1991 ANNUAL REPORT

ARIZONA PUBLIC SERVICE COMPANY

APS

CONTENTS

ABOUT THE COMPANY

Arizona Public Service Company is engaged principally in the generation and sale of electricity. APS, a successor to a series of small utility operations originating in 1886, was incorporated in 1920 under the laws of Arizona and has operated under its present name since 1952. The Company's electric service reaches approximately 1,695,000 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 of the outstanding shares of common stock of the Company are owned by Pinnacle West. Pursuant to a Pledge Agreement, dated as of January 31, 1990 between Pinnacle West and Citibank, N.A., as Collateral Agent (the "Pledge Agreement"), and as part of a restructuring of substantially all of its outstanding indebtedness, Pinnacle West granted certain of its lenders a security interest in all of the Company's outstanding common stock. Until the Collateral Agent and Pinnacle West receive notice of the occurrence and continuation of an Event of Default (as defined in the Pledge Agreement), Pinnacle West is entitled to exercise or refrain from exercising any and all voting and other consensual rights pertaining to the common stock. As to matters other than the election of directors, Pinnacle West agreed not to exercise or refrain from exercising any such rights if, in the Collateral Agent's judgment, such action would have a material adverse effect on the value of the common stock. After notice of an Event of Default, the Collateral Agent will have the right to vote the common stock.

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 seventy-second annual meeting at 10:00 a.m. on Tuesday, April 21, 1992, at the offices of the Company, 400 North Fifth Street, Phoenix, Arizona.

APS OFFICERS

Jan H. Bennett, Vice President, Customer Service
William F. Conway, Executive Vice President, Nuclear
O. Mark De Michele, President and Chief Executive Officer
Walter F. Ekstrom, Executive Vice President, Engineering, Operations and Construction
Armando B. Flores, Vice President, Human Resources
William J. Hemelt, Treasurer and Assistant Secretary
James M. Levine, Vice President, Nuclear Production
Nancy C. Loftin, Secretary and Corporate Counsel
Richard W. MacLean, Vice President, Environmental, Health and Safety
Jaron B. Norberg, Executive Vice President and Chief Financial Officer
William J. Post, Vice President, Finance and Rates
Shirley A. Richard, Executive Vice President, Customer Service, Marketing and Corporate Relations
E. C. Simpson, Vice President, Nuclear Engineering and Construction
Richard Snell, Chairman of the Board

To Our APS Preferred Shareholders:

In our letter to you last year, we told you about several of the challenges confronting the Company in 1991. Among them: our request to the Arizona Corporation Commission (ACC) for a rate increase; our efforts to gain approval of our long-term energy agreement with PacifiCorp; a continuing emphasis on cost management at all levels in the Company; our commitment to safe, reliable operation of the Palo Verde Nuclear Generating Station; dealing with the 1990 reorganization of the Company; and the need to improve the Company's financial condition while at the same time responding to the competitive pressures facing our business.

We are pleased to tell you this year about the success we achieved on each of these challenges and to give you a glimpse into our future.

Rate Case

Perhaps the most significant accomplishment of the past year was the rate settlement between the Company and the ACC which was approved in December. In addition to granting the Company a 5.2 percent overall rate increase, the agreement brought to a close all of the outstanding prudence issues relating to the planning and construction of Palo Verde. On the negative side, the settlement resulted in a $265.2 million after-tax permanent write-off of certain Palo Verde expenses and additional after-tax write-offs reflecting the ACC's excess capacity finding of $109.5 million and a revenue refund obligation of $32.3 million. These write-offs meant posting a net loss for the year.

The agreement also provides for a two-year moratorium on future rate increases and limits the amount of any future increase based on meeting certain cost management targets established in the Company's strategic plan (more about our plan later). Not only does this provision bring greater stability to our prices but it puts in place a more creative approach to future rate cases. For example, these cost targets which, if achieved, establish a foundation for ratemaking based more on Company accountability and regulatory cooperation than on the traditional adversarial approach.

All in all, we believe the rate settlement to be in the long-term best interest of our Company, our investors and our customers. It was obviously viewed by the financial community as a positive development for the Company as well. Two of the national rating agencies increased our bond rating from BBB- to BBB immediately after the settlement was announced and the Pinnacle West common stock price increased significantly as well.

PacifiCorp

In another important development last year, the long-term energy agreements with PacifiCorp were finalized and approved by the ACC. The agreements involved the sale of the Cholla 4 generating unit to PacifiCorp for approximately $230 million and the joint development of other generation and transmission plans in the coming years. The immediate financial benefit to APS of the PacifiCorp agreements is approximately a $2–3 million after-tax savings each month due to lower interest expense and lower operating costs.

Furthermore, the transmission provisions of the agreements provide greater access to the strategic Northwest energy markets. This access allows us to take advantage of the seasonal diversity between these regions for the sale and purchase of energy — a goal we have long sought to achieve. With the PacifiCorp transaction, we significantly enhanced our ability to serve our customers more efficiently and competitively.

Power Plant Performance

1991 was truly an outstanding year from an operating standpoint. Our coal-fired plants achieved a combined equivalent availability factor of over 89 percent for the year. In addition, the capacity factor for the Palo Verde site was 75 percent, well above the industry average. These are both records for the Company and represent tremendous savings for our customers and a significant contribution to the Company's financial success.

Total electrical production by Palo Verde, the top-producing nuclear plant in the nation last year, surpassed the 1990 record-setting mark. In 1991, Palo Verde generated almost 26.7 million gross megawatt-hours of electricity. In fact, one or more of the Palo Verde units led the nation in nuclear generation 11 of the 12 months in 1991, and were in the top 10 world-wide in 10 of those months.

In all, more than 96 percent of the electricity generated by APS came from our coal and nuclear units, a tribute to the operators and managers of our generating facilities.

Financial Results

Although the write-offs resulting from the rate case settlement produced a net loss for the year, we believe the long-term benefits of the settlement present a positive future for the Company. Excluding the effect of the write-offs, the Company's net income would have been $184 million on revenues of $1.5 billion. Additionally, the Company generated all of its capital expenditures internally, the highest level in over 20 years. With the rate settlement in place and aggressive cost management efforts already underway as a result of our strategic plan, we look forward to greater financial success in the future.

Strategic Plan

In 1990, the Company's work force was trimmed significantly as we set about to reorganize APS. To give direction and focus to that effort, we developed a long-range strategic plan. The mission set forth in that plan will guide Arizona Public Service Company for the next several years. It reads:

APS is the leading electric energy company serving the people of Arizona.

By 1995 APS will:

- *Be one of the top five investor-owned electric utilities in America in terms of cost management, customer service, power plant performance, nuclear and industrial safety and environmental performance.*
- *Have significantly improved our price competitiveness.*
- *Have improved our competitive marketplace position.*
- *Be recognized as the premier corporate citizen in Arizona.*

We will succeed through employee commitment to continuous improvement with emphasis on teamwork and workplace innovation.

In addition to giving each APS employee much-needed focus and direction, our strategic plan contains the details of how we intend to achieve our mission. It was this strategic plan and our commitment to achieve specific cost management goals set forth therein that were so vital to the successful rate settlement with the ACC described above.

Over the next several years, our strategic plan will focus our energies on controlling costs in an aggressive and responsible manner, maintaining a safe workplace for our employees, providing exceptional service to our customers and protecting and preserving our environment and natural resources.

APS employees, through their dedication and commitment, are helping us create a bright future for our customers and our investors. We believe our accomplishments in 1991, coupled with the direction and focus of our strategic plan, position APS for continued success in becoming one of the premier utilities and investments in the country.

We invite you to review the detailed financial information in the following pages and to attend our Annual Meeting of Stockholders on April 21, 1992, at our corporate offices in Phoenix, Arizona.

Sincerely,

R Snell

Richard Snell
Chairman of the Board

O. Mark De Michele

O. Mark De Michele
President and
Chief Executive Officer

ARIZONA PUBLIC SERVICE COMPANY

SELECTED FINANCIAL DATA

	1991 (a)	1990	1989	1988	1987
		(Thousands of Dollars)			
Electric Operating Revenues	$1,515,289	$1,508,325	$1,447,154	$1,442,023	$1,322,930
Refund Obligation	(53,436)	—	—	—	—
Net Operating Revenues	1,461,853	1,508,325	1,447,154	1,442,023	1,322,930
Electric Operating Expenses:					
Operation and maintenance	675,507	697,395	641,702	594,041	596,353
Depreciation and amortization	217,198	211,727	202,409	194,334	160,298
Taxes*	310,778	303,694	296,887	318,047	323,204
Palo Verde cost deferral	(70,886)	(64,379)	(68,989)	(67,479)	(84,289)
Total	1,132,597	1,148,437	1,072,009	1,038,943	995,566
Operating Income	329,256	359,888	375,145	403,080	327,364
Other Income (Deductions)*	(324,922)	56,713	56,965	71,694	126,456
Interest Deductions — Net	226,983	236,589	219,756	203,563	156,057
Income (Loss) Before Cumulative Effect of Accounting Change	(222,649)	180,012	212,354	271,211	297,763
Cumulative Effect of Accounting Change — Net of Tax*	—	—	—	—	16,110
Net Income (Loss)	(222,649)	180,012	212,354	271,211	313,873
Preferred Stock Dividend Requirements	33,404	31,060	32,302	33,319	32,950
Earnings (Loss) for Common Stock	$ (256,053)	$ 148,952	$ 180,052	$ 237,892	$ 280,923
Total Assets	$5,887,981	$6,402,680	$6,299,885	$5,990,964	$5,818,588
Long-Term Debt and Redeemable Preferred Stock	$2,412,641	$2,496,406	$2,510,360	$2,455,880	$2,503,928

(a) See Note 2 of Notes to Financial Statements for a discussion of rate case settlement and disallowances of plant costs affecting 1991.

* Federal and state income taxes are included in Taxes, Other Income and Cumulative Effect of Accounting Change. Total income tax expense (benefit) was as follows: 1991, $(94,750,000); 1990, $126,831,000; 1989, $145,678,000; 1988, $183,897,000; and 1987, $197,314,000. Palo Verde cost deferral included in Other Income for 1991, 1990, 1989, 1988, and 1987 was $63,068,000, $71,404,000, $72,861,000, $79,432,000, and $71,961,000, respectively.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of certain information in the foregoing table.

OTHER FINANCIAL AND OPERATING STATISTICS

	1991 (a)	1990	1989	1988	1987
	(Dollars in Thousands, Except Per Hour Amounts)				
Capitalization:					
Common equity	$1,433,463	$ 1,860,110	$ 1,901,615	$ 1,932,419	$ 1,905,577
Non-redeemable preferred stock	168,561	168,561	168,561	168,561	168,561
Redeemable preferred stock	227,278	192,453	204,021	212,948	221,978
Long-term debt	2,185,363	2,303,953	2,306,339	2,242,932	2,281,950
Total	$4,014,665	$ 4,525,077	$ 4,580,536	$ 4,556,860	$ 4,578,066
Utility plant — gross	$6,409,892	$ 6,796,688	$ 6,668,644	$ 6,414,655	$ 6,229,446
Utility plant — net	$4,487,124	$ 5,126,461	$ 5,168,730	$ 5,112,648	$ 5,093,035
Number of employees at year-end	7,063	7,029	8,181	8,135	8,926
Average base payroll per hour	$ 20.43	$ 19.14	$ 17.97	$ 17.02	$ 16.09
Electric resources (kw)*	4,401,800	4,626,800	4,575,300	4,319,200	3,930,600
Peak load — actual (kw)	3,532,000	3,679,700	3,645,600	3,371,600	3,159,300
Peak load — weather adjusted (kw)	3,643,000	3,544,000	3,474,000	3,429,000	3,155,000
Electric sales — total (mwh)	19,986,485	19,776,140	17,488,551	17,760,896	15,404,312
Number of customers at year-end	620,402	606,605	594,820	582,003	566,384

OPERATING REVENUES

	1991 (a)	1990	1989	1988	1987
	(Thousands of Dollars)				
Electric					
Residential	$ 590,345	$ 579,556	$ 559,755	$ 545,082	$ 505,525
Commercial	585,952	571,806	521,665	501,666	467,643
Industrial	165,822	160,913	172,556	166,346	146,925
Irrigation	12,398	13,134	14,424	14,989	16,641
Other	138,182	146,740	112,613	114,180	88,630
Total	1,492,699	1,472,149	1,381,013	1,342,263	1,225,364
Transmission for others	7,871	9,321	14,117	17,187	14,254
Miscellaneous services	14,719	26,855	52,024	82,573	83,312
Electric operating revenues	1,515,289	1,508,325	1,447,154	1,442,023	1,322,930
Refund obligation	(53,436)	—	—	—	—
Net operating revenues	$1,461,853	$ 1,508,325	$ 1,447,154	$ 1,442,023	$ 1,322,930

(a) See Note 2 of Notes to Financial Statements for a discussion of rate case settlement and disallowances of plant costs affecting 1991.

*Includes capacity from the Company's generating resources and purchased power contracts.

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

MAJOR INFLUENCE ON FINANCIAL CONDITION

Rate Case Settlement

In December 1991, the Company and the ACC reached a settlement in a retail rate case that had been pending before the ACC since January 1990. The ACC authorized an annual net revenue increase of $66.5 million or approximately 5.2%. In turn, the Company wrote off $577.1 million of costs associated with Palo Verde and recorded a refund obligation of $53.4 million. The after tax impact of these adjustments reduced net income by $407 million. A discussion of the components of the disallowance follows.

Prudence Audit

The ACC closed its prudence audit of Palo Verde and the Company wrote off $142 million ($101.3 million after tax) of construction costs relating to Palo Verde Units 1, 2, and 3 and $13.3 million ($8.6 million after tax) of deferred costs relating to the prudence audit.

Interim or Temporary Revenues

The ACC removed the interim and temporary designation on $385 million of revenues collected by the Company from 1986 through 1991 that had been previously authorized for Palo Verde Units 1 and 2. The Company recorded a refund obligation to customers of $53.4 million ($32.3 million after tax) related to the Palo Verde write-off discussed above. The refund obligation has been used to reduce the amount of annual rate increase granted rather than require specific customer refunds and accordingly, will be reversed over thirty months beginning December, 1991.

Temporary Excess Capacity — Palo Verde Unit 3

The ACC deemed a portion of Palo Verde Unit 3 to be excess capacity and accordingly, did not recognize the related Unit 3 costs for ratemaking purposes. This action effectively disallows for thirty months the recovery of return on approximately $475 million of the Company's investment in Unit 3. The Company recognized a charge of $181.2 million ($109.5 million after tax), representing the present value of the lost cash flow which will be accreted back over thirty months. In accordance with generally accepted accounting principles, the Company is recording this accretion income on Unit 3 which has been discounted under the ACC's excess capacity finding. The Company recorded $5.3 million ($3.2 million after tax) of accretion income in 1991 and will record after tax accretion income of $40.7 million, $45.3 million, and $20.3 million in 1992, 1993, and 1994, respectively.

In December 1991, the Company stopped deferring Unit 3 costs and recorded a $240.6 million ($155.3 million after tax) write-off of Unit 3 cost deferrals due to Unit 3 being deemed excess capacity. At that time the Company began amortizing to expense and recovering in rates the remaining $320 million ($210.3 million after tax) balance over a thirty-five year period as approved by the ACC.

Future Retail Rate Increase

The Company agreed not to file a new rate application before December 1993 and the ACC agreed to expedite the processing of this rate application. The Company and the ACC also agreed on a unit sales price ceiling of 9.585 cents per kilowatt hour in this future rate application which was based on the Company meeting certain management cost targets. The Company's current unit sales price is approximately 9 cents per kilowatt hour. This ceiling may be adjusted for the effects of significant changes in laws, regulatory requirements or the Company's cost of equity capital. Management believes that the unit sales price ceiling will not adversely impact the Company's future earnings.

Common Stock Dividend Payments

The Company agreed to limit its annual common stock dividends to $170 million through December, 1993.

Sale of Cholla Unit 4

In July 1991, the Company sold Unit 4 of the Cholla Power Plant to PacifiCorp for approximately $230 million. The resulting gain of approximately $20 million (after income tax effects) was deferred and is being amortized as a reduction to operations expense over a four year period in accordance with an ACC order. The transaction also provides for transmission and electrical energy sales between the Company and PacifiCorp.

LIQUIDITY AND CAPITAL RESOURCES

The Company's liquidity is affected primarily by construction expenditures and the required repayments of long-term debt and preferred stock obligations. The capital resources available to meet these requirements include funds provided by operations and external financing.

Present construction plans exclude any major baseload generating plants for the next ten years. In general, most of the construction expenditures are for updating and expanding transmission and distribution capabilities. The anticipated construction expenditures are $228 million, $241 million, and $270 million for 1992, 1993, and 1994, respectively. These amounts include nuclear fuel expenditures, but exclude capitalized property taxes and capitalized interest costs.

In 1991, the Company financed all of its capital expenditures (construction expenditures and capitalized property taxes) with internally generated funds, after the payment of dividends, as compared to approximately 54% and 39% in 1990 and 1989, respectively. The increases in both years were primarily the result of reduced construction expenditures and lower common stock dividend payments. The Company estimates that it will finance all of its capital expenditures with internally generated funds, after the payment of dividends, in the 1992–1994 period.

During 1991, the Company redeemed or repurchased approximately $330 million of its first mortgage bonds and preferred stock, of which $183 million were required. Refunding obligations for preferred stock and long-term debt, a capitalized lease obligation, and certain anticipated early redemptions are expected to total up to approximately $1.041 billion (of which approximately $862 million are optional redemptions), $110 million, and $97 million for the years 1992, 1993, and 1994, respectively. As of March 2, 1992, the Company will have redeemed approximately $512 million of the 1992 total of long-term indebtedness. Although its plans are subject to change, in 1992 the Company intends to issue approximately $750 million of long-term debt (primarily first mortgage bonds). The Company currently expects that substantially all of the net proceeds of the long-term debt to be issued during 1992 will be used to redeem, repay, repurchase, or retire outstanding long-term indebtedness. On January 29, 1992, the Company issued $150 million of its First Mortgage Bonds, 7-1/8% Series due 1997, and $175 million of its First Mortgage Bonds, 8-3/4% Series due 2024.

Provisions in the Company's mortgage bond indenture and articles of incorporation restrict the Company from issuing additional first mortgage bonds or preferred stock, respectively, unless certain coverage ratios are met. In addition, the mortgage bond indenture limits the amount of additional bonds that may be issued to a percentage of net property additions and property previously pledged as security for certain bonds that have been redeemed or retired. The coverage ratio contained in the Company's articles of incorporation has at times limited the Company's ability to issue preferred stock.

The write-offs recorded by the Company in connection with the rate case settlement resulted in negative coverage ratios under the mortgage bond indenture and the articles of incorporation for the year ended December 31, 1991. However, based on certain provisions in the mortgage

bond indenture and the articles of incorporation, the Company will be able to meet the required coverage ratios for the issuance of first mortgage bonds and preferred stock through March 31, 1992, notwithstanding the negative coverage ratios for the year ended December 31, 1991. The Company estimates that it will not be able to meet the required coverage ratios between April 1, 1992 and January 1, 1993. However, during this period (or any other period in which the Company is not able to meet the required coverage ratios), the Company may issue limited amounts of first mortgage bonds (for refunding and other purposes) and shares of additional preferred stock (for the purpose of redeeming or retiring other preferred stock), in each case without the necessity of meeting the required coverage ratios. The Company expects that it will be able to meet its capital requirements with internally generated funds and external financings, even during any period that the Company cannot meet the required coverage ratios.

The ACC has authority over the Company with respect to the issuance of long-term debt and equity securities. Existing ACC orders allow the Company to have up to approximately $2.6 billion in long-term debt and approximately $501 million of preferred stock outstanding at any one time. The Company does not expect these ACC orders to limit the Company's ability to meet its capital requirements.

At December 31, 1991, the Company had credit commitments from various banks totalling approximately $372 million, which were available either to support the issuance of commercial paper or to be used for bank borrowings. There were no outstanding balances at year end.

The Company owns or leases a 29.1% interest in Palo Verde and owns a 15% interest in Four Corners Units 4 and 5. El Paso Electric Company owns or leases a 15.8% interest in Palo Verde and owns a 7% interest in Four Corners Units 4 and 5. On January 8, 1992, EPEC filed a voluntary petition to reorganize under Chapter 11 of the Bankruptcy Code. Each Palo Verde and Four Corners participant is required to fund its proportionate share of specified costs relating to Palo Verde and Four Corners Units 4 and 5, respectively. The Company estimates EPEC's total monthly share of these costs to be approximately $10 million, $9 million of which relates to its share of Palo Verde costs. If a participant fails to meet its payment obligations, each non-defaulting participant pays its proportionate share of the payments owed by the defaulting participant. On February 13, 1992, the bankruptcy court approved a stipulation between EPEC and the Company, as the operating agent of Palo Verde, pursuant to which EPEC agreed to pay its proportionate share of all Palo Verde invoices delivered to EPEC after February 6, 1992. EPEC agreed to make these payments until such time as an order is entered by the bankruptcy court, if ever, authorizing or directing EPEC's rejection of the participation agreement governing the relations among the Palo Verde participants. The stipulation also specifies that approximately $9.2 million of EPEC's Palo Verde payment obligations invoiced prior to February 7, 1992 are to be considered "pre-petition" general unsecured claims of the other Palo Verde participants. The Company cannot currently predict the outcome of this matter.

The Clean Air Act Amendments of 1990 will be implemented through regulations to be developed during the next decade by the EPA and state and local environmental regulatory authorities. Therefore, it is not presently possible to precisely predict the impacts of those regulations on the Company's operations. However, based on information currently available, the Company does not expect its costs relating to the implementation of the Act to have a material impact on its financial statements.

OPERATING RESULTS

Summary

Because of the rate settlement and the resulting write-offs (see "Rate Case Settlement" above), the Company recognized a net loss of ($222,649,000) in 1991 compared to net income of $180,012,000 and $212,354,000 in 1990 and 1989, respectively.

	Year Ended December 31,		
	1991	1990	1989
	(Thousands of Dollars)		
Operating Revenues ...	$1,515,289	$1,508,325	$1,447,154
Net Income (Loss)	$ (222,649)	$ 180,012	$ 212,354

Excluding the write-offs, 1991 results were:

Net Income	$ 184,380

Excluding the effects of the write-offs, net income increased slightly in 1991 primarily due to fuel savings, interest savings resulting from lower interest rates, and organizational restructuring costs incurred in 1990. These cost reductions were partially offset by higher property tax rates, the write-off of costs associated with a proposed generating unit, increased overhaul costs at fossil plants, and various other operating expense increases.

The decrease in net income in 1990 was primarily the result of the expiration of a layoff power sales agreement covering Cholla Unit 4, the cost of an organizational restructuring, and increased property taxes.

Electric Operating Revenues

Changes in operating revenues include the effects of changes in both volume and price of unit sales. An analysis of the changes in 1991 and 1990 revenues excluding the effects of the refund obligation in 1991 follows:

	Changes From Prior Year Ended December 31,	
	1991	1990
	(Thousands of Dollars)	
Volume Variance	$23,823	$79,492
Price Variance	(6,380)	20,735
Change in Other Operating Revenues(1)	(10,479)	(39,056)
Total	$ 6,964	$61,171

(1) Includes revenues for miscellaneous services, transmission for others, and a termination settlement with one wholesale customer.

The volume-related increase in 1991 was largely due to customer growth in residential and business customer classes and increased sales per business customer, partially offset by decreases due to milder weather. In 1990, the volume-related increase was due to increased resale sales, customer growth in residential and business customer classes and increased sales per business customer. The price-related revenue increases and decreases reflect the timing and amounts of base rate changes, discontinuation of the Company's Purchased Power and Fuel Adjustment Mechanism and the effect of weather and seasonal rates on annual average revenue per kilowatt-hour. The decrease in 1991 and 1990 in other operating revenues was primarily due to the expiration of a layoff power sales agreement covering Cholla 4.

Fuel Expenses

Fuel expenses decreased in 1991 due to lower average fuel costs resulting from increased nuclear generation. Fuel expenses increased in 1990 due to increased generation, largely offset by lower average fuel costs resulting from increased nuclear generation.

Increases in purchased power in 1991, primarily due to purchases from PacifiCorp, were nearly offset by a decrease in other interchange purchases. Decreases in purchased power in 1990 were primarily due to increased nuclear generation.

Other Income

Net income reflects accounting practices unique to regulated public utilities and represents a composite of cash and noncash items, including AFUDC and the cost deferrals associated with Palo Verde Unit 3. In addition, beginning on December 6, 1991, the Company began recognizing accretion income on Unit 3 which has been discounted under the ACC's excess capacity finding (see "Statement of Cash Flows").

Palo Verde Unit 3 Cost Deferrals

When Palo Verde Unit 3 began commercial operation in 1988, the Company ceased accruing AFUDC and began expensing the costs of operating and maintaining the unit. Effective on the commercial operation date, the ACC allowed the Company to defer operating costs (excluding fuel) and financing costs for Unit 3, including one-third of the facilities common to all Palo Verde units. These deferrals ended on December 6, 1991, with implementation of new rates.

Accounting Issues

In December 1990, the FASB issued SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," which requires the expected cost of postretirement benefits other than pensions to be charged to expense during the years employees render service. This is a significant change from the Company's current policy of recognizing the costs of these benefits as they are paid. The Company plans to adopt the standard in 1993, and amortize the accumulated benefit obligation at that date over a twenty-year period. The Company's postretirement benefit plans are currently being reviewed, however based on a preliminary actuarial review using the current benefit plans, the accumulated benefit obligation at December 31, 1992 is expected to be approximately $200 million. Based on current estimates, the adoption of the standard will result in an increase in annual postretirement benefit expense of approximately $12 million (before income taxes). The Company intends to seek regulatory approval for the recovery of these costs.

In February 1992, the FASB issued SFAS No. 109, "Accounting for Income Taxes." See Note 8 in Notes to Financial Statements. SFAS No. 109 requires that the liability method be used in calculating deferred income taxes. The Company plans to adopt the new statement in 1993 and does not expect it to have a material effect on net income.

Effects of Inflation

The Company is subject to rate regulation and income tax laws that are based on the recovery of historical cost. Therefore, inflation creates an economic loss because the Company is recovering its cost of investments in dollars that have less purchasing power. While the rate of inflation has been relatively low in recent years, inflation continues to have an adverse effect on the Company due to the large investment in long-lived utility plant. Conventional accounting for historical cost does not recognize this economic loss nor the partially offsetting gain that arises through financing instruments with fixed-money obligations, such as long-term debt and preferred stock. Any recognition of inflation by regulatory authorities is generally reflected in the rate of return allowed. The impact of inflation on the future results of operations by the Company cannot be predicted precisely, since it will depend largely on the timing of rate decisions and the extent to which those decisions are based on current costs of providing electric service.

Report of Management

The primary responsibility for the integrity of the Company's financial information rests with management. Accordingly, management has prepared the accompanying financial statements and related information in this Annual Report. Such information was prepared in accordance with generally accepted accounting principles appropriate in the circumstances, based on management's best estimates and judgments, and giving due consideration to materiality. These financial statements have been examined by independent auditors and their report is included herein.

In recognition of its responsibility for the financial statements, management maintains and relies upon systems of internal accounting controls. The systems are designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management's authorization and properly recorded to permit preparation of reliable financial statements. A limiting factor inherent in all systems of internal accounting control is that the cost of the system should not exceed the benefits to be derived. Management believes that the Company's system provides the appropriate balance between such costs and benefits.

Periodically the internal accounting control system is reviewed by both the Company's internal auditors and its independent auditors to test for compliance. Reports issued by the internal auditors are released to management, and such reports, or summaries thereof, are transmitted to the Audit Committee of the Board of Directors and the independent auditors on a timely basis. Internal audit workpapers are readily available for inspection by the independent auditors.

The Audit Committee, composed solely of outside directors, meets periodically with management, internal auditors, and independent auditors to review the work of each and ensure that each is properly discharging its responsibilities. The internal auditors and independent auditors have free access to the Audit Committee, without management present, to discuss the results of their audit work and their evaluations of the adequacy of internal controls and the quality of financial reporting.

The Company maintains high standards when selecting, training, and developing personnel, with a view toward maintaining strong, effective internal accounting controls and unbiased, uniform reporting standards. Management believes that the Company's policies and procedures provide reasonable assurance that operations are conducted in conformity with the law and with management's commitment to a high standard of business conduct.

O. Mark De Michele
President and
Chief Executive Officer

Jaron B. Norberg
Executive Vice President and
Chief Financial Officer

ARIZONA PUBLIC SERVICE COMPANY

STATEMENTS OF INCOME

	Year Ended December 31,		
	1991	1990	1989
	(Thousands of Dollars)		
Electric Operating Revenues	$1,515,289	$1,508,325	$1,447,154
Refund obligation (Note 2)	(53,436)	—	—
Net Operating Revenues	1,461,853	1,508,325	1,447,154
Fuel Expenses:			
Fuel for electric generation	223,983	242,676	235,854
Purchased power	49,788	46,372	65,125
Deferred fuel (Note 1)	—	—	(31,901)
Total	273,771	289,048	269,078
Operating Revenues Less Fuel Expenses	1,188,082	1,219,277	1,178,076
Other Operating Expenses:			
Operations excluding fuel expenses	286,167	298,533	251,985
Maintenance	115,569	109,814	120,639
Depreciation and amortization	217,198	211,727	202,409
Income taxes (Note 8)	96,273	106,044	122,674
Other taxes (Note 11)	214,505	197,650	174,213
Palo Verde cost deferral (Notes 1 and 2)	(70,886)	(64,379)	(68,989)
Total	858,826	859,389	802,931
Operating Income	329,256	359,888	375,145
Other Income (Deductions):			
Allowance for equity funds used during construction	3,902	4,042	5,954
Palo Verde cost deferral (Notes 1 and 2)	63,068	71,404	72,861
Income taxes (Note 8)	(11,393)	(20,787)	(23,004)
Disallowed Palo Verde costs (Note 2)	(577,145)	—	—
Income taxes on disallowed Palo Verde costs (Note 8)	202,416	—	—
Palo Verde accretion income (Note 2)	5,306	—	—
Other — net	(11,076)	2,054	1,154
Total	(324,922)	56,713	56,965
Income Before Interest Deductions	4,334	416,601	432,110
Interest Deductions:			
Interest on long-term debt	217,261	226,258	213,710
Interest on short-term borrowings	10,363	13,734	10,533
Debt discount, premium and expense	5,995	5,302	5,967
Allowance for borrowed funds used during construction	(6,636)	(8,705)	(10,454)
Total	226,983	236,589	219,756
Net Income (Loss)	(222,649)	180,012	212,354
Preferred Stock Dividend Requirements	33,404	31,060	32,302
Earnings (Loss) for Common Stock	$ (256,053)	$ 148,952	$ 180,052

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

BALANCE SHEETS

ASSETS

	December 31, 1991	December 31, 1990
	(Thousands of Dollars)	
Utility Plant (Notes 4, 6 and 7):		
Electric plant in service and held for future use	$6,037,382	$6,417,743
Less accumulated depreciation and amortization	1,815,373	1,582,528
Total	4,222,009	4,835,215
Construction work in progress	197,643	209,266
Nuclear fuel, net of amortization of $107,395,000 and $87,699,000	67,472	81,980
Utility Plant — net	4,487,124	5,126,461
Investments and Other Assets (at cost)	54,603	52,609
Current Assets:		
Cash and cash equivalents	139,085	10,720
Accounts receivable:		
Service customers	104,752	104,105
Other	17,080	36,490
Allowance for doubtful accounts	(3,641)	(2,647)
Accrued utility revenues (Note 1)	44,462	45,466
Materials and supplies (at average cost)	107,225	101,440
Fossil fuel (at average cost)	30,515	27,810
Other	9,832	9,520
Total Current Assets	449,310	332,904
Deferred Debits:		
Deferred income taxes	267,289	149,118
Palo Verde Unit 3 cost deferral (Notes 1 and 2)	320,070	428,340
Palo Verde Unit 2 cost deferral (Note 1)	190,123	196,186
Unamortized costs of reacquired debt	26,764	29,413
Unamortized debt issue costs	16,754	16,066
Other	75,944	71,583
Total Deferred Debits	896,944	890,706
Total	$5,887,981	$6,402,680

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

BALANCE SHEETS

LIABILITIES

	December 31, 1991	December 31, 1990
	(Thousands of Dollars)	
Capitalization (Notes 3 and 4):		
Common Stock	$ 178,162	$ 178,162
Premiums and expenses — net	1,039,327	1,034,361
Retained earnings	215,974	647,587
Common stock equity	1,433,463	1,860,110
Non-redeemable preferred stock	168,561	168,561
Redeemable preferred stock	227,278	192,453
Long-term debt less current maturities	2,185,363	2,303,953
Total Capitalization	4,014,665	4,525,077
Current Liabilities:		
Notes payable to banks (Note 5)	—	100,000
Commercial paper (Note 5)	—	59,000
Current maturities of long-term debt (Note 4)	299,550	173,366
Accounts payable	79,905	74,288
Accrued taxes	85,183	90,559
Accrued interest	59,941	64,013
Other (Note 2)	91,180	34,297
Total Current Liabilities	615,759	595,523
Deferred Credits and Other:		
Deferred income taxes (Note 8)	857,268	868,001
Deferred investment tax credit	163,571	178,964
Unamortized gain — sale of utility plant (Note 7)	126,669	115,240
Unamortized credit related to sale of tax benefits (Note 8)	—	35,208
Customer advances for construction	15,662	23,392
Other	94,387	61,275
Total Deferred Credits and Other	1,257,557	1,282,080
Commitments and Contingencies (Notes 2 and 10)		
Total	$5,887,981	$6,402,680

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

STATEMENTS OF RETAINED EARNINGS

	Year Ended December 31,		
	1991	1990	1989
	(Thousands of Dollars)		
Retained earnings at beginning of year	$ 647,587	$689,107	$719,999
Add: Net income (loss)	(222,649)	180,012	212,354
Total	424,938	869,119	932,353
Deduct:			
Dividends:			
Common stock (Notes 3 and 4)	170,000	190,472	210,944
Preferred stock (see below)	33,404	31,060	32,302
Premium paid on reacquisition of preferred stock	5,560	—	—
Total deductions	208,964	221,532	243,246
Retained earnings at end of year	$ 215,974	$647,587	$689,107
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
$10.00 Series H	193	353	513
$8.32 Series J	4,160	4,160	4,160
$8.80 Series K	1,794	2,042	2,083
$12.90 Series N	2,994	3,291	3,953
Adjustable Rate Series Q	3,321	3,448	3,442
$11.50 Series R	4,720	5,725	6,110
$8.48 Series S	4,240	4,240	4,240
$8.50 Series T	4,250	4,250	4,250
$10.00 Series U	4,181	—	—
Total	$ 33,404	$ 31,060	$ 32,302

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY
STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	1991	1990	1989
	(Thousands of Dollars)		
Cash Flows from Operations:			
Net income (loss)	$(222,649)	$180,012	$212,354
Items not requiring cash:			
Depreciation and amortization	217,198	211,727	202,409
Nuclear fuel amortization	43,990	44,739	17,241
Allowance for equity funds used during construction	(3,902)	(4,042)	(5,954)
Deferred income taxes — net	(128,904)	82,008	107,860
Deferred investment tax credit — net	(15,393)	(7,012)	(6,159)
Deferred fuel	—	—	(33,543)
Palo Verde cost deferral	(133,954)	(135,783)	(141,850)
Refund obligation — net	52,057	—	—
Disallowed Palo Verde costs	577,145	—	—
Palo Verde accretion income	(5,306)	—	—
Changes in certain current assets and liabilities:			
Accounts receivable — net	19,757	(18,157)	(3,177)
Accrued utility revenues	1,004	(3,048)	(1,394)
Materials, supplies and fossil fuel	(8,490)	(15,318)	(8,968)
Other current assets	(312)	5,147	(4,699)
Accounts payable	10,317	(7,701)	18,322
Accrued taxes	(5,376)	14,475	1,170
Accrued interest	(4,358)	2,422	7,212
Other current liabilities	3,175	(8,758)	8,095
Other — net	2,562	15,651	7,215
Net cash provided	398,561	356,362	376,134
Cash Flows from Financing:			
Preferred stock	49,375	—	—
Long-term debt	319,463	222,215	98,625
Short-term borrowings — net	(159,000)	(81,000)	190,500
Dividends paid on common stock	(170,000)	(190,472)	(210,944)
Dividends paid on preferred stock	(33,127)	(32,088)	(31,823)
Repayment of preferred stock	(15,175)	(11,568)	(8,927)
Repayment and reacquisition of long-term debt	(314,457)	(82,111)	(54,528)
Net cash used	(322,921)	(175,024)	(17,097)
Cash Flows from Investing:			
Capital expenditures	(182,687)	(259,280)	(300,347)
Allowance for equity funds used during construction	3,902	4,042	5,954
Sale of property (Note 2)	233,504	4,771	8,745
Other	(1,994)	5,926	(7,342)
Net cash provided (used)	52,725	(244,541)	(292,990)
Net increase (decrease) in cash and cash equivalents	128,365	(63,203)	66,047
Cash and cash equivalents at beginning of period	10,720	73,923	7,876
Cash and cash equivalents at end of period	$139,085	$ 10,720	$ 73,923
Supplemental Disclosure of Cash Flow Information:			
Cash paid during the year for:			
Interest (excluding capitalized interest)	$ 220,908	$227,985	$205,646
Income taxes	$ 63,104	$ 49,145	$ 51,686

See Notes to Financial Statements.

1. Summary of Significant Accounting Policies

a. Accounting Records — The accounting records are maintained in accordance with generally accepted accounting principles applicable to rate-regulated enterprises. The Company is regulated by the ACC and the FERC and the accompanying financial statements reflect the rate-making policies of these commissions.

b. Common Stock — All of the outstanding shares of common stock of the Company are owned by Pinnacle West Capital Corporation.

c. Cash and Cash Equivalents — For purposes of the statements of cash flows, the Company considers all highly liquid debt instruments purchased with an initial maturity of three months or less to be cash equivalents.

d. Utility Plant and Depreciation — Utility plant represents the buildings, equipment and other facilities used to provide electric service. The cost of utility plant includes labor, materials, contract services, other related items and an allowance for funds used during construction. The cost of retired depreciable utility plant, plus costs of removal minus salvage realized, is charged to accumulated depreciation.

Depreciation on utility property is recorded on a straight-line basis. The applicable ACC approved rates for 1989 through 1991 ranged from 0.68% to 15.00%.

e. Nuclear Decommissioning Costs — The Company estimates it will incur approximately $1.4 billion ($221 million in 1989 dollars), over a thirteen year period beginning in 2023, to decommission its 29.1% interest in the Palo Verde Nuclear Generating Station. This estimate is based on a 1989 site-specific study of costs to completely remove all facilities. The cost is charged to expense over the respective unit's operating license term and included in the accumulated depreciation balance until the station is retired from service.

The Company deposits the latest ACC approved annual decommissioning provision ($6,512,000 approved December 6, 1991; $5,685,000 approved in prior years) into external trust accounts. The trust accounts are included in investments and other assets on the company's balance sheet and have accumulated a $24.3 million balance at December 31, 1991.

f. Revenues — Revenues are recognized on the accrual basis and include estimated amounts for service rendered but unbilled at the end of each accounting period.

g. Fuel Costs — In April, 1989 the ACC issued an order eliminating the Purchased Power and Fuel Adjustment Mechanism. Without the PPFAM, actual purchased power and fuel costs are reflected currently in earnings.

h. Allowance for Funds Used During Construction — AFUDC represents the cost of debt and equity funds used to finance construction of utility plant. Plant construction costs, including AFUDC, are recovered in authorized rates through related depreciation when completed projects are placed into commercial operation. AFUDC does not represent current cash earnings.

AFUDC has been calculated using composite rates of 10.15% for 1991; 10% for 1990; and 10.50% for 1989. The Company compounds AFUDC semiannually and ceases to accrue AFUDC when construction is completed and the property is placed in service.

i. Reacquired Debt Costs — Gains and losses on reacquired debt are deferred and amortized over the remaining original life of the debt, consistent with ratemaking.

j. Nuclear Fuel — Nuclear fuel cost is amortized to fuel expense based on the relationship of the quantity of heat produced in the current period to the total quantity of heat expected to be produced over the remaining life of the fuel.

Future Retail Rate Increase

The Company agreed not to file a new rate application before December 1993 and the ACC agreed to expedite the processing of this rate application. The Company and the ACC also agreed on a unit sales price ceiling of 9.585 cents per kilowatt hour in this future rate application which was based on the Company meeting certain management cost targets. The Company's current unit sales price is approximately 9 cents per kilowatt hour. This ceiling may be adjusted for the effects of significant changes in laws, regulatory requirements or the Company's cost of equity capital. Management believes that the unit sales price ceiling will not adversely impact the Company's future earnings.

Dividend Payments

The Company agreed to limit its annual common stock dividends to $170 million through December, 1993.

Sale of Cholla Unit 4

In July 1991, the Company sold Unit 4 of the Cholla Power Plant to PacifiCorp for approximately $230 million. The resulting gain of approximately $20 million (after income tax effects) was deferred and is being amortized as a reduction to operations expense over a four year period in accordance with an ACC order. The transaction also provides for transmission and electrical energy sales between the Company and PacifiCorp.

Under Federal law, the Department of Energy is responsible for permanent disposal of spent nuclear fuel. The DOE assesses $.001 per kilowatt-hour of nuclear generation. This amount is charged to nuclear fuel expense and recovered through rates.

k. Palo Verde Cost Deferrals — As authorized by the ACC, the Company capitalized operating costs (excluding fuel) and financing costs for Palo Verde Units 2 and 3 (including their share of facilities common to all units) from the commercial operation date until the date the units were included in a rate order. The deferrals are being amortized and recovered in rates over thirty-five year periods.

2. Regulatory Matters

Rate Case Settlement

In December 1991, the Company and the ACC reached a settlement in a retail rate case that had been pending before the ACC since January 1990. The ACC authorized an annual net revenue increase of $66.5 million or approximately 5.2%. In turn, the Company wrote off $577.1 million of costs associated with Palo Verde and recorded a refund obligation of $53.4 million. The after tax impact of these adjustments reduced net income by $407 million. A discussion of the components of the disallowance follows.

Prudence Audit

The ACC closed its prudence audit of Palo Verde and the Company wrote off $142 million ($101.3 million after tax) of construction costs relating to Palo Verde Units 1, 2, and 3 and $13.3 million ($8.6 million after tax) of deferred costs relating to the prudence audit.

Interim or Temporary Revenues

The ACC removed the interim and temporary designation on $385 million of revenues collected by the Company from 1986 through 1991 that had been previously authorized for Palo Verde Units 1 and 2. The Company recorded a refund obligation to customers of $53.4 million ($32.3 million after tax) related to the Palo Verde write-off discussed above. The refund obligation has been used to reduce the amount of annual rate increase granted rather than require specific customer refunds and accordingly, will be reversed over thirty months beginning December, 1991.

Temporary Excess Capacity — Palo Verde Unit 3

The ACC deemed a portion of Palo Verde Unit 3 to be excess capacity and accordingly, did not recognize the related Unit 3 costs for ratemaking purposes. This action effectively disallows for thirty months the recovery of return on approximately $475 million of the Company's investment in Unit 3. The Company recognized a charge of $181.2 million ($109.5 million after tax), representing the present value of the lost cash flow which will be accreted back over thirty months. In accordance with generally accepted accounting principles, the Company is recording this accretion income on Unit 3 which has been discounted under the ACC's excess capacity finding. The Company recorded $5.3 million ($3.2 million after tax) of accretion income in 1991 and will record after tax accretion income of $40.7 million, $45.3 million, and $20.3 million in 1992, 1993, and 1994, respectively.

In December 1991, the Company stopped deferring Unit 3 costs and recorded a $240.6 million ($155.3 million after tax) write-off of Unit 3 cost deferrals due to Unit 3 being deemed excess capacity. At that time the Company began amortizing to expense and recovering in rates the remaining $320 million ($210.3 million after tax) balance over a thirty-five year period as approved by the ACC.

4. Long-Term Debt

	Maturity Dates	Interest Rates	Year Ended December 31, 1991	1990
			(Thousands of Dollars)	
First mortgage bonds	1991–2021	4.4%–13.25%	$1,844,917	$1,748,891
Pollution control indebtedness	2009–2015	Adjustable(a)	424,330	424,330
Bank term loans	1992	LIBOR + .25%(b)	36,000	72,000
Debentures	1992	12.5%	70,000	75,000
Revolving Credit	1993	LIBOR + .30% to .45%(c)	75,000	120,000
Capitalized lease obligation	1991–2001	7.48%(d)	34,666	37,098
Total long-term debt			2,484,913	2,477,319
Less current maturities			299,550	173,366
Total long-term debt less current maturities			$2,185,363	$2,303,953

(a) The interest rates at year end varied from 4.90% to 7.25% for 1991 and from 6.00% to 8.25% for 1990.

(b) The weighted average interest rates on outstanding borrowings at year end for 1991 and 1990 were 6.52% and 8.34% respectively.

(c) The weighted average interest rates on outstanding borrowings at year end for 1991 and 1990 were 6.82% and 8.63% respectively.

(d) 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. See Note 7.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1996 are as follows: 1992, $299,550,000; 1993, $97,217,000; 1994, $7,857,000; 1995, $8,088,000; and 1996, $233,637,000. In addition to the required redemptions the Company has also called subsequent to December 31, 1991 the following First Mortgage Bonds which will be redeemed in 1992: $100,000,000, 9.25% Series; $38,977,000, 10.625% Series; $75,000,000, 9.95% Series; and $100,000,000, 11.0% Series. The Company intends to finance these redemptions with issuances in January, 1992 of $150,000,000 of 7.125% First Mortgage Bonds due January 15, 1997 and $175,000,000 of 8.75% First Mortgage Bonds due January 15, 2024.

Substantially all utility plant (other than nuclear fuel, transportation equipment and the combined cycle plant) is subject to the lien of the first mortgage bonds. The first mortgage bond indenture includes provisions which would restrict the payment of common stock dividends under certain conditions which did not exist at December 31, 1991.

5. Lines of Credit

Committed Lines of Credit	1991	1990	Per Annum Commitment Fee
	(Thousands of Dollars)		
Revolving credit facility	$300,000	$300,000	.1875%
Letter of credit commercial paper program	70,000	70,000	.30%
Other bank lines	2,000	2,000	—
Total	$372,000	$372,000	

By Arizona statute, the Company's short-term borrowings cannot exceed 7% of total capitalization without the consent of the ACC. At December 31, 1991 the Company had no short-term debt outstanding.

6. Jointly Owned Facilities

At December 31, 1991, the Company owned interests in the following jointly-owned electric generating and transmission facilities. The Company's share of related operating and maintenance expenses is included in Operating Expenses.

	Percent Owned by Company	Plant in Service	Accumulated Depreciation	Construction Work in Progress
		(Dollar Amounts in Thousands)		
Generating Facilities:				
Palo Verde Nuclear Generating Station — Units 1 & 3	29.1%	$1,786,003	$255,477	$32,642
Palo Verde Nuclear Generating Station — Unit 2 (See Note 7)	17%	524,222	90,910	16,150
Four Corners Steam Generating Plant — Units 4 & 5	15%	139,867	38,804	187
Navajo Steam Generating Plant — Units 1, 2 & 3	14%	130,680	62,028	8,139
Transmission Facilities:				
ANPP 500KV System	35.8%(a)	62,437	10,729	585
Navajo Southern System	31.4%(a)	28,093	14,296	—
Palo Verde-Yuma 500KV System	23.9%(a)	11,282	2,361	—

(a) Weighted average of interests.

7. Leases

In 1986, the Company entered into sale and leaseback transactions resulting in the sale of approximately 42% of its share of Palo Verde Unit 2 and net proceeds of $487,296,000. The leases are being accounted for as operating leases. The gain of approximately $140,220,000 has been deferred and is being amortized to operations expense over the original lease term. The leases require semiannual payments of approximately $22,061,000 through December 1996, $23,605,000 through June 1997 and $26,963,000 through December 2015. The leases 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. Lease expense for 1991, 1990 and 1989 was $45,633,000, $45,458,000, and $45,458,000, respectively.

In 1976, the Company sold and leased back a combined cycle plant from an independent owner-trustee formed to own the facility. The lease is being accounted for as a capital lease. This plant is included in plant in service at its original cost of $54,405,000; accumulated depreciation at December 31, 1991 was $33,866,000. The lease requires semiannual payments of $2,582,000 through June, 2001 and includes renewal and purchase options based on fair market value.

The Company also leases certain land, buildings, equipment and miscellaneous other items through operating rental agreements with varying terms, provisions and expiration dates. Lease costs charged to expense for 1991, 1990, and 1989 were approximately $18,956,000, $13,605,000, and $9,881,000, respectively. Annual future minimum rental commitments, excluding the Palo Verde and combined cycle leases, for the period 1992 through 1996 range between $13 million and $16 million. The total rental commitments after 1996 are estimated at $123 million.

A reconciliation of the funded status of the plan to the amounts recognized in the balance sheet is presented below (in thousands of dollars):

	1991	1990
Plan assets at fair value	$388,829	$349,755
Less actuarial present value of benefit obligation:		
Accumulated benefit obligation, including vested benefits of $278,060,000 and $229,205,000	296,712	254,956
Effect of projected future compensation increases	103,485	109,364
Projected benefit obligation	400,197	364,320
Plan assets less than projected benefit obligation	(11,368)	(14,565)
Unrecognized net loss from past experience different from that assumed	10,793	25,576
Unrecognized prior service cost	16,749	17,766
Unrecognized net asset at January 1, 1986 being recognized over 20.2 years	(45,675)	(48,892)
Accrued pension liability included in other deferred credits	$ (29,501)	$ (20,115)
Principal actuarial assumptions used were:		
Discount rate	8.25%	8.5%
Rate of increase in compensation levels	5.5%	6.0%
Expected long-term rate of return on assets	10.00%	10.44%

Other Benefits

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for active and retired employees. All benefits are provided through a combination of insurance policies and self-insured plans. The cost of providing those benefits for both active and retired employees amounted to approximately $27,254,000, $28,236,000, and $24,332,000, of which approximately $11,826,000, $12,503,000 and $10,172,000 were charged to expense in 1991, 1990 and 1989, respectively. Remaining amounts were either capitalized as a component of construction costs or billed to participants of jointly-owned facilities. At December 31, 1991 the Company was providing these benefits to 6,704 active employees and 1,615 retirees.

New Accounting Standard

In December 1990, the FASB issued SFAS 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," which requires the expected cost of postretirement benefits other than pensions to be charged to expense during the years employees render service. This is a significant change from the Company's current policy of recognizing the costs of these benefits as they are paid. The Company plans to adopt the standard in 1993, and amortize the accumulated benefit obligation at that date over a twenty-year period. The Company's postretirement benefit plans are currently being reviewed, however based on a preliminary actuarial review using the current benefit plans, the accumulated benefit obligation at December 31, 1992 is expected to be approximately $200 million. Based on current estimates, the adoption of the standard will result in an increase in annual postretirement benefit expense of approximately $12 million (before income taxes). The Company intends to seek regulatory approval for the recovery of these costs.

10. Commitments and Contingencies

Nuclear Insurance

The Palo Verde participants have insurance for public liability payments resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is

covered by primary liability insurance provided by commercial insurance carriers in the amount of $200 million and the balance by an industrywide retrospective assessment program. The maximum assessment per reactor under the retrospective rating program for each nuclear incident is approximately $66 million, subject to an annual limit of $10 million per incident. Based upon the Company's 29.1% interest in the three Palo Verde units, the Company's maximum potential assessment per incident is approximately $58 million, with an annual payment limitation of $8.73 million. The insureds under this 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 property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $2.515 billion, a substantial portion of which must first be applied to stabilization and decontamination. The Company has also secured insurance against portions of any increased cost of generation or purchased power resulting from the accidental outage of any of the three units if the outage exceeds 21 weeks.

Litigation

The Company is a party to various claims, legal actions and complaints arising in the ordinary course of business. 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.

Construction Program

Expenditures in 1992 for the Company's continuing construction program have been estimated at $228 million.

Fuel and Purchased Power Commitments

The Company is a party to various fuel and purchased power contracts with terms expiring from 1992 through 2020 that include required purchase provisions. The Company estimates that the amount of fuel and purchased power that it is required to purchase pursuant to such provisions during 1992 totals approximately $131 million. However, this amount may vary significantly pursuant to certain provisions in such contracts which permit the Company to decrease its required purchases under certain events and circumstances.

11. Supplementary Income Statement Information

Other taxes charged to operations during each of the three years in the period ended December 31, 1991 are as follows:

	Year Ended December 31,		
	1991	1990	1989
		(Thousands of Dollars)	
Property	$120,900	$112,270	$ 92,522
Sales	80,815	74,015	70,866
Other	12,790	11,365	10,825
Total other taxes	$214,505	$197,650	$174,213

8. Income Taxes

The Company is included in the consolidated income tax returns of Pinnacle West. Income taxes are allocated to the Company based on its separate company taxable income or loss. Income taxes paid to Pinnacle West amounted to $58,264,000, $49,145,000 and $51,686,000 in 1991, 1990 and 1989, respectively. In 1991, income tax payments totaling $4,840,000 were made directly to Federal and State agencies.

The components of income tax expense (benefit) are:

	Year Ended December 31,		
	1991	1990	1989
	(Thousands of Dollars)		
Current:			
Federal	$ 39,446	$ 43,637	$ 37,788
State	11,010	9,827	7,662
Total current	50,456	53,464	45,450
Deferred:			
Depreciation — net	56,478	63,979	75,611
Palo Verde cost deferral	46,004	46,681	47,654
Alternative minimum tax	(10,565)	(8,873)	(25,652)
Employee severance plan	5,435	(5,538)	—
Disallowed Palo Verde costs (including ITC)	(202,416)	—	—
Refund obligation	(20,591)	—	—
Other — net	(8,434)	(15,870)	8,774
Investment tax credit — net	(11,117)	(7,012)	(6,159)
Total deferred	(145,206)	73,367	100,228
Total	$ (94,750)	$126,831	$145,678

The difference between income tax expense (benefit) 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, 1991 is as follows:

	Year Ended December 31,		
	1991	1990	1989
	(Thousands of Dollars)		
Federal income tax expense (benefit) at statutory rate (34%)	$(107,916)	$104,327	$121,731
Increase (reductions) in tax expense resulting from:			
Tax under book depreciation	21,776	18,402	15,870
Allowance for funds used during construction	(1,326)	(1,374)	(2,024)
Palo Verde cost deferral	(4,063)	(4,281)	(4,114)
Investment tax credit amortization	(11,117)	(7,353)	(6,946)
State income tax — net of federal income tax benefit	(9,820)	19,003	19,988
Disallowed Palo Verde costs (including ITC)	22,236	—	—
Other	(4,520)	(1,893)	1,173
Total	$(94,750)	$126,831	$145,678

Deferred income taxes are provided for substantially all timing differences arising from the recognition of revenues and expenses in different periods for tax and financial reporting purposes.

Prior to October 1983, the Company reflected the tax effects of certain timing differences in income in accordance with an ACC order. At December 31, 1991, the Company had flowed through to income approximately $140 million of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

Investment tax credits were deferred and are being amortized to other income over the estimated life of the related assets.

In 1981, the Company sold certain federal income tax benefits related to Cholla 4 in exchange for cash. In compliance with an ACC order, the proceeds of the sale were recorded as a deferred credit and prior to July 15, 1991 were amortized over approximately thirty years. The unamortized balance on July 15, 1991 was included in the calculation of the deferred gain on the sale of Cholla 4.

New Accounting Standard

In February 1992, the FASB issued SFAS No. 109, "Accounting for Income Taxes," which requires that the liability method be used in calculating deferred income taxes. Adjustments to balances of accumulated deferred income taxes will have to be made to record income tax rate changes, allowance for funds used during construction, investment tax credits and other temporary differences not previously deferred. It is expected that the additional deferred income tax assets and liabilities will be offset primarily by regulatory assets and liabilities representing the expected future revenue requirement impact of these adjustments. The Company plans to adopt the new statement in 1993 and does not expect it to have a material effect on net income.

9. Pension Plan and Other Benefits

Pension Plan

The Company has a defined benefit pension plan covering substantially all employees. Benefits are based on years of service and compensation using the final average pay plan benefit formula. The plan is funded on a current basis to the extent deductible under existing tax regulation. Plan assets consist primarily of domestic and international common stocks and bonds, and real estate. Pension cost, including administrative cost, for 1991, 1990, and 1989 was approximately $10,590,000, $14,781,000, and $3,657,000, respectively, of which approximately $4,939,000, $7,742,000, and $1,655,000, respectively was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly-owned facilities.

In 1990 the Company implemented a voluntary work force reduction plan. As part of this plan, the Company offered a special early retirement plan to employees who met certain eligibility requirements. The Company also offered an enhanced severance plan to selected employees. The total pension cost recorded for these programs was $8,232,000 of which $5,152,000 was charged to pension expense and the remainder billed to participants of jointly-owned facilities.

Excluding the costs of the early retirement program and the enhanced severance plan, the components of pension costs are as follows (thousands of dollars):

	1991	1990	1989
Service cost-benefits earned during the period	$14,559	$ 16,095	$ 12,920
Interest cost on projected benefit obligation	30,964	29,848	24,910
Return on plan assets	(64,884)	9,467	(61,314)
Net amortization and deferral	28,747	(50,622)	24,322
Net periodic pension cost	$ 9,386	$ 4,788	$ 838

3. Common and Preferred Stocks

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding			Outstanding		
	Authorized	1991	1990	Per Share	1991	1990	
					(Thousands of Dollars)		
Common Stock	100,000,000	71,264,947	71,264,947	$ 2.50	$178,162	$178,162	—
Preferred Stock (cumulative):							
Non-redeemable:							
$1.10	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000						
$2.40 Series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 Series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 Series D		200,000	200,000	50.00	10,000	10,000	50.50
$3.25 Series E		320,000	320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(b)						
$8.32 Series J		500,000	500,000	100.00	50,000	50,000	(c)
Adjustable rate — Series Q		500,000	500,000	100.00	50,000	50,000	(d)
Serial preferred	10,000,000	—	—	25.00	—	—	
Total		2,374,199	2,374,199		$168,561	$168,561	
Redeemable:							
Serial preferred:							
$10.00 Series H		8,677	24,677	$100.00	$ 868	$ 2,468	(e)
$8.80 Series K		191,825	232,100	100.00	19,182	23,210	(f)
$12.90 Series N		213,280	238,255	100.00	21,328	23,825	(g)
$11.50 Series R		359,000	429,500	100.00	35,900	42,950	(h)
$8.48 Series S		500,000	500,000	100.00	50,000	50,000	(i)
$8.50 Series T		500,000	500,000	100.00	50,000	50,000	
$10.00 Series U		500,000	—	100.00	50,000	—	
Total		2,272,782	1,924,532		$227,278	$192,453	

Non-redeemable preferred stock is not redeemable except at the option of the Company. Redeemable preferred stock is redeemable through sinking fund obligations in addition to being callable by the Company.

(a) In each case plus accrued dividends.

(b) This authorization covers both outstanding non-redeemable and redeemable preferred stock.

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

(d) Dividend rate adjusted quarterly to 2% below that of certain United States Treasury securities, but in no event less than 6% or greater than 12% per annum. Redeemable at $103.00 through February 28, 1993; and at $100.00 thereafter.

(e) Redeemable at $103.96 through September 1, 1992, and thereafter declining by $0.36 per year to par after September 1, 2002.

(f) Redeemable at $103.00 through February 28, 1994; and at $101.00 thereafter.

(g) Redeemable after June 1, 1992 at $106.11, declining by $0.68 per year to $100.00 after June 1, 2001.

(h) Redeemable after June 1, 1994 at $105.45, declining by a predetermined amount each year to $100.00 after June 1, 2003.

(i) 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 through June 1, 1992, at $104.24 through June 1, 1993, at $102.12 through June 1, 1994 and at $100.00 thereafter.

If there were to be any arrearage in dividends on any of the Company's preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock the Company could not pay dividends on its common stock or acquire any shares thereof for consideration.

The combined aggregate amount of redemption requirements for the above issues for the next five years are: 1992, $7,363,000; 1993, $18,273,000; 1994, $68,273,000; 1995, $18,273,000; and 1996, $18,273,000.

Changes in redeemable preferred stock

	Number of Shares Outstanding at			Par Value Outstanding at (Thousands of Dollars)		
Description	1991	1990	1989	1991	1990	1989
Balance, January 1	1,924,532	2,040,213	2,129,477	$192,453	$204,021	$212,948
Issuance:						
$10.00 Series U	500,000	—	—	50,000	—	—
Retirements:						
$10.00 Series H	(16,000)	(16,000)	(16,000)	(1,600)	(1,600)	(1,600)
$8.80 Series K	(40,275)	(1,036)	(21,464)	(4,027)	(104)	(2,147)
$12.90 Series N	(24,975)	(28,145)	(51,800)	(2,498)	(2,814)	(5,180)
$11.50 Series R	(70,500)	(70,500)	—	(7,050)	(7,050)	—
Balance, December 31	2,272,782	1,924,532	2,040,213	$227,278	$192,453	$204,021

12. Selected Quarterly Financial Data (Unaudited)

Quarter(a)	Electric Operating Revenues	Operating Income	Net Income (Loss)	Earnings (Loss) for Common Stock
		(Thousands of Dollars)		
1991				
First	$330,646	$ 74,586	$ 29,330	$ 21,391
Second	358,245	88,648	39,312	30,650
Third	471,384	137,371	102,943	94,498
Fourth	355,014	28,651	(394,234)(b)	(402,592)(b)
1990				
First	$342,590	$ 80,307	$ 38,307	$ 30,437
Second	353,802	72,051	26,191	18,377
Third	472,271	128,201	83,720	75,959
Fourth	339,662	79,329	31,794	24,179

(a) The Company's operations are subject to seasonal fluctuations with variations occurring in energy usage by customers from season to season and from month to month within a season, primarily as a result of weather conditions. For this and other reasons, the results of operations for interim periods are not necessarily indicative of the results to be expected for the full year.

(b) Includes rate case settlement write-off of approximately $407 million — see Note 2.

INDEPENDENT AUDITORS' REPORT

Arizona Public Service Company:

We have audited the accompanying balance sheets of Arizona Public Service Company as of December 31, 1991 and 1990 and the related statements of income, retained earnings and cash flows for each of the three years in the period ended December 31, 1991. 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, such financial statements present fairly, in all material respects, the financial position of the Company at December 31, 1991 and 1990 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1991 in conformity with generally accepted accounting principles.

Deloitte & Touche

Phoenix, Arizona
February 18, 1992

GLOSSARY

ACC — Arizona Corporation Commission

AFUDC — Allowance for funds used during construction

APS — Arizona Public Service Company

Cholla — Cholla Power Plant

Cholla 4 — Unit 4 of the Cholla Power Plant

Company — Arizona Public Service Company

DOE — Department of Energy

EPA — Environmental Protection Agency

EPEC — El Paso Electric Company

FASB — Financial Accounting Standards Board

FERC — Federal Energy Regulatory Commission

Four Corners — Four Corners Power Plant

ITC — Investment Tax Credit

PPFAM — Purchased Power and Fuel Adjustment Mechanism

PacifiCorp — An Oregon-based utility company

Palo Verde — Palo Verde Nuclear Generating Station

Pinnacle West — Pinnacle West Capital Corporation

SFAS No. 106 — Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions

SFAS No. 109 — Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes

SRP — Salt River Project Agricultural Improvement and Power District

APS DIRECTORS

Kenneth M. Carr, formerly Commissioner (1986-1991) and Chairman (1989-1991) of the Nuclear Regulatory Commission (retired August 1991); Vice Admiral, United States Navy (retired 1985)

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

Martha O. Hesse, president, Hesse Gas Company, Houston, Texas, and Dolan Energy Corporation and Sierra Blanca Gas Company, Chicago, Illinois

Marianne Moody Jennings, professor of business law, College of Business Administration, Arizona State University, Tempe, Arizona

Jack M. Morgan, attorney at law, Farmington, New Mexico

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

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

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

Donald M. Riley, president and general manager, Gilpin's Construction Co., Inc. (general contractor), Yuma, Arizona

Henry B. Sargent, Jr., executive vice president and chief financial officer, Pinnacle West Capital Corporation, Phoenix, Arizona

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

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

Richard Snell, chairman of the board of the Company, Phoenix, Arizona; chairman of the board, president and chief executive officer, Pinnacle West Capital Corporation, Phoenix, Arizona

Morrison F. Warren, formerly professor emeritus of education (retired June 1988), Arizona State University, Tempe, Arizona

Ben F. Williams, Jr., attorney at law, Tucson, Arizona

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

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.

The chart below sets forth the dividend amount paid on the Company's common stock for each of the four quarters of 1991 and 1990.

Common Stock Dividends
(Thousands of Dollars)

Quarter	1991	1990
1st Quarter	$42,500	$52,736
2nd Quarter	42,500	52,736
3rd Quarter	42,500	42,500
4th Quarter	42,500	42,500

Transfer Agent and Registrar

Pinnacle West Capital Corporation
Stock Transfer Department
P.O. Box 52134
Phoenix, Arizona 85072-2134
(602) 379-2519

The First National Bank of Boston
Shareholder Services Division
Mail Stop 45-02-09
P.O. Box 644
Boston Massachusetts 02102-0644
(617) 575-2900
(common stock only)

General Counsel

Snell & Wilmer
Phoenix, Arizona

Auditors

Deloitte & Touche
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, Station 9068, 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 April 1, 1992, without charge, upon written request of shareholders. Write: Office of the Secretary, Station 9068, at the address below.

MAILING ADDRESS:

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