 342	$ 1	$ —	$ 2,344
Steam Production	1,190,413	19,986	6,694	(13,155)	1,190,550
Hydraulic Production	242	1	—	—	243
Other Production	119,337	4,519	133	—	123,723
Transmission	418,240	6,765	1,557	(457)	422,991
Distribution	622,478	65,385	5,170	246	682,939
General	49,927	5,198	1,508	(281)	53,336
Total Electric Plant In Service	2,402,640	102,196	15,063	(13,647)	2,476,126
Gas Plant In Service:					
Intangible	379	99	51	—	427
Distribution	143,199	22,739	2,377	—	163,561
General	7,833	2,311	94	—	10,050
Total Gas Plant In Service	151,411	25,149	2,522	—	174,038
Common Plant In Service:					
Intangible	10,363	721	170	—	10,914
General	74,768	5,200	845	540	79,663
Total Common Plant In Service	85,131	5,921	1,015	540	90,577
Total Utility Plant In Service	2,639,182	133,266	18,600	(13,107)(b)	2,740,741
Nuclear Fuel	72,663	40,825	—	—	113,488
Construction Work In Progress	1,466,790	540,886	—	(135,112)(c)	1,872,564
Utility Plant Held For Future Use	19,831	1,037	—	13,604 (b)	34,472
Total Utility Plant	$4,198,466	$716,014	$18,600	$(134,615)	$4,761,265
Non-Utility Plant	$ 3,359	$ 780	$ —	$ (497)(c)	$ 3,642

(a) Depreciation is provided on a straight-line basis at rates authorized by the ACC annually; for 1983, those rates were from 3.07% to 4.16% for electric plant, 3.49% for gas plant and from 2.86% to 9.60% for common and general plant.

(b) Transfers from plant in service.

(c) Transfers to plant in service.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE VI — ACCUMULATED DEPRECIATION, DEPLETION AND AMORTIZATION OF PROPERTY, PLANT AND EQUIPMENT YEAR ENDED DECEMBER 31, 1985

Column A Description	Column B Balance at Beginning Of Period	Column C Additions Charged to Costs and Expenses	Column D Retirements	Column E Other Changes—Add (Deduct)—Describe(a)	Column F Balance at End of Period
	(Thousands of Dollars)				
Accumulated Depreciation and Amortization of Utility Plant:					
Electric Plant in Service:					
Steam Production	$297,650	$ 42,941	$ 692	$ 347	$340,246
Other Production	47,754	8,778	15	(18)	56,499
Transmission	130,315	13,617	965	1,025	143,992
Distribution	192,977	26,867	7,811	(561)	211,472
General	62,932	16,159	5,871	521	73,741
Total Electric Plant in Service	731,628	108,362	15,354	1,314	825,950
Plant Held For Future Use:					
Steam Production	12,085	—	—	202(b)	12,287
Transmission	447	—	—	—	447
Total Plant Held For Future Use	12,532	—	—	202(b)	12,734
Total	$744,160	$108,362	$15,354	$1,516	$838,6[illegible]
Accumulated Depreciation of Non-Utility Property	$ 172	$ 8	$ —	$ —	$ 180

(a) Includes removal and salvage—net.

(b) Transfers from plant in service.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE VI — ACCUMULATED DEPRECIATION, DEPLETION AND AMORTIZATION OF PROPERTY, PLANT AND EQUIPMENT YEAR ENDED DECEMBER 31, 1984

Column A Description	Column B Balance At Beginning Of Period	Column C Additions Charged To Costs and Expenses	Column D Retirements	Column E Other Changes—Add (Deduct)—Describe(a)	Column F Balance at End of Period
	(Thousands of Dollars)				
Accumulated Depreciation and Amortization of Utility Plant:					
Electric Plant in Service:					
Steam Production	$259,549	$40,675	$ 2,245	$ (329)	$297,650
Other Production	42,711	5,159	120	4	47,754
Transmission	117,174	13,166	22	(3)	130,315
Distribution	173,810	23,687	4,980	460	192,977
General	26,456	4,440	1,322	33,358	62,932
Total Electric Plant in Service	619,700	87,127	8,689	33,490 (c)	731,628
Gas Plant in Service:					
Distribution	62,853	5,059	3,390	(64,522)	—
General	4,950	833	311	(5,472)	—
Total Gas Plant in Service	67,803	5,892	3,701	(69,994)(b)	—
Common Plant in Service:					
General	27,830	6,061	1,033	(32,858)(c)	—
Total Plant in Service	715,333	99,080	13,423	(69,362)	731,628
Plant Held For Future Use:					
Steam Production	12,085	—	—	—	12,085
Transmission	447	—	—	—	447
Total Plant Held For Future Use	12,532	—	—	—	12,532
Total	$727,865	$99,080	$13,423	$ (69,362)	$744,160
Accumulated Depreciation of Non-Utility Property	$ 149	$ 23	$ —	$ —	$ 172

(a) Includes removal and salvage—net.

(b) Reflects sale of gas plant to Southwest Gas Corporation.

(c) Reflects reclassification of Common Plant to Electric Plant.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE VI — ACCUMULATED DEPRECIATION, DEPLETION AND AMORTIZATION OF PROPERTY, PLANT AND EQUIPMENT YEAR ENDED DECEMBER 31, 1983

Column A Description	Column B Balance at Beginning of Period	Column C Additions Charged To Costs and Expenses	Column D Retirements	Column E Other Changes—Add (Deduct)—Describe*	Column F Balance at End of Period
	(Thousands of Dollars)				
Accumulated Depreciation and Amortization of Utility Plant:					
Electric Plant in Service:					
Steam Production	$233,712	$40,273	$ 6,670	$ (7,766)	$259,549
Other Production	37,384	5,061	133	399	42,711
Transmission	106,347	12,744	1,578	(339)	117,174
Distribution	157,426	21,276	5,157	265	173,810
General	23,586	3,827	1,492	535	26,456
Total Electric Plant in Service	558,455	83,181	15,030	(6,906)	619,700
Gas Plant in Service:					
Distribution	60,969	5,302	2,467	(951)	62,853
General	4,270	728	92	44	4,950
Total Gas Plant in Service	65,239	6,030	2,559	(907)	67,803
Common Plant in Service—General	22,823	5,921	1,027	113	27,830
Total Plant in Service	646,517	95,132	18,616	(7,700)	715,3[illegible]
Plant Held For Future Use:					
Steam Production	—	—	12	12,097	12,085
Transmission	—	—	—	447	447
Total Plant Held For Future Use	—	—	12	12,544	12,532
Total	$646,517	$95,132	$18,628	$ 4,844	$727,865
Accumulated Depreciation of Non-Utility Property	$ 142	$ 7	$ —	$ —	$ 149

* Removal and salvage—net.

ARIZONA PUBLIC SERVICE COMPANY

SCHEDULE IX — SHORT-TERM BORROWINGS

Column A Category of aggregate short-term borrowings	Column B Balance at end of period	Column C Weighted average interest rate at end of period	Column D Maximum amount outstanding during the period	Column E (a) Average amount outstanding during the period	Column F (b) Weighted average interest rate during the period
	(Thousands of Dollars)				
	YEAR ENDED DECEMBER 31, 1985				
Bank Borrowings	$ —	— %	$ 1,893	$ 1,345	6.52%
Commercial Paper	18,000	8.31(c)	155,125	37,426	8.32(c)
	YEAR ENDED DECEMBER 31, 1984				
Bank Borrowings	$ 1,800	6.9875%	$116,817	$82,586	8.34%
Commercial Paper	158,000	8.69(c)	158,000	29,717	9.90(c)
	YEAR ENDED DECEMBER 31, 1983				
Bank Borrowings	$86,308	8.22%	$ 86,308	$46,732	9.71%
Commercial Paper	—	—	150,000	40,808	9.57(c)

(a) Average daily balance during the period.

(b) Total applicable interest paid in the period divided by average daily balance.

(c) Does not include commitment fees on backup lines of credit in support of commercial paper. See Note 7 of Notes to Consolidated Financial Statements.

ITEM 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

The information regarding executive officers called for by Item 10, "Directors and Executive Officers of the Registrant", is furnished under the caption "Executive Officers of the Registrant" in Part I of this report. The other information called for by Item 10, as well as that called for by Item 11, "Executive Compensation," and Item 13, "Certain Relationships and Related Transactions," is hereby incorporated by reference from pages 6 through 14 of the Company's definitive proxy statement, relating to its annual meeting of stockholders to be held on April 24, 1986, as filed with the Securities and Exchange Commission on March 21, 1986.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

As of March 3, 1986 the Company's records and information supplied by the owners indicat that each of the directors of the Company and the officers and directors of the Company as a group beneficially owned the numbers of shares of AZP's Common Stock or the Company's Cumulative Preferred Stock set forth in the table below. Shares beneficially owned by any director and by all officers and directors as a group in all cases constitute less than .1% of the class of the shares so owned.

Name of Beneficial Owner	Title of Class	Number of Shares Owned*
Joe Acosta	Common	1,345
Dino DeConcini	Common	695
O. Mark De Michele	Common	5,616
Karl Eller	Common	1,109
William T. Garland	Common	3,470
Pamela Grant	Common	800
Jack M. Morgan	Common	189
Marvin R. Morrison	Common	4,226
John R. Norton, III	Common	15,000
John J. Rhodes	Common	2,349
Henry B. Sargent, Jr.	Common	7,006
Wilma W. Schwada	Common	919
James P. Simmons	Common	100
Richard Snell	Common	5,738
Donald N. Soldwedel	Common	3,596
Maurice R. Tanner	Common	1,500
Keith L. Turley	Common	14,420
Douglas J. Wall	Common	1,841
Morrison F. Warren	Common	271
Ben F. Williams, Jr.	Common	1,426
Thomas G. Woods, Jr.	Common	2,000
All Officers and Directors as a Group (40 individuals)	Common	106,588

* Including shares of AZP Common Stock as to which voting or investment power is shared with others as follows. Mr. Acosta — 1,345, Mr. De Concini — 474, Mr. Garland — 1,845, Ms. Grant — 800, Mr. Morrison — 4,226, Mr. Norton — 15,000, Mr. Rhodes — 2,349, Ms. Schwada — 919, Mr. Soldwedel — 3,596, Mr. Tanner — 1,500, Mr. Turley — 2,583, Mr. Wall — 1,841, Mr. Williams — 100, Mr. Woods — 2,000 and all officers and directors as a group — 43,772.

PART IV

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

Financial Statements and Schedules

See the Index to Consolidated Financial Statements and Supplemental Consolidated Schedules on page 27.

Exhibits Filed

Exhibit No.	*Description*
3.1	Bylaws, amended as of September 9, 1985.
28.1	Notice and Proxy Statement of the Company relating to its 1986 Annual Meeting of Shareholders.

In addition to those Exhibits shown above, the Company hereby incorporates the following Exhibits pursuant to Exchange Act Rule 12b-32 and Regulation §201.24 by reference to the filings set forth below:

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
3.2	Articles of Incorporation, restated as of June 15, 1985	3.1 to June 1985 Form 10-Q Report	1-4473	8-8-85
3.3	Certificates pursuant to Sections 10-152.01 and 10-016, Arizona Revised Statutes, establishing Series A through Q of the Company's Serial Preferred Stock and	4.2 to Form S-3 Registration Statement	2-87694	11-14-83
3.4	Certificate pursuant to Arizona Revised Statues establishing Series R of the Company's Serial Preferred Stock	4.3 to March 1984 Form 10-Q Report	1-4473	5-14-84
4.1	Mortgage and Deed of Trust Relating to the Company's First Mortgage Bonds, together with twenty-seven indentures supplemental thereto	4.1 to Form S-3 Registration Statement	2-84605	7-6-83
	Twenty-eighth Supplemental Indenture	4.2 to Form S-3 Registration Statement No. 2-84605 by means of July 1983 Form 8-K Report	1-4473	7-7-83

Exhibit No.	Description	Originally Filed as Exhibit:	File No.	Date Effective
	Twenty-ninth Supplemental Indenture	4.2 to Form S-3 Registration Statement No. 2-86955 by means of October 13, 1983 Form 8-K Report	1-4473	10-14-83
	Thirtieth Supplemental Indenture	4.4 to Form S-3 Registration Statement No. 2-86955 by means of June 14, 1984 Form 8-K Report	1-4473	6-15-84
	Thirty-first Supplemental Indenture	4.4 to Form S-3 Registration Statements (Nos. 2-86955 and 2-95340) by means of January 24, 1985 Form 8-K Report	1-4473	1-25-85
	Thirty-second Supplemental Indenture	4.7 to Form S-3 Registration Statement	2-97956	3-29-85
	Thirty-third Supplemental Indenture	4.5 to Form S-3 Registration Statement Nos. 2-95340 and 2-97956 by means of June 6, 1985 Form 8-K Report	1-4473	6-7-85
	Thirty-fourth Supplemental Indenture	4.1 to Form S-3 Registration Statement by means of Post-Effective Amendment No. 2	2-99739	11-21-85
	Thirty-fifth Supplemental Indenture	4.1 to Form S-3 Registration Statement No. 33-2297 by means of January 22, 1986 Form 8-K Report	1-4473	1-23-86
	Thirty-sixth Supplemental Indenture	4.1 to Form S-3 Registration Statement No. 33-3354 by means of February 24, 1986 Form 8-K Report	1-4473	2-25-86
4.2	Agreement, dated August 11, 1983, relating to the filing of instruments defining the rights of holders of long-term debt not in excess of 10% of the Company's total assets	10.14 to June 1983 Form 10-Q Report	1-4473	8-15-83
10.1	Indenture of Lease with Navajo Tribe of Indians, Four Corners Plant	5.01 to Form S-7 Registration Statement	2-59644	9-1-77
10.2	Supplemental and Additional Indenture of Lease, including amendments and supplements to original lease with Navajo Tribe of Indians, Four Corners Plant	5.02 to Form S-7 Registration Statement	2-59644	9-1-77

Exhibit No.	Description	Originally Filed as Exhibit:	File No.	Date Effective
10.3	Amendment and Supplement No. 1 to Supplemental and Additional Indenture of Lease, Four Corners, dated April 25, 1985	10.36 to Registration Statement on Form 8-B of AZP Group, Inc.	1-8962	7-25-85
10.4	Indenture of Lease, Navajo Units 1, 2 and 3	5(g) to Form S-7 Registration Statement	2-36505	3-23-70
10.5	Application and Grant of multi-party rights-of-way and easements, Four Corners Plant	5.04 to Form S-7 Registration Statement	2-59644	9-1-77
10.6	Application and Amendment No. 1 to Grant of multi-party rights-of-way and easements, Four Corners Power Plant Site, dated April 25, 1985	10.37 to Registration Statement on Form 8-B of AZP Group, Inc.	1-8962	7-25-85
10.7	Application and Grant of Company rights-of-way and easements, Four Corners Plant	5.05 to Form S-7 Registration Statement	2-59644	9-1-77
10.8	Application and Amendment No. 1 to Grant of Arizona Public Service Company rights-of-way and easements, Four Corners Power Plant Site, dated April 25, 1985	10.38 to Registration Statement on Form 8-B of AZP Group, Inc.	1-8962	7-25-85
10.9	Application and Grant of rights-of-way and easements, Navajo Plant	5(h) to Form S-7 Registration Statement	2-36505	3-23-70
10.10	Nuclear Fuel Contract with Combustion Engineering, Inc., ANPP	5(y) to Form S-7 Registration Statement, including an amendment filed as Exhibit 10.34 to 1982 10-K Report	1-4473	5-28-74 2-25-83
10.11	Reload Fuel Contract with Westinghouse Corporation for supply of nuclear fuel, ANPP	5(gg) to Form S-7 Registration Statement including an amendment filed as Exhibit 20.5 to 1981 Form 10-K Report	2-52443 1-4473	12-18-74 3-26-82

Exhibit No.	Description	Originally Filed as Exhibit:	File No.	Date Effective
10.12	Agreement for Conversion Services with Allied Chemical Corporation, ANPP	21 to 1975 Form 12-K Report including an amendment filed as Exhibit 20.7 to 1981 Form 10-K Report	1-4473 1-4473	4-16-76 3-26-82
10.13	Water Service Contract Assignment with the United States Department of Interior, Bureau of Reclamation, Navajo Plant	5(l) to Form S-7 Registration Statement	2-39442	3-16-71
10.14	Uranium Concentrates Sales Agreement with Energy Fuels Exploration Company, ANPP	20.8 to 1981 Form 10-K Report including a supplement filed as Exhibit 10.38 to 1983 Form 10-K Report	1-4473 1-4473	3-26-82 3-29-84
10.15	Agreement No. 13904 (Option and Purchase of Effluent) with Cities of Phoenix, Glendale, Mesa, Scottsdale and Tempe, Town of Youngtown and Salt River Project Agricultural Improvement and Power District	20.10 to 1981 Form 10-K Report	1-4473	3-26-82
10.16	Agreement for the Sale and Purchase of Wastewater Effluent with City of Tolleson and Salt River Agricultural Improvement and Power District	20.11 to 1981 Form 10-K Report, including an amendment filed as Exhibit 20.12 to 1981 10-K Report	1-4473 1-4473	3-26-82 3-26-82
10.17	Loan Agreement between the Company and Bankers Trust Company	19.2 to September 1982 10-Q Report	1-4473	10-29-82
10.18	Term Credit Agreement between the Company and Bank of America National Trust and Savings Association	19.3 to September 1982 10-Q Report	1-4473	10-29-82

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
10.19	Agreement relating to the filing of instruments defining the rights of holders of long-term debt not in excess of 10% of the Company's total assets	19.1 to 1982 Form 10-K Report	1-4473	2-25-83
10.20	Gas Sales Agreement dated March 1, 1983 with El Paso Natural Gas Company	10.1 to June 1983 Form 10-Q Report, including an amendment filed as Exhibit 10.2 to June 1983 Form 10-Q Report	1-4473 1-4473	8-15-83 8-15-83
10.21	Supplemental Agreement of Settlement, dated June 2, 1980, with Salt River Agricultural Improvement and Power District, Southern California Edison Company, Public Service Company of New Mexico, El Paso Electric Company, Arizona Electric Power Cooperative, Inc. and the United States Department of Energy ("DOE"), ANPP	10.11 to June 1983 Form 10-Q Report	1-4473	8-15-83
10.22	Agreement for Delivery of Natural UF_6, dated June 2, 1980, between Arizona Public Service Company, Salt River Agricultural Improvement and Power District, Southern California Edison Company, Public Service Company of New Mexico, El Paso Electric Company, Arizona Electric Power Cooperative, Inc., and DOE, ANPP	10.12 to June 1983 Form 10-Q Report	1-4473	8-15-83
10.23	Agreement in Principle, dated October 20, 1983, with Southwest Gas Corporation, relating to the proposed sale of gas distribution system	10.1 to September 1983 Form 10-Q Report including supplements, amendments and modifications filed as Exhibit 10.2 to September 1984 Form 10-Q Report	1-4473 1-4473	11-8-83 11-14-84
10.24	Uranium Concentrates Sales Agreement, dated December 1, 1983 with Energy Fuels Exploration Company, ANPP	10.39 to 1983 Form 10-K Report	1-4473	3-29-84

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
10.25	Uranium Concentrates Sales Agreement, dated December 1, 1983 with Pathfinder Mines Corporation, ANPP	10.40 to 1983 Form 10-K Report	1-4473	3-29-84
10.26	Deferred Compensation Plan, as restated, effective January 1, 1984 and incorporating the first through fifth amendments	10.41 to 1983 Form 10-K Report	1-4473	3-29-84
10.27	Directors' Deferred Compensation Plan, as restated, effective October 1, 1983	10.42 to 1983 Form 10-K Report	1-4473	3-29-84
10.28	Executive Incentive Compensation Plan, as restated, effective January 1, 1983	10.43 to 1983 Form 10-K Report	1-4473	3-29-84
10.29	Credit Agreement, dated May 15, 1984, among the Company, Citibank, N.A., and the Banks	10.1 to June 1984 Form 10-Q Report	1-4473	8-13-84
10.30	Letter Agreement, dated October 30, 1984 with Southwest Gas Corporation ("Southwest") relating to the Company's purchase, under certain conditions, of cumulative preference stock to be issued by Southwest to fund a portion of the costs associated with the replacement of certain gas pipe in the gas distribution system acquired by Southwest from APS	10.3 to September 1984 Form 10-Q Report	1-4473	11-14-84

Exhibit No.	*Description*	*Originally Filed as Exhibit:*	*File No.*	*Date Effective*
10.31	Contract, dated July 21, 1984, with DOE providing for the disposal of nuclear fuel and/or high-level radioactive waste, ANPP	10.31 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85
10.32	Supplemental Agreement of Settlement, dated November 15, 1984 with DOE, ANPP	10.32 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85
10.33	Uranium Enrichment Services Contract, dated November 15, 1984 with DOE, ANPP	10.33 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85
10.34	Agreement, dated January 1, 1985 with El Paso Natural Gas Company amending Gas Sales Agreement dated March 1, 1983	10.34 to AZP Group, Inc.'s Form S-14 Registration Statement	2-96386	3-13-85

Reports on Form 8-K

During the quarter ended December 31, 1985, and the period ended March 24, 1986, the Company filed, on the dates indicated, the following Reports on Form 8-K:

Report filed November 19, 1985, relating to (1) a motion filed by the Residential Utility Consumer Office ("RUCO") requesting emergency adoption of a new Arizona Corporation Commission (the "ACC") rule to require public service corporations to prove by a preponderance of the evidence that their investments were prudent, and (2) an attempt to file a counterclaim in the consolidated state court lawsuits by the plaintiffs in the United States District Court of Arizona lawsuit involving an effluent contract.

Report filed November 23, 1985, comprised of exhibits to the Company's Registration Statement on Form S-3 (Registration No. 2-99739 and Post-Effective Amendment Nos. 1 and 2 thereto), relating to the Company's registration of $100,000,000 in aggregate principal amount of the Company's First Mortgage Bonds.

Report filed November 25, 1985, relating to (1) the United States District Court of Arizona dismissal of the lawsuit asserting claims relating to the primary contract involving effluent for cooling purposes at the Palo Verde Nuclear Generating Station, and (2) a declaratory judgment action in the Superior Court of Maricopa County, Arizona, brought by the municipalities who are parties to the primary effluent contract.

Report filed December 12, 1985, relating to (1) the release of an audit report by the utility regulatory bodies which identified certain areas in which consultants recommended further study, (2) the granting of a facility operating license for Palo Verde Unit 2, (3) the issuance of an order by the ACC changing certain hearing dates, (4) the request by the Company of certain orders from the ACC pertaining to accounting matters, and (5) the amendment to the counterclaim in Superior Court of Maricopa County asserting alternative claims.

Report filed January 20, 1986, relating to (1) delays in the projected commercial operation dates of Palo Verde Units 2 and 3, (2) the impact on the Company if the ACC does not grant the requested accounting/rate-making order relating to Unit 2, (3) the court order upholding the ACC's order purporting to subject AZP and its subsidiaries, including the Company, to certain reporting requirements, (4) the ACC's refusal to grant a motion by RUCO involving the emergency rate reduction application filed by RUCO, and (5) the ACC's refusal to grant a motion by RUCO involving a requested emergency adoption of a new ACC rule to require public service corporations to prove by a preponderance of the evidence that their investments were prudent.

Report filed January 23, 1986 comprised of exhibits to the Company's Registration Statement on Form S-3 (Registration No. 33-2297), relating to the Company's registration of $100,000,000 in aggregate principal amount of the Company's First Mortgage Bonds.

Report filed February 24, 1986 comprised of exhibits to the Company's Registration Statement on Form S-3 (Registration No. 33-3356), relating to the Company's registration of $100,000,000 in aggregate principal amount of the Company's First Mortgage Bonds.

Report filed February 25, 1986 comprised of exhibits to the Company's Registration Statement on Form S-3 (Registration No. 33-3356), relating to the Company's registration of $100,000,000 in aggregate principal amount of the Company's First Mortgage Bonds.

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.

ARIZONA PUBLIC SERVICE COMPANY
(Registrant)

Date: March 24, 1986

/s/ KEITH L. TURLEY
(Keith L. Turley, Chairman of the Board of Directors 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 the registrant and in the capacities and on the dates indicated.

Signature	*Title*	*Date*
/s/ KEITH L. TURLEY (Keith L. Turley, Chairman of the Board of Directors and Chief Executive Officer)	Principal Executive Officer and Director	March 24, 1986
/s/ O. MARK DE MICHELE (O. Mark De Michele, President and Chief Operating Officer)	Principal Operating Officer and Director	March 24, 1986
/s/ H. B. SARGENT, JR. (H. B. Sargent, Jr., Executive Vice President and Chief Financial Officer)	Principal Financial Officer and Director	March 24, 1986
/s/ WILLIAM J. POST (William J. Post, Controller)	Controller	March 24, 1986
/s/ JOE ACOSTA (Joe Acosta)	Directors	March 24, 1986
/s/ DINO DECONCINI (Dino DeConcini)		
/s/ KARL ELLER (Karl Eller)		
/s/ WILLIAM T. GARLAND (William T. Garland)		
/s/ PAMELA GRANT (Pamela Grant)		

Signature	Title	Date
/s/ JACK M. MORGAN (Jack M. Morgan)	Directors	March 24, 1986
/s/ MARVIN R. MORRISON (Marvin R. Morrison)		
/s/ JOHN R. NORTON III (John R. Norton III)		
/s/ JOHN J. RHODES (John J. Rhodes)		
/s/ WILMA W. SCHWADA (Wilma W. Schwada)		
/s/ JAMES P. SIMMONS (James P. Simmons)		
/s/ RICHARD SNELL (Richard Snell)		
/s/ DONALD N. SOLDWEDEL (Donald N. Soldwedel)		
/s/ MAURICE R. TANNER (Maurice R. Tanner)		
/s/ DOUGLAS J. WALL (Douglas J. Wall)		
/s/ MORRISON F. WARREN (Morrison F. Warren)		
/s/ BEN F. WILLIAMS, JR. (Ben F. Williams, Jr.)		
/s/ THOMAS G. WOODS, JR. (Thomas G. Woods, Jr.)		

UNITED STATES OF AMERICA

NUCLEAR REGULATORY COMMISSION

In the matter of ARIZONA PUBLIC SERVICE COMPANY, et al., (Palo Verde Nuclear Generating Station, Unit 2)	)	DOCKET NO. STN 50-529

APPLICATION IN RESPECT OF
SALE AND LEASEBACK TRANSACTIONS BY
ARIZONA PUBLIC SERVICE COMPANY

EXHIBIT G

GENERAL INFORMATION RESPECTING
OWNER TRUSTEE REQUIRED BY
10 CFR 50.33 (a)-(d)

General Information Concerning
The First National Bank of Boston

(a) Name:

The First National Bank of Boston (the "Bank")

(b) Address:

100 Federal Street
Boston, Massachusetts 02110
Attention of Corporate Trust Division

(c) Description of business:

The Bank is a national banking association and has been for a number of years the largest commercial bank in New England. Except for directors' qualifying shares, the Bank is a wholly-owned subsidiary of Bank of Boston Corporation ("BBC"), a bank holding company organized under Massachusetts law. Through its subsidiaries, principally the Bank, BBC is engaged in providing a wide variety of services to corporate and institutional customers, governments, individuals and other banks. These services include domestic corporate banking services, international banking services, investment and fund management services, personal banking services, trust services, and banking operations and corporate services. Through its Corporate Trust Division, the Bank provides corporate trust services to a broad range of entities.

(d) (1) Not applicable.

(d) (2) Not applicable.

(d) (3) (i) State of incorporation and principal location:

The Bank is a national banking association chartered under the National Bank Act in 1864. The principal offices of the Bank are located in Boston, Massachusetts.

(d) (3) (ii) Names of Directors and principal officers:

The names of the directors of the Bank and BBC are set forth in **Attachments A** and **B** hereto, respectively. Information with respect to the officers of the Bank and BBC is set forth on pages 86 and 87 of **Attachment C** hereto.

(d) (3) (iii) Neither the Bank nor BBC is owned, controlled, or dominated by an alien, a foreign corporation, or a foreign government. Further information relating to the

U.S. citizenship of the Bank and BBC and the directors of the Bank and BBC is contained in Attachments A and B hereto, respectively.

(d) (4) The Bank will serve as trustee under two or more trust agreements between the Bank and the respective equity investors described in the Application to which this document is attached as Exhibit B. The trusts created by these trust agreements will (i) receive title to the interests in PVNGS Unit 2 conveyed thereto by El Paso and (ii) lease such interests back to El Paso, all as more fully described in said Application. Although the Bank is not legally an "agent" for or a "representative" of such equity investors, the Bank does act as trustee of the trusts of which such investors are the respective beneficiaries. Under the terms of the trust agreements the Bank is generally obligated to act upon the instructions of the relevant equity investor/beneficiary so long as such instructions are not inconsistent with the provisions of documents constituting the sale and leaseback transaction.

The Bank is without knowledge, however, concerning possible foreign ownership, control or domination of the proposed equity investors, and is thus unable to provide information with respect thereto.

(e) The Bank is not making application for a license under 10 C.F.R. Part 50, or any other license available from the Nuclear Regulatory Commission.

(f) A copy of BBC's 1985 Annual Report is attached as **Attachment C** hereto. Provision to the Commission of BBC's 1984 Annual Report is without prejudice to the provisions of the respective trust agreements which provide that, (i) except in certain very limited circumstances (such as the Bank's wilful misconduct or gross negligence), the Bank is not answerable or accountable in its individual capacity and (ii) that all persons (individuals, partnerships, corporations, trusts, unincorporated associations or joint ventures, governments or any departments or agencies thereof, or any other entities) having any claim against the Bank, in its capacity as trustee, by reason of any aspect of the sale and leaseback transaction (including the holding by the Bank of legal title interests in PVNGS Unit 2) shall look only to the assets held by the Bank (including but not limited to the interests in PVNGS Unit 2 and El Paso's obligations under the transaction documents) pursuant to the trust agreements for payment or satisfaction of such claim.

(g) Not applicable.

(h) Not applicable.

(i) Not applicable.

(j) Not applicable.