"Competition has its critics but APS is not among them. We are working to become the preferred energy supplier in the Southwest."

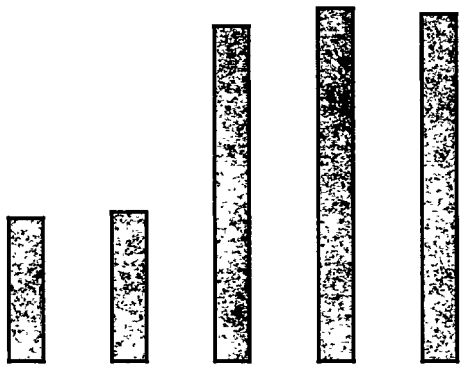
APS is...

APS is Arizona's principal electric energy supplier. The Company serves a rapidly growing market, meeting the electricity needs in all or part of 11 of Arizona's 15 counties. APS also operates and is a co-owner of the Palo Verde Nuclear Generating Station, a primary source of electricity for the southwest region of the United States.

APS is the largest subsidiary of Pinnacle West Capital Corporation (NYSE:PNW).

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.

Contents

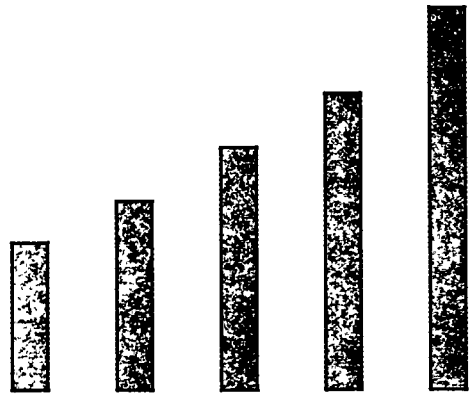


1990	1991	1992	1993	1994
$149	$151*	$214	$220	$218

Earnings Available for Common Stock

(in millions)

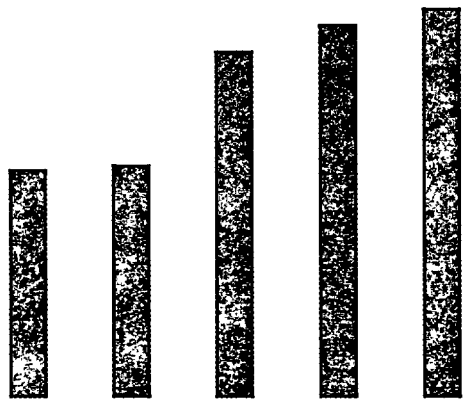
*Earnings exclude $407 million after-tax regulatory write-offs.



1990	1991	1992	1993	1994
607	620	637	654	681

Customers at Year-End

(in thousands)



1990	1991	1992	1993	1994
1.54x	1.57x*	2.34x	2.52x	2.63x

Pretax Coverage Ratios

(excluding non-cash income)

*Earnings exclude $407 million after-tax regulatory write-offs.

1990	1991	1992	1993	1994
53.9%	101.1%	126.5%	126.9%	125.9%

Net Cash Flow* as a Percent of Capital Expenditures

*After dividends

Letter to Preferred Shareholders

By any meaningful measure, 1994 was an outstanding year for APS. We reduced electric service rates for all retail customers — and still achieved ambitious financial goals. We earned $218.2 million compared with $219.5 million in 1993. We lowered the cost of producing and distributing a kilowatt-hour of energy by more than four percent, further improving our overall competitive position.

This year, the issue of increased competition will undoubtedly be a theme of many electric utility reports to shareholders. This is not a new issue for our industry, but it rapidly gained momentum during 1994, as utilities faced more and more varied forms of competition. While the details vary by state, the general focus of the emerging debate seems to have shifted from whether more competition is desirable to how best to achieve it.

The accelerating pace of competition did not cause us to alter the basic strategy we committed to in 1990. By reinventing the way we do business and lowering our cost of capital, we continued to reduce the cost of generating and delivering electricity. We continued to learn about and respond to our customers' differing needs. And we continued to create a new corporate culture—one which sheds the monopoly mindset and places personal accountability at the center of superior performance.

"We continued to create a new corporate culture — one which sheds the monopoly mindset and places personal accountability at the center of superior performance."

Improvements at Palo Verde key to reducing cost of electricity

Improved operational performance at the Palo Verde Nuclear Generating Station was a major factor in reducing the cost of energy. Palo Verde, the Company's largest single asset, operated at a capacity factor of 72.2 percent during 1994. That figure was near the national average, despite additional inspections of the plant's steam generators, a process which required extra outage time.

Through operating and technical improvements, Palo Verde returned to full-power operations in mid-1994, after operating at reduced power levels for about nine months. These improvements appear to have reduced steam generator tube cracking to a manageable level.

The Company's coal-fired plants continued to perform at exceptional levels, and were available for service almost 88 percent of the time during 1994, compared with an industry average of about 83 percent.

Distribution system improvements needed to accommodate effects of high growth

APS serves a rapidly expanding market, particularly in the metropolitan Phoenix area. While the demands of a growing market area are a welcome business challenge, a high rate of growth does have its downside. As we strive to keep pace with growth, the reliability of our system has suffered in certain areas. In 1994, we made improving the reliability of our system an operational priority for the Company. We are intensifying our efforts to replace underground electric cables to improve system reliability. We are upgrading parts of the system which are inadequate for the growth in some communities and we are continuing to work in partnership with our large customers where a higher standard for reliable power is a business necessity.

Customers' rates reduced 2.2% on average

On the marketing front, 1994 was a watershed for APS. For the first time, we reduced retail rates for all customers. This result reflects the aggressive cost reduction effort initiated in 1990.

Our 1994 rate settlement also provides for increased pricing flexibility to negotiate with customers that are considered "at risk" of being lost to competitors. We are encouraged by both the result and, as important, by the constructive involvement of our principal regulator in responding to emerging competitive market conditions.

For several years, we have been developing an intimate knowledge of our customers' needs and identifying the key elements of customer satisfaction. Not surprisingly, there are common concerns, such as price and reliability, which cut across all customer segments. We are learning there are differences, too. This knowledge about our customers is an essential part of becoming the preferred energy supplier in the Southwest. When we talk about changing our culture, it means, in part, learning to value an honest dialogue with our customers.

Environmental management is integral to APS competitiveness

For utilities, environmental protection is a legal requirement, and we take compliance obligations seriously. Compliance, however, is simply a starting point. At APS, effective environmental management is an integral part of how we conduct our business.

During 1994, we demonstrated this "beyond-compliance" philosophy in several noteworthy ways. APS was the first electric utility to sign the CERES Principles, a 10-point code of conduct that makes the Company publicly accountable for our environmental programs and performance. We signed a precedent-setting trade of pollution allowances with Niagara Mohawk Power Corporation, a New York utility. The agreement showed that, working within the framework established by the Federal Clean Air Act Amendments of 1990, market incentives can be used to achieve an overall reduction in pollution. Finally, we completed the APS Environmental Showcase Home, a collaborative effort between the private and public sectors, to demonstrate environmental products currently available to commercial builders. The home is the centerpiece of our program, launched in January 1995, to "move the market" toward more energy-efficient, environmentally friendly housing.

Management changes

In late 1994, we announced plans for an orderly succession of management at Arizona Public Service. Mark DeMichele, President and Chief Executive Officer, announced his intention to retire in 1997. In anticipation of Mark's retirement, Bill Post was named Chief Operating Officer.

The other major management change in 1994 was the addition of Bill Stewart as our Executive Vice President, Nuclear. Bill is a recognized leader in the nuclear power industry and his presence at Palo Verde was a key factor in its improved performance.

We want to thank the employees of APS for their many contributions to the success of our company. Each time we have raised the bar, they have exceeded our expectations. Above all, their attitudes about change and support for our vision give us confidence in our ability to thrive in a more competitive future.

We invite you to review the detailed information in the following pages and to attend our Annual Meeting of Shareholders on May 16.

Sincerely,

Richard Snell
Chairman of the Board

O. Mark DeMichele
President and Chief Executive Officer

William J. Post
Senior Vice President and
Chief Operating Officer

"At APS, effective environmental management is an integral part of how we conduct our business."


ДРО ВНУТРОННИКИ-ОЛ
ВНОЧЕСАВ НОМ

ARIZONA PUBLIC SERVICE COMPANY
Selected Financial Highlights

	1994	1993	1992	1991	1990
			(Thousands of Dollars)		
FINANCIAL HIGHLIGHTS:					
Electric Operating Revenues (a)	$ 1,626,168	$ 1,602,413	$ 1,587,582	$ 1,385,815	$ 1,434,750
Fuel and Purchased Power	300,689	300,546	287,201	273,771	289,048
Operating Expenses	957,046	929,379	908,123	782,788	785;814
Operating Income	368,433	372,488	392,258	329,256	359,888
Other Income (Deductions)	44,510	54,220	48,801	(324,922)	56,713
Interest Deductions — Net	169,457	176,322	194,254	226,983	236,589
Net Income (Loss)	243,486	250,386	246,805	(222,649)	180,012
Preferred Dividends	25,274	30,840	32,452	33,404	31,060
Earnings (Loss) for Common Stock (b)	$ 218,212	$ 219,546	$ 214,353	$ (256,053)	$ 148,952
Total Assets	$ 6,348,261	$ 6,357,262	$ 5,629,432	$ 5,620,692	$ 6,253,562
Capitalization:					
Common Stock Equity	$ 1,571,120	$ 1,522,941	$ 1,476,390	$ 1,433,463	$ 1,860,110
Non-Redeemable Preferred Stock	193,561	193,561	168,561	168,561	168,561
Redeemable Preferred Stock	75,000	197,610	225,635	227,278	192,453
Long-Term Debt	2,181,832	2,124,654	2,052,763	2,185,363	2,303,953
Total	$ 4,021,513	$ 4,038,766	$ 3,923,349	$ 4,014,665	$ 4,525,077
Capital Expenditures	$ 255,308	$ 234,944	$ 224,419	$ 182,687	$ 259,280
FINANCIAL STATISTICS (c):					
Return on average common equity	14.3%	14.8%	15.0%	8.4%	8.0%
Pretax interest coverage:					
Including non-cash income	2.87x	2.99x	2.73x	2.11x	2.05x
Excluding non-cash income	2.63x	2.52x	2.34x	1.57x	1.54x
Non-cash income as percent of earnings	23.0%	29.5%	28.6%	66.3%	66.9%
Net cash flow excluding non-cash income as percent of capital expenditures excluding AFUDC	125.9%	126.9%	126.5%	101.1%	53.9%

(a) Consistent with the 1994 presentation, prior years' electric operating revenues and other taxes have been restated to exclude sales tax on electric revenues.

(b) Financial results for 1991 include a $407 million after-tax write-off related to a rate case settlement.

(c) Non-cash income includes AFUDC, cost deferrals, restoration of temporary asset impairment and "in lieu" refund reversal. In 1991, earnings exclude the effects of a $407 million after-tax write-off related to a rate case settlement.

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

Selected Operating Highlights	1994	1993	1992	1991	1990
			(Thousands of Dollars)		
ELECTRIC OPERATING REVENUES (a)					
Residential	$ 675,418	$ 627,732	$ 611,890	$ 556,889	$ 547,200
Commercial	632,454	610,730	597,373	553,868	540,808
Industrial	166,606	169,154	169,158	156,852	152,228
Irrigation	10,548	9,246	9,752	11,722	12,453
Other	12,730	11,794	12,155	12,341	12,394
Total retail	1,497,756	1,428,656	1,400,328	1,291,672	1,265,083
Sales for resale	95,158	119,385	136,110	125,226	133,725
Transmission for others	9,506	7,979	7,658	7,871	9,321
Miscellaneous services	14,440	25,019	22,112	13,102	26,621
Electric operating revenues	1,616,860	1,581,039	1,566,208	1,437,871	1,434,750
Rate refund reversal (provision)	9,308	21,374	21,374	(52,056)	—
Net electric operating revenues	$ 1,626,168	$ 1,602,413	$ 1,587,582	$ 1,385,815	$ 1,434,750
ELECTRIC SALES (MWh)					
Residential	6,873,300	6,247,002	6,066,830	5,856,791	5,777,871
Commercial	7,456,049	7,040,026	6,904,072	6,726,350	6,567,728
Industrial	2,926,318	2,890,859	2,871,440	2,796,572	2,685,469
Irrigation	132,340	111,902	118,536	160,095	172,763
Other	76,827	75,175	73,853	71,650	69,929
Total retail	17,464,834	16,364,964	16,034,731	15,611,458	15,273,760
Sales for resale	2,764,223	3,685,736	4,528,172	4,375,027	4,502,380
Total electric sales	20,229,057	20,050,700	20,562,903	19,986,485	19,776,140
ELECTRIC CUSTOMERS — END OF YEAR					
Residential	603,989	578,718	562,464	547,425	534,413
Commercial	72,740	70,516	69,426	68,118	67,129
Industrial	2,976	3,061	2,883	3,095	3,196
Irrigation	897	880	960	970	1,071
Other	762	764	749	751	749
Total retail	681,364	653,939	636,482	620,359	606,558
Sales for resale	44	40	46	43	47
Total electric customers	681,408	653,979	636,528	620,402	606,605

(a) Consistent with the 1994 presentation, prior years' electric operating revenues and other taxes have been restated to exclude sales tax on electric revenues.

Financial & Operating Highlights (continued)

	1994	1993	1992	1991	1990
UNIT COSTS (CENTS PER kWh)	8.47	8.85	8.77	9.41	9.81
EMPLOYEES (END OF YEAR)	6,535	7,053	7,133	7,063	7,029
LOADS AND RESOURCES AT PEAK					
Peak Load (kW):					
Actual	4,214,000	3,802,300	3,796,400	3,532,000	3,679,700
Weather adjusted (a)	3,983,000	3,894,000	3,754,000	3,710,000	3,544,000
Resources at peak (kW):					
Generating capacity	4,022,400	4,022,400	4,022,400	3,923,500	4,319,400
Purchase power contracts	491,900	482,600	486,600	478,300	307,400
Total resources	4,514,300	4,505,000	4,509,000	4,401,800	4,626,800
Reserve margin	8.1%	16.7%	16.9%	20.2%	19.5%
POWER PLANT PERFORMANCE					
Nuclear (net capacity factors — MDC):					
Palo Verde Unit 1	91.4%	70.3%	66.4%	87.1%	44.1%
Palo Verde Unit 2	61.5%	47.9%	94.2%	77.3%	58.4%
Palo Verde Unit 3	63.8%	87.8%	78.2%	70.3%	90.1%
Palo Verde site average	72.2%	68.7%	79.6%	78.2%	64.2%
Coal (equivalent availability factors):					
Four Corners	86.7%	85.2%	87.0%	84.5%	87.1%
Cholla (b)	88.2%	94.9%	91.8%	95.3%	94.1%
Navajo	89.1%	87.7%	87.9%	88.8%	82.9%
Total coal average	87.7%	89.1%	88.9%	89.0%	88.8%

(a) Prior years have been restated to reflect average weather statistics for the ten-year period ended December 31, 1994.

(b) All periods exclude Cholla 4, which was sold in 1991.

Results of Operations

1994 Compared with 1993

Earnings in 1994 were $218.2 million compared with $219.5 million in 1993. Electric operating revenues increased primarily due to strong customer growth and significantly warmer weather in 1994, partially offset by lower interchange sales and the 1994 rate reduction. Substantially offsetting the earnings effect of the 1994 rate reduction was a one-time depreciation reversal, also occasioned by the 1994 rate settlement. (See Note 2 of Notes to Financial Statements for information regarding the 1994 rate settlement.) Interest expense declined due to the Company's refinancing efforts in 1994 and 1993. The Company's effort to refinance high-cost debt, started in 1992, was substantially completed at the end of 1994.

Substantially offsetting these positive factors were the completion in May 1994 of the recording of non-cash income related to a 1991 rate settlement (see Note 1 of Notes to Financial Statements); increased operations and maintenance expense due primarily to employee severance costs related to various cost-reduction efforts; and increased nuclear decommissioning costs reflecting the most recent site-specific study (see Note 1 of Notes to Financial Statements).

Fuel and purchased power expenses remained relatively unchanged in 1994 compared with 1993. Higher costs to meet increased retail sales were about offset by lower fuel costs for reduced interchange sales. The Company does not have a fuel adjustment clause as part of its retail rate structure; therefore, changes in fuel and purchased power expenses are reflected currently in earnings.

1993 Compared with 1992

Earnings in 1993 were $219.5 million compared with $214.3 million in 1992. The primary factor that contributed to this increase was lower interest expense due to refinancing debt at lower rates, lower average debt balances and lower interest rates on the Company's variable-rate debt. Partially offsetting the lower interest expense were increased taxes and higher operating expenses.

Operating revenue increased significantly due to customer growth. Offsetting customer growth were the effects of milder weather and increased fuel and purchased power costs due to Palo Verde outages and reduced power levels related to steam generator tube problems (see Note 10 of Notes to Financial Statements).

Operations and maintenance expense for 1993 increased over 1992 levels primarily due to the implementation of new accounting standards for postemployment benefits and postretirement benefits other than pensions, which added $17.0 million to expense in 1993 (see Note 9 of Notes to Financial Statements). Partially offsetting these factors were lower power plant operating costs, lower rent expense and lower costs for an employee cost-saving incentive plan.

Operating Revenues

Operating revenues reflect changes in both the volume of units sold and price per kilowatt-hour of electric sales. An analysis of the changes in 1994 and 1993 electric operating revenues compared with the prior year follows (in millions of dollars):

	1994	1993
Volume variance	$ 86.7	$ 22.3
1994 rate reduction	(27.4)	—
Interchange sales	(19.5)	(7.2)
Reversal of refund obligation	(12.1)	—
Other operating revenues	(3.9)	(.3)
Total change	$ 23.8	$ 14.8

The volume increase in 1994 primarily reflects the effects on retail sales of customer growth ($56 million) and warmer weather ($42 million). The volume increase in 1993 was primarily due to customer growth ($41 million), partially offset by milder weather ($20 million reduction). Other factors affecting volumes include changes in usage, unbilled revenue and firm sales for resale for a net total of $11 million reduction in 1994 and $1 million increase in 1993.

Other Income/Rate Settlement Impacts

Net income reflects accounting practices required for regulated public utilities and represents a composite of cash and non-cash items, including AFUDC, accretion income on Palo Verde Unit 3 and the reversal of a refund obligation arising out of the 1991 rate settlement (see Statements of Cash Flows and Note 1 of Notes to Financial Statements). The accretion and refund reversals, net of income taxes, totaled $25.9 million, $58.2 million and $53.6 million in 1994, 1993 and 1992, respectively. The Company has now recorded all of the Palo Verde Unit 3 accretion income and refund obligation reversals related to the 1991 settlement. Also in 1994 was a one-time Palo Verde depreciation reversal of $15 million, net of income tax, which is included in "Other — net" in the Statements of Income (see Note 2 of Notes to Financial Statements).

The retail rate settlement which was approved by the ACC in May 1994 did not significantly affect 1994 earnings as previously discussed, and is not expected to significantly affect earnings for the years 1995 through 1999 because the rate reduction will be substantially offset by accelerated amortization of deferred investment tax credits (see Note 2 of Notes to Financial Statements).

Capital Needs and Resources

The Company's capital needs consist primarily of construction expenditures and optional and mandatory repayments or redemptions of long-term debt and preferred stock. The capital resources available to meet these requirements include funds provided by operations and external financings.

Present construction plans do not include any major baseload generating plants. In general, most of the construction expenditures are for expanding transmission and distribution capabilities to meet customer growth, upgrading existing facilities and for environmental purposes. Construction expenditures are anticipated to be approximately $300 million, $257 million and $236 million for 1995, 1996 and 1997, respectively. These amounts include about $27 million each year for nuclear fuel expenditures.

In the period 1992 through 1994, the Company funded all of its construction expenditures and capitalized property taxes with funds provided by operations, after the payment of dividends. For the period 1995 through 1997, the Company estimates that it will fund substantially all such expenditures in the same manner.

During 1994, the Company repurchased or redeemed approximately $587 million of long-term debt and preferred stock, of which approximately $518 million was optional. Refunding obligations for preferred stock, long-term debt, a capitalized lease obligation and certain anticipated early redemptions are expected to total approximately $106 million, $4 million and $164 million for the years 1995, 1996 and 1997, respectively. On March 2, 1995, the Company redeemed all of its outstanding first mortgage bonds, 10.25% Series due 2000 (the 10.25% Bonds) for approximately $50 million.

The Company currently expects to issue up to $175 million of debt in 1995. Of this amount, on January 12, 1995, the Company issued $75 million of 10% junior subordinated deferrable interest debentures (MIDS) due 2025, and applied the net proceeds to the repayment of short-term debt that had been incurred for the redemption of preferred stock in 1994. The Company expects that substantially all of the net proceeds of the remaining financing activity in 1995 will be used for the retirement of outstanding debt.

Provisions in the Company's mortgage bond indenture and articles of incorporation require certain coverage ratios to be met before the Company can issue additional first mortgage bonds or preferred stock. In addition, the bond indenture limits the amount of additional first mortgage bonds which may be issued to a percentage of net property additions, to the amount of certain first mortgage bonds that have been redeemed or retired, and/or to cash deposited with the mortgage bond trustee. After giving proforma effect to the redemption of the 10.25% Bonds as of December 31, 1994, the Company estimates that the bond indenture and the articles of incorporation would then have allowed it to issue up to approximately $1.33 billion and $768 million of additional first mortgage bonds and preferred stock, respectively.

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.

Management does not expect any of the foregoing restrictions to limit the Company's ability to meet its capital requirements.

As of December 31, 1994, the Company had credit commitments from various banks totaling approximately $300 million, which were available either to support the issuance of commercial paper or to be used as bank borrowings. There were no bank borrowings outstanding at the end of 1994. Commercial paper borrowings totaling $131.5 million were then outstanding.

Competition

A significant challenge for the Company will be how well it is able to respond to increasingly competitive conditions in the electric utility industry, while continuing to earn an acceptable return for its shareholders. Strategies emphasize managing costs, stabilizing electric rates, negotiating long-term contracts with large customers and capitalizing on the growth characteristics of the Company's service territory.

One of the issues that must be addressed responsibly is the recovery in a more competitive environment of the carrying value of assets (including those referred to in Note 1a of Notes to Financial Statements) acquired or recorded under the existing regulatory environment.

Pursuant to the 1994 rate settlement, APS and the ACC staff will develop certain procedures that are responsive to the competitive forces in larger customer segments, with the objective of making joint recommendations to the ACC in 1995. A separate ACC proceeding on competition was opened in mid-1994 and is expected to continue for some months.

As the forces of competition continue to impact the industry, it will become clearer as to what customer sectors and what regions will be most affected and what strategies are best to deal with those forces.

Report of Management

The primary responsibility for the integrity of the Company's financial information rests with management, which has prepared the accompanying financial statements and related information. 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 audited by independent auditors and their report is included.

Management maintains and relies upon systems of internal accounting controls. A limiting factor 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.

The Audit Committee, composed solely of outside directors, meets periodically with the internal auditors and independent auditors (as well as management) to review the work of each. The internal auditors and independent auditors have free access to the Audit Committee, without management present, to discuss the results of their audit work.

Management believes that the Company's systems, 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 DeMichele
President and
Chief Executive Officer

William J. Post
Senior Vice President and
Chief Operating Officer

Jaron B. Norberg
Executive Vice President and
Chief Financial Officer

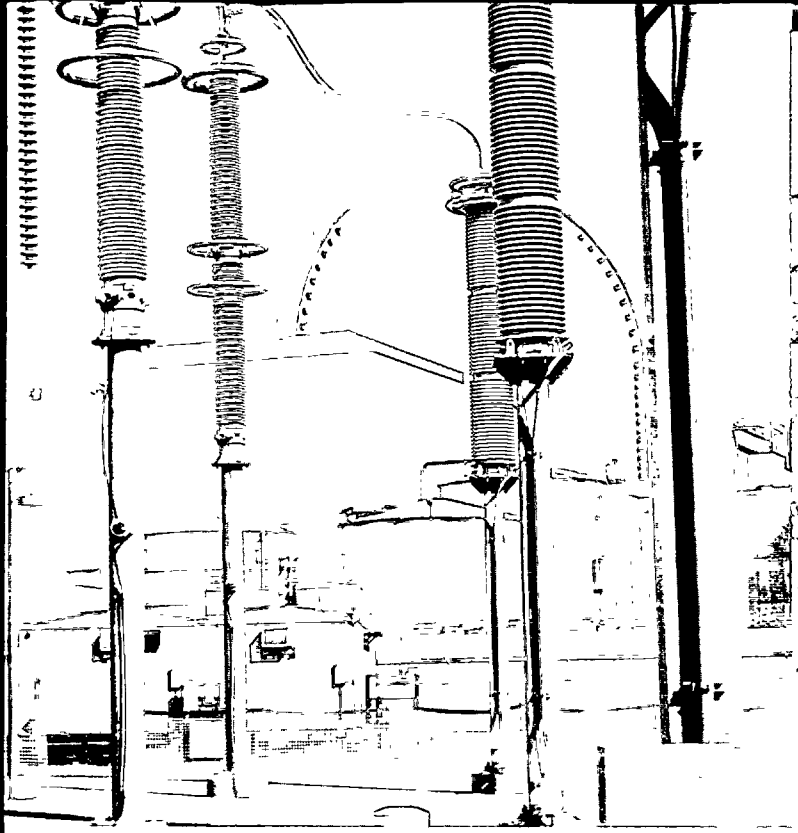
Independent Auditors' Report

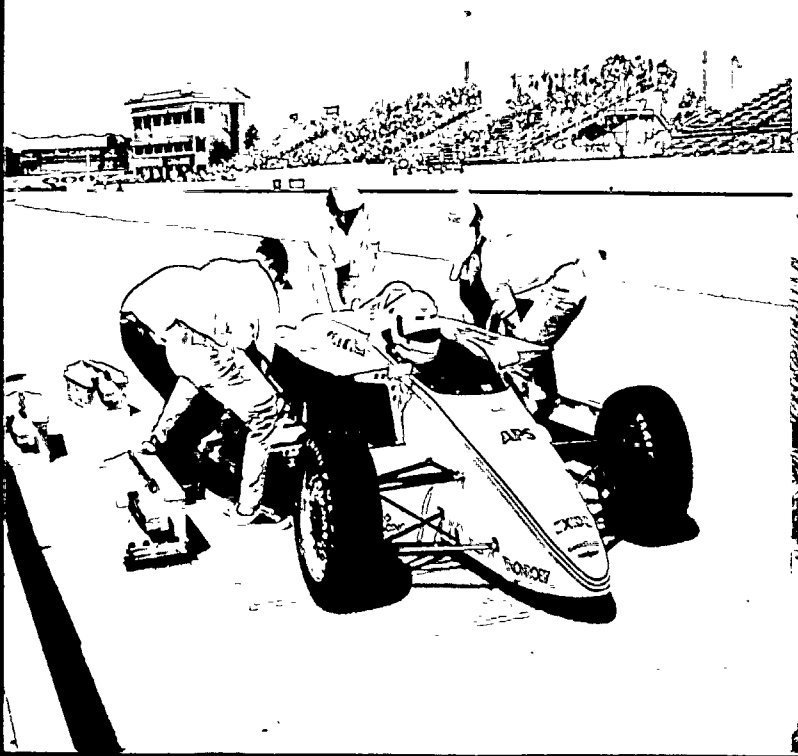
We have audited the accompanying balance sheets of Arizona Public Service Company as of December 31, 1994 and 1993 and the related statements of income, retained earnings and cash flows for each of the three years in the period ended December 31, 1994. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

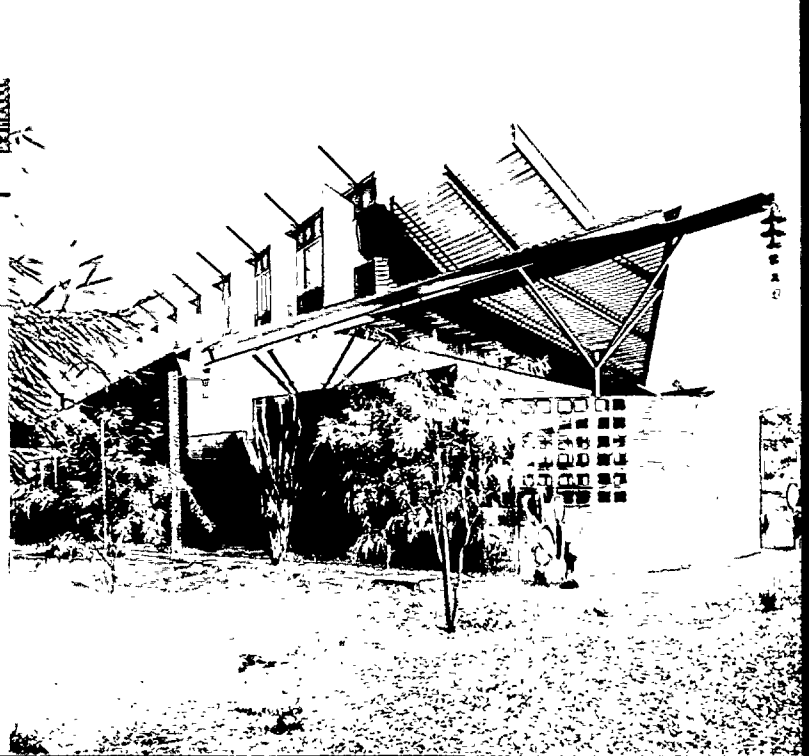
We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence 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, 1994 and 1993 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1994 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP
Phoenix, Arizona
March 3, 1995







Clockwise from upper right:
APS joins with the Grant Park Neighborhood Association to become a better neighbor;
APS Environmental Showcase Home demonstrates environmental products available to commercial builders;
Electric Vehicle technology gets a boost at annual APS Electrics race;
one of three units at Palo Verde Nuclear Generating Station.

ARIZONA PUBLIC SERVICE COMPANY
Statements of Income

	Year Ended December 31,		
	1994	1993	1992
	(Thousands of Dollars)		
Electric Operating Revenues (Note 1)	$ 1,626,168	$ 1,602,413	$ 1,587,582
Fuel Expenses:			
Fuel for electric generation	237,103	231,434	230,194
Purchased power	63,586	69,112	57,007
Total	300,689	300,546	287,201
Operating Revenues Less Fuel Expenses	1,325,479	1,301,867	1,300,381
Other Operating Expenses:			
Operations excluding fuel expenses	292,292	282,660	270,838
Maintenance	119,629	118,556	119,674
Depreciation and amortization	236,108	222,610	219,118
Income taxes (Note 8)	168,202	168,056	164,620
Other taxes	140,815	137,497	133,873
Total	957,046	929,379	908,123
Operating Income	368,433	372,488	392,258
Other Income (Deductions):			
Allowance for equity funds used during construction	3,941	2,326	3,103
Income taxes (Note 8)	(9,042)	(20,851)	(16,735)
Palo Verde accretion income (Note 1)	33,596	74,880	67,421
Other — net	16,015	(2,135)	(4,988)
Total	44,510	54,220	48,801
Income Before Interest Deductions	412,943	426,708	441,059
Interest Deductions:			
Interest on long-term debt	159,840	164,610	186,915
Interest on short-term borrowings	6,205	6,662	3,831
Debt discount, premium and expense	8,854	9,203	8,000
Allowance for borrowed funds used during construction	(5,442)	(4,153)	(4,492)
Total	169,457	176,322	194,254
Net Income	243,486	250,386	246,805
Preferred Stock Dividend Requirements	25,274	30,840	32,452
Earnings for Common Stock	$ 218,212	$ 219,546	$ 214,353

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY
Balance Sheets
Assets

	December 31, 1994	December 31, 1993
	(Thousands of Dollars)	
Utility Plant (Notes 4, 6 and 7):		
Electric plant in service and held for future use	$ 6,475,249	$ 6,333,884
Less accumulated depreciation and amortization	2,122,439	1,991,143
Total	4,352,810	4,342,741
Construction work in progress	224,312	197,556
Nuclear fuel, net of amortization of $80,599,000 and $67,752,000	46,951	60,953
Utility Plant — net	4,624,073	4,601,250
Investments and Other Assets	90,105	63,224
Current Assets:		
Cash and cash equivalents	6,532	7,557
Accounts receivable:		
Service customers	103,711	102,745
Other	27,008	21,091
Allowance for doubtful accounts	(2,176)	(2,569)
Accrued utility revenues (Note 1)	55,432	60,356
Materials and supplies (at average cost)	89,864	96,174
Fossil fuel (at average cost)	35,735	34,220
Deferred income taxes (Note 8)	19,114	29,117
Other	14,162	12,653
Total Current Assets	349,382	361,344
Deferred Debits:		
Regulatory asset for income taxes (Note 8)	557,049	585,294
Palo Verde Unit 3 cost deferral (Note 1)	292,586	301,748
Palo Verde Unit 2 cost deferral (Note 1)	171,936	177,998
Unamortized costs of reacquired debt	60,942	63,147
Unamortized debt issue costs	17,673	17,999
Other	184,515	185,258
Total Deferred Debits	1,284,701	1,331,444
Total	$ 6,348,261	$ 6,357,262

See Notes to Financial Statements.

Balance Sheets
Liabilities

	December 31, 1994	December 31, 1993
	(Thousands of Dollars)	
Capitalization (Notes 3 and 4):		
Common stock	$ 178,162	$ 178,162
Premiums and expenses — net	1,039,303	1,037,681
Retained earnings	353,655	307,098
Common stock equity	1,571,120	1,522,941
Non-redeemable preferred stock	193,561	193,561
Redeemable preferred stock	75,000	197,610
Long-term debt less current maturities	2,181,832	2,124,654
Total Capitalization	4,021,513	4,038,766
Current Liabilities:		
Commercial paper (Note 5)	131,500	148,000
Current maturities of long-term debt (Note 4)	3,428	3,179
Accounts payable	110,854	81,772
Accrued taxes	89,412	112,293
Accrued interest	45,170	45,729
Other	50,487	60,737
Total Current Liabilities	430,851	451,710
Deferred Credits and Other:		
Deferred income taxes (Note 8)	1,436,184	1,391,184
Deferred investment tax credit	142,994	149,819
Unamortized gain — sale of utility plant (Note 7)	98,551	107,344
Customer advances for construction	16,564	15,578
Other	201,604	202,861
Total Deferred Credits and Other	1,895,897	1,866,786
Commitments and Contingencies (Note 10)		
Total	$ 6,348,261	$ 6,357,262

ARIZONA PUBLIC SERVICE COMPANY
Statements of Retained Earnings

	Year Ended December 31,		
	1994	1993	1992
	(Thousands of Dollars)		
Retained earnings at beginning of year	$ 307,098	$ 259,899	$ 215,974
Add: Net income	243,486	250,386	246,805
Total	550,584	510,285	462,779
Deduct:			
Dividends:			
Common stock (Notes 3 and 4)	170,000	170,000	170,000
Preferred stock (see below)	25,274	30,840	32,452
Premium paid on reacquisition of preferred stock	1,655	2,347	428
Total deductions	196,929	203,187	202,880
Retained earnings at end of year	$ 353,655	$ 307,098	$ 259,899
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	—	—	58
$8.32 Series J	—	3,364	4,160
$8.80 Series K	216	1,454	1,654
$12.90 Series N	—	—	1,196
Adjustable Rate Series Q	3,000	3,000	3,083
$11.50 Series R	1,533	3,630	4,081
$8.48 Series S	1,734	3,251	4,240
$8.50 Series T	2,833	4,250	4,250
$10.00 Series U	5,000	5,000	5,000
$7.875 Series V	1,969	1,966	1,179
$1.8125 Series W	5,438	1,374	—
Total	$ 25,274	$ 30,840	$ 32,452

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY
Statements of Cash Flows

	Year Ended December 31,		
	1994	1993	1992
		(Thousands of Dollars)	
Cash Flows from Operations:			
Net income	$ 243,486	$ 250,386	$ 246,805
Items not requiring cash:			
Depreciation and amortization	236,108	222,610	219,118
Nuclear fuel amortization	32,564	32,024	36,605
Allowance for equity funds used during construction	(3,941)	(2,326)	(3,103)
Deferred income taxes — net	83,249	102,697	84,097
Deferred investment tax credit — net	(6,825)	(6,948)	(6,804)
Rate refund reversal	(9,308)	(21,374)	(21,374)
Palo Verde accretion income	(33,596)	(74,880)	(67,421)
Changes in certain current assets and liabilities:			
Accounts receivable — net	(7,276)	30,889	(33,965)
Accrued utility revenues	4,924	(8,839)	(7,055)
Materials, supplies and fossil fuel	4,795	2,252	5,094
Other current assets	(1,509)	(6,616)	3,795
Accounts payable	21,666	(18,622)	7,172
Accrued taxes	(22,881)	8,826	18,284
Accrued interest	(577)	241	(16,131)
Other current liabilities	(9)	7,282	5,405
Other — net	(418)	18,686	(2,386)
Net cash provided	540,452	536,288	468,136
Cash Flows from Financing:			
Preferred stock	—	72,644	24,781
Long-term debt	516,612	520,020	643,360
Short-term borrowings — net	(16,500)	(47,000)	195,000
Dividends paid on common stock	(170,000)	(170,000)	(170,000)
Dividends paid on preferred stock	(26,232)	(30,945)	(32,574)
Repayment of preferred stock	(124,096)	(78,663)	(27,850)
Repayment and reacquisition of long-term debt	(462,643)	(558,799)	(1,013,371)
Net cash used	(282,859)	(292,743)	(380,654)
Cash Flows from Investing:			
Capital expenditures	(255,308)	(234,944)	(224,419)
Allowance for equity funds used during construction	3,941	2,326	3,103
Other	(7,251)	(4,522)	(4,099)
Net cash used	(258,618)	(237,140)	(225,415)
Net increase (decrease) in cash and cash equivalents	(1,025)	6,405	(137,933)
Cash and cash equivalents at beginning of year	7,557	1,152	139,085
Cash and cash equivalents at end of year	$ 6,532	$ 7,557	$ 1,152
Supplemental Disclosure of Cash Flow Information:			
Cash paid during the year for:			
Interest (excluding capitalized interest)	$ 161,294	$ 161,843	$ 200,986
Income taxes	$ 121,578	$ 88,239	$ 85,141

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.

The Company prepares its financial statements in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation". SFAS No. 71 requires a cost-based rate-regulated enterprise to reflect the impact of regulatory decisions in its financial statements.

The Company's major regulatory assets are Palo Verde cost deferrals (see Note 1j) and deferred taxes (see Note 8). These items, combined with miscellaneous other items and regulatory liabilities, amounted to approximately $1.1 billion at December 31, 1994 and 1993, most of which are included in "Deferred Debits" on the Balance Sheets.

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

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 removal costs less salvage realized, is charged to accumulated depreciation.

Depreciation on utility property is recorded on a straight-line basis. The applicable rates for 1992 through 1994 ranged from 0.84% to 15.00%, which resulted in an annual composite rate of 3.43% for 1994.

e. Nuclear Decommissioning Costs — In 1994, the Company recorded $11.9 million for decommissioning expense. The Company estimates it will cost approximately $2.1 billion ($425 million in 1994 dollars), over a thirteen-year period beginning in 2023, to decommission its 29.1% interest in Palo Verde. Decommissioning costs are charged to expense over the respective unit's operating license term and are included in the accumulated depreciation balance until each Palo Verde unit is fully decommissioned. Nuclear decommissioning costs are currently recovered in rates.

The Company is utilizing a 1992 site-specific study for Palo Verde, prepared for the Company by an independent consultant, that assumes the prompt removal/dismantlement method of decommissioning. The study is updated every three years.

As required by the ACC, the Company has established external trust accounts into which quarterly deposits are made for decommissioning. As of December 31, 1994, the Company had deposited a total of $45.0 million. The trust accounts are included in "Investments and Other Assets" on the Balance Sheets at a market value of $55.2 million on December 31, 1994. The trust funds are invested primarily in fixed-income securities and domestic stock and are classified as available for sale. Gains and losses are reflected in accumulated depreciation.

In 1994, FASB added a project to its agenda on accounting for nuclear decommissioning obligations. Only preliminary views have been discussed at this time; however, there is some indication the FASB may require the estimated present value of the cost of decommissioning to be recorded as a liability along with an offsetting plant asset. The Company is unable to determine what, if any, impact these deliberations may have on its financial position or results of operations.

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

In 1991 the Company recorded a refund obligation of $53.4 million ($32.3 million after tax) as a result of a 1991 rate settlement. The refund obligation was used to reduce the amount of a 1991 rate increase granted rather than require specific customer refunds and was reversed over the thirty months ended May 1994. The after-tax refund obligation reversals that were recorded as electric operating revenues by the Company amounted to $5.6 million in 1994 and $12.9 million in each of the years 1993 and 1992.

Consistent with the 1994 presentation, prior years' electric operating revenues and other taxes have been restated to exclude sales tax on electric revenue.

g. 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 depreciation when completed projects are placed into commercial operation. AFUDC does not represent current cash earnings.

AFUDC has been calculated using composite rates of 7.70% for 1994; 7.20% for 1993; and 10.00% for 1992. The Company compounds AFUDC semiannually and ceases to accrue AFUDC when construction is completed and the property is placed in service.

h. Reacquired Debt Costs — The Company amortizes gains and losses on reacquired debt over the remaining life of the original debt, consistent with ratemaking.

i. Nuclear Fuel — 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.

Under federal law, the DOE is responsible for the permanent disposal of spent nuclear fuel. The DOE assesses $.001 per kWh of nuclear generation. This amount is charged to nuclear fuel expense and recovered through rates.

j. Palo Verde Cost Deferrals — As authorized by the ACC, the Company deferred operating costs (excluding fuel) and financing costs for Palo Verde Units 2 and 3 from the commercial operation date (September 1986 and January 1988, respectively) until the date the units were included in a rate order (April 1988 and December 1991, respectively). The deferrals are being amortized and recovered in rates over thirty-five year periods.

k. Palo Verde Accretion Income — In 1991, the Company discounted the carrying value of Palo Verde Unit 3 to reflect the present value of lost cash flows resulting from a 1991 rate settlement agreement deeming a portion of the unit to temporarily be excess capacity. In accordance with generally accepted accounting principles, the Company recorded accretion income over a thirty-month period ended May 1994 in the aggregate amount of the original discount. The after-tax accretion income recorded in 1994, 1993 and 1992 was $20.3 million, $45.3 million and $40.7 million, respectively.

2. Regulatory Matters

In May 1994, the ACC approved a retail rate settlement agreement which was jointly proposed by the Company and the ACC staff. The major provisions of the settlement include:

- A net annual rate reduction of approximately $32.3 million ($19 million after tax), or 2.2% on average, effective June 1, 1994.
- A moratorium on filing for permanent rate changes, except under certain circumstances, prior to the end of 1996 for both the Company and the ACC staff.
- A joint APS-ACC study to develop rate principles allowing the Company greater flexibility to deal with market conditions and increasing competition in the electric industry.
- All of Palo Verde Unit 3 included in rate base.
- An incentive rewarding reduction in fuel and operating and maintenance cost per kWh below established targets.

As part of the settlement, the Company reversed approximately $20 million of depreciation ($15 million after tax) which related to the portion of Palo Verde which was written off as a result of a 1991 rate settlement. The settlement also provided for the accelerated amortization of substantially all deferred ITCs over a five-year period beginning in 1995. Overall, the settlement is not expected to materially affect the Company's financial position or results of operations for the years 1995–1999.

3. Common and Preferred Stocks

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. The balances at December 31, 1994 and 1993 of common and preferred stock are shown below:

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding			Outstanding		
	Authorized	1994	1993	Per Share	1994	1993	
					(Thousands of Dollars)		
Common Stock	100,000,000	71,264,947	71,264,947	$ 2.50	$ 178,162	$ 178,162	—
Preferred Stock:							
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)						
Adjustable rate — Series Q		500,000	500,000	100.00	50,000	50,000	(c)
Serial preferred	10,000,000						
$1.8125 Series W		3,000,000	3,000,000	25.00	75,000	75,000	(d)
Total		4,874,199	4,874,199		$ 193,561	$ 193,561	
Redeemable:							
Serial preferred:							
$8.80 Series K		—	142,100	$ 100.00	$ —	$ 14,210	
$11.50 Series R		—	284,000	100.00	—	28,400	
$8.48 Series S		—	300,000	100.00	—	30,000	
$8.50 Series T		—	500,000	100.00	—	50,000	
$10.00 Series U		500,000	500,000	100.00	50,000	50,000	
$7.875 Series V		250,000	250,000	100.00	25,000	25,000	(e)
Total		750,000	1,976,100		$ 75,000	$ 197,610	

(a) In each case plus accrued dividends.

(b) This authorization also covers all outstanding redeemable preferred stock.

(c) 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 par.

(d) Redeemable at par after December 1, 1998.

(e) Redeemable at $106.30 through May 31, 1995, and thereafter declining by a predetermined amount each year to par after May 31, 2002.

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 redemption requirements for the above issues for the next five years are: $0 in 1995 and 1996, and $10.0 million in each of the years 1997 through 1999.

Redeemable preferred stock transactions during each of the three years in the period ended December 31, 1994 are as follows:

	Number of Shares Outstanding			Par Value Outstanding (Thousands of Dollars)		
Description	1994	1993	1992	1994	1993	1992
Balance, January 1	1,976,100	2,256,350	2,272,782	$ 197,610	$ 225,635	$ 227,278
Issuance:						
$7.875 Series V	—	—	250,000	—	—	25,000
Retirements:						
$10.00 Series H	—	—	(8,677)	—	—	(868)
$8.80 Series K	(142,100)	(45,000)	(4,725)	(14,210)	(4,500)	(472)
$12.90 Series N	—	—	(213,280)	—	—	(21,328)
$11.50 Series R	(284,000)	(35,250)	(39,750)	(28,400)	(3,525)	(3,975)
$8.48 Series S	(300,000)	(200,000)	—	(30,000)	(20,000)	—
$8.50 Series T	(500,000)	—	—	(50,000)	—	—
Balance, December 31	750,000	1,976,100	2,256,350	$ 75,000	$ 197,610	$ 225,635

4. Long-Term Debt

The following table presents long-term debt outstanding as of December 31, 1994 and 1993.

	Maturity Dates	Interest Rates	Year Ended December 31, 1994	1993
			(Thousands of Dollars)	
First mortgage bonds	1997-2028	5.5%-13.25%(a)	$ 1,740,071	$ 1,729,070
Pollution control indebtedness	2024-2029	Adjustable(b)	418,824	369,130
Capitalized lease obligation(c)	1995-2001	7.48%	26,365	29,633
Total long-term debt			2,185,260	2,127,833
Less current maturities			3,428	3,179
Total long-term debt less current maturities			$ 2,181,832	$ 2,124,654

(a) The weighted-average rate at December 31, 1994, and 1993 was 8.04% and 8.25%, respectively. The weighted-average years to maturity at December 31, 1994 and 1993 was 19 years and 20 years, respectively.

(b) The weighted-average rate for the years ended December 31, 1994, and 1993 was 2.99% and 2.64%, respectively. Changes in short-term interest rates would affect the costs associated with this debt.

(c) Represents the present value of future lease payments (discounted at an 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 principal payments due on long-term debt and for sinking fund requirements through 1999 are as follows: 1995, $3.4 million; 1996, $3.5 million; 1997, $153.8 million; 1998, $109.1 million; and 1999, $9.4 million. See Note 3 for redemption and sinking fund requirements of redeemable preferred stock of the Company.

On January 12, 1995, the Company issued $75 million of 10% junior subordinated deferrable interest debentures (MIDS) due 2025.

Substantially all utility plant (other than nuclear fuel, transportation equipment, and the combined cycle plant) is subject to the lien of the mortgage bond indenture. The mortgage bond indenture includes provisions which would restrict the payment of common stock dividends under certain conditions which did not exist at December 31, 1994.

5. Lines of Credit

The Company had committed lines of credit with various banks of $300 million at December 31, 1994, and $302 million at December 31, 1993, which were available either to support the issuance of commercial paper or to be used for bank borrowings. The commitment fees on these lines were 0.25% per annum through June 30, 1994, 0.20% per annum on $200 million and 0.15% per annum on $100 million thereafter, through December 31, 1994. The Company had commercial paper borrowings outstanding of $131.5 million at December 31, 1994, and $148.0 million at December 31, 1993. The weighted average interest rate on commercial paper borrowings was 6.25% on December 31, 1994, and 3.48% on December 31, 1993. By Arizona statute, the Company's short-term borrowings cannot exceed 7% of its total capitalization without the consent of the ACC.

6. Jointly-Owned Facilities

At December 31, 1994, 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
		(Thousands of Dollars)		
Generating Facilities:				
Palo Verde Nuclear Generating Station Units 1 and 3	29.1%	$ 1,832,522	$ 425,908	$ 14,181
Palo Verde Nuclear Generating Station Unit 2 (see Note 7)	17.0%	563,115	131,764	13,415
Four Corners Steam Generating Station Units 4 and 5	15.0%	142,297	50,414	497
Navajo Steam Generating Station Units 1, 2 and 3	14.0%	139,648	74,513	17,035
Cholla Steam Generating Station Common Facilities (a)	62.8%(b)	70,657	33,967	335
Transmission Facilities:				
ANPP 500KV System	35.8%(b)	62,607	15,313	1,013
Navajo Southern System	31.4%(b)	26,737	15,038	15
Palo Verde-Yuma 500KV System	23.9%(b)	11,411	3,304	20
Four Corners Switchyards	27.5%(b)	2,796	1,635	53
Phoenix-Mead System	17.1%(b)	—	—	18,036

(a) The Company is the operating agent for Cholla Unit 4, which is owned by PacifiCorp. The common facilities at the Cholla Plant are jointly-owned.

(b) Weighted average of interests.

7. Leases

In 1986, the Company entered into sale and leaseback transactions under which it sold approximately 42% of its share of Palo Verde Unit 2 and certain common facilities. The gain of approximately $140.2 million has been deferred and is being amortized to operations expense over the original lease term. The leases are being accounted for as operating leases. The amounts paid each year approximate $40.1 million through December 1999, $46.3 million through December 2000, and $49.0 million through December 2015. Options to renew for two additional years and to purchase the property at fair market value at the end of the lease terms are also included. Consistent with the ratemaking treatment, an amount equal to the annual lease payments is included in rent expense. A regulatory asset (totaling approximately $52.8 million at December 31, 1994) has been established for the difference between lease payments and rent expense calculated on a straight-line basis. Lease expense for 1994, 1993 and 1992 was $42.2 million, $41.8 million and $45.8 million, respectively.

The Company has a capital lease on a combined cycle plant which it sold and leased back. The lease requires semiannual payments of $2.6 million 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 $54.4 million; accumulated amortization at December 31, 1994, was $40.3 million.

In addition, the Company also leases certain land, buildings, equipment and miscellaneous other items through operating rental agreements with varying terms, provisions and expiration dates. Rent expense for 1994, 1993 and 1992 was approximately $10.1 million, $11.1 million and $14.7 million, respectively. Annual future minimum rental commitments, excluding the Palo Verde and combined cycle leases, for the period 1995 through 1999 range between $11 million and $12 million. Total rental commitments after 1999 are estimated at $122 million.

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. Approximately $1.8 million of income tax overpayments were due from Pinnacle West at December 31, 1994. Investment tax credits were deferred and are being amortized to other income over the estimated lives of the related assets as directed by the ACC. Beginning in 1995, the ACC portion of the unamortized investment tax credits will be amortized over a five-year period in accordance with the 1994 rate settlement agreement (see Note 2).

Effective January 1, 1993, the Company adopted the provisions of SFAS No. 109, which requires the use of the liability method of accounting for income taxes. Upon adoption the Company recorded deferred income taxes related to the equity component of AFUDC; the debt component of AFUDC recorded net-of-tax; and other temporary differences for which deferred income taxes had not been provided. Deferred tax balances were also adjusted for changes in tax rates. The adoption of SFAS No. 109 had no material effect on net income but increased net deferred income tax liabilities by $585.3 million at December 31, 1993. Historically the FERC and the ACC have allowed revenues sufficient to pay for these deferred tax liabilities and, in accordance with SFAS No. 109, a regulatory asset was established in a corresponding amount.

The components of income tax expense are as follows:

	Year Ended December 31,		
	1994	1993	1992
	(Thousands of Dollars)		
Current:			
Federal	$ 74,272	$ 69,243	$ 80,921
State	26,447	23,915	23,141
Total current	100,719	93,158	104,062
Deferred:			
Depreciation — net	56,450	58,844	75,931
Alternative minimum tax	21,425	13,661	7,732
Palo Verde accretion income	13,288	29,618	26,668
Pension costs	(9,302)	(5,768)	(4,622)
Loss on reacquired debt	(903)	4,288	10,266
Palo Verde start-up costs	(1,590)	(1,335)	(28,976)
Investment tax credit — net	(6,825)	(6,948)	(6,804)
Other — net	3,982	3,389	(2,902)
Total deferred	76,525	95,749	77,293
Total	$177,244	$188,907	$181,355

Income tax expense differed from the amount computed by multiplying income before income taxes by the statutory federal income tax rate due to the following:

	Year Ended December 31,		
	1994	1993	1992
	(Thousands of Dollars)		
Federal income tax expense at statutory rate (35% in 1994 and 1993, 34% in 1992)	$147,256	$153,753	$145,574
Increase (reductions) in tax expense resulting from:			
Tax under book depreciation	17,236	17,671	17,465
Investment tax credit amortization	(6,825)	(6,922)	(7,036)
State income tax — net of federal income tax benefit	24,947	27,005	27,036
Other	(5,370)	(2,600)	(1,684)
Income tax expense	$177,244	$188,907	$181,355

The components of the net deferred income tax liability were as follows:

	December 31, 1994	December 31, 1993
	(Thousands of Dollars)	
Deferred tax assets:		
Deferred gain on Palo Verde Unit 2 sale/leaseback	$ 63,720	$ 66,754
Alternative minimum tax (can be carried forward indefinitely)	14,089	35,514
Other	73,084	86,745
Valuation allowance	(15,072)	(15,413)
Total deferred tax assets	135,821	173,600
Deferred tax liabilities:		
Plant related	802,645	751,520
Income taxes recoverable through future rates — net	557,049	585,294
Palo Verde deferrals	153,410	158,424
Other	39,787	40,429
Total deferred tax liabilities	1,552,891	1,535,667
Accumulated deferred income taxes — net	$ 1,417,070	$ 1,362,067

9. Pension Plan and Other Benefits

Pension Plan

The Company sponsors a defined benefit pension plan covering substantially all employees. Benefits are based on years of service and compensation utilizing a final average pay benefit formula. The plan is funded on a current basis to the extent deductible under existing tax regulations. Plan assets consist primarily of domestic and international common stocks and bonds and real estate. Pension cost, including administrative cost, for 1994, 1993 and 1992 was approximately $25.4 million, $14.0 million and $14.0 million, respectively, of which approximately $11.9 million, $6.5 million and $3.9 million, respectively, was charged to expense. The remainder was either capitalized or billed to others.

Excluding the costs of special termination benefits of $1.4 million in 1994, the components of net periodic pension costs are as follows:

	1994	1993	1992
		(Thousands of Dollars)	
Service cost-benefits earned during the period	$ 20,345	$ 16,754	$ 16,903
Interest cost on projected benefit obligation	39,377	34,724	33,333
Return on plan assets	6,105	(51,597)	(23,058)
Net amortization and deferral	(44,000)	13,420	(15,002)
Net periodic pension cost	$ 21,827	$ 13,301	$ 12,176

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

	1994	1993
	(Thousands of Dollars)	
Plan assets at fair value	$ 388,010	$ 417,938
Less:		
Accumulated benefit obligation, including vested benefits of $308,474 and $347,603 in 1994 and 1993, respectively	333,564	372,364
Effect of projected future compensation increases	112,780	127,388
Total projected benefit obligation	446,344	499,752
Plan assets less than projected benefit obligation	(58,334)	(81,814)
Plus:		
Unrecognized net loss (gain) from past experience different from that assumed	(9,372)	51,361
Unrecognized prior service cost	25,527	14,717
Unrecognized net transition asset	(36,025)	(39,242)
Accrued pension liability	$ (78,204)	$ (54,978)
Principal actuarial assumptions used were:		
Discount rate	8.75%	7.50%
Rate of increase in compensation levels	5.00%	5.00%
Expected long-term rate of return on assets	9.00%	9.50%

In addition to the defined benefit pension plan described above, the Company also sponsors qualified defined contribution plans. Collectively, these plans cover substantially all employees. The plans provide for employee contributions and partial employer matching contributions after certain eligibility requirements are met. The cost of these plans for 1994, 1993 and 1992 was $6.8 million, $6.3 million and $5.3 million, respectively, of which $3.2 million, $3.0 million and $2.5 million, respectively, was charged to expense.

Postretirement Plans

The Company provides medical and life insurance benefits to its retired employees. Employees may become eligible for these retirement benefits based on years of service and age. The retiree medical insurance plans are contributory; the retiree life insurance plan is noncontributory. In accordance with the governing plan documents, the Company retains the right to change or eliminate these benefits.

During 1993, the Company adopted SFAS No. 106, which requires the cost of postretirement benefits be accrued during the years employees render service. Prior to 1993, the costs of retiree benefits were recognized as expense when claims were paid. This change had the effect of increasing 1994 and 1993 retiree benefit costs from approximately $6 million in each year to $28 million and $34 million, respectively. The amount charged to expense for 1994 increased from about $3 million to $13 million, and for 1993 increased from about $2 million to $17 million. The balance was either capitalized or billed to others. The above amounts include the amortization (over 20 years) of the initial postretirement benefit obligation estimated at January 1, 1993, to be $183 million. Funding is based upon actuarially determined contributions that take tax consequences into account. Plan assets consist primarily of domestic stocks and bonds.

The components of the net periodic postretirement benefit costs are as follows:

	1994	1993
	(Thousands of Dollars)	
Service cost — benefits earned during the period	$ 8,785	$ 9,510
Interest cost on accumulated benefit obligation	14,026	15,630
Return on plan assets	(6,459)	—
Net amortization and deferral	11,619	9,146
Net periodic postretirement benefit cost	$ 27,971	$ 34,286

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

	1994	1993
	(Thousands of Dollars)	
Plan assets at fair value	$ 49,666	$ 28,154
Less accumulated postretirement benefit obligation:		
Retirees	65,552	86,972
Fully eligible plan participants	9,128	10,013
Other active plan participants	87,201	102,928
Total accumulated postretirement benefit obligation	161,881	199,913
Plan assets less than accumulated benefit obligation	(112,215)	(171,759)
Plus:		
Unrecognized transition obligation	164,627	173,773
Unrecognized net gain from past experience different from that assumed	(52,470)	(2,072)
Accrued postretirement liability	$ (58)	$ (58)
Principal actuarial assumptions used were:		
Discount rate	8.75%	7.50%
Annual salary increases for life insurance obligation	5.00%	5.00%
Expected long-term rate of return on assets	9.00%	—
Initial health care cost trend rate — under age 65	11.50%	12.00%
Initial health care cost trend rate — age 65 and over	8.50%	9.00%
Ultimate health care cost trend rate (reached in the year 2003)	5.50%	5.50%

Assuming a one percent increase in the health care cost trend rate, the 1994 cost of postretirement benefits other than pensions would increase by approximately $5 million and the accumulated benefit obligation as of December 31, 1994, would increase by approximately $31 million.

In 1993, the Company adopted SFAS No. 112. This standard required a change from a cash method to an accrual method in accounting for benefits (such as long-term disability) provided to former or inactive employees after employment but before retirement. The adoption of this standard resulted in an increase in 1993 postemployment benefit expense of approximately $2 million.

10. Commitments and Contingencies

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 resolution of these matters will not have a material adverse effect on the operations or financial position of the Company.

Palo Verde Nuclear Generating Station

The Company has encountered tube cracking in steam generators and has taken, and will continue to take, remedial actions that it believes have slowed further tube problems to manageable levels. The Company believes that the Palo Verde steam generators are capable of operating for their designed life of 40 years, although at some point, long-term economic considerations may make steam generator replacement desirable. All of the Palo Verde units were operating at full power at December 31, 1994.

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 industry-wide retrospective assessment program. The maximum assessment per reactor under the retrospective rating program for each nuclear incident is approximately $79 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 for all three units is approximately $69 million, with an annual payment limitation of approximately $9 million.

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 $2.78 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 and business interruption resulting from a sudden and unforeseen outage of any of the three units. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

El Paso Electric Company Bankruptcy

El Paso Electric Company (EPEC), one of the joint owners of Palo Verde and Four Corners, has been operating under Chapter 11 of the Bankruptcy Code since 1992. A plan whereby EPEC would become a wholly-owned subsidiary of Central and South West Corporation (CSW) has been confirmed by the bankruptcy court, but cannot become fully effective until several other approvals are obtained. Under the plan, certain issues, including EPEC allegations regarding the 1989–90 Palo Verde outages, would be resolved, and EPEC would assume the joint facilities operating agreements. CSW has stated that several matters have arisen which may impede completion of the merger. If the plan is not approved, the Company does not expect that there would be a material adverse effect on its operations or financial position.

Construction Program

Total construction expenditures in 1995 are estimated at $300 million, excluding capitalized property taxes and capitalized interest.

Fuel and Purchased Power Commitments

The Company is a party to various fuel and purchased power contracts with terms expiring from 1995 through 2020 that include required purchase provisions. The Company estimates its 1995 contract requirements to be approximately $127 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 circumstances.

11. Selected Quarterly Financial Data (Unaudited)

Quarterly financial information for 1994 and 1993 is as follows:

Quarter	Electric Operating Revenues(a)	Operating Income(b)	Net Income	Earnings for Common Stock
		(Thousands of Dollars)		
1994				
First	$346,049	$ 67,147	$ 38,468	$30,958
Second	397,156	83,607	65,851	58,879
Third	540,883	155,115	116,267	110,359
Fourth	342,080	62,564	22,900	18,016
1993				
First	$353,891	$ 79,441	$ 47,166	$39,277
Second	387,871	92,264	61,364	53,716
Third	497,282	132,639	102,911	95,617
Fourth	363,369	68,144	38,945	30,936

(a) Consistent with the presentation for the quarter ended December 31, 1994, prior quarters' electric operating revenues and other taxes have been restated to exclude sales tax on electric revenues.

(b) The Company's operations are subject to seasonal fluctuations primarily as a result of weather conditions. The results of operations for interim periods are not necessarily indicative of the results to be expected for the full year.

12. Fair Value of Financial Instruments

The Company estimates that the carrying amounts of its cash equivalents and commercial paper are reasonable estimates of their fair values at December 31, 1994 and 1993 due to their short maturities. The December 31, 1994 and 1993 fair values of debt and equity investments, determined by using quoted market values or by discounting cash flows at rates equal to its cost of capital, approximate their carrying amounts. Investments in debt and equity securities are held for purposes other than trading.

On December 31, 1994, the carrying amount of long-term debt (excluding $26 million of capital lease obligations) was $2.16 billion and its estimated fair value was approximately $1.99 billion. On December 31, 1993, the carrying amount of long-term debt (excluding $30 million of capital lease obligations) was $2.10 billion and its estimated fair value was approximately $2.26 billion. The fair value estimates were determined by independent sources using quoted market rates where available. Where market prices were not available, the fair values were based on market values of comparable instruments.

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

CSW — Central and South West Corporation

DOE — United States Department of Energy

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

kW — Kilowatt, one thousand watts

kWh — Kilowatt-hour, one thousand watts per hour

MDC — Maximum dependable capacity

MWh — Megawatt hours, one million watts per hour

PacifiCorp — An Oregon-based utility company

Palo Verde — Palo Verde Nuclear Generating Station

Pinnacle West — Pinnacle West Capital Corporation, an Arizona corporation, the Company's parent

SFAS No. 71 — Statement of Financial Accounting Standards No. 71, Accounting for the Effects of Certain Types of Regulation

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

SFAS No. 112 — Statement of Financial Accounting Standards No. 112, Employers' Accounting for Postemployment Benefits

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 serves approximately 681,000 customers 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 would have the right to vote the common stock.

APS Officers

Jack A. Bailey, Vice President, Nuclear Engineering and Projects
Jan H. Bennett, Vice President, Customer Service
Jack E. Davis, Vice President, Generation and Transmission
O. Mark DeMichele, President and Chief Executive Officer
Armando B. Flores, Vice President, Human Resources
William J. Hemelt, Controller
James M. Levine, Vice President, Nuclear Production
Nancy C. Loftin, Secretary and Corporate Counsel
Richard W. MacLean, Vice President, Environmental, Health and Safety
Nancy E. Newquist, Treasurer
Jaron B. Norberg, Executive Vice President and Chief Financial Officer
William J. Post, Senior Vice President and Chief Operating Officer
Shirley A. Richard, Executive Vice President, Customer Service, Marketing and Corporate Relations
E. C. Simpson, Vice President, Nuclear Support
Richard Snell, Chairman of the Board of Directors
William L. Stewart, Executive Vice President, Nuclear

APS Directors

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

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

Martha O. Hesse, president, Hesse Gas Company and Dolan Energy Corporation, Houston, Texas

Marianne Moody Jennings, professor of legal and ethical studies in business, College of Business, Arizona State University, Tempe, Arizona

Robert G. Matlock, president and chief executive officer, R.G. Matlock & Associates, Inc. (management consulting), Richland, Washington

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

William J. Post, senior vice president and chief operating officer of the Company, Phoenix, Arizona

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

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

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

Verne D. Seidel, real estate broker and 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

Dianne C. Walker, independent consultant, Vancouver, Washington

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

Thomas G. Woods, Jr., formerly 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) and the $1.8125 Cumulative Preferred Stock, Series W (Symbol ARPW) are 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 declared on the Company's common stock for each of the four quarters of 1994 and 1993.

COMMON STOCK DIVIDENDS
(THOUSANDS OF DOLLARS)

QUARTER	1994	1993
1st Quarter	$ 42,500	$ 42,500
2nd Quarter	42,500	42,500
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
Transfer Processing
Mail Stop: 45-01-05
P.O. Box 644
Boston, Massachusetts 02102-0644
(617) 575-2900
(common stock only)

Auditors

Deloitte & Touche LLP
Phoenix, Arizona

Pinnacle West Stock Purchase and Dividend Reinvestment Plan

Pinnacle West's Stock Purchase and Dividend Reinvestment Plan has been renamed the Investors Advantage Plan. A Prospectus describing this Plan is available upon request. Write: Shareholder Department, P.O. Box 52133, Phoenix, AZ 85072-2132 or call toll-free 1-800-457-2983, local (in the Phoenix area) 379-2500. Participants in the current Plan will automatically receive this information.

Form 10-K

A copy of our Annual Report to the Securities and Exchange Commission, Form 10-K, will be available after March 31, 1995, 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

Annual Meeting of Shareholders:

All shareholders are invited to attend the Company's seventy-fifth annual meeting at 10:00 a.m. on Tuesday, May 16, 1995, at the offices of the Company, 400 North Fifth Street, Phoenix, Arizona.

SRP's Vision:
The Salt River Project is the premier provider of the electric and water services essential to support the Salt River Valley.

SRP's Mission:
To be the best water and power organization, dedicated to improving service, lowering costs, resource stewardship, and market focus through involved, change-oriented employees.

Contents

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