1990 ANNUAL REPORT

ARIZONA PUBLIC SERVICE COMPANY

APS

ABOUT THE COMPANY

Arizona Public Service Company (the "Company" or "APS") is engaged principally in the generation and sale of electricity. APS, a successor to a series of small utility operations originating in 1886, was incorporated in 1920 under the laws of Arizona and has operated under its present name since 1952. The Company's electric service reaches approximately 1,671,000 people, or about 45 percent of the state's population, in an area that includes all or part of 11 of Arizona's 15 counties.

All of the outstanding shares of common stock of the Company are owned by Pinnacle West Capital Corporation ("Pinnacle West"). Pursuant to a Pledge Agreement, dated as of January 31, 1990 between Pinnacle West and Citibank, N.A., as Collateral Agent (the "Pledge Agreement"), and as part of a restructuring of substantially all of its outstanding indebtedness, Pinnacle West granted certain of its lenders a security interest in all of the Company's outstanding common stock. Until the Collateral Agent and Pinnacle West receive notice of the occurrence and continuation of an Event of Default (as defined in the Pledge Agreement), Pinnacle West is entitled to exercise or refrain from exercising any and all voting and other consensual rights pertaining to the common stock. As to matters other than the election of directors, Pinnacle West agreed not to exercise or refrain from exercising any such rights if, in the Collateral Agent's judgment, such action would have a material adverse effect on the value of the common stock. After notice of an Event of Default, the Collateral Agent will have the right to vote the common stock.

ANNUAL REPORT

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

ANNUAL MEETING OF STOCKHOLDERS

All stockholders are invited to attend the Company's seventy-first annual meeting at 10:00 a.m. on Tuesday, April 16, 1991, at the offices of the Company, 400 North Fifth Street, Phoenix, Arizona.

APS OFFICERS

Jack N. Bailey, Vice President, Nuclear Safety and Licensing
Leslie N. Brockhurst, Vice President, Human Resources
William F. Conway, Executive Vice President, Nuclear
O. Mark De Michele, President and Chief Executive Officer
Walter F. Ekstrom, Executive Vice President, Engineering, Operations and Construction
Karl Eller, Chairman of the Executive Committee
William J. Hemelt, Treasurer and Assistant Secretary
James M. Levine, Vice President, Nuclear Production
Nancy C. Loftin, Secretary and Corporate Counsel
Jaron B. Norberg, Executive Vice President and Chief Financial Officer
William J. Post, Vice President, Finance and Rates
Shirley A. Richard, Executive Vice President, Customer Service,
Marketing and Corporate Relations
E. C. Simpson, Vice President, Nuclear Engineering and Construction
Richard Snell, Chairman of the Board

To Our APS Preferred Shareholders:

At the beginning of 1990, Arizona Public Service Company faced several significant obstacles. Two of three units at our Palo Verde Nuclear Generating Station were off-line for extended refueling outages or repairs. PacifiCorp, an Oregon-based utility holding company, was aggressively pursuing a less-than-friendly takeover of our parent company, Pinnacle West Capital Corporation. Inside APS, we were continuing a series of deep cuts to our capital, operating and maintenance expenditures and to our staffing levels to improve our efficiency and further prepare us to meet increasing competition in our industry. The Arizona economy was still sluggish and we had just filed a request with the Arizona Corporation Commission (ACC) for a 20.8 percent increase in electric rates. The year presented some tremendous challenges and we're pleased to report that we've taken giant steps in surmounting many of these obstacles.

Our most important achievement was the restoration of the Palo Verde units to full-power operation. In fact, in the last half of 1990, Palo Verde was consistently ranked among the top performing nuclear stations in the United States and recorded a site average capacity factor of 87.3 percent. For the year, Palo Verde generated 21.9 million megawatt-hours of electricity and achieved an average capacity factor of 62 percent for the three units. That compares to only 23 percent in 1989 when the units were down for refueling and repairs. These improved performance levels reflect the management and organizational changes implemented at Palo Verde over the last two years and the commitment and professionalism of our employee team.

The Nuclear Regulatory Commission (NRC) has also recognized the progress we've made at Palo Verde. In its recent Systematic Assessment of Licensee Performance (SALP) report, the NRC gave improved ratings on Palo Verde in six of seven operational and management areas. These six areas were rated as meeting all the regulatory requirements and the remaining area exceeded the regulatory requirements.

The nuclear units weren't the only generating units with outstanding performance in 1990. Our two major coal-fired power plants, the Four Corners Power Plant near Farmington, New Mexico, and the Cholla Power Plant near Joseph City, Arizona, also turned in impressive operating results. These two plants together produced approximately 20.5 million megawatt-hours of electricity while maintaining an annual equivalent availability factor of nearly 90 percent — one of the highest in the industry. In fact, Four Corners generated more electricity in 1990 than in any other year in its history.

In all, 96.2 percent of the electricity generated by APS came from our coal and nuclear units. Our dependence on natural gas and fuel oil was minimal.

Because of the high availability of our coal and nuclear plants, we also had a record-setting year selling power on the regional spot market. These sales totalled 2.2 million megawatt-hours of electricity, contributing approximately $45 million in revenue.

On another front, APS and PacifiCorp entered into a long-term energy agreement in 1990. The agreement involves the sale of our Cholla 4 generating unit to PacifiCorp for approximately $230 million (APS will retain responsibility for operating the unit) and the joint development of other generation and transmission arrangements in the coming years. The agreement also gives APS access to energy markets in the Pacific Northwest to purchase and sell bulk power supplies. A firm purchase contract beginning with 175 megawatts growing to 350 megawatts by 1996, together with the other agreements, will replace the Cholla 4 resource on the Company's system. The agreement is pending approval by the ACC and the Federal Energy Regulatory Commission. If approved, APS customers will immediately benefit from the agreement in the form of a reduction in our pending rate request. It will also be a great advantage in our long-term resource planning process.

For APS employees and management, 1990 will be remembered for an early retirement program and a massive corporate restructuring which consumed the last half of the year. Largely through these programs, the Company trimmed more than 1,500 positions, almost all of which were in non-nuclear departments. The operating savings resulting from the 1990 programs will be more than $20 million annually.

But restructuring was not done to simply reduce the work force. In the course of restructuring, we literally reorganized and restaffed the entire Company — from top to bottom. This was done to achieve two key results: keep only those functions that directly help us meet our business goals and make certain each position in the Company is filled with the most capable and qualified person possible. It was a strenuous task, but we completed it as planned. We are now engaged in the rebuilding process with special emphasis on cost management, strategic planning, management development and maintaining excellent customer service and reliability.

In response to an increasingly competitive energy marketplace, all corporate budgets — capital, operating and maintenance — were cut in 1990 to reduce upward pressure on our electric rates. The 1991 construction budget, for example, was cut by $116 million. More than $770 million worth of capital projects were removed from the Company's budget for the period 1990 through 1995.

While cost-cutting and staff reductions were necessary to improve the Company's financial picture and respond to market pressures, they were also needed because of the continued sluggishness of the Arizona economy. Where we once experienced an annual customer growth rate of 4 to 6 percent, we are now planning for customer growth to be about 3 percent each year for the foreseeable future.

Meanwhile, we have stepped up our economic development efforts in concert with local and state economic development agencies. Our achievements in this area — and they are many — boost the general economy of our service territory. They also help us in our resource planning because we can target potential customers with high load factors.

Despite all of our cost-cutting efforts, however, the Company achieved only an 8.0% return on equity for 1990, compared to the 12.5% authorized by the ACC. After payment of preferred dividends, we earned $149 million on revenues of $1.5 billion. Electric sales increased by 13.1% to 19.8 million megawatt-hours.

Finally, we have a 20.8 percent, three-step rate increase request pending before the Arizona Corporation Commission. This request was filed with the ACC in January 1990. Hearings began in February 1991, and will likely continue for the next several months with a final decision expected near the end of the year. In the fall of 1990, we offered to negotiate a rate settlement with the ACC for a 9.3 percent increase in rates followed by a moratorium on further base rate increases through 1994. The ACC declined our offer and, consequently, we are proceeding with the full hearing process. Nevertheless, because of our cost-cutting programs, we will be able to lower our rate request with the ACC by over $20 million. In addition, the PacifiCorp agreement will allow us to reduce our rate request by approximately $48 million when approved by the two regulatory agencies.

We invite you to study the detailed financial information in the following pages and to attend our Annual Meeting of Stockholders on April 16, 1991 in Phoenix.

Sincerely,

R Snell

Richard Snell
Chairman of the Board

O. Mark De Michele

O. Mark De Michele
President and
Chief Executive Officer

ARIZONA PUBLIC SERVICE COMPANY
SELECTED FINANCIAL DATA

	1990	1989	1988	1987	1986
			(Thousands of Dollars)		
Electric Operating Revenues ...	$1,508,325	$1,447,154	$1,442,023	$1,322,930	$1,255,057
Electric Operating Expenses:					
Operation and maintenance ..	697,395	641,702	594,041	596,353	546,253
Depreciation and amortization	211,727	202,409	194,334	160,298	139,541
Taxes*	303,694	296,887	318,047	323,204	305,909
Palo Verde cost deferral	(64,379)	(68,989)	(67,479)	(84,289)	(25,526)
Total	1,148,437	1,072,009	1,038,943	995,566	966,177
Operating Income	359,888	375,145	403,080	327,364	288,880
Other Income*	56,713	56,965	71,694	126,456	173,847
Interest Deductions - Net	236,589	219,756	203,563	156,057	188,607
Income Before Cumulative Effect of Accounting Change	180,012	212,354	271,211	297,763	274,120
Cumulative Effect of Accounting Change - Net of Tax*	—	—	—	16,110	—
Net Income	180,012	212,354	271,211	313,873	274,120
Preferred Stock Dividend Requirements	31,060	32,302	33,319	32,950	39,279
Earnings for Common Stock ...	$ 148,952	$ 180,052	$ 237,892	$ 280,923	$ 234,841
Total Assets	$6,402,680	$6,299,885	$5,990,964	$5,818,588	$5,595,883
Long-term Debt and Redeemable Preferred Stock ..	$2,496,406	$2,510,360	$2,455,880	$2,503,928	$2,107,219

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* Federal and state income taxes are included in Taxes, Other Income and Cumulative Effect of Accounting Change. Total income tax expense was as follows: 1990, $126,831,000; 1989, $145,678,000; 1988, $183,897,000; 1987, $197,314,000; 1986, $156,820,000. Palo Verde cost deferral included in Other Income for 1990, 1989, 1988, 1987 and 1986 was $71,404,000, $72,861,000, $79,432,000, $71,961,000 and $38,262,000, respectively.

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

OTHER FINANCIAL AND OPERATING STATISTICS

	1990	1989	1988	1987	1986
		(Dollars in Thousands, Except Per Hour Amounts)			
Capitalization:					
Common equity	$ 1,860,110	$ 1,901,615	$ 1,932,419	$ 1,905,577	$ 1,835,616
Non-redeemable preferred stock	168,561	168,561	168,561	168,561	218,561
Redeemable preferred stock	192,453	204,021	212,948	221,978	178,728
Long-term debt	2,303,953	2,306,339	2,242,932	2,281,950	1,928,491
Total	$ 4,525,077	$ 4,580,536	$ 4,556,860	$ 4,578,066	$ 4,161,396
Utility plant—gross ...	$ 6,796,688	$ 6,668,644	$ 6,414,655	$ 6,229,446	$ 5,880,435
Utility plant—net	$ 5,126,461	$ 5,168,730	$ 5,112,648	$ 5,093,035	$ 4,904,325
Number of employees at year-end	7,029	8,181	8,135	8,926	8,966
Average wage per hour	$ 19.14	$ 17.97	$ 17.02	$ 16.09	$ 15.23
Electric resources (kw)*	4,681,300	4,575,300	4,319,200	3,930,600	3,592,100
Peak load (kw)	3,679,700	3,645,600	3,371,600	3,159,300	3,194,600
Electric sales—total (mwh)	19,776,140	17,488,551	17,760,896	15,404,312	14,180,458
Number of customers at year-end	606,605	594,820	582,003	566,384	545,018

OPERATING REVENUES

	1990	1989	1988	1987	1986
			(Thousands of Dollars)		
Electric					
Residential	$ 579,556	$ 559,755	$ 545,082	$ 505,525	$ 466,816
Commercial	571,806	521,665	501,666	467,643	441,236
Industrial	160,913	172,556	166,346	146,925	141,729
Irrigation	13,134	14,424	14,989	16,641	21,547
Other	146,740	112,613	114,180	88,630	85,816
Total	1,472,149	1,381,013	1,342,263	1,225,364	1,157,144
Transmission for others	9,321	14,117	17,187	14,254	19,692
Miscellaneous services	26,855	52,024	82,573	83,312	78,221
Total operating revenues	$ 1,508,325	$ 1,447,154	$ 1,442,023	$ 1,322,930	$ 1,255,057

* Includes capacity from the Company's own generating resources as well as purchased power contracts.

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

Liquidity and Capital Resources

The Company's liquidity is affected primarily by construction expenditures and by capital requirements relating to debt and preferred stock redemptions and repurchases. The capital resources available to meet these requirements include internal cash generation and external financings.

Although its plans are subject to change, the Company does not presently intend to construct any new major baseload generating units until the end of the century. Utility construction expenditures for the years 1991 through 1993 are therefore expected to consist primarily of the cost of updating and expanding the electric transmission system and utility distribution systems.

During 1991, 1992, and 1993, the Company expects to incur construction expenditures of $193 million, $204 million, and $245 million, respectively. These amounts include nuclear fuel expenditures, but omit capitalized property taxes and allowance for funds used during construction ("AFC"). The Company conducts a continuing review of its construction program. This program and the above estimates are subject to periodic revisions based upon changes in assumptions as to system load growth, rates of inflation, the availability and timing of environmental and other regulatory approvals, the availability and costs of outside sources of capital, and changes in project construction schedules. During the years 1988 through 1990, the Company incurred approximately $774 million in construction expenditures and $63 million in additional capitalized items. Consistent with the Company's wide-spread cost reduction plan, the Company's construction expenditure estimates for the 1991-1993 timeframe reflect significant reductions from prior estimates.

The Company has a degree of flexibility in adjusting its construction program to its financing capability; however, that flexibility is somewhat limited and its long-term liquidity will depend on its access to the capital markets, which in turn will depend on sufficiency of rates to provide adequate coverages on senior securities and an adequate rate of return on common stock equity. Adequate earnings and coverages are critical to the maintenance of satisfactory credit ratings on the Company's senior securities and, as calculated in accordance with the Company's mortgage bond indenture and articles of incorporation, are prerequisite to the Company's legal ability to issue such securities (see below).

In 1990, the Company financed approximately 54% of its capital expenditures (construction expenditures and capitalized property taxes) with internally generated funds (after the payment of dividends), compared to 39% and 81% in 1989 and 1988, respectively. The increase in 1990 over 1989 was primarily the result of reduced construction expenditures and a reduction in the Company's quarterly common stock dividend from approximately $52.7 million to $42.5 million, beginning in the third quarter of 1990. The decline in 1989 from 1988 was primarily due to higher fuel, purchased power, and operation and maintenance costs attributable to unscheduled outages during 1989 at the Palo Verde Nuclear Generating Station ("Palo Verde"). The Company expects to finance approximately three-quarters of its capital expenditures with internally generated funds (after the payment of dividends) in the period 1991 through 1993, but that level may be impacted by the level of rates determined in the pending rate case. See "ACC Matters—Application for Retail Rate Increase" and "Asset Purchase and Power Exchange" under "Operating Results" below.

In addition to funds required for capital expenditures, and without considering the impact of certain agreements between the Company and PacifiCorp Electric Operations, an assumed business name of PacifiCorp, an Oregon-based utility company ("PacifiCorp") relating principally to sales and purchases of electric power and electric utility assets (see "Operating Results—ACC Matters—Asset Purchase and Power Exchange"), refunding obligations for

preferred stock and long-term debt, a capitalized lease obligation, and certain anticipated early redemptions are expected to total up to $187 million, $370 million, and $38 million, for the years 1991, 1992, and 1993, respectively.

In 1990, the Company issued $225 million in aggregate principal amount of first mortgage bonds. During 1990, the Company redeemed approximately $68 million in aggregate principal amount of its first mortgage bonds and purchased or optionally redeemed shares of various series of its cumulative preferred stock having an aggregate par value of approximately $12 million.

The Company notified the beneficial owners of its $12.90 Cumulative Preferred Stock, Series N (the "Series N Stock"), and its $11.50 Cumulative Preferred Stock, Series R (the "Series R Stock"), of its intent to repurchase such stock on December 1, 1989; however, pursuant to existing agreements with the Company, the beneficial owners denied the Company its options to repurchase at that time. In the event that the beneficial owners have the right to rescind these denials, the Company may be required to repurchase the Series N Stock and/or the Series R Stock for an aggregate repurchase price of approximately $77 million, which amount is not included in the requirements set forth above for the years 1991 through 1993. In addition, the Company may be required to indemnify the beneficial owners of the Series N Stock and the Series R Stock in the aggregate amount of up to approximately $60 million (before income taxes) if certain Internal Revenue Service ("IRS") claims are sustained regarding the taxable nature of distributions in respect of such stock and the beneficial owners' position with respect to indemnification is upheld. The Company believes there are meritorious defenses to the IRS claims.

Provisions in the Company's mortgage bond indenture and articles of incorporation restrict the Company from issuing additional first mortgage bonds or preferred stock, respectively, unless the Company's earnings (as defined) cover by at least the prescribed number of times the amount of interest (as to bonds) and the amount of interest plus preferred stock dividend requirements (as to preferred stock) on the securities to be outstanding after completion of the new issue. Operation of the latter such provision has at times in the past limited the Company's ability to issue preferred stock. In addition, the mortgage bond indenture limits the amount of additional bonds which may be issued to a percentage of net "property additions" and property previously pledged as security for certain bonds that have been redeemed or retired. As of December 31, 1990, the Company estimates that the mortgage bond indenture and the articles of incorporation would have allowed the Company to issue approximately $1.0 billion of additional first mortgage bonds based on property additions and property pledged as security for certain bonds that have been redeemed or retired (as compared to approximately $1.1 billion on the basis of coverages) and $25 million of preferred stock, respectively. Minimum required coverages are 2.0 for bonds and 1.5 for preferred stock. Actual coverages afforded by earnings (as defined) were as follows:

	Year Ended December 31,		
	1990	1989	1988
Bonds	3.40	3.93	4.90
Preferred Stock	1.53	1.68	1.91

In addition to the mortgage bond indenture restrictions on the Company's issuance of additional bonds, provisions in certain Pinnacle West Capital Corporation ("Pinnacle West") financing agreements limit the amount of additional long-term debt that may be incurred by Pinnacle West and its subsidiaries, including the Company. At December 31, 1990, the amount of net additional long-term debt that could be incurred in accordance with these provisions was approximately $537 million. The Company's ability to incur additional indebtedness is also limited by fixed charge coverage provisions in certain of its credit facilities. The Company does not expect that any of these provisions will affect its ability to meet its capital requirements.

By Arizona statute, the Company's short-term borrowings may not exceed 7% of its total capitalization without the consent of the Arizona Corporation Commission (the "ACC"). Such borrowings are an important source of funds, particularly between permanent financings, and the statute could from time to time limit the Company's financing flexibility. However, the Company's own general policy relating to short-term borrowings is consistent with that of the statute.

The Company must obtain ACC approval before issuing equity securities or incurring indebtedness, except for short-term indebtedness within the limits described in the preceding paragraph. Existing ACC orders allow the Company to have approximately $501 million in aggregate par value of preferred stock and approximately $2.566 billion in long-term debt outstanding at any one time and the Company had approximately $361 million and approximately $2.477 billion, respectively, outstanding at December 31, 1990. Both ACC orders allow the Company to redeem, refinance, and refund any outstanding preferred stock or long-term debt and to issue additional preferred stock and long-term debt as long as the limits described above are not exceeded. The Company may seek ACC approval during 1991 for the issuance of additional long-term debt.

Although its plans are subject to change for reasons which would include market conditions, rate relief, regulatory approval of the proposed sale of Unit 4 of the Cholla Power Plant ("Cholla 4"), and limitations imposed by the Company's mortgage bond indenture, articles of incorporation, and certain Pinnacle West financing agreements (see above), the Company intends to issue in 1991 approximately $75 million of long-term debt (presumably first mortgage bonds). In addition, the Company plans to renew a $120 million medium-term revolving credit facility and issue approximately $50 million in aggregate par value of preferred stock. At December 31, 1990, the Company had credit commitments from various banks totalling approximately $372 million, which were available either to support the issuance of commercial paper or to be used for bank borrowings. Under these programs, $159 million was outstanding at year end.

The Company's capital structure at December 31, 1990 consisted of 51% long-term debt (excluding current maturities), 4% preferred stock with mandatory redemption requirements, 4% preferred stock without mandatory redemption requirements, and 41% common stock equity. During 1986, the Company entered into sale and leaseback transactions under which it sold and leased back approximately 42% of its 29.1% ownership interest in Palo Verde Unit 2. The leases are accounted for as operating leases and, accordingly, are not reflected in the Company's capitalization (see Note 8 of Notes to Financial Statements).

Pursuant to the Clean Air Act, the Environmental Protection Agency ("EPA") has adopted regulations, applicable to certain federally-protected areas, that address visibility impairment that can be reasonably attributed to specific sources. On April 7, 1989, the National Park Service ("NPS") issued a draft report to EPA alleging that emissions from the Navajo Generating Station ("NGS"), in which the Company has a 14% ownership interest, are responsible for a majority of the visibility impairment observed in the Grand Canyon National Park, Arizona, on certain days during the winter months. On January 31, 1991, the EPA issued a notice of proposed rulemaking in which it proposed to revise the federal implementation plan for the State of Arizona to include emission limits representing best available retrofit technology for NGS to become applicable to one unit by January 1, 1995, two units by January 1, 1997, and all units by January 1, 1999. Salt River Project Agricultural Improvement and Power District ("SRP"), manager of NGS, has informed the Company that, although no accurate cost estimate is available at the present time, the installation of pollution control equipment at NGS to meet the EPA's proposed emission limits could require capital expenditures of approximately $450 million. The Company would be required to fund 14% of any such expenditures. The Company cannot currently predict the outcome of this matter.

The Clean Air Act Amendments of 1990 (the "Act"), which was signed into law by the President on November 15, 1990, will be implemented through regulations to be developed during the next decade by the EPA and state and local environmental regulatory authorities. Therefore, it is not presently possible to precisely predict the impacts of those regulations on the Company's operations. However, based on information currently available, the Company does not expect its costs relating to the implementation of the Act to have a material impact on its financial statements.

Operating Results

Summary. Net income decreased in 1990 to $180,012,000 compared to $212,354,000 and $271,211,000 in 1989 and 1988, respectively.

	Year Ended December 31,		
	1990	1989	1988
		(Thousands of Dollars)	
Operating Revenues	$1,508,325	$1,447,154	$1,442,023
Net Income	$ 180,012	$ 212,354	$ 271,211

Several factors contributed to the decline in the Company's net income in 1990 as compared to 1989. Operation costs were higher primarily because of severance and other costs relating to the Company's restaffing efforts and the special early retirement program offered by the Company to certain employees. Operation costs were also higher due to expenses associated with Palo Verde operations, including the refueling of Palo Verde Unit 2. Property taxes increased due to higher tax rates, and interest costs increased as a result of greater average debt balances outstanding. Also, depreciation expense was higher due to additional facilities being placed in service.

The decline in net income in 1989 as compared to 1988 was primarily due to higher fuel and purchased power costs incurred as a result of extended unscheduled outages experienced by all three Palo Verde units during 1989. Also, higher operation and maintenance costs in 1989 were in large part due to these outages. Several other factors contributed to the decrease in 1989 net income. Depreciation expenses and property taxes were higher due to additional facilities being placed in service. Property taxes also increased due to higher tax rates. Interest costs increased as result of greater average debt balances outstanding combined with higher interest rates.

Electric Operating Revenues. Total operating revenues include the effects of rate increases and adjustment clauses on prices of units sold. Operating revenues also reflect volume changes in unit sales. The foregoing factors contributed to annual increases in electric operating revenues over the preceding calendar year as follows:

	Year Ended December 31,		
	1990	1989	1988*
	(Thousands of Dollars)		
Energy related:			
Volume increases (1)	$ 79,492	$ 44,690	$ 90,439
Revenue per kilowatt-hour increases (decreases) (2)	20,735	(18,392)	29,732
Non-energy related:			
Revenue (decreases) (3)	(39,056)	(21,167)	(1,078)
Total increase	$ 61,171	$ 5,131	$119,093

* Certain prior year items have been reclassified to conform to 1990 presentation.

(1) Calculated by summing the results of multiplying the year-to-year increases in units sold in each customer class by the weighted average of the applicable rate levels in effect for the prior year.

(2) Calculated by summing the results of multiplying the year-to-year increases in the weighted average of rate levels in each customer class times the applicable number of units sold in the current years.

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

In 1990, the volume-related increases occurred in the resale, business, and residential customer classes. The increases were largely due to increased resale sales, customer growth in residential and business customer classes, and increased sales per business customer. In 1989, the volume-related increases occurred in the residential and business customer classes. The increases were largely due to customer growth and increased sales per customer. In 1988, the volume-related increases incurred in the residential, business, and resale customer classes. The increases were largely due to customer growth, increased sales per customer as a result of warmer summer weather, increased sales to copper mines, and increased sales for resale. Price-related revenue increases and decreases reflect the timing and amounts of base rate changes, discontinuation of the Company's Purchased Power and Fuel Adjustment Mechanism ("PPFAM"), the incentive for customers to migrate over time to that rate schedule which produces the lowest bill, and the effect of weather and seasonal rates on annual average revenue per kilowatt-hour. The decrease in 1990 in non-energy related electric revenues was primarily due to the expiration of a layoff agreement for capacity sold from Cholla 4, combined with a termination settlement received in 1989 from one wholesale customer. The decrease in 1989 was primarily due to a partial expiration of a layoff agreement for capacity sold from Cholla 4, which was partially offset by the aforementioned termination settlement.

Fuel Expenses. Fuel expenses increased in 1990 due to increased generation, largely offset by lower unit fuel costs resulting from increased nuclear generation. Fuel expenses increased in 1989 due to increased fossil generation resulting from extended unscheduled outages experienced by all three Palo Verde units during 1989. Fuel expenses increased in 1988 as increased system energy requirements more than offset lower unit fuel costs resulting from increased nuclear generation attributable to Palo Verde Units 2 and 3.

Variations in purchased power expense reflect contractual commitments with other utilities for purchasing power as a means of augmenting the Company's own generating sources from time to time. Decreases in purchased power in 1988 and 1990 were primarily due to increased nuclear generation. During 1989, the Company incurred additional replacement power costs as a result of extended unscheduled Palo Verde outages.

Until 1989, nearly all of the Company's purchased power and fuel costs were either recovered currently or deferred to the extent allowed by the ACC pursuant to the PPFAM and, accordingly, did not materially affect earnings. On April 13, 1989, the ACC issued an order eliminating the PPFAM. Without the PPFAM, actual purchased power and fuel costs incurred are reflected currently in earnings. The order requires the Company to seek recovery of any changes in fuel and purchased power costs along with changes in other elements of cost of service in a general rate request. In its current rate proceeding before the ACC, the Company requested an expedited procedure to incorporate in rates significant changes in fuel and purchased power costs. See "ACC Matters — Application for Retail Rate Increase" below.

Other Income. Net income reflects accounting practices unique to regulated public utilities and represents a composite of cash and noncash items, including AFC and the cost deferrals associated with Palo Verde Units 2 and 3 (see "Statements of Cash Flows").

Palo Verde Unit 2 commenced commercial operation on September 19, 1986. The Company began expensing the costs of operating and maintaining Unit 2 and ceased accruing AFC on such investment at that time. Pursuant to an ACC accounting and ratemaking order, the Company deferred Unit 2 operating costs (excluding fuel) and accrued a carrying charge on such deferrals until April 1, 1988, the effective date of new rates to cover the costs relating to Unit 2. As a result, earnings were not significantly affected by the increased costs and reduced AFC.

Palo Verde Unit 3 Cost Deferrals. Palo Verde Unit 3 commenced commercial operation on January 8, 1988. The Company began expensing the costs of operating and maintaining Unit 3 and ceased accruing AFC on such investment at that time. On April 6, 1988, the ACC issued an accounting and ratemaking order that allows the Company, for ACC purposes, to defer and capitalize substantially all Unit 3 operating costs (excluding fuel) and to accrue a carrying charge on its ownership interest in Unit 3 and one-third of the facilities common to all three Palo Verde units (collectively, the "Unit 3 Cost Deferrals"). The ACC ordered the period for accumulating such deferrals to commence on January 8, 1988, and to continue until the later of December 31, 1989, or the date that the ACC rules on the application for an extension of the deferral period which was filed by the Company on June 30, 1989 (the "Extension Application"). The Extension Application, which has not as yet been ruled on, requests an extension of the deferral period until such time as the ACC includes Unit 3 in the Company's rate base. Unit 3 Cost Deferrals totalled approximately $281 million, net of income taxes, at December 31, 1990. Unit 3 Cost Deferrals are currently accruing in the amount of approximately $7 million per month, net of income taxes.

An ACC procedural order issued on September 22, 1989, stated that the issues of excess capacity and the unscheduled Palo Verde Unit 3 outages during 1989 are relevant in determining the propriety of continued deferrals. A rate application designed to recover Unit 3 costs including deferrals has been filed with the ACC. The ACC has scheduled consolidated hearings on the Extension Application and the Company's retail rate application. See "ACC Matters—Application for Retail Rate Increase" below. If the ACC rules unfavorably on the Extension Application, recoverability of Unit 3 plant costs or deferrals could be limited and/or deferrals could be discontinued, either of which would have an adverse impact on earnings.

Accounting Matters. The Financial Accounting Standards Board (the "FASB") has issued Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." This Statement will require accrual of postretirement benefits (such as health care benefits) during the years an employee provides services. The costs of these benefits are currently expensed on a pay-as-you-go basis. The impact of this new standard has not been fully determined, but the change likely will result in greater expense being recognized for provision of these benefits. The Company expects that the increased benefits expense will either be recovered currently through rates or that a regulatory

asset will be recorded to reflect amounts to be recovered through rates in the future as the costs are paid; therefore, this Statement should not have a significant impact on the Company's financial position or results of operations. The Company plans to adopt this Statement in 1993.

In December 1987, the FASB issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes" ("SFAS No. 96"). See Note 9 in Notes to Financial Statements. SFAS No. 96 was to have been effective beginning in 1990; however, the FASB has delayed the effective date to 1992, and is currently considering revising the standard again which will likely result in a 1993 effective date. The Company has not yet made a determination as to the timing of implementation.

ACC Matters

The Company's future financial condition and results of operations may be significantly affected by the following ACC matters.

Application for Retail Rate Increase. Palo Verde Unit 3 and Cholla 4 are not currently reflected in the Company's retail rates. The Company's investment in Palo Verde Unit 3 as of December 31, 1990 was approximately $1.3 billion, including cost deferrals. The Company's investment in Cholla 4 as of December 31, 1990 was approximately $233 million. After consideration of accumulated deferred income taxes relating to plant costs and cost deferrals, the Company's net rate base investment was approximately $1.0 billion and $216 million for Palo Verde Unit 3 and Cholla 4, respectively. The Company currently has pending before the ACC a retail rate application that seeks a permanent increase in annual retail rates of approximately $259 million to become effective in three annual 6.5% increments. The proposed rate increase seeks to recover the costs of Palo Verde Unit 3 and Cholla 4, as well as costs incident to the increase in retail customers and in the cost of service since 1986 (the prior test year). The rate application includes requests to (1) remove the "interim" designation for revenues collected under a previous rate order (see "Interim or Temporary Revenues" below); (2) approve an expedited procedure to incorporate in rates significant changes in fuel and purchased power costs; and (3) approve a property tax adjustment clause allowing the Company to recover in rates certain increases in property taxes. The ACC has scheduled consolidated hearings on the Extension Application and the Company's pending retail rate application. The ACC has divided the consolidated hearings into three phases. The "Phase I" hearings (construction and operation of Palo Verde and system capacity) began on February 19, 1991. The "Phase II" hearings (revenue requirements and the financial impacts of recommendations addressed in the "Phase I" hearings) are scheduled to begin on April 8, 1991. The "Phase III" hearings (class cost of service, rate design, and tariffs) are scheduled to begin on May 6, 1991. The procedural orders scheduling the consolidated hearings indicate that a single order addressing all three phases will be issued after the conclusion of the "Phase III" hearings.

On September 21, 1990, the Company filed a Settlement Proposal with the ACC designed to resolve all of the issues in the foregoing consolidated hearings. The Settlement Proposal requested a permanent increase in annual retail rates, to be effective as of January 1, 1991, of approximately $116 million (9.33%), approximately $43 million (3.44%) of which related to certain property tax increases since the final order in the Company's last rate case. The Settlement Proposal reflected cost reductions and revenue adjustments associated with, among other things, a permanent write-off of up to $250 million (net of income taxes) in Palo Verde costs, recently announced capital and operation and maintenance budget cuts, a reduction in the Company's personnel and other anticipated cost savings measures, and the expected impact of certain transactions, including the sale of Cholla 4 (see "Asset Purchase and Power Exchange" below).

On December 4, 1990, the ACC held a meeting to discuss the Settlement Proposal during which the ACC Staff described its counterproposal which included significantly larger

disallowances of plant and/or deferred costs relative to Palo Verde. (The ACC Staff's position is more fully described below.) The Company informed the ACC that the counterproposal is unacceptable.

On December 14, 1990, the ACC Staff filed a Staff Report stating that further settlement discussions would be futile, and that the ACC Staff would focus its efforts on the hearings in the pending rate case. The ACC Staff left open the Company's option to accept the ACC Staff's final settlement offer of 4.6% ($57.1 million). The Staff Report indicates that the ACC Staff's latest settlement offer is its current best estimate of its recommendation in the hearings in the pending rate case.

On December 14, 1990, in accordance with the operative procedural order in the pending rate case, the ACC Staff filed its Phase I direct testimony recommending (1) a complete disallowance and write-off of all deferred costs associated with Palo Verde Unit 3 ($259 million associated with Palo Verde Unit 3 and $22 million of common plant, both net of tax as of December 31, 1990), and (2) that Unit 3 represents "excess capacity," at least until 1995. The state's consumer advocate, the Residential Utility Consumer Office ("RUCO"), also submitted its prefiled testimony making a similar recommendation. The ACC Staff and RUCO positions are based on a conclusion that Palo Verde Unit 3 represented "excess capacity" during the period costs were being deferred and will continue to represent "excess capacity" for current ratemaking purposes. It is the Company's position that a temporary exclusion of Unit 3 investment from rate base coupled with a complete disallowance of cost deferrals would have a severe and unacceptable effect on the Company's financial results. The Company continues to believe that Palo Verde Unit 3 was not and is not "excess capacity" and will strenuously defend that position in the upcoming hearings and will continue to seek the full recovery of the Unit 3 deferred costs and the inclusion of the unit in its rate base for ratemaking purposes.

The ACC Staff has also recommended the permanent write-off as imprudently incurred of between $142-225 million in construction costs for all three Palo Verde units. RUCO's testimony recommends construction prudence write-offs of $400 million for Palo Verde Units 1, 2, and 3. The Company believes the construction costs of Palo Verde were prudent and reasonable. The Company believes its position as filed in direct testimony coupled with the outcome of an ACC-ordered prudence audit (see below) demonstrates that the construction costs of Palo Verde were prudent and reasonable. Thus, the Company will continue to aggressively seek recovery of all Palo Verde construction costs.

Generally accepted accounting principles require the Company to write off asset costs, net of the income tax effects, when it becomes probable that such costs will be disallowed for ratemaking purposes and a reasonable estimate of the amount of the disallowance can be made. At the present time, the outcome of the full rate case proceeding cannot be determined.

Palo Verde Prudence Audit. On March 24, 1989, Ernst & Whinney released its report on the prudence audit of Palo Verde. The report identified approximately $60 million, excluding AFC and property taxes, for the entire project that were unreasonable. Of this amount, the Company's share is approximately $18 million. The report also identified certain areas that were found to exceed the standard of reasonableness and to have had a positive impact on the project, including built-in separation of electrical equipment, design replication of the three units at Palo Verde, certain aspects of the regulatory (licensing) management function, and certain labor and contractual arrangements. The report estimated that the potential direct cost savings of the identified areas in which performance exceeded the standard of reasonableness were approximately $300 million for the entire project (excluding AFC and property taxes), of which the Company's share is approximately $85 million.

Interim or Temporary Revenues. Pursuant to an order issued by the ACC in April 1988, the Company estimates that up to $300 million in revenues collected through December 31, 1990 are to be deemed interim or temporary pending results of the prudence audit and further action of

the ACC. The retail rate application increase pending before the ACC requests that the "interim" designation for revenues collected under this rate order be removed and that no revenues be refunded. In the opinion of management, the amount, if any, of such revenues to be refunded will not be material to the Company's financial statements.

ACC Review of Dividend Payments. On August 15, 1989, as a result of a negotiated settlement (the "Settlement Agreement"), the Company agreed that it will not, without prior ACC approval, transfer any funds to Pinnacle West or any of its subsidiaries, directly or indirectly, except for regular quarterly dividend payments not in excess of that declared and paid immediately prior to July 13, 1989 (approximately $52.7 million per quarter), and for reasonable amounts for the payment of services historically rendered to the Company by Pinnacle West or any of its subsidiaries. Effective as of March 1, 1990, the Company entered into an agreement to amend the Settlement Agreement to extend the termination date from March 1, 1990, to at least December 31, 1990; thereafter the Settlement Agreement will remain in effect until the earlier of September 30, 1991, or the ACC's issuance of a final rate order in the retail rate case pending before the ACC (see "Application for Retail Rate Increase" above). The ACC may initiate proceedings during the term of the Settlement Agreement to effectuate changes in the Company's dividend policy if, and only if, catastrophic and disastrous events occur which could significantly affect the Company's financial condition or prevent the Company from financing at reasonable costs its capital requirements necessary to meet customer service needs. In such event, however, the Company and Pinnacle West would be free to challenge any such action by the ACC.

Asset Purchase and Power Exchange. On September 21, 1990, the Company and PacifiCorp entered into four agreements (the "Agreements") relating principally to sales and purchases of electric power and electric utility assets. As part of the Agreements, PacifiCorp agreed to purchase, from the Company, Cholla 4 and certain associated common facilities, coal inventory, and materials and supplies for a purchase price of approximately $230 million. The Agreements provide that if closing does not occur before March 8, 1991, either party may terminate the Agreements if such party is not in default thereunder. On September 21, 1990, the Company filed an application with the ACC requesting (1) approval to sell Cholla 4 and related common facilities to PacifiCorp and (2) specified ratemaking treatment with respect to certain aspects of the Agreements, including the sale of Cholla 4. On January 28, 1991, a procedural order was issued setting the hearing in this matter to begin on April 8, 1991. On October 12, 1990, the Company and PacifiCorp filed a joint application with Federal Energy Regulatory Commission ("FERC"), as amended on December 12, 1990, requesting approval of the rates and arrangements for transmission and power sales as provided in the Agreements. The matter is currently pending at FERC. The Company intends to take all actions to effect closing as soon as possible.

EFFECTS OF INFLATION

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

Report of Management

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

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

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

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

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

O. Mark De Michele President and Chief Executive Officer	Jaron B. Norberg Executive Vice President and Chief Financial Officer

ARIZONA PUBLIC SERVICE COMPANY

STATEMENTS OF INCOME

	Year Ended December 31, 1990	1989	1988
	(Thousands of Dollars)		
Electric Operating Revenues	$1,508,325	$1,447,154	$1,442,023
Fuel Expenses:			
Fuel for electric generation	242,676	235,854	207,387
Purchased power	46,372	65,125	33,592
Deferred fuel (Note 1)	—	(31,901)	(4)
Total	289,048	269,078	240,975
Operating Revenues Less Fuel Expenses	1,219,277	1,178,076	1,201,048
Other Operating Expenses:			
Operations excluding fuel expenses	298,533	251,985	244,913
Maintenance	109,814	120,639	108,153
Depreciation and amortization	211,727	202,409	194,334
Income taxes (Note 9)	106,044	122,674	157,350
Other taxes (Note 12)	197,650	174,213	160,697
Palo Verde cost deferral (Note 2)	(64,379)	(68,989)	(67,479)
Total	859,389	802,931	797,968
Operating Income	359,888	375,145	403,080
Other Income (Deductions):			
Allowance for equity funds used during construction	4,042	5,954	12,069
Palo Verde cost deferral (Note 2)	71,404	72,861	79,432
Income taxes (Note 9)	(20,787)	(23,004)	(26,547)
Other - net	2,054	1,154	6,740
Total	56,713	56,965	71,694
Income Before Interest Deductions	416,601	432,110	474,774
Interest Deductions:			
Interest on long-term debt	226,258	213,710	202,173
Interest on short-term borrowings	13,734	10,533	4,988
Debt discount, premium and expense	5,302	5,967	6,251
Allowance for borrowed funds used during construction	(8,705)	(10,454)	(9,849)
Total	236,589	219,756	203,563
Net Income	180,012	212,354	271,211
Preferred Stock Dividend Requirements	31,060	32,302	33,319
Earnings for Common Stock	$ 148,952	$ 180,052	$ 237,892

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

BALANCE SHEETS

ASSETS

	December 31, 1990	December 31, 1989
	(Thousands of Dollars)	
Utility Plant (Notes 5, 7 and 8):		
Electric plant in service and held for future use	$6,417,743	$6,213,656
Less accumulated depreciation and amortization	1,582,528	1,399,365
Total	4,835,215	4,814,291
Construction work in progress	209,266	248,207
Nuclear fuel, net of amortization of $87,699,000 and $100,549,000	81,980	106,232
Utility Plant—net	5,126,461	5,168,730
Investments and Other Assets (at cost)	52,609	58,535
Current Assets:		
Cash and cash equivalents	10,720	73,923
Accounts receivable:		
Service customers	104,105	91,258
Other	36,490	31,307
Allowance for doubtful accounts	(2,647)	(2,774)
Accrued utility revenues (Note 1)	45,466	42,418
Materials and supplies (at average cost)	101,440	89,505
Fossil fuel (at average cost)	27,810	24,427
Other	9,520	14,667
Total Current Assets	332,904	364,731
Deferred Debits:		
Deferred income taxes	149,118	134,698
Palo Verde Unit 3 cost deferral (Note 2)	428,340	293,570
Palo Verde Unit 2 cost deferral	196,186	202,248
Unamortized costs of reacquired debt	29,413	29,318
Unamortized debt issue costs	16,066	15,947
Other	71,583	32,108
Total Deferred Debits	890,706	707,889
Total	$6,402,680	$6,299,885

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

BALANCE SHEETS

LIABILITIES

	December 31, 1990	December 31, 1989
	(Thousands of Dollars)	
Capitalization (Notes 3, 4 and 5):		
Common stock	$ 178,162	$ 178,162
Premiums and expenses—net	1,034,361	1,034,346
Retained earnings	647,587	689,107
Common stock equity	1,860,110	1,901,615
Non-redeemable preferred stock	168,561	168,561
Redeemable preferred stock	192,453	204,021
Long-term debt less current maturities	2,303,953	2,306,339
Total Capitalization	4,525,077	4,580,536
Current Liabilities:		
Notes payable to banks (Note 6)	100,000	240,000
Commercial paper (Note 6)	59,000	—
Current maturities of long-term debt (Note 5)	173,366	26,193
Accounts payable	74,288	87,253
Accrued taxes	90,559	76,084
Accrued interest	64,013	60,652
Other	34,297	44,083
Total Current Liabilities	595,523	534,265
Deferred Credits and Other:		
Deferred income taxes (Note 9)	868,001	771,573
Deferred investment tax credit	178,964	185,976
Unamortized gain—sale of utility plant (Note 8)	115,240	119,850
Unamortized credit related to sale of tax benefits	35,208	36,895
Customer advances for construction	23,392	26,138
Other	61,275	44,652
Total Deferred Credits and Other	1,282,080	1,185,084
Commitments and Contingencies (Notes 2 and 11)		
Total	$6,402,680	$6,299,885

ARIZONA PUBLIC SERVICE COMPANY

STATEMENTS OF RETAINED EARNINGS

	Year Ended December 31, 1990	1989	1988
	(Thousands of Dollars)		
Retained earnings at beginning of year	$689,107	$719,999	$693,051
Add—Net income	180,012	212,354	271,211
Total	869,119	932,353	964,262
Deduct—Dividends:			
Common stock (Notes 3, 4 and 5)	190,472	210,944	210,944
Preferred stock (see below)	31,060	32,302	33,319
Total	221,532	243,246	244,263
Retained earnings at end of year	$647,587	$689,107	$719,999
Dividends on preferred stock:			
$1.10 preferred	$ 172	$ 172	$ 172
$2.50 preferred	258	258	258
$2.36 preferred	94	94	94
$4.35 preferred	326	326	326
Serial preferred:			
$2.40 Series A	576	576	576
$2.625 Series C	630	630	630
$2.275 Series D	455	455	455
$3.25 Series E	1,040	1,040	1,040
$10.00 Series H	353	513	674
$8.32 Series J	4,160	4,160	4,160
$8.80 Series K	2,042	2,083	2,372
$12.90 Series N	3,291	3,953	4,561
Adjustable Rate Series Q	3,448	3,442	3,538
$11.50 Series R	5,725	6,110	5,973
$8.48 Series S	4,240	4,240	4,240
$8.50 Series T	4,250	4,250	4,250
Total	$ 31,060	$ 32,302	$ 33,319

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY

STATEMENTS OF CASH FLOWS

	Year Ended December 31, 1990	1989	1988
	(Thousands of Dollars)		
Cash Flows from Operations:			
Net income	$180,012	$212,354	$271,211
Items not requiring cash:			
Depreciation and amortization	211,727	202,409	194,334
Nuclear fuel amortization	44,739	17,241	51,165
Allowance for equity funds used during construction	(4,042)	(5,954)	(12,069)
Deferred income taxes — net	82,008	107,860	118,606
Deferred investment tax credit — net	(7,012)	(6,159)	(9,107)
Deferred fuel	—	(33,543)	(58)
Palo Verde cost deferral	(135,783)	(141,850)	(146,911)
Changes in certain current assets and liabilities:			
Accounts receivable — net	(18,157)	(3,177)	8,644
Accrued utility revenues	(3,048)	(1,394)	(6,029)
Materials, supplies and fossil fuel	(15,318)	(8,968)	(8,605)
Other current assets	5,147	(4,699)	3,842
Accounts payable	(7,701)	18,322	(7,836)
Accrued taxes	14,475	1,170	10,851
Accrued interest	2,422	7,212	1,278
Other current liabilities	(8,758)	8,095	(133)
Other — net	15,651	7,215	18,187
Net cash provided	356,362	376,134	487,370
Cash Flows from Financing:			
Long-term debt	222,215	98,625	11,668
Short-term borrowings — net	(81,000)	190,500	49,500
Dividends paid on common stock	(190,472)	(210,944)	(210,944)
Dividends paid on preferred stock	(32,088)	(31,823)	(33,003)
Repayment of preferred stock	(11,568)	(8,927)	(9,030)
Repayment and reacquisition of long-term debt	(82,111)	(54,528)	(31,406)
Net cash used	(175,024)	(17,097)	(223,215)
Cash Flows from Investing:			
Capital expenditures	(259,280)	(300,347)	(277,228)
Allowance for equity funds used during construction	4,042	5,954	12,069
Sale of property	4,771	8,745	—
Other	5,926	(7,342)	(4,763)
Net cash used	(244,541)	(292,990)	(269,922)
Net increase (decrease) in cash and cash equivalents	(63,203)	66,047	(5,767)
Cash and cash equivalents at beginning of period	73,923	7,876	13,643
Cash and cash equivalents at end of period	$ 10,720	$ 73,923	$ 7,876
Supplemental Disclosure of Cash Flow Information:			
Cash paid during the year for:			
Interest (excluding capitalized interest)	$227,985	$205,646	$193,289
Income taxes	$ 49,145	$ 51,686	$ 67,575

See Notes to Financial Statements.

ARIZONA PUBLIC SERVICE COMPANY
NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies.

a. System of accounts—The accounting records of Arizona Public Service Company (the "Company") are maintained in accordance with the uniform system of accounts prescribed by the Federal Energy Regulatory Commission ("FERC").

b. All of the outstanding shares of common stock of the Company are owned by Pinnacle West Capital Corporation ("Pinnacle West").

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

d. Plant and depreciation—Property is stated at original cost as defined for regulatory purposes. The cost of additions to utility plant and replacements of retirement units is capitalized. Replacements of minor items of property are charged to expense as incurred. In addition to direct costs, capitalized items include the present value of certain future lease payments (see Note 5), research and development expenditures pertaining to construction projects, indirect charges for engineering, supervision, transportation and similar costs, and an allowance for funds used during construction. Costs of depreciable units of plant retired are eliminated from plant accounts and such costs plus removal expenses less salvage are charged to accumulated depreciation. Contributions in aid of construction are credited to plant cost.

Depreciation on utility property is provided on a straight-line basis at rates authorized by the Arizona Corporation Commission (the "ACC") annually. The applicable rates for 1988 through 1990 ranged from 0.68% to 15.00%.

Decommissioning costs for the Company's interest in the Palo Verde Nuclear Generating Station ("Palo Verde") are charged to depreciation expense and are being deposited in external trust funds until the decommissioning of the nuclear facilities takes place. At December 31, 1990 the balance in the trust accounts amounted to $16,837,000, and is included in the Company's Investments and Other Assets on the balance sheets. Total decommissioning costs for all three Palo Verde units are estimated at approximately $760 million (in 1989 dollars), of which the Company's 29.1% share is approximately $221 million.

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

Until 1989 nearly all of the Company's purchased power and fuel costs were either recovered currently or deferred to the extent allowed by the ACC pursuant to the Purchased Power and Fuel Adjustment Mechanism ("PPFAM") and, accordingly, did not materially affect earnings. On April 13, 1989 the ACC issued an order eliminating the PPFAM. Without the PPFAM, actual purchased power and fuel costs incurred are reflected currently in earnings.

f. Allowance for funds used during construction—In accordance with the regulatory accounting practice prescribed by the FERC and the ACC, the Company capitalizes an allowance for the cost of funds used to finance its construction program ("AFC"). AFC, which does not represent current cash earnings, is defined as the cost of borrowed funds and a reasonable rate of return on equity funds used during construction. The calculated amount is capitalized as a part of the cost of utility plant.

AFC has been calculated using composite rates of 11.25% for 1988; 10.50% for 1989; and 10% for 1990. The Company compounds AFC semiannually and ceases to accrue AFC when construction is completed and the property is placed in service.

g. Income taxes—The Company uses accelerated depreciation methods for income tax purposes. As prescribed by the ACC, deferred income taxes are provided for certain timing differences arising from the recording, for income tax and financial reporting purposes, of

depreciation on property placed in service after January 1, 1977. In accordance with an ACC order, the Company defers amounts equal to the change in income taxes arising from substantially all other timing differences, which prior to October 1983 were reflected currently in income. At December 31, 1990 the Company had flowed through to income currently approximately $170 million of income tax benefits arising from income tax timing differences for which deferred taxes have not been provided.

In compliance with an ACC order, the Company defers amounts equal to the reduction in federal income taxes arising from investment tax credits and amortizes these amounts to other income over the estimated life of the related assets.

In 1981, the Company sold to another corporation certain federal income tax benefits in exchange for cash. The Company, pursuant to an order of the ACC, has recorded the proceeds of the sale as a deferred credit and is amortizing the amount of such proceeds on a straight-line basis over approximately 30 years.

The Company is included in the consolidated income tax returns of Pinnacle West. Income taxes are allocated to the Company based on its separate company taxable income or loss. Income taxes paid to Pinnacle West amounted to $49,145,000, $51,686,000 and $67,575,000 in 1990, 1989 and 1988, respectively.

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

i. Reacquired debt costs—In accordance with the regulatory accounting practices prescribed by the ACC, the Company defers the excess of the reacquisition price of reacquired debt over the net carrying amount and amortizes these amounts to expense over the remainder of the original life of the issues reacquired.

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

Pursuant to the Nuclear Waste Policy Act of 1982, as amended (the "Act"), contracts have been entered into with the U.S. Department of Energy for disposal of spent nuclear fuel. The Act provides for an assessment of $0.001 per kilowatt-hour of nuclear generation. This amount is charged to nuclear fuel expense and recovered through rates.

k. Reclassification—certain prior year balances have been reclassified to conform to the 1990 presentation.

2. ACC and Related Matters.

Application for Retail Rate Increase

Palo Verde Unit 3 and Unit 4 of the Cholla Power Plant ("Cholla 4") are not currently reflected in the Company's retail rates. The Company's investment in Palo Verde Unit 3 as of December 31, 1990 was approximately $1.3 billion, including cost deferrals. The Company's investment in Cholla 4 as of December 31, 1990 was approximately $233 million. After consideration of accumulated deferred income taxes relating to plant costs and cost deferrals, the Company's net rate base investment was approximately $1.0 billion and $216 million for Palo Verde Unit 3 and Cholla 4, respectively. The Company currently has pending before the ACC a retail rate application that seeks a permanent increase in annual retail rates of approximately $259 million to become effective in three annual 6.5% increments. The proposed rate increase seeks to recover the costs of Palo Verde Unit 3 and Cholla 4, as well as costs incident to the increase in retail customers and in the cost of service since 1986 (the prior test year). The rate application includes requests to (1) remove the "interim" designation for revenues collected

under a previous rate order (see "Interim or Temporary Revenues" below); (2) approve an expedited procedure to incorporate in rates significant changes in fuel and purchased power costs; and (3) approve a property tax adjustment clause allowing the Company to recover in rates certain increases in property taxes.

The ACC has scheduled consolidated hearings on the Extension Application (defined below) and the Company's pending retail rate application. The ACC has divided the consolidated hearings into three phases. The "Phase I" hearings (construction and operation of Palo Verde and system capacity) began on February 19, 1991. The "Phase II" hearings (revenue requirements and the financial impacts of recommendations addressed in the "Phase I" hearings) are scheduled to begin on April 8, 1991. The "Phase III" hearings (class cost of service, rate design and tariffs) are scheduled to begin on May 6, 1991. The procedural orders scheduling the consolidated hearings indicate that a single order addressing all three phases will be issued after the conclusion of the "Phase III" hearings.

On September 21, 1990, the Company filed a Settlement Proposal with the ACC designed to resolve all of the issues in the consolidated hearings discussed below. The Settlement Proposal requested a permanent increase in annual retail rates, to be effective as of January 1, 1991, of approximately $116 million (9.33%), approximately $43 million (3.44%) of which related to certain property tax increases since the final order in the Company's last rate case. The Settlement Proposal reflected cost reductions and revenue adjustments associated with, among other things, a permanent write-off of up to $250 million (net of income taxes) in Palo Verde costs, capital and operation and maintenance budget cuts, a reduction in the Company's personnel and other anticipated cost savings measures, and the expected impact of certain transactions, including the sale of Cholla 4 (see "Asset Purchase and Power Exchange" below).

On December 4, 1990, the ACC held a meeting to discuss the Settlement Proposal during which the ACC Staff described its counterproposal which included significantly larger disallowances of plant and/or deferred costs relative to Palo Verde. (The ACC Staff's position is more fully described below.) The Company informed the ACC that the counterproposal is unacceptable.

On December 14, 1990, the ACC Staff filed a Staff Report stating that further settlement discussions would be futile, and that the ACC Staff would focus its efforts on the hearings in the pending rate case. The ACC Staff left open the Company's option to accept the ACC Staff's final settlement offer of 4.6% ($57.1 million). The Staff Report indicates that the ACC Staff's latest settlement offer is its current best estimate of its recommendation in the hearings in the pending rate case.

On December 14, 1990, in accordance with the operative procedural order in the pending rate case, the ACC Staff filed its Phase I direct testimony recommending (1) a complete disallowance and write-off of all deferred costs associated with Palo Verde Unit 3 ($259 million associated with Palo Verde Unit 3 and $22 million of common plant, both net of tax as of December 31, 1990) and (2) that Unit 3 represents "excess capacity," at least until 1995. The state's consumer advocate, the Residential Utility Consumer Office ("RUCO"), also submitted its prefiled testimony making a similar recommendation. The ACC Staff and RUCO positions are based on a conclusion that Palo Verde Unit 3 represented "excess capacity" during the period costs were being deferred and will continue to represent "excess capacity" for current ratemaking purposes. It is the Company's position that a temporary exclusion of Unit 3 investment from rate base coupled with a complete disallowance of cost deferrals would have a severe and unacceptable effect on the Company's financial results. The Company continues to

believe that Palo Verde Unit 3 was not and is not "excess capacity" and will strenuously defend that position in the upcoming hearings and will continue to seek the full recovery of the Unit 3 deferred costs and the inclusion of the unit in its rate base for ratemaking purposes.

The ACC Staff has also recommended the permanent write-off as imprudently incurred of between $142-225 million in construction costs for all three Palo Verde Units. RUCO's testimony recommends construction prudence write-offs of $400 million for Palo Verde Units 1, 2, and 3. The Company believes the construction costs of Palo Verde were prudent and reasonable. The Company believes its position as filed in direct testimony coupled with the outcome of an ACC-ordered prudence audit demonstrates that the construction costs of Palo Verde were prudent and reasonable. Thus, the Company will continue to aggressively seek recovery of all Palo Verde construction costs.

Generally accepted accounting principles require the Company to write off asset costs, net of the income tax effects, when it becomes probable that such costs will be disallowed for ratemaking purposes and a reasonable estimate of the amount of the disallowances can be made. At the present time, the outcome of the full rate case proceeding cannot be determined.

Palo Verde Unit 3 Cost Deferrals

Palo Verde Unit 3 commenced commercial operation on January 8, 1988. The Company began expensing the cost of operating and maintaining Unit 3 and ceased accruing AFC on such investment at that time. On April 6, 1988, the ACC issued an accounting and ratemaking order that allows the Company, for ACC purposes, to defer and capitalize substantially all Unit 3 operating costs (excluding fuel) and to accrue a carrying charge on its ownership interest in Unit 3 and one-third of the facilities common to all three Palo Verde units (collectively, the "Unit 3 Cost Deferrals"). The ACC ordered the period for accumulating such deferrals to commence on January 8, 1988, and to continue until the later of December 31, 1989, or the date that the ACC rules on the application for an extension of the deferral period which was filed by the Company on June 30, 1989 (the "Extension Application"). The Extension Application, which has not as yet been ruled on, requests an extension of the deferral period until such time as the ACC includes Unit 3 in the Company's rate base. Unit 3 Cost Deferrals totalled approximately $281 million, net of income taxes, at December 31, 1990. Unit 3 Cost Deferrals are currently accruing in the amount of approximately $7 million per month, net of income taxes.

An ACC procedural order issued on September 22, 1989, stated that the issues of excess capacity and the unscheduled Palo Verde Unit 3 outages during 1989 are relevant in determining the propriety of continued deferrals. A rate application designed to recover Unit 3 costs including deferrals has been filed with the ACC. See "Application for Retail Rate Increase" above. The ACC has scheduled consolidated hearings on the Extension Application and the Company's retail rate application. If the ACC rules unfavorably on the Extension Application, recoverability of Unit 3 plant costs or deferrals could be limited and/or deferrals could be discontinued, either of which would have an adverse impact on earnings.

Prudence Audit

On March 24, 1989, Ernst & Whinney released its report on the prudence audit of Palo Verde. The report identified approximately $60 million, excluding AFC and property taxes, for the entire project that were unreasonable. Of this amount, the Company's share is approximately $18 million. The report also identified certain areas that were found to exceed the standard of reasonableness and to have a positive impact on the project, including built-in separation of electrical equipment, design replication of the three units at Palo Verde, certain aspects of the regulatory (licensing) management function, and certain labor and contractual arrangements. The report estimated that the potential direct cost savings of the identified areas

in which performance exceeded the standard of reasonableness were approximately $300 million for the entire project (excluding AFC and property taxes), of which the Company's share is approximately $85 million.

Interim or Temporary Revenues

Pursuant to an order issued by the ACC in April 1988, the Company estimates that up to $300 million of revenues collected through December 31, 1990 are to be deemed interim or temporary pending results of the prudence audit and further action of the ACC. The retail rate application pending before the ACC requests that the "interim" designation for revenues collected under this rate order be removed and that no revenues be refunded. See "Application for Retail Rate Increase" above. In the opinion of management, the amount, if any, of such revenues to be refunded will not be material to the Company's financial statements.

ACC Review of Dividend Payments. On August 15, 1989, as a result of a negotiated settlement (the "Settlement Agreement"), the Company agreed that it will not, without prior ACC approval, transfer any funds to Pinnacle West or any of its subsidiaries, directly or indirectly, except for regular quarterly dividend payments not in excess of that declared and paid immediately prior to July 13, 1989 (approximately $52.7 million per quarter), and for reasonable amounts for the payment of services historically rendered to the Company by Pinnacle West or any of its subsidiaries. Effective as of March 1, 1990, the Company entered into an agreement to amend the Settlement Agreement to extend the termination date from March 1, 1990, to at least December 31, 1990; thereafter the Settlement Agreement will remain in effect until the earlier of September 30, 1991, or the ACC's issuance of a final rate order in the retail rate case pending before the ACC (see "Application for Retail Rate Increase" above). The ACC may initiate proceedings during the term of the Settlement Agreement to effectuate changes in the Company's dividend policy if, and only if, catastrophic and disastrous events occur which could significantly affect the Company's financial condition or prevent the Company from financing at reasonable costs its capital requirements necessary to meet customer service needs. In such event, however, the Company and Pinnacle West would be free to challenge any such action by the ACC.

Asset Purchase and Power Exchange

On September 21, 1990, the Company and PacifiCorp entered into four agreements (the "Agreements") relating principally to sales and purchases of electric power and electric utility assets. As part of the Agreements, PacifiCorp agreed to purchase, from the Company, Cholla 4 and certain associated common facilities, coal inventory, and materials and supplies for a purchase price of approximately $230 million. The Agreements provide that if closing does not occur before March 8, 1991, either party may terminate the Agreements if such party is not in default thereunder. On September 21, 1990, the Company filed an application with the ACC requesting (1) approval to sell Cholla 4 and related common facilities to PacifiCorp and (2) specified ratemaking treatment with respect to certain aspects of the Agreements, including the sale of Cholla 4. On January 28, 1991, a procedural order was issued setting the hearing in this matter to begin on April 8, 1991. On October 12, 1990, the Company and PacifiCorp filed a joint application with FERC, as amended on December 12, 1990, requesting approval of the rates and arrangements for transmission and power sales as provided in the Agreements. The matter is currently pending at FERC. The Company intends to take all actions to effect closing as soon as possible.

3. Common and Non-redeemable Preferred Stock.

The balances at December 31, 1990 and 1989 of common stock and of preferred stock, which is not redeemable except pursuant to call by the Company at its option, are as follows.

	Number of Shares			Par Value			Call Price Per Share(a)
		Outstanding at December 31,			Outstanding at December 31,		
	Authorized	1990	1989	Per Share	1990	1989	
					(Thousands of Dollars)		
Common Stock	100,000,000	71,264,947	71,264,947	$ 2.50	$178,162	$178,162	—
Non-redeemable Preferred Stock (cumulative):							
$1.10 preferred	160,000	155,945	155,945	$ 25.00	$ 3,898	$ 3,898	$ 27.50
$2.50 preferred	105,000	103,254	103,254	50.00	5,163	5,163	51.00
$2.36 preferred	120,000	40,000	40,000	50.00	2,000	2,000	51.00
$4.35 preferred	150,000	75,000	75,000	100.00	7,500	7,500	102.00
Serial preferred	1,000,000						
$2.40 Series A		240,000	240,000	50.00	12,000	12,000	50.50
$2.625 Series C		240,000	240,000	50.00	12,000	12,000	51.00
$2.275 Series D		200,000	200,000	50.00	10,000	10,000	50.50
$3.25 Series E		320,000	320,000	50.00	16,000	16,000	51.00
Serial preferred	4,000,000(b)						
$8.32 Series J		500,000	500,000	100.00	50,000	50,000	(c)
Adjustable rate Series Q		500,000	500,000	100.00	50,000	50,000	(d)
Serial preferred	10,000,000	—	—	25.00	—	—	
Total		2,374,199	2,374,199		$168,561	$168,561	

(a) In each case plus accrued dividends as of December 31, 1990.

(b) This authorization also covers outstanding redeemable preferred shares shown in Note 4, as well as the non-redeemable shares indicated above.

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

(d) Bears dividends at a rate, adjusted on a quarterly basis, 2% below the rate borne by certain United States Treasury securities, but in no event less than 6% per annum or greater than 12% per annum. Redeemable at the option of the Company at $103.00 through February 28, 1993; and at $100.00 thereafter.

The holders of preferred stock are entitled to one vote for each share held of record. Special requirements for favorable votes of holders of preferred stock, voting by the classes respectively prescribed for the several purposes, pertain to (i) certain conversions or exchanges of outstanding preferred stock, (ii) the authorization of any stock ranking prior to the preferred stock, (iii) making any change in the terms and provisions of preferred stock that would adversely affect the rights and preferences of the holders thereof, (iv) the issuance of any additional shares of preferred stock except under prescribed circumstances or (v) a merger, consolidation or sale of substantially all the assets of the Company. The foregoing voting rights attach to both redeemable and non-redeemable preferred stock, as do the rights that would arise out of dividend arrearages as discussed in Note 4.

Changes in common and non-redeemable preferred stock and premiums and expenses during each of the three years in the period ended December 31, 1990 are as follows (dollars in thousands):

Description	Common Stock Number of Shares	Common Stock Par Value Amount	Non-redeemable Preferred Stock (cumulative) Number of Shares	Non-redeemable Preferred Stock (cumulative) Par Value Amount	Premiums and Expenses Net*
Balance, December 31, 1987	71,264,947	$178,162	2,374,199	$168,561	$1,034,364
Premium and Expenses - Net	—	—	—	—	(106)
Balance, December 31, 1988	71,264,947	178,162	2,374,199	168,561	1,034,258
Premium and Expenses - Net	—	—	—	—	88
Balance, December 31, 1989	71,264,947	178,162	2,374,199	168,561	1,034,346
Premium and Expenses - Net	—	—	—	—	15
Balance, December 31, 1990	71,264,947	$178,162	2,374,199	$168,561	$1,034,361

*Premiums and expenses — net also includes those of redeemable preferred stock issues (see Note 4).

4. Redeemable Preferred Stock.

The balances at December 31, 1990 and 1989 of preferred stock which is redeemable pursuant to sinking fund obligations, in addition to being callable by the Company, are as follows:

	Number of Shares Outstanding at December 31, 1990	Number of Shares Outstanding at December 31, 1989	Par Value Per Share	Par Value Outstanding at December 31, 1990 (Thousands of Dollars)	Par Value Outstanding at December 31, 1989 (Thousands of Dollars)	Call Price Per Share(a)
Redeemable Preferred Stock (cumulative)						
Serial preferred: (b)						
$10.00 Series H	24,677	40,677	$100.00	$ 2,468	$ 4,068	(c)
$8.80 Series K	232,100	233,136	100.00	23,210	23,313	(d)
$12.90 Series N	238,255	266,400	100.00	23,825	26,640	(e)
$11.50 Series R	429,500	500,000	100.00	42,950	50,000	(f)
$8.48 Series S	500,000	500,000	100.00	50,000	50,000	(g)
$8.50 Series T	500,000	500,000	100.00	50,000	50,000	(h)
Total	1,924,532	2,040,213		$192,453	$204,021	

(a) In each case plus accrued dividends.

(b) See Note 3 for authorized number of shares.

(c) Redeemable at $104.32 through September 1, 1991, and thereafter declining by $0.36 per year to par after September 1, 2002. Applicable sinking fund provisions require the redemption of 16,000 shares at par annually (representing annual payments of $1,600,000).

(d) Redeemable at $103.00 through February 28, 1994; and at $101.00 thereafter. Applicable sinking fund provisions require the redemption of 22,500 shares at par annually (representing annual payments of $2,250,000). The Company may, but is not required to, redeem an additional 22,500 shares at par on March 1 in any year.

(e) Redeemable after June 1, 1992 at the option of the Company at $106.11 through June 1, 1993, declining by $0.68 per year to $100.00 after June 1, 2001. Applicable sinking fund provisions require the redemption at par value between 1988 and 2002 of all shares according to a predetermined schedule.

(f) Redeemable after June 1, 1994 at the option of the Company at $105.45, declining each year by a predetermined amount to $100.00 after June 1, 2004. Applicable sinking fund provisions require the redemption at par value between 1990 and 2004 of all shares according to a predetermined schedule.

(g) Not redeemable prior to June 1, 1992 with the proceeds of borrowed funds or stock issues having a lower cost of money than this Series' dividend rate. Otherwise, redeemable at the option of the Company at $108.48 per share prior to June 1, 1992, at $104.24 prior to June 1, 1993, at $102.12 prior to June 1, 1994 and at $100.00 per share thereafter. Applicable sinking fund provisions require the redemption at par of 100,000 shares annually beginning June 1, 1993.

(h) All outstanding shares to be redeemed at par on September 1, 1994.

If there were to be any arrearage in dividends on any of the Company's preferred stock or in the sinking fund requirements applicable to any of its redeemable preferred stock (each such dividend being cumulative and of equal ranking with other such dividends, and each such requirement being cumulative and of equal ranking with other such requirements), the Company could not pay dividends on its common stock or acquire any shares thereof for consideration. If any such dividend arrearage were to equal six or more quarterly dividends, the holders of preferred stock, in addition to their other voting rights and voting by the classes prescribed for this purpose, could elect a total of six directors (all series of serial preferred stock, regardless of par value and whether redeemable or non-redeemable, comprising one such class and being entitled to elect two of the six directors). See Note 3 in regard to other voting rights of holders of preferred stock.

The combined aggregate amount of redemption requirements for the above issues each year through 1995 are as follows: $9,873,000 in 1991; $9,141,000 in 1992; $18,273,000 in 1993; $68,273,000 in 1994 and $18,273,000 in 1995.

ARIZONA PUBLIC SERVICE COMPANY
NOTES TO FINANCIAL STATEMENTS (continued)

Redeemable preferred stock transactions during each of the three years in the period ended December 31, 1990 are as follows (dollars in thousands):

Description	Number of Shares	Par Value Amount
Balance, December 31, 1987	2,219,777	$221,978
Retirements:		
$10.00 Series H	(16,000)	(1,600)
$8.80 Series K	(22,500)	(2,250)
$12.90 Series N	(51,800)	(5,180)
Balance, December 31, 1988	2,129,477	212,948
Retirements:		
$10.00 Series H	(16,000)	(1,600)
$8.80 Series K	(21,464)	(2,147)
$12.90 Series N	(51,800)	(5,180)
Balance, December 31, 1989	2,040,213	204,021
Retirements:		
$10.00 Series H	(16,000)	(1,600)
$8.80 Series K	(1,036)	(104)
$12.90 Series N	(28,145)	(2,814)
$11.50 Series R	(70,500)	(7,050)
Balance, December 31, 1990	1,924,532	$192,453

5. Long-Term Debt.

Details of long-term debt outstanding at December 31, 1990 and 1989 are as follows:

	December 31, 1990	December 31, 1989
	(Thousands of Dollars)	
First Mortgage Bonds:		
Maturing through 1995:		
4.8% due November 1, 1991	$ 35,000	$ 35,000
4.45% due June 1, 1992	25,000	25,000
4.40% due December 1, 1992	25,000	25,000
4.5% due September 1, 1993	15,000	15,000
12% due January 15, 1995	125,000	—
Maturing 1996 through 2000 - 6.25% to 12.875%	544,644	500,000
Maturing 2001 through 2005 - 6.2% to 9.95%	184,400	322,394
Maturing 2006 through 2010 - 6% to 13.25%	127,000	127,000
Maturing 2015 through 2020 - 9% to 11.5%	675,000	550,000
Unamortized discount and premium	(7,153)	(5,550)
Total first mortgage bonds	1,748,891	1,593,844
Pollution Control Indebtedness:(a)		
Maturing August 1, 2009	106,980	106,980
Maturing December 1, 2009	147,000	147,000
Maturing May 1, 2013	65,750	65,750
Maturing May 1, 2014	55,200	55,200
Maturing February 1, 2015	49,400	49,400
Total pollution control indebtedness	424,330	424,330
12.5% guaranteed debentures due February 20, 1992	75,000	75,000
Revolving credit agreement (b)	120,000	120,000
Term loan (c)	72,000	80,000
Capitalized lease obligation (d)	37,098	39,358
Total long-term debt	2,477,319	2,332,532
Less current maturities:		
4.8% first mortgage bonds due November 1, 1991	35,000	—
Sinking fund requirements on first mortgage bonds	15,934	15,933
Revolving credit agreement expires May 28, 1991 (b)	120,000	—
Term loan (c)	—	8,000
Capitalized lease obligation (d)	2,432	2,260
Total current maturities	173,366	26,193
Total long-term debt less current maturities	$2,303,953	$2,306,339

(a) Interest rates on these bonds are adjustable and determined either weekly or annually, which will cause the bonds to have a market value which approximates, as nearly as possible, their par value. The interest rates varied from 5.25% to 8.25% for 1990 and from 5.60% to 7.75% for 1989.

(b) Represents borrowings under a $120,000,000 Eurorevolving credit agreement which expires on May 28, 1991. The Company is in the process of negotiating an extension of this agreement. At December 31, 1990 and 1989, the outstanding balance consisted entirely of borrowings under the Eurorevolver. Interest rates applicable to borrowings under the revolving credit agreement are LIBOR plus 0.30% to 0.45%, with commitment fees of 0.15% on the unused credit line. The weighted average interest rates on outstanding borrowings for 1990 and 1989 were 8.76% and 9.44% respectively.

(c) Represents a term loan credit agreement among the Company and various financial institutions which expires June 20, 1992. Interest rates applicable to borrowings under the term loan agreement are LIBOR plus .25%. The weighted average interest rates on outstanding borrowings for 1990 and 1989 were 8.64% and 9.78% respectively.

(d) Represents the present value of future lease payments (discounted at the interest rate of 7.48%) on a combined cycle plant sold and leased back from the independent owner-trustee formed to own the facility. The lease requires semiannual payments of $2,582,000 through June 2001, and includes renewal and purchase options based on fair market value. This plant is included in plant in service at its original cost of $54,405,000; accumulated depreciation at December 31, 1990 was $32,142,000.

Aggregate annual payments due on long-term debt and for sinking fund requirements through 1995 are as follows: 1991, $173,366,000; 1992, $215,551,000; 1993, $22,217,000; 1994, $7,857,000 and 1995, $133,088,000. See Note 4 for sinking fund requirements and redemptions of redeemable preferred stock.

Substantially all utility plant (other than nuclear fuel, transportation equipment and the combined cycle plant mentioned above) is subject to the lien of the first mortgage bonds. The indenture respecting the first mortgage bonds includes provisions which would restrict the payment of dividends on common stock under certain conditions which did not exist at December 31, 1990.

6. Lines of Credit.

The Company's committed lines of credit at December 31, 1990 and 1989 are summarized below. At December 31, 1990, $159 million of short-term debt was outstanding including $100 million under the $300 million revolving credit facility and $59 million under the $70 million letter of credit commercial paper program.

	1990	1989
	(Thousands of Dollars)	
Revolving credit facility	$300,000	$300,000
Letter of credit commercial paper program	70,000	—
Other bank lines	2,000	2,000
Total	$372,000	$302,000

The commitment fees for the revolving credit facility were .1875% per annum in 1990 and 1989. Similarly, fees for the letter of credit commercial paper program were .30% per annum in 1990.

By Arizona statute, the Company's short-term borrowings cannot exceed 7% of total capitalization without the consent of the ACC.

7. Jointly-Owned Facilities.

At December 31, 1990, the Company-owned interests in jointly-owned electric generating and transmission facilities are as follows (dollars in thousands):

	Percent owned by Company	Plant in Service	Accumulated Depreciation	Net Plant in Service	Construction Work in Progress
Generating Facilities:					
Palo Verde Nuclear Generating Station - Units 1, 2 and 3	(a)	$2,452,681	$294,804	$2,157,877	$28,506
Four Corners Steam Generating Plant - Units 4 and 5	15.0%	135,728	35,902	99,826	3,601
Navajo Steam Generating Plant - Units 1, 2 and 3	14.0%	128,839	58,521	70,318	3,559
Transmission Facilities:					
ANPP 500KV Transmission System .	35.8%(b)	62,413	9,010	53,403	248
Navajo Southern Transmission System .	31.4%(c)	28,021	13,520	14,501	105
Palo Verde-Yuma 500KV System	23.9%(d)	11,282	2,068	9,214	—
Total		$2,818,964	$413,825	$2,405,139	$36,019

(a) The Company owns 29.1% of Units 1 and 3 and approximately 17% of Unit 2 (see Note 8).

(b) Weighted average of interests varying from 34.6% to 43.95%.

(c) Weighted average of interests varying from 14% to 100%.

(d) Weighted average of interests varying from 11% to 100%.

The foregoing dollar amounts correlate to the Company's percentage interest in each facility. The Company's share of related operating and maintenance expenses is included in Operating Expenses.

8. Leases.

In 1986, the Company entered into sale and leaseback transactions under which it sold approximately 42% of its 29.1% share of Palo Verde Unit 2 resulting in net proceeds of $487,296,000. The resulting gain of approximately $140,220,000 has been deferred and is being amortized to operations expense over the original lease term. The leases require semiannual payments of approximately $22,061,000 through December 1996, $23,605,000 through June 1997 and $26,963,000 through December 2015, and include options to renew the leases for two additional years and to purchase the property at fair market value at the end of the lease terms. The leases are being accounted for as operating leases. Lease expense for 1990, 1989 and 1988 was $45,458,000 in each year, of which $10,312,000 was deferred in 1988 (deferrals were made through April 1, 1988 when Unit 2 rates became effective) as allowed by an order from the ACC.

In addition, the Company leases certain land, buildings, and equipment (including transportation, computer, and office equipment) and miscellaneous other items through operating rental agreements with varying terms, provisions, and expiration dates. Rent expense

for 1990, 1989, and 1988 was approximately $13,605,000, $9,881,000, and $5,446,000, respectively. Annual future minimum rental commitments (excluding the Palo Verde leases above) for the period 1991 through 1995 range between $14 and $16 million and the total rental commitments after 1995 are estimated at $117 million.

9. Income Tax Expense.

The components of income tax expense for each of the three years in the period ended December 31, 1990 are as follows:

	Year Ended December 31,		
	1990	1989	1988
	(Thousands of Dollars)		
Currently payable:			
Federal	$ 43,637	$ 37,788	$ 63,457
State	9,827	7,662	12,254
Total current	53,464	45,450	75,711
Deferred:			
Depreciation—net	63,979	75,611	72,709
Palo Verde cost deferral	46,681	47,654	49,178
Alternative minimum tax	(8,873)	(25,652)	(7,570)
Employee severance plan	(5,538)	—	—
Other—net	(15,870)	8,774	2,976
Investment tax credit—net	(7,012)	(6,159)	(9,107)
Total deferred	73,367	100,228	108,186
Total	$126,831	$145,678	$183,897

The difference between income tax expense and the amount obtained by multiplying income before income taxes by the statutory federal income tax rate for each of the three years in the period ended December 31, 1990 is as follows:

	Year Ended December 31,		
	1990	1989	1988
	(Thousands of Dollars)		
Federal income tax expense at statutory rate (34%)	$104,327	$121,731	$154,737
Increases (reductions) in tax expense resulting from:			
Tax under book depreciation	18,402	15,870	22,316
Allowance for funds used during construction	(1,374)	(2,024)	(4,103)
Palo Verde cost deferral	(4,281)	(4,114)	(4,815)
Investment tax credit amortization	(7,353)	(6,946)	(8,287)
State income tax—net of federal income tax benefit	19,003	19,988	23,429
Other	(1,893)	1,173	620
Total provision for federal and state income tax expense	$126,831	$145,678	$183,897

In December 1987, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 96, "Accounting for Income Taxes" ("SFAS No. 96"). SFAS No. 96 retains the concept of comprehensive interperiod tax allocation; however, the way in which deferred income taxes are computed has changed from the existing "deferred" method to a liability method. Adjustments to balances of accumulated deferred income taxes will have to be made to record income tax rate changes, allowance for funds used during construction, investment tax credits and other temporary differences not previously

deferred. It is expected that the additional deferred income tax assets and liabilities will be offset primarily by regulatory assets and liabilities representing the expected future revenue requirement impact of these adjustments. The new statement was to have been effective beginning in 1990; however, the FASB has delayed the effective date to 1992, and currently is considering revising the statement again which will likely result in a 1993 effective date. The Company has not yet made a determination as to the timing of implementation.

10. Pension Plan and Other Benefits.

The Company's pension plan, a defined benefit plan, covers virtually all employees. The benefits are based on years of service and compensation utilizing the final average pay plan benefit formula. It is the Company's policy to fund the plan on a current basis to the extent deductible under existing tax regulations. Pension cost, including administrative cost, for 1990, 1989, and 1988 was approximately $14,781,000, $3,657,000, and $4,368,000, respectively, of which approximately $7,742,000, $1,655,000, and $1,899,000, respectively was charged to expense; the remainder was either capitalized as a component of construction costs or billed to participants of jointly-owned facilities. Plan assets consist primarily of domestic and international common stocks and bonds, and real estate.

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

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

	1990	1989	1988
Service cost-benefits earned during the period	$ 16,095	$ 12,920	$ 12,589
Interest cost on projected benefit obligation	29,848	24,910	22,945
Return on plan assets	9,467	(61,314)	(48,832)
Net amortization and deferral	(50,622)	24,322	15,547
Net periodic pension cost	$ 4,788	$ 838	$ 2,249

The following table sets forth the plan's funded status and amounts recognized in the Company's Balance Sheets (thousands of dollars):

	1990	1989
Actuarial present value of benefit obligation, including vested benefits of $229,205 and $182,409	$254,956	$204,954
Effect of projected future compensation increases	109,364	112,389
Projected benefit obligation	364,320	317,343
Plan assets, at fair value	349,755	380,893
Plan assets in excess of (less than) projected benefit obligation	(14,565)	63,550
Unrecognized net (gain) loss from past experience different from that assumed	25,576	(25,689)
Unrecognized prior service cost	17,766	7,152
Unrecognized net asset at January 1, 1986 being recognized over 20.2 years	(48,892)	(52,108)
Accrued pension liability included in other deferred credits	$(20,115)	$ (7,095)

Principal actuarial assumptions used were:	1990	1989
Discount rate	8.5%	8.5%
Rate of increase in compensation levels	6.0%	6.5%
Expected long-term rate of return on assets	10.44%	10.44%

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for active and retired employees. Life insurance benefits are provided through an insurance company whereas health care costs are paid as expenses are incurred under a self-insured plan. The cost of providing those benefits for both active and retired employees amounted to approximately $28,236,000, $24,332,000 and $21,991,000, of which approximately $12,503,000, $10,172,000 and $8,564,000, were charged to expense in 1990, 1989 and 1988, respectively. Remaining amounts were either capitalized as a component of construction costs or billed to participants of jointly-owned facilities. At December 31, 1990 the Company was providing these benefits to 6,848 active employees and 1,525 retirees.

The FASB has issued Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." This Statement will require accrual of postretirement benefits (such as health care benefits) during the years an employee provides services. The costs of these benefits are currently expensed on a pay-as-you-go basis. The impact of this new standard has not been fully determined, but the change likely will result in greater expense being recognized for provision of these benefits. The Company expects that the increased benefits expense will either be recovered currently through rates or that a regulatory asset will be recorded to reflect amounts to be recovered through rates in the future as the costs are paid; therefore, this Statement should not have a significant impact on the Company's financial position or results of operations. The Company plans to adopt this Statement in 1993.

11. Commitments and Contingencies.

Nuclear Insurance

The Palo Verde participants have insurance for public liability payments resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of $200 million and the balance by an industrywide retrospective assessment program. The maximum assessment per reactor under the retrospective rating program for each nuclear incident is approximately $66 million, subject to an annual limit of $10 million per incident. Based upon the Company's 29.1% interest in the three Palo Verde units, the Company's maximum potential assessment per incident is approximately $58 million, with an annual payment limitation of $8.73 million. The insureds under this liability insurance include the Palo Verde participants and "any other person or organization with respect to his legal responsibility for damage caused by the nuclear energy hazard."

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $2.325 billion, a substantial portion of which must first be applied to decontamination. The Company has also secured insurance against portions of any increased cost of generation or purchased power resulting from the accidental outage of any of the three units if the outage exceeds 21 weeks.

Litigation

The Company is a party to various claims, legal actions and complaints arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the operations or financial position of the Company.

Construction Program

Expenditures in 1991 for the Company's continuing construction program have been estimated at $193 million.

Fuel and Purchased Power Commitments

The Company is a party to various fuel and purchased power contracts with terms expiring from 1991 through 2005 that include required purchase provisions. The Company estimates that the amount of fuel and purchased power that it is required to purchase pursuant to such provisions during 1991 totals approximately $130 million. However, this amount may vary significantly pursuant to certain provisions in such contracts which permit the Company to decrease its required purchases under certain events and circumstances.

12. Supplementary Income Statement Information.

Other taxes charged to operations during each of the three years in the period ended December 31, 1990 are as follows:

	Year Ended December 31,		
	1990	1989	1988
	(Thousands of Dollars)		
Property	$112,270	$ 92,522	$ 79,730
Sales	74,015	70,866	69,107
Other	11,365	10,825	11,860
Total other taxes	$197,650	$174,213	$160,697

13. Selected Quarterly Financial Data (Unaudited).

Quarter	Operating Revenues	Operating Income	Net Income	Earnings for Common Stock
	(Thousands of Dollars)			
1990				
First	$342,590	$ 80,307	$ 38,307	$ 30,437
Second	353,802	72,051	26,191	18,377
Third	472,271	128,201	83,720	75,959
Fourth	339,662	79,329	31,794	24,179
1989				
First	$332,449	$ 92,630	$ 54,435	$ 46,258
Second	359,807	92,964	52,788	44,692
Third	458,793	136,398	94,219	86,270
Fourth	296,105	53,153	10,912	2,832

INDEPENDENT AUDITORS' REPORT

Arizona Public Service Company:

We have audited the accompanying balance sheets of Arizona Public Service Company as of December 31, 1990 and 1989 and the related statements of income, retained earnings and cash flows for each of the three years in the period ended December 31, 1990. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company at December 31, 1990 and 1989 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1990 in conformity with generally accepted accounting principles.

As discussed under Application for Retail Rate Increase in Note 2 to the financial statements, the Company has filed an application with the Arizona Corporation Commission for an increase in retail rates relating to its investments in Unit 3 of the Palo Verde Nuclear Generating Station, including cost deferrals, and Unit 4 of the Cholla Power Plant. Until the level of rate relief ultimately granted by the Commission is determined, an uncertainty exists as to the eventual full recovery of the cost of these assets, the outcome of which cannot presently be determined.

Deloitte & Touche

Phoenix, Arizona
February 20, 1991

APS DIRECTORS

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

[1] Karl Eller, chairman of the board and president, Red River Resources, Inc., Phoenix, Arizona

[1] Marianne Moody Jennings, professor of business law, College of Business Administration, Arizona State University, Tempe, Arizona.

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

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

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

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

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

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

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

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

[1] Richard Snell, chairman of the board of the Company; chairman of the board, president and chief executive officer, Pinnacle West Capital Corporation; and chairman of the board, Aztar Corporation (gaming business), Phoenix, Arizona

Keith L. Turley, member of the board of directors of the Company and of Pinnacle West Capital Corporation, Phoenix, Arizona. Mr. Turley was chairman of the board of the Company and chairman of the board, president and chief executive officer of Pinnacle West Capital Corporation until February 1990.

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

[1] Ben F. Williams, Jr., attorney at law, Douglas, Arizona

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

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[1] Member of the Executive Committee.

SHAREHOLDER INFORMATION

Stock Listing

The Adjustable Rate Cumulative Preferred Stock, Series Q (Symbol ARPQ) is listed for trading on the New York Stock Exchange. The common stock of the Company is wholly-owned by Pinnacle West and as a result is not listed for trading on any stock exchange.

The chart below sets forth the dividend amount paid on the Company's common stock for each of the four quarters of 1990 and 1989.

Common Stock Dividends
(Thousands of Dollars)

Quarter	1990	1989
1st Quarter	$52,736	$52,736
2nd Quarter	52,736	52,736
3rd Quarter	42,500	52,736
4th Quarter	42,500	52,736

Transfer Agent and Registrar

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

The First National Bank of Boston
Shareholder Services
P.O. Box 1865
Boston Massachusetts 02105-1865
(617) 575-2555
(common stock only)

General Counsel

Snell & Wilmer
Phoenix, Arizona

Auditors

Deloitte & Touche
Phoenix, Arizona

Pinnacle West Capital Corporation Stock Purchase and Dividend Reinvestment Plan

A Prospectus describing this plan is available upon request. Write: Office of the Secretary, Station 9068, at the address below.

Form 10-K

A copy of our Annual Report to the Securities and Exchange Commission, Form 10-K, will be available after April 1, 1991, without charge, upon written request of shareholders. Write: Office of the Secretary, Station 9068, at the address below.

MAILING ADDRESS:

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