ARKANSAS POWER & LIGHT COMPANY

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Performance Highlights

	1985	1984	% Increase
Revenues from operations (000)	**$1,364,786**	$1,307,683	4
Operation and maintenance expenses (000)	**$ 904,753**	$ 806,771	12
Allowance for funds used during construction (000)	**$ 10,470**	$ 24,327	(57)
Net income (000)	**$ 110,068**	$ 143,367	(23)
Capitalization—end of year (000) (investment required to provide service)	**$2,326,877**	$2,257,973	3
Construction expenditures (000)	**$ 172,013**	$ 205,050	(16)
Total utility plant investment—end of year (000)	**$3,606,520**	$3,440,991	5
Customers:			
Electric (end of year)	**564,441**	555,694	2
Gas (end of year)	**61,577**	65,687	(6)
Energy sales to retail customers:			
Electric (millions of kilowatt-hours)	**14,563**	15,719	(7)
Natural gas (millions of cubic feet)	**9,376**	12,053	(22)
Employees (end of year)	**5,299**	5,311	–
Peak demand (megawatts)	**3,681**	3,650	1
Average use per customer (kilowatt-hours):			
Residential	**9,804**	9,801	–
Commercial	**55,342**	53,297	4
Average use per customer (mcf):			
Residential	**86**	98	(12)
Commercial	**347**	376	(8)

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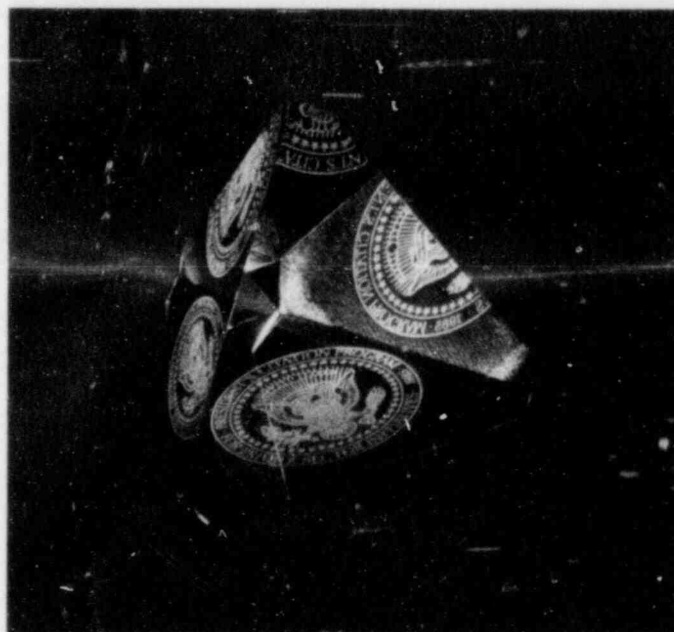


President Reagan honors the Company. *See Page 5.*

Arkansas Power & Light Company successfully completed the most pivotal year of its 72-year corporate life in 1985.

The year was marked by the Arkansas settlement of the Grand Gulf 1 issue—an issue that presented the Company with the greatest public, regulatory, financial, and political challenge it had ever faced.

The year was also significant because it was the year in which our Company began positioning itself to meet the new competitive environment that will dominate our industry in the coming years.

Considering the fact that the Company was facing possible insolvency by year end, our average return on common equity of 11.9% reflected a solid financial performance. The quality of our earnings was evidenced by the reduction of non-cash Allowance for Funds Used During Construction which was only 9.5% of net income in 1985.

The first nine months of 1985 were dominated by interminable regulatory proceedings and public debate concerning the Federal Energy Regulatory Commission's proceedings regarding the allocation among the operating companies of the Middle South Utilities System of Unit 1 of the Grand Gulf nuclear plant. In June, the FERC reached a decision allocating 36% of the unit to AP&L. The Company's position is that it should not have been allocated any of Grand Gulf 1 because of the 1981 Reallocation Agreement with the other operating companies of the Middle South System. That position was not upheld by the FERC.

The Arkansas Public Service Commission hearing on rates to reflect the FERC decision set off a fire storm of public, political, and regulatory debate. The issue was finally resolved in Arkansas in early September when the Arkansas Attorney General, the PSC Staff, other intervenors and a group of our large industrial customers, hammered out a phase-in agreement that could be accepted by all parties. The Arkansas Settlement Agreement was later approved by the Arkansas Public Service Commission. Although none of the parties to the proceedings, including ourselves, were completely happy with the settlement achieved, I believe that time will prove that the sacrifices made by all parties resulted in the best possible solution to a highly emotional and controversial issue.

As comprehended by the Arkansas Settlement Agreement, Arkansas retail rates increased $81.3 million on September 9—$35.5 million to cover Grand Gulf 1's first-year phase-in plan cost, and $45.8 million to cover cost increases in other aspects of doing business. This represented about a 10% increase, with 4.5% attributable to Grand Gulf 1. (Full details of the Arkansas Settlement Agreement can be

found in Note 2 to the Financial Statements—"Rate Matters" on page 17.)

We currently are appealing the FERC allocation decision as are all other Arkansas parties in the case.

We believe the Arkansas Settlement Agreement was important for several reasons. While it recovers the cost for Grand Gulf 1, it does so without having to burden our customers with a massive, sudden rate increase. Additionally, the Arkansas Settlement Agreement called for the termination of a number of pending court proceedings thus eliminating much expense and time in court. And finally, the Arkansas Settlement Agreement removes the cloud of uncertainty that was impacting the state's efforts in the area of economic development.

We still have Grand Gulf 1 proceedings remaining before the Missouri Public Service Commission and in the Federal Courts. We expect those to be concluded in the near future.

Without a doubt, we are rapidly moving into a new era for electric utilities. One only has to examine what is happening in the area of competitive fuel supplies, cogeneration, etc., to know that we can never return to the days of business as usual.

At AP&L, we welcome the new era. Our coal and nuclear units give us a solid base of American energy sources to meet future needs well into the 21st Century.

We have an aggressive marketing effort under way, and as you'll see in the adjoining section of this report, it is geared to meet this new competitive market facing electric utilities.

We also know that to stay competitive we have to continue to take a hard and candid look at our own operations. We must hold down the price of our product.

Our goal at AP&L is simple—no more rate increases for at least four years except those contained in the Arkansas Settlement Agreement to cover Grand Gulf 1 costs. I recognize how tough it is going to be to meet that goal. But we believe this is a time when we must extend our corporate efforts to the utmost, and we must set goals that will require above average performance by every employee. I quite candidly don't know if we will achieve the goal or not; however, I have no doubts about our commitment to trying.

We cut expenditures by over $55 million in 1985 as compared to our budgeted level of spending, and we will eliminate more than that in 1986.

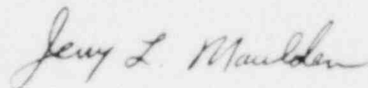
We are making progress in reducing our workforce. We've launched a new Workforce Analysis Program that will determine the number of employees we need for the future. I fully expect after this study is completed in mid-year, further employee reductions can be made. And just as importantly, this study will insure our human resources are deployed where they are most critically needed.

There is little doubt that events of recent years forced us to place a preponderance of our attention on internal financial crisis. Oftentimes this resulted in the customer's perception that our only concerns were about ourselves. We recognize this and are recommitting our Company to improving customer relations. We know full well that we can't survive long term unless we can earn the good will of our customers.

I do not minimize the challenges ahead for our Company. My confidence that we can meet those challenges is grounded in large part in my knowledge of our employees. The Grand Gulf 1 controversy tested the mettle of our employees, and they never let the level of public debate, which was unprecedented, deter them from meeting our service obligations. Hundreds of them took aggressive roles in telling the Company story. Their effective and loyal service is a key reason for my confidence in the future.

I do not believe it overstates our situation to say we face a revolutionary change in our operating philosophy. We must recognize that competition will determine the future price of our product. All of our employees must understand this new competitive environment and their stake in it. We must renew our dedication to our Company and our customers, pledging to do all we can to help ensure the reliability of electric service at the lowest price possible.

Arkansas Power & Light Company will take advantage of the opportunities that either evolve in the marketplace or those we create. In 1985, we demonstrated our abilities to effectively and successfully respond to very real threats to our corporate survival. The determination, dedication and innovation we displayed during this period will greatly assist us in reaching our goals and objectives in 1986 and beyond.



Jerry L. Maulden
President & Chief Executive Officer

Choices. Flexibility. Stability. These are the key words that best describe the thrust of the Company's new industrial marketing program which in its first full year of operation began paying dividends in the form of increased customer optimism toward the future of electric energy in Arkansas.

Five-year incentive rate contracts—just one aspect of the multi-faceted program—signed in the last six months of 1985 will help generate more than 55 megawatts of new load, increase annual billings by $11.4 million and will add 1,671 employees to the Arkansas industrial work force. These results came from 56 incentive contracts signed by 45 industrial customers, most of which will become effective in 1986. The incentive rate contracts were approved by the Arkansas Public Service Commission in October 1985 and explained to the industrial community through a series of well-attended seminars.

The largest portion of the $11.4 million in additional revenues, $6.6 million, will come from the expansion of existing industrial facilities, an indication that the Company was successful in helping economic growth within the state. The incentive rate contracts also proved attractive to new industry, generating $2.6 million additional revenue, and encouraged modernization of existing facilities to the tune of $2.2 million additional revenue. While there is no doubt that some of these industrial additions and expansions would have occurred anyway, the incentive contracts were a factor.

In essence, the incentive rates are designed to give an industrial customer an "up front" price break for adding a certain amount of permanent electric load or temporary load. The price break declines at a pre-determined level annually over the five-year contract period so that at the end of the contract period the customer is paying the prevailing electric rate. The incentives were designed to offer electricity at reduced rates during those times when the variable cost of producing electricity is lowest. This type of incentive rate structure is appealing to those industries concerned with cash flow in the early years.

New and expanded industry creates new jobs which, in turn, benefits commercial and residential electric energy sales. Also, a marketing program that helps strengthen the state's industrial base is healthy for residential customers because, otherwise, they would have to pick up a larger portion of the fixed costs of the new base-load nuclear and coal generating facilities.

The basic goal of the marketing program is to increase sales by making maximum use of existing base-load coal and nuclear units and their lower-cost energy. The large capital costs of these units are fixed, regardless of demand, so each increment of energy sold which is produced by one of these units reduces the average fixed cost per unit. A key feature of this program is to benefit all AP&L customers, not just those who receive the price incentives, by reducing the unit cost of electricity for all customers.

Other marketing opportunities currently being explored for possible consideration by the Commission include a cooperative plan between the Company and industrial customers with cogeneration possibilities. This would give the Company an investment alternative in the future to building large central station power plants beyond the Company's current planning horizon.

One of the options under study for both new industrial prospects and those existing industries that want to expand is a five-year contract that would guarantee the industry a pre-determined rate structure. This is designed to address the problem of plant management's hesitancy to commit to new plant or needed expansions because of uncertainty over the amount and timing of future rates.

NIBCO employees are happy that its plant is staying in Blytheville.

Because of flexibility in dealing with industrial customers, and the ability to provide them with the predictability and stability they need, the marketing program is considered an ideal complement to the state's economic development program. The marketing strategy, which evolved after much study, is geared toward a total commitment to becoming a working partner with each industrial customer. The goal is to understand the specific needs of a given industry so well that Company representatives can use their electric energy expertise to zero in on specific problems and solve them.

Customer choices. Flexibility. Stability. The task is to blend these elements into a true working partnership between the Company and its customers to their mutual benefit.

The flexibility that permits custom-tailored marketing is due largely to the Company's current load shape and to the fixed-cost nature of base-load generating units. Because the Company's nuclear and coal plants provide virtually all required capacity during normal times, the Company has energy to sell at any time. In addition, during the spring and

late fall, low-cost, base-load energy from those plants is available 24 hours a day. Finally, base-load energy is available year-round to sell during certain hours of the day.

One good example of why the marketing program is being well received by state government is provided by NIBCO, a Blytheville manufacturing concern that was seriously considering shutting down its Arkansas plant and moving its manufacturing operation overseas. One reason these jobs weren't permanently lost to overseas competition is the Company's willingness to work closely with the firm in designing an incentive rate contract to provide competitive rates. It helped shift the scales in favor of Blytheville instead of an overseas location.

While the industrial sector has received a lot of attention, the marketing effort remains a broad-based endeavor. Last year saw a 15 percent increase in heat pump sales for residential and commercial applications and renewed emphasis on nightwatcher sales. The energy-efficient concepts the Company pioneered with the all-electric "Arkansas Energy Idea Home" continue to be popular with consumers and there are now a total of 14,453 structures—homes, apartments and mobile homes—in the Company's service area.

The marketing program is in its infancy, but it is considered an important step toward developing new business opportunities in a changing utility marketplace.

AP&L Receives Prestigious President's Citation Award for Private Sector Initiatives

Arkansas Power & Light Company's dedication to "exceptional community assistance" earned it the 1985 President's Citation Award for Private Sector Initiatives. President Reagan presented a crystal medallion and certificate to AP&L President Jerry L. Maulden at a ceremony in June in the White House Rose Garden.

AP&L was the only electric utility and the only Arkansas business among 30 businesses and organizations chosen nationally to receive the prestigious award.

In praising the recipients for the commitment they have shown to their communities, President Reagan said, "Only by working together and finding some private solutions to public problems can we restore the strong balance needed for the future health of our nation. Our country is great because it is built on principles of self-reliance, opportunity, innovation and compassion for others."

AP&L was honored for its Minority Business Development Program and its Helping Hands Programs, specifically Project Deserve and Project Conserve. The Minority Business Development Program helped the Company increase its transactions with minority enterprises from $200,000 in 1983 to about $5 million in 1985. Project Deserve, which operates in conjunction with the American Red Cross, helps the elderly and handicapped pay their electric bills and make emergency repairs to heating and cooling equipment. More than $625,000 has been contributed by AP&L customers, employees and stockholders to this program since its inception in 1982. Project Conserve has assisted in the weatherization of more than 1,330 homes of low-income persons to reduce their energy costs; the program also includes the Company's support of the Watershed self-improvement organization to College Station, a low-income community in Central Arkansas.

These and other community service activities are designed to help AP&L fulfill its objective of "Helping Build Arkansas and Southeast Missouri."

President Reagan presents award to Jerry L. Maulden (left).

Board of Directors

John A. Cooper, Jr.

The president of Cooper Communities, Inc., the firm headquartered at Bentonville that pioneered the concept of "graduated retirement," he has varied business interests but takes special pride in his involvement in programs to better the civic, cultural and political life of northwest Arkansas.

Cathy Cunningham

An active business woman, with a deep appreciation of Helena's historic past, she is noted for using her expertise in real estate, securities and insurance to convert neglected historic structures into attractive inns and business offices, thereby saving them from ruin.

John J. Flake

A real estate professional, this Little Rock native is chairman of the board of Flake & Company, a real estate development firm, who finds time for a wide range of personal interests, including the Arkansas Repertory Theatre and the Greater Little Rock Chamber of Commerce.

M.L. Gernert

President of Arkansas Eastman Company at Batesville, he is a chemical engineer with broad experience in manufacturing and industrial management and serves in many state and local organizations devoted to economic development.

Advisory Directors

All Past Directors of the Company

Lawrence Blackwell
Attorney
Pine Bluff, Arkansas

Richard C. Butler
Past Chairman of the Boards of Commercial National Bank and Peoples Savings & Loan Association
Little Rock, Arkansas

L.C. Carter
Past President
Riceland Foods, Retired
Stuttgart, Arkansas

George K. Reeves
Partner, Ward & Reeves
Caruthersville, Missouri

Reeves E. Ritchie
Past President and Chairman of the Board
Arkansas Power & Light Company, Retired
Little Rock, Arkansas

Dr. Marshall T. Steel
Past President
Hendrix College, Retired
Pine Bluff, Arkansas

R.E.L. Wilson
Chairman of the Board and Chief Executive Officer
Lee Wilson & Company
Wilson, Arkansas

Edwin Lupberger

The chairman, president and director of Middle South Utilities, Inc., is a seasoned 23-year professional in the electric utility industry and is widely known for his financial expertise. He is chairman of the Edison Electric Institute's Finance Division.

Jerry L. Maulden

Long noted for his service in organizations devoted to Arkansas economic development, the president and chief executive officer of Arkansas Power & Light is also particularly interested in development opportunities for youths and minority business enterprises. He is on the National Board of Trustees – Boys Clubs of America and the National Board of Directors of the NAACP.

Raymond P. Miller, Sr., M.D.

This Cotton Plant native is a specialist in internal medicine and, in addition to his private practice, is assistant clinical professor at the University of Arkansas School of Medicine. A champion of quality education, he served a 10-year term on the University of Arkansas Board of Trustees.

Woodson D. Walker

A partner in the law firm of Woodson Walker Associates, P.A., at Little Rock, he also has a varied background in history, economics and journalism and is currently serving as chairman of the Arkansas Department of Correction. He is president-elect of the Pulaski County Bar Association and a member of the Boards of Visitors of the University of Arkansas at Little Rock and the University of Minnesota.

Richard P. Herget, Jr.

Born into a pioneering insurance family at Paragould, he is now a senior vice president of one of the world's largest insurance firms, Marsh & McLennan, Inc., with offices at Little Rock. The author of three books on the operation and management of insurance agencies, he is also active in the state Democratic Party.

Tommy Hillman

A "farmer's farmer" who has worked in every aspect of agri-business, he is president of Winrock Farms, Inc., and vice-chairman of Riceland Foods. He is also active in Carlisle civic programs while serving on the Lonoke County Farm Bureau Board of Directors.

Kaneaster Hodges, Jr.

An attorney, farmer, lay minister in the United Methodist Church and U.S. Senator (1977-79), this Newport native excels in many fields and is also a leader in the state's wildlife conservation movement and a former member of the Arkansas Game and Fish Commission.

Hal E. Hunter, Jr.

This New Madrid, Missouri native is one of Missouri's most distinguished attorneys and is the senior member of the firm of Hunter and Hunter. Active in state Democratic politics, he has been city attorney at New Madrid since 1946 and prosecuting attorney of New Madrid County since 1952.

Roy L. Murphy

The chairman and president of Mid South Engineering Company at Hot Springs first put his education in mechanical engineering and industrial management to work as a leader in the forest products industry, but is now active in many varied business activities. He is also involved in chamber of commerce work and his interest in education led to service on the University of Arkansas at Little Rock's Board of Visitors.

William C. Nolan, Jr.

Radio broadcast executive and timber corporation entrepreneur, this attorney in the El Dorado law firm of Nolan & Alderson has many diverse business and social interests. He is also very interested in state government and was a delegate to the Arkansas Constitutional Convention of 1970.

Robert D. Pugh

Banker, businessman and farmer, he is a recognized leader in agriculture in the Mid-South from his position as chairman of the Portland Gin Company, a family diversified farming operation. He also plays an active role in education as chairman of the University of Arkansas' Board of Trustees.

Mary Anne Stephens

Widely known for her work in development of the arts in Arkansas and for her commitment to excellence in education, she is on the International Advisory Board of the J. William Fulbright College of Arts and Sciences at the University of Arkansas at Fayetteville. She travels widely from her Little Rock home to champion a variety of philanthropic causes.

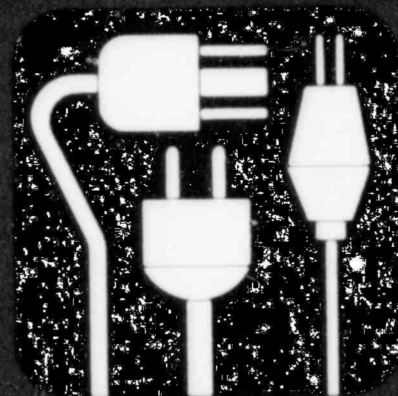
Gus B. Walton, Jr.

A partner in Poe Travel in Little Rock, he is an attorney by profession. He is actively involved in promotion of the Arkansas tourist industry as president of the Arkansas Travel Agents Association and as a member of the American Society of Travel Agents. He is also active in the Friends of the Zoo and is a former president of that organization.

Michael E. Wilson

Active nationally in the field of economic education as a trustee on the prestigious Joint Council on Economic Education, based at New York, the president of Lee Wilson & Company at Wilson is also a leader in many state and national agricultural organizations.

1985 Management Discussion and Financial Report



Report of Management

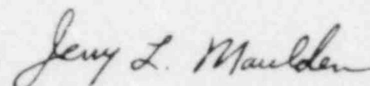
The management of Arkansas Power & Light Company has prepared and is responsible for the financial statements and related financial information included in this annual report. The financial statements are based on generally accepted accounting principles, consistently applied. Financial information included elsewhere in this report is consistent with the financial statements.

To meet its responsibilities with respect to financial information, management maintains and enforces a system of internal accounting controls which provides reasonable assurance, on a cost effective basis, as to the integrity, objectivity and reliability of the financial records and as to the protection of assets. This system includes communication through written policies and procedures, an organizational structure that provides for appropriate division of responsibility, the selection and training of qualified personnel, a performance accountability program and a comprehensive internal audit program.

The Board of Directors pursues its responsibility for reported financial information through its audit committee, composed of outside directors. The audit committee meets periodically with management, the internal auditors and the independent certified public accountants to discuss auditing, internal control and financial reporting matters and reports thereon to the Board of Directors. The independent certified public accountants have full and free access to meet with the audit committee at any time without members of Company management being present.

The independent certified public accountants provide an objective assessment of the degree to which management meets its responsibility for fairness of financial reporting. They regularly evaluate the system of internal accounting control and perform such tests and other procedures they deem necessary to reach and express an opinion of the fairness of the financial statements.

We believe that these policies and procedures provide reasonable assurance that our operations are carried out with a high standard of business conduct.



Jerry L. Maulden
President & Chief Executive Officer

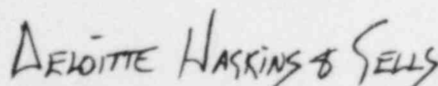
Opinion of Independent Public Accountants

Deloitte Haskins+Sells
39th Floor
One Shell Square
New Orleans, Louisiana 70139

Arkansas Power & Light Company:

We have examined the consolidated balance sheets of Arkansas Power & Light Company and its subsidiary as of December 31, 1985 and 1984 and the related consolidated statements of income and retained earnings and of changes in financial position for each of the three years in the period ended December 31, 1985. 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 consolidated financial statements present fairly the financial position of the Company and its subsidiary at December 31, 1985 and 1984 and the results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.



March 14, 1986

Financial Condition

The Company's financial condition was significantly affected during 1985 by the commercial operation of Middle South Energy's (MSE) Grand Gulf Nuclear Station, Unit 1 (Grand Gulf 1) and the Federal Energy Regulatory Commission's (FERC) allocation to the Company of 36% of the capacity and energy of MSE's 90% ownership share. The FERC decision was strongly contested by the Company and its regulatory agencies. (See Note 4 to the Financial Statements—"Commitments and Contingencies.") This resulted in an unstable regulatory and financial environment for the Company which affected its access to capital markets and delayed recovery through rates of costs associated with the Company's allocation of Grand Gulf 1. However, in September 1985, the Company received Arkansas Public Service Commission (APSC) approval for a comprehensive negotiated settlement agreement (Arkansas Settlement Agreement), including Grand Gulf 1 issues, which stabilized the Company's financial condition. In addition to Grand Gulf 1 relief, the Company was permitted to increase its Arkansas retail rates $45.8 million annually. (See Note 2 to the Financial Statements—"Rate Matters" with respect to the terms of the Arkansas Settlement Agreement and pending litigation.)

Due to the obligations associated with the allocation of Grand Gulf 1 capacity and energy cost, the Company, along with the other System operating companies, did not declare common stock dividends for the third and fourth quarters of 1985 and first quarter of 1986. Dividends on preferred stock were declared and paid. (See Note 8 to the Financial Statements—"Retained Earnings.")

Liquidity and Capital Resources

Liquidity and the Company's access to capital markets were very volatile during a portion of 1985 primarily due to the uncertainty surrounding the effect of Grand Gulf 1 on both the Company and the other System operating companies. The Company's liquidity position has stabilized due to the Arkansas Settlement Agreement which the Company believes will, subject to certain contingencies referred to in Overview below, allow it to maintain an acceptable financial condition and to meet Grand Gulf 1 and other Company obligations. The Company's access to capital markets during 1986, if required, may be adversely affected, however, by the results of MSE's pending review of the Grand Gulf Nuclear Station, Unit 2 (Grand Gulf 2). Any allocation to the Company by the FERC of either capacity and energy or abandonment cost associated with Grand Gulf 2 can be expected to be strongly resisted by state regulatory agencies and could result in increased capital requirements for the Company. (See Note 4 to the Financial Statements—"Commitments and Contingencies.")

The Company had short-term borrowing authority on December 31, 1985 of 10% of capitalization, or $233.7 million. At December 31, 1985 and 1984, the Company had no short-term debt outstanding.(See Note 7 to the Financial Statements—"Lines of Credit and Short-Term Borrowings" regarding lines of credit available to the Company.)

The Company's interest coverage ratio for first mortgage bonds (Bonds), which must be a minimum of 2.0 times the annual mortgage interest requirement for issuance of additional Bonds, was 2.85 at December 31, 1985 as compared to 3.26 and 3.14 at December 31, 1984 and 1983, respectively. The decrease in the ratio at year end 1985 was primarily due to factors discussed below in Results of Operations. While the December 31, 1985 interest coverage ratio of 2.85 would have permitted the Company to issue an additional $433.3 million Bonds, assuming an interest rate of 12%, the Company could have issued only $333.3 million additional Bonds, based on available fundable property at that date, plus any Bonds issued for refunding purposes. The earnings ratio for preferred stock, which must be a minimum of 1.5 times the Company's annual interest charges and preferred stock dividend requirement to allow the issuance of new preferred stock, was 1.48 at December 31, 1985 as compared to 1.73 and 1.73 at year end 1984 and 1983, respectively. Based on the December 31, 1985 ratio of 1.48, the Company could issue no additional preferred stock.

At December 31, 1985, the Company had temporary cash investments of $145.2 million, resulting primarily from the issuance of $120 million pollution control revenue bonds (PCRB) in December 1985.

In 1986, $1.4 million Bonds and $7.5 million preferred stock will be retired pursuant to sinking fund requirements and $70 million Bonds and $0.7 million PCRB will mature. An additional $0.8 million PCRB are subject to redemption at the option of the holders of such PCRB at a redemption price of 100%.

Construction expenditures (excluding AFDC and nuclear fuel) were $163 million, $181 million and $220 million in 1985, 1984 and 1983, respectively. Projected expenditures (excluding AFDC and nuclear fuel) for 1986, 1987 and 1988 are $132 million, $166 million and $173 million, respectively. (See Note 4 to the Financial Statements—"Commitments and Contingencies" as to the current status of the Company's nuclear fuel leases.)

Internally generated funds, after preferred and common stock dividends, amounted to 147%, 58% and 63% of 1985, 1984 and 1983 construction expenditures (excluding AFDC and nuclear fuel), respectively. However, common and preferred stock dividends amounted to only $86.8 million in 1985 as compared to $145.4 million and $132.1 million in 1984 and 1983, respectively. As previously discussed in Financial Condition, the reduction in 1985 dividends was due to the Company not declaring common stock dividends for the third and fourth quarters of 1985.

Results of Operations

Net income for 1985 decreased 23.2%, or $33.3 million from 1984. The primary factors influencing this decrease were: (1) Grand Gulf 1 began commercial operation in July without concurrent rates in place to recover associated costs; (2) as a result of the System's review of its energy load growth projections and resultant capacity requirements, provisions for estimated losses were recorded in December associated primarily with engineering and design costs and estimated liabilities associated with certain planned future fossil generating facilities; and (3) the sale of a portion of the capacity and energy from the White Bluff generating units under the Unit Power Purchase Agreement terminated without concurrent rates in place to recover associated revenue losses.

Despite the overall decrease in net income, the quality of income in 1985 improved significantly. Total AFDC for 1985, 1984 and 1983 was $10.5 million, $24.3 million and $27.8 million, respectively. AFDC as a percent of net income for 1985, 1984 and 1983 was 9.5%, 16.9% and 21.9%, respectively. Based on current construction forecasts, AFDC as a percent of net income is expected to remain low.

Operating revenues for 1985 of $1,364.8 million increased $57.1 million, 4.4%, and $158.6 million, 13.2%, when compared to 1984 and 1983, respectively. Electric revenues increased $69.2 million over 1984 of which $42.0 million can be attributed to revenues which the Company was permitted to collect by surcharge as a result of an appeal by the Company of an APSC rate order. (See Note 2 to the Financial Statements—"Rate Matters.") In addition, $65.5 million of the revenue increase was the result of increased sales to other utilities. These increases in 1985 revenues were offset by decreased revenue from Reynolds Metals Company of $37.1 million (see Note 2 to the Financial Statements—"Rate Matters") and decreased sales to the Middle South System power pool of $24.1 million.

Operation expense in 1985 increased $102.1 million, 13.8%, and $129.5 million, 18.2%, over 1984 and 1983, respectively. Purchased power expenses, which were essentially Grand Gulf 1 cost, accounted for $107.8 million of the increase in 1985. Other operation expenses increased primarily due to the $52.7 million provision for estimated losses. Operation expense increases were offset by a decrease of $54.6 million in fuel and fuel related expenses other than purchased power.

Deferred purchased power cost/capacity return amounted to $46.3 million, net of deferred taxes of $43.7 million.

Miscellaneous income—net in 1985 increased $31.1 million and $34.0 million over 1984 and 1983, respectively, primarily due to regulatory treatment of the return on excess capacity provided by the Arkansas Settlement Agreement of $14.0 million and interest income associated with settlement of the Company's 1981 Arkansas Retail Rate Case of $13.7 million.

Effects of Inflation

Despite the reduced level of inflation in 1985, its effect on the Company's operations in recent years has been significant. (See Note 13 to the Financial Statements—"Effects of Inflation on Operations (Unaudited).")

Overview

The Company's financial position throughout 1985 was significantly affected by events relating to Grand Gulf 1. The unit's commercial operation on July 1, 1985 and the Company's 36% allocated share of Grand Gulf 1 as ordered by the FERC could have had a devastating effect on the Company's 1985 financial condition. However, the Arkansas Settlement Agreement approved in early September, which granted the Company a first year rate increase of approximately $81.3 million, should permit the Company to maintain the financial stability necessary to enable it to meet its obligations, including those related to Grand Gulf 1. (See Note 2 to the Financial Statements— "Rate Matters.")

Depending on the timing and regulatory treatment of cost associated with Grand Gulf 2, the Company's future financial condition could be affected. (See Note 4 to the Financial Statements—"Commitments and Contingencies.")

The Arkansas Settlement Agreement includes provisions which, in accordance with current generally accepted accounting principles, allow the Company to defer costs for recovery in subsequent periods. The Financial Accounting Standards Board has proposed amendments to Statement of Financial Accounting Standards No. 71 (FASB 71) which include proposed criteria for deferral of costs in connection with rate phase-in plans. The Company's future financial condition could be adversely affected if amounts being deferred under the Arkansas Settlement Agreement would not meet deferral criteria, if any, which might ultimately be included in any amendments to FASB 71. (See Note 4 to the Financial Statements—"Commitments and Contingencies.")

Consolidated Balance Sheets

ASSETS	December 31, 1985	1984
	(in thousands)	
Utility Plant (Notes 4 and 5):		
Electric plant	**$3,438,401**	$3,269,726
Gas plant	**39,873**	38,182
Construction work in progress	**92,563**	105,762
Nuclear fuel	**35,683**	27,321
Total	**3,606,520**	3,440,991
Less—accumulated depreciation and amortization	**860,226**	766,537
Utility plant—net	**2,746,294**	2,674,454
Other Property and Investments:		
Investments in associated companies, at equity (Note 4)	**41,330**	39,716
Other, at cost (less accumulated depreciation)	**275**	279
Total	**41,605**	39,995
Current Assets:		
Cash and special deposits	**11,964**	12,967
Temporary investments, at cost which approximates market:		
Associated companies (Note 7)	**—**	91,500
Other	**145,242**	3,925
Notes receivable—net	**1,946**	1,939
Accounts receivable:		
Associated companies	**26,638**	33,044
Customer (less allowance for doubtful accounts —$2,179,000 in 1985 and 1984) (Note 2)	**87,377**	41,149
Other	**10,032**	13,003
Deferred fuel cost	**(4,051)**	(14,178)
Fuel inventory, at average cost	**57,943**	83,998
Materials and supplies, at average cost	**36,290**	42,245
Prepayments and other	**8,219**	8,066
Total	**381,600**	317,658
Deferred Debits:		
Deferred purchased power cost (Notes 2 and 4)	**76,016**	—
Other	**62,367**	28,710
Total	**138,383**	28,710
Total	**$3,307,882**	$3,060,817

See Notes to Consolidated Financial Statements.

LIABILITIES

	December 31, 1985	December 31, 1984
	(in thousands)	
Capitalization:		
Common stock, $12.50 par value: authorized 325,000,000 shares; issued and outstanding, 54,980,196 shares in 1985 and 1984 (Note 9)	**$ 687,252**	$ 687,252
Paid-in capital	**7,512**	7,053
Retained earnings (Note 8)	**49,417**	26,101
Total common shareholder's equity	**744,181**	720,406
Preferred stock and premium, without sinking fund (Note 9)	**126,890**	126,890
Preferred stock and premium, with sinking fund (Note 9)	**120,812**	124,170
Long-term debt (Note 10)	**1,334,994**	1,286,507
Total	**2,326,877**	2,257,973
Other Noncurrent Liabilities (Note 1)	**24,998**	23,030
Current Liabilities:		
Currently maturing long-term debt (Note 10)	**72,870**	21,210
Accounts payable:		
Associated companies	**42,478**	2,649
Other	**83,509**	90,928
Customer deposits	**8,295**	7,519
Taxes accrued	**79,064**	55,201
Accumulated deferred income taxes (Note 3)	**(2,009)**	(6,987)
Interest accrued	**48,516**	45,185
Dividends declared (Note 8)	**5,716**	35,791
Nuclear refueling reserve	**6,040**	19,104
Co-owner advances (Note 1)	**36,868**	54,729
Other	**14,938**	13,985
Total	**396,285**	339,314
Deferred Credits and Other Liabilities:		
Accumulated deferred income taxes (Note 3)	**304,121**	260,309
Accumulated deferred investment tax credits (Note 3)	**172,452**	160,067
Other	**83,149**	20,124
Total	**559,722**	440,500
Commitments and Contingencies (Notes 2, 4 and 5)		
Total	**$3,307,882**	$3,060,817

See Notes to Consolidated Financial Statements.

Consolidated Statements of Income and Retained Earnings

STATEMENTS OF INCOME	1985	1984	1983
	Years ended December 31, (in thousands)		
Operating Revenues (Notes 1, 2 and 11):			
Electric	**$1,316,797**	$1,247,597	$1,148,891
Natural gas	**47,989**	60,086	57,254
Total	**1,364,786**	1,307,683	1,206,145
Operating Expenses:			
Operation:			
Fuel	**328,088**	338,429	322,658
Purchased power—net (Note 2)	**241,805**	133,964	166,126
Gas purchased for resale	**35,816**	44,894	44,150
Other (Note 11)	**235,358**	221,679	178,610
Maintenance	**63,686**	67,805	59,059
Depreciation	**109,686**	97,451	92,621
Taxes other than income taxes	**37,603**	34,818	32,813
Income taxes (Note 3)	**95,955**	126,457	98,831
Total	**1,147,997**	1,065,497	994,868
Operating Income	**216,789**	242,186	211,277
Other Income and Deductions:			
Allowance for equity funds used during construction	**5,998**	15,844	18,095
Miscellaneous—net (Note 2)	**40,330**	9,216	6,372
Income taxes (Note 3)	**(11,459)**	1,988	8,085
Total	**34,869**	27,048	32,552
Interest Charges:			
Interest on long-term debt	**138,752**	126,974	119,466
Other interest—net of debt premium	**7,310**	7,376	7,152
Allowance for borrowed funds used during construction	**(4,472)**	(8,483)	(9,685)
Total	**141,590**	125,867	116,933
Net Income (Note 12)	**$ 110,068**	$ 143,367	$ 126,896

STATEMENTS OF RETAINED EARNINGS	1985	1984	1983
Retained Earnings—January 1	**$ 26,101**	$ 28,158	$ 33,365
Add—Net income (Note 12)	**110,068**	143,367	126,896
Total	**136,169**	171,525	160,261
Deduct—Cash dividends:			
Preferred stock	**22,920**	23,753	24,715
Common stock (Note 8)	**63,832**	121,671	107,388
Total	**86,752**	145,424	132,103
Retained Earnings—December 31 (Note 8)	**$ 49,417**	$ 26,101	$ 28,158

See Notes to Consolidated Financial Statements.

Consolidated Statements of Changes in Financial Position

	Years ended December 31		
	1985	1984	1983
		(in thousands)	
Funds Provided By:			
Operations:			
Net income	**$110,068**	$143,367	$126,896
Depreciation	**109,686**	97,451	92,621
Deferred income taxes and investment tax credit adjustments—net	**61,748**	34,583	78,127
Allowance for equity funds used during construction	**(5,998)**	(15,844)	(18,095)
Provision for losses (Note 12)	**52,707**	—	—
Total funds provided by operations	**328,211**	259,557	279,549
Other:			
Allowance for equity funds used during construction	**5,998**	15,844	18,095
Decrease in working capital*	**—**	58,329	—
Miscellaneous—net	**—**	—	13,234
Total funds provided excluding financing transactions	**334,209**	333,730	310,878
Financing transactions:			
Common stock	**—**	—	65,000
First mortgage bonds	**—**	100,000	25,000
Installment purchase transactions (Note 10)	**118,161**	2,553	44,900
Long-term obligations—Department of Energy (Note 4)	**4,773**	8,509	49,400
Obligations under capital leases	**3,023**	4,164	—
Total funds provided by financing	**125,957**	115,226	184,300
Total funds provided	**$460,166**	$448,956	$495,178
Funds Applied To:			
Utility plant additions:			
Construction expenditures for utility plant	**$172,013**	$205,050	$247,449
Expenditures for nuclear fuel	**8,362**	2,342	8,110
Capital leases	**4,021**	5,000	—
Other—net	**(2,870)**	(2,472)	932
Total gross additions (includes allowance for funds used during construction)	**181,526**	209,920	256,491
Deferred purchased power cost/capacity return (Notes 2 and 3)	**89,993**	—	—
Other:			
Dividends declared on preferred stock	**22,920**	23,753	24,715
Dividends declared on common stock (Note 8)	**63,832**	121,671	107,388
Increase in working capital*	**13,792**	—	11,778
Reserve for spent nuclear fuel disposal (Note 4)	**—**	—	36,019
Miscellaneous—net	**14,519**	9,673	—
Total other funds applied	**115,063**	155,097	179,900
Financing transactions:			
Redemption of preferred stock	**3,337**	9,704	7,175
Retirement of first mortgage bonds	**19,365**	8,865	2,297
Repayment of installment purchase transactions	**1,065**	1,005	40,050
Repayment of short-term debt and investment in short-term securities—net	**49,817**	64,365	9,265
Total funds applied to financing	**73,584**	83,939	58,787
Total funds applied	**$460,166**	$448,956	$495,178

** Increase (Decrease) in Working Capital:*

Current Assets	**1985**	1984	1983
Cash and special deposits	**$ (1,003)**	*$ 5,136*	*$ (471)*
Accounts receivable	**43,257**	*(34,773)*	*41,623*
Intercompany receivable/payable—net	**(46,235)**	*13,736*	*6,209*
Deferred fuel cost	**10,127**	*(19,895)*	*(16,235)*
Fuel inventory	**(26,055)**	*39,388*	*(13,210)*
Materials and supplies	**(5,955)**	*8,534*	*761*
Other current assets	**160**	*(2,367)*	*2,146*
Net change—current assets	**$(25,704)**	*$ 9,759*	*$20,823*

Current Liabilities	**1985**	1984	1983
Accounts payable	**$ 7,419**	*$ (3,921)*	*$ 229*
Taxes accrued	**(23,863)**	*(19,417)*	*(2,088)*
Interest accrued	**(3,331)**	*(1,210)*	*(6,057)*
Dividends declared	**30,075**	*(9,537)*	*(1,624)*
Co-owner advances	**17,861**	*(27,359)*	*5,619*
Other current liabilities	**11,335**	*(6,644)*	*(5,124)*
Net change—current liabilities	**$39,496**	*$(68,088)*	*$ (9,045)*
Net increase (decrease)—working capital	**$13,792**	*$(58,329)*	*$11,778*

See Notes to Consolidated Financial Statements.

1. Summary of Significant Accounting Policies

A. Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Arkansas Power & Light Company and its wholly-owned subsidiary, Associated Natural Gas Company.

B. System of Accounts

The accounts of the Company are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission.

C. Revenues and Fuel Costs

The Company records revenues as billed to its customers on a cycle billing basis. Revenue is not accrued for energy delivered but not billed at the end of the fiscal period.

Substantially all of the rate schedules of the Company include adjustment clauses under which fuel costs above or below the levels allowed in the various rate schedules are permitted to be billed or required to be credited to customers. The Company has adopted a deferral method of accounting for those fuel costs recoverable under fuel adjustment clauses. Under this method, such costs are deferred to the month in which the related revenues are billed.

The fuel adjustment factor contains an amount for a nuclear reserve, estimated to cover the cost of replacement energy when the nuclear plant is down for scheduled maintenance and refueling. The reserve bears interest and is used to reduce fuel expense for fuel adjustment purposes during the shutdown period.

D. Utility Plant and Depreciation

Utility plant is stated at original cost which is less than current cost set forth in Note 13 to the Financial Statements—"Effects of Inflation on Operations (Unaudited)." The cost of additions to utility plant includes contracted work, direct labor and materials, allocable overheads and an allowance for the composite cost of funds used during construction. The costs of units of property retired are removed from utility plant and such costs, plus removal costs, less salvage, are charged to accumulated depreciation. Maintenance and repair of property and replacement of items determined to be less than units of property are charged to operating expenses.

Depreciation is computed on the straight-line basis at rates based on the estimated service lives of the various classes of property. Depreciation on average depreciable property in 1985, 1984 and 1983 amounted to approximately 3.3% each year. Principally all the Company's utility plant is subject to the lien of its first mortgage bond indenture.

E. Jointly-Owned Generating Stations

The Company jointly owns two coal-fueled generating stations, both of which have two units. The Company is the agent for the respective co-owners and operates the stations. It records its investment and expenses associated with these stations to the extent of its ownership interests in the generating stations. The Company's investment and percent ownership in these stations are as follows:

Generating Stations	Investment at Dec. 31, 1985	Percent Ownership
White Bluff Steam Electric Station	$393,646,000	57.0%
Independence Steam Electric Station	$293,348,000	31.5%

F. Postretirement Benefits

The Company has postretirement plans covering substantially all of its employees. The policy of the Company is to fund pension costs in accordance with contribution guidelines established by the Employment Retirement Income Security Act of 1974 and to fund other postretirement plan costs as incurred.

G. Income Taxes

The Company joins its parent in filing a consolidated Federal income tax return. Income taxes are allocated to the Company in proportion to its contribution to consolidated taxable income. Deferred income taxes are provided for differences between book and taxable income to the extent permitted by the regulatory bodies for ratemaking purposes. Investment tax credits allocated to the Company are deferred and amortized over the average useful life of the related property, beginning with the year allowed in the consolidated tax return.

H. Allowance for Funds Used During Construction

To the extent that the Company is not permitted by its regulatory bodies to recover in current rates the carrying cost of funds used for construction, the Company capitalizes, as an appropriate cost of utility plant, an allowance for funds used during construction (AFDC) which is calculated and recorded as provided by the regulatory uniform system of accounts. Under this utility industry practice, construction work in progress on the balance sheet is charged and the income statement is credited for the approximate composite interest cost of borrowed funds and for a reasonable return on the equity funds used for construction. This procedure is intended to remove from the income statement the effect of the cost of financing the construction program and results in treating the AFDC charges in the same manner as construction, labor and material costs. As non-cash items, these credits to the income statement have no effect on current cash earnings. After the property is placed in service the AFDC charged to construction costs is recoverable from customers through depreciation provisions included in rates charged for utility service. The effective composite AFDC rate for the Company was 9.0%, 9.1% and 8.8% for 1985, 1984 and 1983, respectively.

The Company's policy is to capitalize AFDC on projects during periods of interrupted construction when such interruption is temporary and the continuation can be justified as being reasonable under the circumstances.

I. Other Noncurrent Liabilities

It is the policy of the Company to provide provisions for uninsured property risks, certain employee benefits, and claims for injuries and damages through charges to operating expense on an accrual basis. Accruals for these provisions have been allowed for ratemaking purposes.

J. Reclassifications

Certain reclassifications of previously reported amounts have been made to conform with current classifications. These reclassifications had no effect on net income.

2. Rate Matters

Grand Gulf Nuclear Station

The Company is a party to certain agreements and proceedings concerning Middle South Energy, Inc. (MSE) and the Grand Gulf Nuclear Station (Grand Gulf) owned by MSE. (See Note 4 to the Financial Statements—"Commitments and Contingencies" with respect to these matters.)

Arkansas—1981 Rate Request

On May 1, 1981, the Company filed an application with the Arkansas Public Service Commission (APSC) to increase its Arkansas retail rates approximately $101.4 million annually. On March 1, 1982, the APSC entered an order authorizing an estimated increase in retail rates of $26.2 million on an annual basis which, after a rehearing in September 1982, was raised to $29 million. In its March 1982 order, the APSC also required the Company to refund approximately $19.3 million to its Arkansas retail customers. The Company appealed to the Circuit Court of Pulaski County, Arkansas both the amount of the increase as well as the obligation to make the refunds. After a ruling by the Court, the APSC approved a surcharge covering all issues except a $17.9 million unrecovered fuel cost issue. The surcharge was implemented on February 1, 1985, and is designed to collect $32.4 million including interest over a period of 31 months. The amount of revenues to be collected under this surcharge was established in accordance with the court's ruling and includes a reduction to such revenues of approximately $4.8 million which was made in lieu of requiring a refund. On October 31, 1985, the APSC approved an additional surcharge on the unrecovered fuel cost issue which was implemented by the Company on November 1, 1985, and is designed to collect $26.6 million including interest over a period of 31 months. The Company recorded $42.0 million of revenue and $13.7 million in interest in 1985 as a result of the resolution of these issues.

Arkansas—Rate Investigation

On August 24, 1984, the APSC, in response to an APSC staff (Staff) motion alleging that the Company's rates were excessive, issued an order opening a proceeding to investigate the reasonableness of the Company's rates. On April 3, 1985, the APSC entered an order in this proceeding which ordered the Company to reduce Arkansas retail rates and abolished a previously authorized rate rider which would have provided for an automatic increase in the Company's rates to recover revenues associated with the expiration of certain arrangements under which the Company at that time was selling 785 megawatts of capacity. This order was superseded by the Arkansas Settlement Agreement as discussed below.

Arkansas—Show Cause

On August 31, 1984, MSE filed suit against the APSC in the United States District Court for the Eastern District of Arkansas challenging on various grounds an order of the APSC directing the Company to appear and show cause why all contracts and agreements made by it with respect to any obligations to purchase power from or to pay for construction and operation costs of Grand Gulf should not be held to be void *ab initio* as a matter of law because prior APSC approval had not been obtained. After hearings, the Court permanently enjoined the APSC from further proceedings in this matter. The decision was affirmed on an appeal to the United States Court of Appeals for the Eighth Circuit by the APSC and other intervenors in the proceeding. On January 27, 1986, the United States Supreme Court denied a petition for certiorari filed by a party which was an intervenor in the proceedings, but which was not a party to the Arkansas Settlement Agreement discussed below.

Arkansas—1984 Rate Request

On November 9, 1984, the Company filed an application with the APSC requesting an annual increase in Arkansas retail rates of approximately $139.7 million, later revised to $201.2 million, above the then current level of rates. In addition, the application included a proposed rate rider to be effective in the event the Company was required to make payments to MSE for costs associated with Grand Gulf Unit 1 (Grand Gulf 1). The Federal Energy Regulatory Commission's (FERC) June 13, 1985 decision (June 13 Decision) allocated 36% of Grand Gulf 1 capacity and energy to the Company. At that time, the Company proposed a phase-in plan under which recovery of portions of any payments the Company was required to make associated with Grand Gulf 1 could be deferred. On September 9, 1985, the APSC approved the terms of the Arkansas Settlement Agreement which resolved the issues in this proceeding. See Arkansas Settlement Agreement discussed below.

Arkansas—Settlement Agreement

On September 5, 1985, the Company, together with the Staff, the Arkansas Attorney General, other intervenors in the 1984 rate case described above, and Reynolds Metals Company (Reynolds), filed with the APSC a Joint Motion for Approval of a Proposed Arkansas Settlement Agreement (Arkansas Settlement Agreement). The Arkansas Settlement Agreement proposed to resolve all of the disputed issues in the rate case. A hearing was held September 7, 1985, and the APSC, on September 9, 1985, entered an order accepting and adopting the Arkansas Settlement Agreement.

Under the terms of the Arkansas Settlement Agreement, the Company will variously retain, defer and recover differing portions of the costs associated with its 36% allocated share of the capacity and energy from Grand Gulf 1 as follows:

1.) Effective September 1, 1985, the Company will retain and recover only through possible sales to third parties who are not currently customers of the Company, or through sales to the Company's retail customers priced at the Company's avoided energy cost, a portion of the Arkansas retail allocation of the costs associated with its 36% allocated share of Grand Gulf 1 (the "Retained Share"). The Retained Share (stated as a percentage of MSE's share of Grand Gulf 1) ranges from 4.32% in year one to 7.92% in year nine and all succeeding years. In the event MSE subsequently enters into a settlement agreement which results in a permanent reduction in the charges MSE could otherwise recover from the Company under the June 13 Decision, such permanent reduction will first be applied to reduce, on a dollar for dollar basis, the applicable Retained Share.

2.) Effective September 9, 1985 and terminating on August 31, 1995, the Company will defer or inventory the Arkansas

retail allocation of an additional portion of its 36% allocated share of Grand Gulf 1 costs (the "Inventory Share"). The costs deferred and accrued in the Inventory Share will not be recovered from the Company's Arkansas retail customers until September 1, 1995 except under certain conditions. The Inventory Share (stated as a percentage of MSE's share of Grand Gulf 1) ranges from 14.88% in year one to 4.08% in year ten. The Company will be permitted to recover on a current basis the incremental cost of financing the deferral of the Inventory Share. Beginning September 1, 1995, the Company will be allowed to include the balance of costs accumulated in the Inventory Share (which are accumulated during the period September 1, 1985 through August 31, 1995, and until such time as these costs are reflected in Arkansas retail rates on a current recovery basis) in its rate base for determining its Arkansas retail revenue requirements. The Company will amortize such accumulated costs on a level basis and recover them through its retail rates over the remaining depreciable life of Grand Gulf 1, or such shorter period of time as the APSC may subsequently determine to be appropriate. In the event MSE should subsequently enter into a settlement agreement containing an inventory or deferral plan which results in a reduction in the charges MSE could otherwise recover from the Company under the June 13 Decision, such reduction due to an inventory or deferral plan by MSE will first be applied, on a dollar for dollar basis, to reduce the Inventory Share.

3.) On September 9, 1985, the Company began recovery of the Arkansas retail share of an additional portion of its 36% allocated share of Grand Gulf 1 (the "Current Recovery Share") on a current basis. The Current Recovery Share (stated as a percentage of MSE's share of Grand Gulf 1) varies from 16.80% during year one to 28.08% in year eleven and all succeeding years. A portion of Grand Gulf 1 costs to be recovered under the Current Recovery Share is to be phased in over a ten year period, with the Company deferring recovery from customers of 75% of the estimated first year cost associated with the Current Recovery Share in year one, 50% of such estimated first year costs in year two and 25% of such estimated first year costs in year three and subsequently collecting these deferred amounts in years six through ten. Further, the Company will be permitted to recover on a current basis the incremental cost of financing the deferred amounts.

In addition to the recovery, deferral and retention of Grand Gulf 1 costs, the Arkansas Settlement Agreement permitted the Company to increase its Arkansas retail rates, effective September 9, 1985, by $45.8 million. These rates reflect an excess capacity adjustment which denied the Company a current return on 969 megawatts of generating capacity, but allowed the Company to earn a full deferred return on the investment in such capacity. The Company will be permitted to recover the amount capitalized and deferred, amortized on a level basis over a ten year period, commencing on the date new rates are implemented in accordance with an APSC order in the Company's next application for a general retail rate increase or July 1, 1987, whichever first occurs.

Commencing March 1, 1986, the Company was permitted to recover additional revenues from its Arkansas retail customers to recover the revenue loss resulting from the termination of an agreement for the sale of capacity from the Company's White Bluff Steam Electric Station.

In addition, the Arkansas Settlement Agreement provides that no additional rate increases will become effective for the Company's Arkansas retail customers earlier than April 1, 1987, subject to certain exceptions.

The Arkansas Settlement Agreement provides that should any other System operating company enter into a settlement agreement approved by the appropriate retail regulatory authority which provides that any such company would absorb a proportionately greater share of the costs associated with Grand Gulf 1 than that provided by the Arkansas Settlement Agreement, the share of Grand Gulf 1 costs to be absorbed by the Company will be correspondingly increased.

The Arkansas Settlement Agreement provides mechanisms for addressing an adverse effect on costs recovered under the plan associated with a change in circumstances, including a change in accounting standards. If proposed revisions to current accounting standards become effective and apply to the Arkansas Settlement Agreement, the Company will attempt to use these mechanisms to make appropriate revisions. (See Note 4 to the Financial Statements—"Commitments and Contingencies" regarding proposed amendments to Statement of Financial Accounting Standards No. 71.)

In addition to the rate matters covered by the Arkansas Settlement Agreement, the parties thereto, except the Company, agreed to take action voluntarily to dismiss without prejudice, terminate or withdraw their interventions in certain litigation and regulatory proceedings. The Company, for its part, agreed to take action voluntarily to dismiss without prejudice or terminate certain other litigation concerning the APSC or other parties. All parties, including the Company, further agreed to vigorously pursue petitions for rehearing or judicial review of the June 13 Decision.

The Arkansas Settlement Agreement provided that it did not resolve on a permanent basis any issues with respect to allocation or rate design and that a new docket was to be established by the APSC for the resolution of such issues by a final order to be issued on or before March 31, 1986. As contemplated by the Arkansas Settlement Agreement, on December 17, 1985, the APSC entered an order establishing a new docket to deal with the allocation and rate design of the Company's rates as they affect commercial, retail and other customers. Hearings were held in March 1986 and the matter is pending.

Arkansas—Other Rate Litigation

The APSC order approving the Arkansas Settlement Agreement is being contested. On October 3, 1985, a class action suit was filed in the Chancery Court of Pulaski County, Arkansas against the Company and the APSC by an Arkansas retail customer purporting to represent himself, individually, and all Arkansas taxpayers and ratepayers affected by the Arkansas Settlement Agreement. The complaint seeks, among other things, a declaratory judgment declaring the Arkansas Settlement Agreement and the rate increase authorized thereby to be illegal and therefore null and void; ordering the APSC to reconsider and rehear the Company's rate application; ordering the Company to account for and refund as credits on subsequent billings amounts collected pursuant to the Arkansas Settlement Agreement; and revoking the Company's franchise. At a preliminary hearing on October 15, 1985, the Chancery Court concluded that the APSC appeared to have original jurisdiction of the matter and deferred further action pending developments in proceedings before the APSC as described below.

Certain of the Company's Arkansas retail customers have, independently, filed pleadings with the APSC alleging, in essence, that the rates set in accordance with the Arkansas Settlement Agreement were not in compliance with applicable law. A coalition of consumer organizations has filed similar

pleadings with the APSC. These pleadings are being considered separately by the APSC. These matters are pending.

On November 22, 1985, a retail customer of the Company filed in the Circuit Court of Pulaski County, Arkansas, a petition seeking the issuance of an order of mandamus directing the Secretary of the APSC to file the customer's application requesting a rehearing on the Arkansas Settlement Agreement. Motions to dismiss the proceeding and to intervene have been filed by the APSC and the Company, respectively. A hearing on the motions is set for March 24, 1986 and a hearing on the merits, if the proceedings are not dismissed, has been set for April 4, 1986. The matter is pending.

On November 25, 1985, the Company announced that it had agreed with the other parties to the Arkansas Settlement Agreement to issue refunds to certain Arkansas customers for service rendered prior to September 9, 1985, which was billed at rates calculated pursuant to the Arkansas Settlement Agreement. Such refunds did not have a material adverse effect on the Company's earnings.

Arkansas—Wholesale Settlement Agreement

Pursuant to a settlement agreement between the Company and its full requirement wholesale customers, wholesale rates have been agreed upon consistent with the Arkansas Settlement Agreement discussed above. Such rates were approved by the FERC February 21, 1986. One full requirement customer negotiated a flat rate contract, which was approved by the FERC December 24, 1985, and became effective March 1, 1986, in lieu of the above rates.

Missouri—1985 Rate Request

On June 7, 1985, the Company filed an application with the Public Service Commission of Missouri (PSCM) for an annual increase in Missouri retail rates of approximately $5.0 million and an additional rate rider to provide approximately $12.2 million for costs associated with Grand Gulf 1. On September 18, 1985, the Company filed a request with the PSCM for a $13.1 million interim retail rate increase and asked the PSCM to convene a settlement conference and to settle the entire Missouri rate case, including issues related to Grand Gulf 1, in a manner consistent with the Arkansas Settlement Agreement. The PSCM, by order dated January 14, 1986, denied the Company's interim rate request. Hearings began in February 1986 to consider the Company's request for permanent rate relief. The matter is pending.

On February 4, 1986, the Company filed a complaint in the United States District Court for the Western District of Missouri seeking, among other things, judgment declaring that the FERC has exclusive jurisdiction over the transactions approved by the June 13 Decision; that, pursuant to the Federal Power Act and the United States Constitution, the PSCM has no jurisdiction to investigate the reasonableness of the FERC-ordered rates or to otherwise regulate those rates; and that the PSCM, as a matter of federal law, is required to permit the recovery of the Missouri allocated share of Grand Gulf 1 costs (Missouri Cost) incurred under such rates. Hearings were held February 14, 1986 for preliminary and permanent injunctions allowing rates to recover the Missouri Cost to take effect, subject to refund, pending a final hearing before the District Court. On March 10, 1986, the District Court entered an order requiring the PSCM, pending resolution of the Company's rate case described in the immediately preceding paragraph, to authorize the implementation of an interim tariff designed to facilitate collection of the Missouri Cost. On March 11, 1986, the PSCM rejected such an interim tariff tendered by the Company and entered an order in the Company's pending rate case authorizing the Company to file additional tariffs increasing its existing Missouri rate base schedules in an aggregate amount approximately equal to the amount the District Court determined to be the Missouri Costs. The Company considers the PSCM's order to have the effect of granting the Company a general interim increase in its current rates rather than a specific interim increase relating only to the Missouri Costs. On March 13, 1986, the Company filed with the District Court a motion stating the Company's position and its concern that the PSCM's order could result in rate treatment for non-Grand Gulf costs which would be adverse to the Company and that the PSCM's order is not in compliance with the March 10, 1986 order of the District Court. The Company asked the District Court to authorize it to implement tariffs as proposed by the PSCM and to collect the rates established thereunder without prejudice to its rights to question the PSCM's compliance with the District Court's March 10, 1986 order and without prejudice to its rights to seek further relief from the District Court pending the issuance of the PSCM's final order in its pending rate case. The matter is pending.

Reynolds Metals Company

Revenues, including the recovery of fuel and purchased power costs, derived from a power supply contract with Reynolds constituted approximately 4% of the Company's total operating revenues for the year ended December 31, 1985. In August 1985, Reynolds terminated the contract effective January 1, 1987. On September 26, 1985, Reynolds announced that it would close its facilities in Arkansas for the production of primary aluminum. Under this contract, Reynolds is obligated to continue to pay the Company monthly demand charges until termination of the contract. Such demand charges will aggregate approximately $24.5 million in 1986. The Company believes termination of the contract will not have a material adverse effect on its future financial condition.

Transmission Litigation

The Company has been requested by City Water & Light Plant for the City of Jonesboro, Arkansas (CWL) and Farmers Electric Cooperative Corporation (FECC) to transmit bulk power which CWL wishes to sell to FECC and FECC wishes to buy. On February 24, 1986, the Company filed with the FERC a petition for an order declaring the Company's obligations and duties with respect to this request. The Company stated in its petition that its position is that, in accordance with the provisions of the Public Utility Regulatory Policies Act of 1978, it has no obligations or duties with respect to this request. In early March, FECC and CWL filed suit against the Company in the United States District Court for the Eastern District of Arkansas seeking injunctive relief and treble damages under the Sherman Antitrust Act and the Clayton Antitrust Act based upon the Company's refusal to comply with the request that it transmit bulk power CWL wishes to sell to FECC. The plaintiffs requested a hearing, to be held between March 20 and March 31, 1986, on their application for a preliminary injunction requiring the Company to provide such transmission service pending resolution of the issues by the Court and to file with the FERC a tariff for such transmission service equal to the transmission rate on file for service to other municipalities, subject to review by the FERC, and refund of any charges found to be excessive. The Company intends to vigorously assert all available defenses. These matters are pending.

3. Income Taxes

Income tax expense (credit) consists of the following:

	1985	1984	1983
		(in thousands)	
Current:			
Federal	**$ 38,921**	$ 75,725	$ 6,396
State	**6,744**	14,161	6,223
Total	**45,665**	89,886	12,619
Deferred—net:			
Liberalized depreciation	**22,012**	21,383	24,776
Deferred fuel cost	**4,978**	(9,785)	(7,994)
Nuclear fuel disposal costs	**—**	—	17,729
Nuclear reserve and related interest	**6,429**	(3,176)	(171)
Provision for estimated losses	**(25,943)**	—	—
Deferred purchased power cost	**36,835**	—	—
Deferred excess capacity cost	**6,879**	—	—
Other	**(2,039)**	(4,537)	(4,653)
Total	**49,151**	3,885	29,687
Investment tax credit adjustments—net	**12,598**	30,698	48,440
Recorded income tax expense	**$107,414**	$124,469	$90,746
Charged to operations	**$ 95,955**	$126,457	$98,831
Charged (credited) to other income	**11,459**	(1,988)	(8,085)
Recorded income tax expense	**107,414**	124,469	90,746
Income taxes applied against the debt component of AFDC	**1,664**	6,001	9,190
Total income taxes	**$109,078**	$130,470	$99,936

Total income taxes differ from the amounts computed by applying the statutory Federal income tax rate to income before taxes. The reasons for the differences are as follows:

	1985		1984		1983	
	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income	Amount	% of Pre-Tax Income
Computed at statutory rate	**$100,041**	**46.0**	$123,204	46.0	$100,115	46.0
Increases (reductions) in tax resulting from:						
Allowance for funds used during construction	**(3,549)**	**(1.6)**	(10,137)	(3.8)	(12,686)	(5.8)
State income taxes net of Federal income tax effect	**6,899**	**3.2**	8,339	3.1	6,086	2.8
Pension expense	**6,137**	**2.8**	—	—	—	—
Other—net	**(2,114)**	**(1.0)**	3,063	1.2	(2,769)	(1.3)
Recorded income tax expense	**107,414**	**49.4**	124,469	46.5	90,746	41.7
Income taxes applied against debt component of AFDC	**1,664**	**0.4**	6,001	1.1	9,190	2.4
Total income taxes	**$109,078**	**49.8**	$130,470	47.6	$ 99,936	44.1

Unused investment tax credits at December 31, 1985 amounted to $40.0 million, which if not used will expire in 1992 and 1993.

Pursuant to an order of the Arkansas Public Service Commission (APSC) dated March 1, 1982, the Company ceased providing deferred taxes on certain timing differences which were previously normalized. However, the order requires the Company to continue providing deferred taxes on decommissioning costs of nuclear plant and disposal costs of nuclear fuel, and provides for continued normalization of timing differences which are required by the Internal Revenue Code or State law. During 1983, as a result of the nuclear fuel disposal contract with the Department of Energy, disposal costs for spent nuclear fuel became deductible for tax purposes. In addition, the APSC approved normalization for deferred purchased power cost per the Arkansas Settlement Agreement.

Cumulative income tax timing differences for which deferred income tax expense has not been provided are $211.9 million, $202.5 million and $220.0 million in 1985, 1984 and 1983, respectively.

4. Commitments and Contingencies

Construction

The Company's construction program contemplates construction expenditures (excluding AFDC and nuclear fuel) of approximately $132 million in 1986, $166 million in 1987 and $173 million in 1988. Reflecting the Company's cost curtailment program, these estimates were reduced from prior-year estimates by $74 million in 1986, $27 million in 1987 and $17 million in 1988.

Unit Power Sales Agreement and New System Agreement

On June 18, 1982, Middle South Energy, Inc. (MSE) tendered for filing with the Federal Energy Regulatory Commission (FERC), as an initial rate schedule, the Unit Power Sales Agreement under which MSE would sell from its 90% share of Grand Gulf Nuclear Station (Grand Gulf), Unit 1 (Grand Gulf 1) and Unit 2 (Grand Gulf 2) certain percentage allocations of capacity and energy to Louisiana Power & Light Company (LP&L), Mississippi Power & Light Company (MP&L) and New Orleans Public Service Inc. (NOPSI). The rates and charges after commercial operation commenced were to be based on the cost of service of each unit. Various parties, including the Arkansas Public Service Commission (APSC), the Louisiana Public Service Commission, the Mississippi Public Service Commission (MPSC), the Public Service Commission of Missouri and the City of New Orleans intervened in the proceedings, and some of these intervenors proposed, among other things, revised allocations of capacity and energy to the System operating companies, including an allocation of capacity and energy to the Company. The Unit Power Sales Agreement, as approved by the FERC on June 13, 1985 (June 13 Decision), obligates the System operating companies to purchase from MSE, at MSE's full cost of service, all of MSE's 90% share of the capacity and energy from Grand Gulf 1 in accordance with the following percentage allocations: the Company—36%; LP&L—14%; MP&L—33%; and NOPSI—17%. The Company's obligation for the non-fuel portion of payments to MSE for Grand Gulf 1 related charges is approximately $30 million per month.

On April 30, 1982, the System operating companies tendered for filing with the FERC a new agreement (New System Agreement) which provides for the coordinated planning, construction and operation of its generation and transmission facilities. The June 13 Decision also addressed the New System Agreement and, generally, approved it as filed, with certain minor modifications.

Various parties to both proceedings requested rehearings and some parties, including the Company, requested a stay of implementation of the June 13 Decision. On August 2, 1985, the FERC issued an order denying all requests for a stay of its June 13 Decision. On September 3, 1985, the FERC denied several requests for rehearing of its August 2 order. On September 26, 1985, the FERC issued an order denying all requests for a rehearing of the June 13 Decision. Various parties, including the Company and MP&L, have appealed these orders and some parties have filed motions for a stay of these orders with the United States Court of Appeals for the District of Columbia Circuit. On November 26, 1985, the Court of Appeals dismissed a petition for a stay of the June 13 Decision filed by one of these parties. Briefs have been filed and oral arguments were presented in March 1986. The matter is pending.

Availability Agreement and Reallocation Agreement

The Company, together with the other System operating companies, are severally obligated to MSE under the Availability Agreement, as amended, in accordance with stated percentages (the Company 17.1%, LP&L 26.9%, MP&L 31.3%, and NOPSI 24.7%) to make payments or subordinated advances adequate to cover all of the operating expenses, including depreciation, of MSE. The System operating companies, including the Company, in November 1981 entered into a Reallocation Agreement which would have allocated the capacity and energy available to MSE from Grand Gulf to LP&L, MP&L, and NOPSI. These companies thus had agreed to severally assume shares of 100% of the responsibilities and obligations of the Company with respect to Grand Gulf under the Availability Agreement, with the Company relinquishing its rights to the capacity and energy from Grand Gulf. However, the June 13 Decision effectively superseded the Reallocation Agreement insofar as it relates to Grand Gulf 1.

Grand Gulf 2

As of December 31, 1985, MSE had invested approximately $937 million in Grand Gulf 2, which is approximately 34% complete based on the estimated man-hours needed to complete the unit. From late 1979 until September 1985, only a limited amount of construction was performed on Grand Gulf 2. Following a September 18, 1985 order of the MPSC, MSE suspended construction activities on Grand Gulf 2. MSE has determined to continue with full suspension of construction on Grand Gulf 2 until further evaluations are made, which are estimated to be completed sometime in 1986, and to limit expenditures on the unit to only those activities which are absolutely necessary for demobilization and suspension. MSE has indicated that before a final decision is made, consideration will be given to various long-term economic factors and regulatory agency requirements applicable to Grand Gulf 2.

If it is ultimately decided that Grand Gulf 2 should be cancelled, there can be no assurance that MSE would recover the full amount of its investment in the unit. MSE has stated that it believes its investment has been prudent and will take all actions necessary before the FERC and the courts to attempt to recover its investment through rate relief. Such actions would likely involve a filing with the FERC requesting recovery of its full investment, over a period of years, through charges to the System operating companies. As in the case of MSE's filings before the FERC for rate relief necessary to recover Grand Gulf 1 costs, such proceedings and related proceedings before state regulatory authorities with respect to retail rates for Grand Gulf 2 could be protracted and strongly contested on various grounds, including imprudency. If MSE's investment in Grand Gulf 2 were allocated to the Company and it was unable to recover these costs from its customers, the Company's financial condition might be adversely affected.

Proposed Amendments to Statement of Financial Accounting Standards No. 71

An accounting standard related specifically to public utilities and certain other regulated enterprises is promulgated by the Financial Accounting Standards Board (Board) in Statement of Financial Accounting Standards No. 71 (FASB 71). The Board has issued an Exposure Draft proposing certain amendments to FASB 71. The amendments, if adopted as proposed, would become effective for fiscal years beginning after December 15, 1986 with retroactive application for prior transactions. The Exposure Draft includes proposed standards for the deferral of costs of new generating units for future recovery pursuant to a

phase-in plan. The Company's phase-in plan for recovery of its share of the costs of Grand Gulf 1 includes deferrals of cost for future recovery (see Note 2 to the Financial Statements—"Rate Matters") and complies with generally accepted accounting principles and the current requirements of FASB 71. The failure of deferral of costs pursuant to this plan to meet standards which may ultimately be included in any amendments to FASB 71 could have a material adverse effect on the Company. The Company is studying the Exposure Draft; however, until the Board issues a new Statement of Financial Accounting Standards, the Company cannot determine what will be the specific impact of the final changes, if any.

Initiated Acts

On November 22, 1985, and on January 24, 1986, at the request of different individuals, the Arkansas Attorney General approved and certified the popular names and ballot titles to appear on petitions for separate initiated acts which, respectively, would revoke the Company's franchise and exclusive territory and would require the independent operation of all electric generating facilities in Arkansas under a public power authority and of electric distribution systems under county utility commissions. The proposed initiated acts would be voted on in the general election to be held on November 4, 1986 if the prerequisite number of signatures on appropriate ballots is obtained.

SFI

The Company has a 35% interest in System Fuels, Inc. (SFI), a jointly-owned subsidiary of the System operating companies. SFI operates on a non-profit basis for the purpose of planning and implementing programs for the procurement of fuel supplies for the System operating companies; its costs are primarily recovered through charges for fuel delivered. In connection with certain of SFI's external borrowing arrangements, SFI's parent companies, including the Company, have covenanted and agreed, severally in accordance with their respective shares of ownership of SFI's common stock, that they will take any and all action necessary to keep SFI in a sound financial condition and to place SFI in a position to discharge, and to cause SFI to discharge, its obligations under these arrangements. At December 31, 1985, the total loan commitment under these arrangements amounted to $210.0 million, of which $189.1 million was outstanding. Also, SFI's parent companies have made similar covenants and agreements in connection with long-term leases by SFI of oil storage and handling facilities and coal hopper cars. At December 31, 1985, the aggregate discounted value of these lease arrangements was $78.5 million. In connection with SFI's $50 million secured financing of nuclear fuel inventories, the Company, LP&L and MSE have agreed to purchase such inventories financed pursuant to this agreement in the event that SFI is unable to fulfill its obligation under the borrowing arrangement. At December 31, 1985, the total amount outstanding under this arrangement was $27.8 million.

SFI has contracted with a joint venture for a supply of coal from a mine in Wyoming which, based on estimated reserves, is presently expected to provide the projected requirements of the Independence Steam Electric Station (ISES) for at least 30 years. By separate agreement, the Company has contracted to purchase the coal from SFI. SFI's parent companies, including the Company, each acting in accordance with their share of the ownership of SFI's common stock, joined in, ratified, confirmed and adopted the contract and the obligations of SFI thereunder. Under the contract with the joint venture, investment in the mine for leases, plant and equipment is the responsibility of the joint venture. In order to limit the joint venture's investment rights and, hence, the amount to be paid to it as a component of the price of coal, the contract provided that SFI invest any funds for plant and equipment in excess of a specified amount. The Company, MP&L and Arkansas Electric Cooperative Corporation (AECC) as co-owners in part of ISES, have agreed to make the investments rather than SFI and, accordingly, have reimbursed SFI for investments previously made. Through December 31, 1985, the Company had invested $25.1 million in mine facilities and related capitalized assets. The Company has made the required investments on behalf of the other co-owners of ISES and is billing them monthly for the carrying cost of these investments.

The parent companies of SFI have agreed to make loans to SFI to finance its fuel supply business under a loan agreement dated January 1, 1984, as amended January 1, 1986, which provides for SFI to borrow up to $75 million from its parent companies through December 31, 1986. As of December 31, 1985, the Company had loaned $6.1 million to SFI under this agreement and the Company's share of the unused loan commitment was $17.4 million. Notes under this agreement mature December 31, 2011. In addition, the Company had loaned SFI $35 million under previous loan agreements. Notes mature in 2002 and 2008 under provisions of the previous loan agreements.

SFI executed a contract, as amended in November 1982, for the purchase of lignite to be used at a future lignite fueled power plant in Arkansas. The Company has guaranteed SFI's performance and agreed to purchase SFI's share of the lignite. AECC notified the Company that it desired to participate in ownership of the plant. AECC assumed 50% of SFI's obligation to purchase lignite. Delivery of lignite is tied to commercial operation of the plant, which may be delayed at the owner's option until July 1995. The contract, including the guaranty, is conditional upon receipt of regulatory approvals for the construction of the plant.

The Company has agreed to purchase, over an approximate 20-year period, which began in 1980, 100 million tons of coal for use at the White Bluff Steam Electric Station presently in commercial operation.

Stockholders' Suit

During August and September 1985, five purported class action suits were filed by Middle South Utilities (MSU) shareholders in federal court purporting to cover classes who purchased MSU common stock over varying periods of time. These complaints have been consolidated in the United States District Court for the Eastern District of Louisiana. The Consolidated Amended and Supplemental Complaint alleges violations of the disclosure requirements of the Securities and Exchange Act of 1934 and the Securities Act of 1933, common law fraud and common law negligent misrepresentation in connection with the financial condition of MSU and prays for compensatory and punitive damages, legal costs and fees and other proper relief against MSU, various other Middle South System companies, including the Company, certain officers and former officers of MSU, directors of MSU, MSU's outside auditors and certain underwriters of MSU common stock. While

the Company, MSU and the other defendants are reviewing the allegations and plan to assert all available defenses thereto, they believe that MSU's disclosure of its financial condition was in compliance with applicable Securities and Exchange Commission requirements. However, the eventual outcome and impact on the Middle South System's financial condition cannot be predicted at this time.

Effect of Insolvency Defaults under SFI and MSE Financing and Lease Agreements

Certain of SFI's financing agreements and leases may require payments by the Company and the other System operating companies, MSU or MSE in the event SFI's obligations under such documents are accelerated as a result of the insolvency of a System operating company and SFI is unable to meet these obligations or otherwise to satisfy these obligations through the sale of the collateral securing such obligations. Insolvency of any System operating company would cause acceleration of MSE's indebtedness unless waivers were obtained under certain of the agreements relating to MSE's indebtedness. Given the substantial amount of these obligations, MSE, with its financial resources currently limited, would not be able to meet these obligations, if accelerated. Under MSE's financing agreements, MSU, and not the System operating companies, would be responsible to pay MSE's accelerated obligations. MSU, with its financial resources currently limited, including limitations on its ability to borrow funds or issue additional shares of its common stock, would not be in a position to satisfy MSE's accelerated obligations and/or provide the Company with desired common stock equity. In addition, insolvency of one or more Middle South System companies would affect terms of financing including an increase in cost of financing, or could preclude financing for other Middle South System companies. Under these circumstances the viability of the Middle South System would be placed in jeopardy including the possibility of bankruptcy filings for one or more of the insolvent Middle South System companies.

Unit Power Purchase Agreement

The Company and MP&L are parties to a Unit Power Purchase Agreement for the sale to MP&L of the Company's 31.5% share of capacity and energy from Unit 2 of ISES for a five-year term which began in December 1984.

Nuclear Fuel

The Company has agreements for the purchase and fabrication of fuel assemblies for its nuclear plant, Arkansas Nuclear One. The Company has agreed to purchase from Kerr-McGee Nuclear Corporation 0.843 million kg of uranium over the next four years. The Company also has agreements with Babcock & Wilcox Company and Combustion Engineering Company for the fabrication of fuel assemblies used at the plant.

The Company is a party to two nuclear fuel leases permitting it to lease, in the aggregate, up to a maximum of $150 million of nuclear fuel. Two credit lines of $75 million each which support nuclear fuel leases have not been extended and will terminate December 1, 1986 and December 1, 1987, respectively, unless present credit lines are extended or new lines are secured.

Spent Nuclear Fuel and Decommissioning Costs

Under the terms of its nuclear fuel leases, the Company is responsible for the disposal of spent nuclear fuel. The Company considers all costs incurred or to be incurred in the use and disposal of nuclear fuel to be proper components of nuclear fuel expense and provisions to recover such costs have been or will be made in applications to regulatory commissions. SFI, on behalf of the Company, has executed a contract with the Department of Energy (DOE) whereby the DOE will furnish disposal service for the Company's spent nuclear fuel at a cost of one mill per kilowatt-hour of net generation on or after April 7, 1983, plus a one-time fee for previously discharged fuel and in-core burned fuel prior to that date. The Company has selected an option made available by the DOE to pay the one-time fee, plus interest accrued until date of payment, which will not be earlier than 1998. The Company, has recorded approximately $62.7 million necessary for payment to the DOE for the disposal of all spent nuclear fuel on hand at April 6, 1983, including accrued interest.

In addition to the recovery of costs associated with the disposal of spent nuclear fuel, the Company is recovering a total of approximately $160 million for decommissioning costs for its two nuclear units. Based upon a study performed by the Company, nuclear plant decommissioning costs are projected to be in excess of this amount. The Company will request recovery of estimated increased costs in applications to its regulatory commissions.

Nuclear Liability Insurance

The Company is a member-insured of Nuclear Electric Insurance Limited (NEIL), a mutual insurer that provides its members with insurance coverage for certain costs of replacement power incurred due to certain prolonged outages of nuclear units (NEIL I). In addition, the Company is a member-insured under NEIL II which provides $550 million of coverage for property damage sustained by the insured in excess of $500 million caused by radioactive contamination or other specified damage. As a member-insured with this mutual, the Company is subject to assessments if losses exceed the accumulated funds available to the insurer. The present maximum assessment for incidents occurring during a policy year is approximately $23.0 million for the Company.

As of December 31, 1985, the Price-Anderson Act (Act) limited the public liability of a licensee of a nuclear power plant to $650 million for a single nuclear incident. This limit will increase by $5 million for each additional operating license issued by the Nuclear Regulatory Commission (NRC). Insurance for this exposure is provided by private insurance and an indemnity agreement with the NRC. Every licensee of a nuclear power plant is obligated, in the event of a nuclear incident involving any commercial nuclear facility in the United States that results in damages in excess of the private insurance, to pay retrospective assessments of up to $5 million per incident for each licensed reactor it operates or up to a maximum per reactor owned of $10 million in any calendar year. At December 31, 1985, the Company had two licensed reactors. The Act is scheduled to expire in August 1987, and Congress is considering several proposals to amend the Act. The Company is unable to predict what action Congress might ultimately take regarding the Act and what effect such actions might have on the Company.

5. Leases

The Company accounts for leases entered into prior to 1983 on the same basis as that used by its regulatory authority in the ratemaking process which determines the revenues utilized to recover the lease costs. The Company accounts for capital leases entered into subsequent to 1982 in accordance with Statements of Financial Accounting Standards No. 13 and No. 71 (FASB 71). Beginning in 1987, compliance with FASB 71 for capital leases entered into prior to 1983 will require recording the following assets and liabilities on the balance sheet:

	1985	1984	1983
	(in thousands)		
Assets:			
Utility plant	**$108,387**	$111,363	$115,549
Accumulated amortization	**18,109**	17,535	16,742
Net leased property	**$ 90,278**	$ 93,828	$ 98,807
Liabilities:			
Noncurrent obligations under capital leases	**$ 87,224**	$ 90,284	$ 94,882
Current obligations under capital leases:			
Principal	**$ 3,054**	$ 3,544	$ 3,925
Interest accrued	**4,780**	4,598	4,419
Total	**$ 7,834**	$ 8,142	$ 8,344

Recording of such leases would not affect the amounts reported as either expense or net income.

At December 31, 1985, there were noncancellable leases, presently accounted for as operating leases, with minimum rental commitments as follows:

	(in thousands)
1986	$ 21,005
1987	24,387
1988	25,004
1989	26,354
1990	25,630
For years thereafter	187,209
Total	$309,589

Not reflected in the schedules above, but which are subject to FASB 71 requirements described above, are two lease agreements which each allow the Company to lease nuclear fuel up to a maximum of $75 million. Lease payments, which are not included in the tabulations above, are based on nuclear fuel use. Both leases, unless sooner terminated by one of the parties, will continue until 20[illegible]. Two credit lines supporting two nuclear fuel leases have not been extended and lines of $75 million each will terminate December 1, 1986 and December 1, 1987, unless present credit lines are extended or new lines are secured. The unrecovered cost base of the leases at December 31, 1985, 1984 and 1983 was $133,764,000, $136,068,000 and $138,708,000, respectively. Nuclear fuel expense, exclusive of negative salvage, of $66,299,000 in 1985, $72,667,000 in 1984 and $49,687,000 in 1983 was charged to operations.

Rental expense for capital and operating leases (excluding nuclear fuel) amounted to approximately $22,315,000, $21,949,000 and $20,476,000 in 1985, 1984 and 1983, respectively.

6. Postretirement Benefits

The Company has various postretirement plans covering substantially all of its employees.

Pension plans are administered by a trustee who is responsible for pension payments to retired employees. Various investment managers have responsibility for management of the plans' assets. In addition, an independent actuary performs the necessary actuarial valuations for the individual company plans.

Total pension expense of the Company for 1985, 1984, and 1983 was $6,317,000, $9,555,000 and $7,294,000, respectively.

The comparison of the actuarial present values of accumulated pension plan benefits and plan net assets for the Company's defined benefit plans is presented below.

The decrease in 1985 pension expense compared with 1984 results primarily from changes in actuarial assumptions and in actuarial cost methods in the Company's major pension plan. These changes reduced 1985 pension expense approximately $6.7 million. This decrease was offset by approximately $2.1 million due to amendments effective January 1, 1985, to comply with the Employment Retirement Income Security Act of 1974 and a special early retirement program, which was offered for a limited period in 1985, to certain employees of the Company.

	January 1, **1985**	1984
	(in thousands)	
Actuarial present value of accumulated pension plan benefits:		
Vested	**$ 93,652**	$ 84,518
Nonvested	**5,170**	4,661
Total	**$ 98,822**	$ 89,179
Net assets available for pension benefits	**$151,982**	$149,349

The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 9%. The Company also provides certain health care and life insurance benefits for retired employees. Substantially all employees may become eligible for these benefits if they reach retirement age while still working for the Company. These benefits and similiar benefits for active employees are provided through various means including payments of premiums to an insurance company and/or accruals for self insurance policies managed by an insurance company. The Company recognizes the cost of providing these benefits by expensing the payments made to the insurance company or accruing the cost as recommended by the managing insurance company. The cost of providing these benefits for retired employees is not separable from the cost of providing benefits for the active employees. The total cost of providing these benefits and the average number of active and retired employees for the last three fiscal years were as follows:

	1985	1984	1983
Total cost of health care and life insurance (in thousands)	**$6,844**	$6,501	$4,636
Average active employees	**5,349**	5,319	5,255
Average retired employees	**1,007**	941	888

7. Lines of Credit and Short-Term Borrowings

At December 31, 1985, the Company had $59.0 million in lines of credit with Arkansas banks. Additionally, the Company participates with certain other companies of the Middle South System in a money pool arrangement whereby those companies with available funds make short-term loans to other companies in the Middle South System having short-term borrowing requirements. The Company may borrow from these sources subject only to its maximum authorized level of short-term borrowings. The Company has received authorization from the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 to have outstanding at any one time short-term borrowings aggregating not more than 10% of the Company's capitalization or $233.7 million. The aggregate amount of the unused lines of credit with Arkansas banks at the end of 1985 and 1984 was $59.0 million and $70.2 million, respectively. At the end of 1984, the Company participated with the other System operating companies in $180 million of consolidated lines of credit with banks outside the Middle South System service area. At December 31, 1984, $180 million was available under these consolidated lines of credit. At the end of 1985, these non-territorial bank lines of credit were no longer available to the Company and no additional non-territorial bank lines had been established. The short-term borrowings and the applicable interest rates (determined by dividing applicable interest expense by the average amount borrowed) for the Company were as follows:

	1985	1984	1983
		(in thousands)	
Maximum borrowing	**$57,000**	$15,000	$31,000
Year-end borrowing	—	—	—
Average borrowing:			
Bank loans	**$23,660**	$ 176	$ 977
Associated companies	—	$ 1,002	$10,793
Average interest rate during the period:			
Bank loans	**9.56%**	11.07%	10.31%
Associated companies	—	10.22%	9.91%
Compensating and working balances at end of period	—	—	—

8. Retained Earnings

The indenture relating to the Company's long-term debt and provisions of the articles of incorporation relating to the Company's preferred stock provide for restrictions on the payment of cash dividends on common stock. As of December 31, 1985, all retained earnings were free from such restrictions.

In light of the need to conserve cash and in view of the weakened financial condition of the Company stemming from state regulators' delays in approving rate increases, the Company determined not to declare third and fourth quarter dividends on its common stock.

9. Preferred and Common Stock

Preferred stock outstanding at December 31, 1985 and 1984 consisted of the following:

Cumulative, $100 Par Value	Shares Authorized	Shares Outstanding 1985	Shares Outstanding 1984	Current Call Price Per Share
Without sinking fund:				
4.32% series	70,000	**70,000**	70,000	$103.647
4.72% series	93,500	**93,500**	93,500	107.00
4.56% series	75,000	**75,000**	75,000	102.83
4.56% 1965 series	75,000	**75,000**	75,000	102.50
6.08% series	100,000	**100,000**	100,000	102.83
7.32% series	100,000	**100,000**	100,000	103.17
7.80% series	150,000	**150,000**	150,000	105.20
7.40% series	200,000	**200,000**	200,000	104.65
7.88% series	150,000	**150,000**	150,000	104.97
Total	1,013,500	**1,013,500**	1,013,500	
With sinking fund*:				
10.60% series	129,892	**129,892**	135,997	106.74
11.04% series	277,572	**277,572**	286,817	107.02
Total	407,464	**407,464**	422,814	
Unissued	2,386,500			
Total, $100 Par Value	3,807,464			
Cumulative, $25 Par Value				
Without sinking fund:				
8.84% series	400,000	**400,000**	400,000	27.66
10.40% series	600,000	**600,000**	600,000	27.95
Total	1,000,000	**1,000,000**	1,000,000	
With sinking fund*:				
9.92% series	1,375,521	**1,375,521**	1,433,621	27.56
13.28% series	1,797,626	**1,797,626**	1,811,626	29.05
Total	3,173,147	**3,173,147**	3,245,247	
Unissued	5,400,000			
Total, $25 Par Value	9,573,147			

	1985 (in thousands)	1984 (in thousands)
Without sinking fund:		
Stated at $100 a share	**$101,350**	$101,350
Stated at $25 a share	**25,000**	25,000
Premium	**540**	540
Total preferred stock and premium, without sinking fund	**$126,890**	$126,890
With sinking fund:		
Stated at $100 a share	**$ 40,746**	$ 42,281
Stated at $25 a share	**79,329**	81,131
Premium	**737**	758
Total preferred stock and premium, with sinking fund	**$120,812**	$124,170

The changes in the number of shares of common and preferred stock outstanding in 1985, 1984 and 1983 were:

	Common Stock Shares Sold	Preferred Stock Shares Sold (Redeemed) $100 Par	Preferred Stock Shares Sold (Redeemed) $25 Par
1985	—	(15,350)	(72,100)
1984	—	(32,015)	(260,112)
1983	5,200,000	(48,180)	(94,281)

**These series are to be retired in full through the operation of sinking funds. The 9.92% series, 10.60% series, 11.04% series and 13.28% series are being redeemed each year at the rate of 80,000, 10,000, 20,000 and 100,000 shares, respectively. In addition, the Company has the non-cumulative option to redeem an additional like amount of said shares each year.*

10. Long-Term Debt

Long-term debt outstanding consisted of the following:

	1985	1984
	(in thousands)	
FIRST MORTGAGE BONDS:		
3-3/8% series due 1985	**$ —**	$ 18,000
16-1/8% series due 1986	**70,000**	70,000
5-1/2% series due 1988	**373**	418
17-3/8% series due 1988	**75,000**	75,000
5-5/8% series due 1990	**900**	1,000
4-7/8% series due 1991	**12,000**	12,000
16-1/2% series due 1991	**80,000**	80,000
4-3/8% series due 1993	**15,000**	15,000
9-3/8% series due 1993	**5,040**	5,460
4-5/8% series due 1995	**25,000**	25,000
5-3/4% series due 1996	**25,000**	25,000
6-1/4% series due 1996	**2,560**	2,760
5-7/8% series due 1997	**30,000**	30,000
8-3/4% series due 1998	**7,800**	8,200
7-3/8% series due 1998	**15,000**	15,000
9-1/4% series due 1999	**25,000**	25,000
9-5/8% series due 2000	**25,000**	25,000
9-3/4% series due 2000	**3,600**	3,800
7-5/8% series due 2001	**30,000**	30,000
8 % series due 2001	**30,000**	30,000
7-3/4% series due 2002	**35,000**	35,000
7-1/2% series due 2002	**15,000**	15,000
8 % series due 2003	**40,000**	40,000
8-1/8% series due 2003	**40,000**	40,000
10-1/2% series due 2004	**40,000**	40,000
10-1/8% series due 2005	**40,000**	40,000
9-1/8% series due 2007	**75,000**	75,000
9-7/8% series due 2008	**75,000**	75,000
10-1/4% series due 2009	**60,000**	60,000
13-3/8% series due 2012	**75,000**	75,000
13-1/4% series due 2013	**25,000**	25,000
14-1/8% series due 2014	**100,000**	100,000
TOTAL FIRST MORTGAGE BONDS	**1,097,273**	1,116,638
INSTALLMENT PURCHASE CONTRACTS:		
Pope County, Arkansas; due 1986 to 2015 at rates ranging from 7-1/4% to 11%	**140,755***	20,800
Jefferson County, Arkansas; due 1986 to 2008 at rates ranging from 6-1/8% to 10%	**70,625**	71,645
Independence County, Arkansas; due 2013 at rate of 11-1/8%	**45,000**	45,000
Less: Amount held in construction funds	**1,904**	65
TOTAL INSTALLMENT PURCHASE CONTRACTS	**254,476**	137,380
LONG-TERM OBLIGATION—Department of Energy (Note 4)	**62,681**	57,908
UNAMORTIZED PREMIUM AND DISCOUNT ON DEBT—NET	**(6,566)**	(4,209)
TOTAL	**1,407,864**	1,307,717
LESS: CURRENTLY MATURING PORTION	**72,870**	21,210
LONG-TERM DEBT EXCLUDING AMOUNT DUE WITHIN ONE YEAR	**$1,334,994**	$1,286,507

** $120 million, 11% Pope County Arkansas due December 2015 issued December 1985 are secured by $128.8 million, 0% First Mortgage Bonds.*

At December 31, 1985, the sinking fund requirements and maturities for long-term debt for the years 1986 through 1990 are as follows:

	Cash Sinking Fund	Sinking Fund*	Maturities**
		(in thousands)	
1986	$1,365	$7,838	$70,725
1987	1,365	7,718	810
1988	1,320	8,513	76,148
1989	1,320	8,688	925
1990	1,390	8,688	1,425

* *These annual sinking fund requirements may be met by certification of property additions at a rate of 167% of such requirements.*

** *These maturities do not reflect $0.8 million pollution control revenue bonds which are subject to redemption at the option of the holders of such bonds at a redemption price of 100%.*

11. Transactions With Associated Companies

The Company buys from and sells electricity to the operating companies of Middle South Utilities, Inc., its parent, under rate schedules filed with the Federal Energy Regulatory Commission. The Company also purchases capacity and energy from Middle South Energy's Grand Gulf Nuclear Station, Unit 1. In addition, the Company purchases fuel from System Fuels, Inc., and receives technical and advisory services from Middle South Services, Inc.

Operating revenues include revenues from sales to associated companies amounting to $262.7 million in 1985, $286.8 million in 1984 and $305.5 million in 1983. Operating expenses include charges from affiliates for fuel cost, purchased power, and technical and advisory services totaling $244.3 million in 1985, $48.1 million in 1984 and $34.8 million in 1983.

12. Consolidated Quarterly Results (Unaudited)

Operating results for the four quarters of 1985 and 1984 were as follows (in thousands):

	Quarter ended			
1985	March	June	September	December
Operating Revenue	$327,049	$307,742	$413,451	$316,544
Operating Income	76,358	64,539	64,470	11,422
Net Income (Loss)	48,016	33,996	37,797	(9,741)
1984				
Operating Revenue	$315,704	$317,149	$387,468	$287,362
Operating Income	57,867	51,994	90,356	41,969
Net Income	37,307	27,389	64,409	14,262

The business of the Company is subject to seasonal fluctuations with the peak period occurring during the summer months. Accordingly, earnings information for any three-month period should not be considered as a basis for estimating the results for a full year.

The first quarter of 1985 includes the effect of $29.7 million of revenues and interest associated with the partial settlement of the Company's 1981 Arkansas retail rate case. The reduction in net income for the third quarter of 1985 is the result of Grand Gulf 1 being placed in commercial operation on July 1, 1985 without concurrent rates in place to recover associated expenses.

The fourth quarter of 1985 includes the effect of $52.7 million provision for estimated losses recorded in December 1985 associated primarily with engineering and design costs and estimated liabilities associated with certain planned future fossil generating facilities, offset by $24.6 million of revenues and interest associated with the final settlement of the Company's 1981 Arkansas retail rate case.

13. Effects of Inflation on Operations (Unaudited)

The following supplementary information about the effects of changing prices on the Company is provided in accordance with the requirements of Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices," as amended by Statement of Financial Accounting Standards No. 82. It should be viewed as an estimate of the effect of changing prices, rather than a precise measure.

STATEMENT OF INCOME FROM OPERATIONS AND
OTHER FINANCIAL DATA ADJUSTED FOR EFFECTS OF CHANGING PRICES
FOR THE YEAR ENDED DECEMBER 31, 1985
(in thousands)

	As Reported In The Financial Statements	Adjusted For Changes In Specific Prices (Current Costs)
Revenues*	$1,364,786	$1,364,786
Operating expenses (excluding depreciation)*	1,038,311	1,038,311
Depreciation	109,686	215,322
Total operating expenses	1,147,997	1,253,633
Operating income	216,789	111,153
Other income*	34,869	34,869
Interest and other charges*	141,590	141,590
Income from operations (excluding adjustment to net recoverable cost)	$ 110,068	$ 4,432
Increase in specific prices (current costs) of property, plant and equipment held during the year**		$ 77,521
Adjustment to net recoverable cost		120,523
Effect of increase in general price level		(192,822)
Excess (deficiency) of increase in specific prices, after adjustment to net recoverable cost, over increase in general price level		5,222
Gains from decline in purchasing power of net amounts owed		73,295
Net		$ 78,517

** Assumed to be in "average for the year" dollars and thus are not restated.*
*** At December 31, 1985, current cost of property, plant, and equipment, net of accumulated depreciation, was $5,219,725,000 while historical cost or net cost recoverable through depreciation was $2,746,294,000.*

FIVE-YEAR COMPARISONS OF SELECTED SUPPLEMENTARY FINANCIAL DATA
ADJUSTED FOR EFFECTS OF CHANGING PRICES
(in thousands of average 1985 dollars)

	Years ended December 31,				
	1985	1984	1983	1982	1981
Operating revenues	**$1,364,786**	$1,354,341	$1,302,346	$1,165,919	$1,201,225
Current cost information:					
Income from operations (excluding adjustment to net recoverable cost)	**$ 4,432**	$ 44,689	$ 26,724	$ 14,198	$ 14,882
Excess (deficiency) of increase in specific prices after adjustment to net recoverable cost, over increase in general price level	**$ 5,222**	$ (1,296)	$ 30,733	$ 19,021	$ (114,298)
Net assets at year-end at net recoverable cost	**$ 732,361**	$ 735,704	$ 765,907	$ 728,447	$ 675,669
General information:					
Gain from decline in purchasing power of net amounts owed	**$ 73,295**	$ 75,973	$ 61,246	$ 61,030	$ 151,999
Average consumer price index	**322.2**	311.1	298.4	289.1	272.4

Current cost amounts reflect the changes in specific prices of property, plant and equipment from the year of acquisition to the present. The current costs of property, plant and equipment, which represent the estimated costs of replacing existing plant assets, are determined by applying the Handy-Whitman Index of Public Utility Construction Costs (HWI) to the cost of the surviving plant by year of acquisition. Land and certain other plant assets which are not included in the HWI were converted using the Consumer Price Index for all Urban Consumers (CPI-U).

The current year's depreciation expense on the current cost amounts of property, plant and equipment was determined by applying the Company's depreciation rates to the indexed amounts.

Fuel inventories, the cost of fuel used in generation, and gas purchased for resale have not been restated from their historical cost in nominal dollars. Regulation limits the recovery of fuel and purchased gas costs to actual costs incurred through the operation of adjustment clauses or adjustments in basic rate schedules. For this reason, fuel inventories are effectively monetary assets.

As prescribed in Statement of Financial Accounting Standards No. 33, income taxes were not adjusted.

The regulatory commissions to which the Company is subject allow only the historical cost of plant to be recovered in revenues as depreciation. Therefore, the excess cost of plant is not presently recoverable in rates. This excess (deficiency) is reflected as an adjustment to net recoverable cost. While the rate-making process gives no recognition to the current cost of replacing property, plant, and equipment, the Company believes, based on past experiences, that it will be allowed to earn on the increased cost of its net investment when replacement of facilities actually occurs.

To properly reflect the economics of rate regulation in the Statement of Income from Operations presented above, the adjustment of net property, plant and equipment to net recoverable cost is adjusted by the gain from the decline in purchasing power of net amounts owed. During a period of inflation, holders of monetary assets suffer a loss of general purchasing power while holders of monetary liabilities experience a gain. The gain from the decline in purchasing power of net amounts owed is primarily attributable to the substantial amount of debt which has been used to finance property, plant and equipment. Since the depreciation on this plant is limited to the recovery of historical costs, the Company does not have the opportunity to realize a holding gain on debt and is limited to recovery only of the embedded cost of debt capital.

Arkansas Power & Light Company Officers

Jerry L. Maulden
President and Chief Executive Officer
Age 49

Michael B. Bemis
Executive Vice President, Chief Financial and Administrative Officer, Secretary and Assistant Treasurer
Age 39

Jack L. King
Executive Vice President and Chief Operating Officer
Age 46

Charles L. Steel
Executive Vice President and Chief Public Affairs Officer
Age 62

John M. Griffin
Senior Vice President, Generation, Transmission and Engineering
Age 41

Cecil L. Alexander
Vice President, Public Affairs
Age 50

Robert A. Allen
Vice President, Customer Services
Age 64

Kenneth R. Breeden
Vice President, Marketing
Age 37

Gene Campbell
Vice President, Nuclear Operations
Age 45

John J. Harton
Vice President, Treasurer and Assistant Secretary
Age 44

Charles L. Kelly
Vice President, Corporate Communications
Age 49

Marshall Pendergrass
Vice President, Engineering
Age 40

M.W. Rice
Vice President, System Planning and Operations
Age 58

W.R. Southern
Vice President, Administrative Services
Age 54

Henry L. Warren
Vice President and Assistant to the President
Age 45

Louis N. Burgess
Assistant Vice President
Age 52

Shirley A. Hunter
Assistant Secretary
Age 38

Company Directory

Transfer Agents for Preferred Stock— Union National Bank of Little Rock
1 Union National Plaza
Little Rock, Arkansas 72201

First Commercial Bank
Post Office Box 1471
Little Rock, Arkansas 72203

Registrar of Preferred Stock— First Commercial Bank
Post Office Box 1471
Little Rock, Arkansas 72203

Certified Public Accountants— Deloitte Haskins & Sells
One Shell Square
New Orleans, Louisiana 70139

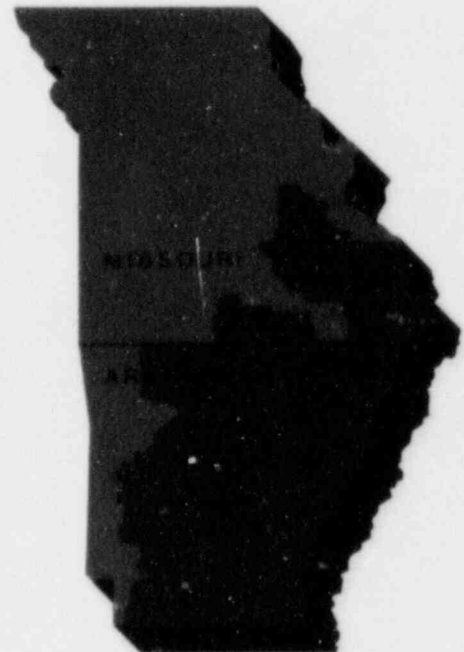
Executive Offices— Arkansas Power & Light Company
First Commercial Building
Capitol and Broadway Streets
Little Rock, Arkansas 72201
(501) 371-4000

Associated Natural Gas Company
401 West Park Street
Blytheville, Arkansas 72315
(501) 762-3660

Annual Meeting— Third Wednesday of May

Middle South System's 1985 Annual Report to the Securities and Exchange Commission on Form 10-K, which includes the Company, is available to any stockholder upon request, without charge. Persons interested in obtaining a copy should contact Mr. Michael B. Bemis, Executive Vice President, at the address below:

ARKANSAS POWER & LIGHT COMPANY
Post Office Box 551
Little Rock, Arkansas 72203

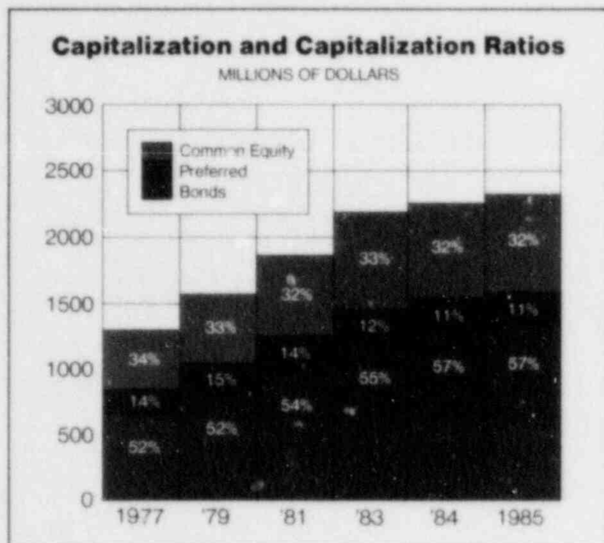


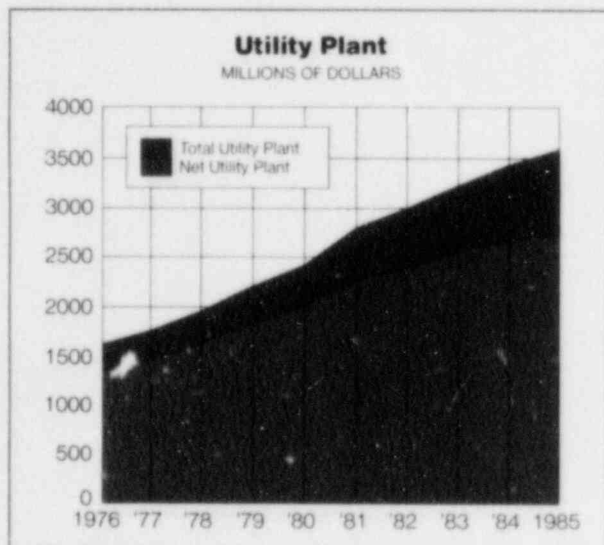
Arkansas Power & Light Company Electric System and Service Area

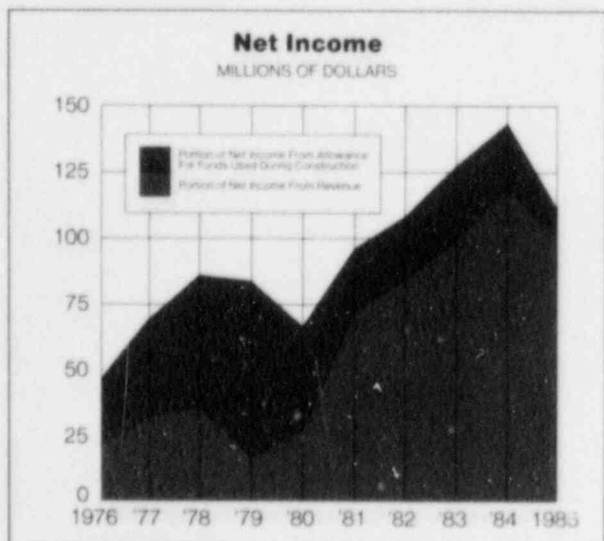
Arkansas Power & Light Company owns electric facilities in 65 of Arkansas' 75 counties and in 12 of Missouri's 114 counties. At December 31, 1985, the Company furnished retail electric service in 325 Arkansas and Missouri incorporated municipalities. AP&L also provides power at wholesale to eight Arkansas and Missouri municipalities and in Arkansas to two rural electric cooperatives and one association of rural electric cooperatives.

AP&L's system is interconnected with and operated as part of the Middle South Utilities System, which supplies the power requirements of more than 1.6 million customers in a 92,000 square-mile area of Arkansas, Louisiana, Mississippi and southeast Missouri.

Ten Years of Progress/Financial (Consolidated)[1]





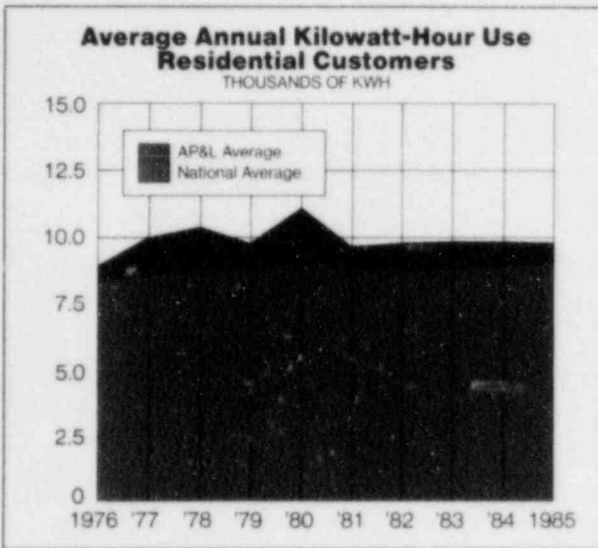


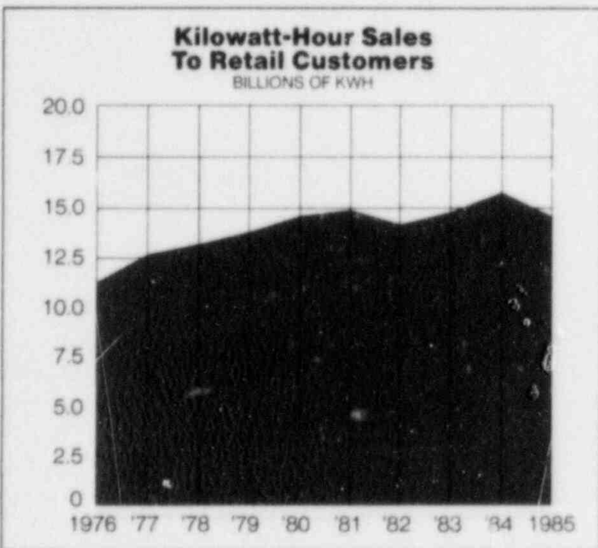
(in thousands of dollars)	1985
Selected Financial Data:	
Operating revenues	$1,364,786
Net income	110,068
Total assets	3,307,882
Long-term debt	1,334,994
Preferred stock, with sinking fund	120,812
Capitalization (end of period):	
Preferred stock and premium	$ 247,702
Common stock and paid-in capital	694,764
Retained earnings	49,417
Total	991,883
Long-term debt:	
First mortgage bonds[2]	1,019,342
Installment purchase contracts[2]	252,971
Long-term obligations—DOE[3]	62,681
Total	1,334,994
Total capitalization	$2,326,877
Annual Payment Requirements:	
Interest on:	
First mortgage bonds	$ 121,772
Installment purchase contracts	24,704
Dividends on preferred stock	22,864
Utility Plant (end of period):	
Plant completed	$3,478,274
Construction work in progress	92,563
Nuclear fuel in excess of fuel leases	35,683
Total utility plant	3,606,520
Less—accumulated depreciation	860,226
Net utility plant	$2,746,294
Income Statement:	
Operating revenues	$1,364,786
Operating expenses:	
Fuel	328,088
Purchased power—net	241,805
Gas purchased for resale	35,816
Payroll—operation and maintenance	102,832
Other operation and maintenance	196,212
Depreciation	109,686
Taxes	133,558
Total	1,147,997
Operating income	216,789
Other income and deductions—net (excluding AFDC[4])	28,871
Interest and other charges:	
Interest on long-term debt	138,752
Other interest—net of debt premium	7,310
Total (excluding AFDC[4])	146,062
Income from revenues	99,598
Non-cash income from AFDC[4]	10,470
Income from accounting change[5]	—
Net income	$ 110,068

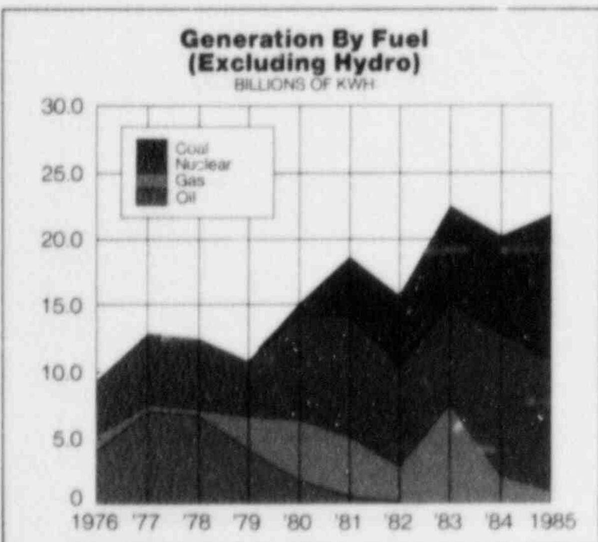
1. *On January 1, 1981, Arkansas Power & Light Company acquired Arkansas-Missouri Power Company. The financial data in this report for the years prior to 1981 have not been restated for the consolidation since the effect is immaterial.*
2. *Excludes currently maturing portion.*
3. *DOE—Department of Energy.*
4. *AFDC—Allowance for funds used during construction.*
5. *Cumulative effect to January 1, 1976, of change in accounting for fuel costs.*

1984	1983	1982	1981	1980	1979	1978	1977	1976
$1,307,683	$1,206,145	$1,046,143	$1,015,561	$ 750,497	$ 582,610	$ 553,605	$ 535,298	$ 396,597
143,367	126,896	107,372	96,140	65,230	82,404	86,014	69,305	46,963
3,060,817	2,859,517	2,669,417	2,474,249	2,147,983	1,940,643	1,693,906	1,562,999	1,421,940
1,286,507	1,195,738	1,127,540	993,163	848,667	819,716	749,262	667,484	591,382
124,170	133,931	141,138	144,120	147,065	100,518	60,063	60,063	60,063
$ 251,060	$ 260,821	$ 268,028	$ 271,010	$ 273,955	$ 227,408	$ 171,772	$ 171,772	$ 171,772
694,305	693,297	627,709	547,185	458,569	427,960	397,960	382,960	367,960
26,101	28,158	33,365	43,134	54,700	86,333	78,462	54,261	39,040
971,466	982,276	929,102	861,329	787,224	741,701	648,194	608,993	578,772
1,093,065	1,014,797	1,000,255	849,585	765,430	763,549	709,549	642,979	575,184
135,534	131,541	127,285	143,578	83,237	56,167	39,713	24,505	16,198
57,908	49,400	—	—	—	—	—	—	—
1,286,507	1,195,738	1,127,540	993,163	848,667	819,716	749,262	667,484	591,382
$2,257,973	$2,178,014	$2,056,642	$1,854,492	$1,635,891	$1,561,417	$1,397,456	$1,276,477	$1,170,154
$ 122,494	$ 108,727	$ 105,568	$ 82,986	$ 73,551	$ 62,436	$ 56,536	$ 49,364	$ 42,837
11,595	11,688	10,386	14,016	6,593	4,980	4,980	4,103	1,224
23,222	24,366	25,131	25,456	25,778	19,548	14,020	14,020	14,020
$3,307,908	$2,910,470	$2,623,319	$2,546,046	$2,133,704	$1,231,832	$1,178,601	$1,139,511	$1,111,119
105,762	306,398	364,252	255,468	282,376	980,054	785,684	610,557	505,669
27,321	24,979	16,869	10,214	7,151			12,747	4,562
3,440,991	3,241,847	3,004,440	2,811,728	2,423,231	2,211,886	1,964,285	1,762,815	1,621,350
766,537	679,232	605,404	532,261	417,435	364,447	331,231	297,464	265,099
$2,674,454	$2,562,615	$2,399,036	$2,279,467	$2,005,796	$1,847,439	$1,633,054	$1,465,351	$1,356,251
$1,307,683	$1,206,145	$1,046,143	$1,015,561	$ 750,497	$ 582,610	$ 553,605	$ 535,298	$ 396,597
338,429	322,658	262,604	307,213	237,346	174,667	167,681	169,890	107,213
133,964	166,126	178,841	141,316	154,126	171,425	120,804	114,225	107,983
44,894	44,150	40,986	30,637	—	—	—	—	—
97,659	87,210	77,566	67,897	49,774	40,607	35,400	29,448	26,626
191,825	150,459	109,500	132,862	100,700	50,994	55,478	53,014	31,224
97,451	92,621	84,194	77,923	59,574	39,708	38,365	36,768	35,025
161,275	131,644	101,146	90,530	54,033	34,948	55,693	62,753	36,022
1,065,497	994,868	854,837	848,378	655,553	512,349	473,421	466,098	344,093
242,186	211,277	191,306	167,183	94,944	70,261	80,184	69,200	52,504
11,204	14,457	12,687	17,497	17,468	23,627	16,986	12,466	10,328
126,974	119,466	108,557	90,755	67,036	67,091	56,949	45,047	43,152
7,376	7,152	11,272	21,038	17,649	10,296	4,469	3,980	2,703
134,350	126,618	119,829	111,793	84,685	77,387	61,418	49,027	45,855
119,040	99,116	84,164	72,887	27,727	16,501	35,752	32,639	16,977
24,327	27,780	23,208	23,253	37,503	65,903	50,262	36,666	26,445
—	—	—	—	—	—	—	—	3,541
$ 143,367	$ 126,896	$ 107,372	$ 96,140	$ 65,230	$ 82,404	$ 86,014	$ 69,305	$ 46,963

Ten Years of Progress/Operating (Electric)[1]







	1985
Electric Operating Revenues (thousands of dollars):	
Residential	$ 356,492
Commercial	202,856
Industrial—aluminum processing	56,930
Industrial—other	242,247
Government and municipal	19,213
Total from retail customers	877,738
Public utilities	405,767
Miscellaneous revenues	33,292
Total electric operating revenues	$1,316,797
Electric Sales (millions of kilowatt-hours):	
Residential	4,742
Commercial	3,269
Industrial—aluminum processing	1,676
Industrial—other	4,548
Government and municipal	328
Total to retail customers	14,563
Public utilities	11,999
Total energy sold	26,562
Number of Customers (end of year):	
Residential	487,275
Commercial	59,546
Industrial—aluminum processing	1
Industrial—other	16,465
Government and municipal	1,137
Total retail customers	564,424
Public utilities	17
Total customers	564,441
Electric Energy (millions of kilowatt-hours):	
Source and disposition	
Generated—net station output:	
Coal	10,853
Gas	927
Oil	6
Nuclear	9,889
Hydro	207
Total generated	21,882
Purchased	6,247
Net interchange	94
Total	28,223
Less: Company uses, losses and unaccounted for	1,661
Total energy sold	26,562
Peak demand (megawatts)[2]	3,681

1. See note 1 on bottom of page thirty-two.
2. The year 1981 includes 538 megawatts to supply Arkansas Electric Cooperative Corporation's (AECC) load which is now being supplied by their own capability. Years prior to 1981 also include varying amounts of load supplied to AECC.

1984	1983	1982	1981	1980	1979	1978	1977	1976
$ 334,693	$ 315,960	$282,204	$257,801	$212,833	$160,992	$164,224	$154,403	$121,267
187,595	169,367	153,393	148,938	128,477	100,741	98,293	92,999	75,641
94,067	56,629	50,175	69,527	69,171	65,861	43,972	40,482	33,100
224,392	200,296	183,975	179,331	140,422	112,515	104,930	102,264	83,844
23,288	20,989	19,081	14,787	12,824	11,447	11,234	10,468	8,536
864,035	763,241	688,828	670,384	563,727	451,556	422,653	400,616	322,388
364,581	379,598	299,724	298,781	181,650	125,980	124,653	128,174	70,362
18,981	6,052	5,572	5,569	5,120	5,074	6,299	6,508	3,847
$1,247,597	$1,148,891	$994,124	$974,734	$750,497	$582,610	$553,605	$535,298	$396,597
4,664	4,612	4,514	4,418	4,480	3,884	4,062	3,838	3,369
3,079	2,927	2,870	2,819	2,682	2,444	2,472	2,353	2,162
3,060	2,571	2,081	3,064	3,411	3,349	2,686	2,597	2,145
4,511	4,251	4,246	4,311	3,675	3,681	3,545	3,443	3,160
405	394	410	312	292	326	334	325	307
15,719	14,755	14,121	14,924	14,540	13,684	13,099	12,556	11,143
8,918	8,965	7,388	8,358	5,445	4,204	4,475	5,170	3,247
24,637	23,720	21,509	23,282	19,985	17,888	17,574	17,726	14,390
480,133	471,508	462,753	458,941	405,717	400,290	394,766	387,495	379,556
58,080	57,141	56,709	57,133	49,444	49,009	48,424	47,580	46,844
1	1	1	1	1	1	1	1	1
14,811	14,161	13,528	13,529	12,284	12,151	11,724	11,182	10,913
2,652	2,481	2,372	2,332	1,548	1,617	1,573	1,519	1,500
555,677	545,292	535,363	531,936	468,994	463,068	456,488	447,777	438,814
17	17	18	23	19	19	19	25	25
555,694	545,309	535,381	531,959	469,013	463,087	456,507	447,802	438,839
7,191	7,237	5,224	4,293	601	—	—	—	—
2,111	2,978	2,660	4,727	4,741	2,468	470	487	1,168
3	35	72	389	1,653	4,050	6,741	6,973	4,010
10,770	7,583	7,463	9,173	7,831	4,101	5,220	5,085	3,858
235	201	176	140	103	251	131	98	94
20,310	18,034	15,595	18,722	14,929	10,870	12,562	12,643	9,130
5,440	7,402	7,241	5,980	6,459	7,740	6,162	6,133	6,172
165	100	82	12	(209)	296	8	(65)	43
25,915	25,536	22,918	24,714	21,179	18,906	18,732	18,711	15,345
1,278	1,816	1,409	1,432	1,194	1,018	1,158	985	955
24,637	23,720	21,509	23,282	19,985	17,888	17,574	17,726	14,390
3,650	3,748	3,541	4,369	4,179	3,521	3,654	3,336	3,242

President's 1985 Message
Associated Natural Gas Company

A Wholly-Owned Subsidiary of Arkansas Power & Light Company

Reacting to market pressures the field price of natural gas declined throughout 1985. The rapid drop of oil prices at year-end and during the first two months of this year will have a further moderating influence.

During the last quarter of the year the Company was able to purchase a substantial quantity of spot market gas at very favorable rates. With the abundance of supply it is expected that this opportunity will continue through the current year.

The consumer will be the ultimate beneficiary of this cost reduction but at the same time the Company's competitive position will be improved and its marketing potential enhanced.

As a result of warmer than normal weather in March and April and a mid-year slump in industrial usage, sales were depressed. Service was extended to two new towns during the year and the effect of customer additions should have a positive effect on 1986 sales and revenue.

After almost 25 years with the Company, I retired on March 1, 1986. Thomas J. Wright, a long-term AP&L employee and former Division Manager, was elected President and Chief Executive Officer of the Company. With the favorable marketing conditions that exist in the industry today and under Tom's capable leadership, Associated is positioned to take full advantage of the growth and increased earnings potential.

L T McSpadden

L. Thurl McSpadden
Past President and Chief Operating Officer
Associated Natural Gas Company

Associated Natural Gas Company Officers

Jerry L. Maulden
Chairman of the Board and Past Chief Executive Officer
Age 49

Thomas J. Wright
President and Chief Executive Officer
Age 40

L. Thurl McSpadden
Past President and Chief Operating Officer, Retired
Age 64

Ernest L. McKenzie
Vice President, Secretary, Treasurer and Chief Financial Officer
Age 63

Ralph M. Wafler
Vice President, Operations
Age 58

Glen E. Veteto
Assistant Treasurer
Age 43

Ricky A. Gunter
Assistant Treasurer
Age 36

Peggy Warrington
Assistant Secretary
Age 62

Associated Natural Gas Company Directors

Paul C. Hughes
President and Chief Executive Officer
Farmers Soybean Corporation
Blytheville, Arkansas

Hal E. Hunter, Jr.
Attorney, Hunter & Hunter
New Madrid, Missouri

Jerry L. Maulden
Chairman of the Board and Past Chief Executive Officer of the Company
Little Rock, Arkansas

Robert G. McHaney
Vice President
McHaney Monuments
Blytheville, Arkansas

Ernest L. McKenzie
Vice President, Secretary, Treasurer and Chief Financial Officer of the Company
Blytheville, Arkansas

L. Thurl McSpadden
Past President and Chief Operating Officer of the Company, Retired
Blytheville, Arkansas

Kenneth E. Storey
President and Chief Executive Officer
Food Giant Super Markets, Inc.
Sikeston, Missouri

Ralph M. Wafler
Vice President, Operations of the Company
Blytheville, Arkansas

Thomas J. Wright
President and Chief Executive Officer of the Company
Blytheville, Arkansas

ARKANSAS POWER & LIGHT COMPANY

MIDDLE SOUTH UTILITIES SYSTEM

ARKANSAS POWER & LIGHT COMPANY
POST OFFICE BOX 551 LITTLE ROCK, ARKANSAS 72203 (501) 371-4000

April 15, 1986

ØCANØ4861Ø

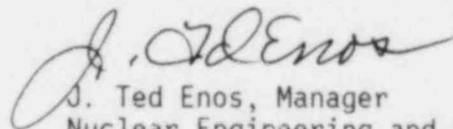
Mr. Harold R. Denton, Director
Office of Nuclear Reactor Regulation
U. S. Nuclear Regulatory Commission
Washington, DC 20555

SUBJECT: Arkansas Nuclear One - Units 1 & 2
Docket Nos. 50-313 and 50-368
License Nos. DPR-51 and NPF-6
1985 Annual Financial Report

Dear Mr. Denton:

In accordance with 10CFR50.71(b) and 10CFR140.15(b)1, enclosed are thirteen copies of the 1985 Annual Financial Report for Arkansas Power & Light Company. This report contains financial statements for the fiscal years 1983, 1984 and 1985. The financial statements include balance sheets, operating statements, and supporting schedules which may be used for interpretation of the balance sheets and operating statements.

Very truly yours,



J. Ted Enos, Manager
Nuclear Engineering and Licensing

JTE/RJS/sg

Enclosure

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