



To Our Shareholders

You read correctly, our cover says “2008 Annual Report.” There’s a good reason. This is where we spend a lot of our time – planning to meet the energy needs of customer demand that’s growing 4 to 5 percent each year.

For Pinnacle West, 2008 is here – now.

This emphasis on the future is more than a clever idea. It’s a way to bring our vision into sharp focus for customers, investors and policymakers. A long-term view has always been critically important to us. Growth makes our future orientation even more crucial today. There is simply no room for error or delay – or extended regulatory uncertainty.

We are focused with laser-like intensity on the outcome of our current rate case and what it will say about the future – for our customers and our state.

Understanding how we got to this point – at the end of one state regulatory era but not yet firmly in a new era – requires a quick look at where we are now and how we got here.

HOW WE GOT TO NOW

In 2003, our year-end earnings were in line with expectations, and we strengthened our liquidity position. We had another strong year of operating performance. Our gas- and coal-fired power plants recorded some of their best production years ever. And the Palo Verde Nuclear Generating Station was the largest power producer of any kind in the U.S. for the 12th straight year.

We also achieved regulatory milestones. With approval from the Arizona Corporation Commission (ACC), APS loaned funds to Pinnacle West Energy to relieve the debt burden incurred in the construction of new gas-fired power plants. We also completed a bidding process to secure more than 2,200 megawatts of capacity, including about 1,800 megawatts from Pinnacle West Energy’s Arizona plants that were specifically built to serve APS customers. And our service area remained vibrant, as evidenced by customer growth of three times the national average and record levels of electricity consumption by our retail customers.

That growth, however, came at a price. Over the past few years, we’ve invested about \$2 billion in new infrastructure to increase system reliability. In addition to expanding our generation portfolio, we completed a new 500-kilovolt transmission line from Palo Verde to the metropolitan Phoenix area. The 1,200-plus megawatt line played a significant role in APS’ ability to avoid delivery problems during the summer of 2003.

To recover these and other costs – and as required by our 1999 Settlement Agreement with the ACC – we filed our first general rate case in more than a decade. This rate case covers our cost of service, return on equity, and fuel and purchased power adjusters. Just as important, it addresses a host of issues left unresolved when the ACC reversed its position on deregulation in 2002.

In 1999, we signed a regulatory agreement with the ACC that brought competitive choice to our customers, required us to transfer our APS power plants to an unregulated subsidiary and lowered prices by an average of 1.5 percent per year for five years. This agreement provided a foundation for Pinnacle West to form a business plan consistent with the ACC's wishes. It also explicitly recognized that our unregulated subsidiary could include our low-cost coal and nuclear units in one consolidated generating company.

In 2002, when the ACC reversed course and ordered us not to consolidate our power plants, we had been preparing for deregulation for nearly a decade. We built new gas-fired plants needed for APS customers in Arizona expecting they would be part of a much larger generation fleet that would include APS' fossil and nuclear units. As directed, we stopped course. But the ACC reversal changed everything, leaving many important issues open, including the financial integrity of those plants.

Because of unresolved issues – such as the critical need to consolidate our power plants going forward – our 2003 rate filing goes beyond a rate case. It's really about the future. In that sense, our current rate case is similar to our 1999 Settlement Agreement. The 1999 Settlement Agreement set out a path to the future. *That* future was the last five years and our performance was outstanding.

HOW FOCUSING ON THE FUTURE LED TO SUCCESS: 1999 TO 2003

Our future focus is not a new concept. In fact, it has been a necessity. During the last five years, we honed the traits that allowed us to navigate previously unseen industry volatility.

It took agility and adaptability. In 1999, like now, there was conflict between federal and state regulators, not to mention the unfettered presence of public power in the West.

We insisted on keeping our existing power plants, and we didn't speculate in large merchant generation. We built much-needed new units to serve APS' new customers.

It took the ability to manage risk. Upon approval of the 1999 Settlement Agreement, we embarked upon a two-pronged approach to address customer reliability and price exposure. First, we announced the construction of 1,800 megawatts of new generation under Pinnacle West Energy to cover a portion of APS' needed generation. Second, we immediately began a short-term electric and natural gas hedging program to cover the interim period. We didn't panic and sign purchase power agreements at the peak of market prices, and our two-pronged approach allowed us to navigate the western fuel and power markets without harming customers or investors.

In the summer of 2000 and again in 2001, when wholesale power markets erupted, we were almost fully protected against price spikes with a combination of supply contracts, new generation and financial hedges. At no time did we dedicate the output of our new generation to anyone else.

It took commitment to meeting customer needs. We knew the generation capacity we would need wasn't going to be found in the wholesale marketplace. We were wary of the California market structure, so we fought from the very beginning against the divestiture of APS generation to a third party. We had envisioned what a decent wholesale market should look like and we didn't see one – and still don't – anywhere in the western United States.

Under the electric competition rules adopted by the ACC in 1999, we could not build any new generation at APS, and without new plants under construction we would have been forced to enter the wholesale energy market at the worst possible time. As our requests for proposals from the wholesale market have shown, no one else could have supplied the power our customers needed last year – and will need in the future – as economically as our new plants.

It took a focus on creating customer value. While other utilities were going bankrupt or passing along unheard-of price increases, we lowered our rates by 16 percent over a 10-year period. We delivered these price decreases,

as promised, and delivered the best customer satisfaction of any investor-owned utility in the West.

For the years 1999 through 2003, our peak demand grew nearly 25 percent. When combined with the 1,200-megawatt shortage APS had in 1999, APS' shortage grew to 2,500 megawatts, approximately one-third of our total responsibility. We met that shortage. During that time, we didn't have a single outage because of generation shortages or transmission congestion. We kept the lights on with outstanding operations – at our coal, nuclear and gas plants and throughout our “wires” organization.

It took a focus on creating shareholder value. We've proven adept at translating customer growth into financial results for our shareholders. While our market grew substantially, our workforce count remained flat. Since 1999, we've deployed more than \$140 million of cash distributions from our real estate operations to improve liquidity and fund operating capital. Our common stock dividend growth over the last decade has been the best in our industry. And, the total return on our stock has consistently outpaced the S&P 500 Index.

WHY THE CURRENT RATE CASE IS SO IMPORTANT

We remain focused on the future, just as we were in 1999. But today we're in a state of regulatory transition, without sufficient structure to meet our rapidly growing customer demand. That regulatory structure is needed now so we can continue our outstanding performance for customers and investors.

The unresolved issues in the rate case we filed last year include consolidating Pinnacle West Energy's Arizona units into APS and restoring the \$234 million write-off we were ordered to take as part of the 1999 Settlement Agreement. These issues, while important in themselves, point to the central regulatory issue confronting the ACC and this company – establishing the rules for the future.

In the past, we have been clear that a focus on the future required a firm grounding in regulatory consistency.

We thought with the signing of the 1999 Agreement, we had achieved sufficient predictability and certainty, and we kept our commitments. With our agile approach to regulation and competition, we were able to secure the power we needed to keep the lights on, our customers satisfied and Arizona's economy running.

Today, that predictability and consistency are lacking. We have unfinished business, but we are confident we and our regulators can work together to re-establish a framework that balances customer value with investment risk and reward.

WHY THE FUTURE IS DEJA VU: 2004 TO 2008

Looking ahead, we're focused on ensuring that our company can build on its stellar performance of the last decade. To re-create our past successes – to make the long-term investment in infrastructure we will need in Arizona – requires a clear and consistent regulatory path. With that clarity in place, we will continue to:

Manage the future with agility and adaptability. Agility will always be fundamental. We will retain a sensitivity and responsiveness to the market and to regulatory uncertainty, which can be managed but never completely eliminated. And we'll remain focused on customer needs and Arizona's growth potential.

Utilize our risk management skills. We clearly know our way around western energy markets. Over the next five years, the skills we used to navigate the market storms of 2000 and 2001 will repeatedly prove their value. We will use every tool we possess to sidestep the ill effects of any future boom-bust cycle and protect our customers from market spikes.

Keep the lights on for our customers. We see no slowdown in customer growth, and likely a modest acceleration. To serve customers reliably, we must take action now, just as we made decisions in 1999 that gave us the power we needed. Our forecast shows we'll need about 1,800 more

megawatts of generating capacity by 2008, and a total of more than 3,000 by 2012. Those figures are in addition to the Pinnacle West Energy units we are asking to include in APS. That's why we issued a request for proposal late last year seeking additional capacity by 2007.

Our preference is to buy an existing station or build one ourselves. As long as power markets are rudimentary, illiquid and volatile, increasing reliance on the wholesale market presents unacceptable risk to customers and investors. But at present, we have no assurance that we would be allowed to recover the cost of a prudently planned and constructed plant.

Provide ongoing value for our customers. Providing value to our customers is the driving force of the people of our company. Through their dedication, creativity and commitment we will continue to achieve an enviable combination of price and service.

On the horizon, there are many exciting developments in technology, such as the "self-healing" grid, advances in metering and customer information, distributed generation, solar and other renewable energy sources. These new technologies, combined with the spirit of our people, will continue to produce excellent customer value.

Create shareholder value. For you, the owners of our company, we will continue to produce solid shareholder returns by capitalizing on our region's growth, concentrating on our core business and focusing on our future. We will continue to emphasize dividends, while striving to achieve a regulatory structure that recognizes the importance of aligning investment expectations with potential returns.

WHY THE FUTURE IS NOW

We are poised to become a new kind of vertically integrated utility – one that provides customers with reliable power at a reasonable price but remains subject to the discipline of the energy marketplace. A utility that uses its skills to navigate the energy market for the benefit of both customers and investors.

As I said in last year's Annual Report letter, competition and regulation will co-exist and we must operate effectively in both worlds. The fundamental forces of market structure, electric reliability, customer value and investment risk/reward will shape the consistency and alignment between the two, and as a new kind of vertically integrated utility we must anticipate their evolution. Since competitive markets often move faster than regulation, it's imperative that the regulatory structure considers the future, and that regulators go beyond traditional, historical regulation.

Our Arizona regulators recognize the absolute need to manage electric reliability and price volatility on behalf of customers and the importance of a financially solid electric utility. The regulatory decisions needed in 2004 are critical to the foundation of operating and resource decisions we must make now for 2008 and beyond. I believe our commissioners understand the long-term need to have a reliable and affordable electric infrastructure as a base to fuel Arizona's economy.

Resolving our current rate case fairly means balancing customer and shareholder interests by recognizing that those interests are frequently aligned. Over the long term, a financially strong utility and low customer rates go hand-in-hand.

We are committed to achieving a regulatory outcome that sets a firm foundation for important operating and resource decisions. Simultaneously, we will continue to meet our customers' growing needs, improve service levels, build on our excellent operating performance and manage our resources in a safe and ethical manner while providing our shareholders a fair return on their investment.

This is our hallmark.



William J. Post, Chairman