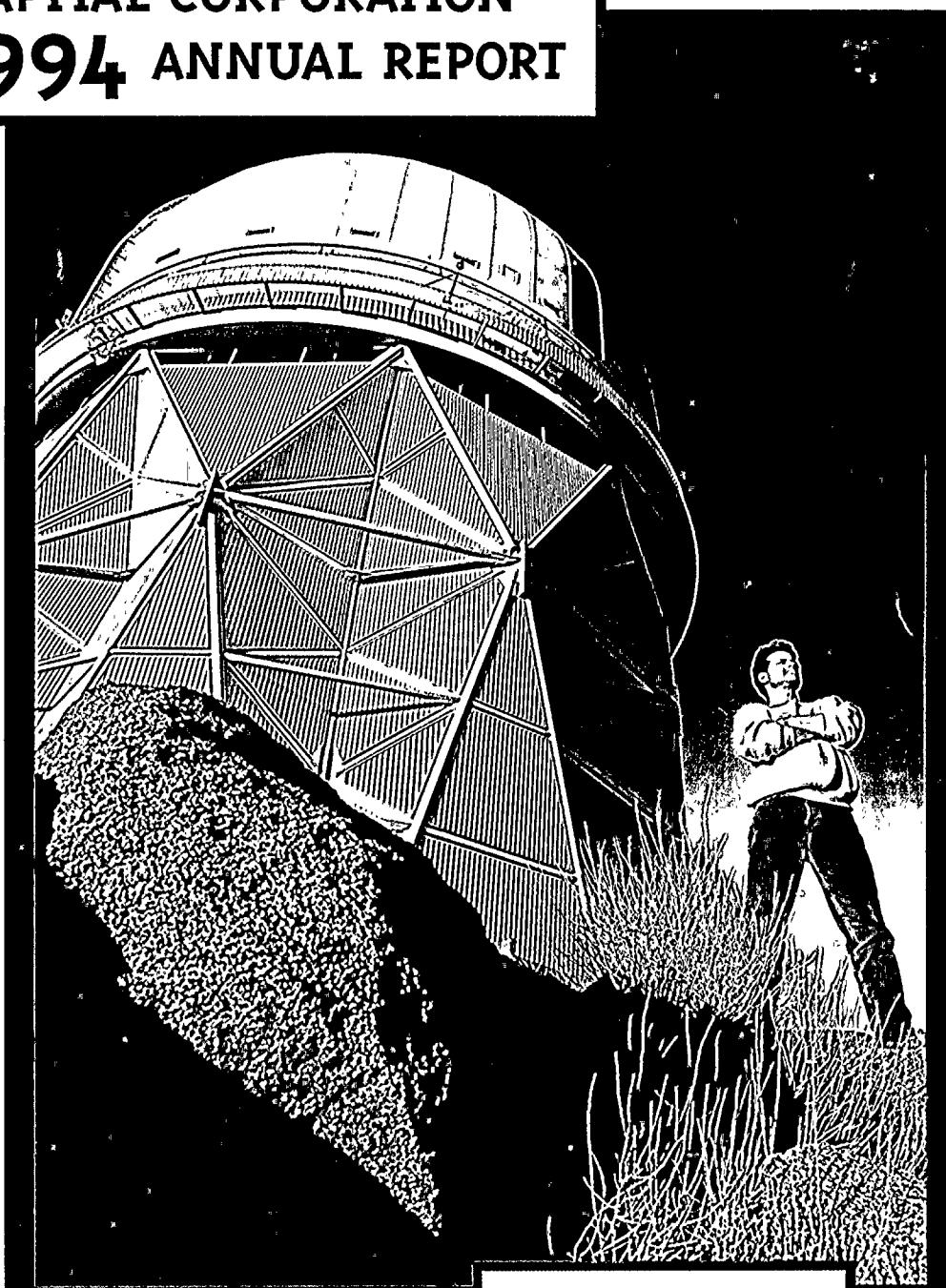


**PINNACLE WEST  
CAPITAL CORPORATION  
1994 ANNUAL REPORT**



**CAPTURE  
THE FUTURE**

## ABOUT THE COMPANY

Pinnacle West Capital Corporation, a Phoenix-based holding company, has consolidated assets of approximately \$7 billion. Pinnacle West's major subsidiary is Arizona Public Service Company, the state's largest electric utility serving approximately 681,000 customers in an area that includes all or part of 11 of Arizona's 15 counties. Pinnacle West's other two subsidiaries are SunCor Development Company, developer of residential and commercial projects on some 14,000 acres predominantly in the metropolitan Phoenix area, and El Dorado Investment Company, a venture capital firm with a diversified portfolio.

## ABOUT THIS ANNUAL REPORT

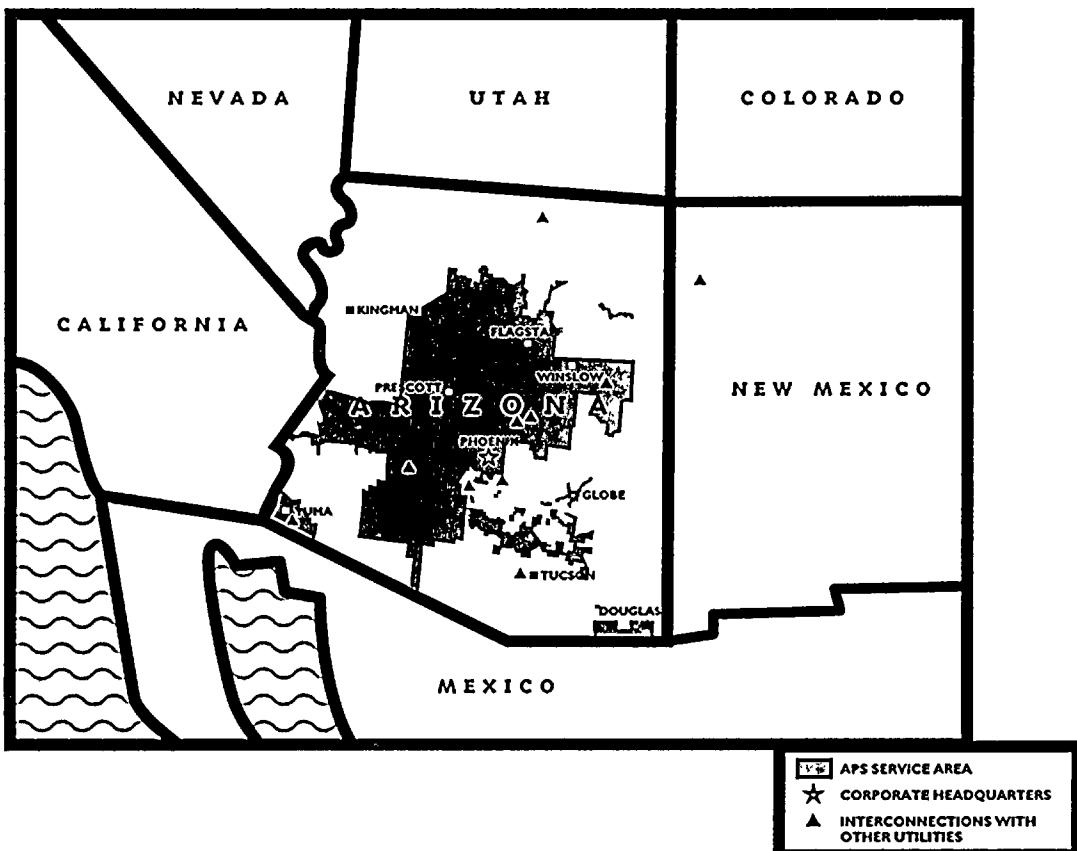
Illustrating the text of this annual report are a few selected images from across the spectrum of the Arizona educational experience, which we chose to illustrate this year's theme: CAPTURE THE FUTURE.

## ABOUT THE COVER

Shown on the cover, the Mayall telescope at Kitt Peak, 160 miles southwest of Phoenix, is one of the largest optical telescopes in the United States. It is part of the Observatories of Kitt Peak, which is a national center for research and graduate education under contract with 22 member universities.

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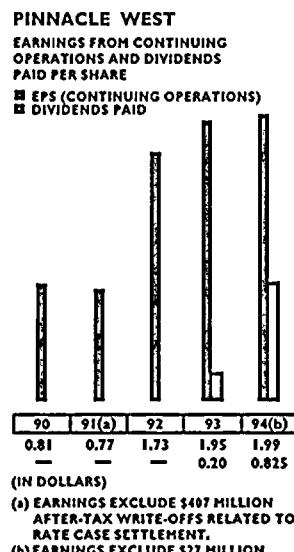
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**FINANCIAL OVERVIEW**  
**PINNACLE WEST CAPITAL CORPORATION**

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)	1994	1993	1992
Operating Revenues	\$ 1,685,421	\$ 1,634,661	\$ 1,607,541
Income From Continuing Operations (a)	\$ 200,619	\$ 169,978	\$ 150,440
Earnings From Continuing Operations Per Average Common Share Outstanding (a)	\$ 2.30	\$ 1.95	\$ 1.73
Average Common Shares Outstanding	87,411	87,242	87,044
Book Value Per Share - Year-end	\$ 20.32	\$ 18.87	\$ 17.00

(a) Income from continuing operations includes \$26.8 million (\$0.31 per share) non-recurring income tax benefit related to a change in tax law (see Note 3 of Notes to Consolidated Financial Statements).



# TO OUR SHAREHOLDERS

1994 was another good year. We produced good earnings and a healthy cash flow; we and our regulators produced a new settlement agreement that makes further progress into the future of our industry; we firmed internal succession plans with an eye on that future; and we increased the dividend to our shareholders. All told, we achieved what we had intended — a little more, actually.

In this respect we were aided by unusually warm weather and by a one-time income tax benefit. In our ongoing operations we needed — and got — excellence in continuing cost management, fossil plant performance and real estate operations. We needed this excellence in order to deal with a rate decrease that was part of the settlement agreement, Palo Verde steam generator problems that took much of the year to resolve, and disappointing results from our venture capital subsidiary.

That subsidiary's performance reflects, in part, the poor 1994 showing of U.S. securities markets in general. Our own stock was no exception to that showing; in addition, our stock took some hits from the Palo Verde problems and from general uncertainties about electric utilities which the financial community is trying to sort through.

1995 stock performance is something we won't predict, nor is the weather. We do know we won't get another income tax benefit of the sort we recorded in late 1994. We also know there won't be a repeat in 1995 of any of the non-cash earnings from the 1991 rate settlement (because they ran out in May of last year) and that we will incur fuel reloadings at Palo Verde this year in an unusually high number (three), so from the standpoint of ongoing operations we have our work cut out.

We do have the benefits of rapid growth in our region of the country and a healthy relationship with our principal regulator, the Arizona Corporation Commission (ACC). The challenge will be to build upon these benefits as we progress through 1995 and the years beyond without unduly jeopardizing our earnings base or making commitments we may later regret.

In discussing the "years beyond", I offer my personal views as of this moment only. I say that because: my views of what will happen are not shared by everyone; and things are developing at such a rate that I reserve the right to change my own views at any time. As a matter of fact, a prime objective in our company is corporate agility, and we believe that end is served by a diversity of views and by readiness to change them as things evolve.



RICHARD SNELL  
CHAIRMAN AND  
PRESIDENT

That said, these are the forces I see as shaping the future of the industry in the United States:

- Electricity will continue to be generated at central stations (much as it is now) and be distributed by electric wire.
- New, duplicating distribution systems will not be cost effective.
- New transmission capacity, duplicating or otherwise, will be constrained by siting difficulties, as well as by cost and other factors.
- The western states are already efficiently dispatching their generating facilities on a lowest-cost basis because of the prevalence of the economy interchange power market among western utilities.
- The western states are already organizing into regional transmission groups with "comparability" tariffs being filed by each member.
- Historical regulatory structures and objectives, both state and federal, are unique to the electric utility industry and significantly complicate its restructuring.
- The states will preserve substantial jurisdictional power over the way the electricity business is conducted within their respective boundaries.
- At least in Arizona the state constitution presents significant hurdles to competitive initiatives.
- State regulation of most residential electricity prices will continue well into the future, though it will be less linked to cost of service.
- Larger industrial customers which, themselves, face intense national and international competition will successfully press for competitive electricity prices and service.
- Service reliability presents interesting challenges to utility management as market forces begin to affect such things as prudent reserve margins that have previously been established in the regulatory process.
- Recovery of stranded commitments and social costs through exit fees, wire charges or the like is desirable, but full recovery is not a sure bet.
- Regulators in low-cost states will be hard put to allow energy and jobs to flow out-of-state if the effect is to increase in-state electricity prices and retard economic growth.
- Utilities will resist competition from outside if not allowed a fair chance to go outside themselves.
- In a competitive environment a utility's "obligation to serve" large, low-margin customers may become burdensome as its system load grows and reserves shrink.
- Continuing government participation in the industry (in the form of public power), after the advent of widespread competition, would be unparalleled in the deregulation experience in the United States.
- The "POOLCO" generating concept substitutes one form of regulation for another, and does not offer long-term stability.
- One also has to wonder about the long-term stability of a regime in which generation is priced at market but transmission at cost.

#### COMPARABILITY:

WHEREBY THIRD PARTIES ARE ENTITLED TO USE A UTILITY'S TRANSMISSION SYSTEM AT THE SAME PRICE AND ON THE SAME TERMS AS THE UTILITY USES THE SYSTEM FOR ITSELF

#### STRANDED COMMITMENTS:

THE VALUE OF GENERATING PLANTS, OTHER ASSETS AND CONTRACT OBLIGATIONS THAT WOULD BE LOST (I.E., NOT RECOVERED) IN AN ENVIRONMENT WHERE THE PRICE OF ELECTRICITY IS DRIVEN DOWN BY MARKET FORCES

#### SOCIAL COSTS:

COSTS NOW INCLUDED IN REGULATED UTILITY RATES, BUT NOT RELATED DIRECTLY TO THE COST OF PROVIDING SERVICE, SUCH AS LOW-INCOME ASSISTANCE, RENEWABLE ENERGY AND CONSERVATION

#### POOLCO:

WHEREBY AN INDEPENDENT ENTITY WOULD ASSUME REGIONAL AUTHORITY FOR DISPATCHING ELECTRIC GENERATING PLANTS WITHIN THE REGION AND SETTING A COMMON PRICE FOR THEIR OUTPUT ON AN HOURLY BASIS

- Consolidation will come to the industry, but not in a big way until the effect of the foregoing forces on individual utilities can be discerned; i.e., not until one is better able to ascertain their true value in the brave new world.

What to make of this disjointed and sometimes conflicting listing of forces? Well, it seems obvious that competition is coming to the industry, but less obvious as to what sector or sectors of customers it is coming, when it will come, and what the relevant geographic market will be when it comes.

Internally, we have developed alternative plans which deal with important questions: how far must we continue to drive down costs in order to compete on the price of our electricity product while providing acceptable returns to our shareholders; where do we want to go with our product beyond our traditional market and how do we get there; how do we (and the rest of the industry) finance our capital needs in the future and deal with mortgage indentures and the like in the process; where, exactly, does our regulatory relationship with the ACC need to be modified; what is our exposure to stranded commitments and how do we minimize that exposure; how are our likely competitors responding to these same questions; and where should we be positioned when industry consolidation truly begins. The answers to these questions drive our business strategies.

In some respects we have important advantages. We have had an intensive focus on cost management for more than five years now. Though some utilities in our region have lower generating costs (particularly in the Pacific Northwest), more have higher costs (particularly in California). We have agreements with the ACC that recognize comprehensive cost and price targets as a way of redefining the regulatory relationship and that, for our larger customers, may lead to important revisions in the relationship itself. We have sharpened our focus on these larger customers and have entered into long-term contracts with the biggest. Conversely, we are not burdened by expensive power purchase contracts. The uniquely strong growth in our service territory is definitely an advantage.

We also have some open issues. We carry significant regulatory assets on our balance sheet pursuant to commitments made to us by our regulators; some of these could be at risk to the forces described above. Our job is to minimize the risk. Regardless of that particular risk, we recognize some weakness in the capital structure and are addressing this issue in a manner consistent with the interests of our shareholders.

Relative to hard assets, we have the paradox of our lowest variable costs, but highest fixed costs, being centered in the Palo Verde investment. The objectives here are to get variable costs down even further and to increase the availability of the three units with a view to lowering total costs per kWh generated. Our fossil plants are in good shape from the standpoints of total cost and availability. All told, we think our generating assets justify their carrying values, given our view of the future. The same is true of our transmission and distribution assets.

As we look around us, we see utility companies as our major competitors (much more so than independent power producers, marketers and the like) and our immediate neighbor, Salt River Project, as one of the toughest. It is a large, well-run electric utility with quasi-

#### REGULATORY ASSETS:

BOOK-ENTRY ASSETS, SUCH  
AS DEFERRED COSTS, CREATED  
BY THE REGULATORY PROCESS  
FOR FUTURE RECOVERY  
THROUGH RATES

government status and attendant benefits. SRP recently announced a four percent rate decrease for its largest customers (approximately the same decrease that we effectively provided our largest customers in May). On average, SRP's rates are under ours, though there are a number of exceptions. Despite the difference between investor-owned and government status and the separateness of our adjoining territories, it is fair to say that we and they are, and have been, in serious competition for customers. So competition is not new to us, and we have been preparing for it a long time.

With what we have been able to accomplish to date, with the people we have in place, and with an eye on our extensive database for power generation and sale in our part of the country, we look forward to the future with enthusiasm. The narrative which follows this letter provides further information with regard to that forward look, and is organized along the lines of the seven-part plan I announced in last year's annual report.

In furtherance of that forward look we announced a succession plan whereby Bill Post became Chief Operating Officer of APS in September. He reports to Mark DeMichele, APS President and CEO, who plans to retire in two years. Nuclear operations, headed by APS Executive Vice President Bill Stewart since he joined the company last June, will in September of this year be the last of the APS operational units to begin reporting to Bill Post.

Henry Sargent, Executive Vice President of the parent company, will retire from management in June of this year and at that time Bill Post will also become an officer of the parent. Henry has been with the company 37 years and is well known and respected in the financial community. He has certainly been of invaluable assistance to me ever since I joined the company, and I will continue to seek his advice after he retires. The same is true of Don Soldwedel, who is retiring as a Pinnacle West director after 37 years of service. My own employment contract with the company was extended by two years to February 1997.

Although this letter has largely been devoted to APS, special recognition is due the 1994 accomplishments of SunCor Development Company under John Ogden. The scale of activity John's people achieved in 1994 to produce a strong cash flow is really quite impressive.

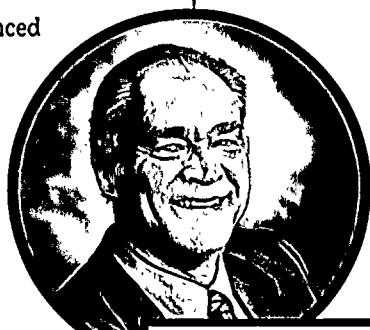
This letter has also been largely directed to the future. That future will be in the hands of those young people who are now in the education stream. Interesting things are happening along that stream in Arizona, and we are displaying some of them in this annual report.



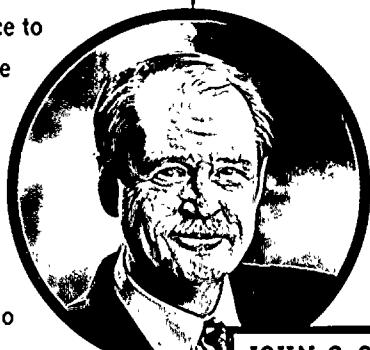
Richard Snell  
Chairman and President



WILLIAM J. POST  
CHIEF OPERATING  
OFFICER APS



WILLIAM L. STEWART  
EXECUTIVE VICE PRESIDENT  
APS

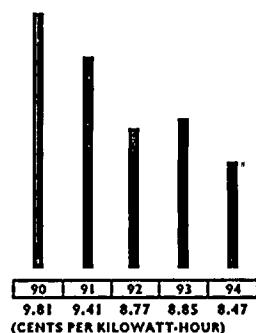


JOHN C. OGDEN  
PRESIDENT & CHIEF  
EXECUTIVE OFFICER  
SUNCOR

# 1. MANAGE OUR COSTS

IN 1994

ARIZONA PUBLIC SERVICE  
COST OF PRODUCING AND  
DELIVERING ELECTRICITY



Successfully managing costs is the cornerstone of strategic planning throughout Pinnacle West and its subsidiaries, and vital to APS as it enters a more competitive future.

In 1994, APS reduced the cost of producing and delivering electricity more than four percent to 8.47 cents per kWh from 8.85 cents in 1993. The average annual cost reduction since 1990, as depicted in the graph on this page, is 3.6 percent.

APS reduced its work force by more than seven percent during 1994 and, more importantly, streamlined many work processes. Other examples of cost management activities at APS in 1994 include renegotiated coal contracts and new inventory management practices.

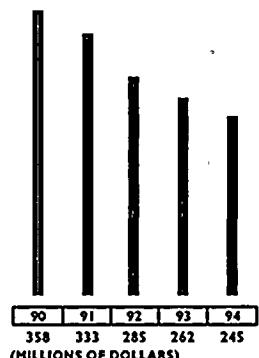
At the end of 1994, APS substantially completed an effort that began in 1992 to refinance all its high-coupon senior securities at favorable interest rates. Utility interest expense and preferred stock dividend requirements decreased \$6.9 million and \$5.6 million, respectively, from 1993 levels.

Parent-level interest expense decreased \$13.3 million from 1993 to 1994 due to debt repayment. Consolidated interest expense has declined since 1990 as shown in the margin.

The APS employee incentive plan in place since 1992 continued to produce results. APS made employee incentive payments for 1994 totaling approximately \$9 million, which related to cost saving measures directly attributable to employee efforts.

## LOOKING AHEAD

PINNACLE WEST  
CONSOLIDATED INTEREST EXPENSE



Much cost management work remains to be done at APS, and continued progress gets harder because the company cannot simply downsize its way to greater profitability but must continue to reinvent the way it does business. To that end, APS is already well immersed in a process that raises individual and team accountability and relates directly to profitability. Meeting its goals will allow APS to protect its market from known and unknown sources of competition and pursue opportunities in other markets.

- COSTS OF PRODUCING AND DELIVERING ELECTRICITY DECLINE
- CONTINUED DECREASE IN INTEREST EXPENSE



THOUSANDS OF UNDERGRADUATE STUDENTS IN THE PHOENIX AREA MANAGE THEIR COSTS AND THEIR EDUCATION BY TAKING ADVANTAGE OF THE SECOND LARGEST JUNIOR COLLEGE SYSTEM IN THE UNITED STATES. PICTURED HERE IS ESTRELLA JUNIOR COLLEGE, ONE OF TEN JUNIOR COLLEGES IN THE SYSTEM AND A NEW FEATURE OF SUNCOR'S PALM VALLEY MASTER-PLANNED COMMUNITY.

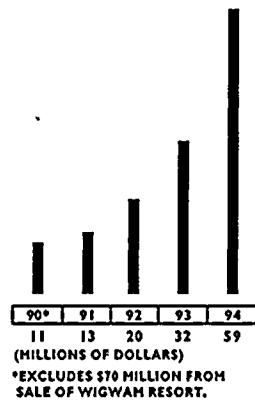
## 2. OPTIMIZE OUR ASSETS

IN 1994

### KEY PALO VERDE STRATEGIES

- MAXIMIZE SAFE RELIABLE POWER PRODUCTION
- SHORTEN PLANNED OUTAGES
- INCREASE CAPACITY FACTORS
- IMPROVE PREVENTIVE MAINTENANCE AND CORRECTIVE ACTION PROGRAMS
- REDUCE ANNUAL EXPENDITURES FOR FUEL, OPERATIONS, MAINTENANCE AND CONSTRUCTION

### SUNCOR DEVELOPMENT COMPANY REVENUES



The company optimizes its assets by maximizing kWh from its generating facilities, cash from its real estate holdings, productivity from its employees and service to its customers. The company considers its employees and its customers as important parts of its asset base.

By implementing 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, including improved water chemistry, appear to have reduced steam generator tube cracking to manageable levels. In 1994, the Palo Verde Nuclear Generating Station, the company's largest single asset, achieved an overall capacity factor of approximately 72 percent for the year, near the national average. This result was far from what management wants to achieve at Palo Verde, but was good considering the problems that Palo Verde faced during the year.

The company's coal-fired plants were available for service almost 88 percent of the time during 1994 — exceptional and well above an 83 percent industry average.

Although APS eliminated some 500 positions during 1994, employees maintained high levels of customer satisfaction while serving an expanding customer base.

SunCor Development Company, the company's real estate development subsidiary, reported a profit — \$1/2 million — for the first time in 1994 and increased real estate revenues almost 84 percent compared with 1993. With \$435 million in assets and approximately 14,000 acres of real estate under its control, SunCor is one of the major Phoenix area real estate firms.

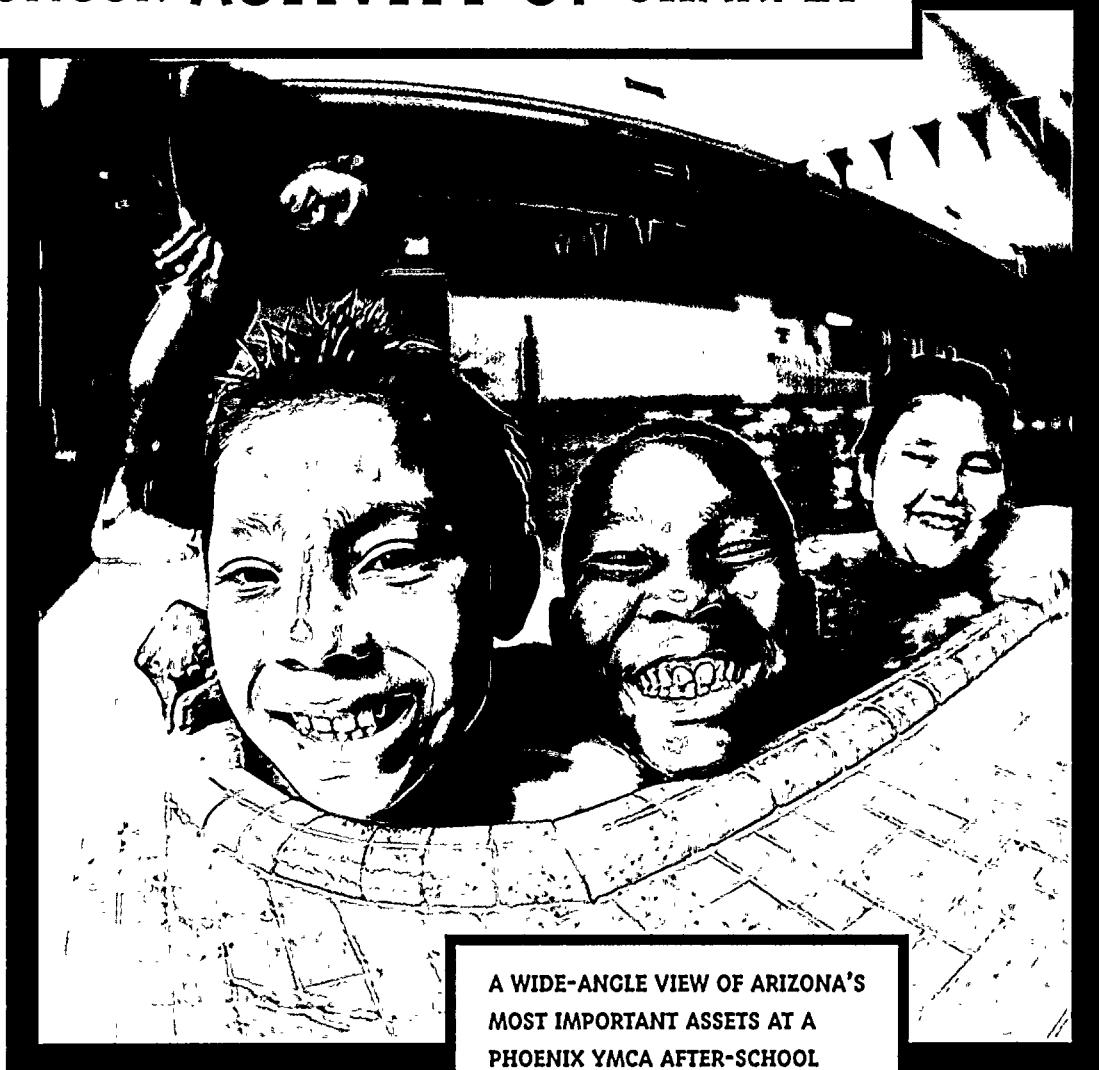
Sales activity in 1994 at each of SunCor's major residential properties increased dramatically. This included activity at Tatum Ranch, Palm Valley, PebbleCreek and Scottsdale Mountain. Sales of commercial acreage at Autoplex/MarketPlace and Talavi were notably higher as well.

### LOOKING AHEAD

Management attention is keenly focused on improving utility system productivity, especially at Palo Verde. Maintaining top quality customer service will require underground cable replacement in some older communities and upgrades of distribution lines to some fast growing communities, as well as improved reliability and quality of electricity service for large accounts where an especially high standard is required.

SunCor will continue to take advantage of the very active Phoenix area residential market where most of its properties are concentrated. Single-family housing permits in 1994 were issued at the highest level since 1978 and are expected to remain strong in 1995, although mortgage rates may affect this market.

- **PALO VERDE RETURNS TO FULL POWER OPERATIONS**
- **SUNCOR ACTIVITY UP SHARPLY**



A WIDE-ANGLE VIEW OF ARIZONA'S MOST IMPORTANT ASSETS AT A PHOENIX YMCA AFTER-SCHOOL PROGRAM. YMCA OFFICIALS IN THE METROPOLITAN AREA ARE MORE THAN HALFWAY TOWARD A \$9 MILLION CAPITAL FUND DRIVE WHICH WILL INCREASE SUCH SERVICES THROUGHOUT THE AREA.

# 3. WORK WITH OUR REGULATORS

IN 1994

The company worked with its regulators in 1994 against the backdrop of a new national political agenda and a rapidly evolving electricity industry.

In May 1994, APS and the ACC reached an innovative agreement that effected an overall rate decrease of 2.2 percent in a manner which provided larger customers with an effective decrease of approximately four percent. In recognition of competitive forces in larger customer segments, the agreement calls for the development by the company and the ACC staff of pricing and operating procedures that are responsive to these forces and address the ACC's relationship to utilities and their customers.

In January 1995, the Nuclear Regulatory Commission gave Palo Verde a "good performance" rating in all four categories measured under what the NRC said was a more stringent rating system than previously used. The NRC stated that there was an "obvious trend toward excellence" and noted management's clear recognition of the issues needing attention and actions taken to identify weaknesses.

The company's environmental programs and initiatives in 1994 continued to strengthen relationships with local, state and federal environmental agencies. The company is watching the progress of national risk assessment legislation which is part of the "Contract with America". The company supports efforts that lead to a more scientific cost-benefit and risk analysis of regulation and an easing of bureaucratic burdens as long as public safety is maintained at high levels. For a discussion of environmental issues, see page 20.

## LOOKING AHEAD

Having assembled an extensive database on production costs, power flows and other facets of the electricity business in the western part of the United States, the company will soon begin meetings with the ACC staff to develop the pricing and operating procedures called for by the 1994 agreement. The current objective is to make joint recommendations to the ACC before the end of this year.

On a separate track the staff of the ACC is holding open meetings with all parties interested in Arizona's electricity business about possibilities of competition in that business. Similar activity is occurring in other states and at the Federal Energy Regulatory Commission.

The company sees that competition is coming to the industry in some form, and it aims to be well positioned for that to occur in Arizona on a positive basis. Its settlement agreements with the ACC in 1991 and 1994 were part of that positioning, and the work with the ACC staff to be completed this year is expected to make further progress toward that aim.

- APS REDUCES RATES
- NUCLEAR REGULATORS RECOGNIZE  
POSITIVE TRENDS AT PALO VERDE

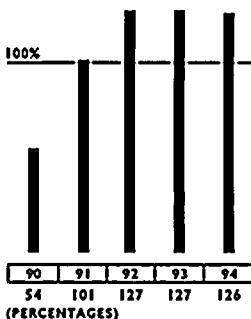


NO BUSINESS CHALLENGE  
IS UNWORKABLE AT  
THE THEORETICAL BUSINESS  
STRATEGY CENTER IN THE  
COLLEGE OF BUSINESS AT THE  
UNIVERSITY OF ARIZONA  
IN TUCSON.

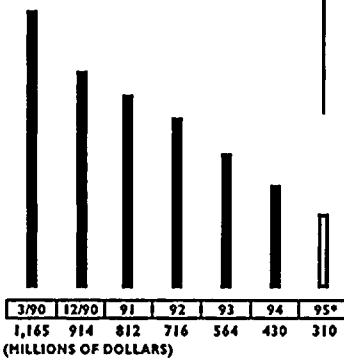
# 4. CHANNEL OUR CASH FLOW

IN 1994

ARIZONA PUBLIC SERVICE  
NET CASH FLOW, AFTER DIVIDENDS,  
AS PERCENT OF CAPITAL  
EXPENDITURES



PINNACLE WEST  
PARENT COMPANY LONG-TERM DEBT



In 1994, the company used its strong cash flow to increase dividends and pay down debt. The dividend on Pinnacle West common stock was increased 12.5 percent in October, resulting in an indicated annual dividend of 90 cents per share. The average dividend increase for the electric utility industry was less than three percent.

During the year, parent-company debt was reduced by \$134 million to \$430 million, down from a high of \$1.2 billion in 1990.

In 1994, APS internally generated, after dividends, 126 percent of the cash needed to pay for its construction program.

## LOOKING AHEAD

Pinnacle West's current cash flow strategy is straightforward: pay down debt and annually increase its dividend at a relatively steady percentage rate that is well over the average dividend growth rate in the electric utility industry.

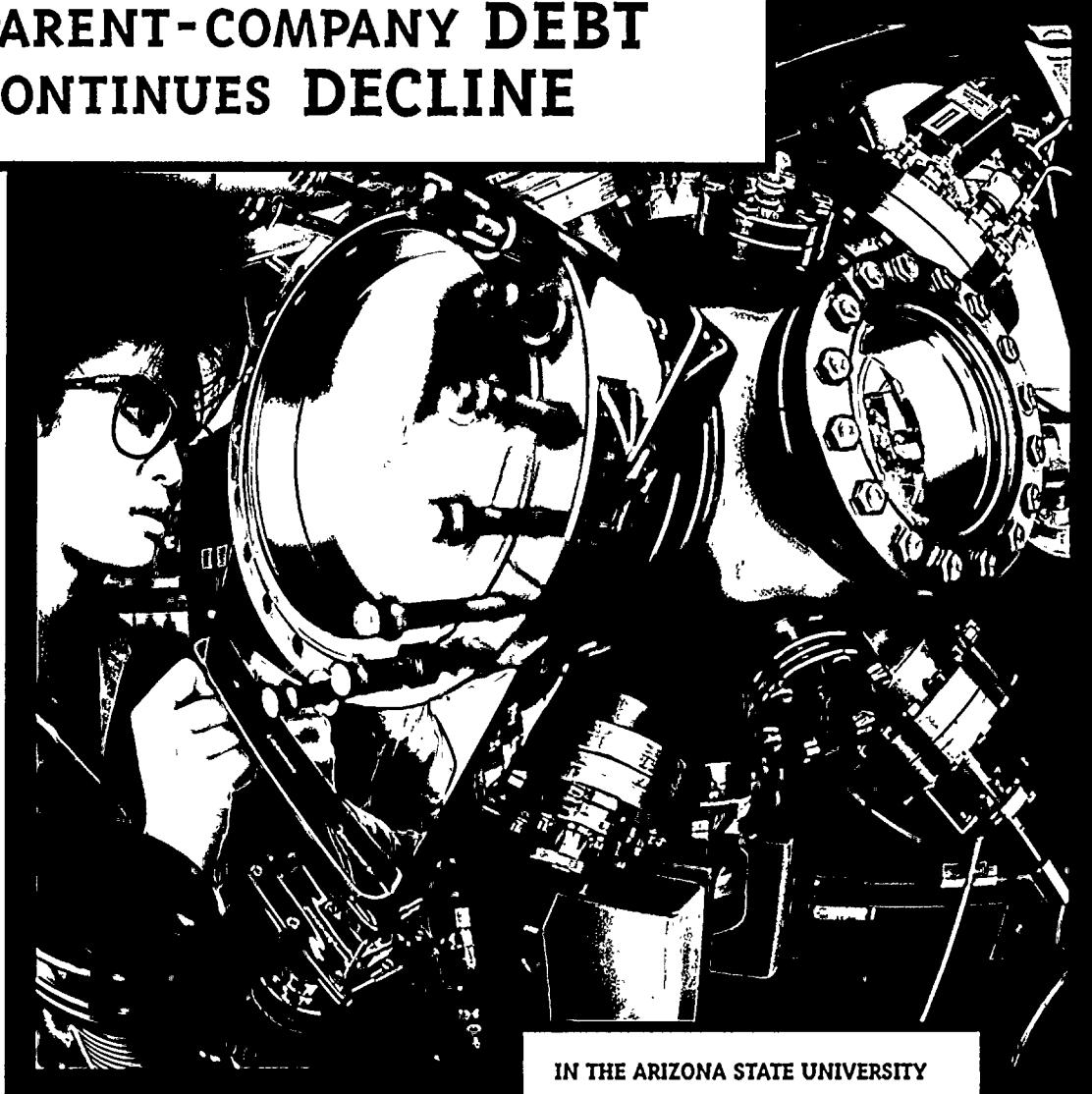
Pinnacle West expects to continue producing strong cash flow over and above its dividends to shareholders and in 1995 will apply most of that excess to reducing parent-level debt. By around year-end the balance should be down to \$310 million, consisting of a 1990 secured debenture issue due in 2000 that carries stiff prepayment penalties, and the company will then be announcing its cash flow strategies beyond that point.

The company's ability to increase its dividend and its healthy cash flow are some of the positive fundamentals that are often mentioned by those evaluating Pinnacle West's financial outlook.

Dividends from APS will continue to be Pinnacle West's primary source of cash. SunCor and El Dorado are also expected to contribute.

For the period 1995 through 1997, APS estimates that it will fund substantially all of its capital expenditures with internally generated funds.

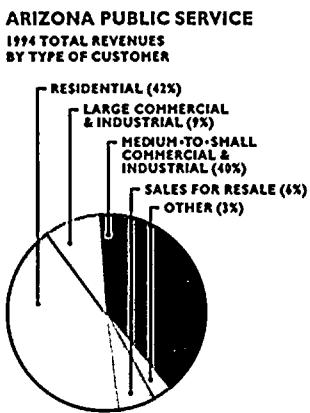
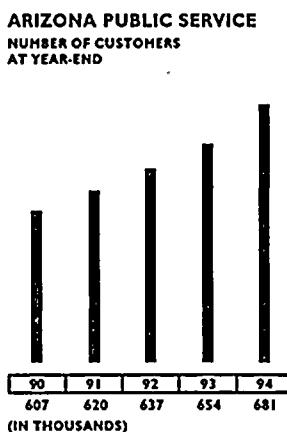
- PINNACLE WEST INCREASES DIVIDEND AT ABOVE AVERAGE RATE
- PARENT-COMPANY DEBT CONTINUES DECLINE



IN THE ARIZONA STATE UNIVERSITY CENTER FOR SOLID STATE SCIENCE, A 1.7 MILLION VOLT ACCELERATOR CHANNELS AN ION BEAM AT VARIOUS SAMPLES TO DETERMINE THEIR COMPOSITION.

# 5. ANTICIPATE OUR CUSTOMERS

IN 1994



In 1994, APS experienced customer growth of 4.2 percent — exceptional compared with other regions, but not unusual for the company as reflected in the graph on this page.

APS summer residential rates, 13th highest in the nation in 1988, now rank 43rd per kWh, based on Edison Electric Institute rankings of investor-owned utilities. APS' average industrial rate is 5.7 cents per kWh, and the average rate for its ten largest customers is 4.8 cents. The average unweighted industrial rate is 5.9 cents for neighboring utilities in Arizona, California, Nevada, New Mexico and Utah based on information from federal regulators.

During the year, the two largest APS industrial customers and its biggest wholesale customer signed new long-term contracts. The large industrial and commercial market segment represented nine percent of APS' revenue in 1994. The graph on this page illustrates sources of revenue by customer class.

## LOOKING AHEAD

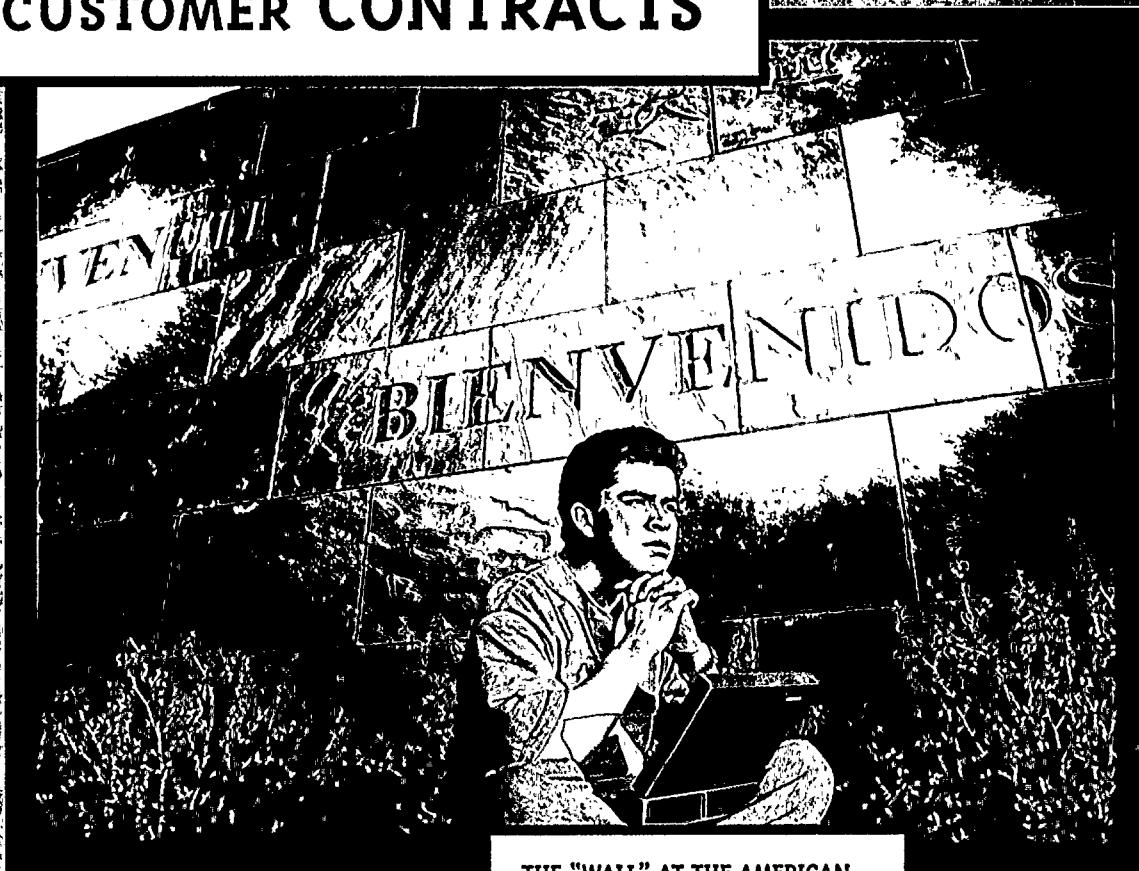
Opportunities and pitfalls will coexist in a new competitive market. There is already pressure from big customers for lower rates as well as a very competitive wholesale market in the APS region.

With a current and planned reserve margin of a prudent 16 percent and the kind of customer growth it has historically experienced, APS can increase its focus on managing profit margins. While it will work with all customers to retain their business, the financial exposure to loss of larger customers is manageable.

APS belongs to the Southwestern Regional Transmission Association, a regional transmission group formed to coordinate the planning of future transmission facilities and system access, consistent with the 1992 Energy Policy Act. There is considerable excess power in this region that will tend to moderate wholesale prices for the next five to ten years. Nevertheless, APS is aggressive in this market and believes there are opportunities due to the company's competitive power production costs, strategic location of its transmission system and seasonal diversity exchanges; the latter is exemplified in the 1991 long-term agreements with PacifiCorp, which have been very beneficial to the company.

APS signed a contract in November with the Mexican utility, Comision Federal de Electricidad (CFE), which could open a new market for energy sales. Under the contract, APS and CFE will begin economic and technical feasibility studies to connect the utilities' transmission systems. Electricity demands in Mexico are expected to increase substantially in the next decade, although recent events in that country could slow its rate of growth.

- CUSTOMER GROWTH AT 4.2 PERCENT IN 1994
- COMPETITIVE RATES/ CUSTOMER CONTRACTS



THE "WALL" AT THE AMERICAN GRADUATE SCHOOL OF INTERNATIONAL MANAGEMENT IN GLENDALE, WEST OF PHOENIX, IS SYMBOLIC OF THE SCHOOL'S GLOBAL STUDENT BODY AND INTERNATIONAL STUDIES.

# 6. CONTROL OUR COMMITMENTS

IN 1994

To Pinnacle West, controlling commitments means careful management of its assets, liabilities (including contractual obligations) and opportunities to preserve and augment financial strength and corporate agility. A low dividend payout ratio and a healthy cash flow are helping in that respect, and the characteristics of the APS service territory mean that it doesn't have to look elsewhere for growth.

At APS there are no plans to build any baseload plants, and current estimates of future construction expenditures primarily relate to upgrading existing facilities and expanding transmission and distribution capabilities to meet customer growth.

During the past three years, the non-utility subsidiaries together financed all of their operations through cash flow from operations and financing that did not involve Pinnacle West.

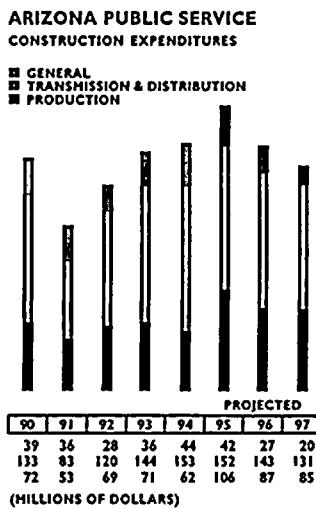
## LOOKING AHEAD

Pinnacle West does not plan any major investment in international generating facilities, nor will it pursue various domestic all-gas generating ventures. The recent devaluation of the Mexican peso is an example of the need for caution in pursuing new ventures.

The basic strategy for SunCor and El Dorado is to capture the value of their investments and provide cash to the parent. El Dorado's primary business consists of liquidating its equity holdings as soon and as advantageously as possible. Its progress can be affected by the stock market, especially the market for initial public offerings.

While the primary strategy at SunCor is to develop and sell its existing assets to provide cash to the parent, it will remain active in the marketplace. By leveraging its expertise and strengths and taking advantage of key new opportunities, it can improve its overall profitability and cash flow while continuing to build value.

Under this measured approach, in 1994 and early 1995 SunCor became managing partner in the development of SunRidge, a 950-acre residential golf community located in Fountain Hills east of Scottsdale, and Sedona Golf Resort, a 300-acre residential golf community near Sedona, 90 miles north of Phoenix.



- STRATEGIES FOR FINANCIAL STRENGTH AND CORPORATE AGILITY
- LOW DIVIDEND PAYOUT RATIO



ONE PLAYER CONTROLS 1,800  
PIPES WHICH ARE PART OF THE  
WORLD-FAMOUS FRITTS ORGAN,  
A SHOWPIECE OF ARIZONA STATE  
UNIVERSITY'S SCHOOL OF MUSIC,  
COLLEGE OF FINE ARTS.

# 7. CAPTURE THE FUTURE

IN 1994

## ARIZONA HIGHLIGHTS

- ARIZONA POPULATION GROWTH MORE THAN TWO TIMES NATIONAL AVERAGE
- ARIZONA SINGLE-FAMILY HOUSING PERMITS HIGHEST IN OVER 15 YEARS
- ARIZONA RANKED BY FORBES MAGAZINE AS ONE OF THE TOP SIX STATES IN THE U.S. FOR JOBS; EXCELLENT FOR DOING BUSINESS; EXCELLENT FOR EXPORTS
- GREATER PHOENIX IS 2ND FASTEST GROWING MAJOR METROPOLITAN AREA IN THE U.S.
- PHOENIX AREA RANKED 2ND IN U.S. FOR NEW MANUFACTURING PLANTS
- METROPOLITAN PHOENIX RANKED 6TH IN THE U.S. IN NEW BUSINESS CAPITAL INVESTMENT IN 1994
- SITE OF 1996 NFL SUPER BOWL
- HOME OF THREE MAJOR-LEAGUE SPORTS TEAMS: PHOENIX SUNS, ARIZONA CARDINALS AND THE NEW ARIZONA DIAMONDBACKS BASEBALL TEAM (TO BEGIN PLAY IN 1998)

As discussed in the preceding six parts, the company continued positioning itself for the future by: further cost, asset and cash management; more progress at the ACC in the form of the 1994 agreement on top of the 1991 agreement; contracts with large electricity customers; better understanding of our market from a competitive perspective; substantially increased activity at SunCor and further liquidation at El Dorado; and overall improvement in financial strength and corporate agility. The end game, of course, is to build shareholder value, and earnings growth will be a major determinant of that value.

Near term, 1995 earnings will be difficult. Major positive forces will be strong customer growth and interest expense reduction. However, several factors which contributed significantly to 1994 earnings are not expected to recur in 1995: non-cash income (including accretion income); a one-time income tax benefit; and the beneficial revenue impact of warmer than normal weather.

## LOOKING AHEAD

After 1995, customer growth and other fundamental contributors to the company's financial progress should become more apparent in year-over-year comparisons.

At some point, large scale change will occur in the electric utility industry, but the timing and final outcome are not predictable with any precision. As in other states, groups in Arizona with a stake in the industry are currently weighing the potential benefits and consequences of various actions related to electric utility markets. A retail wheeling bill was introduced during the current session of the Arizona legislature but has not advanced.

The company expects that the most important factor in the next stage of its own evolution into the future will be the work it will complete with the ACC staff later this year. That effort is discussed in the "Chairman's Letter" in this annual report, as are corporate strategies and principles designed to further position the company for the future.

Pinnacle West, APS and SunCor benefit from the strong underlying fundamentals of the Arizona economy such as population growth, job creation and business expansion and relocation, as well as from the state's attractive lifestyle. A few of the state's statistical and economic development highlights are listed in the margin to the left.

- IDENTIFY AND SEIZE INDUSTRY OPPORTUNITY
- CAPITALIZE ON ARIZONA GROWTH CHARACTERISTICS



A YOUNG ARIZONAN CAPTURES THE INGREDIENTS OF LIGHT WITH A HANDS-ON EXHIBIT AT THE ARIZONA SCIENCE CENTER. A NEW \$50 MILLION SCIENCE CENTER AND AN ARIZONA HISTORY MUSEUM ARE UNDER CONSTRUCTION IN DOWNTOWN PHOENIX.

# THE ENVIRONMENT

IN 1994

The company is subject to a significant number of environmental laws and regulations which affect its operations and planning and its capital and operating budgets. This is particularly true with respect to electric production and transmission facilities but is also the case with respect to real estate operations.

## NUCLEAR PLANT

The nation's nuclear industry shares a growing problem of what to do with high-level (spent-fuel) and low-level radioactive waste, which national policy had intended to be stored in centralized locations away from generating facilities. A millage assessment toward the nuclear waste fund, originally intended to be applied to the study and development of off-site facilities for high-level waste and levied on all nuclear generating plants in the U.S., is included in APS' operating and maintenance expenses, as is the cost of off-site transportation, processing and disposal of low-level waste.

However, off-site facilities for storage or disposal of high-level or low-level waste will not be available for Palo Verde in the foreseeable future. Due to the relatively young age of Palo Verde, APS has on-site storage available for high-level waste in spent-fuel pools for a number of years. The company will also store low-level waste on site until an off-site location becomes available.

While believing that scientific and financial aspects of the waste issues can be resolved satisfactorily, APS acknowledges that their ultimate resolution in a timely fashion will require political resolve and action on a national and regional basis which it is less able to predict.

## FOSSIL PLANTS

In 1991, the U.S. Environmental Protection Agency issued a final rule that would limit sulfur dioxide emissions at the Navajo Generating Station, beginning in 1997. As a 14 percent owner in this facility, APS estimates that its share of capital costs for necessary modifications will be approximately \$70 million, almost half of which was funded in 1994.

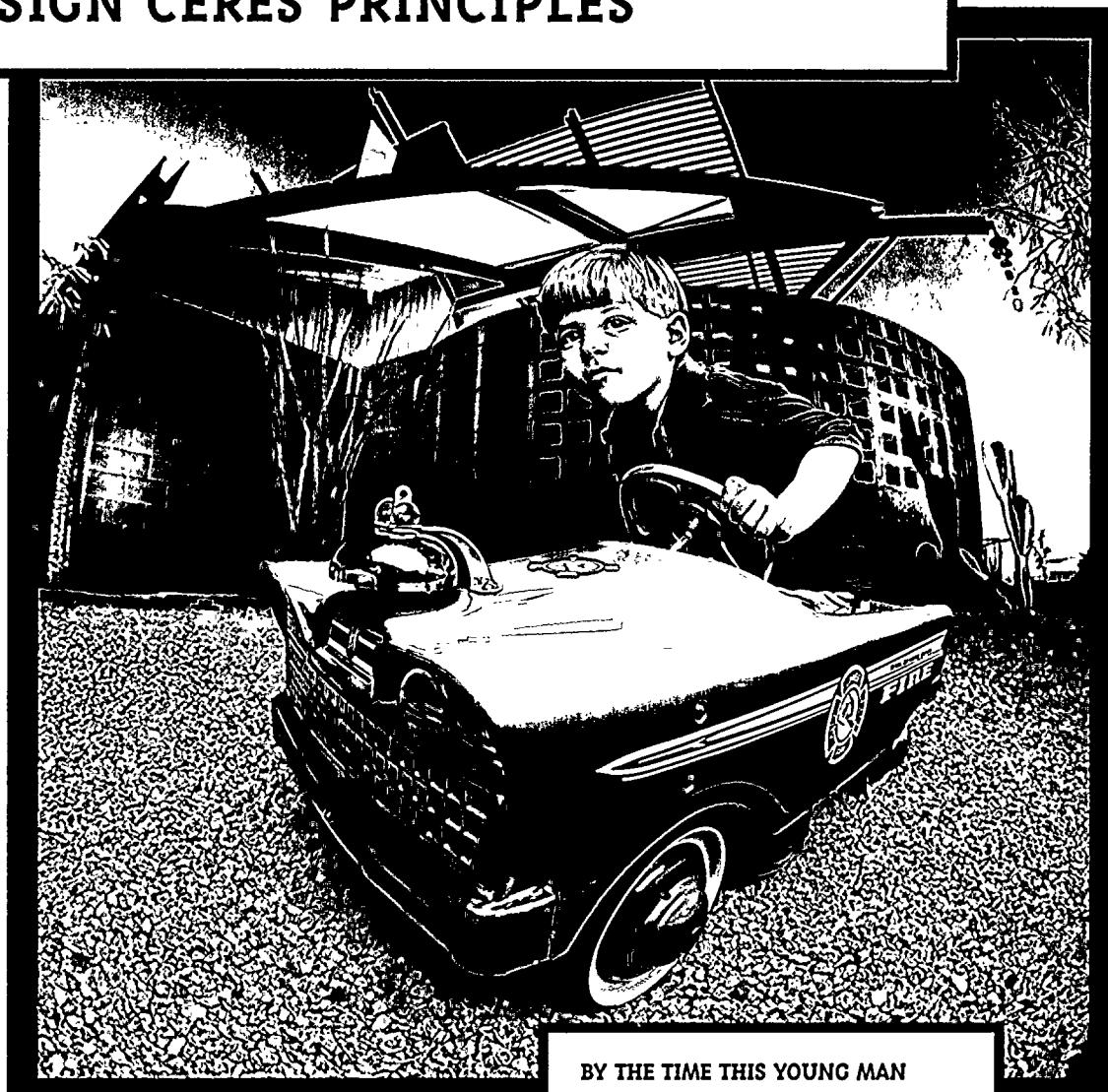
In addition, the EPA is conducting a number of studies and proceedings related to emissions and pollutants from steam generating units as well as visibility in certain federally protected areas. The company cannot predict the outcome of these matters, but does not believe they will have a materially adverse effect on its operations.

In 1993, the EPA established a system which allocated each utility unit a certain number of emissions "allowances". Based on 1993 allocations, and due to past investment in pollution

## THE CERES PRINCIPLES

- PROTECTION OF THE BIOSPHERE
- SUSTAINABLE USE OF NATURAL RESOURCES
- REDUCTION AND DISPOSAL OF WASTES
- ENERGY CONSERVATION
- RISK REDUCTION
- SAFE PRODUCTS AND SERVICES
- ENVIRONMENTAL RESTORATION
- INFORMING THE PUBLIC
- MANAGEMENT COMMITMENT
- AUDITS AND REPORTS

- THE APS ENVIRONMENTAL SHOWCASE HOME OPENED IN 1994
- APS IS FIRST UTILITY TO SIGN CERES PRINCIPLES



BY THE TIME THIS YOUNG MAN GETS HIS DRIVER'S LICENSE, THE APS ENVIRONMENTAL SHOWCASE HOME SHOWN HERE WILL HAVE EDUCATED THOUSANDS OF HOME BUYERS AND BUILDERS ABOUT WAYS TO BUILD ENVIRONMENTALLY-RESPONSIBLE HOMES.

## THE ENVIRONMENT

control equipment, the company will have sufficient allowances to operate its plants at current levels without installing additional equipment.

In a first-of-its-kind emission trade, APS agreed to trade a number of its sulfur dioxide emission allowances for New York-based Niagara Mohawk Power's carbon dioxide credits. This is part of a national effort to use market incentives to reduce greenhouse gases and will also assist APS in satisfying its commitment to the U.S. Department of Energy to limit carbon dioxide emissions to 1990 levels in the year 2000.

### INITIATIVES

In 1994, APS became the first utility in the nation to endorse the CERES principles, a ten-point environmental code of conduct. CERES, the Coalition for Environmentally Responsible Economies, is a nonprofit independent organization comprised of environmental and public interest advocacy organizations. Joining CERES makes APS more publicly accountable while increasing its visibility to environmentally concerned investors.

Also in 1994, APS completed the development and construction of the APS Environmental Showcase Home, an education project for home builders and buyers which is pictured on page 21. The goal of the project and a corresponding residential marketing program is to change the way homes are built in the Phoenix area and ultimately eliminate large volumes of pollutants. The project received the City of Phoenix Mayor's award for overall excellence in environmental innovation.

During 1994, APS met its target to reduce the use of chlorinated solvents by 90 percent and has established future goals related to further decreasing hazardous wastes. It also implemented systems to help employees manage hazardous substances, reduce waste and meet regulatory reporting requirements.

### SUNCOR

Suncor believes it adds value to its projects by committing significant resources to environmentally sound development strategies. This has often meant setting aside more land as open space than would otherwise be required by local regulation, encouraging low water use and protecting native plants as land is developed for use.

There are a number of Superfund sites throughout the metropolitan Phoenix area where contamination of groundwater has occurred and where remedial actions are being taken by parties responsible for contamination. These clean-up activities take considerable time to complete, and in the meantime contaminated groundwater in one location may migrate beneath adjoining locations. As previously reported, this appears to be occurring under a small portion of SunCor property to the west of Phoenix. SunCor is not a "responsible party" at any Superfund site, but continues to closely monitor remediation efforts at this site.

Important aspects of the Superfund law expire at the end of 1995, and the reauthorization process could include substantial reform. Separately, proposed "risk assessment" legislation that would change the way that regulation is evaluated seems to have strong congressional support. The company is taking part in the national discussion on these legislative matters.

**1994  
FINANCIAL  
INFORMATION**

**SELECTED CONSOLIDATED DATA**  
PINNACLE WEST CAPITAL CORPORATION

(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)	<b>1994</b>	<b>1993</b>	<b>1992</b>	<b>1991</b>	<b>1990</b>
<b>OPERATING RESULTS</b>					
Operating revenues					
Electric (a)	\$ 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)	—
Real estate	59,253	32,248	19,959	12,697	81,264
Income (loss) from continuing operations (b)	\$ 200,619	\$ 169,978	\$ 150,440	\$ (340,317)	\$ 70,208
Income from discontinued operations - net of tax (c)	—	—	6,000	153,455	27,125
Cumulative effect of change in accounting for income taxes (d)	—	19,252	—	—	—
Net income (loss)	<u>\$ 200,619</u>	<u>\$ 189,230</u>	<u>\$ 156,440</u>	<u>\$ (186,862)</u>	<u>\$ 97,333</u>
<b>COMMON STOCK DATA</b>					
Book value per share - year-end	\$ 20.32	\$ 18.87	\$ 17.00	\$ 15.23	\$ 17.40
Earnings (loss) per average common share outstanding					
Continuing operations	\$ 2.30	\$ 1.95	\$ 1.73	\$ (3.91)	\$ 0.81
Discontinued operations (c)	—	—	0.07	1.76	0.31
Accounting change (d)	—	0.22	—	—	—
Total	<u>\$ 2.30</u>	<u>\$ 2.17</u>	<u>\$ 1.80</u>	<u>\$ (2.15)</u>	<u>\$ 1.12</u>
Dividends declared per share (e)	\$ 0.825	\$ 0.200	\$ —	\$ —	\$ —
Common shares outstanding					
Year-end	87,429,642	87,423,817	87,161,872	87,009,974	86,873,174
Average	87,410,967	87,241,899	87,044,180	86,937,052	86,769,924
<b>TOTAL ASSETS</b>	<b><u>\$ 6,909,752</u></b>	<b><u>\$ 6,956,799</u></b>	<b><u>\$ 6,270,476</u></b>	<b><u>\$ 6,147,639</u></b>	<b><u>\$ 6,793,755</u></b>
<b>LIABILITIES AND EQUITY</b>					
Long-term debt less current maturities	\$ 2,588,525	\$ 2,633,620	\$ 2,774,305	\$ 2,996,910	\$ 3,218,168
Other liabilities	2,276,249	2,282,508	1,620,250	1,429,488	1,702,628
	<u>4,864,774</u>	<u>4,916,128</u>	<u>4,394,555</u>	<u>4,426,398</u>	<u>4,920,796</u>
Minority interests					
Non-redeemable preferred stock of APS	193,561	193,561	168,561	168,561	168,561
Redeemable preferred stock of APS	75,000	197,610	225,635	227,278	192,453
Common stock equity	<u>1,776,417</u>	<u>1,649,500</u>	<u>1,481,725</u>	<u>1,325,402</u>	<u>1,511,945</u>
Total	<u>\$ 6,909,752</u>	<u>\$ 6,956,799</u>	<u>\$ 6,270,476</u>	<u>\$ 6,147,639</u>	<u>\$ 6,793,755</u>

- (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) Includes approximately \$407 million of write-offs and adjustments in 1991, net of income tax, related to the Palo Verde Nuclear Generating Station. Also includes after-tax Palo Verde Unit 3 accretion income in 1994, 1993, 1992 and 1991 of approximately \$20.3 million, \$45.3 million, \$40.7 million and \$3.2 million, respectively.
- (c) Results of MeraBank, A Federal Savings Bank, and Malapai Resources Company, a uranium mining company.
- (d) Results of the adoption of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes". See Note 3 of Notes to Consolidated Financial Statements.
- (e) In October 1993, the PinnacleWest Board of Directors declared a quarterly dividend, which was previously suspended in October 1989.

(DOLLARS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)		1994			
		1993	1992	1991	1990
<b>ELECTRIC OPERATING REVENUES (a)</b>					
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
<b>ELECTRIC SALES (MWh)</b>					
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
<b>ELECTRIC CUSTOMERS-END OF YEAR</b>					
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.

#### QUARTERLY STOCK PRICES AND DIVIDENDS

Stock Symbol: PNW	DIVIDENDS PER SHARE				DIVIDENDS PER SHARE				
	1994	HIGH	LOW	CLOSE					
1st Quarter	22 7/8	19 1/2	20	\$ 0.200	1st Quarter	21 3/4	19 5/8	21 5/8	—
2nd Quarter	21	16	16 3/8	\$ 0.200	2nd Quarter	23 1/2	20 7/8	23 1/8	—
3rd Quarter	18 3/4	16 1/8	17 7/8	\$ 0.200	3rd Quarter	25 1/4	23 1/8	24 3/8	—
4th Quarter	20 1/8	17 1/8	19 5/8	\$ 0.225	4th Quarter	24 3/8	20 3/8	22 3/8	\$ 0.200

**M A N A G E M E N T ' S D I S C U S S I O N A N D A N A L Y S I S O F  
F I N A N C I A L C O N D I T I O N A N D R E S U L T S O F O P E R A T I O N S**  
**P I N N A C L E W E S T C A P I T A L C O R P O R A T I O N**

The following discussion relates to Pinnacle West Capital Corporation (Pinnacle West) and its subsidiaries: Arizona Public Service Company (APS), SunCor Development Company (SunCor) and El Dorado Investment Company (El Dorado). The discussion also relates to the discontinued operations of MeraBank, A Federal Savings Bank (MeraBank).

#### **CAPITAL NEEDS AND RESOURCES**

##### **PARENT COMPANY**

During the past three years, Pinnacle West's primary cash needs were for the payment of interest and the optional and mandatory repayment of principal on its long-term debt (see Note 5 of Notes to Consolidated Financial Statements). Additional cash needs in 1993 and 1994 were related to the resumption and subsequent growth of common stock dividends.

Dividends from APS have been Pinnacle West's primary source of cash. Tax allocations within the consolidated group and net operating loss carryforwards associated primarily with MeraBank have also been sources of cash.

SunCor provided cash in 1994, and SunCor and El Dorado are both expected to contribute to Pinnacle West's cash flow in 1995.

Pinnacle West repaid substantial amounts of its parent-level debt in each of the last three years. Management expects Pinnacle West to have sufficient cash flow to reduce parent company debt to approximately \$310 million at the end of 1995 from \$430 million at the end of 1994.

##### **APS**

APS' 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 base-load 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, APS 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, APS estimates that it will fund substantially all such expenditures in the same manner.

During 1994, APS 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, APS redeemed all of its outstanding first mortgage bonds, 10.25% Series due 2000 (the 10.25% Bonds) for approximately \$50 million.

APS currently expects to issue up to \$175 million of debt in 1995. Of this amount, on January 12, 1995, APS 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. APS 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 APS' mortgage bond indenture and articles of incorporation require certain coverage ratios to be met before APS 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, APS 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 Arizona Corporation Commission (ACC) has authority over APS with respect to the issuance of long-term debt and equity securities. Existing ACC orders allow APS 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 APS' ability to meet its capital requirements.

As of December 31, 1994, APS 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.

#### **NON-UTILITY SUBSIDIARIES**

During the past three years, the non-utility subsidiaries together funded all of their operations through cash flow from operations and financings that did not involve Pinnacle West. SunCor's capital needs consist primarily of construction expenditures, which, on the basis of projects now under development by it, are expected to approximate \$35 million, \$31 million and \$11 million for 1995, 1996 and 1997, respectively. Capital resources available to meet these requirements include funds provided by SunCor's operations and external financings.

During 1994, SunCor issued \$30 million of collateralized mortgage bonds. These bonds are secured by specified parcels of real property. Additionally, SunCor established revolving lines of credit totaling \$24.5 million; at December 31, 1994, borrowings of \$18.5 million were outstanding thereunder.

#### **RESULTS OF OPERATIONS**

##### **1994 COMPARED WITH 1993**

Pinnacle West reported income from continuing operations of \$200.6 million in 1994, which included a non-recurring income tax benefit of \$26.8 million. Excluding the non-recurring tax benefit, income from continuing operations in 1994 was \$173.8 million compared with \$170.0 million in 1993.

Underlying the small increase were several significant factors. 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. Interest expense declined due primarily to parent company debt repayment and APS' refinancing efforts in 1994 and 1993. APS' 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; increased utility 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.

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. APS 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.

SunCor reported a small profit in 1994 compared with a \$4.0 million loss in 1993. Real estate revenues and operating expenses in 1994 increased \$27.0 million and \$21.6 million, respectively, reflecting increased volumes of residential and commercial property sales.

#### **1993 COMPARED WITH 1992**

Pinnacle West reported income from continuing operations of \$170.0 million in 1993 compared with \$150.4 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 APS' variable-rate debt. Partially offsetting the lower interest expense were increased taxes and higher utility operating expenses.

Electric 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 11 of Notes to Consolidated Financial Statements).

Utility 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 8 of Notes to Consolidated 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.

Real estate revenues and operating expenses increased \$12.3 million and \$10.9 million, respectively, in 1993 due primarily to increased sales of residential lots.

#### **ELECTRIC OPERATING REVENUES**

Electric operating revenues reflect changes in both the volume of units sold and price per kilowatt-hour (kWh) 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)	(0.3)
Total change	<u>\$ 23.8</u>	<u>\$ 14.8</u>

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.

#### **INCOME TAX ISSUES**

See Note 3 of Notes to Consolidated Financial Statements regarding recognition of \$26.8 million of income tax benefits in 1994 and a recent accounting standard for income taxes which required the recognition in 1993 of \$19.3 million of tax benefits related to net operating loss carryforwards.

#### **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 Allowance for Funds Used During Construction (AFUDC), accretion income on Palo Verde Unit 3 and the reversal of a refund obligation arising out of the 1991 rate settlement (see Consolidated Statements of Cash Flows and Note 1 of Notes to Consolidated 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. APS 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 Consolidated Statements of Income (see Note 2 of Notes to Consolidated 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 Consolidated Financial Statements).

#### **COMPETITION**

A significant challenge for APS 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 APS' 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 1K of Notes to Consolidated 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 AND INDEPENDENT  
AUDITORS' REPORT**  
**PINNACLE WEST CAPITAL CORPORATION**

**REPORT OF MANAGEMENT**

The primary responsibility for the integrity of Pinnacle West'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 judgements 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 Pinnacle West's system provides the appropriate balance between such costs and benefits.

Periodically the internal accounting control system is reviewed by both Pinnacle West'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 Pinnacle West'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.

*R Snell*

Richard Snell  
Chairman & President

*Henry Sargent*

Henry B. Sargent  
Executive Vice President  
& Chief Financial Officer

**INDEPENDENT AUDITORS' REPORT**

We have audited the accompanying consolidated balance sheets of Pinnacle West Capital Corporation and its subsidiaries as of December 31, 1994 and 1993 and the related consolidated 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 consolidated financial statements present fairly, in all material respects, the financial position of Pinnacle West Capital Corporation and its subsidiaries at December 31, 1994 and 1993 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1994 in conformity with generally accepted accounting principles.

As discussed in Note 3 of Notes to Consolidated Financial Statements, the Company changed its method of accounting for income taxes effective January 1, 1993 to conform with Statement of Financial Accounting Standards No. 109.

*Deloitte & Touche LLP*

Phoenix, Arizona  
March 3, 1995

**CONSOLIDATED STATEMENTS OF INCOME**  
**PINNACLE WEST CAPITAL CORPORATION**

YEAR ENDED DECEMBER 31,

	1994	1993	1992
<b>Operating Revenues</b>			
Electric (Note 1)	\$ 1,626,168	\$ 1,602,413	\$ 1,587,582
Real estate	<u>59,253</u>	<u>32,248</u>	<u>19,959</u>
Total	<u>1,685,421</u>	<u>1,634,661</u>	<u>1,607,541</u>
<b>Fuel Expenses</b>			
Fuel for electric generation	237,103	231,434	230,194
Purchased power	<u>63,586</u>	<u>69,112</u>	<u>57,007</u>
Total	<u>300,689</u>	<u>300,546</u>	<u>287,201</u>
<b>Operating Expenses</b>			
Utility operations and maintenance	411,921	401,216	390,512
Real estate operations	<u>59,789</u>	<u>38,220</u>	<u>27,309</u>
Depreciation and amortization	<u>237,326</u>	<u>223,558</u>	<u>220,076</u>
Taxes other than income taxes	<u>141,926</u>	<u>138,468</u>	<u>134,966</u>
Total	<u>850,962</u>	<u>801,462</u>	<u>772,863</u>
<b>Operating Income</b>	<u>533,770</u>	<u>532,653</u>	<u>547,477</u>
<b>Other Income (Deductions)</b>			
Allowance for equity funds used during construction (Note 1)	3,941	2,326	3,103
Palo Verde accretion income (Note 1)	<u>33,596</u>	<u>74,880</u>	<u>67,421</u>
Interest on long-term debt	<u>(229,810)</u>	<u>(245,961)</u>	<u>(272,240)</u>
Other interest	<u>(15,185)</u>	<u>(16,505)</u>	<u>(12,718)</u>
Allowance for borrowed funds used during construction (Note 1)	<u>5,442</u>	<u>4,153</u>	<u>4,492</u>
Preferred stock dividend requirements of APS	<u>(25,274)</u>	<u>(30,840)</u>	<u>(32,452)</u>
Other - net	<u>17,109</u>	<u>(2,282)</u>	<u>(13,045)</u>
Total	<u>(210,181)</u>	<u>(214,229)</u>	<u>(255,439)</u>
<b>Income from Continuing Operations Before Income Taxes</b>	<u>323,589</u>	<u>318,424</u>	<u>292,038</u>
<b>Income Taxes (Note 3)</b>			
Income tax expense	149,740	148,446	141,598
Non-recurring income tax benefit	<u>(26,770)</u>	<u>—</u>	<u>—</u>
Total	<u>122,970</u>	<u>148,446</u>	<u>141,598</u>
<b>Income From Continuing Operations</b>	<u>200,619</u>	<u>169,978</u>	<u>150,440</u>
<b>Income From Discontinued Operations</b>	<u>—</u>	<u>—</u>	<u>6,000</u>
<b>Cumulative Effect of Change in Accounting for Income Taxes (Note 3)</b>	<u>—</u>	<u>19,252</u>	<u>—</u>
<b>Net Income</b>	<u>\$ 200,619</u>	<u>\$ 189,230</u>	<u>\$ 156,440</u>
Average Common Shares Outstanding	<u>87,410,967</u>	<u>87,241,899</u>	<u>87,044,180</u>
<b>Earnings Per Average Common Share Outstanding</b>			
Continuing operations	\$ 2.30	\$ 1.95	\$ 1.73
Discontinued operations	<u>—</u>	<u>—</u>	<u>0.07</u>
Accounting change	<u>—</u>	<u>0.22</u>	<u>—</u>
Total	<u>\$ 2.30</u>	<u>\$ 2.17</u>	<u>\$ 1.80</u>
<b>Dividends Declared Per Share</b>	<u>\$ 0.825</u>	<u>\$ 0.200</u>	<u>\$ —</u>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

**CONSOLIDATED BALANCE SHEETS**  
**PINNACLE WEST CAPITAL CORPORATION**

DECEMBER 31,

(THOUSANDS OF DOLLARS)	1994	1993
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 34,719	\$ 52,127
Customer and other receivables - net	136,143	126,343
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
Other current assets	15,422	13,782
Deferred income taxes (Note 3)	<u>68,263</u>	<u>100,234</u>
Total current assets	<u>435,578</u>	<u>483,236</u>
<b>Investments and Other Assets</b>		
Real estate investments - net	408,505	402,873
Other assets (Note 1)	<u>153,384</u>	<u>136,074</u>
Total investments and other assets	<u>561,889</u>	<u>538,947</u>
<b>Utility Plant (Notes 5, 9 and 10)</b>		
Electric plant in service, including nuclear fuel	6,602,799	6,462,589
Construction work in progress	<u>224,312</u>	<u>197,556</u>
Total utility plant	<u>6,827,111</u>	<u>6,660,145</u>
Less accumulated depreciation and amortization	<u>2,203,038</u>	<u>2,058,895</u>
Net utility plant	<u>4,624,073</u>	<u>4,601,250</u>
<b>Deferred Debits</b>		
Regulatory asset for income taxes (Note 3)	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
Other deferred debits	<u>266,641</u>	<u>268,326</u>
Total deferred debits	<u>1,288,212</u>	<u>1,333,366</u>
<b>TOTAL ASSETS</b>	<b>\$ 6,909,752</b>	<b>\$ 6,956,799</b>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

DECEMBER 31.

(THOUSANDS OF DOLLARS)	1994	1993
<b>LIABILITIES AND EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 126,842	\$ 97,489
Accrued taxes	89,144	96,303
Accrued interest	56,058	57,674
Short-term borrowings (Note 4)	131,500	148,000
Current maturities of long-term debt (Note 5)	78,512	78,841
Other current liabilities	50,060	60,845
Total current liabilities	<u>532,116</u>	<u>539,152</u>
<b>Non-Current Liabilities</b>		
Long-term debt less current maturities (Note 5)	2,588,525	2,633,620
Other liabilities	<u>8,679</u>	<u>8,246</u>
Total non-current liabilities	<u>2,597,204</u>	<u>2,641,866</u>
<b>Deferred Credits and Other</b>		
Deferred income taxes (Note 3)	1,297,298	1,278,673
Deferred investment tax credit (Note 1)	121,426	127,331
Unamortized gain - sale of utility plant	98,551	107,344
Other deferred credits	<u>218,179</u>	<u>221,762</u>
Total deferred credits and other	<u>1,735,454</u>	<u>1,735,110</u>
<b>Commitments and Contingencies (Note 11)</b>		
<b>Minority Interests (Note 6)</b>		
Non-redeemable preferred stock of APS	<u>193,561</u>	<u>193,561</u>
Redeemable preferred stock of APS	<u>75,000</u>	<u>197,610</u>
<b>Common Stock Equity</b>		
Common stock, no par value; authorized 150,000,000 shares; issued and outstanding 87,429,642 in 1994 and 87,423,817 in 1993	<u>1,641,196</u>	<u>1,642,783</u>
Retained earnings	<u>135,221</u>	<u>6,717</u>
Total common stock equity	<u>1,776,417</u>	<u>1,649,500</u>
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>\$ 6,909,752</b>	<b>\$ 6,956,799</b>

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
 PINNACLE WEST CAPITAL CORPORATION

YEAR ENDED DECEMBER 31.

(THOUSANDS OF DOLLARS)	1994	1993	1992
<b>CASH FLOWS FROM OPERATING ACTIVITIES (NOTE I)</b>			
Income from continuing operations	\$ 200,619	\$ 169,978	\$ 150,440
Items not requiring cash			
Depreciation and amortization	271,654	258,562	259,637
Deferred income taxes - net	78,841	139,725	84,146
Rate refund reversal (Note I)	(9,308)	(21,374)	(21,374)
Palo Verde accretion income (Note I)	(33,596)	(74,880)	(67,421)
Other - net	(5,093)	(168)	(1,829)
Changes in current assets and liabilities			
Accounts receivable - net	(7,693)	31,090	(31,715)
Accrued utility revenues	4,924	(8,839)	(7,055)
Materials, supplies and fossil fuel	4,795	2,252	5,094
Other current assets	(1,640)	(5,782)	2,042
Accounts payable	25,068	(27,196)	9,547
Accrued taxes	(7,159)	(21,391)	45,962
Accrued interest	(1,616)	(905)	(16,593)
Other current liabilities	(1,730)	(18,408)	(16,549)
Decrease (increase) in land held	(10,163)	(7,894)	1,975
Other - net	<u>(10,730)</u>	<u>34,292</u>	<u>5,973</u>
Net Cash Flow Provided By Operating Activities	<u>497,173</u>	<u>449,062</u>	<u>402,280</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Capital expenditures	(255,308)	(234,944)	(224,419)
Allowance for equity funds used during construction	3,941	2,326	3,103
Sale of property	151	89	5,480
Other - net	<u>(1,924)</u>	<u>1,609</u>	<u>(6,555)</u>
Net Cash Flow Used For Investing Activities	<u>(253,140)</u>	<u>(230,920)</u>	<u>(222,391)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Issuance of long-term debt	595,362	535,893	649,165
Issuance of preferred stock	—	72,644	24,781
Short-term borrowings - net	(16,500)	(47,000)	195,000
Dividends paid on common stock	(72,115)	(17,466)	—
Repayment of long-term debt	(643,991)	(711,241)	(1,109,181)
Redemption of preferred stock	(124,096)	(78,663)	(27,850)
Other - net	<u>(101)</u>	<u>(8,108)</u>	<u>2,407</u>
Net Cash Flow Used For Financing Activities	<u>(261,441)</u>	<u>(253,941)</u>	<u>(265,678)</u>
Net Cash Flow	<u>(17,408)</u>	<u>(35,799)</u>	<u>(85,789)</u>
Cash and Cash Equivalents at Beginning of Year	<u>52,127</u>	<u>87,926</u>	<u>173,715</u>
Cash and Cash Equivalents at End of Year	<u>\$ 34,719</u>	<u>\$ 52,127</u>	<u>\$ 87,926</u>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

**CONSOLIDATED STATEMENTS OF RETAINED EARNINGS**  
**PINNACLE WEST CAPITAL CORPORATION**

YEAR ENDED DECEMBER 31.

(THOUSANDS OF DOLLARS)	1994	1993	1992
Retained Earnings (Deficit) at Beginning of Year	\$ 6,717	\$ (165,047)	\$ (321,487)
Net Income	200,619	189,230	156,440
Common Stock Dividends	<u>(72,115)</u>	<u>(17,466)</u>	—
Retained Earnings (Deficit) at End of Year	<u>\$ 135,221</u>	<u>\$ 6,717</u>	<u>\$ (165,047)</u>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**PINNACLE WEST CAPITAL CORPORATION**

**I. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. CONSOLIDATION**

The consolidated financial statements include the accounts of Pinnacle West Capital Corporation and its subsidiaries: Arizona Public Service Company, an electric utility; SunCor Development Company, a real estate development company; and El Dorado Investment Company, a venture capital firm.

**B. 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. Depreciation and amortization of non-utility property and equipment are provided over the estimated useful lives of the related assets, ranging from 3 to 33.3 years.

**C. REVENUES**

Electric 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 APS 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 APS 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.

**D. 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. APS compounds AFUDC semiannually and ceases to accrue AFUDC when construction work is completed and the property is placed in service.

#### **E. INCOME TAXES**

Pinnacle West and its subsidiaries file a consolidated U.S. income tax return. Provisions for income taxes are made by each subsidiary as if separate income tax returns were filed. The difference, if any, between these provisions and consolidated income tax expense is allocated to Pinnacle West.

Investment tax credits (ITCs) were deferred and are being amortized to other income over the estimated lives of the related assets as directed by the ACC. The 1994 retail rate settlement provides for accelerated amortization of ITCs over five years beginning in 1995 (see Note 2).

#### **F. REACQUIRED DEBT COSTS**

APS amortizes gains and losses on reacquired debt over the remaining life of the original debt, consistent with ratemaking.

#### **G. NUCLEAR FUEL AND DECOMMISSIONING COSTS**

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

Under federal law, the United States Department of Energy (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.

In 1994, APS recorded \$11.9 million for decommissioning expense. APS 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.

APS is utilizing a 1992 site-specific study for Palo Verde, prepared for APS 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, APS has established external trust accounts into which quarterly deposits are made for decommissioning. As of December 31, 1994, APS has deposited a total of \$45.0 million. The trust accounts are included in "Investments and Other Assets" on the Consolidated 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, the Financial Accounting Standards Board (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. Pinnacle West is unable to determine what, if any, impact these deliberations may have on its financial position or results of operations.

#### **H. STATEMENTS OF CASH FLOWS**

Temporary cash investments and marketable securities are considered to be cash equivalents for purposes of the Consolidated Statements of Cash Flows. During 1994, 1993 and 1992 Pinnacle West and its subsidiaries paid interest, net of amounts capitalized, of \$231.6 million, \$243.9 million and \$286.4 million, respectively. Income taxes paid were \$56.5 million, \$45.3 million and \$33.8 million, respectively; and dividends paid on preferred stock of APS were \$26.2 million, \$30.9 million and \$32.6 million, respectively.

#### **I. PALO VERDE COST DEFERRALS**

As authorized by the ACC, APS deferred operating costs (excluding fuel) and financing costs of 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 through rates over thirty-five year periods.

#### **J. PALO VERDE ACCRETION INCOME**

In 1991, APS 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, APS 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 by APS in 1994, 1993 and 1992 was \$20.3 million, \$45.3 million and \$40.7 million, respectively.

#### **K. REGULATORY ACCOUNTING**

APS 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.

APS' major regulatory assets are Palo Verde cost deferrals (see Note 1) and deferred taxes (see Note 3). 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 Consolidated Balance Sheets.

## 2. REGULATORY MATTERS

In May 1994, the ACC approved a retail rate settlement agreement which was jointly proposed by APS 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 APS and the ACC staff.
- A joint APS-ACC study to develop rate principles allowing APS 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, APS reversed approximately \$20 million of depreciation (\$15 million after tax) related to a 1991 Palo Verde write-off. The 1994 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 APS' results of operations for the years 1995-1999.

## 3. INCOME TAX EXPENSE

### NON-RECURRING INCOME TAX BENEFIT

The recognition of \$26.8 million of non-recurring income tax benefits in 1994 relates to a change in tax law.

### CHANGE IN ACCOUNTING FOR INCOME TAXES

Effective January 1, 1993, Pinnacle West adopted SFAS No. 109, "Accounting for Income Taxes," which requires the use of the liability method of accounting for income taxes. The cumulative effect on prior years of this change in accounting principle resulted in an increase in 1993 net income of \$19.3 million, due primarily to the recognition of deferred tax benefits relating to state net operating loss (NOL) carryforwards of Pinnacle West.

As a result of adopting SFAS No. 109, APS recorded additional 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 increased net deferred income tax liabilities by \$585.3 million at December 31, 1993. Historically, the Federal Energy Regulatory Commission 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.

### INCOME TAXES

The components of income tax expense from continuing operations are as follows:

YEAR ENDED DECEMBER 31,

(THOUSANDS OF DOLLARS)	1994	1993	1992
<b>Current</b>			
Federal	\$ 49,112	\$ 43,065	\$ 30,418
State	922	816	624
Total current	<u>50,034</u>	<u>43,881</u>	<u>31,042</u>
<b>Deferred</b>			
Depreciation - net	56,450	58,844	76,175
Investment tax credit - net	(5,905)	(6,028)	(5,574)
Alternative minimum tax	(65,510)	(53,212)	(40,434)
Palo Verde start-up costs	(1,590)	(1,335)	(28,976)
Palo Verde accretion income	13,288	29,618	26,668
NOL and ITC carryforward utilized	115,623	81,494	81,180
Change in federal tax rate	—	(4,855)	—
Change in tax law	(26,770)	—	—
Other - net	(12,650)	39	1,517
Total deferred	<u>72,936</u>	<u>104,565</u>	<u>110,556</u>
<b>Total</b>	<b>\$ 122,970</b>	<b>\$ 148,446</b>	<b>\$ 141,598</b>

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

YEAR ENDED DECEMBER 31,

(THOUSANDS OF DOLLARS)	1994	1993	1992
Federal income tax expense at statutory rate (35% in 1994 and 1993, 34% in 1992)	\$ 113,256	\$ 111,448	\$ 99,293
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	17,236	17,671	17,499
Preferred stock dividends of APS	8,846	10,794	11,034
ITC amortization	(5,905)	(6,002)	(6,124)
State income tax net of federal income tax benefit	(5,983)	21,604	21,589
Change in federal tax rate	—	(4,855)	—
Other	(4,480)	(2,214)	(1,693)
<b>Income tax expense</b>	<b>\$ 122,970</b>	<b>\$ 148,446</b>	<b>\$ 141,598</b>

The components of the net deferred income tax liability at December 31 were as follows:

(THOUSANDS OF DOLLARS)	1994	1993
<b>Deferred tax assets</b>		
NOL and ITC carryforwards	\$ 72,139	\$ 159,490
Alternative minimum tax (can be carried forward indefinitely)	165,971	100,461
Deferred gain on Palo Verde Unit 2 sale/leaseback	63,720	66,754
Other	124,498	126,905
Valuation allowance	(58,431)	(43,818)
Total deferred tax assets	<u>367,897</u>	<u>409,792</u>
<b>Deferred tax liabilities</b>		
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	83,828	92,993
Total deferred tax liabilities	<u>1,596,932</u>	<u>1,588,231</u>
Accumulated deferred income taxes - net	<u>\$1,229,035</u>	<u>\$1,178,439</u>

At December 31, 1994, Pinnacle West had federal NOL carryforwards of approximately \$80 million which may be used through 2005 and state NOL carryforwards of approximately \$490 million which expire in 1995. Pinnacle West also had ITC carryforwards of approximately \$18 million which expire in 2000 through 2005.

#### 4. LINES OF CREDIT

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

SunCor had revolving lines of credit totaling \$24.5 million at December 31, 1994, and none at December 31, 1993. Any borrowings are collateralized by certain real property and would bear interest based on the prime rate or on London Interbank Offered Rate (LIBOR). The commitment fees on these lines were 0.5% per annum on \$15.0 million and 0.2% per annum on \$9.5 million. SunCor had \$18.5 million outstanding under these lines at December 31, 1994.

#### 5. LONG-TERM DEBT

In January 1990, Pinnacle West restructured the majority of its long-term debt. Pinnacle West granted the affected lenders a security interest in the outstanding common stock of APS and agreed not to incur new debt except to reduce, refinance or prepay existing debt. Pinnacle West's ability to pay dividends is dependent upon the satisfaction of specified interest coverage ratios. Additionally, cumulative dividend payments for the period April 1, 1990 through any dividend declaration date are limited to 50% of cumulative consolidated net income (as defined) for the same period. As of December 31, 1994, Pinnacle West could have declared dividends of approximately \$259 million based on this formula. Pinnacle West's aggregate investments in its existing subsidiaries (excluding APS) and new investments are generally limited to \$15 million and \$20 million, respectively. Pinnacle West must maintain certain interest coverage ratios and meet certain funded debt tests. Additionally, Pinnacle West would be required to use the net cash proceeds from the sale of SunCor or El Dorado or substantially all of their assets to repay debt. The following table presents long-term debt outstanding as of December 31, 1994 and 1993.

DECEMBER 31.

(THOUSANDS OF DOLLARS)

	MATURITY DATES	INTEREST RATES	1994	1993
<b>APS</b>				
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%	<u>26,365</u>	<u>29,633</u>
			<u>2,185,260</u>	<u>2,127,833</u>
<b>SUNCOR</b>				
Revolving credit	1997-2001	LIBOR plus 2.50% to 2.75%(d)	18,500	—
Notes payable	1994-1998	(e)	3,450	20,936
Mortgage bonds	1996-2004	LIBOR plus 3%(f)	<u>30,000</u>	<u>—</u>
			<u>51,950</u>	<u>20,936</u>
<b>PINNACLE WEST</b>				
Bank term loans	1996	(g)	44,416	112,663
Debentures	1994-2000	11.35%-11.61%(h)	<u>385,411</u>	<u>451,029</u>
			<u>429,827</u>	<u>563,692</u>
Total long-term debt			2,667,037	2,712,461
Less current maturities			78,512	78,841
Total long-term debt less current maturities			<u>\$ 2,588,525</u>	<u>\$ 2,633,620</u>

- (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 rates for the years ended December 31, 1994, and 1993 were 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 9.
- (d) The weighted-average interest rate at December 31, 1994 was 8.47%.
- (e) Includes \$2.0 million of fixed-rate notes in 1994 at 10.25% and \$8.1 million in 1993 at 10.25% to 12.00%. Interest rates on the balance vary with the lenders' prime rates.
- (f) The bonds have a two-year interest-only period and quarterly principal repayments over the remaining term. The interest rate at December 31, 1994 was 9.00%. Subsequent to year-end, the bonds were purchased by a third party and certain terms of the debt may be modified.

(g) The 1994 balance includes \$30.0 million at LIBOR plus 0.55%, adjusted periodically, and the balance at 9.21%. The 1993 balance consists of \$74.0 million at 10.56% and the balance at 8.91%.

(h) Includes \$310.4 million of 11.61% senior secured debentures at December 31, 1994 and 1993, which are due in 2000 and are redeemable before then only at a premium determined by a make-whole formula related to U.S. Treasuries. The balance in both years represents senior debentures with a weighted-average interest rate of approximately 11.35%. Aggregate annual principal payments due on total long-term debt and for sinking fund requirements through 1999 are as follows: 1995, \$78.5 million; 1996, \$50.7 million; 1997, \$166.9 million; 1998, \$113.4 million; and 1999, \$12.8 million. See Note 6 for redemption and sinking fund requirements of redeemable preferred stock of APS.

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

## 6. PREFERRED STOCK OF APS

Non-redeemable preferred stock is not redeemable except at the option of APS. Redeemable preferred stock is redeemable

through sinking fund obligations in addition to being callable by APS. The balances at December 31, 1994 and 1993 of preferred stock of APS are shown below:

	NUMBER OF SHARES OUTSTANDING AT DECEMBER 31.		PAR VALUE OUTSTANDING AT DECEMBER 31.			CALL PRICE PER SHARE (a)
	AUTHORIZED	1994	PAR VALUE PER SHARE (THOUSANDS)	1994	1993	
		1993		OF DOLLARS)	1993	
<b>NON-REDEEMABLE:</b>						
\$1.10 preferred	160,000	155,945	\$ 25.00	\$ 3,898	\$ 3,898	\$ 27.50
\$2.50 preferred	105,000	103,254	50.00	5,163	5,163	51.00
\$2.36 preferred	120,000	40,000	50.00	2,000	2,000	51.00
\$4.35 preferred	150,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000					
\$2.400 Series A		240,000	50.00	12,000	12,000	50.50
\$2.625 Series C		240,000	50.00	12,000	12,000	51.00
\$2.275 Series D		200,000	50.00	10,000	10,000	50.50
\$3.250 Series E		320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(b)					
Adjustable rate Series Q		500,000	100.00	50,000	50,000	(c)
Serial preferred:	10,000,000					
\$1.8125 Series W		3,000,000	25.00	75,000	75,000	(d)
Total		4,874,199		\$ 193,561	\$ 193,561	
<b>REDEEMABLE:</b>						
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 its preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock, APS 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 of APS during each of the three years in the period ended December 31, 1994, are as follows:

	NUMBER OF SHARES	PAR VALUE AMOUNT	(DOLLARS IN THOUSANDS)
<b>Balance, December 31, 1991</b>	<b>2,272,782</b>	<b>\$ 227,278</b>	
<b>Issuance</b>			
\$7.875 Series V	250,000	25,000	
<b>Retirements</b>			
\$10.00 Series H	(8,677)	(868)	
\$8.80 Series K	(4,725)	(472)	
\$12.90 Series N	(213,280)	(21,328)	
\$11.50 Series R	(39,750)	(3,975)	
<b>Balance, December 31, 1992</b>	<b>2,256,350</b>	<b>225,635</b>	
<b>Retirements</b>			
\$8.80 Series K	(45,000)	(4,500)	
\$11.50 Series R	(35,250)	(3,525)	
\$8.48 Series S	(200,000)	(20,000)	
<b>Balance, December 31, 1993</b>	<b>1,976,100</b>	<b>197,610</b>	
<b>Retirements</b>			
\$8.80 Series K	(142,100)	(14,210)	
\$11.50 Series R	(284,000)	(28,400)	
\$8.48 Series S	(300,000)	(30,000)	
\$8.50 Series T	(500,000)	(50,000)	
<b>Balance, December 31, 1994</b>	<b>750,000</b>	<b>\$ 75,000</b>	

## 7. COMMON STOCK

Pinnacle West's common stock issued during each of the three years in the period ended December 31, 1994, is as follows:

	NUMBER OF SHARES	AMOUNT(a)	(DOLLARS IN THOUSANDS)
<b>Balance, December 31, 1991</b>	<b>87,009,974</b>	<b>\$ 1,646,889</b>	
Common stock issued	151,898	(117)	
<b>Balance, December 31, 1992</b>	<b>87,161,872</b>	<b>1,646,772</b>	
Common stock issued	261,945	(3,989)	
<b>Balance, December 31, 1993</b>	<b>87,423,817</b>	<b>1,642,783</b>	
Common stock issued	5,825	(1,587)	
<b>Balance, December 31, 1994</b>	<b>87,429,642</b>	<b>\$ 1,641,196</b>	

(a) Including premiums and expenses of preferred stock issues of APS.

The Pinnacle West Stock Purchase and Dividend Reinvestment Plan (renamed the Investors Advantage Plan in 1995) provides that any participant may purchase shares of its common stock directly from Pinnacle West.

Both Pinnacle West and APS have employee savings plans under which contributions by participating employees and contributions by employers could involve the issuance of new shares of Pinnacle West common stock. Contributions made by Pinnacle West and APS to their respective employee retirement plans may also involve one or more such issuances of common stock. However, Pinnacle West plans to continue making market purchases of its outstanding stock to meet its needs related to the Stock Purchase and Dividend Reinvestment Plan, the employee savings plans and the employee retirement plans.

Pinnacle West has incentive plans under which it may grant non-qualified stock options (NQSOs), incentive stock options (ISOs) and restricted stock awards to officers and key employees of Pinnacle West and its subsidiaries up to an aggregate of 6.5 million shares of Pinnacle West common stock. The plans also provide for the granting of any combination of stock appreciation rights or dividend equivalents. As of December 31, 1994, approximately 1,917,500 NQSOs, 9,000 ISOs, 287,000 restricted shares and 35,000 dividend equivalent shares were outstanding. A plan for Pinnacle West's directors under which an additional 150,500 NQSOs were outstanding at December 31, 1994, was replaced in 1994 by a plan that provides for the granting of stock to directors as part of their annual retainers up to an aggregate amount of 50,000 shares.

## 8. PENSION PLANS AND OTHER BENEFITS

### PENSION PLANS

Pinnacle West and its subsidiaries sponsor defined benefit pension plans covering substantially all employees. Benefits are based on years of service and compensation utilizing a final average pay benefit formula. The plans are 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 \$25.8 million, \$14.3 million and \$14.4 million, respectively, of which approximately \$12.3 million, \$6.8 million and \$4.3 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:

(THOUSANDS OF DOLLARS)	1994	1993	1992
Service cost - benefits earned during the period	\$ 20,728	\$ 17,051	\$ 17,227
Interest cost on projected benefit obligation	39,748	35,046	33,633
Return on plan assets	6,053	(52,026)	(23,225)
Net amortization and deferral	<u>(44,283)</u>	<u>13,547</u>	<u>(15,097)</u>
Net consolidated periodic pension cost	<u>\$ 22,246</u>	<u>\$ 13,618</u>	<u>\$ 12,538</u>

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

(THOUSANDS OF DOLLARS)	1994	1993
Plan assets at fair value	<u>\$ 391,620</u>	<u>\$ 421,563</u>
Less:		
Accumulated benefit obligation, including vested benefits of \$311,126 and \$350,812 in 1994 and 1993, respectively	336,880	375,800
Effect of projected future compensation increases	<u>113,753</u>	<u>128,797</u>
Total projected benefit obligation	<u>450,633</u>	<u>504,597</u>
Plan assets less than projected benefit obligation	<u>(59,013)</u>	<u>(83,034)</u>
Plus:		
Unrecognized net loss (gain) from past experience different from that assumed	(9,900)	51,551
Unrecognized prior service cost	25,628	14,866
Unrecognized net transition asset	<u>(36,143)</u>	<u>(39,371)</u>
Accrued pension liability	<u>\$ (79,428)</u>	<u>\$ (55,988)</u>

Principal actuarial assumptions used were:

	1994	1993
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 plans described above, Pinnacle West and its subsidiaries also sponsor 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 \$7.0 million, \$6.4 million and \$5.4 million, respectively, of which \$3.3 million, \$3.1 million and \$2.6 million, respectively, was charged to expense.

### POSTRETIREMENT PLANS

Pinnacle West and its subsidiaries provide medical and life insurance benefits to their 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 plans are non-contributory. In accordance with the governing plan documents, the companies retain the right to change or eliminate these benefits.

During 1993, Pinnacle West adopted SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," 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 benefits costs from approximately \$6 million in each year to \$28 million and \$35 million, respectively. The amount charged to expense for 1994 increased from about \$3 million to \$14 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 \$184 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:

(THOUSANDS OF DOLLARS)	1994	1993
Service cost - benefits earned during the period	\$ 9,030	\$ 9,710
Interest cost on accumulated benefit obligation	14,152	15,755
Return on plan assets	(6,459)	—
Net amortization and deferral	11,680	9,212
Net consolidated periodic postretirement benefit cost	\$ 28,403	\$ 34,677

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

(THOUSANDS OF DOLLARS)	1994	1993
Plan assets at fair value	\$ 49,666	\$ 28,154
Less accumulated postretirement benefit obligation:		
Retirees	65,712	87,169
Fully eligible plan participants	9,219	10,180
Other active plan participants	88,396	104,179
Total accumulated postretirement benefit obligation	163,327	201,528
Plan assets less than accumulated benefit obligation	(113,661)	(173,374)
Plus:		
Unrecognized transition obligation	165,811	175,023
Unrecognized net gain from past experience different from that assumed	(53,012)	(2,089)
Accrued postretirement liability	\$ (862)	\$ (440)

Principal actuarial assumptions used were:

	1994	1993
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, Pinnacle West adopted SFAS No. 112, "Employers' Accounting for Postemployment Benefits". The 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.

## 9. LEASES

In 1986, APS 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.

APS 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, Pinnacle West and its subsidiaries lease 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 \$21.3 million, \$21.5 million and \$26.1 million, respectively. Annual future minimum rental commitments, excluding the Palo Verde and combined cycle leases, through 1999 are as follows: 1995, \$17.6 million; 1996, \$14.6 million; 1997, \$14.5 million; 1998, \$14.6 million; and 1999, \$14.7 million. Total rental commitments after 1999 are estimated at \$189 million.

## 10. JOINTLY-OWNED FACILITIES

At December 31, 1994, APS owned interests in the following jointly-owned electric generating and transmission facilities.

APS' share of related operating and maintenance expenses is included in utility operations and maintenance.

(DOLLARS IN THOUSANDS)	PERCENT OWNED BY APS	PLANT IN SERVICE	ACCUMULATED DEPRECIATION	CONSTRUCTION WORK IN PROGRESS
<b>GENERATING FACILITIES</b>				
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 9)	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
<b>TRANSMISSION FACILITIES</b>				
ANPP 500 KV system	35.8%(b)	62,607	15,313	1,013
Navajo Southern System	31.4%(b)	26,737	15,038	15
Palo Verde - Yuma 500 KV 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) APS 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.

## **II. COMMITMENTS AND CONTINGENCIES**

### **LITIGATION**

Pinnacle West and its subsidiaries are parties 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 Pinnacle West.

### **PALO VERDE NUCLEAR GENERATING STATION**

APS 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. APS 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 APS' 29.1% interest in the three Palo Verde units, APS' 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. APS 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 the Palo Verde and Four Corners facilities, 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, Pinnacle West 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 \$335 million, excluding capitalized property taxes and capitalized interest.

### **FUEL AND PURCHASED POWER COMMITMENTS**

APS is a party to various fuel and purchased power contracts with terms expiring from 1995 through 2020. APS 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 APS to decrease its required purchases under certain circumstances.

## 12. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Consolidated quarterly financial information for 1994 and 1993 is as follows:

(THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS)		1994			
QUARTER ENDED		MARCH 31	JUNE 30	SEPTEMBER 30	DECEMBER 31
Operating Revenues					
Electric (a)	\$ 346,049	\$ 397,156	\$ 540,883	\$ 342,080	
Real estate	9,424	15,436	13,473	20,920	
Operating Income (b)	\$ 88,470	\$ 117,329	\$ 245,436	\$ 82,535	
Net Income	\$ 21,619	\$ 48,702	\$ 93,991	\$ 36,307	
Earnings per average share of common stock outstanding	\$ 0.25	\$ 0.56	\$ 1.08	\$ 0.41	
Dividends declared per share	\$ 0.200	\$ 0.200	\$ 0.200	\$ 0.225	

(THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS)		1993			
QUARTER ENDED		MARCH 31	JUNE 30	SEPTEMBER 30	DECEMBER 31
Operating Revenues					
Electric (a)	\$ 353,891	\$ 387,871	\$ 497,282	\$ 363,369	
Real estate	3,799	6,277	10,093	12,079	
Operating Income (b)	\$ 107,335	\$ 129,155	\$ 207,954	\$ 88,209	
Income from continuing operations	\$ 27,474	\$ 38,899	\$ 86,734	\$ 16,871	
Cumulative effect of change in accounting for income taxes		19,252	—	—	—
Net Income	\$ 46,726	\$ 38,899	\$ 86,734	\$ 16,871	
Earnings per average share of common stock outstanding					
Continuing operations	\$ 0.32	\$ 0.45	\$ 0.99	\$ 0.19	
Accounting change	0.22	—	—	—	
Total	\$ 0.54	\$ 0.45	\$ 0.99	\$ 0.19	
Dividends declared per share	\$ —	\$ —	\$ —	\$ 0.200	

(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) APS' 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.

### **13. FAIR VALUE OF FINANCIAL INSTRUMENTS**

Pinnacle West estimates that 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 Pinnacle West's cost of capital, approximate their carrying amounts.

It was not practical to estimate the fair values of several investments in joint ventures and untraded equity securities because costs to do so would be excessive. The carrying value of these investments totaled \$40.6 million and \$45.6 million at year-end 1994 and 1993, respectively. 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 \$2.64 billion and its estimated fair value was approximately \$2.49 billion. On December 31, 1993, the carrying amount of long-term debt (excluding \$30 million of capital lease obligations) was \$2.68 billion and its estimated fair value was approximately \$2.91 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.

**BOARD OF DIRECTORS**  
**PINNACLE WEST CAPITAL CORPORATION**



**DONALD N. SOLDWEDEL**  
(70) 1958\*  
Chairman of the Board,  
Western Newspapers, Inc.  
Committees:  
Human Resources  
Audit

**MARK DEMICHELE**  
(61) 1982  
President & Chief Executive  
Officer, APS  
Committee:  
Finance and Planning



**RICHARD SNELL**  
(64) 1975  
Chairman & President

**JOHN R. NORTON III**  
(65) 1984  
Chairman & Chief Executive  
Officer,  
J.R. Norton Company  
Committees:  
Finance and Planning, Chairman  
Human Resources



**HENRY B. SARGENT**  
(60) 1976  
Executive Vice President &  
Chief Financial Officer

**MARTHA O. HESSE**  
(52) 1991  
President, Hesse Gas Company and  
Dolan Energy Corporation  
Committees:  
Audit  
Human Resources



**DOUGLAS J. WALL**  
(67) 1976  
Of Counsel to the Law Firm of  
Mangum, Wall, Stoops & Warden  
Committees:  
Audit, Chairman  
Human Resources

**BILL JAMIESON, JR.**  
(51) 1991  
Archdeacon, Episcopal Diocese  
of Arizona  
Committees:  
Audit  
Finance and Planning



**PAMELA GRANT**  
(56) 1980  
Civic Leader  
Formerly, President, TableScapes, Inc.  
Committees:  
Human Resources, Chairman  
Finance and Planning

**ROY A. HERBERGER, JR.**  
(52) 1992  
President,  
American Graduate School of  
International Management  
Committees:  
Audit  
Finance and Planning



\* The year in which the individual first joined the Board of Pinnacle West or a predecessor corporation.  
At mandatory retirement age, Mr. Soldwedel will not stand for re-election in 1995.

**O F F I C E R S**  
**PINNACLE WEST CAPITAL CORPORATION AND SUBSIDIARIES**

**PINNACLE WEST**

**RICHARD SNELL**  
 (64) 1990\*  
 Chairman & President

**HENRY B. SARGENT**  
 (60) 1957  
 Executive Vice President &  
 Chief Financial Officer

**MICHAEL S. ASH**  
 (41) 1983  
 Corporate Counsel

**ARLYN J. LARSON**  
 (60) 1980  
 Vice President of Corporate  
 Planning & Development

**NANCY E. NEWQUIST**  
 (43) 1987  
 Vice President & Treasurer

**FAYE WIDENMANN**  
 (46) 1978  
 Vice President of Corporate  
 Relations & Administration &  
 Secretary

**ARIZONA PUBLIC SERVICE**

**RICHARD SNELL**  
 Chairman of the Board

**MARK DEMICHELE**  
 (61) 1978  
 President & Chief Executive Officer

**WILLIAM J. POST**  
 (44) 1973  
 Senior Vice President &  
 Chief Operating Officer

**JARON B. NORBERG**  
 (57) 1982  
 Executive Vice President &  
 Chief Financial Officer

**SHIRLEY A. RICHARD**  
 (48) 1984  
 Executive Vice President, Customer  
 Service, Marketing & Corporate  
 Relations

**ARIZONA PUBLIC SERVICE**  
**(CONT.)**

**WILLIAM L. STEWART**  
 (51) 1994  
 Executive Vice President, Nuclear

**JACK A. BAILEY**  
 (41) 1989  
 Vice President, Nuclear  
 Engineering & Projects

**JAN H. BENNETT**  
 (47) 1967  
 Vice President, Customer Service

**JACK E. DAVIS**  
 (48) 1973  
 Vice President, Generation &  
 Transmission

**ARMANDO B. FLORES**  
 (51) 1991  
 Vice President, Human Resources

**JAMES M. LEVINE**  
 (45) 1989  
 Vice President, Nuclear Production

**RICHARD W. MACLEAN**  
 (48) 1991  
 Vice President, Environmental,  
 Health & Safety

**ELBERT C. SIMPSON**  
 (47) 1990  
 Vice President, Nuclear Support

**WILLIAM J. HEMELT**  
 (41) 1980  
 Controller

**NANCY C. LOFTIN**  
 (41) 1985  
 Secretary & Corporate Counsel

**NANCY E. NEWQUIST**  
 Treasurer

**SUNCOR DEVELOPMENT**

**RICHARD SNELL**  
 Chairman of the Board

**JOHN C. OGDEN**  
 (49) 1972  
 President & Chief Executive Officer

**HENRY B. SARGENT**  
 Executive Vice President

**GEOFFREY L. APPLEYARD**  
 (41) 1987  
 Vice President &  
 Chief Financial Officer

**DUANE S. BLACK**  
 (42) 1989  
 Vice President &  
 Chief Operating Officer

**STEVEN GERVAIS**  
 (39) 1987  
 Vice President & General Counsel

**MARGARET E. KIRCH**  
 (45) 1988  
 Vice President,  
 Commercial Development

**EL DORADO INVESTMENT**

**RICHARD SNELL**  
 Chairman of the Board

**HENRY B. SARGENT**  
 President & Chief Executive Officer

\* The year in which the individual was first employed within the Pinnacle West group of companies.

**SHAREHOLDER INFORMATION**  
PINNACLE WEST CAPITAL CORPORATION

**CORPORATE HEADQUARTERS**

Street address:  
400 East Van Buren Street  
Phoenix, Arizona 85004

Mailing address:  
P.O. Box 52132  
Phoenix, Arizona 85072-2132

Main telephone number: (602) 379-2500

**ANNUAL MEETING OF SHAREHOLDERS**

Wednesday, May 17, 1995  
10:30 a.m.  
Centennial Hall  
Mesa Community and Conference Center  
201 North Center Street  
Mesa, Arizona

**STOCK LISTING**

Ticker symbol: PNW on New York Stock Exchange and  
Pacific Stock Exchange  
Newspaper financial listings: PinWst

**FORM 10-K**

Pinnacle West's Annual Report to the Securities and  
Exchange Commission on Form 10-K will be available after  
April 1, 1995 to shareholders upon written request, without  
charge. Write: Office of the Secretary.

**STATISTICAL REPORT**

A detailed Statistical Report for Financial Analysis for 1989-  
1994 will be available in April upon request. Write: Investor  
Relations Department.

**PINNACLE WEST INVESTORS ADVANTAGE PLAN**

Pinnacle West's Stock Purchase and Dividend Reinvestment  
Plan has been renamed the Investors Advantage Plan. The Plan  
provides shareholders of record and interested investors with a  
convenient and economical way to purchase shares of common  
stock with cash investments or reinvested dividends. For a  
copy of the prospectus describing the Investors Advantage Plan,  
please call the Shareholder Department toll-free at 1-800-457-2983  
(379-2500 in the Phoenix area) or write to the Shareholder Depart-  
ment at the address above. Participants in the current Plan  
automatically receive this information.

**TRANSFER AGENTS AND REGISTRARS**

**COMMON AND APS PREFERRED STOCK**

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

**PINNACLE WEST COMMON STOCK ONLY**

The First National Bank of Boston  
Transfer Processing  
Mail Stop 45-01-05  
P.O. Box 644  
Boston, Massachusetts 02102-0644  
Telephone: (617) 575-2900

**SHAREHOLDER ACCOUNT AND  
ADMINISTRATIVE INFORMATION**

Shareholder Department telephone number  
(toll-free): 1-800-457-2983

**INVESTOR RELATIONS CONTACT**

Rebecca L. Hickman  
Director, Investor Relations  
Telephone: (602) 379-2568  
Fax: (602) 379-2640

**STATEWIDE ASSOCIATION FOR UTILITY  
INVESTORS**

The Arizona Utility Investors Association represents  
the interests of investors in Arizona utilities.  
If interested, send your name and address to:

Arizona Utility Investors Association  
P.O. Box 34805  
Phoenix, Arizona 85067



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