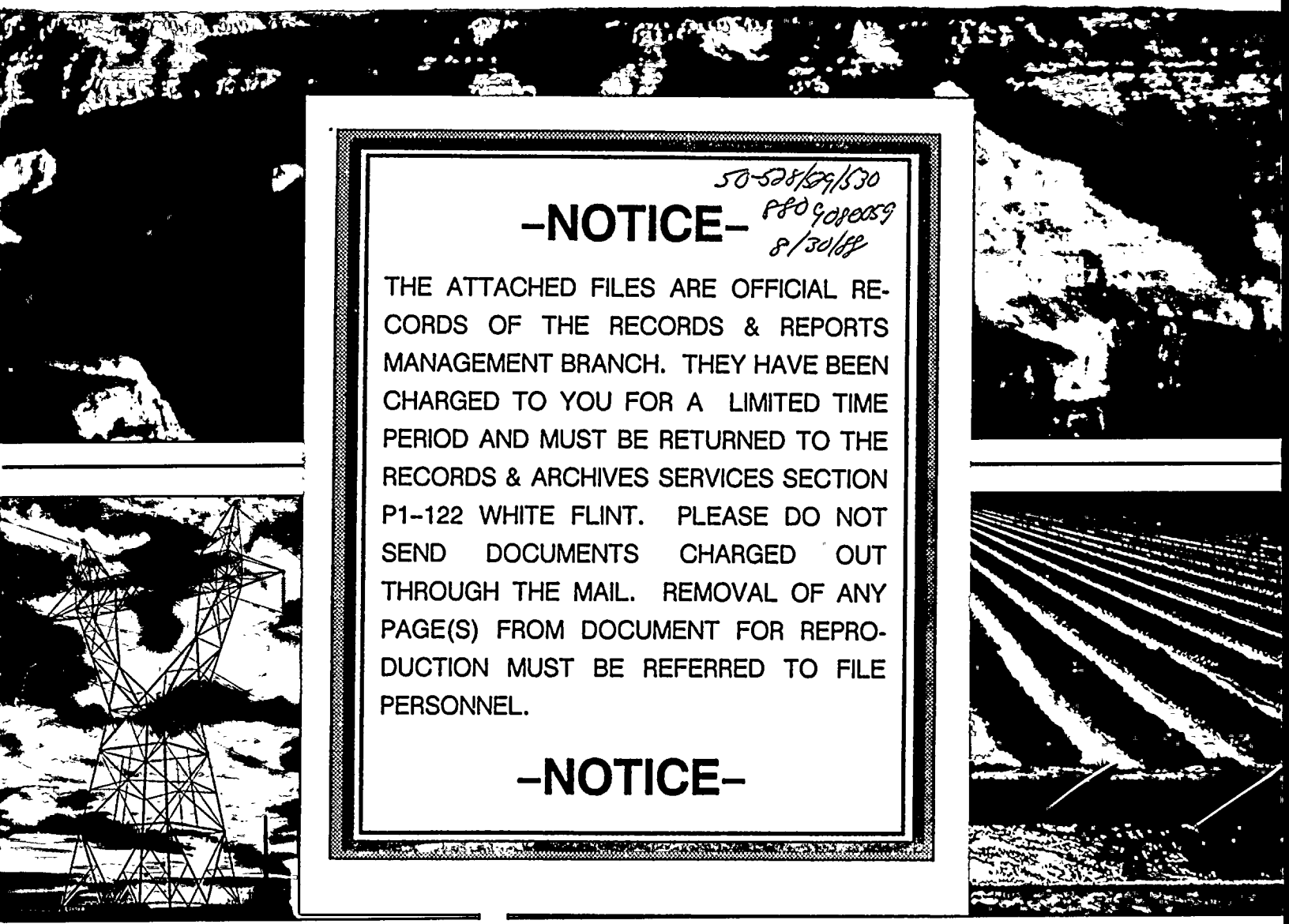
SALT RIVER PROJECT

ANNUAL REPORT 1987-88



Purpose of Salt River Project:
Provide reliable and adequate water and energy at the lowest reasonable price and in a publicly responsible manner.

Background

Salt River Project is named for the major river which supplies water to the Phoenix metropolitan area. SRP plays a significant part in the growth of the Salt River Valley, providing water and power to residents through two organizations — the Salt River Valley Water Users' Association (the Association) and the Salt River Project Agricultural Improvement and Power District (the District).

The Association is a private Arizona corporation. It administers water rights of SRP's 240,000-acre area and operates and maintains the irrigation transmission and distribution system which carries water to municipal, industrial, agricultural and residential users. In cooperation with the U.S. Forest Service, it participates in the management of the 13,000-square-mile watersheds of the Salt and Verde rivers.

The District is a public power utility and a political subdivision of Arizona. It operates under contracts with the United States and provides electricity to residential, commercial, industrial and agricultural power users in a 2,900-square-mile service area in parts of Maricopa, Gila and Pinal counties.

In line with the long-standing reclamation principle, SRP uses a portion of its electric revenues to help support its water operations. This practice helps keep water-delivery charges to cities, farmers and homeowners at reasonable levels. At the same time, SRP maintains electric rates that are competitive with those of other utilities in the area.

SALT RIVER PROJECT

Salt River Project is an Equal Opportunity Employer

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COMPUTER GRAPHICS *Jeff Stanley*

On the cover—*Salt River Project is the Grand Canyon State's largest water supplier and the nation's third-largest public power utility. SRP serves more than 500,000 customers in central Arizona. The Project operates six reservoirs for its water supply and operates or participates in 17 Southwest generating stations for its power supply.*

Highlights

REVENUES/EXPENSES *(See Page 20)*	Fiscal 1988	Fiscal 1987
Total operating revenues ($000) ..	959,346	888,506
Total operating expenses ($000) ..	790,972	706,377
Net operating revenues ($000)...	168,374	182,129
Financing costs (less AFUDC) ($000).....	146,424	105,293
Other expenses, net ($000).....	5,689	2,075
Reinvested ($000)	16,261	74,761
POWER OPERATIONS *(See Page 27)*		
Energy customers at year end	505,618	487,321
Total kilowatt-hour sales (000) ...	16,335,115	15,566,478
Average annual kilowatt-hour usage/res. customer.....	12,824	12,440
Avg. annual kilowatt-hour revenues/res. customer (cents)....	7.66	7.54
WATER OPERATIONS *(See Page 26)*	Calendar 1987	Calendar 1986
Assessed water accounts.....	182,110	181,894
Water runoff (acre-feet).....	1,120,034*	1,036,805
Water in storage, Dec. 31 (acre-feet)	1,624,272	1,691,741
Water deliveries (acre-feet).....	997,324	870,658
SELECTED OTHER DATA *(See Page 26)*	Fiscal 1988	Fiscal 1987
Gross plant investment ($000)....	5,335,784	4,834,055
Long-term debt ($000-See Page 19)	3,278,717	2,986,737
Taxes & tax equivalents ($000) ...	121,154	103,097
Electric-revenue contributions to support water operations ($000)	29,227	15,975
Employees at year end	5,805	5,735

* Based on U.S.G.S. provisional records and subject to adjustment.

Contents

As a special service, SRP is making this Annual Report information available through the Arizona State Library for the Blind and Physically Handicapped, 1030 N. 32nd St., Phoenix, AZ 85008, (602) 255-5578.

To Our Shareholders and Bondholders:

The past fiscal year was filled with indicators of impending change—the threshold of a new era. The year also was filled with plans for managing the changes and forging an ever stronger bond with our customers and shareholders.

Included among the indicators of change were a slowing of the growth in numbers of electric customers and increasingly aggressive steps of various energy suppliers to gain additional markets.

In response to these and other changes, Salt River Project took a number of important steps to continue to achieve its corporate purpose of providing reliable and adequate water and energy at the lowest reasonable price and in a publicly responsible manner.

These steps included delaying the in-service date of Coronado Generating Station Unit 3 until 2004; signing contracts for existing low-cost energy; implementation of a strategic direction plan; and continuing to add new demand-side programs which encourage customers to shift energy use to off-peak hours.

We expect reduced energy use will postpone the need to build expensive generating stations in the future. Postponing the in-service date of Coronado Generating Station Unit 3 will defer $470 million in construction costs.

Our shareholders and customers also benefitted from an existing low-cost energy surplus when we signed contracts for 100 megawatts of power each from Tucson Electric Power Co. and the Arizona Electric Power Cooperative. The purchases are expected to save $185 million—in today's dollars—between now and 2004.

Palo Verde Nuclear Generating Station Unit 3 began commercial operation February 1, 1988. Since SRP is a 17.49 percent owner in the nuclear plant, additional inexpensive nuclear power became available to us.

Accordingly, we increased our nuclear energy use from 12.4 percent for fiscal year 1986-87 to 16.4 percent in fiscal year 1987-88.

During the year Palo Verde Nuclear Generating Station Unit 3 set several world industry records, including the record for the longest continuous run—the greatest number of days on line (181.5 days)—by any American-manufactured nuclear plant in the world during the first year of operation. And Unit 3 also set three U.S. nuclear industry standards for operating performance during the year.

The start-up of Palo Verde Unit 3 contributed to the reduction of our net revenues for the year, however. Accounting transactions related to the start-up of the third unit means we began listing financing costs as expenses rather than allowance of funds used during construction. At the same time SRP began recording depreciation, operating and maintenance expenses for the unit.

As a result, net revenues were $16.3 million for fiscal year 1987-88, a decrease of 78.2 percent from $74.8 million for fiscal year 1986-87.

As part of SRP's financial plan, last year we made four trips to the municipal bond market and conducted an investor information program for 100 leading bond buyers. Also, we raised electric rates for the first time in two years and formalized a five-year financial plan.

In working with the changes SRP and the utility industry is experiencing, we decided to adopt a formal strategic direction plan. It is a product of a two-year management study to establish our direction for the next 20 to 25 years, focusing on SRP's role as a major public power utility and water supplier. (In January we began serving our 500,000th electric customer, making SRP the third-largest public power utility in the nation.)

The plan's key elements include a reaffirmation that the primary business of SRP will be water and energy services.

SRP will not seek to expand either its water or electric-service areas, but instead will plan to continue to pursue activities complementary to our main business objectives, such as water conservation, groundwater recharge, water quality and demand-side programs.

These activities always have been important to us. Our water conservation efforts decreased lost-and-unaccounted-for water to below 10 percent last year for the first time. This means we're already in compliance with the 1980 Groundwater Management Act requiring lost-and-unaccounted-for water to decline to 10 percent by 1990.

And our strategic direction calls for us to intensify programs to become closer to water and electric customers to best meet their specific needs. Also, the plan recognizes that if SRP is to remain a low-cost producer of electricity, we must intensify programs to improve efficiencies and contain costs.

We'll continue to evaluate other types of business activities on a case-by-case basis where a reasonable net revenue return will help hold down rates for power and water.

At the same time, we intend to continue our high quality of customer service, remaining competitive in our area and enhancing our market. Our electric customers' needs and choices will determine SRP's actions. We want our services to be available at a better price than competing energy services.

SRP will continue to develop a "balanced strategy" for energy supply and services that will include utility and customer resources, and other resources which evolve as our customers' requirements change.

Once again, our 5,805 employees were essential in laying a solid foundation for our success. They met the challenges of change and maintained a level of service to customers and shareholders that represents leadership among comparable utilities. In the coming years, our employees will continue to play a large role as they implement the practices designed to make SRP as efficient as possible.

Officers

Elected Officers

John R. Lassen *President*

Marcel J. Boulais *Vice President*

Principal Officers and Other Executives

A.J. Pfister *General Manager*

John R. McNamara *Associate General Manager, Corporate Engineering and Power Group*

Robert J. Conlon *Assistant General Manager, Corporate Engineering*

John H. Steffen *Assistant General Manager, Power Construction & Maintenance (replaced Trent Meacham, who retired January 18, 1988)*

John O. Rich *Assistant General Manager, Power Operations*

D.S. Wilson, Jr. *Associate General Manager, Water Group*

Richard Juetten *Assistant General Manager, Water Resources & Services*

Robert W. Mason *Director, Water Group Management Staff*

Don G. Parlett *Associate General Manager, Corporate Services Group*

Paul G. Ahler *Assistant General Manager, Human Resources*

James L. Swartz *Assistant General Manager, Operations Services*

Carroll M. Perkins *Associate General Manager, Financial & Information Services Group*

John D. Jacobs *Assistant General Manager, Information Systems*

Mark B. Bonsall *Corporate Treasurer, Financial Services*

Leroy Michael Jr. *Associate General Manager, Planning & Resources*

Arnold L. Schwalb *Director, Corporate Planning*

Darrell E. Smith *Director, Resource Planning*

Oren D. Thompson *Assistant General Manager, Communications & Public Affairs (replaced Stanley E. Hancock, who retired March 31, 1988)*

D. Michael Rappoport *Assistant General Manager, Government Affairs*

Richard H. Silverman *Assistant General Manager, Law & Land*

C.A. Howlett *Assistant General Manager, Customer Services & Marketing (formerly Assistant General Manager, Special Projects)*

Paul D. Rice *Corporate Secretary*

(From left) Salt River Project Vice President Marcel J. Boulais, President John R. Lassen and General Manager A.J. Pfister.

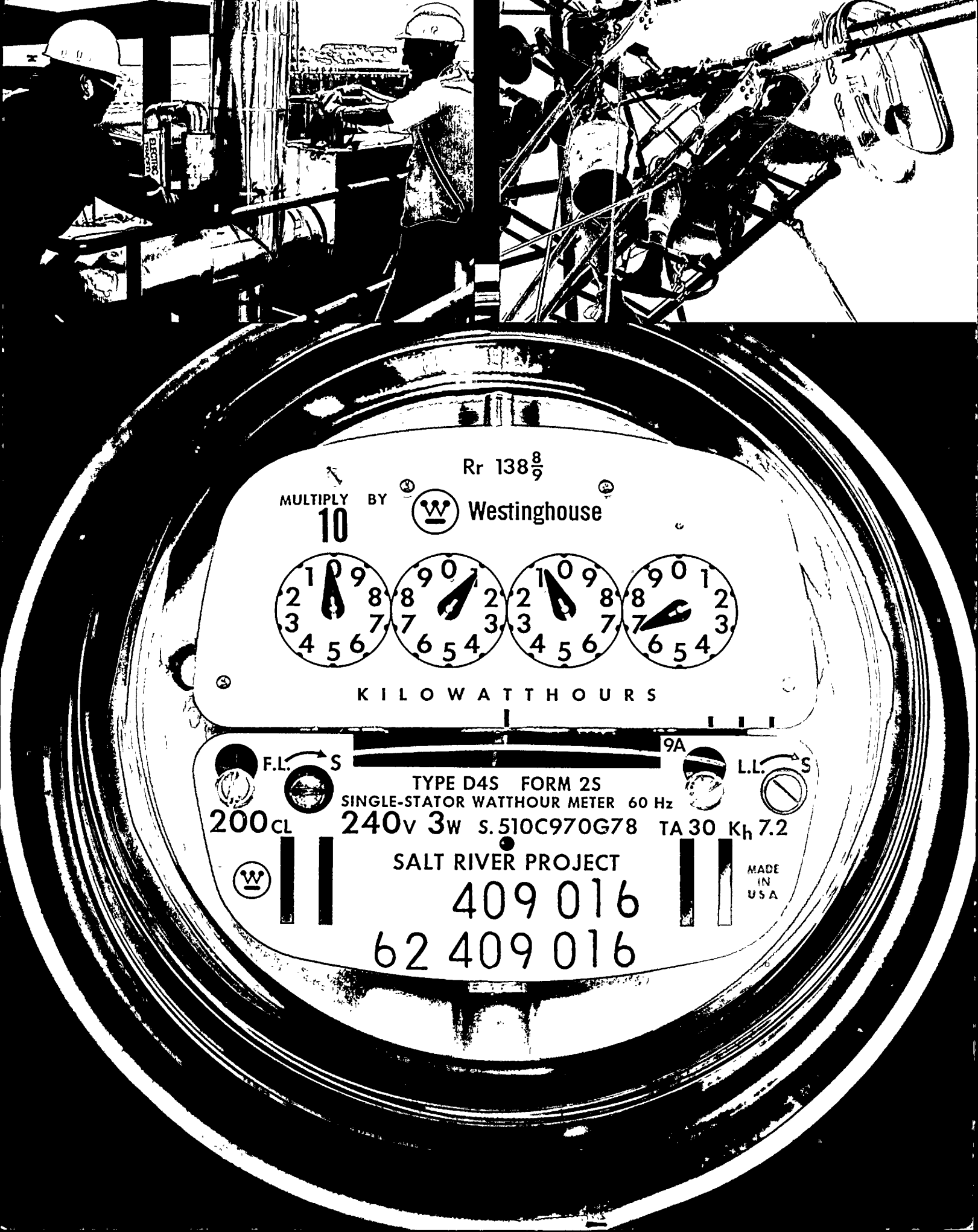
Consultants

Legal Advisers Jennings, Strouss & Salmon

Auditors Arthur Andersen & Co.

Bond Counsel Mudge Rose Guthrie Alexander & Ferdon

Financial Consultant Lazard Freres & Co.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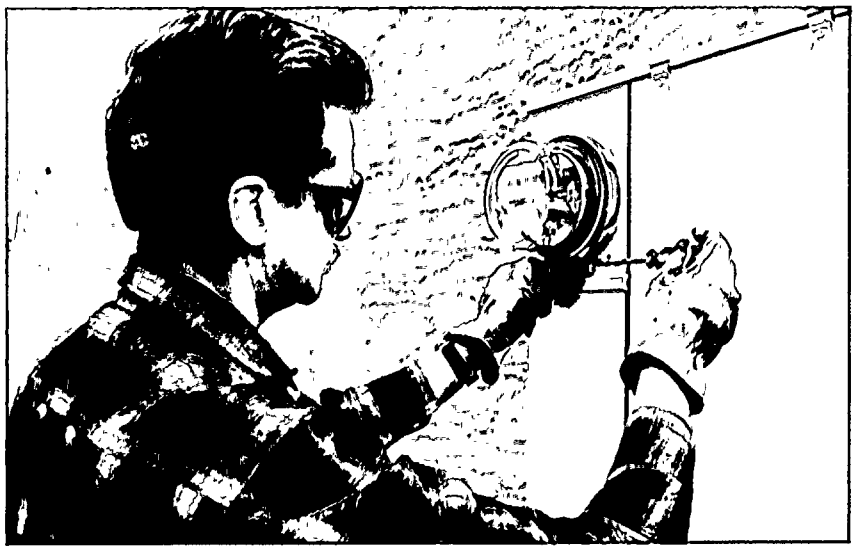
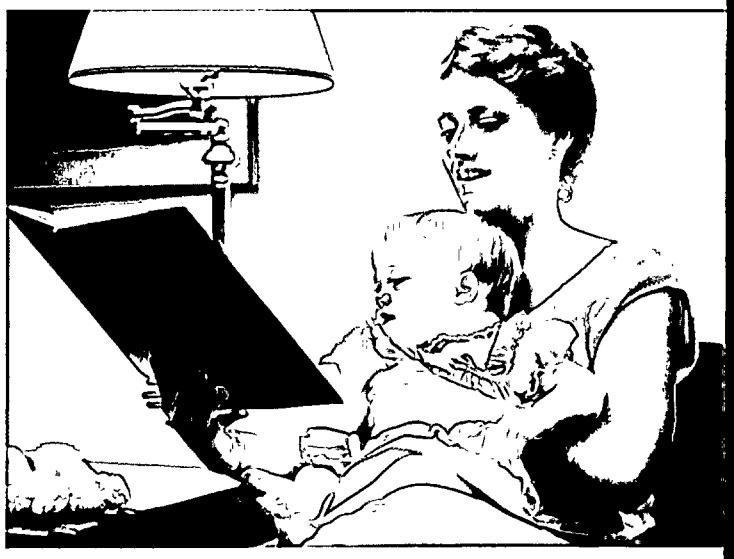




Power: planning for more than megawatts

When Kurt and Jackie Seifert moved to Phoenix from Denver in November they didn't expect that their family would become a statistical milestone for Salt River Project.

But as SRP's 500,000th customer, the Seifert family was honored in January with a special electric meter and a SRP minibond.

The Seifert family was one of 18,297 customers added to the Project's electric system during the fiscal year. By April 30, SRP had a total of 505,618 customers.

The utility had added about 30,000 customers per year each of the four previous years. To meet the heavy demand caused by such rapid growth, the Project had been adding generating capacity to its system by constructing the third unit at Coronado Generating Station in St. Johns and participating in construction of the Palo Verde Nuclear Generating Station west of Phoenix.

And, during fiscal year 1987-88, SRP constructed five new distribution substations, added additional capacity at nine existing substations, and installed 250 miles of new distribution line.

SRP supplies electricity to three Arizona counties from six coal-fired power plants, six hydroelectric facilities, four natural gas-powered generating stations and one nuclear generating station. Navajo Generating Station, (top left) produces electricity which is carried on 230-kilovolt transmission lines to substations. During the year SRP sold a total of more than 16.3 billion kilowatt-hours (kWh), an increase of 4.9 percent. The average cost for residential customers was 7.66 cents per kWh. Electrical demand by customers reached a new peak of 2.8 million kilowatts.

However, with the recent downturn in customer growth, SRP management began making some changes. While Arizona still is expected to grow faster than the rest of the nation, management is expecting to see the effects of the "baby bust generation," the national slowdown in the birthrate that began in 1964.

That means a slowdown in the rate new households are added to the utility's power lines. Even with the slowdown, SRP expects to add about 200,000 more electric customers by the year 2000. That's an average of 16,600 customers per year.

SRP also expects increased competition among energy providers due partially to increased deregulation and further conservation efforts by electric customers.

The Project is planning a "balanced strategy" for supply and demand. The supply side includes delaying the in-service date of Coronado Generating Station Unit 3 for 13 years and signing purchase power agreements with other utilities. The demand side includes new programs, some of which encourage customers to shift energy use to off-peak hours. The utility hopes to use these programs to reduce customer load by about 350 megawatts (MW) throughout the next 10 years.

Palo Verde Unit 3 begins operation

February 1, 1988 marked the first day of commercial operation of Palo Verde Nuclear Generating Station's Unit 3. Unit 3 was the final unit of the three 1,270 MW units to begin operation. The completion of Palo Verde Unit 3 gives SRP a total of 641 MW of nuclear power and a total installed generating capacity of 3,934 MW.

Unit 3 set several industry records during its six months of commercial operation. It holds the record for the longest continuous run—the greatest number of days on line—by an American-manufactured nuclear plant in the world during its first year of operation. Unit 3 exceeded the 181.5-day record on June 30, 1988 and continues daily to set the record in that category.

Other records include three for U.S. nuclear industry standards for operating performance, including: the longest continuous run by any large nuclear generating unit of more than 1,000 MW in the U.S. during the first year; highest in the nation in electrical output in March with 995,400 megawatt-hours; and successfully completing all required system checks and entering commercial operation in less time (43 days) than any other nuclear unit in the nation.

Also, Palo Verde Nuclear Generating Station received the country's highest engineering

honor last year, the Outstanding Engineering Achievement Award. The station was one of six oustanding engineering achievements honored by the National Society of Professional Engineers.

Although SRP's nuclear capacity increased with Palo Verde Unit 3 in operation, coal remains SRP's most-used fuel. Coal provided 64 percent of the Project's energy requirements during the past fiscal year. Nuclear fuel provided 16 percent, hydroelectric generators, 8 percent, natural gas, 6 percent and purchased power, 6 percent.

SRP uses natural gas instead of fuel oil whenever gas is available and the price is competitive.

Board delays completion of Coronado Unit 3 until 2004

During the fiscal year, SRP continued to examine its energy options and concluded, due to energy surpluses in the region, the utility could purchase long-term power for less money than it would be able to produce power at Coronado Generating Station Unit 3. Instead of continuing with the construction schedule, the SRP board voted in February to sign long-term purchase power contracts and delay the in-service date of Coronado Unit 3.

SRP signed contracts for 50 MW each from Tucson Electric Power Co. and the Arizona Electric Power Cooperative. Deliveries begin in 1990. The power purchases increase to 100 MW from each utility in 1991. The purchases are expected to produce a savings in today's dollars of $185 million between now and 2004, and would defer about $470 million in construction costs.

"Continuing construction of Coronado Unit 3 would make us just one more utility with excess power in the Southwest," explained General Manager Jack Pfister. "Sometimes it's better to buy than to own."

Buying power from other utilities also means SRP will borrow less for construction during the next five years and will be better able to maintain a favorable financial position. This will result in lower interest payments on its long-term debt for SRP and lower rates for its customers.

Demand-side management keys to customer needs

The Seiferts and other electric customers may benefit from new "demand-side" services being offered by SRP. The services provide choices for customers and allow the utility to delay the need to invest in new generation such as Coronado Generating Station Unit 3.

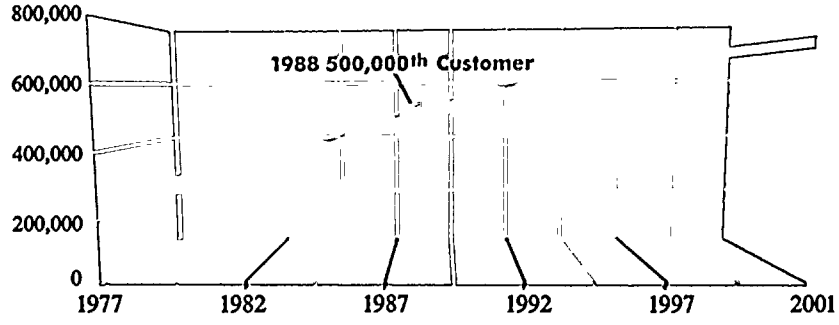
Some utilities are using demand-side planning to cope with uncertain load growth, rising fuel and construction costs, and assorted regulatory and environmental constraints.

At SRP, existing and new programs are under study to help customers make the best use of electricity. These programs are closely aligned with customer needs and save money for all customers by reducing overall costs of providing electricity.

Programs already in effect at SRP include:

- Heat pump incentives that pay up to $400 to SRP customers who replace inefficient central air conditioning systems or gas furnaces with high-efficiency electric heat pumps.
- Electric Savings Time, which is being offered as an opportunity for residential customers to reduce their electric bills. The Electric Savings Time program encourages customers to shift their use from

Electric Customers
(all classes)



Kurt and Jackie Seifert were SRP's 500,000th customer. To celebrate the occasion, SRP President John Lassen, (left) presented the Seiferts with a clock and an SRP minibond in January. The Seifert family was one of more than 18,000 customers added to the Project during the fiscal year.

the expensive peak period to the less expensive off-peak period.

- Energy Efficient Homes, which have stringent building and appliance efficiency standards to help keep demand for electricity at manageable levels. The EEH program is a marketing tool for builders of total-electric homes.
- Thermal energy storage systems, which chill water or make ice at night to provide cooling during the day, move electric loads to off-peak periods. SRP provides financial incentives to assist commercial and industrial customers in the installation of these systems.
- Commercial lighting, aimed at improving business office lighting efficiency. Incentives began being offered in June 1988 for owners of new and existing buildings who upgrade the efficiency of their lighting systems.

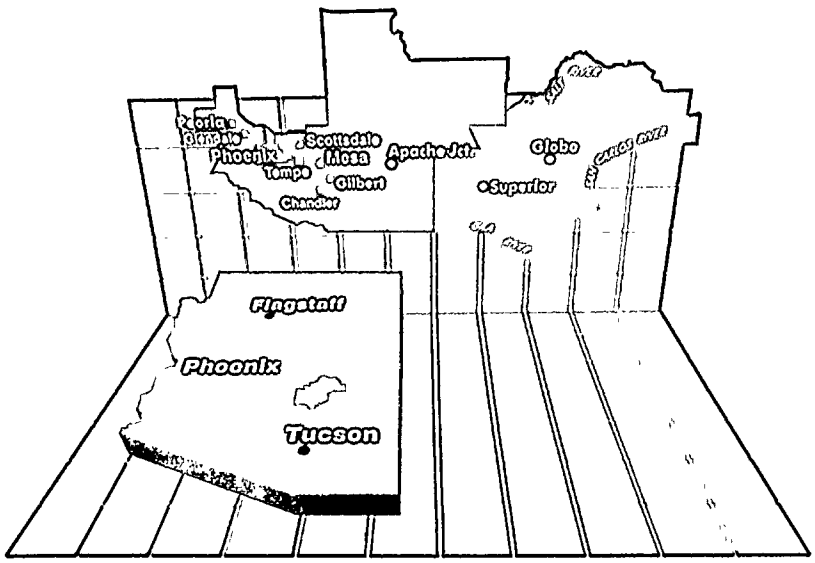
SRP has developed an analytical framework to plan, evaluate and fine-tune the programs. Planners are using a software package developed by a private company under contract with the Electric Power Research Institute (EPRI) in Palo Alto, Calif. SRP is a member of EPRI. The software enables simulation of various programs to predict how they would effect SRP and its customers. When the demand-side strategy is completely implemented, it will offer customers a menu of options from which they can select to help them live comfortably and use energy wisely. The menu will change periodically in response to customer needs.

New headquarters construction continues

Construction continues on the first phase of SRP's new 38-acre headquarters in north Tempe. Sundtcorp., the construction manager, broke ground in early 1987 on the first building at the site. That facility—the information systems building which will house the Project's entire computer system and staff—is scheduled to be finished in the spring of 1989.

SRP will open another 440 acres in the area, called the Papago Park Center, to private, commercial development and use the resulting revenues to help offset the costs of providing electricity to SRP customers.

Salt River Project Electric Service Area



- Electric Service Area Served Exclusively by Salt River Project.
- Salt River Project Provides Full Power Requirements of Arizona Public Service for Resale.
- Salt River Project Provides Full Power Requirements of Arizona Public Service for Resale. Project Makes Direct Sales to Customers for All Mining Loads
- Electric Service Areas Not Served by Salt River Project.

Work continues on Service Centers

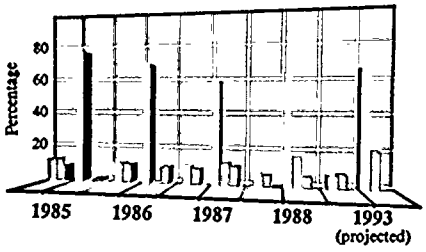
To speed service in SRP's service area, the utility is continuing to build regional service centers. The East Valley Service Center is scheduled for occupancy in the fall of 1988. The center will be the focus of operations for more than 450 SRP employees.

The Fountain Hills Service Center was completed in July 1988. It is home base for employees who install new electric service area and maintain, improve, and enhance existing service.

The goal of all SRP service centers is better customer service to Project customers. By locating large and complete facilities closer to customers, SRP is able to serve customers' faster through reduced travel time.

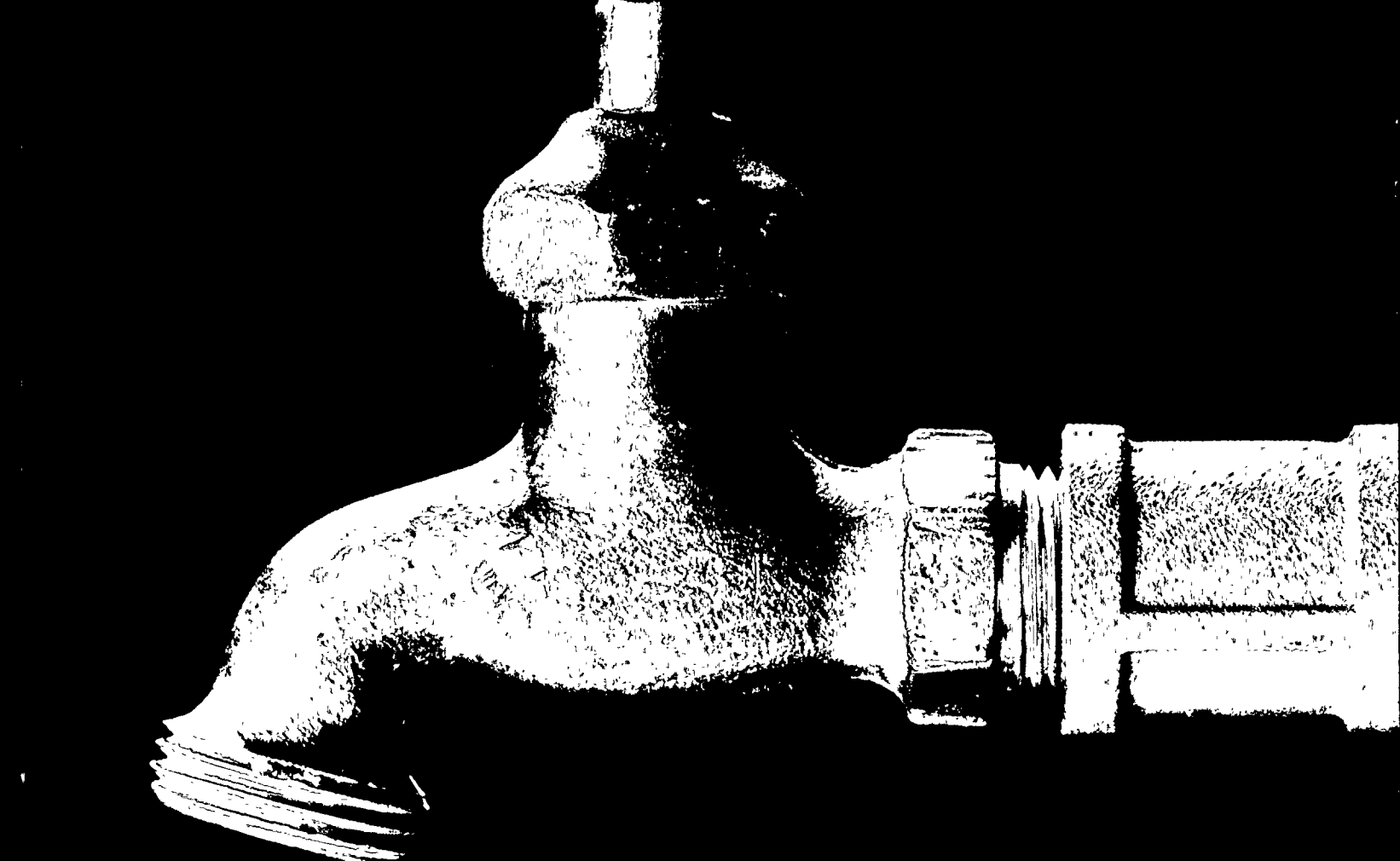
It's part of an ongoing plan to locate the utility's service personnel closer to where they're needed the most. Similar service centers, such as the West Valley Service Center (completed in 1986) and the Tempe Service Center (completed in 1983) have increased customer service and satisfaction.

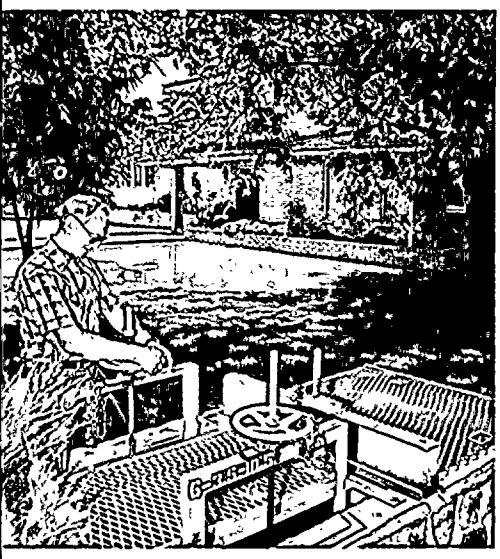
Energy Sources



- Hydro*
- Coal
- Gas
- Nuclear
- Oil
- Misc. Purch.

**includes hydro purchases*
(All numbers in percentages)





Water in the desert: always important, never certain

SRP is planning future water needs today. During 1987 SRP's water managers were actively involved in artificial groundwater recharge, water rights settlements, water supply and demand studies, and water conservation activities.

SRP studies groundwater recharge

With pumping restrictions required by Arizona's 1980 Groundwater Management Act and a steadily declining groundwater table, artificial groundwater recharge is looking more and more appealing to SRP.

Groundwater recharge can provide a supplemental water supply, additional water storage and insurance against drought.

Although eight of the past 11 years were wetter than usual, dry years are far more common in Arizona. In most years, groundwater provides one-third of SRP's supply.

During 1987 SRP began cost-sharing negotiations with the Arizona Municipal Water Users' Association (AMWUA) for the proposed Granite Reef Storage and Recovery Project. AMWUA, a coalition of eight Valley cities, and the Salt River Pima-Maricopa Indian Community will share the costs and benefits of the pilot groundwater recharge project with the Project.

SRP was an active participant in negotiations resulting in a historic water rights agreement with the Salt River Pima-Maricopa Indian Community. The agreement, signed by most parties Feb. 12, 1988, will substantially increase the water supply to the Indian community. The signing also removes some of the uncertainty regarding future water supplies for SRP, seven Valley cities, the Roosevelt Irrigation District and the Roosevelt Water Conservation District.

Arizona's Congressional delegation is supporting the agreement by introducing federal legislation to fund the accord. If approved and funded by Congress, the Pima-Maricopa agreement will provide up to 122,400 acre-feet (af) of water per year for the 51,000-acre community, located east of Phoenix. At present, the community receives about 35,000 af per year for use on more than 11,000 acres.

It's a long journey to the water taps. Melting snow and rainfall drains from a 13,000-square-mile watershed to six reservoirs on the Salt and Verde rivers. As needed, the water is sent through a system of canals and laterals to farms, cities and residential customers. SRP is committed to water conservation. The Project lines canals and laterals with concrete and conducts community education projects on conservation to reduce water losses.

Good water year leaves reservoirs almost full

Above-average precipitation left SRP's reservoirs almost full at the end of 1987. (Water statistics are based on the calendar year.) This assured a substantial supply of water for the eight Valley cities and agricultural community which SRP serves.

Runoff into SRP reservoirs totaled 1,120,034 af during the year, which was 91 percent of the 30-year normal and 83,229 af more than 1986. As a result, SRP's six reservoirs contained 1,624,272 af at year-end, which was 80 percent of capacity but 125 percent of the 30-year normal. During two periods totaling 31 days, runoff outpaced water orders and caused SRP to release 29,778 af of water past Granite Reef Diversion Dam into the normally dry Salt River.

Water deliveries to cities and other non-agricultural users continued to increase as more farmland was taken out of production and developed for urban purposes. Since 1984, more than half of SRP water deliveries have been for municipal and industrial uses instead of agriculture.

During the past year deliveries for urban uses totaled 417,914 af, while deliveries for agricultural purposes totaled 336,527 af. During the previous year, urban use totaled 395,158 af and agricultural use was 290,572 af.

A total of 3,501 acres was removed from agricultural use during 1987. By year's end, 70.1 percent of the 238,170 acres of SRP member lands was urbanized while 29.1 percent was used for agriculture.

During a time when public attention is focused intently on ways to better use and conserve the valuable resource of water, SRP is seeking ways to improve the efficiency of urban water deliveries through two separate studies.

In 1987 a study team began examining the way SRP delivers approximately 110,000 af of flood irrigation water to more than 27,000 urban irrigators. The team believes prudent conservation in urban irrigation could result in significant water savings. A 10 percent decrease in water usage could produce annual savings of enough water to serve nearly 50,000 people. And the water's value could be more than $1.5 million if compared to the cost of new conservation storage of modified Roosevelt Dam, estimated at $150 per af.

The study is expected to be completed in the late summer of 1988. It includes determining how efficient urban deliveries are now and comparing SRP's delivery method to other irrigation techniques. Researchers also are studying what actions can be taken to improve efficiency and examining the possible uses of other urban irrigation conservation measures.

In SRP's second water study, the Well Utilization Plan, the consulting firm of Camp, Dresser & McKee is helping the Project develop a 20-year management plan for the ultimate use of each of SRP's 246 wells. Engineers also will define the first five-year operations plan to target specific high-priority wells for refurbishment, repair or retrofit.

The Well Utilization Plan is needed because many of SRP's wells were developed between the 1930s and 1950s for agricultural water deliveries and cannot be used efficiently today for urban deliveries.

As SRP's water service area becomes fully urbanized, the Project will need to manage both surface and groundwater supplies to meet the needs of all water users. Supply and demand studies indicate SRP will need to maintain a minimum pumping capacity of 400,000 af a year to meet agricultural and urban needs during drought periods.

SRP is recognized as a world leader in water management. The Project's Office of International Affairs hosted a record 680 visitors from 50 nations in 1987, including this group of Egyptians touring Roosevelt Dam under the direction of Larry Lambert, SRP senior consulting engineer. During the office's fourth year of operation, 240 foreign technical personnel took part in nine on-the-job training programs and six seminars.

Groundwater below SRP's three landfills in the Salt River bed is free of contamination. The conclusion is based on more than two years of tests. SRP initiated the voluntary tests in August 1985 based on a commitment to assure water supplies are safe for use.

Early studies included soil gas surveys and visual inspections. The surveys showed low levels of organic vapors in the soil at all sites. The inspections revealed the landfills contained construction and maintenance debris, broken concrete, tree trimmings, lumber, silt, and other material.

SRP sent a final report about its landfills to the Arizona Department of Environmental Quality in December 1987.

SRP reduces water losses

Hard work and a lot of concrete is saving water. For the first time, lost-and-unaccounted-for water dropped below 10 percent. During 1987, lost-and-unaccounted-for water was 97,277 af, or 9 percent of SRP's total water diversions and pumping. Water losses have declined each year from 23 percent in 1978 to 12 percent in 1986.

The latest decline means that SRP complies with a mandate from the Arizona Department of Water Resources to reduce lost-and-unaccounted-for water to 10 percent by 1990. The reduction is primarily due to continued lining and maintenance work in SRP's canals, improved measurement facilities, and more efficient management of water deliveries.

A total of 5.67 miles of canals were lined in 1987, and 14.41 miles of laterals were either lined or piped. To date, SRP has lined 97 miles of its 133 miles of major canals and lined or piped 807 miles of its 899 miles of distribution laterals.

Beyond supply-side conservation, SRP remains committed to wise end-use of water. One example is SRP's involvement in the "Desert House," a home that will showcase water and energy conservation ideas for the Valley.

"Desert House" is a project sponsored by SRP, the University of Arizona, the city of Phoenix, the Desert Botanical Garden, Arizona Department of Water Resources and the Valley Partnership, a group of development-related organizations in the Valley.

The city of Phoenix and SRP each have contributed $15,878 for

the research and design phase of the project. The University of Arizona's Office of Arid Lands Studies and the College of Architecture are working on the design.

Another conservation activity includes SRP's involvement with a xeriscape (low-water use landscape) garden, being built at Mesa Community College (MCC). The garden will be opened in the fall of 1988. SRP entered into a $20,000 contract with MCC to research landscape water use.

The garden is designed as a demonstration of outdoor water conservation for the general public and as a research project for MCC faculty and students.

Recreation activities may increase along SRP canals

Cities and developers are looking at SRP's canals as excellent opportunities for recreation and commercial development. During 1987, SRP began preparing to permit multiple use of SRP's canals and canal rights of way.

Municipal governments, special interest groups and local agencies have received draft copies of canal use guidelines for comment. Final guidelines are expected to be released in August 1988.

The adoption of multiple-use guidelines will permit the use of SRP's canals and canal property by Valley communities, developers, planners and special interest groups. Commercial possibilities for multiple-use of SRP canals could include restaurants, cafes, vendors, outdoor advertising, parking, commercial recreation and boating. Recreation uses could include parks, cultural exhibits, jogging paths, horseback riding, bicycling and fishing.

For several years SRP has beautified its canals, canal structures and wellsites to make those structures aesthetically pleasing to the community. Last year 10 miles of SRP's Western Canal and five miles of the Consolidated Canal were beautified. Maintenance continued on sections of the canals beautified earlier.

Of SRP's 246 wellsites, 88 are now beautified. Work on these wellsites include designs which blend into the surrounding area.

Fish to keep SRP canals clean

SRP will be one of the first to use a new state law that allows special weed-eating fish in selected canals. SRP has applied for a permit from the Arizona Game and Fish Department to test the use of triploid white amur fish in sections of the canal system. Commonly called grass carp, the fish can eat their own weight daily in aquatic weeds.

SRP currently spends about $1.6 million annually to control aquatic weeds in SRP canals. Grass carp could control the vegetation for approximately a tenth of that cost and, at the same time, reduce the water loss caused by weed growth.

Use of the fish on a trial basis will begin in the summer of 1988.

Work began in 1987 for a new spillway at Stewart Mountain Dam on the Salt River. The first phase of construction is expected to be finished by next February. When all work is completed in the summer of 1990, the new spillway will provide increased dam safety.

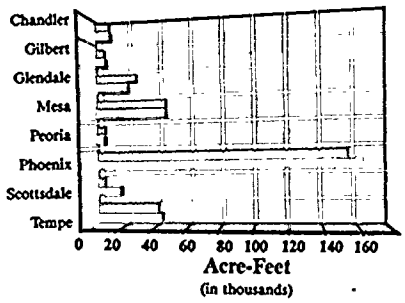
Stewart Mountain Dam has the smallest spillway capacity of SRP's dams on the Salt River. The dam's safety was in question in early 1980 when flooding threatened to overtop the dam.

Channel excavation for the additional spillway on the dam's west side began May 1987. When construction is completed, the new spillway will be able to pass flows of up to 94,000 cubic feet per second (cfs), in addition to flows of up to 120,000 cfs that can pass safely through the existing spillway.

At Roosevelt Dam, work is underway to construct a new bridge on the lake side of the dam and to raise the overall height of the dam by 77 feet. The bridge should be completed in 1990 and the higher dam in 1994.

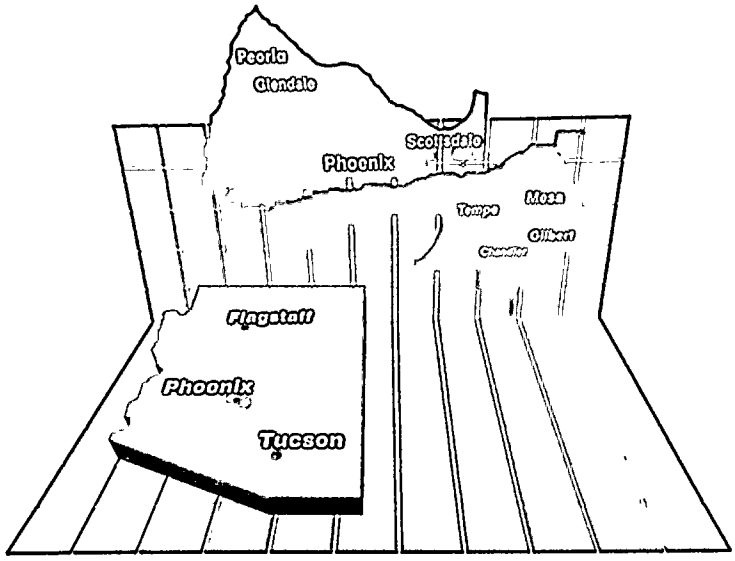
The changes to the appearance and purpose of Roosevelt Dam are in accordance with Plan 6, the preferred choice among nine flood control and regulatory storage options developed by the Central Arizona Water Control Study. The modified Roosevelt Dam will provide flood control, dam safety and additional water conservation storage on the Salt River.

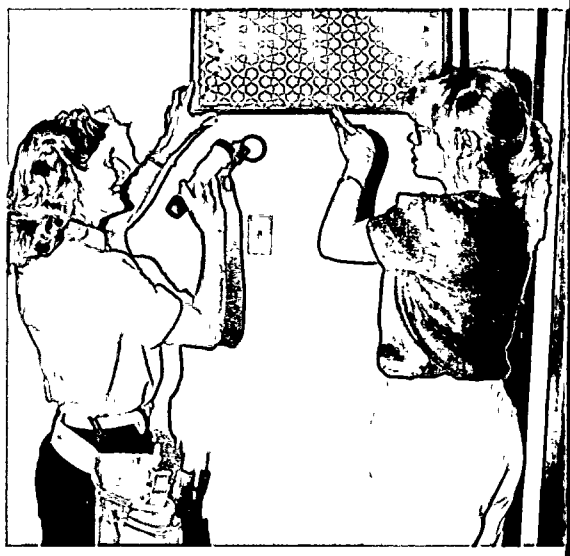
Domestic Water Deliveries



☐ 1986 ☐ 1987

Salt River Project Irrigated Area





SRP services benefit communities and customers

Salt River Project and its employees do more than supply water and power. Through educational programs, tours and donations in both time and money, employees aid the communities where SRP facilities are located. They also show a deep concern for their heritage.

Archeological site educates public, SRP

Following a longstanding company policy, archeologists probed the site designated for a new electric substation. In the process, they discovered an ancient Hohokam Indian community. The discovery lead to an extensive archeological excavation by SRP archeologists and a hired consulting team.

The two-month investigation determined the site is part of the 1,000-year-old La Ciudad de Los Hornos, Spanish for "City of Ovens." More than 4,000 members of the public toured the site during the archeological work, which yielded a rare argillite stone ax, cooking vessels, arrowheads, paint palettes and other artifacts.

SRP's cultural resource policy goes beyond legal requirements. Not only are state and federal lands subject to an archeological clearance, but it is SRP's policy to survey and mitigate its own lands for cultural resources before any construction can begin.

Archeological Consulting Services discovered the Hohokam village in November 1987 while performing archeological clearance testing at the substation site for SRP. The Hohokam were the developers of a complex canal system, the basis of SRP's present-day irrigation system.

The archeological tour was just one example of the many informational programs sponsored by SRP. Last year SRP's Speakers Bureau employee volunteers talked to more than 73,000 members of community groups about SRP's resource management, Project history, Arizona water rights, and energy and water topics. The utility also provided about 155 public tours of SRP canals, dams, power plants and other Project facilities; about 23,000 people took part.

During the year more than 138,000 students and teachers learned about water safety, electrical safety, energy sources, electricity generation, and water and energy conservation from SRP's educational services staff. In addition, SRP gave about 40 tours to school groups totaling more than 1,000 people.

Also, nearly 23,000 people visited SRP's Silva House museum in Phoenix's Heritage Square. Almost 8,000 others toured SRP's History Center at SRP headquarters in Tempe. There, the Valley's water history and operation fundamentals were on public display.

Contributions benefit community organizations

SRP makes corporate contributions to state organizations such as the United Way, the American Cancer Society (Arizona chapter), the Easter Seal Society, the March of Dimes and the Arizona Lung Association. Employees also donate through payroll deductions. Last year SRP employees donated a total of $326,954 to 57 nonprofit agencies in Arizona.

As a result, the Cystic Fibrosis Association of Arizona recognized SRP's Valley Employees' Boosters Association as the largest employee group contributor during 1987. SRP employees gave more than $6,000 of the total $135,000 donated in Arizona to the Cystic Fibrosis Association for the year.

Customers of SRP and Arizona Public Service Co. contributed $351,705 to the utility bills of the elderly, jobless and handicapped through the S.H.A.R.E. program (Service to Help Arizonans with Relief on Energy). Of that amount, $133,475 was from SRP and its customers. The Salvation Army disburses the funds.

SRP's interest includes a deep respect for the state's culture and environment. This concern is evident as SRP archeologists carefully excavate proposed construction sites before any tools of the past are lost. These findings also make interesting history lessons for Valley students. Projects such as community cleanups, althletic competitions and home energy efficiency inspections make SRP a community leader.

Degradable litter bag big hit

A new degradable litter bag stole the show at this year's "Page Attacks Trash" cleanup campaign. The annual cleanup campaign featured the degradable cornstarch bags, which will decompose 18 months from production. Ordinary plastic bags take at least 100 years to decompose.

More than 5,000 citizens used about 43,000 of the 40-pound capacity litter bags to collect about 400 tons of trash. In addition to the bags' use at "Page Attacks Trash," SRP bought more than a half million of the degradable bags to give to customers and other Arizonans throughout the year to help keep the state clean.

The city of Page, the Page Kiwanis Club, the Page Elks Lodge and Navajo Generating Station employees sponsored the eighth annual "Page Attacks Trash."

Navajo Generating Station also donated $2,000 to the Boy Scouts of America to train leaders, establish new scout units and to defray costs and maintenance for Camp Raymond, a summer camp near Flagstaff. Almost 300 boys, ages 6 to 18, belong to units in Page.

At Coronado Generating Station, employees raised $1,700 for the St. Johns Senior Citizens through the station's 10,000-meter fun run, which drew 700 participants.

An employee of the Navajo Generating Station was one of many Project employees who donated their time, not to mention their blood, for a statewide blood drive.

Participation in SRP's incentive program for high-efficiency heat pumps and air conditioners increased, with more than 4,000 customers replacing their old equipment with newer, more efficient units. Of the total, about 580 customers replaced old gas furnaces with new heat pumps.

Because of the new units' high efficiencies they use less power than the old units. As a result, SRP is able to serve more customers and delay the need to build new generators. Defering such expenses helps hold down rates to Project customers.

Incentive payments totaled more than $812,000.

The Better Way Program is another cost-saver for the utility and its customers. Employees' suggestions saved the company more than $1 million in the past two years. By reducing operating costs, employees help hold down rates for SRP customers.

One example of a cost-saving idea came from a field service representative who's idea eliminates the need for duplicate meter readings. Mike McBride's suggestion also provides better customer service and saved SRP $118,300 during the first year of implementation.

McBride found there were an average of 1,600 occasions each month when a field service representative and a meter reader were given an order to take a meter reading at the same location on the same day, but for different purposes. McBride realized a computer program could be written to identify and avoid the need for duplicate readings.

As a result of his idea, a meter reader now completes the service call, thereby eliminating the extra trip by a field service representative. The customers benefit from a more timely response time, while the representatives benefit by having more time to perform other work.

Operating costs also are reduced through SRP's Quality Circle program. The program involves those employees who are most directly involved with day-to-day operations to point out problems and recommend solutions. Recommended changes save time and money.

SRP also offered free personal computer protection seminars, power saver workshops and energy audits throughout the year as a community service to SRP customers. Energy audit representatives made personal visits to SRP customers' homes, giving evaluations of customers' energy usage and tips for decreasing their power requirements. More than 1,800 customers received home energy audits last year.

Taxes benefit communities

As the state's third largest property taxpayer, SRP continued to benefit the communities where its electric facilities are located. Last year SRP contributed about $53 million of in-lieu property taxes to seven Arizona counties.

Under special legislation passed in 1963, SRP, a political subdivision of the state, makes voluntary contributions in-lieu of property taxes to school districts, cities, special districts, counties and the state. Payments, which are based on the value of SRP's electric facilities in each county, are computed with the same formula used for investor-owned utilities.

Outstanding students receive support

Each year SRP sponsors several scholarships to deserving engineering, business and agricultural majors. In addition, SRP contributes to Hispanic scholarship funds and to a scholarship fund at Grand Canyon College.

One such award winner is Kurt Wilhelm, 18, of St. Johns High School. The 1988 Coronado Generating Station engineering scholarship will pay for his college expenses at Arizona State University beginning this fall. He is the seventh recipient of the Coronado Generating Station scholarship program, which began in 1982 and is offered to St. Johns High School seniors.

The scholarship includes an option for paid summer employment at the station.

Sixty-two high school seniors were honored at the sixth annual "Spotlight On Excellence" recognition dinner. Honored students were graduating seniors from Maricopa County, Page and St. Johns, areas in which SRP owns or operates facilities.

For younger students, SRP hosts the annual Energy Fair. This year students entered more than 180 energy projects from 36 different schools. Kelly Crandall, a fourth-grader at West Side Private School in Glendale won the grand prize.

The fair helps students develop an awareness of how energy fits into their daily lives.

Also, more than 3,000 posters were entered in SRP's annual Water Safety and Electric Safety poster contests.

Ten outstanding employees were honored for their service to civic and community organizations in Arizona through the Karl F. Abel Volunteer Spirit awards. The award is named for the retired SRP president who is active in numerous community and civic organizations. Each employee received a plaque and a $150 contribution to the agency of his or her choice.

Honored volunteer work included involvement in an employee's church; work with the Holiday Project (for the poor); the Center Against Sexual Assault (for battered women and children); Make-A-Wish Foundation (for terminally ill children); and work with the Arizona Special Olympics (for mentally retarded athletes).

SRP also recognizes volunteers in the community. Amy Nelson, 13, an eighth-grader at Orangedale Elementary School in Phoenix, was honored with SRP's fourth annual Young Adult Volunteer award for her work with the Southwest Human Development Head Start Program.

Kathy Shergalis, SRP public affairs representative, shows Valley school children that there is more to learn than reading, writing and arithmetic. Water and electrical safety, energy sources and water and energy topics were among the subjects the Project's educational services staff taught last year.

Employees support Junior Achievement, Explorer Post

SRP sponsored two Junior Achievement companies, the "Lites-N-Tee's" and the "D'Argent's" last year. Members of the Junior Achievement companies set up, operate and manage businesses of their own with the support and help of SRP employees.

The "Lites-N-Tee's" sold SRP meter lamps, travel lights and Arizona State University T-shirts. The "D'Argent's" sold oak paper-towel holders and cookie sheets.

SRP-sponsored Explorer Post 170 earned two post achievement awards and two individual merit awards during the year. The explorer post is a group of high school students interested in pursuing careers in science and engineering fields.

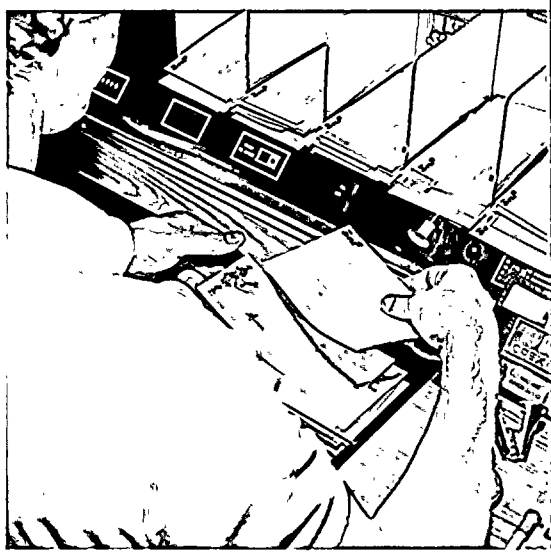
In addition, employees contributed to the community as members of 118 business and service clubs and non-profit organizations, while the Project was represented with membership in 381 trade, technical and non-profit community organizations.

For example: General Manager Jack Pfister is a member of the Arizona Board of Regents and serves on the board of directors of Arizona Clean and Beautiful. President John Lassen serves on the board of the Arizona 4-H Youth Foundation and the Arizona Groundwater Users Advisory Council. Vice President Marcel Boulais is a member of the Arizona Cotton Growers Association and the Arizona Farm Bureau.

Ed Kirdar, manager of SRP's Office of International Affairs, is a member of the board of directors of the World Affairs Council of Phoenix and first vice president of Arizona Teen Talent Search, Inc. Paul Rice, corporate secretary, is president of both boards of the Tempe Community Council and the Tempe Arts Center. Joe Tittle, manager of SRP labor relations, serves as vice president of the Goodwill board of directors and serves in the American Cancer Society Fund Drive.

Carletta M. Johnson, secretary, energy services, works with Friends of the Family (a counseling center); and Karen Boyle, tradeshelper, Coronado Generating Station, works with the American Youth Soccer Organization in St. Johns, Arizona.

They are representative of the involvement of many SRP employees.



Financial planning: a steady path through bears and bulls

It takes a lot of money to finance one of the largest public power utilities in the nation.

With more than $5.3 billion in gross utility plant, Salt River Project is ranked first among all public power utilities in the United States by the American Public Power Association. With more than 500,000 electric customers, the utility ranks third among U.S. public power systems.

In continuation of its financing program, last year SRP made four trips to the municipal bond market; conducted an investor information program for 100 leading bond buyers; raised electric rates for the first time in two years; and formalized a five-year financial plan.

An extensive study of the Project's future resource needs and changes in the regional resource market last year led SRP to defer the in-service date of Coronado Generating Station Unit 3 and enter into two long-term power purchase contracts with nearby utilities. This transaction is expected to yield substantial financial benefits to SRP.

The utility ended the fiscal year (FY) on April 30, 1988 with gross revenues of $959.3 million, an increase of 8.0 percent from $888.5 million in FY 1987. Operating expenses totaled $791.0 million, which were 12.0 percent greater than the $706.4 million in FY 1987. Net revenues were $16.3 million, a decrease of 78.2 percent from $74.8 million in FY 1987.

The decrease in net revenues was due primarily to the start-up of the three units of the Palo Verde Nuclear Generating Station (commercial operating dates for Units 1, 2 and 3 are January 30, 1986, September 2, 1986, and February 1, 1988, respectively). When the units began commercial operation, SRP began expensing financing costs rather than taking them as an allowance for funds used during construction. At the same time, the Project began expensing in-lieu taxes, depreciation, operating and maintenance expenses for the units.

Despite the decrease in net revenues, funds from operations remained very strong. SRP uses its funds from operations to help finance construction of electric facilities. As a public power utility, it does not issue stock or pay dividends.

SRP's future tied to municipal bond market

Funds from operations are not sufficient, however, to finance all the construction needed to serve customers. Plans call for the sale of bonds to finance much of the utility's construction and improvements to electric facilities.

SRP went to the bond market four times last year with issues totaling $559 million. Standard & Poor's Corp. and Moody's Investor Services rated all four issues "AA" and "Aa" respectively.

At the end of the fiscal year, the Project had $3.3 billion in outstanding long-term debt, of which some $2.9 billion was in revenue bonds, $350 million in commercial paper and $6.9 million in government loans.

All SRP bonds sold since 1973 are revenue bonds secured by revenues from the sale of power. Before that date general obligation bonds were issued, secured by revenues, land liens, and the right to assess a tax levy on land. For the 12 months ended April 30, 1988, revenues available for debt service totaled $408.4 million, or 1.90 times the utility's debt service requirements of $214.6 million for the year.

SRP projects cash needs for capital expenditures and attempts to enter the bond market at opportune periods to obtain favorable interest rates. The four bond sales in FY 1987-88 were: a $22.3 million minibond issue in May at 6.875 percent; a $150 million revenue bond issue at 8.41 percent in November; a $23.4 million minibond issue in December at 7.875 percent; and a $363.4 million revenue bond

About $790 million was needed to operate SRP for fiscal year 1987-88. A majority of the funding came directly from power sales to customers. More than 100 investors learned firsthand about SRP from executives such as General Manager Jack Pfister during an investor information program in April.

refunding issue at 7.83 percent in February.

The biggest bond issue during the fiscal year was in February when the Project sold $363.4 million of bonds at an effective interest rate of 7.83 percent. SRP used $263.4 million of the bonds to refund portions of seven earlier bond issues carrying higher interest rates.

The refunding is expected to save more than $42 million in interest costs during the next 30 to 40 years. The February sale included an additional $100 million of a new issuance of revenue bonds to support the utility's capital program.

SRP is awaiting approval from the Arizona Corporation Commission to issue another $630 million in new electric system revenue bonds during the next two years as authorized by the Project's board of directors.

More than 100 bankers, mutual fund managers, insurance industry representatives, and other investors and market participants received an inside look at SRP in mid-April during an investor information program. Executives provided thorough briefings about the utility's plans and operations.

The information programs are credited with helping SRP secure and retain high ratings on its electric system revenue bonds. The high ratings of "AA" and "Aa" hold down interest costs.

The commercial paper program is more important than ever in keeping down financing costs. Through the commercial paper program, the utility is able to borrow money, for short-term periods up to 270 days, at a lower interest rate than through other financing options.

SRP's board of directors approved issuance of up to $350 million in commercial paper, as well as a backup line of credit of $350 million with a consortium of banks lead by First Interstate Bank of Arizona. Also available is a $40 million credit line with Fuji Bank Limited of Tokyo to support the minibond program.

SRP relates its commercial paper financing to the size of fuel inventories and construction work in progress. Goldman, Sachs & Co. is the utility's dealer for commercial paper.

Board raises electric rates for first time in two years

Electric rates rose by 5.6 percent overall and by 5.9 percent to SRP residential customers effective October 15, 1987. The new rates were needed to offset rising costs of operation, maintenance and financing.

In addition, the rate increase was needed to finance expansion of SRP's transmission and distribution facilities, and construct regional service centers and a corporate headquarters building to serve the utility's increasing number of customers.

The Project's previous rate increase in October 1985 averaged 4.0 percent. Between rate increases the Consumer Price Index rose about 6.1 percent.

By the end of the fiscal year, the new rates produced about $10.7 million in additional revenues, bringing total electric revenues to $952.1 million. SRP expects the rate increase to produce an additional $43.5 million annually.

In conjunction with the electric rate increase, Project management developed a formal five-year financial plan. The plan, completed in March 1988, anticipates a slowdown in customer growth, and attendant slowdowns in operating and maintenance expenses for the next five years.

The plan limits growth in employment to 0.5 percent in FY 1989 and to 1.0 percent annually thereafter, significantly below the 3.8 percent average annual growth rate of the past five years. Similarly, the plan targets real growth in controllable operating and maintenance expenses at 2.3 percent per year, down from its historical average real growth rate of 12.7 percent over recent years.

The plan includes a $241 million reduction from the five-year capital improvement program of June 1987, in addition to the deferral of the in-service date of the third unit at Coronado Generating Station near St. Johns.

In February, SRP's board of directors voted to defer the in-service date of coal-fired Coronado Unit 3 until 2004.

Instead, the utility will purchase 50 megawatts (MW) of power from Tucson Electric Power Co. and 50 MW of power from Arizona Electric Power Cooperative beginning in 1990. The purchases increase to 100 MW from each utility beginning in 1991.

The purchases are expected to produce a savings in today's dollars of $185 million between now and 2004 and would delay $470 million in construction costs on Coronado Generating Station Unit 3.

COMBINED BALANCE SHEETS

As of April 30, 1988 and 1987

Assets

	($000) 1988	1987
UTILITY PLANT, at historical cost *(Notes 1, 2, 3 and 4):*		
Plant in service-		
Electric	$4,305,817	$3,721,898
Irrigation	101,122	92,127
General	203,356	166,559
	4,610,295	3,980,584
Less - Accumulated depreciation on plant in service	995,525	861,043
	3,614,770	3,119,541
Plant held for future use	309,343	19,968
Construction work in progress	333,795	740,767
Nuclear fuel, net of amortization	82,351	92,736
	4,340,259	3,973,012
OTHER PROPERTY AND INVESTMENTS:		
Non-utility property and other investments	30,222	42,842
Segregated funds:		
Debt service funds	105,350	99,318
Construction fund	---	49,652
Decommissioning fund	3,657	721
	109,007	149,691
	139,229	192,533
CURRENT ASSETS:		
Cash and temporary investments, at cost	198,119	110,691
Deposit in debt service fund for payment of accrued interest on bonds	68,282	61,916
Trade and other accounts receivable, net	50,824	46,754
Note receivable *(Note 4)*	---	28,969
Fuel stocks, at last-in, first-out cost	99,104	81,144
Materials and supplies, at average cost	71,575	69,297
Prepayments, interest receivable and other	20,763	13,433
	508,667	412,204
DEFERRED CHARGES AND OTHER ASSETS:		
(Notes 1 and 5)	145,902	123,371
	$5,134,057	$4,701,120

The accompanying notes are an integral part of these combined balance sheets.

Capitalization and Liabilities

	($000) 1988	1987
LONG-TERM DEBT *(Notes 5 and 8):*		
Electric system revenue bonds	$2,918,384	$2,626,709
Commercial paper and other	360,333	360,028
	3,278,717	2,986,737
ACCUMULATED NET REVENUES:		
Balance, beginning of year	1,426,665	1,351,904
Net revenues for the year	16,261	74,761
Balance, end of year	1,442,926	1,426,665
TOTAL CAPITALIZATION	4,721,643	4,413,402
CURRENT LIABILITIES, excluding $26,993,000 in 1988 and $26,140,000 in 1987, representing current portion of long-term debt which is to be paid from segregated funds:		
Accrued plant deferral costs, current portion *(Note 3)*	105,200	---
Accounts payable	79,326	85,428
Accrued taxes and tax equivalents	44,305	41,434
Accrued interest	70,381	63,761
Customers' deposits	24,647	21,462
Other liabilities	27,654	24,881
	351,513	236,966
DEFERRED CREDITS AND OTHER NON-CURRENT LIABILITIES *(Notes 3 and 7)*	60,901	50,752
COMMITMENTS AND CONTINGENCIES *(Notes 3, 5 and 7)*		
	$5,134,057	$4,701,120

COMBINED STATEMENTS OF NET REVENUES

For the Years Ended April 30, 1988 and 1987

	($000) 1988	1987
OPERATING REVENUES *(Notes 1 and 9)*:		
Electric	$ 952,133	$ 881,340
Water and irrigation	7,213	7,166
Total operating revenues	959,346	888,506
OPERATING EXPENSES:		
Purchased power	26,626	49,086
Fuel used in electric generation	216,093	181,331
Other operating expenses	174,251	151,308
Maintenance	101,530	88,231
Depreciation and amortization *(Note 1)*	151,318	133,324
Taxes and tax equivalents	121,154	103,097
Total operating expenses	790,972	706,377
Net operating revenues	168,374	182,129
FINANCING COSTS:		
Interest on bonds	189,296	179,109
Amortization of bond discount, issue and refinancing expenses *(Note 1)*	6,096	6,089
Interest on other obligations	18,409	16,081
Interest earned on investments, deposits and other	(24,949)	(36,084)
Net financing costs	188,852	165,195
Less - Allowance for funds used during construction (AFUDC) *(Note 1)*	(42,428)	(59,902)
Financing costs less AFUDC	146,424	105,293
OTHER EXPENSES, net	5,689	2,075
NET REVENUES	$ 16,261	$ 74,761

The accompanying notes are an integral part of these combined statements.

COMBINED STATEMENTS OF CASH FLOWS

For the Years Ended April 30, 1988 and 1987

	($000) 1988	1987
NET CASH FLOWS FROM OPERATING ACTIVITIES:		
Net revenues	$ 16,261	$ 74,761
Noncash items included in income:		
Depreciation and amortization	151,318	133,324
Amortization of bond related expenses	6,096	6,089
Increase in fuel stocks and materials and supplies	(20,238)	(47,824)
Decrease (increase) in other assets, net	8,648	(8,897)
Increase (decrease) in accounts payable	(6,102)	18,771
Increase in accrued taxes and tax equivalents	2,871	5,292
Increase in accrued interest	6,620	11,133
Increase in other liabilities, net	10,639	9,317
Gain on sale of property	(242)	(96)
Net cash provided by operating activities	175,871	201,870
NET CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to utility plant, net of AFUDC *(Note 3)*	(361,881)	(309,356)
Allowance for funds used during construction	(42,428)	(59,902)
Additions to non-utility plant	(12,475)	(10,812)
Decrease in note receivable	28,969	61,684
Contributions in aid of construction	18,518	25,398
Proceeds from sale of plant	433	972
Net cash used by investing activities	(368,864)	(292,016)
NET CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds of bond issues *(Note 5)*	266,347	120,814
Other long-term borrowings, net of repayments	1,191	21,845
Repayment of principal on bonds and U.S. debt	(27,801)	(18,867)
Net cash provided by financing activities	239,737	123,792
NET INCREASE IN CASH AND TEMPORARY INVESTMENTS AND SEGREGATED FUNDS	46,744	33,646
BALANCE AT BEGINNING OF YEAR IN CASH AND TEMPORARY INVESTMENTS AND SEGREGATED FUNDS	260,382	226,736
BALANCE AT END OF YEAR IN CASH AND TEMPORARY INVESTMENTS AND SEGREGATED FUNDS	$ 307,126	$ 260,382

The accompanying notes are an integral part of these combined statements.

NOTES TO COMBINED FINANCIAL STATEMENTS

For the Years Ended April 30, 1988 and 1987

(1) Summary of Significant Accounting Policies:

(a) Principles of Combination

The combined financial statements include the accounts of the Salt River Project Agricultural Improvement and Power District (the District) and the accounts of its agent, the Salt River Valley Water Users' Association (the Association) and a wholly owned subsidiary, Salt River Generating Company, together referred to as the Salt River Project (the Project). All significant intercompany transactions have been eliminated. The Project follows the accounting principles promulgated by the Financial Accounting Standards Board.

(b) Regulatory Agent

The District's Board of Directors serves as its regulatory agent.

(c) Utility Plant, Depreciation and Maintenance

The accounting records of the Project are maintained substantially in accordance with the Uniform System of Accounts prescribed for electric utilities by the Federal Energy Regulatory Commission. Utility plant is stated at the historical cost of construction. Construction costs include labor, materials, services purchased under contract, and allocations of indirect charges for engineering, supervision, transportation and administrative expenses.

An allowance for funds used to finance construction work in progress (AFUDC) is capitalized as a part of the electric and general plant. This allowance is deducted from net financing costs in the combined statements of net revenues and added to utility plant. Capitalization rates of 8.75 % and 10.72% were used in 1988 and 1987, respectively. The equity component of AFUDC was $20,005,000 and $30,458,000 in 1988 and 1987, respectively.

Depreciation expense is computed on the straight-line basis over the estimated useful lives of the various classes of plant. Rates in effect resulted in provisions approximating 3.42% and 3.37% for 1988 and 1987, respectively, on the average cost of depreciable electric plant, and 1.43% and 1.42% for 1988 and 1987, respectively, for depreciable irrigation plant. When property representing a retirement unit is replaced, removed or abandoned, the cost of such property is credited to the appropriate utility plant account, and such cost, together with removal costs less salvage, is charged to accumulated depreciation.

The Project charges to maintenance expense the cost of labor, materials, and other expenses incurred in the repair and replacement of minor items of property.

(d) Bond Expense

Bond discount, issue and refinancing expenses are being amortized over the terms of the related bond issues.

(e) Revenues

Meters for residential, commercial and small industrial customers are read cyclically and sales recorded only when billed. This system of billing results in estimated earned but unbilled revenues which amounted to $23,743,000 and $20,273,000 at April 30, 1988 and 1987, respectively. For large industrial customers, meters are read near month-end and billings recorded on the accrual basis. Electric revenue billings are adjusted periodically for changes in costs of fuel and purchased power. Revenues from water and irrigation operations are recorded when earned.

(f) Electric Rates

Under Arizona law, the District's Board of Directors has the exclusive authority to establish electric rates. The District is required to follow certain procedures, including certain public notice requirements and holding a special Board meeting, before implementing any changes in the standard electric rate schedules. A rate increase of 5.6%, effective October 15, 1987, was approved by the District's Board on September 14, 1987.

(g) Nuclear Fuel

The District amortizes nuclear fuel to fuel expense on a unit of production method.

Under the provisions of the Nuclear Waste Act of 1982, the District is charged one mill per kilowatt-hour (kWh) on its share of electricity produced by Palo Verde Nuclear Generating Station (PVNGS) Units 1, 2 and 3. The District records this charge as a current year expense.

(h) Decommissioning

The District began reserving for the cost of decommissioning PVNGS Units 1, 2 and 3 commencing with their dates of commercial operation. The estimate to decommission the District's share of PVNGS Units 1, 2 and 3 of $108 million is based upon an outside engineer's study. The estimated costs are reviewed and adjusted periodically. Decommissioning funds collected from the ratepayers are maintained as a separate fund.

(i) Income Taxes

The District is exempt from federal and state income taxes.

(j) Reclassifications

Certain 1987 amounts have been reclassified to conform to the current year presentation.

(2) Possession and use of utility plant:

The United States of America retains a paramount right or claim in the Project which arises from the original construction and operation of the Project's facilities as a Federal Reclamation Project. The Project's right to the possession and use of, and to all revenues produced by, these facilities is evidenced by contractual arrangements with the United States.

(3) Construction program:

Balances shown for construction work in progress (CWIP) represent expenditures for new facilities required to service anticipated customer needs, and consist of:

	(Thousands)	
	1988	1987
Electric generating facilities	$49,280	$540,802
Transmission and distribution	113,071	98,766
Irrigation plant	22,039	19,506
Other construction	149,405	81,693
	$333,795	$740,767

Construction expenditures planned for fiscal years 1989 through 1993 are shown below.

	(Thousands)		
	Construction	AFUDC	Total
1989	$413,109	$9,801	$422,910
1990	297,069	7,075	304,144
1991	241,982	6,258	248,240
1992	277,982	4,287	282,269
1993	304,314	5,945	310,259

These expenditures will be financed primarily by funds currently on hand, future net revenues and the sale of revenue bonds.

Palo Verde Nuclear Generating Station Unit 3 became operational during February of 1988. With the completion of Unit 3, construction of Palo Verde Nuclear Generating Station has been completed and all three units are now operational.

On February 1, 1988, the Board of Directors approved deferring the in-service date of Coronado Generating Station Unit 3 until the year 2004. This action was taken as a result of a study which concluded that the deferral would allow SRP to realize savings in future revenue requirements.

The Coronado Unit 3 costs of $290.3 million were transferred to Plant Held for Future Use in accordance with a resolution approved by the Board of Directors on June 13, 1988. The costs consist of $134.5 million of April 1988 inception-to-date costs, $22.8 million of AFUDC, and $133 million of estimated costs necessary to defer the in-service date of Coronado Unit 3. The estimated deferral costs include $105.2 million which are classified as current liabilities and $27.8 million which are classified as other non-current liabilities. The resolution provided that these costs would be included in the amounts to be recovered from consumers over the depreciable life of Coronado Generating Station subject to the rate adjustment procedures set forth in the Arizona Revised Statutes.

The Board also approved long-term power purchase agreements to replace a portion of the power which would have been supplied by Coronado Unit 3. These agreements have been negotiated with Arizona Electric Power Cooperative and Tucson Electric Power Company. Each contract is for 50 megawatt (MW) of firm power starting June 1990, increasing to 100 MW beginning in June 1991 and expiring in the year 2011.

Additions to utility plant, net of AFUDC, equalled $361.9 million for 1988 as shown in the combined statements of cash flows. The amount does not include the non-cash addition to utility plant of $133.0 million which resulted from the estimated costs necessary to defer Coronado Unit 3.

Projected construction expenditures include contingency allowances to reflect potential cost increases.

At April 30, 1988, commitments had been entered into for delivery of materials and services on construction projects. In addition, various firm commitments exist under coal and fuel oil supply contracts.

The Project has committed to spend approximately $50 million over the next seven years for its share of a project to build or modify dams on the Salt, Verde and Agua Fria rivers for flood control, to ensure dam safety and provide water storage associated with the Central Arizona Project. Recent actions by the U.S. Congress will result in significant changes to the project. Management has not yet been able to determine the impact upon the construction program, however it is believed the previously committed amount will not increase signficantly.

(4) Interests in jointly owned electric utility plants:

The District has entered into various agreements with other electric utilities for the joint ownership of electric generating and transmission facilities. Each participating owner in these facilities must provide for the cost of its ownership share. The following schedule reflects the District's ownership interest (at cost) in jointly owned electric utility plants at April 30, 1988:

		(Thousands)		
Plant Name	Ownership Share Percent	Plant In Service	Accumulated Depreciation	CWIP
Four Corners (NM)	10.00%	$ 81,610	$ 18,896	$ 4,028
Mohave (NV)	10.00	44,151	16,988	2,156
Navajo (AZ)	21.70	216,754	84,171	5,453
Hayden (CO)	50.00	67,260	26,120	323
Craig (CO)	29.00	224,397	56,224	1,037
Palo Verde (AZ)	17.49	1,563,127	85,880	6,625
		$2,197,299	$288,279	$19,622

On December 31, 1987, a $26,225,000 payment was received from the Los Angeles Department of Water and Power as a final cash settlement of the transaction to exchange a 5.7% interest in PVNGS for a 30% share of the Coronado Generating Station Units 1 and 2.

The District acts as the operating agent for the participants in the Navajo Project. As operating agent, the District utilizes advanced billings to the participants, based on ownership percentage, to pay the cost of operations. A separate operating fund is maintained by the District to process Navajo transactions.

The District's share of direct expenses of the jointly owned plants is included in operating expenses in the combined statements of net revenues.

(5) Long-term debt:

		(Thousands)		
	Interest Rate	1988	1987	Maturities
Electric System Revenue Bonds	4.7-11.5%	$3,010,961	$2,716,276	1989-2028
Unamortized Bond Discount		(92,577)	(89,567)	
Total Revenue Bonds Outstanding		2,918,384	2,626,709	
U.S. Government Non-Interest Bearing Debt		6,883	7,768	1988-2004
Commercial Paper	4.2-6.3%	350,000	350,000	
Other	6.5-7.7%	3,450	2,260	1989-1990
Total Long-Term Debt		$3,278,717	$2,986,737	

Electric system revenue bonds are secured by a pledge of, and a lien on, the revenues of the electric system after deducting operating expenses, as defined in the bond resolution, subject to amounts due the United States of $6,882,562.

The debt service coverage ratio, as defined in the bond resolution, is used by bond rating agencies to help determine the financial health of the District and other bond issuers. For the years ended April 30, 1988 and 1987, debt service coverage was as follows:

	(Thousands) (except for ratios)	
	1988	1987
Revenues available for debt service	$408,442	$399,465
Total debt service requirements	214,634	199,764
Debt service coverage ratio	1.90	2.00

The annual maturities of long-term debt (excluding commercial paper) as of April 30, 1988, due in the fiscal years ending April 30, are as follows:

	(Thousands)
1989	$ 26,993
1990	36,068
1991	32,370
1992	37,675
1993	42,830
Thereafter	2,845,358
	$3,021,294

Interest and amortization of discount on the various issues results in an effective rate of approximately 7.16% over the remaining terms of the bonds.

At April 30, 1988, the Project has authority to issue additional electric system revenue bonds totalling $130,762,160 principal amount and electric system refunding revenue bonds totalling $838,405,000 principal amount.

The cash proceeds from the sale of revenue bonds during fiscal year 1988 totalled $266.3 million as shown in the combined statement of cash flows. This amount does not include non-cash items such as the defeasance of revenue bonds and the loss on defeasance as described in the following paragraph.

On February 18, 1988, the District defeased $239,210,000 of electric system revenue bonds, resulting in lower debt service requirements as well as a loss of $22,464,079. The District's Board of Directors determined that such loss should be recovered from the ratepayers during the period of reduced debt service requirements. Accordingly, under the provisions of Statement of Financial Accounting Standards No. 71, the loss will be amortized on a monthly basis over the life of the refunded bonds.

On February 9, 1984, the District refunded its then outstanding general obligation bonds. Although the refunding constituted a legal defeasance of the prior lien on revenues which secured said bonds, the general obligation bonds continue to be general obligations of the District, secured by a lien upon the real property included in the District, a guarantee by the Association, and by the District's taxing authority. As of April 30, 1988 the amount of defeased general obligation bonds outstanding was $117,945,000.

(6) Employees' Retirement Plan:

The Project has a retirement plan (the Plan) covering substantially all employees. The Plan is funded entirely from Project contributions and the income earned on invested assets. No contribution was required to be made to the Plan in fiscal year 1988. In fiscal year 1987, the contribution to the Plan was $2,181,799. Plan assets consist primarily of common stocks, U.S. obligations and corporate bonds.

In 1987, the Project adopted Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions. Net periodic pension cost under that statement, as of the dates of the latest actuarial report (April 30), is made up of the components listed below as determined using the projected unit credit actuarial cost method:

	(Thousands)	
	1988	1987
Service cost	$ 8,902	$ 8,024
Interest cost	14,751	13,123
Actual return on assets	1,345	(45,542)
Net amortization and deferral	(28,775)	20,296
Net periodic pension expense (income)	$(3,777)	$(4,099)

The discount rate used in determining the actuarial present value of the projected benefit obligation was 9.0% for both 1988 and 1987. The rate of increase used to determine future compensation levels was 5.5% for fiscal year 1988. For fiscal year 1987, the rate of increase in future compensation levels varied from 9.0% to 5.5%, on a graded scale, based on the age of the participant. The expected long-term rate of return on assets is 9.75% for both 1988 and 1987.

The following schedule reconciles the funded status of the Plan with amounts reported in the Project's combined financial statements as of April 30:

	(Thousands)	
	1988	1987
Plan assets at fair value	$252,294	$259,669
Actuarial present value of projected benefit obligation:		
Vested benefit obligation	(120,008)	(111,017)
Nonvested benefit obligation	(8,767)	(12,485)
Accumulated benefit obligation	(128,775)	(123,502)
Excess of projected benefit obligation over accumulated benefit obligation	(48,938)	(44,872)
Projected benefit obligation	(177,713)	(168,374)
Plan assets in excess of projected benefit obligation	74,581	91,295
Unrecognized net assets	(60,702)	(65,038)
Unrecognized net gain	(5,963)	(21,445)
Prior service cost not yet recognized in net periodic pension cost	1,415	741
Prepaid Pension Cost	$ 9,331	$ 5,553

In addition to providing pension benefits, the Project provides certain health care and life insurance benefits for retired persons. Substantially all of the Project's employees may become eligible for those benefits if they reach normal retirement age while working for the Project, retire from the Project, are eligible for pension benefits, and have completed a minimum of five years regular employment. The cost of retiree health care and life insurance benefits is recognized as expense as the premiums and/or deposits to the Trustee are paid. For 1988 and 1987, those costs totalled $1,696,765 and $1,361,170, respectively.

(7) Litigation and other contingencies:

Environmental:

Various pending litigation or administrative proceedings involving environmental matters could affect the Project and its present and proposed generating facilities. In general, these lawsuits seek to impose higher air quality standards for generating plants. If ultimately decided adversely to the interest of the Project, the lawsuits could result in increased construction costs, increased future operating costs or possible loss in the operational reliability of certain generating plants. Such increased costs would be passed on to customers through increased electric rates.

Other Litigation:

In the normal course of business, the Project is a defendant in various litigation matters. In management's opinion, the ultimate resolution of these matters will not have a significant adverse effect on the Project's financial position or results of operations.

Payments to Certain Property Owners in the Association's Service Areas Now Provided Electric Power by Others:

The Articles of Incorporation of the Association provide for the indemnification of certain property owners in the Association's service areas now provided electric power by

others if they are required to pay substantially more for power than they would if they were furnished electric power by the Association. A reserve for these payments has been established which, in the opinion of management, adequately covers the Project's liability as of April 30, 1988.

Navajo Taxes:

In 1977 and 1978, the Navajo Tribe promulgated three tax resolutions affecting electric generating stations in which the District has an interest. The District and other participants in the affected generating stations filed lawsuits challenging the resolutions on grounds the Tribe had previously approved generating station leases containing covenants not to tax. In 1981, the Tribe mooted the lawsuits by enacting a resolution reaffirming its covenants not to tax. Hence, the lawsuits were dismissed.

In the fall of 1984, the Navajo Tribe notified the District of its enactment of amended tax resolutions, which contained provisions purporting to repeal any prior waiver of the Tribe's power to tax. The District responded by reminding the Tribe of its prior resolution, reaffirming its tax covenants.

While no taxes were assessed directly against the District, the fuel suppliers for the generating stations were assessed taxes by the Tribe. The suppliers for the Navajo and Four Corners Generating Stations responded to these assessments by reminding the Tribe that they are also immune from taxation under the covenant not to tax contained in the Navajo Project and Four Corners Project Leases. The fuel supplier for the Mohave Generating Station does not have the benefit of a covenant not to tax for lands or activities associated with Mohave.

In the fall of 1987, Peabody Coal Company, the Navajo Tribe, and the Mohave Project and the Navajo Project Participants negotiated amendments to the Navajo Tribal Coal Leases from which coal for these projects is mined, reaffirming the validity of the Navajo Tribe's covenant not to tax the Navajo Project Participants and its fuel supplier. These amended leases have been approved by the Navajo Tribe, Peabody, the Mohave Project and the Navajo Project Participants, and the Secretary of the Interior. These amended leases have resolved the Navajo Tribe's most recent disavowal of its covenant not to tax the Navajo Project Participants and its fuel supplier. Regarding the other generating stations, the Board of Directors of the District has approved an action allowing it to recover from its customers the amounts of such taxes if the payment thereof is ultimately required.

(8) Revolving credit agreement/ commercial paper program:

The District's Board has authorized the issuance of up to $350,000,000 of short-term promissory notes (the Promissory Notes), which are sold in the tax-exempt commercial paper market. The Promissory Notes will mature in no more than 270 days from the date of issuance and in no event after October 15, 1989. As of April 30, 1988, the District had $350,000,000 of the Promissory Notes outstanding at an average interest rate to the District of 4.65%.

The District maintains a revolving credit agreement (the Agreement) with a consortium of 19 banks to provide liquidity support for the Promissory Notes. Under the terms of the Agreement, the District may borrow up to $350,000,000 through October 15, 1990. The District must repay all outstanding borrowings by October 15, 1990. Borrowings under the Agreement initially bear interest at a rate equal to 0.625% plus the weekly average rate for three-month Certificates of Deposit, as published in the Wall Street Journal, plus certain adjustments. As of April 30, 1988, the District had no borrowings outstanding under the Agreement.

The indebtedness of the District evidenced by the Promissory Notes and/or borrowings under the Agreement is an unsecured obligation of the District payable from the general funds of the District lawfully available therefore, subject in all respects to the prior lien of the United States, the Revenue Bonds, and other indebtedness of the District secured by revenues or assets of the District. The Promissory Notes and borrowings under the Agreement are not payable from taxes.

The District's Board has limited the total amount of indebtedness evidenced by the borrowings under the Agreement and Promissory Notes to an aggregate of $350,000,000.

In addition to the revolving credit agreement to support the Commercial Paper Program, the District on May 15, 1988 has entered into a revolving credit agreement with Fuji Bank, Ltd. This agreement provides support to the District's mini-bond program. Under its terms, the District may borrow up to $40,000,000 at the Federal Funds Rate plus one-quarter to one- half percent, depending on the term of the borrowing. The agreement expires on November 14, 1989.

(9) Irrigation and water operations:

Irrigation and water operations expenses, including depreciation, exceeded the assessments, delivery fees, and other revenues therefrom by approximately $29,227,000 for 1988 and $15,975,000 for 1987. These amounts do not include expenditures for additions and improvements to irrigation plant and for repayment of long-term debt.

Independent Auditor's Report

To the Board of Directors,
Salt River Project Agricultural Improvement and Power District, and
Board of Governors,
Salt River Valley Water Users' Association:

We have audited the accompanying combined balance sheets of SALT RIVER PROJECT AGRICULTURAL IMPROVEMENT AND POWER DISTRICT and its agent, SALT RIVER VALLEY WATER USERS' ASSOCIATION, together referred to as SALT RIVER PROJECT, as of April 30, 1988 and 1987, and the related combined statements of net revenues and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Salt River Project as of April 30, 1988 and 1987, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Arthur Andersen & Co.

Phoenix, Arizona,
July 1, 1988.

Statistical Review

PROJECT GENERAL

($000)

	12 Months Ended April 30			12 Months Ended December 31
	1988	1987	1982	1977
Operating revenues	$ 959,346	$ 888,506	$ 664,463	$ 311,087
Electric	952,133	881,340	655,682	305,621
Water and irrigation	7,213	7,166	8,781	5,466
Operating expenses	790,972	706,377	460,907	220,384
Net financing costs less capitalized interest	146,424	105,293	45,382	37,451
Other deductions (revenues), net	5,689	2,075	(168)	43
Net revenues	16,261	74,761	158,342	53,209
Additions to plant, excluding allowances for funds used during construction	361,881	309,356	395,270	312,538
Utility plant, gross	5,335,784	4,834,055	3,265,863	1,473,520
Contributions of electric revenues to support water operations	29,227	15,975	13,676	9,462
Taxes and tax equivalents	121,154	103,097	64,589	34,257
Employees at year-end	5,805	5,735	4,776	3,652

WATER*

	1988	1987	1982	1977
Total storage and pumping capacity (acre-feet)	2,881,972	2,889,725	2,827,428	2,810,645
Storage capacity (six reservoirs)	2,019,102	2,019,102	2,019,102	2,072,050
Installed pumping capacity	862,870	870,623	808,326	738,595
Water in storage Jan. 1 (acre-feet)	1,691,741	1,671,535	1,116,338	711,353
Project storage only	1,464,527	1,445,710	895,118	367,122
Runoff (acre-feet)	1,120,034**	1,036,805	1,689,485	325,087
Water in storage Dec. 31 (acre-feet)	1,624,272	1,691,741	1,631,411	1,209,197
Project storage only	1,391,376	1,464,978	1,345,252	809,373
Sources of water for deliveriers (acre-feet)	1,094,601	1,136,429	1,054,163	391,627
Gravity supply	1,039,457**	928,053	936,680	8,197
Groundwater supply (pumping by SRP)	50,591	50,482	104,019	1,209,197
Groundwater supply (pumping by others)	4,553	15,056	13,464	441,103
Use of water (acre-feet)	997,324	870,658	955,389	316,325
Agricultural	336,527	290,572	379,903	205,921
Urban	417,914	395,158	355,278	316,325
City domestic	304,532	284,192	247,216	205,921
Subdivision irrigation	61,872	60,877	61,460	57,952
Other non-agricultural irrigation (schools, parks, churches, etc.)	51,510	50,089	46,603	52,452
Decreed deliveries	50,783	47,963	58,400	66,158
Contract deliveries	192,100	136,965	103,686	86,920
Seepage and evapotranspiration	97,277	122,933	169,460	298,691
Canals, total (miles)	133	133	131	131
Lined	97	91	71	61
Laterals, total (miles)	899	892	888	878
Lined and piped	807	792	764	726
Drainage and waste ditches (miles)	236	240	243	250
Lined and piped	88	82	68	55
Assessed area (acres)	238,170	238,170	238,172	238,220
Number of assessed accounts	182,110	181,894	179,532	168,736
Number of times water delivered to water users	475,364	471,845	491,242	493,043

* Water statistics are computed on a calendar year basis.

** Based on U.S.G.S. provisonal records and are subject to adjustment.

POWER

	12 Months Ended April 30			12 Months Ended December 31
	1988	1987	1982	1977
Energy Sources (kWh)				
Net nuclear generation	2,714,798,000	1,955,479,000	-0-	-0-
Net steam generation*	11,599,545,000	9,667,574,000	12,429,457,000	7,499,002,000
Net gas turbine generation	4,694,000	2,287,000	24,298,000	59,167,000
Net combined cycle generation	762,125,000	991,739,000	4,188,000	477,808,000
Net run of river generation	357,928,000	410,679,000	255,762,000	319,851,000
Pumped storage generation	174,844,000	211,088,000	155,560,000	22,694,000
Total net generation*	15,613,934,000	13,238,846,000	12,869,265,000	8,378,522,000
Purchased	1,986,549,414	3,586,056,028	1,691,696,160	1,730,201,348
Interchange received	127,353,000	105,387,000	109,169,000	178,417,000
Wheeling received	10,572,500	15,091,962	7,788,840	7,402,652
Total energy sources*	17,738,408,914	16,945,380,990	14,677,919,000	10,294,543,000
Energy disposition (kWh)***				
Residential	5,755,597,879	5,333,601,362	3,996,561,567	3,169,000,667
Commercial & Industrial	6,806,397,526	6,252,344,184	5,076,034,947	3,728,299,603
Irrigation pumping	226,113,617	233,684,815	249,286,026	283,926,606
Street & highway lighting	103,537,571	98,746,120	46,963,317	38,198,033
Public authorities	293,322,023	270,239,264	374,397,640	321,266,390
Interdepartmental	85,065,218	82,902,577	179,577,422	214,648,125
Sales for resale	3,065,080,688	3,294,959,549	3,564,619,094	1,859,308,829
Total sales	16,335,114,522	15,566,477,871	13,487,440,013	9,614,648,253
Interchange delivered	130,915,000	104,549,000	63,328,000	185,980,000
Wheeling delivered	7,163,127	13,887,031	7,148,429	6,854,855
Energy losses	1,015,442,265	958,912,088	895,393,558	453,313,892
Energy for pumped storage operation	249,774,000	301,555,000	224,609,000	33,746,000
Total disposition of energy	17,738,408,914	16,945,380,990	14,677,919,000	10,294,543,000
Peak overall power system (kW)	3,234,000	3,264,000	2,729,000	2,149,000
Date and time (MST)	Aug. 4, 6 p.m.	Aug. 20, 5 p.m.	July 30, 6 p.m.	June 29, 5 p.m.
Peak Project customers (kW)	2,840,000	2,785,000	2,266,000	1,731,000
Date and time (MST)	Aug. 4, 6 p.m.	Aug. 20, 5 p.m.	Aug. 26, 6 p.m.	Sept. 7, 6 p.m.
Generating capability (kW)**				
Nuclear****	427,460	213,730	-0-	-0-
Steam*	2,411,115	2,411,115	2,285,250	1,548,250
Gas turbines	393,000	393,000	393,000	378,000
Combined cycle	288,000	288,000	288,000	288,000
Hydroelectric conventional	96,400	96,400	95,000	94,000
Hydroelectric pumped storage	137,000	137,000	137,000	140,000
Total operating capability*	3,752,975	3,539,245	3,198,250	2,448,250
Contract purchase at peak	517,744	605,547	329,547	461,813
Total resources*	4,270,719	4,144,792	3,527,797	2,910,063
Electric customers—year end***				
Residential	457,235	441,293	315,948	248,877
Commercial & Industrial	39,358	37,218	23,840	18,526
Other	9,025	8,810	1,624	1,488
Total	505,618	487,321	341,412	268,891
Average annual kWh use***				
Residential	12,824	12,440	12,798	13,108
Average annual kWh revenue***				
Residential (cents/kWh)	7.66	7.54	6.55	4.25

* Includes SRP participation in jointly owned projects

** Unit capabilities during summer peak

*** Energy disposition kWh through total sales, electric customers year end, average kWh use and average annual revenue are estimated figures.

**** 641,190 kW after Februrary 1, 1988 when PVNGS unit 3 was declared to be in commercial operation.

Board Members

Pictured above are SRP Board Members John M. Williams Jr. (District 5) and Gilbert R. Rogers (District 4).*

SRP Board Members pictured above are (left to right) William P. Schrader (District 7), Rudolph Johnson (District 1), John L. Burton Jr. (At-large) and Bruce B. Brooks (District 3).

*Salt River Project Board Members shown above are (left to right) Stanford F. Hartman (At-large**), Clarence C. Pendergast Jr. (District 2), Olen Sharp (District 9), Joe Bob Neely (District 8) and Fred J. Ash (At-large).*

Shown above are SRP Board Members William W. Arnett (At-large) and Dwayne E. Dobson (District 10). Not pictured is Thomas P. Hurley (District 6).

** District and At-large positions are noted in parentheses.*

*** Stanford F. Hartman retired June 13, 1988, and was replaced by Eldon Rudd.*

Board members establish policies for the management and conduct of Salt River Project's business affairs.

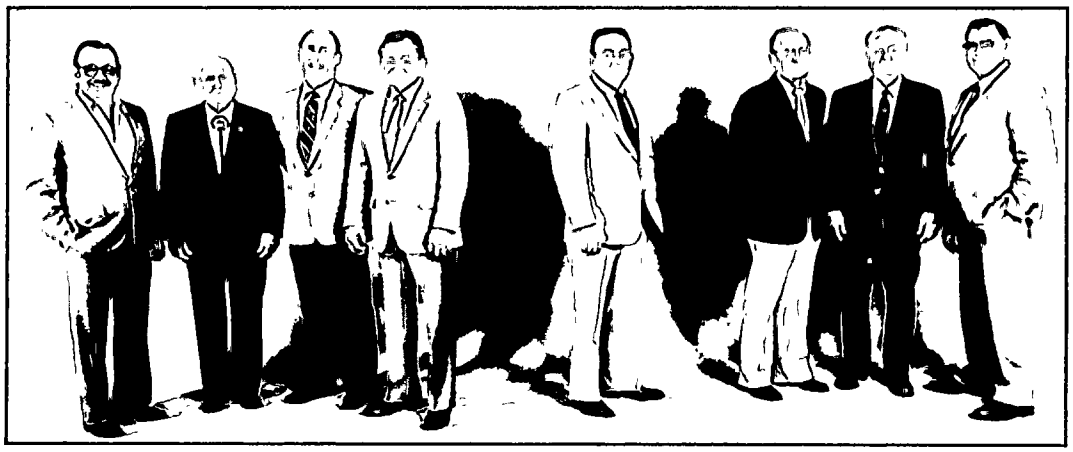
The 10 members of the Board of Governors of the Salt River Valley Water Users' Association are elected every two years by the shareholders (property owners) of the Association.

The Board of Directors of the Salt River Project Agricultural Improvement and Power District consists of 14 members who serve staggered four-year terms. One District board member is elected from each of the 10 SRP voting divisions, and four members are elected at-large.

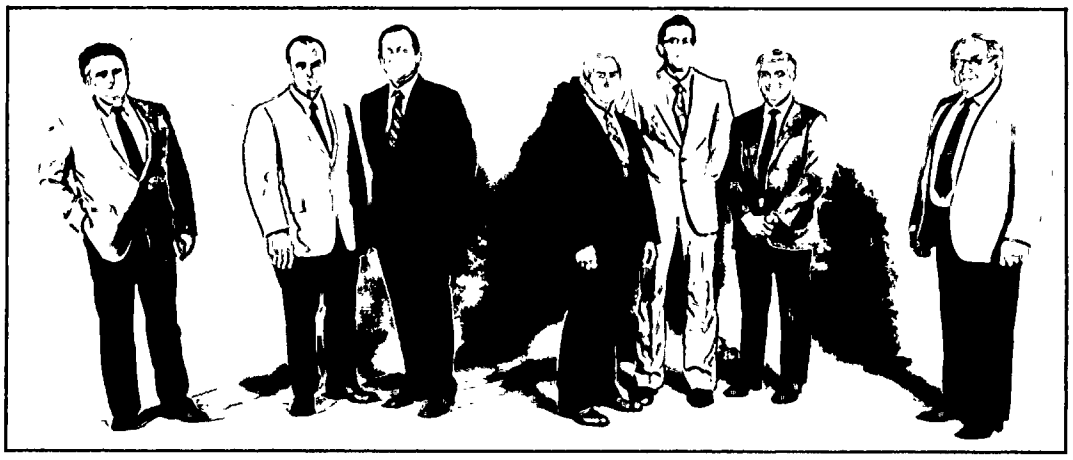
Traditionally, members of the Association board are elected to similar positions on the District board.

Council Members

SRP Council members pictured are (left to right) Wayne A. Marletta (District 7), Lester R. Mowry (District 7), Carl E. Weller, Council chairman (District 5), Edmund Navarro (District 5), John E. Anderson (District 3), James R. Marshall (District 6), Dean W. Lewis (District 6) and Orland R. Hatch (District 10).*



Pictured are (left to right) C. Dale Willis (District 10), Robert E. Hurley (District 9), Mark V. Pace (District 8), Elvin E. Fleming (District 3), Wayne A. Hart (District 2), Martin Kempton, Council vice chairman (District 8) and James L. Diller (District 6).



Shown are (left to right) John A. Vanderwey (District 2), Howard W. Lydic (District 1), George B. Willmoth (District 7), Lloyd Lee Banning (District 4), James M. Accomazzo (District 3), Larry D. Rovey (District 2), Levi H. Reed (District 4), Byron G. Williams (District 4) and Roy W. Cheatham (District 5).

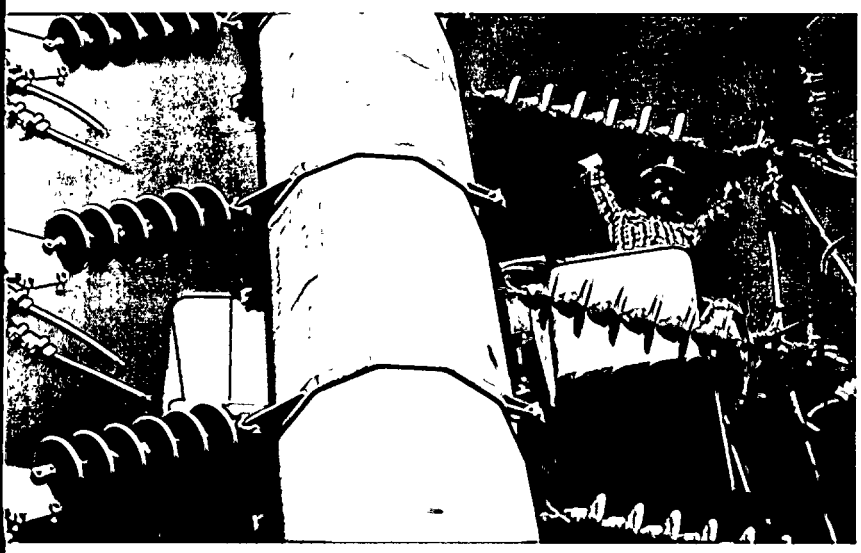
Council members not pictured are Robert L. Cook (District 1), Emil M. Rovey (District 1), Michael K. Gantzel (District 8), W. Curtis Dana (District 9), Lee L. Tregaskes (District 9) and William P. Schrader Jr. (District 10).

** District positions are noted in parentheses.*

The councils enact and amend bylaws relating to the management and conduct of SRP's business affairs, and they approve negotiated revenue bond sales.

Three council members are elected by SRP shareholders to two-year terms in each of the 10 areas of the Salt River Valley Water Users' Association. Three council members are elected to staggered four-year terms in each of the 10 divisions of the Salt River Project Agricultural Improvement and Power District.

Traditionally, Association council members seek identical positions on the District council.



1987 ANNUAL REPORT

ARIZONA PUBLIC SERVICE COMPANY

APS

ABOUT THE COMPANY

Arizona Public Service Company (the "Company" or "APS") 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. The Company's electric service reaches approximately 1,561,000 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 Pinnacle West Capital Corporation ("Pinnacle West") (formerly AZP Group, Inc.), which became the Company's corporate parent, effective in April 1985, pursuant to a corporate restructuring. 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. APS Finance Company N.V., Bixco, Inc., and APS Fuels Company are wholly-owned subsidiaries of the Company. APS Finance Company N.V. was dissolved as of June 30, 1987, APS Fuels Company is in the process of dissolution, and Bixco, Inc. is currently inactive.

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-eighth annual meeting at 10:00 a.m. on Thursday, April 21, 1988 at the Sheraton Phoenix, 111 North Central Avenue, Phoenix, Arizona.

APS OFFICERS

O. Mark De Michele, 54, President and Chief Executive Officer
Walter F. Ekstrom, 50, Vice President, Electric Operations
Karl Eller, 59, Chairman of the Executive Committee
David W. Ellis, 49, Vice President, Marketing and Energy Management
Kathryn A. Forbes, 37, Vice President and Controller
Joseph A. Gelinas, 43, Vice President, Employee Relations
Jerry G. Haynes, 53, Vice President, Nuclear Production
William J. Hemelt, 34, Treasurer and Assistant Secretary
Russell D. Hulse, 60, Vice President, Resources Planning
Jerry Human, 57, Vice President, Customer Services, State Region
Charles D. Jarman, 52, Vice President, Construction
Donald B. Karner, 36, Vice President, Engineering
Nancy C. Loftin, 34, Secretary
Jaron B. Norberg, 50, Executive Vice President and Chief Financial Officer
William J. Post, 37, Vice President, Finance and Rates
Shirley A. Richard, 41, Vice President, Corporate Relations and Marketing
Keith L. Turley, 64, Chairman of the Board
Edwin E. Van Brunt, Jr., 56, Executive Vice President, Arizona Nuclear Power Project

(Age on Annual Meeting date, April 21, 1988)

To Our APS Preferred Shareholders:

Although 1987 saw many positive accomplishments for your company, the highlight undoubtedly was the December 4 dedication ceremony marking the completion of construction of the Palo Verde Nuclear Generating Station. Commenting at the dedication ceremony, John Herrington, the Secretary of the U.S. Department of Energy, labeled Palo Verde "the energy cornerstone of the Southwest" and stated that it ranks among the finest nuclear power plants in the world.

Bringing all three of the Palo Verde units into commercial operation within a two year period is an achievement of which we as management are justifiably proud. It is also a feat never before accomplished by any other utility. However, we recognize that it was made possible only through the dedication of our employees, our partners in the Project, and the support of our investors. With the completion of Palo Verde, we have the resources to continue to fuel the growing electrical needs of our service territory well into the next century.

Obviously, uncertainties remain with respect to the rate treatment for Units 2 and 3. At the time this report went to press, we were awaiting regulatory decisions on a phase-in plan for the costs of Unit 2 and an accounting order to defer recovery of the costs of Unit 3. Both of these proposals were designed by the company to minimize the impact on our customers of bringing the Palo Verde units into service. Regardless of the outcome of those pending rate matters, however, the marketplace itself has dictated that we take a hard look at how we do business now and plan to do business in the future.

The reality is that the utility business is changing. For the first time in our company's history, we're facing intense competition in every segment of our business — from natural gas suppliers, from promoters of municipal takeover, from co-generation entrepreneurs, from other utilities who may bargain for wholesale customers, and more. Meeting this competition requires a whole new strategy for doing business.

In 1987 we began a strategic marketing plan for marketing and selling such products as off-peak security lighting, industrial heat pumps and thermal storage, power conditioning, induction cooking, and more. We are devoting more resources to increasing economic development in Arizona, thereby enhancing our electric sales, and investigating new bulk power marketing opportunities outside our state.

Frankly, these rate and marketing strategies will probably not be enough, so we are considering a wide range of other options that will reduce our costs in 1988 and beyond. We have already begun streamlining our organizational structure and reducing levels of management. These efforts, combined with our corporate goal of reducing staff positions, will lead to a lower employee level in 1988 than in 1986.

Additionally, we have asked every level of management to review their operations for ways in which costs may be reduced. We are convinced that, through innovation, efficiency, and productivity improvements, our costs — both capital and operations and maintenance — can be reduced.

At the same time, we have emphasized to our employees that cutting costs cannot be done at the expense of service quality. To that end, we launched our Service *Plus* program in 1987. We're instilling a greater awareness of how each individual job affects the ultimate cost of our product and how each employee can help make APS a more productive, efficient, and socially responsible entity.

The completion of Palo Verde brings to a successful conclusion a tremendous challenge of the past. The uncertain future we face brings formidable challenges as well. We are confident, however, that through the creativity and dedication of our employees, those challenges will be successfully met.

We invite you to study the detailed financial information in the following pages and to attend our Annual Meeting of Stockholders on April 21 in Phoenix.

Sincerely,

Keith L. Turley
Chairman of the Board

O. Mark De Michele
President and
Chief Executive Officer

ARIZONA PUBLIC SERVICE COMPANY
SELECTED CONSOLIDATED FINANCIAL DATA

	1987	1986	1985	1984	1983
	(Dollars in Thousands, Except Per Share Amounts)				
Electric Operating Revenues	$ 1,313,438	$ 1,249,912	$ 1,174,502	$ 994,967	$ 871,875
Electric Operating Expenses:					
Operation and maintenance	586,861	541,108	447,985	358,665	349,150
Depreciation and amortization	160,298	139,541	99,221	87,494	83,707
Taxes*	323,204	305,909	320,312	285,548	185,606
Palo Verde cost deferral	(84,289)	(25,526)	—	—	—
Total	986,074	961,032	867,518	731,707	618,463
Operating Income	327,364	288,880	306,984	263,260	253,412
Other Income*	126,456	173,847	190,047	190,818	134,459
Interest Deductions - Net	156,057	188,607	171,608	156,508	118,819
Income from Continuing Operations Before Cumulative Effect of Accounting Change	297,763	274,120	325,423	297,570	269,052
Loss from Discontinued Operations	—	—	—	(26,503)	(4,255)
Cumulative Effect of Accounting Change - Net of Tax*	16,110	—	—	—	—
Net Income	313,873	274,120	325,423	271,067	264,797
Preferred Stock Dividend Requirements	32,950	39,279	44,412	48,375	43,741
Earnings for Common Stock	$ 280,923	$ 234,841	$ 281,011	$ 222,692	$ 221,056
Total Assets	$ 5,818,588	$ 5,595,883	$ 5,251,327	$ 4,653,774	$ 4,386,312
Long-term Debt and Redeemable Preferred Stock	$ 2,503,928	$ 2,107,219	$ 2,425,361	$ 1,967,486	$ 1,892,477
Common Stock Data:					
Book value per share	$ 26.74	$ 25.76	$ 25.42	$ 24.18	$ 23.78
Earnings (loss) per average common share outstanding:					
Continuing Operations Before Accounting Change	$ 3.71	$ 3.30	$ 3.96	$ 3.65	$ 3.53
Discontinued Operations	—	—	—	(0.39)	(0.07)
Cumulative Effect of Accounting Change - Net	0.23	—	—	—	—
Total	$ 3.94	$ 3.30	$ 3.96	$ 3.26	$ 3.46
Dividends declared per share	$ 2.88	$ 2.94	$ 2.73	$ 2.60	$ 2.56
Common shares outstanding:					
Year-end	71,264,947	71,264,947	71,264,947	70,128,329	66,710,852
Average	71,264,947	71,264,947	71,031,228	68,308,131	63,865,210
Number of common shareholders	1**	1**	1**	124,274	127,387

* Federal and state income taxes are included in Taxes, Other Income and Cumulative Effect of Accounting Change. Total income tax expense was as follows (thousands of dollars): 1987, $197,314; 1986, $156,820; 1985, $165,279; 1984, $137,072; 1983, $93,930. Palo Verde cost deferral included in Other Income for 1987 and 1986 was $71,961 and $38,262, respectively.

** See Note 2 of Notes to Consolidated Financial Statements for a description of the 1985 corporate restructuring.

OTHER FINANCIAL AND OPERATING STATISTICS

	1987	1986	1985	1984	1983
		(Dollars in Thousands, Except Per Hour Amounts)			
Capitalization:					
Common equity	$ 1,905,577	$ 1,835,616	$ 1,811,405	$ 1,695,923	$ 1,586,671
Non-redeemable preferred stock	168,561	218,561	218,561	218,561	218,561
Redeemable preferred stock	221,978	178,728	219,421	282,740	237,400
Long-term debt	2,281,950	1,928,491	2,205,940	1,684,746	1,655,077
Total	$ 4,578,066	$ 4,161,396	$ 4,455,327	$ 3,881,970	$ 3,697,709
Utility plant—gross	$ 6,229,446	$ 5,880,435	$ 5,712,507	$ 5,088,243	$ 4,761,265
Utility plant—net	$ 5,093,035	$ 4,904,325	$ 4,873,823	$ 4,344,083	$ 4,033,400
Number of employees at year-end	8,926	8,966	8,324	7,358	7,642
Average wage per hour	$ 16.09	$ 15.23	$ 14.48	$ 13.61	$ 13.11
Electric resources (kw)	3,925,600	3,592,100	3,570,800	3,425,900	3,528,400
Peak load (kw)	3,159,300	3,194,600	3,197,800	2,970,600	2,899,000
Electric sales—total (mwh)	14,769,603	13,863,473	13,971,314	13,054,987	12,753,542
Number of customers at year-end	566,384	545,018	521,567	499,751	468,768

OPERATING REVENUES

	1987	1986	1985	1984	1983
			(Thousands of Dollars)		
Electric					
Residential	$ 505,525	$ 466,816	$ 438,265	$ 378,536	$ 314,404
Commercial	467,643	441,236	401,439	343,971	296,364
Industrial	146,925	141,729	135,254	126,187	122,184
Irrigation	16,641	21,547	22,853	25,540	15,113
Other	79,138	80,671	97,728	86,394	90,118
Total	1,215,872	1,151,999	1,095,539	960,628	838,183
Transmission for others	14,254	19,692	16,602	13,023	12,555
Miscellaneous services	83,312	78,221	62,361	21,316	21,137
Total operating revenues	$ 1,313,438	$ 1,249,912	$ 1,174,502	$ 994,967	$ 871,875

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

Liquidity and Capital Resources

The Company has capital requirements for its ongoing construction program (see Note 12 of Notes to Consolidated Financial Statements) and for the refunding of maturing securities. Its reliance on external financing to meet those requirements is detailed in Notes 4, 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 5 with respect to the Company's capitalization at December 31, 1987. 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. During 1986 the Company entered into sale and leaseback transactions under which it sold and leased back approximately 42% of its 29.1% ownership interest in Unit 2 ("Unit 2") of the Palo Verde Nuclear Generating Station ("Palo Verde"). The leases are accounted for as operating leases and, accordingly, are not reflected in the Company's consolidated capitalization (see Note 9 of Notes to Consolidated Financial Statements).

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 Arizona Corporation Commission (the "ACC")). The funds available from operations after the payment of dividends, although less than the amount considered appropriate by management, have increased in the last few years as compared to recent periods (see Consolidated Statements of Changes in Financial Position). This situation may deteriorate unless the Company receives adequate and timely rate relief for the recovery of costs of Palo Verde Unit 2. See Note 3 of Notes to Consolidated Financial Statements for further information. In addition, the Company's retention of funds from operations has been affected by its policy of increasing common stock dividends periodically.

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 issued an order that 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 presumed as imprudently incurred for ratemaking purposes (although no presumption of prudence will attach to expenditures made up to such limit). The Company considers Palo Verde Unit 3 ("Unit 3") to have commenced commercial operation on January 8, 1988, at which time the Company's share of total Palo Verde construction costs was estimated to be $2.77 billion.

On September 4, 1986, the ACC issued an order establishing the format for a prudence audit of Palo Verde costs. Ernst & Whinney, a national accounting firm, is overseeing the prudence audit and is expected to complete the audit sometime in 1988. Pursuant to the order, the Company submitted for review ten areas in which it believes its performance in the construction of Palo Verde exceeds the prudence audit standard of "reasonableness." Any Palo Verde costs disallowed by the ACC for inclusion in the Company's rates (whether as a result of the prudence audit or otherwise) will be recognized as a loss by the Company at such time as it

becomes probable that the costs will be disallowed for ratemaking purposes. Although the Company is unable to predict the ultimate outcome of this matter, management believes that, overall, Palo Verde was constructed and planned in a prudent manner.

Palo Verde Unit 1 Rate Matters

On October 9, 1986, the ACC issued an order in the rate case in which the Company requested an increase in annual retail electric rates premised on Palo Verde Unit 1 ("Unit 1") being fully included in the Company's rate base. The order provided that those revenues attributable to the inclusion in the Company's rate base of $210 million of the capital costs of Unit 1 (representing approximately 25% of total Unit 1 costs) were to be deemed "interim or temporary in nature until further Order of the [ACC]." The Company estimates that up to $47 million in revenues collected through December 31, 1987 are to be deemed "interim or temporary" pending the outcome of the Palo Verde prudence audit. The order also granted the Company's request that, for ACC purposes, the facilities common to all three Palo Verde units (the "Common Facilities") be treated as entering rate base in three equal installments, each tied to the commercial operation date of a Palo Verde unit. Consequently, for ACC purposes the Company ceases to accrue a carrying charge on, and begins expensing the cost of owning, operating, and maintaining, its share of the Common Facilities in one-third increments.

Palo Verde Unit 2 Rate Matters

Palo Verde Unit 2 commenced commercial operation on September 19, 1986. On December 5, 1986, the ACC issued an accounting and ratemaking order (the "December Order") that allows the Company, for ACC purposes, to defer substantially all operating costs relating to, and accrue a carrying charge on, its ownership interest in Unit 2 and one-third of the Common Facilities for the period of time between the commercial operation date of Unit 2 and the effective date of new rates to cover the costs relating to Unit 2. In accordance with Statement of Financial Accounting Standards No. 92, Regulated Enterprises—Accounting for Phase-in Plans ("SFAS No. 92"), effective January 1, 1988, the Company is no longer able to accrue an equity return on Unit 2 cost deferrals, which will adversely affect net income by approximately $2.7 million per month. The impact, however, should be short-term as a decision in the Unit 2 Rate Case (defined below) is expected in early 1988. See Note 3 of Notes to Consolidated Financial Statements for a discussion of SFAS No. 92.

On December 18, 1985, the Company filed an application with the ACC for an increase in annual retail electric rates to recover the costs of Unit 2 and other increased costs of service (the "Unit 2 Rate Case"). On December 19, 1986, and again on June 10, 1987, the Company updated its filing to a requested increase in retail electric rates of approximately $183 million, which includes approximately $3.7 million annually for decommissioning Unit 1 and Unit 2, to be effective in two steps: an increase, at the earliest possible date, of approximately 15.5%, which would be partially offset by a reduction in the Company's cost of fuel (equivalent to a 9.2% base rate reduction) and an increase of approximately 2.6% on January 1, 1989. Hearings in the Unit 2 Rate Case began on March 19, 1987, and ended on June 22, 1987. A decision in the Unit 2 Rate Case is expected in early 1988. If the ACC does not grant adequate rate relief in the Unit 2 Rate Case, the Company expects its future earnings to be adversely affected.

Palo Verde Unit 3 Rate Matters

The Company considers Unit 3 to have commenced commercial operation on January 8, 1988. A specific rate application designed for the recovery of Unit 3 costs has not yet been filed with the ACC. However, the Company filed on July 24, 1987 and amended on October 2, 1987, an application with the ACC seeking an accounting and ratemaking order allowing the Company to defer substantially all operating costs relating to, and accrue a carrying charge on, its ownership interest in Unit 3 and one-third of the Common Facilities for the period of time between the commercial operation date of Unit 3 and the effective date of new rates to cover the costs relating to Unit 3. A decision in the Unit 3 accounting and ratemaking proceeding is

expected in early 1988. Failure to grant the requested Unit 3 accounting and ratemaking order would adversely affect the Company's net income by approximately $7.5 million per month from the date that Unit 3 has commenced commercial operation. In accordance with SFAS No. 92, effective January 8, 1988, the Company will not be able to accrue an equity return for Unit 3, which will adversely affect net income by approximately $2.5 million per month. See Note 3 of Notes to Consolidated Financial Statements for a discussion of SFAS No. 92.

Operating Results

Total operating revenues include 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 operating revenues over the preceding calendar year as follows:

	Year Ended December 31,		
	1987	1986	1985
	(Thousands of Dollars)		
Energy related:			
Volume increases (1)	$ 80,509	$ 3,742	$ 71,169
Revenue per KWH increases (decreases) (2)	(14,608)	52,718	63,742
Non-energy related:			
Revenue increases (decreases) (3)	(2,375)	18,950	44,624
Total increase	$ 63,526	$75,410	$179,535

(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.

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

In 1987, 1986, and 1985, the volume-related increases in electric revenues were primarily due to increased customers and sales per customer in the residential and commercial classes. In 1987, increases in residential sales per customer were largely due to colder weather conditions in the winter months of 1987. In 1986, the increase was partially offset by lower sales to resale customers. In 1985, the volume related increases were primarily due to warm weather conditions during the summer of that year. 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. Price related revenue increases and decreases reflect the timing and amounts of base rate changes, the operation of the Company's purchased power and fuel adjustment mechanism (the "PPFAM") (See Note 1d of Notes to Consolidated Financial Statements), the incentive for customers to migrate over time to that rate which produces the lowest bill, and the interaction of weather and seasonal rates on revenues. The year-to-year changes in non-energy related electric revenues reflect changes in the revenues collected for the capacity sold to other utilities.

Unit fuel costs decreased in 1987 largely due to increased nuclear generation associated with the commercial operation of Unit 2. Fuel expenses, however, increased in 1987 as increased system energy requirements, reflecting increased energy sales, more than offset lower unit fuel costs. In 1986, fuel expenses decreased due to lower unit fuel costs associated with the commercial operation of Units 1 and 2 which displaced higher cost gas and coal generation.

Variations in purchased power expense reflect contractual commitments with other utilities for purchasing power as a means of augmenting the Company's own generating sources from

time to time, the testing schedule of the Company's own nuclear generating units, and the operation of the Company's PPFAM. Fluctuations in net interchange expense reflect the market demand for interchange power purchasing and sales associated with varying weather conditions and the Company's ability to produce inexpensive energy to sell to neighboring utilities.

The decrease in purchased power and interchange expense in 1987 was primarily due to reduced purchased power and increased interchange sales due to increased nuclear generation. In 1986, the increase in purchased power and interchange expense was primarily due to the operation of the Company's PPFAM, partially offset by reduced purchased power due to the availability of energy from Units 1 and 2, the availability of low cost interchange power and reduced system energy requirements.

Operations, excluding fuel expenses, increased in 1987 due primarily to increased expenses resulting from the commercial operation of Unit 2, particularly the lease expense associated with the sale and leaseback of a portion of the Company's interest in that unit. See Note 9 of Notes to Consolidated Financial Statements.

Depreciation and amortization expenses and ad valorem taxes increase with the size of the Company's utility plant. See Note 13 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.

In December 1987, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes. The Company will adopt the new standard in 1988 or 1989 and expects it to have little impact on earnings. See Note 10 of Notes to Consolidated Financial Statements.

Palo Verde cost deferrals result from the deferral of substantially all costs of owning, operating, and maintaining Unit 2, and a carrying charge thereon, from the commercial operation date (September 19, 1986) until the effective date of new rates to cover those costs. The increase in 1987 reflects a full year of recorded cost deferrals. See "Liquidity and Capital Resources" above and Note 3 of Notes to Consolidated Financial Statements.

The aggregate amount of allowance for funds used during construction ("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 placed in service. See Note 1e of Notes to Consolidated Financial Statements for changes in AFC rates.

The decrease in interest on long-term debt in 1987 as compared to 1986 and 1985 reflects the effect of refinancing high coupon debt with the proceeds of lower interest rate debt and redeeming high coupon debt with the proceeds of the sale and leaseback of a portion of the Company's interest in Palo Verde Unit 2 in 1986. See "Liquidity and Capital Resources" above and Note 6 of Notes to Consolidated Financial Statements.

Effective January 1, 1987, the Company changed its method of recording revenues to include revenue related to electricity delivered to customers but not yet billed at year end. The cumulative effect, as of January 1, 1987, of the change, net of income taxes, was $16.1 million ($0.23 per common share) and is reported as a separate component of 1987 net income. See Note 1d of Notes to Consolidated Financial Statements for further discussion.

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

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.

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 nuclear and 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.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	1987	1986	1985
	(Dollars in Thousands, Except Per Share Amounts)		
Electric Operating Revenues	$ 1,313,438	$ 1,249,912	$ 1,174,502
Fuel Expenses:			
Fuel for electric generation	180,597	178,814	219,575
Purchased power and interchange - net	90,435	107,066	16,789
Total	271,032	285,880	236,364
Operating Revenues Less Fuel Expenses	1,042,406	964,032	938,138
Other Operating Expenses:			
Operations excluding fuel expenses	213,510	157,196	122,751
Maintenance	102,319	98,032	88,870
Depreciation and amortization	160,298	139,541	99,221
Income taxes (Note 10)	178,850	182,316	216,036
Other taxes (Note 13)	144,354	123,593	104,276
Palo Verde cost deferral (Note 3)	(84,289)	(25,526)	—
Total	715,042	675,152	631,154
Operating Income	327,364	288,880	306,984
Other Income (Deductions):			
Allowance for equity funds used during construction	59,015	93,734	143,612
Palo Verde cost deferral (Note 3)	71,961	38,262	—
Income taxes (Note 10)	(6,004)	25,496	50,757
Other - net	1,484	16,355	(4,322)
Total	126,456	173,847	190,047
Income Before Interest Deductions	453,820	462,727	497,031
Interest Deductions:			
Interest on long-term debt	190,587	214,029	209,220
Interest on short-term borrowings	5,122	6,973	6,951
Debt discount, premium and expense	6,781	5,851	3,613
Allowance for borrowed funds used during construction	(46,433)	(38,246)	(48,176)
Total	156,057	188,607	171,608
Income Before Cumulative Effect of Accounting Change	297,763	274,120	325,423
Cumulative Effect as of January 1, 1987 of Accruing Unbilled Revenues, Net of Income Taxes of $12,460,000 (Note 1)	16,110	—	—
Net Income	313,873	274,120	325,423
Preferred Stock Dividend Requirements	32,950	39,279	44,412
Earnings for Common Stock	$ 280,923	$ 234,841	$ 281,011
Average Common Shares Outstanding	71,264,947	71,264,947	71,031,228
Earnings per Average Share of Common Stock Outstanding:			
Before cumulative effect of accounting change	$ 3.71	$ 3.30	$ 3.96
Cumulative effect as of January 1, 1987 of accruing unbilled revenues (Note 1)	0.23	—	—
Total	$ 3.94	$ 3.30	$ 3.96
Dividends Declared per Share of Common Stock	$ 2.88	$ 2.94	$ 2.73

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED BALANCE SHEETS

ASSETS

	December 31, 1987	December 31, 1986
	(Thousands of Dollars)	
Utility Plant (Notes 6, 8 and 9):		
Electric plant in service and held for future use	$4,993,363	$4,807,226
Less accumulated depreciation and amortization	1,088,356	947,555
Total	3,905,007	3,859,671
Construction work in progress	1,154,829	979,733
Nuclear fuel, net of amortization of $48,055,000 and $28,555,000	33,199	64,921
Utility Plant—net	5,093,035	4,904,325
Investments and Other Assets (at cost)	46,430	40,692
Current Assets:		
Cash and marketable securities	13,643	6,770
Special deposits and working funds	3,942	167,212
Accounts receivable:		
Service customers	84,781	76,555
Other	34,365	35,143
Allowance for doubtful accounts	(2,518)	(2,060)
Accrued utility revenues (Note 1)	34,995	—
Materials and supplies (at average cost)	66,766	65,283
Fossil fuel (at average cost)	26,873	30,006
Deferred fuel	—	23,994
Other	9,868	8,060
Total Current Assets	272,715	410,963
Deferred Debits:		
Deferred income taxes	111,388	94,246
Palo Verde cost deferral (Note 3)	219,689	63,694
Unamortized costs of reacquired debt	29,301	31,002
Unamortized debt issue costs	17,643	17,563
Other	28,387	33,398
Total Deferred Debits	406,408	239,903
Total	$5,818,588	$5,595,883

See Notes to Consolidated Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED BALANCE SHEETS

LIABILITIES

	December 31, 1987	December 31, 1986
	(Thousands of Dollars)	
Capitalization (Notes 2, 4, 5 and 6):		
Common stock	$ 178,162	$ 178,162
Premiums and expenses—net	1,034,364	1,040,084
Retained earnings	693,051	617,370
Common stock equity	1,905,577	1,835,616
Non-redeemable preferred stock	168,561	218,561
Redeemable preferred stock	221,978	178,728
Long-term debt less current maturities	2,281,950	1,928,491
Total Capitalization	4,578,066	4,161,396
Current Liabilities:		
Commercial paper	—	37,000
Current maturities of long-term debt (Note 6)	17,796	312,554
Accounts payable	76,612	70,313
Accrued taxes	64,063	91,792
Accrued interest	52,162	52,498
Deferred fuel	33,601	—
Other	35,326	48,331
Total Current Liabilities	279,560	612,488
Deferred Credits and Other:		
Deferred income taxes	521,797	373,646
Deferred investment tax credit	201,242	203,066
Unamortized gain—sale of utility plant (Note 9)	131,659	141,786
Unamortized credit related to sale of tax benefits	40,270	41,958
Customers' advances for construction	26,077	23,852
Other	39,917	37,691
Total Deferred Credits and Other	960,962	821,999
Commitments and Contingencies (Notes 3 and 12)		
Total	$5,818,588	$5,595,883

ARIZONA PUBLIC SERVICE COMPANY

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

	Year Ended December 31,		
	1987	1986	1985
	(Thousands of Dollars)		
Retained earnings at beginning of year	$617,370	$592,334	$505,414
Add—Net income	313,873	274,120	325,423
Total	931,243	866,454	830,837
Deduct—Dividends:			
Common stock (Notes 4, 5 and 6)	205,242	209,805	194,091
Preferred stock (see below)	32,950	39,279	44,412
Total	238,192	249,084	238,503
Retained earnings at end of year	$693,051	$617,370	$592,334
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
$10.00 Series H	833	994	1,459
$10.70 Series I	—	942	2,300
$8.32 Series J	4,160	4,160	4,160
$8.80 Series K	2,686	3,033	3,407
$9.70 Series L	858	3,880	4,656
$11.95 Series M	—	426	1,235
$12.90 Series N	4,835	4,773	4,773
$3.58 Series O	2,983	7,160	7,160
Adjustable Rate Series P	315	1,250	1,250
Adjustable Rate Series Q	3,263	3,360	4,615
$11.50 Series R	5,824	5,750	5,750
$8.48 Series S	2,544	—	—
$8.50 Series T	1,098	—	—
Total	$ 32,950	$ 39,279	$ 44,412

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,		
	1987	1986	1985
	(Thousands of Dollars)		
Source of Funds:			
Funds from operations:			
Income before cumulative effect of accounting change	$ 297,763	$ 274,120	$ 325,423
Principal non-fund charges (credits) to income:			
Depreciation and amortization	160,298	139,541	99,221
Nuclear fuel amortization	31,722	21,762	—
Allowance for equity funds used during construction	(59,015)	(93,734)	(143,612)
Deferred income taxes—net	131,009	62,420	106,158
Deferred investment tax credit—net	(1,824)	28,563	36,383
Palo Verde cost deferral	(156,250)	(63,788)	—
Other	(6,953)	(11,499)	31,361
Total	396,750	357,385	454,934
Cumulative effect of accounting change—net	16,110	—	—
Total funds from operations	412,860	357,385	454,934
Funds from external sources:			
Sale of utility plant	—	487,296	—
Common stock	—	—	28,562
Preferred stock	99,562	—	—
Long-term debt	383,318	521,738	745,030
Other items—net	23,704	21,416	(160)
Decrease in working capital*	137,078	—	—
Total funds from external sources	643,662	1,030,450	773,432
Total source of funds	$1,056,522	$1,387,835	$1,228,366
Application of Funds:			
Capital expenditures	$ 399,701	$ 552,991	$ 637,717
Allowance for equity funds used during construction	(59,015)	(93,734)	(143,612)
Funds used for capital expenditures	340,686	459,257	494,105
Investments and other assets	5,738	18,188	(44,777)
Short-term borrowings—net	37,000	(19,000)	141,800
Repayment and reacquisition of long-term debt	328,156	537,114	275,421
Redemption of preferred stock	106,750	40,693	63,319
Dividends on preferred and common stock	238,192	249,084	238,503
Increase in working capital*	—	102,499	59,995
Total application of funds	$1,056,522	$1,387,835	$1,228,366
Increase (Decrease) in Working Capital*:			
Cash, marketable securities, special deposits and working funds	$ (156,397)	$ 162,769	$ 309
Accounts receivable—net	6,990	(16,915)	22,098
Materials, supplies and fossil fuel	(1,650)	23,331	(1,147)
Accrued utility revenue, deferred fuel and other assets	12,809	(46,154)	71,245
Accounts payable and accrued liabilities	21,766	(1,377)	(38,846)
Deferred fuel and other liabilities	(20,596)	(19,155)	6,336
Net increase (decrease)	$ (137,078)	$ 102,499	$ 59,995

*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. All significant intercompany balances and transactions have been eliminated. Certain prior year items have been reclassified to conform to 1987 presentation.

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 (the "ACC") annually. The applicable rates for 1985 through 1987 ranged from 0.68% to 9.86%.

d. Revenues and fuel costs—Effective January 1, 1987, the Company changed its method of recording revenues. Prior to that date, the Company recorded revenues as billed to its customers on a monthly cycle billing basis. The unbilled revenue for those kilowatt hours delivered to customers after meter reading dates became part of operating revenues in the following month. In order to better match revenues with expenses, the Company changed its method of accounting to accrue an estimate of revenue for sales unbilled at the end of each month. This change also serves to conform the Company's accounting treatment with the treatment of unbilled revenues as taxable under the Tax Reform Act of 1986. The cumulative effect as of January 1, 1987 of the change, net of income taxes, is $16.1 million ($0.23 per common share) and is reported as a separate component of 1987 net income. The pro forma effect of this change on the reported earnings and earnings per share of prior periods presented is not significant.

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 expense.

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 cost of borrowed funds and a reasonable rate of return on equity funds used during construction. The calculated amount is capitalized as a part of the cost of utility plant.

AFC has been calculated using composite rates of 12.75% from January 1985 through October 1986; 11.25% for November and December 1986; and 11.20% thereafter. The Company compounds AFC semi-annually and ceases to accrue AFC when construction is completed and the property is placed in service.

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 accordance with an ACC order, the Company defers amounts equal to the change in income taxes arising from substantially all other timing differences, which prior to October 1983 were reflected currently in income. At December 31, 1987 the Company had flowed through to income currently approximately $230 million of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

In compliance with an ACC order, the Company defers amounts equal to the reduction in Federal income taxes arising from investment tax credits and amortizes these amounts to other income over the estimated life of the related assets.

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.

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. Reacquired debt costs—In accordance with the regulatory accounting practices prescribed by the ACC, the Company defers the excess of the reaquisition price of reacquired debt over the net carrying amount and amortizes these amounts to expense over the remainder of the original life of the issues reacquired.

i. Nuclear fuel and decommissioning costs—Nuclear fuel is charged to fuel expense using the unit of production method under which the number of units of thermal energy produced in the current period is related to the total thermal units expected to be produced over the remaining life of the fuel.

Pursuant to the Nuclear Waste Policy Act of 1982 ("Act"), contracts have been entered into with the U.S. Department of Energy for disposal of spent nuclear fuel. The Act provides for an assessment of one mil per kilowatt-hour of nuclear generation. This amount is charged to nuclear fuel expense and recovered through the Company's fuel adjustment clauses.

The Company has made no provision for decommissioning costs for the Palo Verde Nuclear Generating Station ("Palo Verde") pending ACC action in its current rate case filing. Total decommissioning costs for all three Palo Verde units are currently estimated at approximately $615,000,000 (in 1986 dollars) of which the Company's share (29.1%) is approximately $179,000,000.

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., which on April 24, 1987 changed its name to Pinnacle West Capital Corporation ("Pinnacle West").

As part of the restructuring, the Company sold to Pinnacle West, at book value of $34,703,000, the common stock of three of its previously wholly-owned subsidiaries, Malapai Resources Company, SunCor Development Company (formerly Energy Development Company) and El Dorado Investment Company.

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

3. ACC and Related Matters.

Prudence Audit

On September 4, 1986, the ACC issued an order establishing the format for a prudence audit of Palo Verde costs. Ernst & Whinney, a national accounting firm, is overseeing the prudence audit and is expected to complete the audit sometime in 1988. Pursuant to the order, the Company submitted for review ten areas in which it believes its performance in the construction of Palo Verde exceeds the prudence audit standard of "reasonableness". Costs ultimately deemed by the ACC to have been imprudently incurred will be recognized as a loss by the Company at such time as it becomes probable that the costs will be disallowed for ratemaking purposes. Although the Company is unable to predict the ultimate outcome of this matter, management believes that overall Palo Verde was constructed and planned in a prudent manner.

Pursuant to an order issued by the ACC in October 1986, the Company estimates that up to $47 million in revenues attributable to the inclusion of $210 million of capital costs of Palo Verde Unit 1 ("Unit 1") collected through December 31, 1987 are to be deemed interim and temporary pending the outcome of the prudence audit.

Construction Cap

As an incentive to complete construction and commence operation of Palo Verde, in November 1984, the ACC issued an order that set a construction cost limit of $2.86 billion for the Company's share of Palo Verde. Amounts expended in excess of the construction cost limit are presumed to be imprudently incurred for ratemaking purposes (although no presumption of prudence will attach to expenditures made up to such limit). The Company considers Palo Verde Unit 3 ("Unit 3") to have commenced commercial operation on January 8, 1988, at which time the Company's share of total Palo Verde construction costs was estimated to be $2.77 billion.

Cost Deferrals

On October 9, 1986, the ACC issued an order allowing the Company, for ACC purposes, to defer substantially all costs relating to, and accrue a carrying charge on, that portion of common facilities associated with Palo Verde Unit 2 ("Unit 2") and Unit 3 from January 1, 1986 until the commercial operation dates of each unit. The Company considers Unit 2 and Unit 3 to have commenced commercial operation on September 19, 1986 and January 8, 1988, respectively.

On December 5, 1986, the ACC issued an accounting and ratemaking order allowing the Company, for ACC purposes, to defer substantially all costs relating to, and accrue a carrying charge on, its share of Unit 2 and associated common facilities, for the period of time between Unit 2 going into commercial operation and new retail electric rates going into effect to cover these costs. The Company has proposed that the costs of owning and operating Unit 2 be phased into its retail electric rates in 1988 and 1989. The hearing in the Unit 2 rate case was completed in June 1987 with a decision expected in early 1988.

On July 24, 1987, the Company filed an application with the ACC requesting an accounting and ratemaking order allowing the Company to defer expenses relating to, and accrue a carrying charge on, its ownership interest in Unit 3 and related common facilities for the period of time between the commercial operation date of Unit 3 and the effective date of new rates to cover the costs relating to Unit 3. Failure to grant such accounting and ratemaking order would adversely affect the Company's net income by approximately $7.5 million per month from the commercial operation date of Unit 3. A specific rate application designed for recovery of Unit 3 costs has not yet been filed with the ACC.

Financial Accounting Standards

In October 1987, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 92, Regulated Enterprises—Accounting for Phase-in Plans. SFAS No. 92 will preclude the Company from recording an equity return on cost deferrals. In accordance with an ACC order, the Company has been accruing a carrying charge, which includes an equity return, related to Unit 2 and its associated common facilities. Effective January 1, 1988, the Company will not be able to continue accruing an equity return for Unit 2, which will adversely affect net income by approximately $2.7 million per month. Such impact, however, should be short-term as a decision in the Unit 2 rate case is expected in early 1988. The Company will not be able to accrue an equity return for Unit 3, which will adversely affect net income by approximately $2.5 million per month.

Effective January 1, 1988, SFAS No. 90, Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs requires any disallowance, direct or indirect, of the cost of a recently completed plant to be recognized as a loss.

4. Common and Non-Redeemable Preferred Stock.

The balances at December 31, 1987 and 1986 of common stock and of preferred stock, which is not redeemable except pursuant to call by the Company at its option, are as follows.

	Number of Shares			Par Value			Call Price Per Share(a)
	Authorized	Outstanding at December 31, 1987	Outstanding at December 31, 1986	Per Share	Outstanding at December 31, 1987	Outstanding at December 31, 1986	
					(Thousands of Dollars)		
Common Stock	100,000,000	71,264,947(b)	71,264,947(b)	$ 2.50	$178,162	$178,162	—
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	25.00	—	50,000	(f)
Total		2,374,199	4,374,199		$168,561	$218,561	

(a) In each case plus accrued dividends.

(b) As a result of the 1985 corporate restructuring described in Note 2, these shares are now held by Pinnacle West.

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

(d) 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) The $3.58 Series O was repurchased on June 1, 1987 at $27.39 per share plus accrued dividends.

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.

Changes in common and non-redeemable preferred stock and premiums and expenses during each of the three years in the period ended December 31, 1987 are as follows (dollars in thousands):

	Common Stock		Non-Redeemable Preferred Stock (cumulative)		Premiums and Expenses
Description	Number of Shares	Par Value Amount	Number of Shares	Par Value Amount	Net*
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	—	—	—	—	(825)
Balance, December 31, 1986	71,264,947	178,162	4,374,199	218,561	1,040,084
$3.58 Series O	—	—	(2,000,000)	(50,000)	—
Premiums & Expenses - Net	—	—	—	—	(5,720)
Balance, December 31, 1987	71,264,947	$178,162	2,374,199	$168,561	$1,034,364

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

5. Redeemable Preferred Stock.

The balances at December 31, 1987 and 1986 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 as follows.

	Number of Shares Outstanding at December 31,		Par Value			
			Per	Outstanding at December 31,		Call Price
	1987	1986	Share	1987	1986	Per Share(a)
				(Thousands of Dollars)		
Redeemable Preferred Stock (cumulative)						
Serial preferred: (b)						
$10.00 Series H	72,677	88,677	$100.00	$ 7,268	$ 8,868	(c)
$8.80 Series K	277,100	344,600	100.00	27,710	34,460	(d)
$9.70 Series L	—	384,000	100.00	—	38,400	
$12.90 Series N	370,000	370,000	100.00	37,000	37,000	(e)
Adjustable Rate Series P	—	100,000	100.00	—	10,000	
$11.50 Series R	500,000	500,000	100.00	50,000	50,000	(f)
$8.48 Series S	500,000	—	100.00	50,000	—	(g)
$8.50 Series T	500,000	—	100.00	50,000	—	(h)
Total	2,219,777	1,787,277		$221,978	$178,728	

(a) In each case plus accrued dividends.

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

(c) Redeemable at $105.40 through September 1, 1988, 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 $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 (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.

(e) 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, 2001. Applicable sinking fund provisions require the redemption at par value between 1988 and 2002 of all shares according to a predetermined schedule.

(f) 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 at par value between 1990 and 2004 of all shares according to a predetermined schedule.

(g) Not redeemable prior to June 1, 1992 with the proceeds of borrowed funds or stock issues having a lower cost of money than this Series' dividend rate. Otherwise, redeemable at the option of the Company at $108.48 per share prior to June 1, 1992, at $104.24 prior to June 1, 1993, at $102.12 prior to June 1, 1994 and at $100.00 per share thereafter. Applicable sinking fund provisions require the redemption at par of 100,000 shares annually beginning June 1, 1993.

(h) All outstanding shares to be redeemed at par on September 1, 1994.

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 were 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 1992 are as follows: $6,440,000 in 1988; $6,440,000 in 1989; $9,873,000 in 1990; $9,873,000 in 1991; and $9,141,000 in 1992.

Redeemable preferred stock transactions during each of the three years in the period ended December 31, 1987 are as follows (dollars in thousands):

Description	Number of Shares	Par Value Amount
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
Retirements:		
$10.00 Series H	(16,000)	(1,600)
$10.70 Series I	(209,934)	(20,993)
$9.70 Series L	(96,000)	(9,600)
$11.95 Series M	(85,000)	(8,500)
Balance, December 31, 1986	1,787,277	178,728
Issuances:		
$8.48 Series S	500,000	50,000
$8.50 Series T	500,000	50,000
Retirements:		
$10.00 Series H	(16,000)	(1,600)
$8.80 Series K	(67,500)	(6,750)
$9.70 Series L	(384,000)	(38,400)
$12.50 Series P	(100,000)	(10,000)
Balance, December 31, 1987	2,219,777	$221,978

6. Long-Term Debt.

Details of long-term debt outstanding at December 31, 1987 and 1986 are as follows:

	December 31, 1987	December 31, 1986
	(Thousands of Dollars)	
First Mortgage Bonds:		
Maturing through 1992:		
5.125% due October 1, 1987	$ —	$ 15,000
4.7% due March 1, 1989	20,000	20,000
4.8% due November 1, 1991	35,000	35,000
4.45% due June 1, 1992	25,000	25,000
4.40% due December 1, 1992	25,000	25,000
Maturing 1993 through 1997 - 4.50% to 12%	515,000	390,000
Maturing 1998 through 2002 - 7.45% to 12.875%	249,645	277,311
Maturing 2003 through 2007 - 6.20% to 13.25%	218,000	218,000
Maturing 2008 through 2012 - 6%	34,000	34,000
Maturing 2013 through 2017 - 9% to 11.5%	450,000	350,000
Unamortized discount and premium	(4,598)	(1,487)
Total first mortgage bonds	1,567,047	1,387,824
Pollution Control Indebtedness:		
Maturing August 1, 2009 (a)	106,980	106,980
Maturing December 1, 2009 (c)	147,000	147,000
Maturing May 1, 2013 (c)	65,750	65,750
Maturing May 1, 2014 (d)	55,200	55,200
Maturing February 1, 2015 (a)	49,400	49,400
Less securities held by trustee (b)	(11,104)	(12,689)
Total pollution control indebtedness	413,226	411,641
Debentures:		
11.75% guaranteed due January 15, 1990 (e)	—	60,000
12.5% due February 15, 1992	75,000	75,000
Total debentures	75,000	135,000
Unsecured notes payable due 1987	—	70,000
Revolving credit agreements (f)	120,000	110,000
Term loan due June 1990 (LIBOR plus ¼%)	80,000	80,000
Capitalized lease obligation (g)	43,410	45,222
Other	1,063	1,536
Unamortized discount	—	(178)
Total long-term debt	2,299,746	2,241,045
Less current maturities:		
5.125% first mortgage bonds due October 1, 1987	—	15,000
11.50% first mortgage bonds due June 1, 2015	—	150,000
Unsecured notes payable due 1987	—	70,000
11.75% guaranteed debentures due January 15, 1990 (e)	—	60,000
Sinking fund requirements on first mortgage bonds	15,333	15,333
Capitalized lease obligation (g)	1,952	1,748
Other	511	473
Total current maturities	17,796	312,554
Total long-term debt less current maturities	$2,281,950	$1,928,491

(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 an interest 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 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 an interest rate, determined annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value.

(e) The 11.75% debentures due January 15, 1990 were redeemed on January 15, 1987 at 101½% plus accrued interest.

(f) Represents domestic commercial paper and borrowings under a $120,000,000 Eurocommercial paper program agreement among the company and various financial institutions that is supported by a revolving credit agreement which expires in 1991. At December 31, 1987, the outstanding balance consisted of $86,000,000 of Eurocommercial paper and $34,000,000 of domestic commercial paper. At December 31, 1986, the outstanding balance consisted of $100,000,000 of Eurocommercial paper and $10,000,000 on the revolving credit agreement. Interest rates are negotiated at the time of borrowing. Interest rates applicable to borrowings under the revolving credit agreement are LIBOR plus 0.30% to 0.45% with commitment fees of 0.15% on the unused credit line.

(g) 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, 1987 was $25,892,000.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1992 are as follows: 1988, $17,796,000; 1989, $37,985,000; 1990, $98,193,000; 1991, $173,365,000 and 1992 $143,551,000. See Note 5 for sinking fund requirements and redemptions of redeemable preferred stock.

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, 1987.

7. Lines of Credit and Compensating Balances.

The Company's lines of credit at December 31, 1987 and 1986 are summarized below. No amounts were outstanding under the lines at December 31, 1987 and 1986.

	1987	1986
	(Thousands of Dollars)	
Commercial paper backup lines	$200,000	$175,000
Other domestic bank lines (a)	226,000	240,000
Total	$426,000	$415,000

(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 and virtually all of the other bank lines (exclusive of the credit agreement referred to in (a) above) were ⅜% per annum in 1987 and 1986. Compensating balances required (but which were not legally restricted) for a small portion of the other bank lines (exclusive of the credit agreement referred to in (a) above) were 5% of the lines plus 10% of borrowings in 1987, and generally 7½% of the lines plus 5% of borrowings in 1986.

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, 1987, the Company-owned interests in jointly-owned electric generating and transmission facilities are as follows (dollars in thousands):

	Percent owned by Company	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Generating Facilities:					
Palo Verde Nuclear Generating Station - Units 1, 2 and 3	(a)	$1,600,463	$ 78,890	$1,521,573	$831,420
Four Corners Steam Generating Plant - Units 4 and 5	15.0%	127,496	25,473	102,023	815
Navajo Steam Generating Plant - Units 1, 2 and 3	14.0%	125,335	46,081	79,254	166
Transmission Facilities:					
ANPP Transmission System	35.8%(b)	61,470	4,009	57,461	4,922
Navajo Southern Transmission System	31.4%(c)	27,887	10,724	17,163	131
Palo Verde-Yuma 500KV System	23.9%(d)	15,376	1,450	13,926	—
Total		$1,958,027	$166,627	$1,791,400	$837,454

(a) The Company owns 29.1% of Units 1 and 3 and approximately 17% of Unit 2 (see Note 9).

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

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

(d) 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. Leases

In 1986, the Company entered into sale and leaseback transactions under which it sold approximately 42% of its 29.1% share of Palo Verde Unit 2 resulting in net proceeds of $487,296,000. The resulting gain of approximately $140,220,000 has been deferred and is being amortized to operations expense over the original lease term. The leases require semi-annual payments of approximately $22,061,000 through December 1996, $23,605,000 through June 1997 and $26,963,000 through December 2015 and include options to renew the leases for two additional years and to purchase the property at fair market value at the end of the lease terms. The leases are being accounted for as operating leases. Lease expense for 1987 and 1986 amounted to $43,445,000 and $9,985,000, respectively, of which $39,421,000 and $9,060,000 was deferred as allowed by an order from the ACC (see Note 3).

10. Income Tax Expense.

The components of income tax expense for each of the three years in the period ended December 31, 1987 are as follows:

	Year Ended December 31,		
	1987	1986	1985
	(Thousands of Dollars)		
Currently payable:			
Federal	$ 50,073	$ 46,463	$ 10,095
State	3,428	17,951	10,664
Other	235	1,643	2,861
Total current	53,736	66,057	23,620
Deferred:			
Depreciation—net	86,128	62,347	57,273
Taxes, pension costs and other—net	59,274	84,550	48,003
Sale of utility plant	—	(84,697)	—
Investment tax credit—net	(1,824)	28,563	36,383
Total deferred	143,578	90,763	141,659
Total	$197,314	$156,820	$165,279

The difference between income tax expense and the amount obtained by multiplying income before income taxes by the statutory federal income tax rate for each of the three years in the period ended December 31, 1987 are as follows:

	Year Ended December 31,		
	1987	1986	1985
	(Thousands of Dollars)		
Federal income tax expense at statutory rate (40% in 1987 and 46% in 1986 and 1985)	$204,475	$198,232	$225,723
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	30,935	18,855	16,431
Allowance for funds used during construction	(27,430)	(60,711)	(88,222)
Palo Verde cost deferral	(20,965)	(11,505)	—
Investment tax credit amortization	(8,273)	(5,975)	(2,955)
State income tax—net of federal income tax benefit	18,481	13,239	11,815
Other	91	4,685	2,487
Total provision for federal and state income tax expense	$197,314	$156,820	$165,279

In December 1987, the FASB issued SFAS No. 96, Accounting for Income Taxes. SFAS No. 96 retains the concept of comprehensive interperiod tax allocation, however, the way in which deferred income taxes are computed has changed from the existing "deferred" method to a liability concept. The new statement will be effective beginning in 1989, although earlier adoption is encouraged. SFAS No. 96 will be implemented by recording a cumulative effect adjustment as of the beginning of the year in which SFAS No. 96 is first adopted. The Company expects adoption of SFAS No. 96 to have little impact on earnings and has not yet made a determination as to the timing of implementation.

11. Pension Plan and Other Benefits.

The Company's pension plan, a defined benefit plan, covers virtually all employees. The benefits are based on years of service and compensation utilizing the final average pay plan benefit formula. It is the Company's policy to fund the plan on a current basis to the extent deductible under existing tax regulations. Pension cost, including administrative cost, for 1987, 1986, and 1985 was approximately $1,484,000, $2,751,000, and $15,458,000, respectively, of which approximately $601,000, $602,000, and $5,081,000, respectively was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly-owned facilities. Plan assets consist primarily of common stocks, U.S. obligations and bonds.

In 1986, the Company adopted SFAS No. 87, Employers Accounting for Pensions. Net periodic pension cost under SFAS No. 87 is made up of the components listed below as determined using the projected unit credit actuarial cost method. For prior years, the Company's net periodic pension cost was normal cost as determined using the aggregate actuarial cost method.

Net periodic pension cost (income) included the following (thousands of dollars):

	1987	1986
Service cost-benefits earned during the period	$ 12,580	$10,253
Interest cost on projected benefit obligation	20,095	18,587
Return on plan assets	(17,634)	(54,441)
Net amortization and deferral	(15,790)	26,171
Net periodic pension cost (income)	$ (749)	$ 570

The following table sets forth the plan's funded status and amounts recognized in the Company's balance sheets (thousands of dollars):

	1987	1986
Actuarial present value of benefit obligation, including vested benefits of $137,857 and $152,884	$165,869	$173,825
Effect of projected future compensation increases	79,852	68,319
Projected benefit obligation	245,721	242,144
Plan assets, at fair value	299,073	294,934
Plan assets in excess of projected benefit obligation	53,352	52,790
Unrecognized net loss from past experience different from that assumed	989	4,241
Unrecognized prior service cost	90	—
Unrecognized net asset at January 1, 1986 being recognized over 20.2 years	(58,541)	(62,005)
Accrued pension liability included in other deferred credits	$ (4,110)	$ (4,974)

	1987	1986
Principal actuarial assumptions used were:		
Discount rate	9.0%	8.0%
Rate of increase in compensation levels	6.5%	5.5%
Expected long-term rate of return on assets	10.15%	10.15%

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 for both active and retired employees amounted to approximately $22,721,000, $18,591,000 and $14,509,000, of which approximately $8,922,000, $6,285,000 and $5,825,000 was charged to expense in 1987, 1986 and 1985, respectively. Remaining amounts were either capitalized as a component of construction costs or billed to participants of jointly-owned facilities. The cost of providing such benefits solely to retired employees is not significant.

12. Commitments and Contingencies.

Nuclear Insurance

The Palo Verde participants have insurance for public liability payments resulting from nuclear energy hazards to the full limit ($720 million as of January 1, 1988) of liability under federal law (such law being commonly referred to as the "Price-Anderson Act.") The maximum amount of insurance available from private carriers of $160 million has been purchased. The balance of the coverage ($560 million as of January 1, 1988) is provided through a secondary financial protection program using an industry retrospective rating plan, under which the Palo Verde participants could be assessed deferred premium charges of up to $5 million (of which the Company's share would be 29.1%) for each Palo Verde unit licensed by the NRC in the event the total liability arising from any nuclear incident involving any licensed facility in the nation exceeds $160 million. In the event of more than one incident, the potential $5 million assessment would apply to each incident, subject to a maximum annual assessment of $10 million (of which the Company's share would be 29.1%) for each Palo Verde unit for all incidents. The insureds under the liability insurance include the Palo Verde participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard."

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for nuclear property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $1.525 billion as of January 1, 1988, a substantial portion of which must first be applied to decontamination. The Company has also secured insurance against the increased cost of generation or purchased power resulting from the accidental outage of Units 1, 2, and 3 which, after a 26-week deductible period, will pay up to approximately $813,000 per week for Unit 1, approximately $851,000 per week for Unit 2, and approximately $662,000 per week for Unit 3 for 52 weeks and up to 50% of the respective amounts for an additional 52 weeks. In the event that the incident affects more than one unit, the indemnity is reduced by 20% for each additionally affected unit (i.e., two units simultaneously out of service result in 80% of single unit recovery for the second unit; three units simultaneously out of service result in 60% of single unit recovery for the third unit).

In addition to the above-described policies of insurance, the Palo Verde participants are parties to an indemnity agreement with the NRC containing an undertaking by the NRC to indemnify the Palo Verde participants and any other person who may be legally liable for public

liability arising from nuclear incidents. The maximum aggregate indemnity for each nuclear incident is $500 million less the amount by which the amount of required financial protection exceeds $60 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 Palo Verde participants falls below $560 million.

The provisions of the Price-Anderson Act relating to the authority of the NRC to enter into new indemnity agreements with licensees of nuclear power plants expired on August 1, 1987. However, the Comptroller General of the United States has delivered an opinion stating that, until new legislation is adopted, the provisions of the Price-Anderson Act relating to the retrospective rating plan and the limitation of liability will continue to be applicable to nuclear power plants licensed for construction or operation prior to that date. The 100th Congress has considered extension of the expired provisions of the Price-Anderson Act as well as amendment or elimination of other provisions thereof. If the Price-Anderson Act is modified to increase or eliminate the limit of liability, the Company's potential assessment in the event of a nuclear incident would be significantly increased.

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 its continuing construction program. Construction expenditures in 1988 have been estimated at $316,000,000.

13. Supplementary Income Statement Information.

Other taxes charged to operations during each of the three years in the period ended December 31, 1987 are as follows:

	Year Ended December 31,		
	1987	1986	1985
	(Thousands of Dollars)		
Ad valorem	$ 71,357	$ 55,798	$ 45,554
Sales	62,783	58,606	51,438
Other	10,214	9,189	7,284
Total other taxes	$144,354	$123,593	$104,276

14. Selected Quarterly Financial Data (Unaudited).

Quarter	Operating Revenues	Operating Income	Net Income	Earnings for Common Stock	Earnings Per Share of Common Stock
		(Dollars in Thousands, Except Per Share Amounts)			
1987					
First	$290,325	$ 65,171	$ 74,320(a)	$65,109(a)	$0.91(a)
Second	326,820	81,122	75,185	67,267	0.94
Third	392,792	108,539	101,453	94,068	1.32
Fourth	303,501	72,532	62,915	54,479	0.76
1986					
First	$274,530	$ 61,317	$ 59,263	$48,682	$0.68
Second	295,452	60,108	53,689	43,662	0.61
Third	391,738	99,942	102,223	92,874	1.30
Fourth	288,192	67,513	58,945	49,623	0.70

(a) Includes cumulative effect as of January 1, 1987 of accruing unbilled revenues, net of income taxes, of $16,110,000 ($0.23 per common share).

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, 1987 and 1986 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, 1987. 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, 1987 and 1986 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, 1987, in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in 1987 in the method of accounting for unbilled revenues as described in Note 1 to the consolidated financial statements.

Deloitte Haskins & Sells

Phoenix, Arizona
February 16, 1988

APS DIRECTORS

Joe Acosta, 64, Campbell, Sindlinger and Strassels, Ltd., C.P.A.s, P.A., Phoenix, Arizona

Dino DeConcini, 54, attorney at law, Phoenix, Arizona

[1] O. Mark De Michele, 54, president and chief executive officer of the Company, Phoenix, Arizona

[1] Karl Eller, 58, chairman of the board, The Circle K Corporation, Phoenix, Arizona

[2] Marianne Moody Jennings, 34, professor of business law, College of Business Administration, Arizona State University, Tempe, Arizona.

Jack M. Morgan, 64, attorney at law and state senator in New Mexico, Farmington, New Mexico

Marvin R. Morrison, 64, farmer, cattle feeder and dairyman, Morrison Brothers Ranch, Higley, Arizona

Jaron B. Norberg, 50, executive vice president and chief financial officer of the Company, Phoenix, Arizona

[1] John R. Norton III, 58, chairman and chief executive officer, J. R. Norton Company (agricultural production), Phoenix, Arizona

[3] Donald M. Riley, 44, president and general manager, Gilpin's Enterprises, Inc. (general contractor), Yuma, Arizona

Wilma W. Schwada, 61, civic leader and homemaker, Tempe, Arizona

[3] Verne D. Seidel, 62, managing partner of HMS Properties (property management), Flagstaff, Arizona

[1] Richard Snell, 57, chairman of the board and president, Ramada Inc., Phoenix, Arizona

[1] Keith L. Turley, 64, chairman of the board of the Company; chairman of the board and president of Pinnacle West Capital Corporation, Phoenix, Arizona

[1] Morrison F. Warren, 64, professor emeritus of education, Arizona State University, Tempe, Arizona

[1] Ben F. Williams, Jr., 58, mayor of the City of Douglas and attorney at law, Douglas, Arizona

Thomas G. Woods, Jr., 61, formerly executive vice president of the Company for the Arizona Nuclear Power Project (retired February 1985), Phoenix, Arizona

(Age on Annual Meeting date, April 21, 1988)

---

[1] Member of the Executive Committee.

[2] Elected to the Board of Directors as of March 19, 1987.

[3] Elected to the Board of Directors as of June 16, 1987.

William T. Garland, Pamela Grant, John J. Rhodes, Donald N. Soldwedel, Maurice R. Tanner, and Douglas J. Wall served as directors to April 23, 1987.

SHAREHOLDER INFORMATION

Stock Listing

The adjustable rate cumulative preferred stock, Series Q (Symbol ARPQ) is listed for trading on the New York Stock Exchange. The common stock of the Company is wholly-owned by Pinnacle West 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 dividends per share paid on the Company's common stock for each of the four quarters of 1987 and 1986.

Common Stock Dividends Per Share

Quarter	1987	1986
1st Quarter	$0.72	$0.72
2nd Quarter	0.72	0.72
3rd Quarter	0.72	0.74
4th Quarter	0.72	0.76

Transfer Agent and Registrar

Pinnacle West Capital Corporation
Stock Transfer Department
P.O. Box 52134
Phoenix, Arizona 85072-2134
(602) 222-6951

General Counsel

Snell & Wilmer
Phoenix, Arizona

Auditors

Deloitte Haskins & Sells
Phoenix, Arizona

Pinnacle West Capital Corporation Stock Purchase and Dividend Reinvestment Plan

A Prospectus describing this plan is available upon request. Write: Office of the Secretary, Sta. 1930, 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, 1988, without charge, upon written request of shareholders. Write: Office of the Secretary, Sta. 1930, at the address below.

MAILING ADDRESS:

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