

# To Our Shareholders



WILLIAM J. POST, CHAIRMAN

## Last year the economy didn't perform. Our company did.

Still, our earnings were down. In 2002, net income dropped due to a depressed electric wholesale market and non-recurring charges. However, earnings from our core operations remained relatively strong as a result of outstanding operational performance.

Despite punishing markets and a slack economy over the last two years, we continued to improve reliability and customer satisfaction, and took extraordinary steps to meet customer demand. In this challenging environment, flexibility and agility remain essential to our success.

We continued an unprecedented series of price reductions, insulated customers from volatile wholesale markets and added new generation capacity to meet Arizona Public Service (APS) electricity demand not met by existing APS generation. Our power plant performance set records. We saw significant earnings improvement from unregulated subsidiaries SunCor and APS Energy Services.

Going forward, our story will include a large component of state regulation. We know the regulatory environment and have shown the ability to adjust to its changes. This is a challenge, but it's familiar.

There is no place we'd rather do business than here in Arizona. This is a unique and dynamic state. Our growth has been robust, and has slowed little through the current economic downturn. We're still adding customers at about three times the national average. When economic growth and business investment return to historical norms, our strong fundamentals will, again, support earnings growth. Excellent performance has softened the blow of a weak economy and changing regulation. We've been through a turbulent year, and we won't attempt to minimize its impact. In coming years, the overall picture looks brighter.

Throughout these pages you'll see images of our state. Those that survive and thrive here possess unique adaptive abilities, hard-earned experience and the flexibility to adjust to change. I see a lot of our company in these examples.

## **WE ARE ADAPTABLE**

If you're a long-time owner of our company, you know we emphasized agility, long-term growth and adaptability as we prepared for competition. We knew changes would come. This approach has served us well. For example, we didn't sell our generating plants, even though we felt the same pressure to sell as other utilities. We also didn't over-commit to competitive markets. We built new generation, primarily in Arizona, to match the growing needs of APS customers.

After preparing for deregulation for nearly a decade, we neared completion of that process in 2002. Under the 1999 regulatory settlement agreement with the Arizona Corporation Commission (ACC), we were to transfer APS' generation to Pinnacle West Energy by the end of 2002. The competition and affiliate rules adopted by the ACC kept APS from adding new generation to serve its needs, while requiring APS to remain the provider of last resort.

To meet APS' growing demand for power, Pinnacle West Energy built state-of-the-art, gas-fired combined-cycle power plants, financed with temporary "bridge" debt. This temporary financing was to be converted to permanent financing when the APS generation assets were consolidated with Pinnacle West Energy's new plants as required by the 1999 settlement. Meanwhile, our company and the ACC recognized market conditions were radically different than envisioned in 1999. Serious structural flaws in the wholesale market were painfully apparent. In response, the ACC reversed course in August of 2002 and prohibited the transfer of APS generation to Pinnacle West Energy.

Prior to that, in the fall of 2001, we proposed a different solution in response to the same market weaknesses. The company and the ACC each sought to protect Arizona customers from a competitive debacle that could have mirrored the California disaster.

When the ACC changed its policy on competitive generation, however, it did not address the treatment of our plants built since 1999 to serve APS customers. Our request for financial treatment of the plants followed, and recognizing that the debt markets are essentially closed to unregulated generation companies, the ACC acted quickly on our application to allow APS to extend Pinnacle West a \$125 million line of credit. Then, in March of 2003, the ACC also approved a \$500 million loan from APS to Pinnacle West Energy. The loan will provide sufficient liquidity while the ACC decides the long-term rate treatment of these plants.

As required by the 1999 settlement agreement, we will file a full general rate case in 2003 – our first in well over a decade – to update our cost of service and address issues arising from the change in direction by the ACC. These issues include folding Pinnacle West Energy's Arizona plants into rates, reversal of the \$234 million write-off we took as part of the 1999 settlement agreement, and consideration of the costs incurred preparing to transfer APS' generation to Pinnacle West Energy. We face a hefty regulatory agenda, but it's an agenda we will continue to address to the benefit of our customers and shareholders. We have anticipated the issues and are resolving them before they turn into greater problems. We believe the ACC recognizes the importance of this agenda.

## **WE MANAGE CONFLICTING AGENDAS**

When California wanted more natural gas at the expense of our transportation contract (and the contracts of other southwestern companies) with El Paso Natural Gas, we went to the Federal Energy Regulatory Commission (FERC) and fought against erosion of this "full requirements" contract. Erosion of the El Paso gas contract would increase our costs and make for a less stable supply. We expect resolution by mid-2003 without material cost increases.

04

We have actively sought a workable transmission structure for the Southwest by forming an independent transmission group known as WestConnect. In 2002, the FERC granted conditional approval of WestConnect, its for-profit structure and its departures from the current standard model. A for-profit structure will provide incentive for new investment in the transmission grid, which is needed in the West. We've said for years, without a robust transmission system, there can be no robust wholesale market. Without a robust wholesale market, we can't have broad retail competition. In fact, the current path is leading to more regulation, not competition.

## The growth of APS customers implies a strong core business that will drive future financial performance.

In the West, we believe the FERC must spend more effort addressing the real barriers to competition – insufficient transmission capacity and the inability to incorporate public power into the competitive structure. Municipal and federal agencies control large chunks of transmission, making tight coordination of scarce capacity even more difficult. Patchwork rules only result in disorder. Without a set of common protocols and full participation by all parties, western wholesale market development is problematic.

There are other unique issues in the West that must be respected. We have long geographic distances between load centers, typically with only one or two transmission lines. Our systems are not “networked” to the degree of denser East Coast systems. The West has large amounts of hydro capacity that often cannot be scheduled a day ahead.

The mantra of competition will continue to be the catalyst for greater state and federal regulatory involvement. Competition, regulation and the physics of a western electric system will coexist, inconsistencies aside. With the FERC continuing to push for generation deregulation and the ACC maintaining vertical integration, we must deal with incompatibilities and live in different universes at the same time. Business opportunities have and will continue to develop from these apparently colliding forces. We plan to capitalize on them by remaining agile and versatile enough to occupy the ground between these two, while always remaining focused on the ultimate best interests of our customers and shareholders.

### **OUR BUSINESS STRATEGY IS SOLID**

Pinnacle West and APS occupy a solid niche in the business landscape. We'll continue to concentrate primarily on our core business in an area our employees know well – Arizona and the western U.S. power markets – with a combination of customer focus, exceptional operational performance and financial strength.

We have worked hard to shape this landscape. We avoided price increases by keeping control of our power plants. We didn't sell our generation. We brought in temporary generating resources and built new permanent plants to protect our customers. When prices reached hundreds of dollars per megawatt-hour in 2000 and 2001, we had “hedged” our market position – with financial instruments as well as short-term power contracts – to insulate customers from price volatility, ensure reliability and protect our shareholders' returns.

This risk management expertise has served us well. We learned to manage purchased power and fuel price risks, then market risk. Even in today's battered wholesale market, our Power Marketing group has produced positive results, and we expect they will continue to do so in the future.

By July of 2003, we will have decreased our electricity prices 16 percent over the last decade while significantly improving customer satisfaction. That's customer value. Our employees – the "we" I've referred to throughout this letter – will continue our tenacious focus on efficiency and operational excellence.

As we work through the implications of our change in course – the 1999 regulatory write-off, the expense of creating a generation subsidiary, the rate treatment of plants built to serve APS customers and the many issues that affect a traditional rate case – we will not accept inferior outcomes. We acted responsibly in protecting our customers during the power market debacle. We avoided the blackouts, price spikes and bankruptcies that afflicted other states. We honored the terms of our 1999 settlement agreement and the ACC's competition rules. We expect to achieve a regulatory solution that is fair to our customers and shareholders.

Despite major regulatory shifts, our business strategy has seen little fundamental change. Our core strategic objectives – outlined on page one of this report – still lock together, allowing us to occupy a rewarding business niche, positioning us well to provide solid shareholder returns.

#### **WE ARE FOCUSED ON DELIVERING VALUE**

For our shareholders, our performance is judged by the delivery of returns in the form of share appreciation and dividends over time. In 2002, the convergence of regulatory change, financial and credit market fears, a weak economy, wholesale electric market declines and our own non-recurring charges contributed to a lower stock price. Although our stock performance for the year mirrored the industry, we are not satisfied with relative industry performance, let alone a decline.

Steps taken in 2002 to reposition our regulatory structure, improve efficiency, reduce staffing, realign our generation portfolio and improve our liquidity, place us well for the future. Although 2003 continues to be a transition year as we work through regulatory and other issues, our operations and market base are strong. We expect debt ratios to improve as we complete our current power plant projects, and even now we have a sound liquidity position, significantly exceeding our cash requirements. The growth of APS customers – both in number and energy usage – implies a strong core business that will drive future financial performance. Meanwhile, we will continue to emphasize dividends for our shareholders tied to factors such as our cash flow, dividend payout trends and financial market conditions.

Our company, and others in our industry, moved in one direction for nearly a decade – toward a new competitive industry. In 2002, that direction reversed. Such sudden change is not easy, and it caused disruptions. But everything that makes us a good company and a good investment remains intact. Our customer growth is powerful and customer satisfaction has never been higher. Our power plants and wires networks are operating beyond our previous high performance. We know this region and the opportunities it holds.

Our course is set. Arizona – with its intense climate, aesthetic beauty and nearly limitless potential – has never seemed more attractive. This is our home. This is our future. This is our element. •



William J. Post

