

PINNACLE WEST CAPITAL CORP

Form 8-K

December 20, 2004

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 8-K

**CURRENT REPORT
Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934**

Date of Report (Date of earliest event reported): November 18, 2004

PINNACLE WEST CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

Arizona	1-8962	86-0512431
(State or Other Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification Number)
400 North Fifth Street, P.O. Box 53999, Phoenix, Arizona		85072-3999

(Address of Principal Executive Offices)	(Zip Code)
(602) 250-1000	

(Registrant's telephone number, including area code)
NONE

(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- Written communications pursuant to Rule 425 under the Securities Act (17CFR 230.425)
 - Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
 - Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
 - Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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GLOSSARY

ACC Arizona Corporation Commission

ADEQ Arizona Department of Environmental Quality

AFUDC allowance for funds used during construction

ALJ Administrative Law Judge

ANPP Arizona Nuclear Power Project, also known as Palo Verde

APS Arizona Public Service Company, a subsidiary of the Company

APS Energy Services APS Energy Services Company, Inc., a subsidiary of the Company

CC&N Certificate of Convenience and Necessity

Cholla Cholla Power Plant

Citizens Citizens Communications Company

Clean Air Act the Clean Air Act, as amended

Company Pinnacle West Capital Corporation

CPUC California Public Utility Commission

DOE United States Department of Energy

EITF the FASB's Emerging Issues Task Force

El Dorado El Dorado Investment Company, a subsidiary of the Company

EPA United States Environmental Protection Agency

ERMC Energy Risk Management Committee

FASB Financial Accounting Standards Board

FERC United States Federal Energy Regulatory Commission

FIN FASB Interpretation

Financing Order ACC Order that authorized APS \$500 million loan to Pinnacle West Energy in May 2003

Four Corners Four Corners Power Plant

GAAP accounting principles generally accepted in the United States of America

IRS United States Internal Revenue Service

ISO California Independent System Operator

kWh kilowatt-hour, one thousand watts per hour

Moody's Moody's Investors Service

MW megawatt, one million watts

MWh megawatt-hours, one million watts per hour

NAC NAC Holding Inc. and NAC International Inc., subsidiaries of El Dorado

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Native Load retail and wholesale sales supplied under traditional cost-based rate regulation

1999 Settlement Agreement comprehensive settlement agreement related to the implementation of retail electric competition

NRC United States Nuclear Regulatory Commission

Nuclear Waste Act Nuclear Waste Policy Act of 1982, as amended

OCI other comprehensive income

Palo Verde Palo Verde Nuclear Generating Station

PCAOB Public Company Accounting Oversight Board

PG&E PG&E Corp.

Pinnacle West Pinnacle West Capital Corporation, the Company

Pinnacle West Energy Pinnacle West Energy Corporation, a subsidiary of the Company

PWEC Dedicated Assets the following Pinnacle West Energy power plants, each of which is dedicated to serving APS customers: Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3

PX California Power Exchange

RTO regional transmission organization

Rules ACC retail electric competition rules

SCE Southern California Edison Company

SEC United States Securities and Exchange Commission

September 2004 10-Q Report Pinnacle West Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2004

SFAS Statement of Financial Accounting Standards

SNWA Southern Nevada Water Authority

SPE special-purpose entity

Standard & Poor's Standard & Poor's Corporation

SunCor SunCor Development Company, a subsidiary of the Company

T&D transmission and distribution

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Track A Order ACC order dated September 10, 2002 regarding generation asset transfers and related issues

Track B Order ACC order dated March 14, 2003 regarding competitive solicitation requirements for power purchases by Arizona's investor-owned electric utilities

Trading energy-related activities entered into with the objective of generating profits on changes in market prices

2003 Form 10-K Pinnacle West Capital Corporation Annual Report on Form 10-K for the fiscal year ended December 31, 2003

VIE variable interest entity

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ITEM 1.01 ENTRY INTO A MATERIAL DEFINITIVE AGREEMENT

Asset Purchase Agreement

On December 14, 2004, APS and PPL Sundance Energy, LLC, a wholly-owned subsidiary of PPL Corporation (PPL Sundance) amended the Asset Purchase Agreement dated as of June 1, 2004 (the Asset Purchase Agreement), relating to the sale by PPL Sundance to APS of the assets comprising the 450 MW Sundance power plant located in Pinal County, Arizona. See Note 5 of Notes to Condensed Consolidated Financial Statements in the Company s September 2004 10-Q Report.

The Asset Purchase Agreement as in effect prior to the amendment provided that either party could terminate the Asset Purchase Agreement on or before January 10, 2005 if the ACC did not, on or before December 31, 2004, issue an order approving, among other things, the purchase of the power plant assets by APS. PPL Sundance and APS have amended the Asset Purchase Agreement to provide that either party may terminate the agreement on or before January 31, 2005 if the ACC does not issue such order on or before January 21, 2005. A copy of the amendment to the Asset Purchase Agreement is attached as Exhibit 99.1 and is incorporated herein by reference.

2005 Incentive Plans

On December 14, 2004, the Human Resources Committee (the Committee) of the Company s Board of Directors approved the Chairman and CEO Variable Incentive Plan (the CEO Incentive Plan). The Company s Chairman of the Board and CEO, William J. Post, is eligible to receive an incentive award under the CEO Incentive Plan. Incentive award funding under the CEO Incentive Plan is triggered by the attainment of specified 2005 Company earnings. The amount of the award to Mr. Post is in the sole discretion of the Committee. Accordingly, the Committee may consider factors other than 2005 Company earnings to measure Mr. Post s performance.

On December 15, 2004, the Company s Board of Directors, acting on the recommendation of the Committee, approved the 2005 Officer Variable Incentive Plan (the Officer Incentive Plan). Each of the Company s officers, as well as the officers of APS (currently 19 officers), are eligible to participate in the Officer Incentive Plan, including the following four most highly-compensated current executive officers (excluding the CEO) named in the Company s proxy statement relating to its May 19, 2004 annual meeting: Jack E. Davis, President and Chief Operating Officer of the Company; Donald E. Brandt, Executive Vice President and Chief Financial Officer of the Company; James M. Levine, Executive Vice President, Generation of APS; and Steven M. Wheeler, Executive Vice President, Customer Service and Regulation of APS (the Named Executive Officers).

The Officer Incentive Plan is composed of two components, one of which is based on the Company s 2005 earnings and the other on the achievement of specified business unit results. Once a specified earnings threshold is met, the achievement of the level of earnings and business unit results generally determines what award, if any, the officer receives. However, the amount of the award, if any, to each officer under the Officer Incentive Plan is in the sole discretion of the Committee. Accordingly, the Committee may consider factors other than Company earnings and the achievement of business unit results to measure performance, including input from the CEO about each officer s 2005 achievements.

Subject to the foregoing, award opportunities (expressed as a percentage of the officer s base salary) for the Chairman and CEO and the Named Executive Officers will be based on the following performance measures (weighted according to the indicated percentages):

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Officer	Performance Measure(s)	Award Opportunity
William J. Post	Company Earnings	Threshold (63%) Midpoint (125%) Maximum (200%)
Jack E. Davis	Company Earnings	Threshold (37.5%) Midpoint (75%) Maximum (150%)
Donald E. Brandt	-Company Earnings (50%) -Shared Services Business Unit Results (Combined Generation Business Unit, Palo Verde Business Unit, and Delivery Business Unit Performance; Meeting or Exceeding Budget Targets; and Preventable Recordable Injuries) (50%)	-Company Earnings: Threshold (0%) Midpoint (25%) Maximum (50%) -Shared Services Business Unit Results (up to 50%)
James M. Levine	-Company Earnings (50%) -Generation Business Unit Results (Preventable Recordable Injuries; Coal & Nuclear Production Cost; APS Gas Units Annual Equivalent Availability Factor; Coal and Nuclear Capacity Factor; and Environmental) (50%)	-Company Earnings: Threshold (0%) Midpoint (25%) Maximum (50%) -Generation Business Unit Results (up to 50%)
Steven M. Wheeler	-Company Earnings (50%) -Delivery Unit Results (Preventable Recordable Injuries; Customer Satisfaction; Business Performance Trends; Customer Reliability; and Environmental Incidents) (50%)	-Company Earnings: Threshold (0%) Midpoint (25%) Maximum (50%) -Delivery Business Unit Results (up to 50%)

Award opportunities for other executive vice presidents and senior vice presidents are up to 100% of base salary (up to 50% based on Company earnings and up to 50% based on the achievement of business unit results). Award opportunities for other officers are up to 70% of base salary (up to 35% based on Company earnings and up to 35% based on the achievement of business unit results).

2005 Deferred Compensation Plan

On December 15, 2004, the Company's Board of Directors, acting on the Committee's recommendation, authorized the Company's management to adopt a new nonqualified deferred compensation plan applicable to post-2004 deferrals. No future deferrals will be permitted under the Company's existing nonqualified deferred compensation plan, the Pinnacle West Capital Corporation, Arizona Public Service Company, SunCor

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Development Company, and El Dorado Investment Company Deferred Compensation Plan (the Pre-2005 Plan). The new plan will be based in large part on the Pre-2005 Plan, and is required as a result of the new tax law requirements imposed by Internal Revenue Code Section 409A, which was added by the American Jobs Creation Act of 2004. Under the terms of the new plan, an account will be established for each participant to record the participant s deferrals and interest credits thereon.

Eligibility Participation is limited to Directors, officers and a select group of management or highly compensated employees of the Company, APS, SunCor and El Dorado selected by an administrative committee appointed by the Company s Board of Directors (the Plan Committee). Participants include Mr. Post and each of the Named Executive Officers.

Deferrals A participant is allowed to defer up to 50% of the participant s base salary and up to 100% of the participant s bonus. Amounts deferred are credited with interest rates determined by the Plan Committee. Assuming the participants meet certain length-of-service requirements, the interest rate for 2005 under the Pre-2005 Plan and the new plan will be 7.5%. Deferrals of base salary must be made prior to the calendar year in which such base salary will be paid. Deferrals of any bonus payable in 2005 must be made before the end of 2004. Deferrals of bonuses paid in 2006 and future years must be made at least six months prior to the end of the earning period.

Distributions When making a deferral election, a participant will also make an election regarding the timing and manner of distributions of the participant s deferrals and interest thereon. Changes in any such election will be permitted only to the extent allowed by Internal Revenue Code Section 409A. All distributions under the Plan will be made in accordance with Internal Revenue Code Section 409A.

Effective Date The plan will be effective as of January 1, 2005.

Table of Contents**ITEM 8.01. OTHER EVENTS****Financial Statement Reclassification**

Section 8 of this Current Report on Form 8-K is limited to the disclosure of the reclassification of financial statements of Pinnacle West to reflect reclassifications of the activities of NAC to discontinued operations, as defined by SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets. In July 2004, we entered into an agreement to sell our investment in NAC. The transaction closed on November 18, 2004. This Report reflects the impact of the reclassification on the following disclosures in our 2003 Form 10-K.

Item 8. Financial Statements and Supplementary Data; and

Schedule II Valuation and Qualifying Accounts.

NO ATTEMPT HAS BEEN MADE IN THIS REPORT TO MODIFY OR UPDATE OTHER DISCLOSURES IN OUR 2003 FORM 10-K OR OUR OTHER SECURITIES AND EXCHANGE COMMISSION FILINGS.

As previously disclosed in our September 2004 10-Q Report, revenues and expenses related to NAC activities were required to be reported as discontinued operations in accordance with SFAS 144. Among other guidance, SFAS 144 prescribes accounting for discontinued operations and defines certain activities as discontinued operations. The September 2004 10-Q Report reflects certain reclassifications related to NAC's discontinued operations for 2004 and 2003.

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FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
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FINANCIAL STATEMENT SCHEDULE**

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<u>Financial Statement Schedule for 2003, 2002 and 2001 Schedule II Valuation and Qualifying Accounts for 2003, 2002 and 2001</u>	73
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See Note 13 for the selected quarterly financial data required to be presented in this Item.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
Pinnacle West Capital Corporation
Phoenix, Arizona

We have audited the accompanying consolidated balance sheets of Pinnacle West Capital Corporation and subsidiaries (the Company) as of December 31, 2003 and 2002 and the related consolidated statements of income, changes in common stock equity and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in the Index. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Pinnacle West Capital Corporation and subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 18 to the consolidated financial statements, in 2003 the Company changed its method of accounting for non-trading derivatives in order to comply with the provisions of Emerging Issues Task Force Issue No. 03-11, *Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not Held for Trading Purposes as Defined in Issue No. 02-3*.

As discussed in Note 18 to the consolidated financial statements, in 2002 the Company changed its method of accounting for trading activities in order to comply with the provisions of Emerging Issues Task Force Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*.

As discussed in Note 18 to the consolidated financial statements, in 2001 the Company changed its method of accounting for derivatives and hedging activities in order to comply with the provisions of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

/s/ DELOITTE & TOUCHE LLP

Phoenix, Arizona
March 11, 2004 (December 15, 2004 as to the effects of the discontinued operations of NAC described in Note 22)

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(dollars and shares in thousands, except per share amounts)

	Year Ended December 31,		
	2003	2002	2001
OPERATING REVENUES			
Regulated electricity segment	\$ 1,978,075	\$ 1,890,391	\$ 1,984,305
Marketing and trading segment	391,886	286,879	469,784
Real estate segment	361,604	201,081	168,908
Other revenues	27,929	26,899	11,771
	<u>2,759,494</u>	<u>2,405,250</u>	<u>2,634,768</u>
OPERATING EXPENSES			
Regulated electricity segment purchased power and fuel	517,320	376,911	583,080
Marketing and trading segment purchased power and fuel	344,862	154,987	152,762
Operations and maintenance	548,732	584,538	530,095
Real estate operations segment	305,974	185,925	153,462
Depreciation and amortization	435,140	422,299	427,903
Taxes other than income taxes	110,270	107,952	101,068
Other expenses	23,254	21,895	10,375
	<u>2,285,552</u>	<u>1,854,507</u>	<u>1,958,745</u>
	<u>473,942</u>	<u>550,743</u>	<u>676,023</u>
OPERATING INCOME			
OTHER			
Allowance for equity funds used during construction	14,240		
Other income	35,563	14,910	26,416
Other expenses	(20,574)	(33,655)	(33,577)
	<u>29,229</u>	<u>(18,745)</u>	<u>(7,161)</u>
INTEREST EXPENSE			
Interest charges	204,339	187,039	175,822

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Capitalized interest	(29,444)	(43,749)	(47,862)
	<u> </u>	<u> </u>	<u> </u>
Total	174,895	143,290	127,960
	<u> </u>	<u> </u>	<u> </u>
INCOME FROM CONTINUING OPERATIONS			
BEFORE INCOME TAXES	328,276	388,708	540,902
INCOME TAXES	102,473	152,145	213,535
	<u> </u>	<u> </u>	<u> </u>
INCOME FROM CONTINUING OPERATIONS	225,803	236,563	327,367
Income (loss) from discontinued operations net of income tax expense (benefit) of \$9,616 and (\$14,045)	14,776	(21,410)	
Cumulative effect of a change in accounting for derivatives net of income tax benefit of (\$9,892)			(15,201)
Cumulative effect of a change in accounting for trading activities net of income tax benefit of (\$43,123)		(65,745)	
	<u> </u>	<u> </u>	<u> </u>
NET INCOME	\$ 240,579	\$ 149,408	\$ 312,166
	<u> </u>	<u> </u>	<u> </u>
WEIGHTED-AVERAGE COMMON SHARES			
OUTSTANDING BASIC	91,265	84,903	84,718
WEIGHTED-AVERAGE COMMON SHARES			
OUTSTANDING DILUTED	91,405	84,964	84,930
EARNINGS PER WEIGHTED AVERAGE			
COMMON SHARE OUTSTANDING			
Income from continuing operations basic	\$ 2.47	\$ 2.79	\$ 3.86
Net income basic	2.64	1.76	3.68
Income from continuing operations diluted	2.47	2.78	3.85
Net income diluted	2.63	1.76	3.68
DIVIDENDS DECLARED PER SHARE	\$ 1.725	\$ 1.625	\$ 1.525

See Notes to Consolidated Financial Statements.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONSOLIDATED BALANCE SHEETS**

(dollars in thousands)

	December 31,	
	2003	2002
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 222,912	\$ 77,566
Customer and other receivables	354,666	362,587
Allowance for doubtful accounts	(9,223)	(9,607)
Accrued utility revenues	88,629	94,504
Materials and supplies (at average cost)	96,099	91,652
Fossil fuel (at average cost)	28,367	28,185
Deferred income taxes (Note 4)		4,094
Assets from risk management and trading activities (Note 18)	97,630	102,664
Assets held for sale (Note 22)	23,065	42,339
Other current assets	72,649	66,388
	<hr/>	<hr/>
Total current assets	974,794	860,372
	<hr/>	<hr/>
INVESTMENTS AND OTHER ASSETS		
Real estate investments net (Notes 1 and 6)	343,322	384,427
Assets from risk management and trading activities-long term (Note 18)	138,946	191,754
Decommissioning trust accounts	240,645	194,440
Other assets	88,473	76,843
	<hr/>	<hr/>
Total investments and other assets	811,386	847,464
	<hr/>	<hr/>
PROPERTY, PLANT AND EQUIPMENT (Notes 1, 6, 9, 10 and 12)		
Plants in service and held for future use	9,904,874	9,058,900
Less accumulated depreciation and amortization	3,145,609	2,917,552
	<hr/>	<hr/>
Total	6,759,265	6,141,348
Construction work in progress	554,876	777,542
Intangible assets, net of accumulated amortization	108,534	109,815

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Nuclear fuel, net of accumulated amortization of \$58,053 and \$59,163	52,011	51,124
	<u> </u>	<u> </u>
Net property, plant and equipment	7,474,686	7,079,829
	<u> </u>	<u> </u>
DEFERRED DEBITS		
Regulatory assets (Notes 1, 3 and 4)	164,804	241,045
Other deferred debits	110,708	110,447
	<u> </u>	<u> </u>
Total deferred debits	275,512	351,492
	<u> </u>	<u> </u>
TOTAL ASSETS	\$9,536,378	\$9,139,157
	<u> </u>	<u> </u>

See Notes to Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION
CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	December 31,	
	2003	2002
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 283,021	\$ 332,441
Accrued taxes	69,769	71,107
Accrued interest	51,825	53,018
Short-term borrowings (Note 5)	86,081	227,683
Current maturities of long-term debt (Note 6)	704,914	280,888
Customer deposits	49,783	42,190
Deferred income taxes (Note 4)	631	
Liabilities from risk management and trading activities (Note 18)	92,755	111,329
Liabilities held for sale (Note 22)	16,427	28,855
Other current liabilities	77,362	85,585
	1,432,568	1,233,096
 LONG-TERM DEBT LESS CURRENT MATURITIES (Note 6)		
	2,616,585	2,743,741
 DEFERRED CREDITS AND OTHER		
Deferred income taxes (Note 4)	1,329,253	1,209,074
Regulatory liabilities (Notes 1, 3 and 4)	510,423	26,264
Liability for asset retirements and removals (Note 12)	234,440	600,431
Pension liability (Note 8)	188,041	183,880
Liabilities from risk management and trading activities-long term (Note 18)	82,730	147,900
Unamortized gain sale of utility plant (Note 9)	54,909	59,484
Other	257,650	249,134
	2,657,446	2,476,167
 COMMITMENTS AND CONTINGENCIES (NOTES 3, 11 AND 12)		
COMMON STOCK EQUITY (Note 7)		

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Common stock, no par value; authorized 150,000,000 shares; issued 91,379,947 at end of 2003 and 2002	1,744,354	1,737,258
Treasury stock at cost; 92,015 shares at end of 2003 and 124,830 shares at end of 2002	(3,273)	(4,358)
	<u>1,741,081</u>	<u>1,732,900</u>
Accumulated other comprehensive income (loss):		
Minimum pension liability adjustment	(66,564)	(71,264)
Derivative instruments	27,563	(20,020)
	<u>(39,001)</u>	<u>(91,284)</u>
Total accumulated other comprehensive loss		
Retained earnings	<u>1,127,699</u>	<u>1,044,537</u>
Total common stock equity	<u>2,829,779</u>	<u>2,686,153</u>
TOTAL LIABILITIES AND EQUITY	<u>\$9,536,378</u>	<u>\$9,139,157</u>

See Notes to Consolidated Financial Statements.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income	\$ 240,579	\$ 149,408	\$ 312,166
Adjustment to reconcile net income to net cash provided by operating activities:			
Loss (income) from discontinued operations, net of tax	(14,776)	21,410	
Cumulative effect of accounting change, net of tax		65,745	15,201
Depreciation and amortization	435,140	422,299	427,903
Nuclear fuel amortization	28,757	31,185	28,362
Allowance for equity funds used during construction	(14,240)		
Deferred income taxes	81,756	191,135	(17,203)
Change in mark-to-market valuations	17,410	(18,146)	(133,573)
Redhawk Units 3 and 4 cancellation charge		49,192	
Changes in current assets and liabilities:			
Customer and other receivables	(12,456)	60,336	146,581
Accrued utility revenues	5,875	(18,373)	(1,565)
Materials, supplies and fossil fuel	(4,629)	(11,599)	(16,867)
Other current assets	(6,865)	(6,643)	64
Accounts payable	(7,125)	17,008	(128,017)
Accrued taxes	(1,338)	(36,041)	7,483
Accrued interest	(1,193)	4,212	5,852
Other current liabilities	8,668	24,755	3,761
Proceeds from the sale of real estate assets	163,700	57,178	35,783
Real estate investments	(71,618)	(72,412)	(80,603)
Increase in regulatory assets	(11,697)	(11,029)	(17,516)
Change in risk management and trading assets	46,911	(11,700)	(51,894)
Change in risk management and trading liabilities	(11,613)	(22,783)	45,330
Change in customer advances	7,270	(23,780)	28,599
Change in pension liability	19,074	(3,009)	(30,205)
Change in other long-term assets	3,850	(13,593)	14,746
Change in other long-term liabilities	12,829	9,785	(23,345)
	<u>914,269</u>	<u>854,540</u>	<u>571,043</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(693,475)	(893,202)	(1,055,574)

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Capitalized interest	(29,444)	(43,749)	(47,862)
Discontinued operations Real Estate	27,193	28,917	
Discontinued operations NAC	(19,971)	(12,259)	
Other	(21,040)	36,635	(16,481)
	<u> </u>	<u> </u>	<u> </u>
Net cash flow used for investing activities	(736,737)	(883,658)	(1,119,917)
	<u> </u>	<u> </u>	<u> </u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Issuance of long-term debt	656,850	674,919	995,447
Short-term borrowings and payments net	(173,303)	(306,079)	322,987
Dividends paid on common stock	(157,417)	(137,721)	(129,199)
Repayment of long-term debt	(366,497)	(354,916)	(621,057)
Common stock equity issuance		199,238	
Other	8,181	2,624	(1,048)
	<u> </u>	<u> </u>	<u> </u>
Net cash flow (used for) provided by financing activities	(32,186)	78,065	567,130
	<u> </u>	<u> </u>	<u> </u>
NET INCREASE IN CASH AND CASH EQUIVALENTS			
	145,346	48,947	18,256
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR			
	<u>77,566</u>	<u>28,619</u>	<u>10,363</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR			
	<u>\$ 222,912</u>	<u>\$ 77,566</u>	<u>\$ 28,619</u>
Supplemental disclosure of cash flow information			
Cash paid during the period for:			
Income taxes paid/(refunded)	\$ 32,816	\$ (17,918)	\$ 223,037
Interest paid, net of amounts capitalized	\$ 161,581	\$ 126,322	\$ 115,276

See Notes to Consolidated Financial Statements.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONSOLIDATED STATEMENTS OF CHANGES IN COMMON STOCK EQUITY**

(dollars in thousands)

	Year Ended December 31,		
	2003	2002	2001
COMMON STOCK (Note 7)			
Balance at beginning of year	\$1,737,258	\$1,536,924	\$1,537,920
Issuance of common stock		199,238	
Other	7,096	1,096	(996)
	<u>1,744,354</u>	<u>1,737,258</u>	<u>1,536,924</u>
TREASURY STOCK (Note 7)			
Balance at beginning of year	(4,358)	(5,886)	(5,089)
Purchase of treasury stock		(5,971)	(16,393)
Reissuance of treasury stock used for stock compensation, net	1,085	7,499	15,596
	<u>(3,273)</u>	<u>(4,358)</u>	<u>(5,886)</u>
RETAINED EARNINGS			
Balance at beginning of year	1,044,537	1,032,850	849,883
Net income	240,579	149,408	312,166
Common stock dividends	(157,417)	(137,721)	(129,199)
	<u>1,127,699</u>	<u>1,044,537</u>	<u>1,032,850</u>
ACCUMULATED OTHER COMPREHENSIVE INCOME/(LOSS)			
Balance at beginning of year	(91,284)	(64,565)	
Minimum pension liability adjustment, net of tax of \$3,700, \$46,109 and \$634	4,700	(70,298)	(966)
Cumulative effect of a change in accounting for derivatives, net of tax of \$47,404			72,274
Unrealized gain/(loss) on derivative instruments, net of tax of \$33,298, \$28,820 and \$71,720	51,089	43,939	(109,346)

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Reclassification of realized gain to income, net of tax of \$2,343, \$237 and \$17,399	(3,506)	(360)	(26,527)
	<u> </u>	<u> </u>	<u> </u>
Balance at end of year	(39,001)	(91,284)	(64,565)
	<u> </u>	<u> </u>	<u> </u>
TOTAL COMMON STOCK EQUITY	\$2,829,779	\$2,686,153	\$2,499,323
	<u> </u>	<u> </u>	<u> </u>
COMPREHENSIVE INCOME (LOSS)			
Net income	\$ 240,579	\$ 149,408	\$ 312,166
Other comprehensive income (loss)	52,283	(26,719)	(64,565)
	<u> </u>	<u> </u>	<u> </u>
Comprehensive income	\$ 292,862	\$ 122,689	\$ 247,601
	<u> </u>	<u> </u>	<u> </u>

See Notes to Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Consolidation and Nature of Operations

The consolidated financial statements include the accounts of Pinnacle West and our subsidiaries: APS, Pinnacle West Energy, APS Energy Services, SunCor and El Dorado (principally NAC). See Note 22 for a discussion of the sale of NAC. Significant intercompany accounts and transactions between the consolidated companies have been eliminated.

APS is a vertically-integrated electric utility that provides either retail or wholesale electric service to substantially all of the state of Arizona, with the major exceptions of the Tucson metropolitan area and about one-half of the Phoenix metropolitan area. APS also generates, sells and delivers electricity to wholesale customers in the western United States. In early 2003, the marketing and trading division of Pinnacle West was moved to APS for future marketing and trading activities (existing wholesale contracts remained at Pinnacle West) as a result of the ACC's Track A Order prohibiting the previously required transfer of APS's generating assets to Pinnacle West Energy. See Note 3 for a discussion of the Track A Order. Pinnacle West Energy, which was formed in 1999, is the subsidiary through which we conduct our unregulated generation operations. APS Energy Services was formed in 1998 and provides competitive commodity energy and energy-related products to key customers in competitive markets in the western United States. SunCor is a developer of residential, commercial and industrial real estate projects in Arizona, New Mexico, Idaho and Utah. El Dorado is an investment firm (see Note 22 for a discussion of the sale of NAC).

Accounting Records and Use of Estimates

Our accounting records are maintained in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We have reclassified certain prior year amounts to conform to the current year presentation.

Derivative Accounting

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas, coal and emissions allowances. We manage risks associated with these market fluctuations by utilizing various commodity instruments that qualify as derivatives, including exchange-traded futures and options and over-the-counter forwards, options and swaps. As part of our overall risk management program, we use such instruments to hedge purchases and sales of electricity, fuels, and emissions allowances and credits. In addition, subject to specified risk parameters monitored by the ERMC, we engage in marketing and trading activities intended to profit from market price movements.

We account for our derivative contracts in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 133 requires that entities recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair

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**PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

value. Changes in the fair value of derivative instruments are either recognized periodically in income or, if hedge criteria are met, in common stock equity (as a component of other comprehensive income (loss)). SFAS No. 133 provides a scope exception for contracts that meet the normal purchases and sales criteria specified in the standard.

Prior to the fourth quarter of 2002, we accounted for our trading activity at fair value, with changes in fair value reported in earnings as required by EITF 98-10 Accounting for Contracts Involved in Energy Trading and Risk Management Activities. In the fourth quarter of 2002, we adopted EITF 02-3 Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities, which rescinded EITF 98-10. We recorded a \$66 million after-tax charge in net income as a cumulative effect adjustment for the previously recorded accumulated unrealized mark-to-market on energy trading contracts that did not meet the accounting definition of a derivative. Our energy trading contracts that are derivatives are accounted for at fair value under SFAS No. 133. Energy trading contracts that do not meet the definition of a derivative are now accounted for on an accrual basis with the associated revenues and costs recorded at the time the contracted commodities are delivered or received.

See Note 18 for additional information about our derivative and energy trading accounting policies.

Mark-to-Market Accounting

Under mark-to-market accounting, derivative contracts for the purchase or sale of energy commodities are reflected at fair market value, net of valuation adjustments, with resulting unrealized gains and losses recorded as current or long-term assets and liabilities from risk management and trading activities in the Consolidated Balance Sheets.

We determine fair market value using actively-quoted prices when available. We consider quotes for exchange-traded contracts and over-the-counter quotes obtained from independent brokers to be actively-quoted.

When actively-quoted prices are not available, we use prices provided by other external sources. This includes quarterly and calendar year quotes from independent brokers. We convert quarterly and calendar year quotes into monthly prices based on historical relationships.

For options, long-term contracts and other contracts for which price quotes are not available, we use models and other valuation methods. The valuation models we employ utilize spot prices, forward prices, historical market data and other factors to forecast future prices. The primary valuation technique we use to calculate the fair value of contracts where price quotes are not available is based on the extrapolation of forward pricing curves using observable market data for more liquid delivery points in the same region and actual transactions at the more illiquid delivery points. We also value option contracts using a variation of the Black-Scholes option-pricing model.

For non-exchange traded contracts, we calculate fair market value based on the average of the bid and offer price, and we discount to reflect net present value. We maintain certain valuation adjustments for a number of risks associated with the valuation of future commitments. These include valuation adjustments for liquidity and credit risks based on the financial condition of

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PINNACLE WEST CAPITAL CORPORATION
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counterparties. The liquidity valuation adjustment represents the cost that would be incurred if all unmatched positions were closed-out or hedged.

The credit valuation adjustment represents estimated credit losses on our overall exposure to counterparties, taking into account netting arrangements, expected default experience for the credit rating of the counterparties and the overall diversification of the portfolio. Counterparties in the portfolio consist principally of major energy companies, municipalities and local distribution companies. We maintain credit policies that management believes minimize overall credit risk. Determination of the credit quality of counterparties is based upon a number of factors, including credit ratings, financial condition, project economics and collateral requirements. When applicable, we employ standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. See Note 18 for further discussion on credit risk.

The use of models and other valuation methods to determine fair market value often requires subjective and complex judgment. Actual results could differ from the results estimated through application of these methods. Our marketing and trading portfolio includes structured activities hedged with a portfolio of forward purchases that protects the economic value of the sales transactions. Our practice is to hedge within timeframes established by the ERMIC.

Regulatory Accounting

APS is regulated by the ACC and the FERC. The accompanying financial statements reflect the rate-making policies of these commissions. For regulated operations, we prepare our financial statements in accordance with SFAS No. 71, Accounting for the Effects of Certain Types of Regulation. SFAS No. 71 requires a cost-based, rate-regulated enterprise to reflect the impact of regulatory decisions in its financial statements. As a result, we capitalize certain costs that would be included as expense in the current period by unregulated companies. Regulatory assets represent incurred costs that have been deferred because they are probable of future recovery in customer rates. Regulatory liabilities generally represent the recovery of expected future costs in current customer rates.

Management continually assesses whether our regulatory assets are probable of future recovery by considering factors such as applicable regulatory environment changes and recent rate orders to other regulated entities in the same jurisdiction. This determination reflects the current political and regulatory climate in the state and is subject to change in the future. If future recovery of costs ceases to be probable, the assets would be written off as a charge in current period earnings.

As part of the 1999 Settlement Agreement with the ACC (see Note 3), we continue to amortize certain regulatory assets over an eight-year period as follows (dollars in millions):

<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>Total</u>
\$164	\$158	\$145	\$115	\$86	\$18	\$686

The detail of regulatory assets is as follows (dollars in millions):

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PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
Remaining balance recoverable under the 1999 Settlement Agreement (a)	\$ 18	\$104
Spent nuclear fuel storage (Note 11)	49	46
Electric industry restructuring transition costs (Note 3)	46	40
Deferred compensation	24	23
Contributions in aid of construction	11	10
Loss on reacquired debt (b)	12	9
Other	5	9
	<u> </u>	<u> </u>
 Total regulatory assets	 \$165	 \$241
	<u> </u>	<u> </u>

(a) The majority of our unamortized regulatory assets above relates to deferred income taxes (see Note 4) and rate synchronization cost deferrals (see Rate Synchronization Cost Deferrals below).

(b) See Reacquired Debt Costs below.

The detail of regulatory liabilities is as follows (dollars in millions):

	<u>December 31,</u>	
	<u>2003</u>	<u>2002</u>
Removal costs (a)	\$480	\$
Deferred gains on utility property	20	20
Deferred interest income (b)	8	
Other	2	6
	<u> </u>	<u> </u>
 Total regulatory liabilities	 \$510	 \$26
	<u> </u>	<u> </u>

(a) See Note 12 for information on Asset Retirement Obligations.

(b) See ACC Financing Orders in Note 3 for information on the APS Loan .

Rate Synchronization Cost Deferrals

As authorized by the ACC, operating costs (excluding fuel) and financing costs of Palo Verde Units 2 and 3 were deferred from the commercial operation dates (September 1986 for Unit 2 and January 1988 for Unit 3) until the date the units were included in a rate order (April 1988 for Unit 2 and December 1991 for Unit 3). In accordance with the 1999 Settlement Agreement, we are continuing to accelerate the amortization of the deferrals over an eight-year period that will end June 30, 2004. Amortization of the deferrals is included in depreciation and amortization expense in the Consolidated Statements of Income.

Utility Plant and Depreciation

Utility plant is the term we use to describe the business property and equipment that supports electric service, consisting primarily of generation, transmission and distribution facilities. We report utility plant at its original cost, which includes:

material and labor;

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**PINNACLE WEST CAPITAL CORPORATION
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contractor costs;

capitalized leases;

construction overhead costs (where applicable); and

capitalized interest or an allowance for funds used during construction.

We expense the costs of plant outages, major maintenance and routine maintenance as incurred. We charge retired utility plant to accumulated depreciation. Prior to 2003, we charged removal costs, less salvage, to accumulated depreciation. Effective January 1, 2003, we applied the provisions of SFAS 143 (see Note 12).

We record depreciation on utility plant on a straight-line basis over the remaining useful life of the related assets. The approximate remaining average useful lives of our utility property at December 31, 2003 were as follows:

Fossil plant 23 years;

Nuclear plant 20 years;

Other generation 29 years;

Transmission 36 years;

Distribution 23 years; and

Other 9 years.

For the years 2001 through 2003, the depreciation rates, as prescribed by our regulators, ranged from a low of 1.51% to a high of 12.5%. The weighted-average rate was 3.35% for 2003, 3.35% for 2002 and 3.40% for 2001. We depreciate non-utility property and equipment over the estimated useful lives of the related assets, ranging from 3 to 30 years.

El Dorado Investments

El Dorado accounts for its investments using the equity (if significant influence) and cost (less than 20% ownership) methods.

Capitalized Interest

Capitalized interest represents the cost of debt funds used to finance construction projects. Plant construction costs, including capitalized interest, are expensed through depreciation when completed projects are placed into commercial operation. The rate used to calculate capitalized interest was a composite rate of 4.55% for 2003, 4.80% for 2002 and 6.13% for 2001. Capitalized interest ceases to accrue when construction is complete.

Allowance for Funds Used During Construction

AFUDC represents the approximate net composite interest cost of borrowed funds and a reasonable return on the equity funds used for construction of utility plant. Plant construction costs, including AFUDC, are recovered in

authorized rates through depreciation when completed projects are placed into commercial operation.

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**PINNACLE WEST CAPITAL CORPORATION
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AFUDC was calculated by using a composite rate of 8.55% for 2003. APS compounds AFUDC monthly and ceases to accrue AFUDC when construction work is completed and the property is placed in service.

In 2003, APS returned to the AFUDC method of capitalizing interest and equity costs associated with construction projects in a regulated utility. This is consistent with APS returning to a vertically-integrated utility, as evidenced by APS recent general rate case filing, which includes the request for rate recognition of generation assets. Previously, APS capitalized interest in accordance with SFAS No. 34, Capitalization of Interest Cost. Although AFUDC both increases the plant balance and results in higher current earnings during the construction period, AFUDC is realized in future revenues through depreciation provisions included in rates. This change increased earnings by \$11 million in 2003 as compared to what it would have been under SFAS No. 34.

Electric Revenues

We derive electric revenues from sales of electricity to our regulated Native Load customers and sales to other parties from our marketing and trading activities. Revenues related to the sale of electricity are generally recorded when service is rendered or electricity is delivered to customers. However, the determination and billing of electricity sales to individual Native Load customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. At the end of each month, amounts of electricity delivered to customers since the date of the last meter reading and billing and the corresponding unbilled revenue are estimated. We exclude sales taxes on electric revenues from both revenue and taxes other than income taxes. Revenues from our Native Load customers and non-derivative instruments are reported on a gross basis in our Consolidated Statements of Income.

All gains and losses (realized and unrealized) on energy trading contracts that qualify as derivatives are included in marketing and trading segment revenues on the Consolidated Statements of Income on a net basis.

We adopted EITF 03-11, Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not Held for Trading Purposes As Defined in Issue No. 02-3, effective October 1, 2003. EITF 03-11 provides guidance on whether realized gains and losses on physically settled derivative contracts not held for trading purposes should be reported on a net or gross basis and concluded such classification is a matter of judgment that depends on the relevant facts and circumstances. In the electricity business, some contracts to purchase energy are netted against other contracts to sell energy. This is called book-out and usually occurs in contracts that have the same terms (quantities and delivery points) and for which power does not flow. We netted these book-outs reducing both revenues and purchased power and fuel costs in 2003, 2002 and 2001, but this did not impact our financial condition, net income or cash flows (see Note 18 for additional information).

SunCor

SunCor recognizes revenue from land, home and qualifying commercial operating assets sales in full, provided (a) the income is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, SunCor is not obligated to perform significant activities after

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

the sale to earn the income. Unless both conditions exist, recognition of all or part of the income is postponed. SunCor recognizes income only after the assets' title has passed. A single method of recognizing income is applied to all sales transactions within an entire home, land or commercial development project. Commercial property and management revenues are recorded over the term of the lease or period in which services are provided. In addition, see Note 22 Discontinued Operations.

Cash and Cash Equivalents

We consider all highly liquid investments purchased with an initial maturity of three months or less to be cash equivalents.

Nuclear Fuel

APS charges nuclear fuel to fuel expense by using the unit-of-production method. The unit-of-production method is an amortization method based on actual physical usage. APS divides the cost of the fuel by the estimated number of thermal units it expects to produce with that fuel. APS then multiplies that rate by the number of thermal units produced within the current period. This calculation determines the current period nuclear fuel expense.

APS also charges nuclear fuel expense for the permanent disposal of spent nuclear fuel. The DOE is responsible for the permanent disposal of spent nuclear fuel, and it charges APS \$0.001 per kWh of nuclear generation. See Note 11 for information about spent nuclear fuel disposal and Note 12 for information on nuclear decommissioning costs.

Income Taxes

Income taxes are provided using the asset and liability approach prescribed by SFAS No. 109, Accounting for Income Taxes. We file our federal income tax return on a consolidated basis and we file our state income tax returns on a consolidated or unitary basis. In accordance with our intercompany tax sharing agreement, federal and state income taxes are allocated to each subsidiary as though each first-tier subsidiary filed a separate income tax return. Any difference between that method and the consolidated (and unitary) income tax liability is attributed to the parent company. See Note 4.

Reacquired Debt Costs

For debt related to the regulated portion of APS' business, APS defers those gains and losses incurred upon early retirement and is seeking recovery in the APS general rate case (see Note 3). In accordance with the 1999 Settlement Agreement, APS is continuing to accelerate the amortization of reacquired debt costs over an eight-year period that will end June 30, 2004. All regulatory asset amortization is included in depreciation and amortization expense in the Consolidated Statements of Income.

Real Estate Investments

Real estate investments primarily include SunCor's land, home inventory and investments in joint ventures. Land includes acquisition costs, infrastructure costs, property taxes and capitalized

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interest directly associated with the acquisition and development of each project. Land under development and land held for future development are stated at accumulated cost, except that, to the extent that such land is believed to be impaired, it is written down to fair value. Land held for sale is stated at the lower of accumulated cost or estimated fair value less costs to sell. Home inventory consists of construction costs, improved lot costs, capitalized interest and property taxes on homes under construction. Home inventory is stated at the lower of accumulated cost or estimated fair value less costs to sell. Investments in joint ventures for which SunCor does not have a controlling financial interest are not consolidated but are accounted for using the equity method of accounting. In 2003, SunCor acquired two joint ventures for \$10 million and consolidated \$53 million of assets and \$43 million of liabilities, which are included in the Consolidated Balance Sheets at December 31, 2003. The \$10 million cash investment is included on the other investing line of the Consolidated Statements of Cash Flow at December 31, 2003. In addition, see Note 22 Discontinued Operations.

Stock-Based Compensation

In 2002, we began applying the fair value method of accounting for stock-based compensation, as provided for in SFAS No. 123, Accounting for Stock-Based Compensation. The fair value method of accounting is the preferred method. In accordance with the transition requirements of SFAS No. 123, we applied the fair value method prospectively, beginning with 2002 stock grants. In prior years, we recognized stock compensation expense based on the intrinsic value method allowed in Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees.

The following chart compares our net income, stock compensation expense and earnings per share to what those items would have been if we had recorded stock compensation expense based on the fair value method for all stock grants through 2003 (dollars in thousands, except per share amounts):

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net Income as reported:	\$240,579	\$149,408	\$312,166
Add: Stock compensation expense included in reported net income (net of tax):	1,288	300	
Deduct: Total stock compensation expense determined under fair value method (net of tax)	(2,994)	(1,695)	(2,292)
Pro forma net income	<u>\$238,873</u>	<u>\$148,013</u>	<u>\$309,874</u>
Earnings per share basic:			
As reported	\$ 2.64	\$ 1.76	\$ 3.68
Pro forma (fair value method)	\$ 2.62	\$ 1.74	\$ 3.66
Earnings per share diluted:			
As reported	\$ 2.63	\$ 1.76	\$ 3.68
Pro forma (fair value method)	\$ 2.61	\$ 1.74	\$ 3.65

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In order to calculate the fair value of the 2003, 2002 and 2001 stock option grants and the pro forma information above, we calculated the fair value of each fixed stock option in the incentive plans using the Black-Scholes option-pricing model. The fair value was calculated based on the date the option was granted. The following weighted-average assumptions were also used in order to calculate the fair value of the stock options:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Risk-free interest rate	3.35%	4.17%	4.08%
Dividend yield	5.26%	4.17%	3.70%
Volatility	38.03%	22.59%	27.66%
Expected life (months)	60	60	60

See Note 16 for further discussion about our stock compensation plans.

Intangible Assets

We have no goodwill recorded and have separately disclosed other intangible assets on our Consolidated Balance Sheets in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. The intangible assets are amortized over their finite useful lives. The Company's gross intangible assets (which are primarily capitalized software costs) were \$237 million at December 31, 2003 and \$214 million at December 31, 2002. The related accumulated amortization was \$128 million at December 31, 2003 and \$104 million at December 31, 2002. Amortization expense was \$25 million in 2003, \$21 million in 2002, and \$22 million in 2001. Estimated amortization expense on existing intangible assets over the next five years is \$28 million in 2004, \$27 million in 2005, \$25 million in 2006, \$20 million in 2007, and \$9 million in 2008. At December 31, 2003, the weighted average amortization period for intangible assets is 7 years.

2. Accounting Matters

See the following Notes for information about new accounting standards and other accounting matters:

Note 8 for amended disclosure requirements (SFAS No. 132) on retirement plans and other benefits;

Note 12 for a new accounting standard (SFAS No. 143) on asset retirement obligations;

Note 16 for a new accounting standard (SFAS No. 148) related to stock-based compensation;

Note 18 for EITF issues (EITF 02-3 and 03-11), DIG Issue No.

C15, and a new accounting standard (SFAS No. 149) related to accounting for derivatives and energy contracts;

Note 20 for a new FASB interpretation (FIN No. 46R) related to VIEs;

Note 21 for a new FASB interpretation (FIN No. 45) on guarantees; and

Note 22 for a standard (SFAS No. 144) on accounting for the impairment or disposal of long-lived assets.

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3. Regulatory Matters

Electric Industry Restructuring

State

1999 Settlement Agreement

The following are the major provisions of the 1999 Settlement Agreement, as approved by the ACC:

APS has reduced rates for standard-offer service for customers with loads less than three MW in a series of annual retail electricity price reductions of 1.5% on July 1 for each of the years 1999 to 2003 for a total of 7.5%. Based on the price reductions authorized in the 1999 Settlement Agreement, there were retail price decreases of approximately \$24 million (\$14 million after taxes), effective July 1, 1999; approximately \$28 million (\$17 million after taxes), effective July 1, 2000; approximately \$27 million (\$16 million after taxes), effective July 1, 2001; approximately \$28 million (\$17 million after taxes), effective July 1, 2002; and approximately \$29 million (\$18 million after taxes), effective July 1, 2003. For customers having loads of three MW or greater, standard-offer rates have been reduced in varying annual increments that total 5% in the years 1999 through 2002.

Unbundled rates being charged by APS for competitive direct access service (for example, distribution services) became effective upon approval of the 1999 Settlement Agreement, retroactive to July 1, 1999, and also became subject to annual reductions beginning January 1, 2000, that vary by rate class, through January 1, 2004.

There is a moratorium on retail price changes for standard-offer and unbundled competitive direct access services until July 1, 2004, except for the price reductions described above and certain other limited circumstances. Neither the ACC nor APS is prevented from seeking or authorizing rate changes prior to July 1, 2004 in the event of conditions or circumstances that constitute an emergency, such as an inability to finance on reasonable terms; material changes in APS cost of service for

ACC-regulated services resulting from federal, tribal, state or local laws; regulatory requirements; or judicial decisions, actions or orders.

APS will be permitted to defer for later recovery prudent and reasonable costs of complying with the Rules, system benefits costs in excess of the levels included in then-current (1999) rates, and costs associated with the provider of last resort and standard-offer obligations for service after July 1, 2004. These costs are to be recovered through an adjustment clause or clauses commencing on July 1, 2004. See APS General Rate Case and Retail Rate Adjustment Mechanisms below.

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APS distribution system opened for retail access effective September 24, 1999. Customers were eligible for retail access in accordance with the phase-in adopted by the ACC under the Rules (see Retail Electric Competition Rules below), including an additional 140 MW being made available to eligible non-residential customers. APS opened its distribution system to retail access for all customers on January 1, 2001. The regulatory developments and legal challenges to the Rules discussed in this Note have raised considerable uncertainty about the status and pace of electric competition and of electric restructuring in Arizona. Although some very limited retail competition existed in APS service area in 1999 and 2000, there are currently no active retail competitors providing unbundled energy or other utility services to APS customers. As a result, we cannot predict when, and the extent to which, additional competitors will re-enter APS service territory.

Prior to the 1999 Settlement Agreement, APS was recovering substantially all of its regulatory assets through July 1, 2004, pursuant to a 1996 regulatory agreement. In addition, the 1999 Settlement Agreement states that APS has demonstrated that its allowable stranded costs, after mitigation and exclusive of regulatory assets, are at least \$533 million net present value (in 1999 dollars). The 1999 Settlement Agreement also states that APS will not be allowed to recover \$183 million net present value (in 1999 dollars) of the \$533 million. The 1999 Settlement Agreement provides that APS will have the opportunity to recover \$350 million net present value (in 1999 dollars) through a competitive transition charge that will remain in effect through December 31, 2004, at which time it will terminate. The costs subject to recovery under the adjustment clause described above will be decreased or increased by any over/under-recovery of the \$350 million due to sales volume variances. As discussed below under APS General Rate Case and Retail Rate Adjustment Mechanisms, APS is seeking to recover amounts written off by APS as a result of the 1999 Settlement Agreement.

The 1999 Settlement Agreement required APS to form, or cause to be formed, a separate corporate affiliate or affiliates and transfer to such affiliate(s) its competitive electric assets and services no later than December 31, 2002. The 1999 Settlement Agreement provided that APS would be allowed to defer and later collect, beginning July 1, 2004, 67% of its costs to accomplish the required transfer of generation assets to an affiliate. However, as discussed below, in 2002 the ACC unilaterally modified this aspect of the 1999 Settlement Agreement by issuing the Track A Order, an order preventing APS from transferring its generation assets. APS is seeking to recover all costs incurred by APS in preparation for the previously anticipated transfer of generation assets to Pinnacle West Energy. See APS General Rate Case and Retail Rate Adjustment Mechanisms below.

Retail Electric Competition Rules

The Rules approved by the ACC include the following major provisions:

They apply to virtually all Arizona electric utilities regulated by the ACC, including APS.

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Effective January 1, 2001, retail access became available to all APS retail electricity customers.

Electric service providers that get CC&N s from the ACC can supply only competitive services, including electric generation, but not electric transmission and distribution.

Affected utilities must file ACC tariffs that unbundle rates for noncompetitive services.

The ACC shall allow a reasonable opportunity for recovery of unmitigated stranded costs.

Absent an ACC waiver, prior to January 1, 2001, each affected utility (except certain electric cooperatives) must transfer all competitive electric assets and services to an unaffiliated party or parties or to a separate corporate affiliate or affiliates. Under the 1999 Settlement Agreement, APS received a waiver to allow transfer of its competitive electric assets and services to affiliates no later than December 31, 2002. However, as discussed below, in 2002 the ACC reversed its decision, as reflected in the Rules, to require APS to transfer its generation assets.

Under the 1999 Settlement Agreement, the Rules are to be interpreted and applied, to the greatest extent possible, in a manner consistent with the 1999 Settlement Agreement. If the two cannot be reconciled, APS must seek, and the other parties to the 1999 Settlement Agreement must support, a waiver of the Rules in favor of the 1999 Settlement Agreement.

On November 27, 2000, a Maricopa County, Arizona, Superior Court judge issued a final judgment holding that the Rules are unconstitutional and unlawful in their entirety due to failure to establish a fair value rate base for competitive electric service providers and because certain of the Rules were not submitted to the Arizona Attorney General for certification. The judgment also invalidates all ACC orders authorizing competitive electric service providers, including APS Energy Services, to operate in Arizona. We do not believe the ruling affects the 1999 Settlement Agreement. The 1999 Settlement Agreement was not at issue in the consolidated cases before the judge. Further, the ACC made findings related to the fair value of APS property in the order approving the 1999 Settlement Agreement. The ACC and other parties aligned with the ACC appealed the ruling to the Arizona Court of Appeals, and in January 2004, the Court invalidated some, but not all, of the Rules as either violative of Arizona s constitutional requirement that the ACC consider the fair value of a utility s property in setting rates or as being beyond the ACC s constitutional and statutory powers. Other Rules were set aside for failure to submit such regulations to the Arizona Attorney General for approval as required by statute.

Provider of Last Resort Obligation

Although the Rules allow retail customers to have access to competitive providers of energy and energy services, APS is, under the Rules, the provider of last resort for standard-offer, full-service customers under rates that have been approved by the ACC. These rates are established until at least July 1, 2004. The 1999 Settlement Agreement allows APS to seek adjustment of these rates in the event of emergency conditions or circumstances, such as the inability to secure financing on reasonable terms; material changes in APS cost of service for ACC-regulated services resulting from federal, tribal, state or local laws; regulatory requirements; or judicial decisions, actions or orders. Energy

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prices in the western wholesale market vary and, during the course of the last two years, have been volatile. At various times, prices in the spot wholesale market have significantly exceeded the amount included in APS' current retail rates. In the event of shortfalls due to unforeseen increases in load demand or generation or transmission outages, APS may need to purchase additional supplemental power in the wholesale spot market. Unless APS is able to obtain an adjustment of its rates under the emergency provisions of the 1999 Settlement Agreement, there can be no assurance that APS would be able to fully recover the costs of this power. See APS General Rate Case and Retail Rate Adjustment Mechanisms below for a discussion of retail rate adjustment mechanisms that were the subject of ACC hearings in April 2003.

Track A Order

On September 10, 2002, the ACC issued the Track A Order, in which the ACC, among other things:

reversed its decision, as reflected in the Rules, to require APS to transfer its generation assets either to an unrelated third party or to a separate corporate affiliate; and

unilaterally modified the 1999 Settlement Agreement, which authorized APS' transfer of its generating assets, and directed APS to cancel its activities to transfer its generation assets to Pinnacle West Energy.

On November 15, 2002, APS filed appeals of the Track A Order in the Maricopa County, Arizona Superior Court and in the Arizona Court of Appeals. Arizona Public Service Company vs. Arizona Corporation Commission, CV 2002-0222 32. Arizona Public Service Company vs. Arizona Corporation Commission, 1CA CC 02-0002. On December 13, 2002, APS and the ACC staff agreed to principles for resolving certain issues raised by APS in its appeals of the Track A Order. APS and the ACC are the only parties to the Track A Order appeals. The major provisions of the principles include, among other things, the following:

APS and the ACC staff agreed that it would be appropriate for the ACC to consider the following matters in APS' general rate case, which was filed on June 27, 2003:

the generating assets to be included in APS' rate base, including the question of whether the PWEC Dedicated Assets should be included in APS' rate base;

the appropriate treatment of the \$234 million pretax asset write-off agreed to by APS as part of the 1999 Settlement Agreement; and

the appropriate treatment of costs incurred by APS in preparation for the previously anticipated transfer of generation assets to Pinnacle West Energy.

Upon the ACC's issuance of a final decision that is no longer subject to appeal approving APS' request to provide \$500 million of financing or credit support to Pinnacle West Energy or the Company, with appropriate conditions, APS' appeals of the Track A Order would be limited to the issues described in the preceding bullet points, each of which would be presented to the ACC for consideration prior to any final judicial resolution. As noted below, the ACC issued the Financing Order on April 4, 2003. The Financing Order is final and no longer subject to appeal. As a result, APS' appeals of the Track A Order are limited to the issues described in the preceding bullet points.

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On August 27, 2003, APS, Pinnacle West and Pinnacle West Energy filed a lawsuit asserting damage claims relating to the Track A Order. Arizona Public Service Company et al. v. The State of Arizona ex rel., Superior Court of the State of Arizona, County of Maricopa, No. CV2003-016372.

Track B Order

On March 14, 2003, the ACC issued the Track B Order, which required APS to solicit bids for certain estimated amounts of capacity and energy for periods beginning July 1, 2003. For 2003, APS was required to solicit competitive bids for about 2,500 MW of capacity and about 4,600 gigawatt-hours of energy, or approximately 20% of APS total retail energy requirements. The bid amounts are expected to increase in 2004 and 2005 based largely on growth in APS retail load and APS retail energy sales. The Track B Order also confirmed that it was not intended to change the current rate base status of [APS] existing assets.

The order recognizes APS right to reject any bids that are unreasonable, uneconomical or unreliable. The ACC staff and an independent monitor participated in the Track B procurement process. The Track B Order also contains requirements relating to standards of conduct between APS and any affiliate of APS participating in the competitive solicitation, requires that APS treat bidders in a non-discriminatory manner and requires APS to file a protocol regarding short-term and emergency procurements. The order permits the provision by APS of corporate oversight, support and governance as long as such activities do not favor Pinnacle West Energy in the procurement process or provide Pinnacle West Energy with confidential APS bidding information that is not available to other bidders. The order directs APS to evaluate bids on cost, reliability and reasonableness. The decision requires bidders to allow the ACC to inspect their plants and requires assurances of appropriate competitive market conduct from senior officers of such bidders. Following the solicitation, the decision requires APS to prepare a report evaluating environmental issues relating to the procurement, and a series of workshops on environmental risk management will be commenced thereafter.

APS issued requests for proposals in March 2003 and, by May 6, 2003, APS entered into contracts to meet all or a portion of its requirements for the years 2003 through 2006 as follows:

- (1) Pinnacle West Energy agreed to provide 1,700 MW in July through September of 2003 and in June through September of 2004, 2005 and 2006, by means of a unit contingent contract.
- (2) PPL EnergyPlus, LLC agreed to provide 112 MW in July through September of 2003 and 150 MW in June through September of 2004 and 2005, by means of a unit contingent contract.

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- (3) Panda Gila River LP agreed to provide 450 MW in October of 2003 and 2004 and May of 2004 and 2005, and 225 MW from November 2003 through April 2004 and from November 2004 through April 2005, by means of firm call options.

ACC Financing Orders

On April 4, 2003, the ACC issued the Financing Order authorizing APS to lend up to \$500 million to Pinnacle West Energy, guarantee up to \$500 million of Pinnacle West Energy debt, or a combination of both, not to exceed \$500 million in the aggregate (the APS Loan), subject to the following principal conditions:

any debt issued by APS pursuant to the order must be unsecured;

the APS Loan must be callable and secured by the PWEC Dedicated Assets;

the APS Loan must bear interest at a rate equal to 264 basis points above the interest rate on APS debt that could be issued and sold on equivalent terms (including, but not limited to, maturity and security);

the 264 basis points referred to in the previous bullet point will be capitalized as a deferred credit and used to offset retail rates in the future, with the deferred credit balance bearing an interest rate of six percent per annum;

the APS Loan must have a maturity date of not more than four years, unless otherwise ordered by the ACC;

any demonstrable increase in APS cost of capital as a result of the transaction (such as from a decline in bond rating) will be excluded from future rate cases;

APS must maintain a common equity ratio of at least forty percent and may not pay common dividends if such payment would reduce its common equity ratio below that threshold, unless otherwise waived by the ACC. The ACC will process any waiver request within sixty days, and for this sixty-day period this condition will be suspended. However, this condition, which will continue indefinitely, will not be permanently waived without an order of the ACC; and

certain waivers of the ACC's affiliated interest rules previously granted to APS and its affiliates will be temporarily withdrawn and, during the term of the APS Loan, neither Pinnacle West nor Pinnacle West Energy may reorganize or restructure, acquire or divest assets, or form, buy or sell affiliates (each, a Covered Transaction), or pledge or otherwise encumber the Pinnacle West Energy assets without prior ACC approval, except that the foregoing restrictions will not apply to the following categories of Covered Transactions:

Covered Transactions less than \$100 million, measured on a cumulative basis over the calendar year in which the Covered Transactions are made;

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Covered Transactions by SunCor of less than \$300 million through 2005, consistent with SunCor's anticipated accelerated asset sales activity during those years;

Covered Transactions related to the payment of ongoing construction costs for Pinnacle West Energy's (a) West Phoenix Unit 5, located in Phoenix, and (b) Silverhawk plant, located near Las Vegas, with an expected commercial operation date in mid-2004; and

Covered Transactions related to the sale of 25% of the Silverhawk plant to SNWA pursuant to an agreement between SNWA and Pinnacle West Energy.

The ACC also ordered the ACC staff to conduct an inquiry into our and our affiliates' compliance with the retail electric competition and related rules and decisions. On June 13, 2003, APS submitted its report on these matters to the ACC staff. The ACC has indicated that the preliminary investigation would be addressed in the pending general rate case (see below).

On May 12, 2003, APS issued \$500 million of debt pursuant to the Financing Order and made a \$500 million loan to Pinnacle West Energy. Pinnacle West Energy distributed the net proceeds of that loan to us to fund the repayment of a portion of the debt we incurred to finance the construction of the PWEC Dedicated Assets. See Note 6.

On November 22, 2002, the ACC issued an order approving APS' request to permit APS to make short-term advances to Pinnacle West in the form of an interaffiliate line of credit in the amount of \$125 million. As of December 31, 2003, there were no borrowings outstanding under this financing arrangement, and this authority expired on December 4, 2003.

APS General Rate Case and Retail Rate Adjustment Mechanisms

As noted above, on June 27, 2003, APS filed a general rate case with the ACC and requested a \$175.1 million, or 9.8%, increase in its annual retail electricity revenues, to become effective July 1, 2004. In this rate case, APS updated its cost of service and rate design.

Major Components of the Request The major reasons for the request include:

complying with the provisions of the 1999 Settlement Agreement;

incorporating significant increases in fuel and purchased power costs, including results of purchases through the ACC's Track B procurement process;

recognizing changes in APS' cost of service, cost allocation and rate design;

obtaining rate recognition of the PWEC Dedicated Assets;

recovering \$234 million written off by APS as a result of the 1999 Settlement Agreement; and

recovering restructuring and compliance costs associated with the ACC's Rules.

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Requested Rate Increase The requested rate increase totals \$175.1 million, or 9.8%, and is comprised of the following items (dollars in millions):

	Annual Revenue	Percent
Increase in base rates	\$ 166.8	9.3%
Rules compliance charge	8.3	0.5%
Total increase	\$ 175.1	9.8%

Test Year The filing is based on an adjusted historical test year ended December 31, 2002.

Cost of Capital The proposed weighted average cost of capital for the test year ended December 31, 2002 is 8.67%, including an 11.5% return on equity.

Rate Base The request is based on a rate base of \$4.2 billion, calculated using Original Cost Less Depreciation (OCLD) methodology. The OCLD rate base approximates the ACC-jurisdictional portion of the net book value of utility plant, net of accumulated depreciation and deferred taxes, as of December 31, 2002, except as set forth below.

The requested rate base includes the PWEC Dedicated Assets, with a total combined capacity of approximately 1,800 MW. These assets were included at their estimated July 1, 2004 net book value. Upon approval of the request, the PWEC Dedicated Assets would be transferred to APS from Pinnacle West Energy.

The filing also includes calculated amounts for Fair Value Rate Base and Replacement Cost New Depreciated (RCND) rate base. The ACC is required by the Arizona Constitution to make a finding of Fair Value Rate Base, which has traditionally been defined by the ACC as the arithmetic average of OCLD rate base and RCND rate base.

Recovery of Previous \$234 Million Write-Off The request includes recovery, over a fifteen year period, of the write-off of \$234 million pretax of regulatory assets by APS as a result of the 1999 Settlement Agreement. See 1999 Settlement Agreement above.

Estimated Timeline APS has asked the ACC to approve the requested rate increase by July 1, 2004. The ACC ALJ has issued a procedural schedule setting a hearing date on the application of May 25, 2004. Based on the schedule and existing ACC regulations, we believe the ACC will be able to make a decision in this general rate case by the end of 2004.

The general rate case also addresses the implementation of rate adjustment mechanisms that were the subject of ACC hearings in April 2003. The rate adjustment mechanisms, which were authorized as a result of the 1999 Settlement Agreement, would allow APS to recover several types of costs, the most significant of which are power supply costs (fuel and purchased power costs) and costs associated with complying with the Rules.

On November 4, 2003, the ACC approved the issuance of an order which authorizes a rate adjustment mechanism allowing APS to recover changes in purchased power costs (but not changes in fuel costs) incurred after July 1, 2004. The other rate adjustment mechanisms authorized in the 1999 Settlement Agreement (such as the costs associated with complying with the ACC electric competition rules) were also tentatively approved for subsequent implementation in the general rate case. The provisions of this order will not become effective until there is a final order in the general rate case, and the ACC further reserved the right to amend, modify or reconsider, in its entirety, this November 4 order during the rate case.

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Testimony As required by the procedural schedule, on February 3, 2004, the following parties filed their initial written testimony with the ACC on all issues except cost of service (i.e., cost allocation among customer classes) and rate design:

the ACC litigation staff;

the Arizona Residential Utility Consumers Office (RUCO), an office established by the Arizona legislature to represent the interests of residential utility consumers before the ACC; and

other approved rate case interveners.

ACC Staff Recommendations In its filed testimony, the ACC staff recommended, among other things, that the ACC:

decrease APS annual retail electricity revenues by at least \$142.7 million, which would result in a rate decrease of approximately 8%, based on a 9% return on equity;

not allow the PWEC Dedicated Assets to be included in APS rate base;

not allow APS to recover any of the \$234 million written off as a result of the 1999 Settlement Agreement; and

not implement any adjustment mechanisms for fuel and purchased power.

The ACC staff recommendations, if implemented as proposed, could have a material adverse impact on our results of operations, financial position, liquidity, dividend sustainability, credit ratings and access to capital markets. We believe that APS rate case requests are supported by, among other things, APS demonstrated need for the PWEC Dedicated Assets; APS need to attract capital at reasonable rates of return to support the required capital investment to ensure continued customer reliability in APS high-growth service territory; and the conditions in the western energy market. As a result, we believe it is unlikely that the ACC would adopt the ACC staff recommendations in their present form, although we can give no assurances in that regard.

The ACC staff also submitted testimony indicating that APS and its affiliates had violated the spirit, if not the letter of the Rules, the Code of Conduct and the 1999 Settlement Agreement.

RUCO Recommendations In its filed testimony, RUCO recommended, among other things, that the ACC:

decrease APS annual retail electricity revenues by \$53.6 million, which would result in a rate decrease of approximately 2.84%, based on a 9.5% return on equity;

not allow the PWEC Dedicated Assets to be included in APS rate base;

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not allow APS to recover any of the \$234 million written off as a result of the 1999 Settlement Agreement; and

not implement any adjustment mechanisms for fuel and purchased power.

APS believes that its rate request is necessary to ensure APS' continued ability to reliably serve one of the fastest growing regions in the country and views any ultimate decision that would deny recovery of the Company's investment in the PWEC Dedicated Assets as constituting a regulatory taking. APS will vigorously oppose the recommendations of the ACC staff, RUCO, and other parties offering similar recommendations.

Request for Proposals

In early December 2003, APS issued a request for proposals (RFP) for long-term power supply resources, and on January 8, 2004, an ACC Administrative Law Judge issued an order requiring, among other things, APS to file a summary of the proposals with the ACC. On January 27, 2004, APS filed a summary of the proposals with the ACC. APS is negotiating with certain of the parties that submitted proposals.

Federal

In July 2002, the FERC adopted a price mitigation plan that constrains the price of electricity in the wholesale spot electricity market in the western United States. The FERC adopted a price cap of \$250 per MWh for the period subsequent to October 31, 2002. Sales at prices above the cap must be justified and are subject to potential refund.

On July 31, 2002, the FERC issued a Notice of Proposed Rulemaking for Standard Market Design for wholesale electric markets. Voluminous comments and reply comments were filed on virtually every aspect of the proposed rule. On April 28, 2003, the FERC Staff issued an additional white paper on the proposed Standard Market Design. The white paper discusses several policy changes to the proposed Standard Market Design, including a greater emphasis on flexibility for regional needs. We cannot currently predict what, if any, impact there may be to the Company if the FERC adopts the proposed rule or any modifications proposed in the comments.

General

The regulatory developments and legal challenges to the Rules discussed in this Note have raised considerable uncertainty about the status and pace of retail electric competition and of electric restructuring in Arizona. Although some very limited retail competition existed in APS' service area in 1999 and 2000, there are currently no active retail competitors providing unbundled energy or other utility services to APS' customers. As a result, we cannot predict when, and the extent to which, additional competitors will re-enter APS' service territory. As competition in the electric industry continues to evolve, we will continue to evaluate strategies and alternatives that will position us to compete in the new regulatory environment.

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