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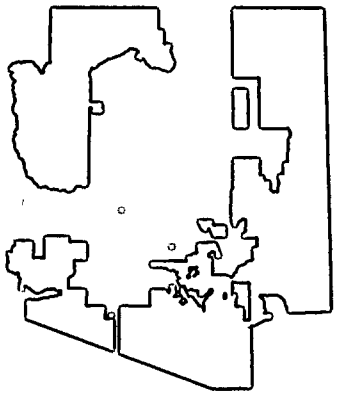
RECORDS FACILITY BRANCH

Arizona Public Service Company

Arizona Public Service is engaged principally in the generation and sale of electricity and in the purchase and sale of natural gas.
Successor to a series of small utility operations originating in 1886, the company was incorporated in 1920 under the laws of Arizona.

The company's service territory includes all or part of 11 of Arizona's 14 counties. It is estimated that one or both services of electricity or natural gas reaches approximately 1,586,000 persons, or about 70% of the state's population.

Arizona Public Service Company's principal executive offices are located at 411 North Central Avenue, Phoenix, Az. 85004, phone 602 271-7900.



All stockholders are invited to attend the company's fifty-seventh annual meeting. It will be held at 10 a.m. Thursday, April 21, in the Grand Ballroom of the Adams Hotel, Central Avenue at Adams, Phoenix, Arizona.

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

CONTENTS

HIGHLIGHTS 1976

	1976	1975	% Increase (Decrease)
Property and Plant:			
Total utility plant, year end	$1,580,672,000	$1,368,370,000	15.5
Construction expenditures	$ 194,266,000	$ 167,912,000	15.7
Sales and Customers:			
Total operating revenues	$ 394,779,000	$ 359,747,000	9.7
Total electric sales (mwh)	9,606,571	8,892,570	8.0
Electric customers, year end	342,059	331,382	3.2
Total gas sales (m therms)	491,007	526,659	(6.8)
Gas customers, year end	339,265	336,839	.7
Income, Earnings, Dividends:			
Net income	$ 60,479,000	$ 56,496,000	7.1
Earnings available for common stock	$ 47,168,000	$ 46,074,000	2.4
Average common shares outstanding	19,105,191	17,739,726	7.7
Earnings per average share of common stock	$ 2.47	$ 2.60	(5.0)
Dividends paid per share of common stock	$ 1.39	$ 1.36	2.2
Shareholders:			
Common	56,011	56,003	—
Preferred	6,243	5,641	10.7
Employees, year end:	4,042	3,731	8.3

TO OUR SHAREHOLDERS

In reviewing your company's 1976 business highlights, you will note that earnings per share of common stock declined from $2.60 to $2.47. These lower than anticipated results were caused by rate case and judicial proceedings not being resolved as early as we had expected.

We have always contended that matters subsequent to the historical test year should be considered in rate proceedings and, last spring, found it necessary to take our position before the Maricopa County Superior Court. This court recognized the validity of the forward look, allowing the company to place increased rates into effect under bond April 23, 1976.

Other parties appealed the lower court action to the Arizona Supreme Court. This resulted in a decision last September in which the higher court agreed with the company's position, ruling that the Arizona Corporation Commission has the authority and discretion to consider matters subsequent to the test year in its rate deliberations. This ruling was part of a decision which held that the Superior Court should not have interfered with the Commission's last permanent rate decision, and referred the question of rates back to the Commission.

The Commission ordered a refund to customers of approximately $17 million collected under rates authorized by the Superior Court. The Commission also approved an overall 13.8% interim rate increase effective October 1. The net effect was lower earnings for the year, with an improvement the fourth quarter when the interim increase applied.

Your company does not consider the 13.8% interim increase adequate. Consequently, we are currently before the Corporation Commission with a request that the interim increase be made permanent and that additional rate relief be granted in the form of a two-step increase. Step 1 seeks a 6.5% increase effective June 1, 1977, and Step 2 asks for an 11.1% increase effective January 1, 1978. In this request, we are urging the Commission to consider the forward look permitted in the Supreme Court ruling.

Despite the adverse decision related to the refund and lowered earnings for the year, your company in 1976 continued to make progress toward a more conservative capital structure. Common equity increased to 35.4%, with debt at 51.7% and the balance preferred. We hope to achieve our objective of at least 38% common equity by 1978, and thereafter to minimize dilutions.

The Need for a National Energy Policy

The severe shortage of natural gas suffered by much of the United States this past winter again emphasizes the need for a unified national energy policy — a policy geared to provide energy supplies that will adequately support our nation's economic growth.

Even though the Arab oil embargo brought the energy dilemma to a head, such a policy has not been forthcoming. We hope the additional lessons learned from the natural gas crisis will spur Congress and the Administration into action.

A sound policy has to recognize that transportation takes about 60% of our total energy output, and that most of our energy and fuel problems are man-made. Moreover, the policy must acknowledge that jobs and the economic health and growth of our nation depend upon adequate energy supplies.

Our country must adopt programs that will motivate consumers to eliminate wasteful uses of energy. Less dependence on foreign imports calls for legislation that stimulates the exploration and development of domestic oil and natural gas reserves. At the same time, our nation must establish environmental goals which strike a balance with the needs of an energy-based economy and encourage better utilization of our nation's abundant coal resources.

Streamlined procedures are needed to minimize delays in carrying out the nuclear energy program. We must accelerate research and development of the breeder reactor, solar, geothermal and other yet-to-be-developed energy sources.

Finally, a national energy policy must assure the energy industry full opportunity to provide consumers' requirements, unfettered by unnecessary and ill-advised governmental regulations.

APS remains strongly committed to solar energy, but we realize that at best it can be relied upon for only a small portion of the total energy to be consumed by the end of the century. Fortunately, your company is embarked on a program of coal and nuclear power generation which, by the mid-1980's, will produce 90% of the electricity our customers will need.

Dividend Reinvestment and Stock Purchase Plan

In response to many shareholder requests, we have initiated a dividend reinvestment and stock purchase plan, effective with dividends payable March 1, 1977. This plan provides holders of the company's common stock a convenient, economical means of systematically acquiring additional shares.

If you would like further information, please write to the company secretary at the address listed on the inside back cover.

Anti-Nuclear Initiative Defeated

One of the most serious challenges to confront your company in 1976 was the anti-nuclear initiative which appeared on the November general election ballot.

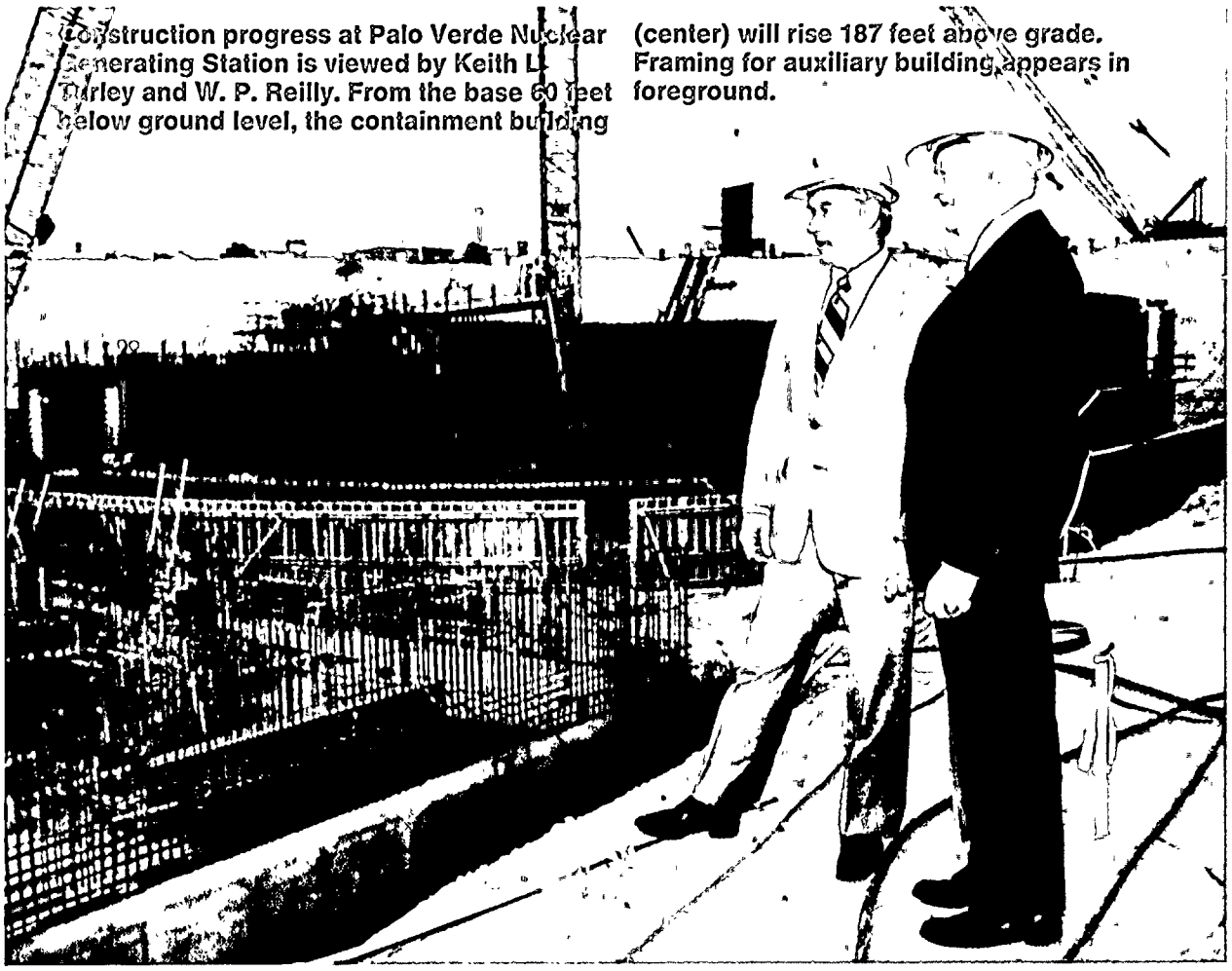
The measure was soundly defeated, thanks in large part to the voluntary support of our employee families in informing the public about the issue. We were tremendously gratified by the supportive response from throughout Arizona — by labor, scientists, educators, business leaders, people from all walks of life. We also appreciate deeply the encouragement you, our shareholders, gave in the successful effort to keep nuclear energy in Arizona's future.

Sincerely,

February 24, 1977

W. P. REILLY
Chairman of the Board

KEITH L. TURLEY
President and Chief Executive Officer



Construction progress at Palo Verde Nuclear Generating Station is viewed by Keith L. Turley and W. P. Reilly. From the base 60 feet below ground level, the containment building (center) will rise 187 feet above grade. Framing for auxiliary building appears in foreground.

BUSINESS AND FINANCE

Earnings and Dividends
Earnings per share on common stock amounted to $2.47 on 19,105,191 average shares outstanding in 1976. This compares with per share earnings of $2.60 in 1975, with 1,365,465 fewer average shares.

A Maricopa County Superior Court decision last spring was rejected later by the Arizona Supreme Court, leading the Arizona Corporation Commission to disallow a 10.5% retail rate increase and order a refund to customers. The refund, amounting to approximately $17 million in revenues collected over a five-month period, had a marked impact on 1976 earnings.

However, the Commission granted a 13.8% interim increase in retail rates effective October 1, 1976, and this action turned the earnings decline around. As a result, earnings for the last quarter of 1976 were 86 cents per share of common, versus 52 cents per share for the same quarter of 1975.

An increase to 37 cents per share in the quarterly dividend paid to holders of common stock December 1, 1976, brought the total for the year to $1.39 and raises the indicated annual dividend rate to $1.48. Quarterly dividends of 34 cents per share had been paid since December, 1973.

The company estimates that 17% of the common dividends for 1976 are nontaxable as dividend income for shareholders' federal income tax purposes. However, preferred dividends remain fully taxable as dividend income.

Revenues
Operating revenues of $394.8 million were up 9.7% over 1975. Factors contributing principally to the gain were: increased electric general business; revenue from retail and wholesale customers from rate adjustment clauses to cover increases in power plant fuel, purchased power and natural gas costs; plus the interim rate increase effective since October. Additional rate matters are reviewed later.

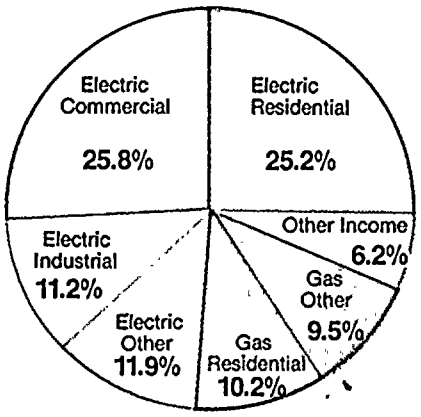
Electric business produced $312 million or 79% of our 1976 total operating revenues, with the balance of $82.8 million coming from gas operations. Please refer to "Lines of Business" on page 16 for a five-year comparison of Operating Revenues and Operating Income Before Income Taxes.

Expenses
Total operating expenses amounted to $215.5 million, up 9.7% over 1975. Significant items among our operating and other expenses were:

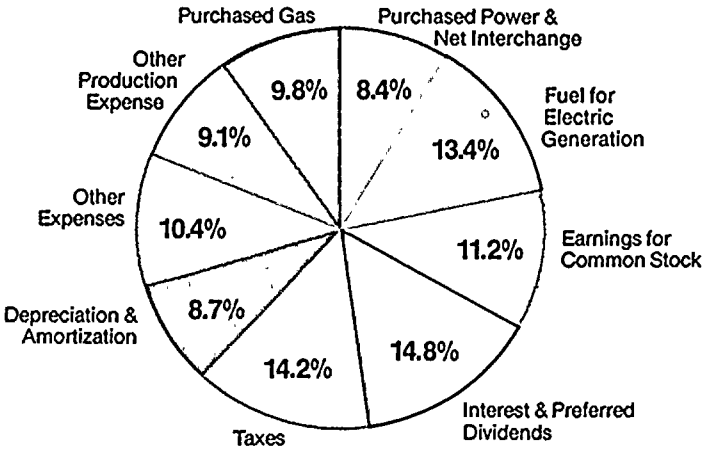
- Maintenance, up 24.3% due largely to increased plant, coupled with continued efforts to increase the availability of economical power from the coal-fired Four Corners Power Plant.
- Generating fuel and purchased gas, up

1976 APS INCOME
$421,080,000

SOURCES



DISBURSEMENTS



More than one-half our income is derived from residential and commercial electric revenue. Expenses related directly to power production and purchases, plus the purchase of natural gas, account for more than 40% of the outlays.

a combined 16.4% because of increased electric sales and higher costs of fuel and natural gas from our suppliers. The increase in the outlay for these items did not materially affect earnings because of the fuel adjustment clause.

- Interest, up 23.5% due to a greater amount of outstanding long-term debt.
- Depreciation and amortization, up 11.7% as a result of continued additions to plant in service.

Rate and Regulatory Matters

The Arizona Corporation Commission has scheduled hearings to begin February 28, 1977, on the company's request to make permanent the refundable interim increase of 13.8% instituted last October. At the same time, the company is requesting additional retail rate increases designed to meet our revenue needs until 1979.

Our filing for additional rate relief seeks a Step 1 increase of 6.5% effective June 1, 1977, and a Step 2 increase of 11.1% effective January 1, 1978. Additional revenues from increased wholesale electric rates will be sought through a later filing with the Federal Power Commission.

In applying for these retail increases, the company is requesting the Corporation Commission to consider matters subsequent to the historic test year used in rate proceedings. This is an effort to overcome regulatory lag problems and reduce the frequency of future rate increase filings.

The Arizona Supreme Court decision, mentioned at the beginning of this section, included a ruling which permits the Commission to consider this forward approach to rate making.

Matters pertaining to wholesale electric rates and adjustment clauses affecting our wholesale customers are pending final decisions from the Federal Power Commission and related court proceedings. We do not believe that any refund of the resulting revenues collected through December 31, 1976, would be significant.

Awaiting court and FPC decisions are: (1) a February, 1976, filing with the FPC which led to an interim, refundable increase in wholesale electric rates for certain customers effective since last spring. The increase produces approximately $3.2 million annually.

The FPC action will consider not only the rates for customers to whom the interim increase has been applied, but also will consider the rates for additional wholesale customers for whom the interim increase was denied;

(2) Other matters relating to fuel and other adjustment clauses applicable to wholesale electric customers since April, 1974.

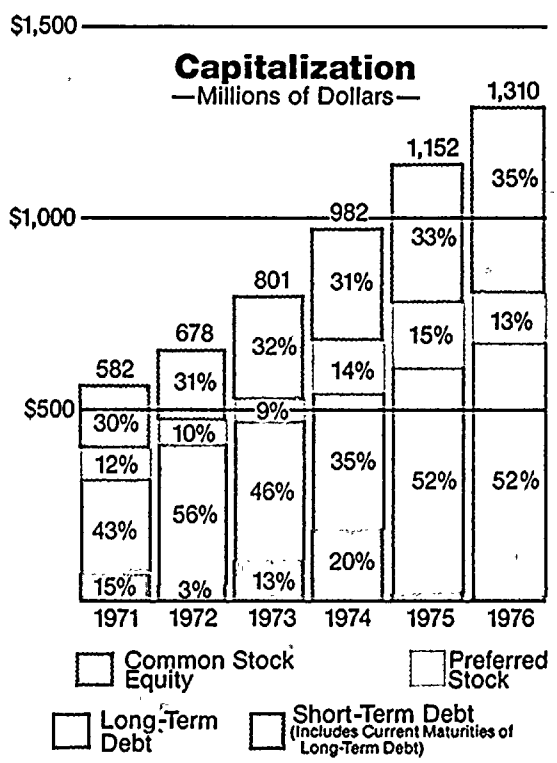
1976 Financing

Principal sources of funds secured from outside the company during 1976 were: (1) an offering of 3.5 million shares of common stock, and (2) a sale-lease back financing negotiated on the company's new combined cycle electric generating plant in Phoenix.

The stock was offered to the public December 15 through an underwriting group. Marketed at $18⅞ per share, the offering produced net proceeds of $64.1 million.

The sale-lease back of the generating facility produced approximately $55 million, and an estimated savings of $1.5 million annually in interest costs.

Funds from these sources were applied to the construction program and other purposes, to retire short-term debt incurred for these



Capitalization ratios are being strengthened by more common equity, less dependence on short-term debt.

purposes, and to meet the maturity of $8.5 million in first mortgage bonds.

The highest amount of short-term borrowings outstanding during 1976 was $59.5 million, substantially less than the high of $185 million for 1975. Short-term debt was zero at the end of 1976.

Supplementing funds from the above sources, we utilized $17 million carried over from financings the latter part of 1975 which had been invested temporarily in bank certificates of deposit. We also drew down an additional $26.3 million from a 1974 Navajo County Pollution Control bond issue.

Internally-generated funds contributed an additional $35.9 million to our financial requirements, representing 18% of the total for 1976.

1977 Financing Plans

Financing plans for 1977 are based on estimated capital requirements of $273 million, and may be affected by the outcome of the hearing on retail rates scheduled to begin February 28 of this year.

Tentative plans call for approximately $200 million of permanent financing. Included will be one or more issues of common stock, totaling four to five million shares, and a pollution control revenue bond issue in the spring. The balance of permanent financing will include the sale of senior securities or a possible project financing.

Proceeds from these sources will be supplemented by modest amounts each quarter from the new common stock dividend reinvestment plan mentioned in the Letter to Shareholders, page 3.

Additional cash funds will come from a nominal amount of short-term borrowings, and the balance of capital requirements will be obtained from internal cash generation.

NYSE Audit Committee Policy

The New York Stock Exchange recently has instituted a policy requiring listed companies to establish audit committees composed of directors independent of management.

We are pleased to report that APS complies with this requirement, having followed this policy since 1972.

Common Stock Price Range (symbol AZP)

Quarter	1976		1975	
	High	Low	High	Low
First	17⅛	15¼	14⅞	11⅞
Second	17	15	16⅜	13⅜
Third	17⅞	15¾	16⅜	13½
Fourth	19⅞	16½	15⅞	14⅛

OPERATIONS

Electric

For the first time in 21 years, APS served more electric customers than natural gas customers during the past year. Two factors were largely responsible for this turnabout. One was the continued steady population growth in our service area; the other, a moratorium which has restricted gas connections the past two years because of declining gas supplies.

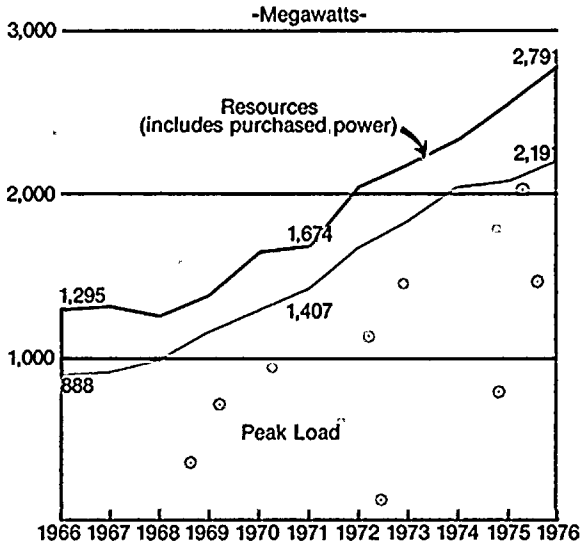
We extended electric service to a net total of 10,677 new customers, bringing the year end count to 342,059 or 3.2% over 1975. Electric sales increased to 9.6 million kilowatt-hours, up 8%, while electric revenue of $312 million showed a gain of 11%.

Residential sales increased 3% due mainly to customer growth. Average residential use amounted to 9,268 kwh, about the same as 1975. This level reflects continued customer efforts to conserve energy, plus reduced heating and cooling loads due to mild weather in both the winter and summer seasons.

Sales to both commercial and industrial customer classifications were up 7.1%, attributable for the most part to improved economic conditions which were particularly evident the latter part of the year.

Sales for resale, long term, increased

Growth of Peak Load and Electric Resources



Growth of electric resources, up 116% over the past 10 years, is keeping ahead of peak load requirements.

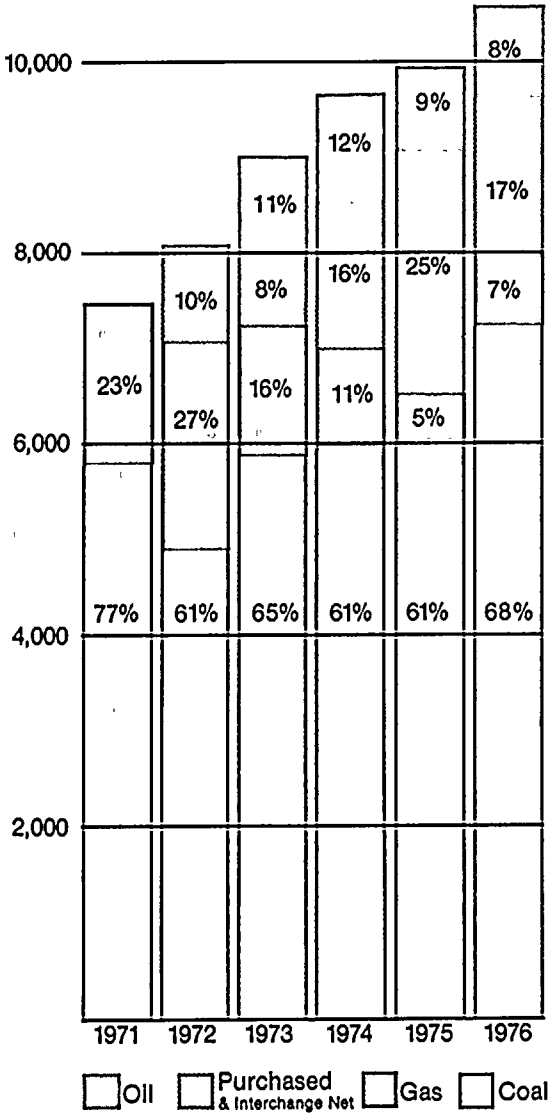
32.6%. This reflects the addition of two wholesale customers and greater sales to others.

For an analysis of operating revenues by types of business, please see the table on page 16.

APS resources were called upon last summer to meet a peak electric load of 2,190,900 kilowatts, 5.9% over 1975. Resources available to meet the peak totaled 2,790,700 kw, including about 230,000 kw through purchased power contracts.

Sources of Electric Energy

—Thousands of MWH—



Economical coal generation represents a major portion of APS electric resources, holding down the use of more expensive oil as gas becomes unavailable for power plant fuel.

With new generating additions, our planned reserve margin amounted to 27.4%. However, the available reserve was but 6% at the time of peak demand last July, due to unplanned repairs required on certain major generating units. Eventualities such as these point up the necessity for maintaining adequate reserve margins.

Construction expenditures during 1976 amounted to $194.3 million, an increase of $26.4 million over the previous year. Electric property and equipment, including environmental protection facilities, amounted to $187.3 million. Gas facilities required $1.8 million, and the balance went for common properties.

Two additions totaling 330,000 kw were made to the company's generating capacity in 1976.

Our first combined cycle generating station, consisting of three units located at the West Phoenix Power Plant, added 225,000 kw to the system last May. (See page 5 for information about the sale-lease back financing.)

About the same time, we began receiving 105,000 kw from our 14% joint ownership of Unit 3 at the Navajo Power Plant. Installation of this unit completes the development of this coal-fired plant near Page in northern Arizona.

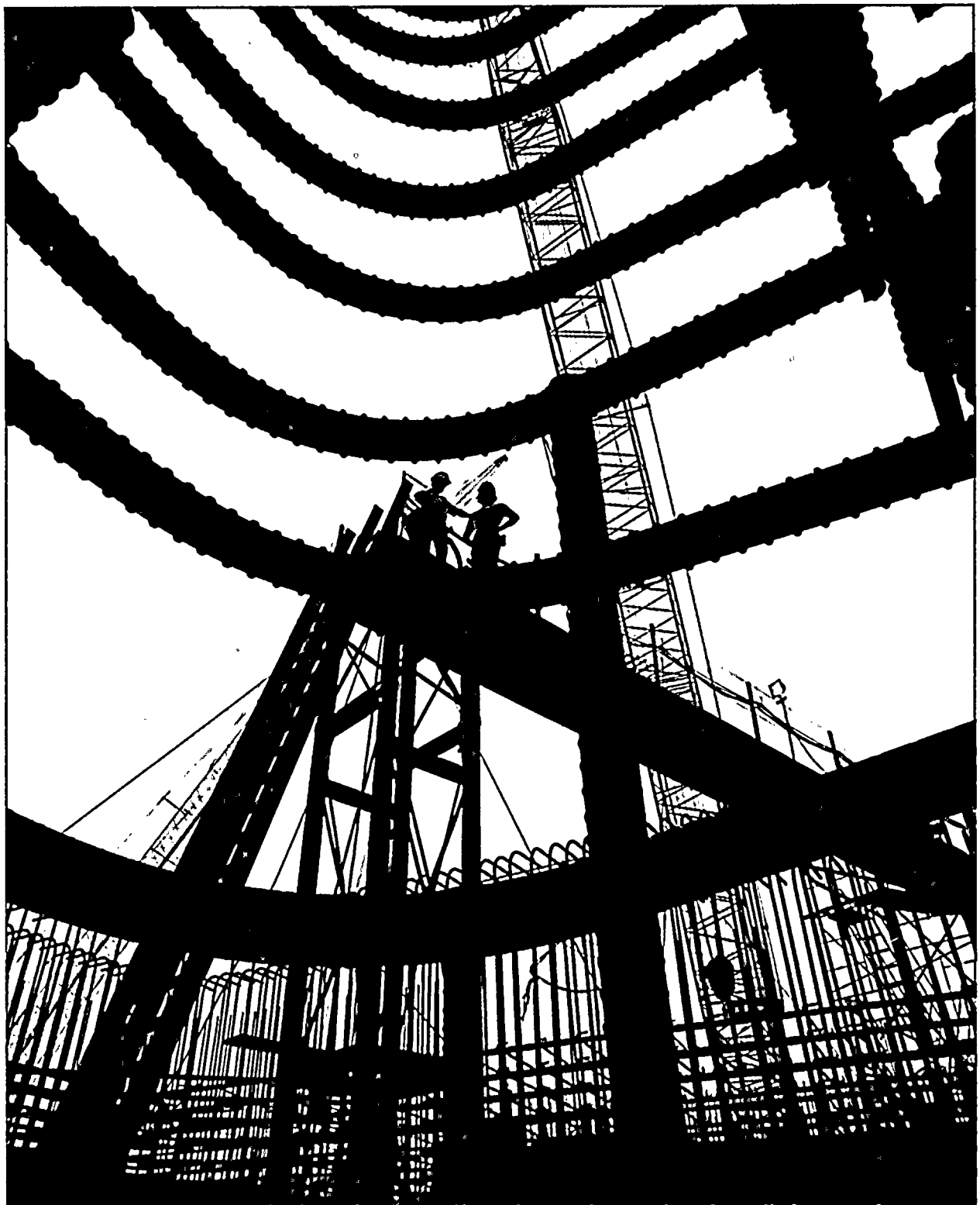
With the continued expansion of coal-fueled power generation, we were able to produce 68% of our electric requirements from these sources in 1976. (Excluding power purchases, coal produced 82.2% of our total generation.)

Economies of coal are shown by these comparative average fuel costs to the company, in cents per million Btu: coal, 32.69¢; gas, 80.87¢; and oil, 251.18¢.

Purchased power supplied 12.1% of our electric needs last year, and the balance came about equally from company generation by gas and oil.

We were fortunate in being able to secure a sizable amount of excess power from other sources, as well as an unexpected supply of natural gas for power plant fuel. These reduced the need for expensive generation by oil.

Because of recent drought conditions in hydroelectric areas of the Pacific Northwest, we cannot count on any excess power being available in 1977, except through existing purchased power contracts. Consequently, we anticipate that more expensive generation will be required this year. This will have an impact



Arizona-produced steel reinforcing bars 2½ inches thick form gigantic framework for Unit 1 containment building of Palo Verde Nuclear Generating Station. Overall view may be seen in background of photo accompanying the Letter to Shareholders.

on customers' energy costs, but will not affect earnings significantly because of the fuel adjustment clauses in company rates.

To meet future load growth, APS has under construction or plans the following additions to generating resources over the next 10 years:

Type of Facility	Nameplate Capacity, kw	Scheduled Completion
Coal, all at Cholla Plant —		
Unit 2	250,000	1978
Unit 3	250,000	1979
Unit 4	350,000	1980
Unit 5	350,000	1982
TOTAL	1,200,000	
Nuclear, all at Palo Verde, consisting of APS' 29.1% ownership —		
Unit 1	370,000	1982
Unit 2	370,000	1984
Unit 3	370,000	1986
TOTAL	1,110,000	

During 1976, construction began on Unit 4 at Cholla and continued on the earlier-started Units 2 and 3. Unit 5 was announced late in the year, to fill a major portion of the void left by cancellation of the Kaiparowits project.

On completion of this expansion program, our wholly-owned Cholla Plant located in northeast Arizona will be the company's largest single source of power, with a capacity of 1,316,000 kw.

Receipt of the Nuclear Regulatory Commission's construction permit last May launched construction of the $2.8 billion Palo Verde Nuclear Generating Station. APS is project manager for the four other participants in the project, being developed 50 miles west of Phoenix.

The other participants are El Paso Electric Company, Public Service Company of New Mexico, Salt River Project (Arizona) and Southern California Edison Company.

At year's end, the project was on schedule, having cleared the threat of an anti-nuclear power initiative measure that was defeated decisively in the November general election.

Reference was made in last year's Annual Report to two additional planned power projects which have since been suspended.

After several years of planning and exploration of coal reserves by subsidiaries of APS and two other utilities, the proposed construction of a large generating plant on the Kaiparowits Plateau in southern Utah was cancelled last year. This decision stemmed from several factors, including environmental road blocks, governmental indecision and delay, which affected seriously the economics as well as the timing to meet forecast needs.

APS and the other participants continue to hold leases on Kaiparowits coal reserves and are now pursuing other alternatives to utilize these resources.

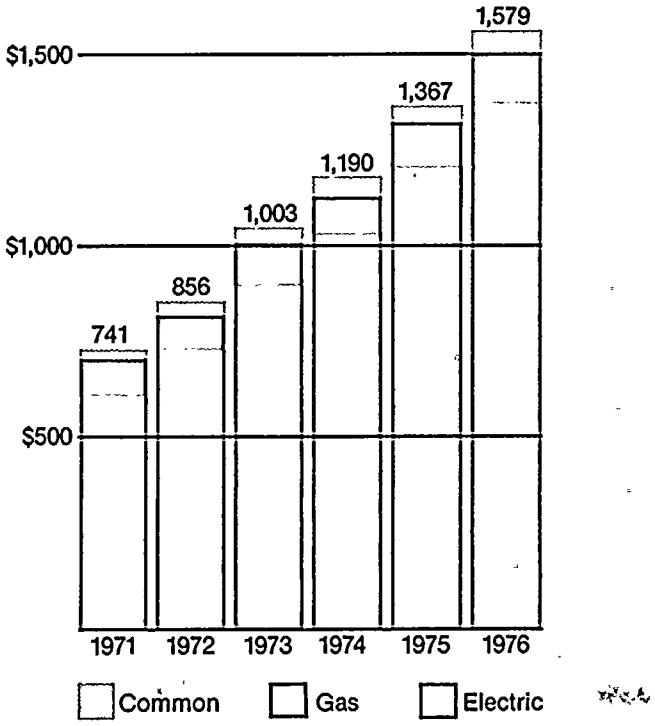
The company's investment in the power portion of the Kaiparowits project amounted to $2.6 million. APS is amortizing this investment over a five-year period.

The other project on which preliminary planning has been suspended is the Montezuma Pumped Storage facility. This joint undertaking is being reassessed by the participants, as they review the relative costs and their individual financial/resource planning schedules.

Plant in Service

Except plant held for future use & plant adjustments

—Millions of Dollars—



Increased customer energy needs have required more than doubling our plant in service since 1971.

Power flow through the company's major transmission substations around the system is monitored and controlled from this dispatching center in Phoenix. Here, operations supervisor Bill D. Ashworth uses a "light pen" to spot control point on substation diagram projected by cathode ray tube.

Another potential for supplementing our power resources, now being studied, is a possible exchange — on a firm basis — with the Pacific Northwest. The arrangement would make use of surplus power normally available at different times of the year in the Northwest and Southwest, because of the seasonal variation in peak loads.

Should the agreement become a reality, we have indicated our interest in as much as 200,000 kw initially (about 1984), increasing up to 500,000 kw in later years. The feasibility of the plan will depend primarily on whether sufficient excess power from the Northwest can be assured to support the investment in a large transmission intertie.

Meanwhile, APS continues to seek and utilize economical, excess power whenever it is available from other utilities.

Natural Gas

From 1974 to 1976, winter weather in our gas service area completed a full circle — from abnormally warm, to colder-than-normal, and back to abnormally warm in the 1975-76 heating season.

The weather effect is measured by the number of heating degree days, up 34% in 1975, and down 32% in 1976. This fluctuation was reflected in the company's gas business.

Sales totaling 491 million therms declined 6.8% from 1975. However, revenues made a modest gain of 5.3% to $82.8 million, due mainly to the adjustment clause covering increases to the company in the cost of gas.

APS was able to supply industrial customers with more gas than had been expected. They were curtailed 108 days during the 1975-76 heating season, compared with 160 days of at least partial curtailment that had been forecast.

Anticipating a severe impact on jobs and industrial production because of industrial gas curtailment projections for early 1977, the company contracted for a short-term emergency purchase from a Texas-based pipeline company. The purchase, enabled by regulations of the Federal Power Commission, helped ease somewhat the gas supply situation during the early part of 1977. Arranged on a "best efforts as available" basis, the deliveries fluctuated due to extreme cold weather in other areas which limited the amount available to APS.

Average residential use of gas, 631 therms in 1976, compared with 726 therms the previous year. Customer conservation efforts contributed to this reduction, along with lower heating needs.

Gas customer additions during 1976 were made in accordance with a Corporation Commission-ordered moratorium on new connections. Addition of 2,426 customers brought the year end total to 339,265.

The moratorium took effect in mid-April, 1975, limiting gas connections to commitments made prior to that time. The Commission later established a deadline of year-end 1976 for new connections on those commitments, except mobile homes which can be connected through May, 1977. Connections beyond those dates will be limited to variances approved by the Commission.

As noted in last year's Annual Report, a Federal Power Commission order essentially limits the gas supply available to APS from its principal supplier. The company's connected load requirements as of October 31, 1974, are the benchmark for this order. Actions prohibiting new gas connections and restricting service for certain new large loads on existing lines are

designed to protect the amount of gas available for existing customers.

APS is continuing to seek supplemental gas supplies whenever they can be secured within constraints of the FPC. Without additional supplies, curtailments are expected to increase for industrial customers, and extend to other customer classes in the future.

Load Management

Efforts to encourage more efficient use of energy continued during 1976 and will be intensified through a broad-scale customer load management program in 1977.

The main thrust of this program is directed toward lessening energy use at peak load periods, thereby holding down customer energy costs and minimizing the company's cost of service. Reductions in the company's costs, ultimately benefiting the customer, can be realized from lower oil requirements for peaking generation, from reduced needs for additions to generating capacity and associated financing requirements.

Parabolic solar concentrator atop company service building casts reflection of Merwyn Brown, manager of APS research programs. Manufactured in Casa Grande, Az., the concentrator is part of a solar heating and cooling test facility.

These efforts have a long-range goal of lowering peak load growth, building up to a 100,000-kilowatt reduction from the peak forecast for 1985. This also will improve system load factor.

To further encourage customer load management, the company early in 1977 filed a set of rate proposals which provide economic incentives for customers to limit their demand during peak electric use periods and shift some of their use into off-peak times. These proposals will be considered by the Arizona Corporation Commission as part of the rate hearing beginning February 28.

One of Arizona's most abundant natural resources is sunshine, a resource that creates a unique potential for widespread use of solar energy within our service area.

APS took an active part last year in efforts to locate a demonstration solar electric generating facility in the state. We and two other Arizona utilities had committed $10 million toward this project. Our state was one of three finalists, from which a California location was selected early this year by the Energy Research and Development Administration.

Despite this disappointment, our company is continuing to aggressively pursue methods of utilizing solar energy. We are researching and testing solar energy applications wherever they can be adopted to supplement or replace other energy applications.

We are presently cooperating in a state effort to seek an Arizona location for the federal Solar Energy Research Institute. Arizona is among 19 areas being considered by the government.

Among our research projects are a solar energy facility designed to heat and cool a company service building, a solar-assisted water heating installation, and another system which recaptures waste heat from air conditioners for use in preheating water and other purposes.

APS also has become an important source of solar energy information for customers and the general public, offering a variety of authoritative manuals and booklets on the subject.

Community Support At Polls

Customer confidence in the company was reflected in the outcome of several elections related to APS operations last year.

Arizonans demonstrated strong support for the company's position against an anti-nuclear initiative when, by a 7 to 3 margin, they voted

down the measure on the November general election ballot. (Similar anti-nuclear issues were defeated during the year in six additional states — five on general election ballots and another in the California primary election last June.)

At a special election in the City of Page, Arizona, voters rejected municipal ownership of electric facilities. The vote constituted approval of continued service from APS, and an endorsement of a proposal for the company to purchase the City's share of Glen Canyon Dam hydroelectric power.

Agreements renewing 25-year electric service franchises for APS were approved by wide margins by voters in the cities of Holbrook and Prescott.

APS PEOPLE

Employees played a key role in successful efforts to defeat the anti-nuclear initiative, mentioned elsewhere in this report.

Over a month-long period prior to the election, employees and their families devoted thousands of hours of personal time to inform others about the issue. Their loyalty and concern, their willingness to act on this important matter, point up why they are considered the company's most valuable asset.

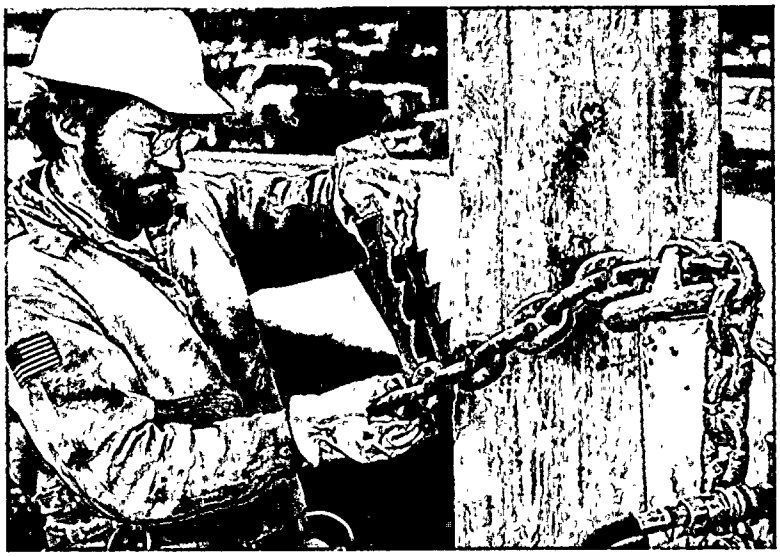
It is a pleasure to report that 1976 was the best year for safety performance in the company's history. The number of disabling injuries dropped to 3.4 per million manhours worked, 53% below 1975. This compares with the latest available national average of 7.05 for combination gas and electric utilities, published by the National Safety Council through August, 1976.

Particularly impressive is the record of Four Corners Power Plant employees. They compiled more than 1,090,000 manhours worked in 1976 without a disabling injury. This achievement earned plant personnel the top company safety award as well as a citation from the Edison Electric Institute.

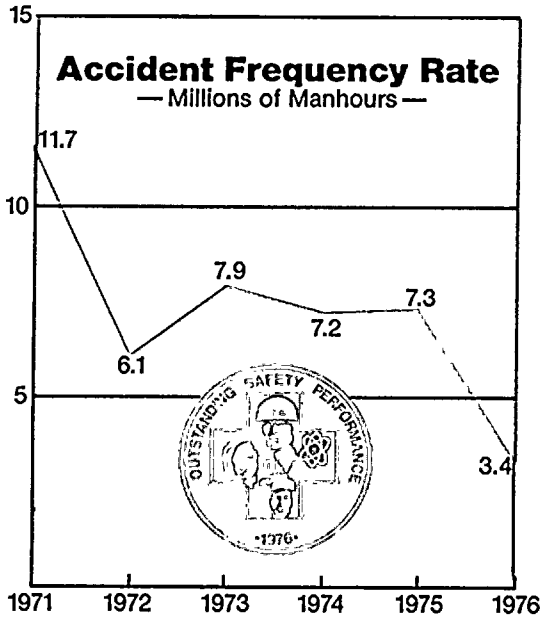
Due primarily to additions required for operation and maintenance of power plants, the number of APS employees increased 311 over the previous year, for a total of 4,042 at the end of 1976. All employees laid off in 1975 have either been re-hired or have been given APS job opportunities.

Contract negotiations last year resulted in a two-year wage agreement for employees in job classifications represented by unions. The settlement resulted in an 8.5% increase for the first year ending April 1, 1977, and an 8% increase the second year. Salary adjustments for other employees are based on a performance review program.

In a constant search for new and better



Two of 24 employees compensated during 1976 for productivity suggestions valued at $827,000: (left) Curtis R. Fields of Four Corners Power Plant submitted idea with largest single savings, an estimated $735,000 annually. Here he explains to President Keith Turley his proposed modifications of plant equipment which will reduce drastically the time otherwise needed for repairs. (right) Richard J. Bartell of Navajo Division demonstrates metal wedge he designed to speed pole removal, worth approximate yearly savings of $9,270.



Employees made company history last year when they reduced disabling injuries to the lowest rate in APS records.

ways of performing jobs, the company late in 1975 introduced a suggestion incentive plan related to its existing productivity program. Cash awards are offered for "Idealine" suggestions which cut expenses, improve productivity, reduce maintenance and other costs of doing business. The plan is proving highly successful.

Management changes during 1976 included:

Thomas G. Woods, Jr., vice president of Operations, elected executive vice president. Woods succeeds Max R. Llewellyn, who retired after 42 years in the utility industry of which the last 29 were with APS. He had served as a company officer since 1961.

Two new vice presidents were named — Howard F. Hersey, responsible for Gas Operations, and Charles D. Jarman, in charge of Engineering Services.

Additional responsibilities were assumed by Lyman K. Mundth, former vice president of Power Production now responsible for Electric Operations, and Edwin Van Brunt, Jr., former vice president of Nuclear Services now responsible for Construction Projects. Van Brunt supervises all major construction projects, in addition to having continued responsibility for nuclear construction and nuclear engineering.

Two new directors were named to the board late in 1976: Douglas J. Wall, partner in the law firm of Mangum, Wall, Stoops and Warden at Flagstaff, Arizona; and Leon Levy, prominent Tucson businessman and civic leader.

Due to the company's mandatory retirement age policy, Norman W. Fain, a director since 1965, will not stand for re-election at the 1977 Annual Meeting. His service to the company as a member of the board, as Chairman of the Audit Review Committee and as a member of the Executive Committee is deeply appreciated.


Douglas J. Wall


Leon Levy


Woods


Hersey


Jarman


Mundth


Van Brunt

LEGAL MATTERS

The company's present and future operations are subject to stringent environmental protection measures imposed under federal and state laws and regulations. Operations at the Four Corners Plant, which is older than most of the company's other coal-fired units, are particularly affected by such measures. The plant is not in full compliance with New Mexico restrictions on the emission of nitrogen oxides, and the acceptability of water discharges from the plant is in controversy at both state and federal levels. The applicability of certain existing air quality standards to operation of the plant is unclear, and additional standards are anticipated by mid-1977. Problems of interpreting and complying with the various standards, and the evolution of new standards, require continuing involvement of the company in proceedings before state legislatures, federal and state regulatory agencies and the courts.

Future operations are subject to further measures designed to prevent "significant deterioration" of air quality in areas where the air is already cleaner than required by existing federal standards. The company conducts most of its operations in such an area. Regulations promulgated to meet this objective were contested by the company and other parties before the U. S. Court of Appeals, where the regulations were affirmed. A petition for review is now pending before the U. S. Supreme Court.

- Fuel costs of the company's coal-fired plants could escalate by an indeterminate amount if strip mining legislation similar to that previously passed by Congress, but vetoed, is enacted. In addition, the New Mexico legislature is considering a tax on the extraction of coal and other minerals, as well as a tax on the emission of sulphur into the atmosphere; Navajo Tribal authorities are considering the institution of a tax system and are demanding an increase in royalties for certain coal mined on the Reservation; and the supplier of coal to the Cholla Plant is seeking an upward adjustment in its price to compensate for company delays in accepting deliveries.

The company expects that its fuel expense may ultimately increase as these matters are resolved, but expects to pass any such increases through to its customers under the fuel adjustment clauses in its rate schedules. It is possible, however, that the pass-through of certain of these costs could be contested, particularly in the case of increased royalties to the Navajo Tribe.

- A decrease ordered by the Arizona State Board of Tax Appeals in the 1974 assessed valuation of the company's properties in Arizona, which resulted in a $2.2 million reduction in 1974 Arizona property taxes, was appealed by the Arizona Department of Revenue to the Superior Court of Maricopa County. On dismissal of this action, the issue was taken to the Arizona Court of Appeals where the matter is now pending.
- The State of New Mexico has enacted an "electrical generation tax," effective July 21, 1975. This excise tax applies to all electricity generated in New Mexico and consumed outside the state. Believing that the tax is unconstitutional and that it violates a provision of the Tax Reform Act of 1976 prohibiting state taxes which discriminate against out-of-state producers of electricity, the company brought an action in the state District Court of New Mexico to have the tax set aside. That court dismissed the action, and a petition for review is being filed by the company with the New Mexico Supreme Court. Notwithstanding the lower court's decision, counsel to the company considers it probable that the company will ultimately prevail in this matter.
- The company's entrance into a capitalized lease of its new combined cycle plant required an order from the Arizona Corporation Commission, the granting of which was appealed by an intervenor in the proceeding to the Maricopa County Superior Court, where the matter is now pending. In the opinion of the company's legal counsel, there are no valid grounds for setting aside the Commission's order.

(See page 5 for information about legal matters concerning the Federal Power Commission.)

BOARD OF DIRECTORS

* **Ralph M. Bilby, 59,** President, Babbitt Brothers Trading Co. (general mercantile), Flagstaff, Arizona

† **Karl Eller, 48,** President, Combined Communications Corporation (broadcasting and outdoor advertising), Phoenix, Arizona

*† **Norman W. Fain, 70,** President, Fain Land and Cattle Co., Prescott, Arizona

* **Del W. Fisher, 66,** Chairman of the Board, Fisher Contracting Co., Phoenix, Arizona

William T. Garland, 60, Chairman of the Board, Garland-Rhuart Development Corporation (land development), Sedona, Arizona

Leon Levy, 63, Personal Investments; Consultant to Federated Department Stores, Inc., Tucson, Arizona

* **Victor H. Lytle, 65,** Chartered Life Underwriter, Prescott, Arizona

Marvin R. Morrison, 53, Farmer and Cattle Feeder, Higley, Arizona

* **W. P. Reilly, 69,** Chairman of the Board of the Company, Phoenix, Arizona

James B. Rolle, Jr., 68, Member of the Law Firm of Rolle, Jones, Benton & Cole, Yuma, Arizona

Henry B. Sargent, Jr., 42, Financial Vice President and Treasurer of the Company, Phoenix, Arizona

Richard Snell, 46, Member of Snell & Wilmer (general counsel to the Company), Phoenix, Arizona

* **Donald N. Soldwedel, 52,** President, Western Newspapers, Inc., Prescott, Arizona; Publisher and General Manager, Yuma Daily Sun, Yuma, Arizona

* **Maurice R. Tanner, 55,** Chairman of the Board, President and Chief Executive Officer, The Tanner Companies (construction and materials supply), Phoenix, Arizona

* **Keith L. Turley, 53,** President and Chief Executive Officer of the Company, Phoenix, Arizona

Douglas J. Wall, 50, Member of the Law Firm of Mangum, Wall, Stoops and Warden, Flagstaff, Arizona

† **Morrison F. Warren, 53,** Director of Experimental Programs, College of Education, Arizona State University, Tempe, Arizona

† **K. O. Wilbanks, 55,** President, First National Bank of Farmington, Farmington, New Mexico

† **Ben F. Williams, Jr., 47,** Attorney at Law, Douglas, Arizona

** Member of Executive Committee*

† Member of Audit Review Committee

DIRECTORS EMERITI

E. Ray Cowden, President, Cowden Livestock Company, Phoenix, Arizona

W. C. Quebedeaux, President, Quebedeaux Investment Company (personal investments), Phoenix, Arizona

OFFICERS

Ralph M. Bilby, 59, Chairman of the Executive Committee

D. L. Broussard, 56, Vice President, Corporate Planning and Control

Gerald J. Griffin, 56, Assistant Secretary

Howard F. Hersey, 48, Vice President, Gas Operations

Russell D. Hulse, 49, Vice President, Resources Planning

Jerry P. Human, 46, Vice President, Customer Services

Charles D. Jarman, 41, Vice President, Engineering Services

William F. Lerch, 41, Vice President, Management Services

Lyman K. Mundth, 60, Vice President, Electric Operations

Wm. T. Quinsler, 52, Secretary and Assistant Treasurer

W. P. Reilly, 69, Chairman of the Board

Henry B. Sargent, Jr., 42, Financial Vice President and Treasurer

Keith L. Turley, 53, President and Chief Executive Officer

Edwin E. Van Brunt, Jr., 45, Vice President, Construction Projects

Thomas G. Woods, Jr., 50, Executive Vice President, Operations

DIVISION MANAGERS

A. G. Anderson, 45, Western Division, Goodyear

Glen D. Daly, 48, Cochise Division, Douglas

Jack Duffy, 38, Navajo Division, Flagstaff

Robert Haag, 45, Metropolitan Division, Phoenix

James C. Lauchner, 51, Pinal Division, Casa Grande

Guy W. Lunt, 43, Mountain Division, Globe

Don Roberts, 56, Yuma Division, Yuma

Jesse F. Thomas, 54, Yavapai Division, Prescott

(Numerals are ages at annual meeting date, April 21, 1977.)

Lines of Business

Operating revenues, and operating income before income taxes, attributable to electric and gas operations of the Company during the five years ended December 31, 1976 were as follows:

	Operating Revenues (Millions of Dollars)				Operating Income Before Income Taxes (Millions of Dollars)			
	Electric		Gas		Electric		Gas	
Year Ended December 31,	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
1976	$312.0	79.0%	$ 82.8	21.0%	$ 78.8	88.0%	$ 10.7	12.0%
1975	281.1	78.1	78.7	21.9	69.3	85.6	11.7	14.4
1974	213.3	78.0	60.3	22.0	49.6	89.2	6.0	10.8
1973	171.0	76.0	54.0	24.0	47.3	84.2	8.9	15.8
1972	142.2	75.5	46.2	24.5	40.3	88.8	5.1	11.2

Operating Revenues

	1976	1975	% Increase (Decrease)
	(Thousands of Dollars)		
Electric:			
Residential	$106,334	$ 98,420	8.0
Commercial	108,506	97,508	11.3
Industrial	47,055	40,737	15.5
Irrigation	9,799	9,669	1.3
Other	28,565	21,880	30.6
Total	300,259	268,214	11.9
Transmission for others	9,591	10,598	(9.5)
Miscellaneous services	2,119	2,268	(6.6)
Total Electric Operating Revenue	311,969	281,080	11.0
Gas:			
Residential	42,922	42,096	2.0
Commercial	17,156	15,761	8.9
Industrial	10,130	8,760	15.6
Irrigation	10,979	10,639	3.2
Other	830	652	27.3
Miscellaneous services	793	759	4.5
Total Gas Operating Revenue	82,810	78,667	5.3
Total Operating Revenues	$394,779	$359,747	9.7

Statement of Income

For the Years Ended December 31, 1976 and 1975 and Comparison

	1976	1975	Increase (Decrease)
	(Thousands of Dollars)		
Operating Revenues:			
Electric	$ 311,969	$ 281,080	$ 30,889
Gas	82,810	78,667	4,143
Total	394,779	359,747	35,032
Operating Expenses:			
Operating and maintenance expenses:			
Fuel for electric generation	56,362	46,557	9,805
Purchased gas	41,474	37,521	3,953
Purchased power and interchange — net	35,249	42,335	(7,086)
Other production expenses	7,377	7,058	319
Transmission and distribution	11,782	10,961	821
Maintenance	31,129	25,044	6,085
Administrative, general and other	32,127	26,999	5,128
Total	215,500	196,475	19,025
Depreciation and amortization	36,621	32,793	3,828
Taxes — other than income	53,120	49,523	3,597
Income taxes (Note 2)	6,497	6,891	(394)
Total	311,738	285,682	26,056
Operating Income	83,041	74,065	8,976
Other Income:			
Allowance for funds used during construction	21,478	16,191	5,287
Income taxes (Note 2)	4,943	4,769	174
Other — net	(120)	1,043	(1,163)
Total	26,301	22,003	4,298
Gross Income	109,342	96,068	13,274
Interest Deductions:			
Interest on long-term debt	46,738	32,215	14,523
Interest on short-term borrowings	1,559	6,964	(5,405)
Amortization of debt discount, premium and expense	566	393	173
Total	48,863	39,572	9,291
Net Income	60,479	56,496	3,983
Preferred Dividend Requirements	13,311	10,422	2,889
Earnings for Common Stock	$ 47,168	$ 46,074	$ 1,094
Average Common Shares Outstanding	19,105,191	17,739,726	1,365,465
Per Share of Common Stock:			
Earnings (based on average shares outstanding)	$2.47	$2.60	$(.13)
Dividends declared and paid	$1.39	$1.36	$ .03

See Notes to Financial Statements, including Note 1 as to significant accounting policies.

Balance Sheet

Assets	1976	1975
	(Thousands of Dollars)	
Utility Plant:		
Plant in service — at original cost:		
Electric	$1,053,254	$ 902,660
Gas	123,359	122,204
Common, used in all services	36,659	33,138
Total	1,213,272	1,058,002
Less accumulated depreciation and amortization	301,139	264,802
Plant in service — depreciated	912,133	793,200
Construction work in progress	366,039	309,090
Plant held for future use	1,361	1,279
Utility plant — depreciated	1,279,533	1,103,569
Investments and Other Assets:		
Investments (at equity) in and receivables from subsidiaries	10,091	10,032
Other investments and notes receivable	7,797	6,752
Other physical property (less accumulated depreciation: 1976 $24,000; 1975 $20,000)	1,363	1,088
Total investments and other assets	19,251	17,872
Current Assets:		
Cash (Note 3)	2,580	1,171
Temporary cash investments	—	17,000
Special deposits and working funds (Note 3)	2,716	1,045
Accounts receivable:		
Service customers	33,774	26,898
Miscellaneous	6,054	6,924
Allowance for doubtful accounts	(1,236)	(400)
Materials and supplies (at average cost)	12,609	11,824
Fuel (at average cost)	23,797	21,436
Prepayments and other	7,902	7,854
Total current assets	88,196	93,752
Deferred Debits:		
Deferred interest	4,176	3,844
Unamortized debt issue costs	4,913	4,506
Other	6,921	5,315
Total deferred debits	16,010	13,665
Total	$1,402,990	$1,228,858

Liabilities	1976	1975
	(Thousands of Dollars)	
Capitalization:		
Common stock	$ 56,250	$ 47,500
Premiums and expenses	256,091	200,724
Retained earnings	152,069	131,311
Common stock equity	464,410	379,535
Preferred stock	168,561	168,561
Long-term debt, less current maturities	673,639	595,569
Total capitalization	1,306,610	1,143,665
Current Liabilities:		
Current maturities of long-term debt	3,013	8,500
Accounts payable	33,309	27,211
Advances from subsidiaries	1,100	1,368
Accrued taxes	28,966	25,318
Accrued interest	10,063	10,069
Accrued dividends on preferred stock	1,109	1,163
Customers' deposits, advances and other	10,949	3,183
Total current liabilities	88,509	76,812
Deferred Credits and Other:		
Customers' advances for construction	5,488	4,660
Deferred income taxes — accelerated amortization	973	1,183
Other	1,410	2,538
Total deferred credits and other	7,871	8,381
Commitments and Contingencies (Note 5)		
Total	$1,402,990	$1,228,858

See Notes to Financial Statements, including Note 1 as to significant accounting policies.

Statement of Changes in Financial Position

For the Years Ended December 31, 1976 and 1975

	1976	1975
	(Thousands	of Dollars)
Source of Funds:		
Funds from operations:		
Net income	$ 60,479	$ 56,496
Principal non-fund charges (credits) to income:		
Depreciation and amortization	36,621	32,793
Equity in unconsolidated subsidiaries	191	469
Deferred income taxes	(210)	(210)
Allowance for funds used during construction	(21,478)	(16,191)
Total funds from operations	75,603	73,357
Funds from external sources:		
Long-term debt	81,001	255,687
Preferred stock	—	29,160
Common stock	64,243	56,390
Total funds from external sources	145,244	341,237
Decrease in working capital*	22,740	—
Other items — net	—	4,802
Total source of funds	$243,587	$419,396
Application of Funds:		
Plant additions and replacements, excluding allowance for funds used during construction	$194,266	$167,912
Repayment of short-term borrowings — net	—	162,102
Repayment of long-term debt	8,500	38,250
Dividends on preferred and common stock	39,721	34,222
Other items — net	1,100	—
Increase in working capital*	—	16,910
Total application of funds	$243,587	$419,396
Increase (Decrease) in Working Capital*:		
Cash and temporary cash investments	$(15,591)	$ 15,826
Accounts receivable	5,170	3,512
Materials, supplies and fuel	3,146	5,763
Accounts payable and accrued expenses	(9,686)	(8,972)
Customers' deposits, advances and other	(7,766)	(625)
Other — net	1,987	1,406
Net increase (decrease)	$(22,740)	$ 16,910

*Excluding notes payable to banks, commercial paper and current maturities of long-term debt.

See Notes to Financial Statements, including Note 1 as to significant accounting policies.

Statement of Retained Earnings

For the Years Ended December 31, 1976 and 1975

	1976	1975
	(Thousands of Dollars)	
Retained earnings at beginning of year	$131,311	$109,037
Add — Net income	60,479	56,496
Total	191,790	165,533
Deduct — Dividends:		
Preferred stock	13,311	10,422
Common stock	26,410	23,800
Total	39,721	34,222
Retained earnings at end of year	$152,069	$131,311

See Notes to Financial Statements, including Note 1 as to significant accounting policies.

Long-Term Debt

December 31, 1976 and 1975

	1976	1975
	(Thousands of Dollars)	
First Mortgage Bonds:		
2¾% series due July 1, 1976	$ —	$ 8,500
3⅛% series due December 1, 1977	2,500	2,500
3% series due April 1, 1979	4,000	4,000
2¾% series due February 1, 1980	5,000	5,000
9.80% series due June 1, 1980	75,000	75,000
2⅞% series due December 1, 1980	6,000	6,000
9.50% series due February 15, 1982	100,000	100,000
3½% series due February 1, 1983	14,500	14,500
3½% series due November 1, 1983	5,723	5,723
3¼% series due March 1, 1984	15,000	15,000
5⅛% series due October 1, 1987	15,000	15,000
4.70% series due March 1, 1989	20,000	20,000
4.80% series due November 1, 1991	35,000	35,000
4.45% series due June 1, 1992	25,000	25,000
4.40% series due December 1, 1992	25,000	25,000
4.50% series due September 1, 1993	15,000	15,000
6.25% series due September 1, 1997	25,000	25,000
10.625% series due November 15, 2000	75,000	75,000
7.45% series due March 15, 2002	60,000	60,000
6.20% series due April 1, 2004	50,000	50,000
Less certain securities held by trustee	—	(26,271)
Unamortized discount and premium	(802)	(883)
Total First Mortgage Bonds	571,921	554,069
Unsecured Notes Payable:		
Due September 1, 1979 (a)	50,000	50,000
Capitalized Lease Obligation (b)	54,731	—
Total Long-Term Debt	676,652	604,069
Less current maturities:		
2¾% series due July 1, 1976	—	(8,500)
3⅛% series due December 1, 1977	(2,500)	—
Capitalized lease obligation	(513)	—
Total Long-Term Debt Less Current Maturities	$673,639	$595,569

(a) $30,000,000 bears interest at 114% of prime rate plus ¼ of 1% to September 1, 1977, then 114% of prime rate plus ½ of 1%. $20,000,000 bears interest at a percentage of prime rate to September 1 in the year indicated as follows: 1977, 120%; 1978, 121%; 1979, 122%. The actual interest rate to final maturity of these loans is not to exceed 7½% per annum; payments in excess of this amount are carried as deferred interest.

(b) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) of a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semi-annual payments of $2,299,340 through June 1983 and then $2,581,850 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 $54,404,530; accumulated amortization at December 31, 1976 was $1,082,762.

Aggregate annual payments which will be due on long-term debt and for sinking fund requirements through 1981 are as follows: 1977, $3,013,000; 1978, $552,000; 1979, $54,594,000; 1980, $86,639,000; 1981, $3,688,000. Other sinking fund requirements through 1981 for the outstanding First Mortgage

(Notes continued next page)

Bonds (which may be met by property additions) will be as follows: 1977 and 1978, $2,702,230; 1979, $2,662,230; 1980, $2,552,230; 1981, $2,552,230. As allowed in the bond indentures, requirements of this type have in the past been satisfied by certification of property additions of 1⅔ times the amount stated and the Company expects to meet similar requirements in that manner in the future. For sinking fund payment requirements and redemptions at the option of the holders on cumulative preferred stock, see Capital Stock.

Substantially all utility plant is subject to the lien of the First Mortgage Bonds. The indenture respecting the First Mortgage Bonds includes provisions which would restrict the payment of dividends on Common Stock under certain conditions which did not exist at December 31, 1976.

Capital Stock

December 31, 1976 and 1975

Class	Number of Shares			Par Value			Call Price Per Share
	Authorized	Outstanding		Per Share	Outstanding (Thousands of Dollars)		(Before Adding Accumulated Dividends)
		1976	1975		1976	1975	
Common Stock	30,000,000	22,500,000	19,000,000	$ 2.50	$ 56,250	$ 47,500	
Cumulative Preferred Stock:							
$1.10 preferred	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred:	1,000,000						
$2.40 series A ...		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 series C ..		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 series D ..		200,000	200,000	50.00	10,000	10,000	(b)
$3.25 series E ...		320,000	320,000	50.00	16,000	16,000	(c)
Serial preferred:	2,000,000						
$8.50 series F		210,000	210,000	100.00	21,000	21,000	(d)
$8.50 series G ...		90,000	90,000	100.00	9,000	9,000	(d)
$10 series H		400,000	400,000	100.00	40,000	40,000	(e)
$10.70 series I ...		300,000	300,000	100.00	30,000	30,000	(f)
Serial preferred(a) ..	3,000,000	—	—	25.00	—	—	
Total	6,535,000	2,374,199	2,374,199		$168,561	$168,561	

(a) On April 22, 1976, the stockholders of the Company approved amendments to its Articles of Incorporation authorizing 3,000,000 shares of Serial Preferred Stock, $25 par value.

(b) From $51.00 through February 29, 1980; then to $50.50 thereafter.

(c) From $52.50 through February 28, 1978; then to $51.50 through February 28, 1983; then to $51.00 thereafter.

(d) Redeemable at par after May 30, 1979 (series F) or May 30, 1982 (series G) at the option of either the Company or the holders. Both series are also subject to redemption at par at the demand of the holders prior to the foregoing dates under certain conditions, including a condition that would occur if dividend payments on preferred stock (including series F and G) of the Company exceed its "earnings and profits" for federal income tax purposes (such condition not having existed on December 31, 1976). Sinking fund provisions applicable to the two series require the retirement of a total of 12,000 shares at par semiannually commencing June 1, 1979 (representing annual payments of $2,400,000).

(e) From $109.30 through September 1, 1977 to par after September 1, 2002. Not refundable at a lower cost of money through September 1, 1984. Applicable sinking fund provisions require the retirement of 16,000 shares at par annually commencing September 1, 1979 (representing annual payments of $1,600,000).

(f) Not redeemable prior to December 1, 1985 through certain refunding operations; otherwise at $110.70 through November 30, 1980 to $101.00 after November 30, 1990. Applicable sinking fund provisions require the

retirement of 15,000 shares at par annually commencing December 1, 1981 (representing annual payments of $1,500,000). The Company may, but is not required to, redeem an additional 15,000 shares at par on December 1 in any year beginning in 1981.

In the opinion of counsel, amounts paid in any redemption of capital stock funded other than with the proceeds of a concurrent new issue of capital stock would reduce the amount of retained earnings available under Arizona law for the payment of dividends. Because of the option of the holders thereof to require redemption of the series F and G shares as indicated in note (d) above, the Company considers that a portion of its retained earnings which is equal to the aggregate par value of such series ($30,000,000) is unavailable for dividend payments.

Capital stock sales and changes in premiums and expenses during the years ended December 31, 1976 and 1975 were as follows (dollars in thousands):

	Common Stock		Cumulative Preferred Stock		Premiums and (Expenses) — Net
Description	Number of Shares	Par Value Amount	Number of Shares	Par Value Amount	
Balance, December 31, 1974	15,000,000	$37,500	2,074,199	$138,561	$155,472
Common Stock	4,000,000	10,000	—	—	46,168
Cumulative Preferred Stock, $10.70 series I	—	—	300,000	30,000	(916)
Balance, December 31, 1975	19,000,000	47,500	2,374,199	168,561	200,724
Common Stock	3,500,000	8,750	—	—	55,367
Balance, December 31, 1976	22,500,000	$56,250	2,374,199	$168,561	$256,091

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

a. System of accounts — The accounting records of the Company are maintained in accordance with the uniform system of accounts prescribed by the Federal Power Commission and used by the Arizona Corporation Commission.

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

(Notes continued next page)

construction are credited to plant cost.

Depreciation is provided on a straight-line basis at rates authorized by the Arizona Corporation Commission effective January 1, 1975, generally 2.80% to 4.00% for electric plant, 3.25% for gas plant, and 3.00% to 15.50% for common plant.

c. Allowance for funds used during construction — In accordance with the uniform system of accounts, an allowance for funds used during construction is included in construction work in progress and credited to income (but does not represent cash earnings) using a composite rate (8% in 1976 and 1975), applied to construction work in progress, which assumes that funds used for construction were provided by borrowings, preferred stock and common equity. This accounting practice results in the inclusion in utility plant in service of a cost of funds used during construction as considered appropriate by regulatory authorities for rate making purposes.

d. Subsidiaries — The Company's investment in its subsidiaries is stated at equity. The subsidiaries are not consolidated inasmuch as their assets, revenues, net income and retained earnings are not significant in relation to those of the Company.

e. Bond premium or discount and issue expenses — Bond issuance premium or discount and related expenses are amortized over the lives of the issues to which they pertain.

f. Income taxes — The Company uses accelerated depreciation methods for income tax purposes. The reductions in income taxes resulting from this practice and from allowable investment tax credits are reflected currently in income, together with reductions arising from timing differences respecting certain other items of income and expense reported differently for income tax and financial purposes. Such accounting methods are in accordance with orders or practices of the Arizona Corporation Commission for rate making purposes.

Income tax reductions relating to the five-year amortization of emergency facilities in previous years were deferred, with the deferred amount being restored to income over a twenty-year period.

Income taxes included in utility operating expenses are reported before tax reductions due to interest expense applicable to construction work in progress; the effects of such reductions are included in other income since construction work in progress is not considered utility operating property until placed in service. Income taxes related to non-utility operations are also reflected in other income.

The Company and its subsidiaries file consolidated tax returns, and income taxes are allocated to the several entities based on the taxable income or loss of each.

g. Employees' pension plan — The Company's policy is to accrue and fund the current and prior service costs of its pension plan. Prior service costs are amortized over a fifteen year period.

h. Revenues and recognition of certain costs — Operating revenues are recorded on a monthly cycle billing basis. Timing differences resulting from fuel adjustment clauses are reflected by deferring purchased power and fuel costs, or revenues, to be matched against revenues or costs in the subsequent period. The estimated cost of gas purchased from the supplier but not billed to gas customers is similarly deferred. Under its approved rate schedules, the Company may pass on to its customers increases in specified taxes, purchased power and fuel costs, and resale gas costs.

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

Certain reclassifications have been made to the prior year to conform to current year classifications.

2. Income Tax Expense

Details of factors related to income taxes were as follows (see Note 1):

	Year Ended December 31,	
	1976	1975
	(Thousands of Dollars)	
Federal and state income tax expense at statutory rates	$31,435	$29,704
Increases (reductions) in taxes resulting from:		
Timing differences:		
Tax over book depreciation	(5,901)	(7,163)
Allowance for funds used during construction capitalized	(10,884)	(8,205)
Sale of combined cycle plant	3,478	—
Other — principally taxes, pensions and other items capitalized	(5,758)	(4,630)
Other items	194	(1,006)
Investment credit	(10,800)	(6,368)
Taxes currently payable	1,764	2,332
Deferred taxes restored	(210)	(210)
Total federal and state income taxes	$ 1,554	$ 2,122
Federal and state income taxes included in:		
Operating expenses	$ 6,497	$ 6,891
Other income (credit)	(4,943)	(4,769)
Total	$ 1,554	$ 2,122
Taxes currently payable (refundable):		
Federal	$ (965)	$ 762
State	2,729	1,570
Total	$ 1,764	$ 2,332
Deferred taxes:		
Federal	$ (201)	$ (201)
State	(9)	(9)
Total	$ (210)	$ (210)

The Company has approximately $3,200,000 of unused investment tax credit which can be carried forward through 1983.

3. Short-Term Borrowings and Compensating Balances

The Company had the following bank lines of credit (all unused) as of December 31: 1976, $107,000,000; 1975, $106,600,000. Bank lines which expired at the end of 1976 were renewed or replaced by new one-year arrangements at the same amounts.

Average aggregate short-term borrowings outstanding during 1976 and 1975 were $16,133,000 and $80,838,000 respectively; weighted daily average interest rates on such amounts were 6.75% and 8.35% respectively. The maximum amount of short-term borrowings outstanding at any month end was $46,000,000 in 1976 and $179,029,000 in 1975.

Compensating balances required at banks, but which were not legally restricted, were generally 10% of the line plus 5% (10% in some instances) of borrowings. Substantially all cash shown in the balance sheet is considered compensating balances.

4. Pension Plan

The Company's pension plan covers virtually all employees. Contributions to the plan were as follows: 1976, $6,086,000; 1975, $4,933,000. The liability for unfunded prior service costs at December 31, 1976 was $2,076,138 which is expected to be completely funded by 1981. *(Notes continued next page)*

5. Commitments and Contingencies

The Company's 1976 and 1975 income includes revenues of approximately $9,300,000 and $4,700,000, respectively, under a fuel adjustement clause and interim rate increase applicable to wholesale sales that may be refundable depending on the outcome of pending FPC proceedings. Total FPC revenues subject to refund at December 31, 1976, aggregated approximately $16,500,000.

The Company was granted an interim refundable rate increase effective October 1, 1976 by the Arizona Corporation Commission pending its decision in a new permanent rate hearing scheduled to begin in February, 1977. The Company's 1976 income includes revenues of approximately $9,300,000 relating to the interim increase.

The Company is involved in certain proceedings more fully described under "Legal Matters."

Based upon the opinion of its counsel, the Company does not believe that ultimate resolution of the above matters will have a material effect on the accompanying financial statements.

The Company has significant purchase commitments in connection with its continuing construction program. The construction program is currently estimated at $273,000,000 for 1977. Annual rentals under non-capitalized, non-cancellable leases were not material.

6. Replacement Cost Data (Unaudited)

The impact of the rate of inflation experienced in recent years and other factors have resulted in replacement costs of productive capacity that are significantly greater than the historical costs of such assets reported in the Company's financial statements. In compliance with reporting requirements, estimated replacement cost information will be disclosed in the Company's annual report to the Securities and Exchange Commission on Form 12-K.

7. Selected Quarterly Information (Unaudited)

A summary of 1976 quarterly financial data is as follows:

	Three Months Ended			
	March 31	June 30	Sept. 30	Dec. 31
	(Thousands of Dollars)			
Operating Revenues	$88,675	$92,674	$111,630	$101,800
Operating Income	14,168	13,216	30,106	25,551
Net Income	10,641	6,169	23,722	19,947
Earnings for Common Stock	7,313	2,841	20,394	16,620
Earnings Per Average Share of Common Stock	$ 0.38	$ 0.15	$ 1.07	$ 0.86

Accountants' Opinion

Haskins & Sells, Certified Public Accountants
Phoenix, Arizona

Arizona Public Service Company:

We have examined the balance sheets of Arizona Public Service Company as of December 31, 1976 and 1975 and the related statements of income, retained earnings and changes in financial position, and schedules of capital stock and long-term debt for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the above-mentioned financial statements and schedules present fairly the financial position of the Company at December 31, 1976 and 1975 and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Haskins & Sells

February 11, 1977

Summary of Operations

	1976	1975	1974	1973	1972
		(Thousands of Dollars)			
Operating Revenues	$ 394,779	$ 359,747	$ 273,599	$ 224,956	$ 188,436
Operating Expenses:					
Operating and maintenance expenses	215,500	196,475	153,006	116,864	94,710
Depreciation and amortization	36,621	32,793	26,398	23,529	21,409
Taxes*	59,617	56,414	38,413	34,032	31,353
Total	311,738	285,682	217,817	174,425	147,472
Other Income*	26,301	22,003	17,065	9,097	5,013
Interest Deductions	48,863	39,572	35,890	28,361	20,399
Net Income	$ 60,479	$ 56,496	$ 36,957	$ 31,267	$ 25,578
Ratio of Earnings to Fixed Charges	2.25	2.45	1.94	2.20	2.37
Preferred Dividend Requirements	$ 13,311	$ 10,422	$ 6,258	$ 3,551	$ 3,551

*Federal and State income taxes are included in Other Income and in Taxes. Total income tax expense (credit) was as follows (in thousands): 1976, $1,554; 1975, $2,122; 1974, $(2,664); 1973, $3,514; 1972, $3,283.

Common Stock Data:					
Earnings for common stock	$ 47,168	$ 46,074	$ 30,699	$ 27,716	$ 22,027
Book value per share	$ 20.64	$ 19.98	$ 20.13	$ 20.74	$ 19.99
Earnings per average share of common stock outstanding	$ 2.47	$ 2.60	$ 2.34	$ 2.63	$ 2.29
Dividends paid per share	$ 1.39	$ 1.36	$ 1.36	$ 1.21	$ 1.12
Shares of common — year end	22,500,000	19,000,000	15,000,000	12,500,000	10,500,000
— average	19,105,191	17,739,726	13,102,740	10,527,397	9,612,022
Number of common shareholders	56,011	56,003	43,497	35,687	35,150

Comments on the Summary of Operations

Increases in operating revenues and expenses reflect increases in unit sales of electricity. Such increases have slowed in recent periods because of customer resistance to higher prices of energy and effects of adverse economic conditions. Unit sales of gas are substantially affected by weather conditions, but generally may be expected to decline in future periods with increased service curtailments by the Company. Operating revenues also reflect rate increases (some of which are subject to refund) and effects of adjustment clauses.

In addition to the effect of volume increases on operating expenses, the cost of fuel for the generation of a given amount of electricity has risen sharply, as indicated on pages 4, 5. Unit costs of purchased gas have increased significantly. Variations in purchased power and interchange (net) reflect varying degrees of availability of power from other sources and varying needs of the Company to augment its own generating sources from time to time; large quantities of low-priced power became available and were purchased in 1975 by the Company in partial substitution for operation of its own generating facilities. The increase in maintenance expense is discussed on page 4. The start of the five-year amortization of the Kaiparowits power project (see page 9) and an expansion of the allowance for doubtful accounts receivable (see page 18) contributed to the increase in administrative, general and other expense in 1976.

(continued next page)

Operating expenses attributable to depreciation and amortization and to taxes other than income (primarily consisting of property taxes) increase with the size of the Company's utility plant. In addition, depreciation rates were increased as of January 1, 1975. Fluctuations in income tax expense are shown in Note 2 of Notes to Financial Statements.

The allowance for funds used during construction included in Other Income is primarily a function of the amount of construction work in progress during a given period. Income taxes included in Other Income primarily reflects tax benefits from interest attributable to construction work in progress that is capitalized for reporting purposes.

The substantial increase in interest on long-term debt since 1974 reflects large amounts of new debt at relatively high interest rates. Recent issues of preferred stock (giving rise to the increased dividend requirements) and common stock (giving rise to the increased average number of shares outstanding) are summarized on page 23.

The Company's net income and its earnings for common stock represent composites of cash and non-cash items (see the Statement of Changes in Financial Position) and, in part, reflect accounting practices unique to regulated public utilities.

NOTE: A detailed Statistical Report for Financial Analysis 1966-1976 is available on request. Direct inquiries to the company treasurer, P.O. Box 21666, Phoenix, Arizona 85036.

Other Financial and Operating Statistics

	1976	1975	1974	1973	1972
		(Thousands of Dollars)			
Capitalization:					
Long-term debt	$ 673,639	$ 595,569	$ 340,976	$ 369,609	$ 377,223
Preferred stock	168,561	168,561	138,561	68,561	68,561
Common equity	464,410	379,535	302,009	259,249	209,886
Total	$ 1,306,610	$ 1,143,665	$ 781,546	$ 697,419	$ 655,670
Utility Plant — Gross	$ 1,580,672	$ 1,368,370	$ 1,190,399	$ 1,003,218	$ 856,827
Utility Plant — Depreciated	1,279,533	1,103,569	955,399	791,578	668,871
Number of Employees at Year End	4,042	3,731	3,898	3,899	3,545
Average Wage per Hour	$ 7.44	$ 6.82	$ 6.16	$ 5.61	$ 5.32
Electric:					
Electric resources (kw)	2,790,700	2,568,700	2,343,600	2,191,000	2,045,300
Peak load (kw)	2,190,900	2,068,300	2,032,000	1,812,700	1,658,600
Electric sales — total (mwh)	9,606,571	8,892,570	8,692,304	8,098,712	7,198,947
Number of customers at year end	342,059	331,382	323,094	308,643	287,680
Gas:					
Total gas sales (m therms)	491,007	526,659	518,999	547,068	506,574
Number of customers at year end	339,265	336,839	334,908	328,406	313,928

(Symbol: AZP)
Common stock of the Company and the $10.70 Cumulative Preferred Stock, Series I, are listed for trading on the New York Stock Exchange. Common stock is also listed on the Pacific Stock Exchange.

First National Bank of Arizona, Phoenix, Arizona
Irving Trust Company, New York, N.Y. (Common stock only)

The Valley National Bank of Arizona, Phoenix, Arizona
Irving Trust Company, New York, N.Y. (Common stock only)

Snell & Wilmer, Phoenix, Arizona

Haskins & Sells, Phoenix, Arizona

A Prospectus describing this plan for holders of the company's Common Stock is available to shareholders upon request. Write: Office of the Secretary, Sta. 1240, at the General Offices address below.

A copy of our Annual Report to the Securities and Exchange Commission, Form 12-K, will be available after April 30, 1977 without charge, upon written request of shareholders. Write: Office of the Secretary, Sta. 1245, at the address below.

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