

# To our shareholders: 2001...

Unprecedented electric price volatility...

Continued price decreases for our customers...

Bankruptcies of some of the industry's largest companies.

**Our response:**  
We had one of the best financial years in our company's history.

Our direction going forward: Stay on plan. Use what we have learned. Figure out answers to new questions – both known and unknown. Mix discipline with creativity. Stay agile.



As a company, we strive to remain flexible in the face of changing markets, yet unwavering in our commitments to increasing customer satisfaction and shareholder value. We stood like a rock on those commitments in 2001. Our customer satisfaction ratings have never been higher. Our financial results have never been stronger.

Despite some hefty expenses last summer to ensure reliability, earnings from continuing operations increased year-over-year by 8.1 percent. Outstanding power marketing results and steady customer growth allowed us to improve earnings while providing customers with their seventh price decrease in eight years.

It may be hard to recall now – just 12 months later – how different the energy situation looked in 2001. In May 2001 the futures price for power delivered in August ended up ten times August's actual price. Our Power Marketing group steered through this volatility and produced outstanding results.

Our performance looks even better against the national and industry backdrop of a slowing economy and the missteps of some large companies. We made different choices. We put our trust in real assets generating real electrons that travel over real wires into real homes and businesses. Even as some of the fundamentals of our business change, this approach will not.

Our customer base continues to grow. Last year, APS experienced 3.7 percent customer growth – about three times the national average. To meet this growing demand, we added a 120-megawatt unit at our West Phoenix plant – our first generation addition since 1988. This summer we'll add more than 1,000 megawatts at our new Redhawk facility, and next year we'll complete our West Phoenix expansion by firing up another 530-megawatt unit. When these new gas-fired

units are completed, they will enhance our supply options by providing a balanced fuel mix of coal, nuclear and natural gas.

Equally important, we've recently received approval to build a new 500,000-volt transmission line extending from the Palo Verde Switchyard to a new substation west of Phoenix. This much-needed line will add to our system capacity, further strengthening our reliability.

With that, let's get right to the future. Looking ahead, I see opportunities in three significant areas. First, although today we face tougher power markets and a slower economy, customer growth and wholesale market opportunities will prevail. Second, we've taken on an important regulatory agenda. And third, evolutionary market developments will determine the structure and substance of future electric competition.

#### **THE POWER MARKET OPPORTUNITY**

For Pinnacle West, the key to mastering the power market challenge is risk management – one of our core strengths. Risk management is not just power marketing and trading, though that is key to our approach. We “build in” risk management from the bottom up by staying close to our core business, managing our exposure in new markets, growing generation in a disciplined manner, competing in regulatory arenas, adhering to tight financial guidelines and testing every action for impact on customers and shareholders.

Power Marketing is part of our parent company, which positions it uniquely to manage our enterprise-wide energy risk. Power Marketing supplements our existing resources with short-term purchases and reduces financial exposure with hedging techniques. By buying wholesale power to serve our retail customers, and selling available output from our generating facilities and other energy resources, this group optimizes results of energy markets and owned generation.

We've been both calculating and aggressive with our power marketing. We calculate our risks in buying and selling power, striking a balance between moderate risk and the cost of hedging those risks. When opportunities arise, we move swiftly and aggressively to improve our positions. We've exceeded expectations in the past, and it is our intention to do so in the future.

Given the current depressed wholesale power prices, we expect lower gross margins from Power Marketing. On the other hand, we foresee lower expenditures for reliability and purchased power in 2002 – we won't have to spend the \$140 million we spent in 2001 to ensure uninterrupted electric service for our customers.

While the Arizona economy is slowing somewhat, it remains robust by comparison with the rest of the nation – and growth will continue. We expect to add customers at a rate of 3.2 percent in 2002, compared to the 3.7 to 4.2 percent of the last few years. Moving forward, this continued growth will drive our top-line revenues and strengthen our bottom-line results.

We also believe market volatility may increase in Western power markets later in the year. That could create trading opportunities, especially as we bring Redhawk Units 1 and 2 on line.

These new gas-fired units, with their greater efficiency in converting natural gas to electricity, will have a higher profit potential over the long run. Analysts refer to this margin as “spark spread” – the relationship between the price of natural gas and the price of wholesale power produced from gas. While our generation capacity will remain close to the size of our native customer demand, these more efficient units will widen our power marketing options in the future.

Price caps – assuming they remain – present another challenge to power markets and to generators and suppliers trying to negotiate those markets. At first, the “soft” price caps imposed last year had a dramatic effect on prices, treating the entire region as one pricing point, ignoring regional differences and transmission bottlenecks. While price caps are benign in the current depressed market, over the long-term they will likely prevent price signals from attracting new capital and generation where they are needed.

Anticipating future regulatory impacts – from federal price caps to individual state actions – is the key to success in Western power markets.

#### **THE REGULATORY OPPORTUNITY**

If our industry learned anything from California, it is that the public will not tolerate price volatility or low levels of reliability. Regulators and politicians will act accordingly.

To avoid that situation in our state, last October we filed with the Arizona Corporation Commission (ACC) a plan designed to provide our APS customers with reliable electricity supplies at stable prices well into the future. This plan also permits a more deliberate approach to competitive markets in the Southwest.

Our plan doesn't change the substance of our 1999 Settlement Agreement, which provided rate decreases for customers through 2003, opened the door to competition for our retail customers and required that we transfer APS generation assets to a competitive subsidiary.

Our plan deals with current realities and provides a sure path to meeting our state's energy needs. The plan builds toward a robust wholesale market, supporting the move to competition rather than allowing the old rules to fail.

What we're requesting is a modification to one part of the ACC competition rules – a very important part that never measured up to expected realities.

At the time the rules were put in place, the expectation was that the wholesale market would develop over the following years. As California has shown, the market hasn't developed as expected and without change to the competition rules we'll be required in 2003 to obtain all APS customer power from the wholesale market. Acquiring all of APS' customer power needs in today's wholesale market is simply not possible.

During the Arizona restructuring debates, we were adamant about not divesting our power stations and exposing APS customers to an untested wholesale market. It was clear, few customers – and almost no residential and small business customers – had the technology or expertise to respond to real-time power prices, alter their usage and “hedge” their market risk. Dealing with market risk for our customers and shareholders is our job, and we expect to meet their demands.

As they consider our plan, the ACC – like many state commissions in the wake of the California experience – is taking another look at the existing competition rules. We can't say at this time how far this “look” will go. While the commissioners have not indicated a need for sweeping change, they are prudently responding to the same environment and the same concerns that led us to propose our regulatory plan for reliability, price stability and competition.

## We enjoyed solid customer growth and a growing economy.

Under our proposal, the competitive bidding would begin in 2003 with a 270-megawatt auction. The same amount would be added each year through 2008. By that time, competitive bidding would supply at least 1,620 megawatts – nearly 25 percent – of APS customer needs. At that point, the market should be mature enough to supply that amount without distortion.

For our customers, this plan offers stable and predictable prices from a diversity of fuel sources, and reliability that cannot be obtained elsewhere in today's wholesale market. We have an obligation to keep the lights on. That's an obligation we accept and our customers expect us to keep. But without this or a similar plan, we think the cost of keeping the lights on will be more than our customers will want to pay.

For our shareholders, the plan provides a solid generation earnings platform plus the ability to sell extra capacity and energy in the wholesale market. The end result will be a generation component comprised of substantial owned assets, considerable earnings strength and opportunities for profit in the wholesale market.

For regulators, our reliability plan protects customers from price volatility and guarantees reliable power while preserving an orderly progression toward an increasingly competitive wholesale market in the Southwest.

### THE MARKET STRUCTURE OPPORTUNITY

The most significant factor affecting future electric competition in the West is the sputtering development of the electric market structure. This structure, both physical and financial, is beset by its complex composition – a collection of entities comprising state and federal regulators, federal agencies, public power, municipalities, industry associations and private companies all simultaneously operating to meet instantaneous customer demand.

This structure requires an extraordinary amount of coordination and distinguishes electricity from any other commodity, making the development of a competitive electric wholesale market particularly difficult. Regulators – focused on the theme and promise of competition – did not fully consider the complexity of this process or the laws of physics and set up unworkable markets – or none at all.

This competitive theme camouflaged what, in substance, was increased and incomplete regulation. These regulatory efforts produced real world problems and reinforced movement toward even greater regulation. The difficulties of many companies and the higher prices charged to California consumers can be traced to the imperfect market structures California created and regulators are now trying to correct through re-regulation.

This re-regulation goes beyond California to most of the Western states. When compounded with the significant role public power plays in the West, the development of a robust competitive electric wholesale market will be slowed at best.

Public power owns approximately half of the generating and transmission resources in the Western grid. They are not regulated by the Federal Energy Regulatory Commission (FERC) and therefore aren't required to comply with federal regulations concerning competitive market structures or operations. Although they currently participate in the interstate market, they can do so without regulatory interference, making the development of independent transmission organizations particularly challenging.

The FERC should support regional transmission organizations (RTOs) such as our proposed WestConnect RTO. WestConnect, encompassing roughly the Southwest, recognizes regional differences and state authority and complies with the FERC's requirements for RTOs. Public power is a part of it, and it is designed to interact effectively with other RTOs – addressing the so-called “seams” issue – while providing a firm structure to enhance the competitive generation market.

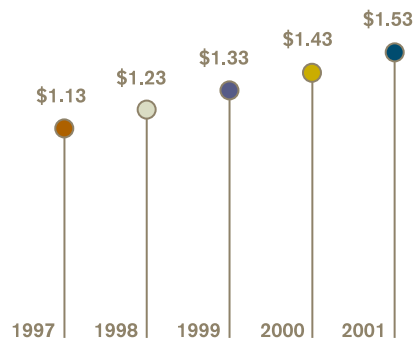
As long as incomplete or unworkable themes continue to mark our industry and competitive power markets, the threat of re-regulation and potential loss of customer choice will loom over every regulatory proceeding.

#### HOW WE ARE DIFFERENT

Last year was turbulent. There were challenges. There were pitfalls. We set our company apart. We were different. We prospered.

We're different because we've disregarded simple assumptions and predictions about the future. We realized deregulation didn't mean power prices had to drop or that markets would somehow satisfy hourly demands at reasonable prices. We held on to our power plants. We established long-term power contracts. We kept control over costs. We protected customers by building power plants. We reduced our customers' prices.

As we face challenges in 2002 and beyond, we enjoy some solid advantages. These include natural advantages we recognize and build on. Our geographic location gives us seasonal diversity so that in typical years we have a favorable power exchange situation with the Northwest. We enjoy solid customer growth and a growing economy.



ANNUAL DIVIDENDS PAID PER SHARE  
(dollars per share)

But these “natural” advantages are not as important as the ones we've created:

- an unwavering focus on customer satisfaction
- outstanding power plant operations
- an increasingly balanced fuel mix
- disciplined generation expansion roughly matching our native load growth
- a creative but risk-averse approach to power marketing

These advantages support a strategy that is our definition of creating value: combined growth of earnings and dividends above the industry average. Our advantages form a strategic mix we believe is unique and sustainable. I'm confident the people of Pinnacle West will meet the complex challenges of the future. We have the skills, experience and intellectual capital to develop the answers and deliver shareholder value. We have, and we will. ●

William J. Post