

TO OUR SHAREHOLDERS

Customers, investors, employees – our futures are connected. Not just by the lines that deliver power, but also by Arizona's growth potential and limitless possibilities.

This letter, like our company, is focused on our ongoing task of preparing for and connecting to Arizona's energy future. In the short term, that means recovering our unexpectedly high natural gas costs. Full and timely recovery of our fuel costs is essential to our ability to finance future growth.

In the long term, ensuring Arizona's energy future requires a diverse portfolio of new generating resources. Extending our transmission system into new coal and renewable markets, as well as encouraging conservation efforts through customer-driven demand-side management programs, requires aggressive action today.

As we make the transition from a competitive model to re-regulation, we're working with our state regulators to forge a sustainable approach to Arizona's energy growth. In 2005, we consolidated all of our generation, established a new resource acquisition process and we're now implementing a new fuel cost recovery clause. These steps will improve our financial health, and only a healthy utility company can supply the energy demands of our dynamic state.

A healthy Arizona doesn't just require a healthy utility, it demands one. Only a financially strong company can simultaneously manage growth, improve reliability and provide outstanding customer service – as we have for the last decade.

WE MET THE GROWTH CHALLENGE

Over the last 10 years, Arizona has experienced unprecedented economic and population growth. During the last decade, our gross state product increased by 74 percent (double the national level during that time) while job growth exceeded 40 percent. And the future looks just as promising.

In 2005, our core business was strong – net income from retail electric customers increased by nearly 10 percent. However, our earnings per share were lower than the previous year due primarily to regulatory write-offs and a loss on the sale of our Nevada generating unit. We replaced this generation with local Arizona generation at comparable terms and our consolidated APS generation will provide a solid platform as we complete our progress toward a vertically integrated, regulated company.

For APS, last year's 4.3 percent customer growth – and 9.3 percent load growth – came after we added 300,000 customers from 1995 to 2004. Last year we also added our millionth customer.

While adding customers at a record pace, we also strengthened our infrastructure with a \$5 billion investment over the last 10 years, including one of the few 500-kilovolt transmission lines built in the West in the last decade.

AT A GLANCE | APS ranked first among investor-owned electric utilities in the West and third among investor-owned utilities in the nation in J.D. Power and Associates' 2005 Electric Utility Residential Customer Satisfaction Study

AT A GLANCE | Pinnacle West received the top rating – AAA – from Innovest Strategic Value Advisors, an investment research and advisory firm that analyzes companies' performance on environmental, social and strategic governance issues

When the Arizona competitive rules kept APS from building new generation, we invested in new generation for APS customers under our competitive subsidiary, Pinnacle West Energy. Our 1,000-megawatt Redhawk combined-cycle plant and our 600-megawatt West Phoenix units were vital additions to support the Phoenix "load pocket."

Supplying our customers with reliable power required that we recognize the physical reality of electricity, not just evolving regulatory structures. That meant we built new generation with our transmission capability and our customers firmly in mind. Some who built plants in Arizona were focused primarily on short-term profitability from potential new markets. Our company, on the other hand, focused on our duty to meet customers' and shareholders' needs for the long term.

WE'RE RE-ENGAGING WITH VERTICALLY INTEGRATED REGULATION

Last year in my letter to shareholders, I wrote that our company was starting to become a new kind of integrated utility, tempered by competitive forces, relying on our own generation as well as market resources.

We're making the transition to a new regulatory platform – working closely with the Arizona Corporation Commission – and we're moving forward with steady success. In April 2005, we received our first rate increase since 1991 and, perhaps even more important, we gained approval for our first fuel and purchased power adjustor since 1989. With our greater reliance on natural gas, the market price of which we clearly cannot control, the fuel adjustor will greatly reduce our financial risk profile given volatile fuel markets. This reduces uncertainty for our investors and long-term costs for our customers.

That's been and will continue to be one of our strongest themes – reducing uncertainty by aggressively tackling issues. We knew a fuel adjustor would be fundamental due to our increased reliance on natural gas and purchased power, and we achieved that goal.

After a decade of price decreases, made possible by operational excellence, employee productivity and technological advances, we're now in an era of high natural gas fuel prices. Price pressures have compounded the implementation of the adjustor as well as the transition to vertically integrated regulation. However, we are making progress toward a strong regulatory platform for the future.

As we continue to move out of our transitional regulatory structure, we'll stay focused on Arizona's energy future, engaging regulators cooperatively on the best approach to new energy sources as we enter a new resource cycle. To achieve timely resolution of resource issues and preserve our momentum toward greater reliability, working together with our regulators early in the cycle will be vital.



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GROW WITH

EACH DAY BRINGS MORE – MORE RESIDENTS, MORE HOMES, MORE BUSINESSES, MORE POSSIBILITIES. ARIZONA CONTINUES TO GROW AT A PACE THREE TIMES THE NATIONAL AVERAGE. FOR OUR COMPANY, THIS MEANS MORE CUSTOMERS, USING MORE POWER AND THE NEED FOR MORE POWER RESOURCES. TO MEET THIS GROWTH, IN 2005 WE ADDED 900 MILES OF TRANSMISSION AND DISTRIBUTION WIRES TO OUR NETWORK.

AT A GLANCE Increased efficiency allowed our company to serve 220 customers per employee in 2005, compared to 167 per employee a decade ago

AT A GLANCE Pinnacle West earned a place on a list of the world's 100 most sustainable corporations, as named by *Corporate Knights*, a Canada-based social responsibility magazine

OUR OPERATIONS ARE SOUND

Despite an extended outage for a steam generator replacement on Unit 1, the Palo Verde Nuclear Generating Station produced more electricity than any other single power plant in the United States for the 14th consecutive year. Over the last decade, Palo Verde has provided an outstanding hedge against rising fuel costs. Our average unit production cost over the last 10 years was 25 percent below the nuclear industry average. This means our costs over that period were about \$450 million lower than what they would have been had Palo Verde's unit operating costs been at industry averages. This has translated into significant savings for our customers.

Yet Palo Verde's performance last year fell behind our own high standards and the results we've produced over the last decade. Frankly, we're not accustomed to anything less than stellar performance, and we have in place a comprehensive performance improvement plan to return Palo Verde to the top rank of nuclear plants.

Our future is strong because our customer growth provides an inherent competitive advantage, and our focus on performance helps us shape the future, not just respond to it.

In 2005, our coal units achieved their highest capacity factor ever. Over the last decade, our coal units have improved from a capacity factor of 69 percent in 1996 to better than 87 percent in 2005. That's an increase of more than 2.5 billion kilowatt-hours of low-cost, reliable coal generation to meet the growing needs of our customers.

Construction is a big part of our job to meet customer growth and improve reliability. In 2005, we added 900 miles of distribution and transmission lines as well as eight new substations. While our construction workload continues to grow, so does our productivity. For example, using new work methods and techniques, APS employees can now build an average substation in half the time it took a little over a decade ago.

Customer service increasingly means much more than just keeping the lights on; it also means providing swift, accurate and useful information. In the last decade, we successfully reduced our staffing through applied technology tailored to our business, and there's more to come. Intelligent metering, new clean coal technologies, advancements in renewable generation, conservation improvements through applied technologies, information system enhancements and other high-tech applications will transform our industry. In the next decade our focus is to modify our core business through technology – to expand customer value in addition to improving productivity.

While we've improved customer service, we've also increased the number of customers served per employee from 167 to 220 over the last decade. While increasing their productivity, our employees have achieved the highest J.D. Power customer satisfaction rating of any investor-owned utility in the West (we're third in the U.S. as a whole). While we're using every technological means at our disposal to control costs and improve service, our dedicated and creative employees remain our most important assets in this effort.

AT A GLANCE SunCor, our real estate development subsidiary, had another strong year, adding nearly \$56 million to the bottom line

AT A GLANCE For the 14th consecutive year, the Palo Verde Nuclear Generating Station earned the title of the nation's largest power producer

OUR FUTURE IS STRONG

Our future is strong because our customer growth provides an inherent competitive advantage, and our focus on performance helps us shape the future, not just respond to it.

We have embarked on a new generation resource cycle. To provide new resources, we've engaged regulators early in the cycle by accessing the market through competitive bids. We constantly evaluate the potential of renewable resources, and we're enhancing our transmission infrastructure to broaden our geographic base. We will continue to need new natural gas capacity, but we're rapidly lining up a diverse portfolio of new generating resources.

We're very excited about the potential of our TransWest Express project for Arizona and for the entire southwestern region. Compelling even in the planning stage, this new large-capacity transmission line would bring to Arizona the vast coal and wind resources of Wyoming. Also, we'll likely be adding a new coal unit closer to home in the next decade.

We're increasing our use of renewable technologies to 5 percent of our energy mix by 2015 and 15 percent by 2025. This year, we continued to demonstrate renewable leadership with Arizona's first solar trough plant, a one-megawatt facility near our existing Saguaro Power Plant.

Our customers will begin to benefit from our greatly expanded demand-side management program. With incentives for energy-saving measures such as lighting and high-efficiency air conditioning, this multi-year program will deploy \$48 million to reduce our peak demand by more than 50 megawatts and energy consumption by more than 3 million megawatt-hours over the life of the energy-saving measures.

OUR FINANCIAL RESULTS: IMPROVING TOWARD EXCELLENCE

Our investors and customers can have confidence in our ability to manage our access to capital as well as our physical assets. Our financing goals are crafted with one fundamental objective: maintaining access to low-cost sources of capital so we can supply our growing service area reliably and economically.

In Arizona's high-growth environment, we will continue to need substantial amounts of capital. Last year, we accessed about \$1 billion in debt and equity on favorable terms, including an equity placement of \$250 million. Combining the proceeds of our equity offering with the sale of our share of a Nevada generating unit, we invested \$460 million in APS. This equity infusion bolstered APS' cash position and brought the debt/equity ratio into the appropriate range. Strengthening APS' balance sheet is critical to meeting our future financial requirements, which are driven by the growing energy demands of our customers.



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PURPOSE

A FUTURE OF INNOVATION AND ACHIEVEMENT LIES AHEAD FOR ARIZONA. LIKE YOU, WE'RE EAGER TO WATCH IT UNFOLD. BUT THIS FUTURE WON'T JUST HAPPEN BY ITSELF. ARIZONA WILL NEED SAFE, RELIABLE POWER – IN LARGE QUANTITIES. THAT'S WHY OVER THE LAST DECADE, WE'VE INVESTED MORE THAN \$5 BILLION ON ELECTRIC INFRASTRUCTURE – ABOUT \$18,000 PER NEW CUSTOMER. AND WE PLAN ON SPENDING ANOTHER \$7 BILLION OVER THE NEXT DECADE.

\$18,000

AT A GLANCE

APS continued its investment in Arizona's electric future by adding more than 900 miles of transmission and distribution wire and eight new substations to its growing network

AT A GLANCE

The company completed construction of a one-megawatt solar trough power plant, the first such plant of its kind in Arizona and the first to be built in the United States in 17 years

However, to remain viable, our customers' prices must reflect our costs. After a decade of price reductions made possible by our gains in efficiency, we've requested increases for fuel and other costs which offset our historical price decreases. However, once fully implemented, our total net price increase over the period will be about 1 percent per year.

IN SUMMARY

We've met the growth challenge of the last decade despite dueling state and federal regulation that exacerbated an uncertain market structure. Our operations are sound, our customer relations are among the best in the nation and our employee productivity gains are impressive.

We manage our financial resources well even as we meet the challenges of growth. We're using new technology to improve service and serve more customers per employee. We're steadily embracing new and diversified generating resources and employing innovative approaches like our TransWest Express transmission project. We're managing the regulatory transition and forging a new regulatory platform with increasing clarity for the future.

The old uncertain regulatory history was resolved last year, and we're making progress toward a sustainable regulatory structure with improved predictability for investors and assured reliability for customers. With improved cash flow and timely recovery of our fuel costs, APS will be positioned as a strong, healthy company poised to continue benefiting from our customer growth.

The future success of Arizona – its residents, its communities, its economy – depends on the availability of a reliable electric supply and the infrastructure to deliver it. We will continue to work side-by-side with the people of our state to power innovation for an enviable quality of life and a successful future – yours and ours.



WILLIAM J. POST
Chairman & CEO

