

TO OUR SHAREHOLDERS

CHAIRMAN'S LETTER

We may not need a blinking light to tell you how fast we're growing, but it does make the point, doesn't it?

Now that I've got your attention, I'll admit the Arizona growth story is not news. But our *re-accelerating* growth is. Customer growth re-accelerated last year to 3.7 percent, back to our five-year average after a slight dip in 2002 and 2003. And our five-year average growth of 3.7 percent is three times the industry average.

That re-acceleration *is* news because growth will continue and even accelerate more this year. That story – and why growth is good for shareholders *and* customers – is the focus of this year's report to our owners.

Managing Growth in 2004

Reaching agreement on our rate case with customer groups and other stakeholders marked a high point in 2004, but it was only one among many. It was a demanding year for employees, who managed record growth, worked safer than ever, added another to a string of "top producing power station" years at the Palo Verde Nuclear Generating Station and calmly and professionally resolved a once-in-a-career transmission event.

Palo Verde's 10-year average capacity factor of 89.5 percent exceeded the 10-year national average by more than five percentage points. That means, just looking at APS' 29-percent share of Palo Verde, we averaged over 500,000 more megawatt-hours of production per year than we would have achieved with merely average performance. And Palo Verde's three-year-average production cost of 1.35 cents per kilowatt-hour was 27 percent below the national average for nuclear units. Higher capacity factors and lower costs add up to considerable savings for customers and a sizable contribution to earnings.

For our shareholders, the results in 2004 were strong. We set ourselves apart with our eleventh consecutive annual dividend increase. Shareholders received a total return (stock price increase plus dividends) of 16 percent. Our stock performance, even in the face of re-regulation, nearly matched the strong utility industry.

Our customers continued to enjoy high reliability, exceptional service and lower prices. From 1996 through 2004, APS invested about \$3.6 billion to expand generation and upgrade transmission and distribution systems. Over this same period, the number of customer outages dropped by a third and the average interruption decreased in duration by 44 percent.

Those numbers illustrate our ability to manage growth *and* improve service. In a testament to the dedication to service shared throughout our company, our customer satisfaction ratings remained outstanding. APS ranked in the top 10 percent nationally – and first among investor-owned utilities in the West – in overall customer satisfaction in both the latest J.D. Power and Associates residential and business customer surveys.

In 2004, our customers experienced a full year of prices that were lower than 20 years ago, and 44 percent lower on an inflation-adjusted basis. After a decade of price decreases which ended in 2003, nominal prices are 16 percent lower than they were in 1993. To produce these kinds of numbers, we've been innovative in finding ways to cut costs and increase efficiencies. Year after year, with a series of price decreases over the last decade, we improved performance while keeping our regulatory commitments.

Growth means constant attention to resource planning. We grew into – and now we're outgrowing – the chunks of base-load generation and transmission capacity we've added over the years. The good news hidden in those engineering realities is that, with cooperation from our regulators, we can accommodate growth with upgraded facilities and a faster pace of technological innovation.

Leveraging Growth for Greater Reliability and Environmental Quality

Our customer growth is not just compatible with high reliability and environmental quality – it will ultimately enhance both. A high rate of growth brings opportunities that a stagnant or declining customer base would not allow – opportunities for achieving new efficiencies and employing new technologies.

Opportunities to replace older equipment come faster because of our growth. At every opportunity we're leveraging growth to improve reliability with new and better technology and infrastructure. Ultimately, the result is greater flexibility, cost efficiency and reliability. Growth-generated enhancements will propel us further and faster toward our goal of becoming a model 21st century utility.

Growth also has advantages for creating a sustainable environment. With the support of our regulators, we are pursuing growth of solar power – a technology in which we are a national leader among utilities – and of biomass, wind and hydrogen as future alternative sources of power.

We know the challenges of growth. We're vigilant, but not intimidated. We have a skilled and experienced group of men and women who tackle the opportunities. Our employees demand more of themselves today in order to meet the needs of tomorrow. That's the attitude guiding us toward continuing improvement.

Clashing Visions, Growing Agendas

As we said in last year's Annual Report, we're becoming a new kind of integrated utility. This year, with our new regulatory platform, we're much closer to our goal: a utility meeting its customers' needs reliably and efficiently with vertically integrated resources in an evolving market.

That vision is becoming more common as it's evident that competition and regulation – or re-regulation – will continue to clash and coexist. Clearly, our company will continue to live in both worlds. We're a vertically integrated company, and that means our generation resources as well as our "wires" infrastructure will primarily earn a regulated return. Yet we plan to obtain over 1,000 megawatts from the competitive market in the next three years. And with the high availability factors of our recently completed gas units, we will sell into the wholesale market. That sounds like competition.

The Federal Energy Regulatory Commission (FERC) and many states, including Arizona, will continue to adopt new and sometimes discordant positions. It's our job to satisfy both sets of rules and succeed in both worlds. In reality, market and regulatory structures will be determined by many factors – core competencies of the utility, market robustness and liquidity, and the interplay of power, policy and politics among state regulators, Congress and the FERC. Until there is more clarity, we will continue to balance these evolving structures, maintaining flexibility to exceed customer and shareholder expectations.

Turning Growth into Shareholder Value

We're confident in our ability to continue long-term improvement in earnings and cash flow. To attract the capital we need to keep up with growth, we must continue to compensate investors for shouldering risk. That's also the key that unlocks our ability to continue improving reliability while protecting our natural environment. We won't diminish our obligation to secure Arizona's energy future for our customers or concede our commitment to a fair return for shareholders.

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Growth is good news for investors because it drives revenue growth that, well managed, produces earnings growth. We're confident we can continue to capture the benefits of growth for investors in the form of greater overall profitability, improved cash flow and higher dividends.

We have an enviable track record of converting growth into shareholder value, and we will continue that value creation in the future. Our strategy to secure the benefits of customer growth for investors is built around four major elements: achieving regulatory collaboration, controlling operating and capital costs through operational excellence and risk management, etching a strong financial profile and embracing technology and innovation.

First, we will continue to work with regulators to refine our newly restructured regulatory platform. After avoiding the structural failures of California-style deregulation, we expanded our approach to competition and regulation. We reached agreement last year with major customer groups on a new regulatory platform, the main elements of which were endorsed in early March by an administrative law judge. As this report goes to press, we are awaiting approval by our Arizona regulators.

The new platform will remedy our most urgent regulatory issues: it consolidates our company by putting the Arizona plants built by Pinnacle West Energy, our unregulated generation subsidiary, into the APS rate base. There, the plants will earn a regulated return and provide valuable, reliable, cost-effective and environmentally suitable capacity for our customers. It provides for a fuel and purchased power adjustment clause, our first since 1989, and includes a 4.2 percent rate increase.

Perhaps most important, this long overdue restructured regulatory platform will give us the opportunity to look forward not backward. Instead of re-doing the regulatory decisions of the late 90s, we can anticipate the infrastructure and service needs of our customers. We are responsible for meeting our customers' needs. We've done it before and we will continue to do so.

Second, we will manage power costs and capacity needs with excellent operations of a broad resource base and effective risk management strategies. With our low-cost nuclear and coal units fully deployed and achieving high capacity factors, we are well positioned to supply economical power for our customers. The new gas

units at Redhawk, West Phoenix and Saguaro will enable a diverse energy supply mix of nuclear, coal and gas. As supplies tighten and spark spreads widen over the next few years, our gas units will allow us to capture opportunities in the wholesale market as well as supply our customers' needs.

We've controlled fuel and purchased power risk for years, and we will continue to do so. With a fuel adjustment clause added to our risk management tools, we will not reduce our intensity on minimizing cost. This fuel adjuster will become increasingly important as we achieve a more diverse generation fuel mix and as we contract for additional purchased power. Our new regulatory platform calls for a hiatus on building generation until 2015 – unless regulators agree the market is failing to provide adequate new capacity.

Third among our strategies for capturing the benefits of growth, we will achieve an improved financial profile. The new regulatory platform will provide some revenue boost. In addition, with the Arizona gas-fired units expected soon to be in the APS rate base, our corporate risk profile will be much lower, which will bolster our financial flexibility.

We've enhanced our cash flow over the last two years with asset sales, primarily by SunCor, our real estate subsidiary. As we've often said in the past about SunCor, we will maximize the value of our assets for shareholders over the long term with sales or purchases depending on opportunity and the economy. Years ago, we adopted a two-pronged financial strategy – maintaining an investment-grade rating on all corporate-level debt and targeting a steady pace of dividend increases. The former keeps our financing costs low – essential for a rapidly growing utility like APS – and the latter sets our financial profile apart from many other utilities.

Finally, innovation and further deployment of technology will help control our generation costs, but the potential for digital advances on the delivery side – the “wires” and customer service part – of our business is truly exciting. Technology will allow us to fully utilize our current assets and leverage our talented employee base. With computer software and digital intelligence facilitating and enhancing our operations, we will continue to provide better as well as more efficient customer service. In 1994, we served about

160 customers per employee. In 2004, we served 224 customers per employee while providing outstanding customer service, including more information, faster response to outages and higher reliability. Over the next decade, we expect to see equal or greater productivity gains and continuing service enhancements.

Over the long term, despite 10 years of regulatory uncertainty, market blowups in California and rate decreases in Arizona, we've generated a positive earnings and cash flow trend. With historic deregulation tremors behind us, we look forward to a more stable regulatory environment, a more robust wholesale power market, a better economy – and a resumption of earnings growth.

The past offers strong evidence of our ability to manage growth for the benefit of investors, but the earnings blip and dip from power marketing over the last few years may disguise the underlying stability of our core regulated utility business. Every year over the last 10 years, with the exception of the recession year 2001, our electricity sales growth exceeded both the Arizona population growth and our customer growth rates. The regulated core business gave us solid earnings and now it will drive future earnings growth.

What makes this all possible?

The answer is simple – our people. Each day, they come to the job ready to work hard, solve challenges and deliver unmatched service to our customers. They are the reasons we have succeeded for 118 years. They are the reasons we will continue to succeed in the future.



WILLIAM J. POST
Chairman

