

PINNACLE WEST CAPITAL CORP

FORM 10-Q (Quarterly Report)

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Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 1-8962

PINNACLE WEST CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

Arizona
(State or other jurisdiction of
incorporation or organization)

86-0512431
(I.R.S. Employer
Identification No.)

400 North Fifth Street, P.O. Box 53999, Phoenix, Arizona
(Address of principal executive offices)

85072-3999
(Zip Code)

Registrant's telephone number, including area code: (602) 250-1000

(Former name, former address and former fiscal year,
if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Number of shares of common stock, no par value, outstanding as of May 9, 2003: 91,254,179

Glossary

ACC - Arizona Corporation Commission

ACC Staff - Staff of the Arizona Corporation Commission

ADEQ - Arizona Department of Environmental Quality

ALJ - Administrative Law Judge

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

Citizens - Citizens Communications Company

Company - Pinnacle West Capital Corporation

CPUC - California Public Utility Commission

EITF - the FASB's Emerging Issues Task Force

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

ERMC -Energy Risk Management Committee

FASB - Financial Accounting Standards Board

FERC - United States Federal Energy Regulatory Commission

FIN - FASB Interpretation

Financing Order - ACC order issued on April 4, 2003 relating to APS' request to provide financing or credit support to Pinnacle West Energy or the Company

Fitch - Fitch, Inc.

GAAP - accounting principles generally accepted in the United States of America

Interim Financing Order - Order issued by the ACC on November 22, 2002 relating to APS' request to provide financing or credit support to the Company

IRS - United States Internal Revenue Service

ISO - California Independent System Operator

Moody's - Moody's Investors Service

MW - megawatt, one million watts

MWh - megawatt-hours, one million watts per hour

NAC - NAC International Inc., a subsidiary of El Dorado

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

OCI - other comprehensive income

Palo Verde - Palo Verde Nuclear Generating Station

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

PX - California Power Exchange

Rules - ACC retail electric competition rules

SCE - Southern California Edison Company

SEC - United States Securities and Exchange Commission

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

System - non-trading energy related activities

T&D - transmission and distribution

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

2002 10-K - the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2002

VIE - variable interest entity

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

(in thousands, except per share amounts)

	Three Months Ended March 31,	
	2003	2002
Operating Revenues		
Regulated electricity segment	\$ 384,960	\$ 380,241
Marketing and trading segment	162,743	75,815
Real estate segment	40,688	39,511
Other revenues	15,571	4,277
Total	603,962	499,844
Operating Expenses		
Regulated electricity segment purchased power and fuel	74,671	61,531
Marketing and trading segment purchased power and fuel	143,645	35,785
Operations and maintenance	133,117	117,430
Real estate operations segment	40,159	36,646
Depreciation and amortization	105,398	99,656
Taxes other than income taxes	28,496	26,758
Other expenses	9,221	3,302
Total	534,707	381,108
Operating Income	69,255	118,736
Other		
Other income (Note 16)	5,721	5,161
Other expense (Note 16)	(4,197)	(5,089)
Total	1,524	72
Interest Expense		
Interest charges	47,851	44,519
Capitalized interest	(9,979)	(13,859)
Total	37,872	30,660
Income From Continuing Operations Before Income Taxes	32,907	88,148
Income Taxes	12,754	34,897
Income From Continuing Operations	20,153	53,251
Income From Discontinued Operations		
- Net of Income Tax Expense of \$3,375 and \$332	5,145	506
Net Income	\$ 25,298	\$ 53,757
Weighted-Average Common Shares Outstanding - Basic	91,256	84,735
Weighted-Average Common Shares Outstanding - Diluted	91,359	84,884
Earnings Per Weighted-Average Common Share Outstanding		
Income From Continuing Operations - Basic	\$ 0.22	\$ 0.63
Net Income - Basic	0.28	0.63
Income From Continuing Operations - Diluted	0.22	0.63
Net Income - Diluted	0.28	0.63
Dividends Declared Per Share	\$ 0.425	\$ 0.40

See Notes to Condensed Consolidated Financial Statements.

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

(in thousands, except per share amounts)

	Twelve Months Ended March 31,	
	2003	2002
Operating Revenues		
Regulated electricity segment	\$ 2,017,742	\$ 2,529,522
Marketing and trading segment	412,859	468,750
Real estate segment	202,258	176,084
Other revenues	73,231	14,505
Total	2,706,090	3,188,861
Operating Expenses		
Regulated electricity segment purchased power and fuel	512,683	1,092,767
Marketing and trading segment purchased power and fuel	301,899	218,588
Operations and maintenance	600,225	522,275
Real estate operations segment	189,438	159,100
Depreciation and amortization	429,824	422,778
Taxes other than income taxes	109,690	102,523
Other expenses	110,878	12,717
Total	2,254,637	2,530,748
Operating Income	451,453	658,113
Other		
Other income (Note 16)	16,226	27,096
Other expense (Note 16)	(33,519)	(32,864)
Total	(17,293)	(5,768)
Interest Expense		
Interest charges	190,844	177,592
Capitalized interest	(39,869)	(51,294)
Total	150,975	126,298
Income From Continuing Operations Before Income Taxes	283,185	526,047
Income Taxes	110,085	207,634
Income From Continuing Operations	173,100	318,413
Income From Discontinued Operations		
- Net of Income Tax Expense of \$8,916 and \$332	13,594	506
Cumulative Effect of a Change in Accounting for Derivatives		
- Net of Income Tax Benefit of \$8,099	--	(12,446)
Cumulative Effect of a Change in Accounting for Trading Activities		
- Net of Income Tax Benefit of \$43,123	(65,745)	--
Net Income	\$ 120,949	\$ 306,473
Weighted-Average Common Shares Outstanding - Basic	86,509	84,719
Weighted-Average Common Shares Outstanding - Diluted	86,627	84,910
Earnings Per Weighted-Average Common Share Outstanding		
Income From Continuing Operations - Basic	\$ 2.00	\$ 3.76
Net Income - Basic	1.40	3.62
Income From Continuing Operations - Diluted	2.00	3.75
Net Income - Diluted	1.40	3.61
Dividends Declared Per Share	\$ 1.65	\$ 1.55

See Notes to Condensed Consolidated Financial Statements.

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

(unaudited)

ASSETS

	March 31, 2003	December 31, 2002
	-----	-----
Current Assets		
Cash and cash equivalents	\$ 67,289	\$ 77,566
Trust fund for bond redemption	87,225	--
Customer and other receivables--net	340,156	373,196
Accrued utility revenues	57,306	72,915
Materials and supplies (at average cost)	91,106	91,652
Fossil fuel (at average cost)	32,922	28,185
Deferred income taxes	4,094	4,094
Assets from risk management and trading activities	106,348	59,162
Real estate assets held for sale	--	46,475
Other current assets	89,428	103,978
	-----	-----
Total current assets	875,874	857,223
	-----	-----
Investments and Other Assets		
Real estate investments--net	386,983	382,719
Assets from risk management and trading activities - long-term	100,209	122,336
Other assets	227,882	229,891
	-----	-----
Total investments and other assets	715,074	734,946
	-----	-----
Property, Plant and Equipment		
Plant in service and held for future use	9,179,261	9,058,900
Less accumulated depreciation and amortization	3,344,900	3,474,325
	-----	-----
Total	5,834,361	5,584,575
Construction work in progress	860,190	777,542
Intangible assets, net of accumulated amortization	122,721	109,815
Nuclear fuel, net of accumulated amortization	12,232	7,466
	-----	-----
Net property, plant and equipment	6,829,504	6,479,398
	-----	-----
Deferred Debits		
Regulatory assets	219,344	241,045
Other deferred debits	115,125	113,194
	-----	-----
Total deferred debits	334,469	354,239
	-----	-----
Total Assets	\$8,754,921	\$8,425,806
	=====	=====

See Notes to Condensed Consolidated Financial Statements.

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

(unaudited)

LIABILITIES AND EQUITY

	March 31, 2003	December 31, 2002
	-----	-----
Current Liabilities		
Accounts payable	\$ 300,849	\$ 354,218
Accrued taxes	108,016	71,107
Accrued interest	42,763	53,018
Short-term borrowings	207,667	102,183
Current maturities of long-term debt	485,794	280,888
Customer deposits	45,893	42,190
Real estate liabilities held for sale	--	29,451
Liabilities from risk management and trading activities	93,074	70,667
Other current liabilities	77,626	63,847
	-----	-----
Total current liabilities	1,361,682	1,067,569
	-----	-----
Long-Term Debt Less Current Maturities	2,644,449	2,869,241
	-----	-----
Deferred Credits and Other		
Liabilities from risk management and trading activities - long-term	52,143	75,642
Deferred income taxes	1,209,950	1,209,074
Unamortized gain - sale of utility plant	58,340	59,484
Pension liability	199,456	183,880
Liability for asset retirement (Note 13)	223,147	--
Other	320,048	274,763
	-----	-----
Total deferred credits and other	2,063,084	1,802,843
	-----	-----
Commitments and Contingencies (Note 12)		
Common Stock Equity		
Common stock, no par value	1,738,689	1,737,258
Treasury stock	(4,236)	(4,358)
	-----	-----
Total common stock	1,734,453	1,732,900
	-----	-----
Accumulated other comprehensive loss:		
Minimum pension liability adjustment	(71,233)	(71,264)
Derivative instruments	(8,565)	(20,020)
	-----	-----
Total accumulated other comprehensive loss	(79,798)	(91,284)
	-----	-----
Retained earnings	1,031,051	1,044,537
	-----	-----
Total common stock equity	2,685,706	2,686,153
	-----	-----
Total Liabilities and Equity	\$ 8,754,921	\$ 8,425,806
	=====	=====

See Notes to Condensed Consolidated Financial Statements.

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

(dollars in thousands)

	Three Months Ended March 31,	
	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Income from continuing operations	\$ 20,153	\$ 53,251
Items not requiring cash:		
Depreciation and amortization	105,398	99,656
Nuclear fuel amortization	7,726	7,484
Deferred income taxes	(9,675)	(10,434)
Change in mark-to-market	(6,008)	(3,090)
Changes in current assets and liabilities:		
Customer and other receivables	33,040	53,815
Accrued utility revenues	15,609	12,423
Materials, supplies and fossil fuel	(4,191)	476
Other current assets	16,234	(2,937)
Accounts payable	(55,049)	(117,731)
Accrued taxes	36,909	41,735
Accrued interest	(10,255)	(6,448)
Other current liabilities	17,482	24,872
Change in real estate investments	(4,277)	(7,841)
Increase in regulatory assets	(2,152)	(2,096)
Change in risk management and trading - assets	11,334	(8,862)
Change in risk management and trading - liabilities	(12,370)	6,229
Change in customer advances	(1,334)	(24,767)
Change in pension liability	15,576	7,521
Change in other long-term assets	6,278	(9,710)
Change in other long-term liabilities	1,006	22,275
Net cash flow provided by operating activities	181,434	135,821
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(174,324)	(219,923)
Trust fund for bond redemption	(87,225)	(121,668)
Proceeds from sale of assets from discontinued operations	25,150	--
Capitalized interest	(9,979)	(13,859)
Other	8,238	26,706
Net cash flow used for investing activities	(238,140)	(328,744)
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of long-term debt	18,500	603,430
Short-term borrowings and payments--net	105,484	(253,462)
Dividends paid on common stock	(38,783)	(33,888)
Repayment of long-term debt	(40,325)	(133,749)
Other	1,553	2,416
Net cash flow provided by financing activities	46,429	184,747
Net Cash Flow	(10,277)	(8,176)
Cash and Cash Equivalents at Beginning of Period	77,566	28,619
Cash and Cash Equivalents at End of Period	\$ 67,289	\$ 20,443
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest paid, net of amounts capitalized	\$ 46,439	\$ 35,212
Income taxes paid	\$ --	\$ 30,557

See Notes to Condensed Consolidated Financial Statements.

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. The condensed 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). All significant intercompany accounts and transactions between the consolidated companies have been eliminated. We have reclassified certain prior year amounts to conform to the current year presentation (see Notes 10 and 19.)
2. Our unaudited condensed consolidated financial statements reflect all adjustments which we believe are necessary for the fair presentation of our financial position and results of operations for the periods presented. These adjustments are of a normal recurring nature with the exception of the cumulative effect of a change in accounting for derivatives, the cumulative effect of a change in accounting for trading activities (see Note 10), asset retirement obligations (see Note 13) and real estate discontinued operations (see Note 19). We suggest that these condensed consolidated financial statements and notes to condensed consolidated financial statements be read along with the consolidated financial statements and notes to consolidated financial statements included in our 2002 10-K.
3. Weather conditions cause significant seasonal fluctuations in our revenues. In addition, trading and wholesale marketing activities can have significant impacts on our results for interim periods. Consequently, results for interim periods do not necessarily represent results to be expected for the year.
4. In March 2003, APS deposited monies with its first mortgage bond trustee to redeem the entire \$33 million of outstanding First Mortgage Bonds, 8% Series due 2025, and the entire \$54 million of outstanding First Mortgage Bonds, 7.25% Series due 2023. On April 7, 2003, APS redeemed \$33 million of its First Mortgage Bonds, 8% Series due 2025. APS will redeem \$54 million of its First Mortgage Bonds, 7.25% Series due 2023, on August 1, 2003.

On May 12, 2003, APS issued \$500 million of debt as follows: \$300 million aggregate principal amount of its 4.650% Notes due 2015 and \$200 million aggregate principal amount of its 5.625% Notes due 2033. Also on May 12, 2003, APS made a \$500 million loan to Pinnacle West Energy, and Pinnacle West Energy distributed the net proceeds of that loan to us to fund our repayment of a portion of the debt incurred to finance the construction of the following Pinnacle West Energy power plants: Redhawk Units 1 and 2, West Phoenix Units 4 and 5, and Saguaro Unit 3. See "ACC Financing Orders" in Note 5 for additional information. With Pinnacle West Energy's distribution to us, on May 12, 2003, we repaid the outstanding balance (\$167 million) under a credit facility. We used a portion of the remaining proceeds to repay our short-term debt, with the balance being temporarily invested pending the planned optional repayment of our \$250 million Floating Rate Notes due 2003.

ELECTRIC INDUSTRY RESTRUCTURING

STATE

OVERVIEW

On September 10, 2002, the ACC issued the Track A Order, which, among other things, directed APS not to transfer its generation assets to Pinnacle West Energy, as previously required under the Rules and the 1999 Settlement Agreement. See "Track A Order" below. The Track A Order and legal challenges to the Rules have raised considerable uncertainty about the status and pace of retail electric competition in Arizona.

On March 14, 2003, the ACC issued the Track B Order, which requires APS to solicit bids for certain estimated capacity and energy requirements for periods beginning July 1, 2003. See "Track B Order" below.

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. See "ACC Financing Orders" 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 certain of our debt. See Note 4.

As required by the 1999 Settlement Agreement, on or before June 30, 2003, APS will file a general rate case with the ACC. The general rate case will also address the implementation of retail rate adjustment mechanisms that were the subject of ACC hearings in April 2003. See "APS General Rate Case and Retail Rate Adjustment Mechanisms" below.

1999 SETTLEMENT AGREEMENT

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

o APS has reduced, and will reduce, 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; and approximately \$28 million (\$17 million after taxes), effective July 1, 2002. The final price reduction is to be implemented 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.

o 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.

o There will be 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 will be 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.

o 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.

o 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 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.

o 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). APS will not be allowed to recover \$183 million net present value (in 1999 dollars) of the above amounts. 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 due to sales volume variances.

o APS will form, or cause to be formed, a separate corporate affiliate or affiliates and transfer to such affiliate(s) its competitive electric assets and services at book value as of the date of transfer, and will complete the transfers no later than December 31, 2002. APS will 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 noted above and discussed in greater detail below, in 2002 the ACC unilaterally modified this aspect of the 1999 Settlement Agreement by issuing an order preventing APS from transferring its generation assets.

RETAIL ELECTRIC COMPETITION RULES

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

- o They apply to virtually all Arizona electric utilities regulated by the ACC, including APS.
- o Effective January 1, 2001, retail access became available to all APS retail electricity customers.
- o 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.
- o Affected utilities must file ACC tariffs that unbundle rates for noncompetitive services.
- o The ACC shall allow a reasonable opportunity for recovery of unmitigated stranded costs.
- o 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 noted above and discussed in greater detail 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 have appealed the ruling to the Arizona Court of Appeals, as a result of which the Superior Court's ruling is automatically stayed pending further judicial review. That appeal is still pending. In a similar appeal concerning the issuance of competitive telecommunications CC&N's, the Arizona Court of Appeals invalidated rates for competitive carriers due to the ACC's failure to establish a fair value rate base for such carriers. That decision was upheld by the Arizona Supreme Court.

PROVIDER OF LAST RESORT OBLIGATION

Although the Rules allow retail customers to have access to competitive providers of energy and energy services, APS is 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 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 March 2003.

TRACK A ORDER

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

o 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

o 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 this document include, among other things, the following:

o The parties agreed that it would be appropriate for the ACC to consider the following matters in APS' upcoming general rate case, anticipated to be filed before June 30, 2003:

o the generating assets to be included in APS' rate base, including the question of whether certain power plants currently owned by Pinnacle West Energy (specifically, Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3) should be included in APS' rate base;

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

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

o 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 will be limited to the issues described in the preceding bullet points.

On February 21, 2003, a Notice of Claim was filed with the ACC and the Arizona Attorney General on behalf of APS, Pinnacle West and Pinnacle West Energy to preserve their and our rights relating to the Track A Order. As of

April 22, 2003, the Notice of Claim was deemed denied with respect to the ACC and the Arizona Attorney General, and APS, Pinnacle West and Pinnacle West Energy may now pursue the claim in court.

TRACK B ORDER

On March 14, 2003, the ACC issued the Track B Order, which requires APS to solicit bids for certain estimated capacity and energy requirements for periods beginning July 1, 2003. For 2003, APS will be required to solicit competitive bids for about 2,500 megawatts 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 Track B procurement process will involve the ACC Staff and an independent monitor. The Track B Order also contains requirements relating to standards of conduct between APS and any affiliate of APS that may participate 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 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, APS will 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.
- (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:

- o any debt issued by APS pursuant to the order must be unsecured;
- o the APS Loan must be callable and secured by certain Pinnacle West Energy assets;
- o 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);
- o 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;
- o the APS Loan must have a maturity date of not more than four years, unless otherwise ordered by the ACC;
- o 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;
- o 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
- o 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:
 - o Covered Transactions less than \$100 million, measured on a cumulative basis over the calendar year in which the Covered Transactions are made;

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

o Covered Transactions related to the payment of ongoing construction costs for Pinnacle West Energy's (a) West Phoenix Unit 5, located in Phoenix, with an expected commercial operation date in mid-2003, and (b) Silverhawk plant, located near Las Vegas, with an expected commercial operation date in mid-2004; and

o Covered Transactions related to the sale of 25% of the Silverhawk plant to SNWA if SNWA exercises its existing purchase option to do so.

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.

No party filed an application for reconsideration of the Financing Order. As a result, the Financing Order is final and not subject to appeal.

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 certain of our debt. See Note 4.

On November 22, 2002, the ACC issued an order (the "Interim Financing Order") approving APS' request to permit APS to (a) make short-term advances to Pinnacle West in the form of an inter-affiliate line of credit in the amount of \$125 million, or (b) guarantee \$125 million of Pinnacle West's short-term debt, subject to certain conditions.

APS GENERAL RATE CASE AND RETAIL RATE ADJUSTMENT MECHANISMS

As required by the 1999 Settlement Agreement, on or before June 30, 2003, APS will file a general rate case with the ACC. In this rate case, APS will update its cost of service and rate design. In addition, APS expects to seek:

o rate base treatment of certain power plants currently owned by Pinnacle West Energy (specifically, Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3);

o recovery of the \$234 million pretax asset write-off recorded by APS as part of the 1999 Settlement Agreement (\$140 million extraordinary charge recorded on the 1999 Consolidated Statement of Income); and

o recovery of costs incurred by APS in preparation for the previously required transfer of generation assets to Pinnacle West Energy.

The general rate case will also address 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. We assume that the ACC will make a decision in this general rate case by the end of 2004.

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 has 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 issued an additional white paper on the proposed Standard Market Design. The white paper makes several changes to the proposed Standard Market Design, including a greater emphasis on flexibility for regional needs. The FERC invited comments on the white paper, but has not yet set a due date for filing comments. We are reviewing the proposed rulemaking and 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 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.

6. Nuclear Insurance

The Palo Verde participants have insurance for public liability resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of \$300 million and the balance by an industry-wide retrospective assessment program. If losses at any nuclear power plant covered by the programs exceed the accumulated funds, APS could be assessed retrospective premium adjustments. The maximum assessment per reactor under the program for each nuclear incident is approximately \$88 million, subject to an annual limit of \$10 million per incident. Based on APS' interest in the three Palo Verde units, APS' maximum potential assessment per incident for all three units is approximately \$77 million, with an annual payment limitation of approximately \$9 million.

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde

in the aggregate amount of \$2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. APS has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen outage of any of the three units. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

7. Business Segments

We have three principal business segments (determined by products, services and the regulatory environment):

- o our regulated electricity segment, which consists of regulated traditional retail and wholesale electricity businesses and related activities, and includes electricity generation, transmission and distribution;
- o our marketing and trading segment, which consists of our competitive energy business activities, including wholesale marketing and trading and APS Energy Services' commodity-related energy services. In early 2003, we moved our marketing and trading division from Pinnacle West to APS for future marketing and trading activities (existing wholesale contracts will remain at Pinnacle West) as a result of the ACC's Track A Order prohibiting the previously required transfer of APS' generating assets to Pinnacle West Energy; and
- o our real estate segment, which consists of SunCor's real estate development and investment activities.

The amounts in our other segment include activity principally related to NAC in the periods ended March 31, 2003 (see Note 12), as well as the parent company and other subsidiaries. Financial data for the Company's business segments follows (dollars in millions):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Operating Revenues:				
Regulated electricity	\$ 385	\$ 380	\$ 2,018	\$ 2,530
Marketing and trading	163	76	413	469
Real estate	41	40	202	176
Other	15	4	73	14
Total	\$ 604	\$ 500	\$ 2,706	\$ 3,189
	=====	=====	=====	=====
Income From Continuing Operations:				
Regulated electricity	\$ 8	\$ 31	\$ 147	\$ 179
Marketing and trading	8	20	46	133
Real estate (a)	1	1	9	4
Other	3	1	(29)	1
Total	\$ 20	\$ 53	\$ 173	\$ 317
	=====	=====	=====	=====

(a) Excludes income from discontinued operations for the three months ended March 31 of \$5 million (after tax) in 2003 and \$1 million (after tax) in 2002. Excludes income from discontinued operations for the twelve months ended March 31 of \$14 million (after tax) in 2003 and \$1 million (after tax) in 2002. See Note 19 for further discussion of our real estate activities.

	As of March 31, 2003	As of December 31, 2002
Assets:		
Regulated electricity	\$ 8,033	\$ 7,589
Marketing and trading	250	301
Real estate	448	504
Other	24	32
Total	\$ 8,755	\$ 8,426
	=====	=====

8. Accounting Matters

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This statement amends and clarifies financial accounting and reporting for derivative instruments and for hedging activities under SFAS No. 133. The provisions of SFAS No. 149 that relate to previously issued SFAS No. 133 derivatives implementation guidance should continue to be applied in accordance with the effective dates of the original implementation guidance. In general, other provisions are applied prospectively to contracts entered into or modified after June 30, 2003, and for

hedging relationships designated after June 30, 2003. We are currently evaluating the impacts of the new standard on our financial statements.

In November 2002, the EITF reached a consensus on EITF 00-21, "Revenue Arrangements with Multiple Deliverables." EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF 00-21 specifically addresses how to determine whether an arrangement has identifiable, separable revenue-generating activities. EITF 00-21 does not address when the criteria for revenue recognition are met or provide guidance on the appropriate revenue recognition convention. EITF 00-21 is effective for revenue arrangements entered into after July 1, 2003. We are currently evaluating the impacts of this new guidance, but we do not believe it will have a material impact on our financial statements.

In 2001, the American Institute of Certified Public Accountants (AICPA) issued an exposure draft of a proposed Statement of Position (SOP), "Accounting for Certain Costs Related to Property, Plant, and Equipment." This proposed SOP would create a project timeline framework for capitalizing costs related to property, plant and equipment construction. It would require that property, plant and equipment assets be accounted for at the component level and require administrative and general costs incurred in support of capital projects to be expensed in the current period. In November 2002, the AICPA announced they would no longer issue general purpose SOPs. In February 2003, the FASB determined that the AICPA should continue their deliberations on certain aspects of the proposed SOP. We are waiting for further guidance from the FASB and the AICPA on the timing of the final guidance.

See the following Notes for other new accounting standards:

- o Note 9 for a new interpretation (FIN No. 46) related to VIEs;
- o Note 10 for a new EITF issue (EITF 02-3) related to accounting for energy trading contracts;
- o Note 13 for a new accounting standard (SFAS No. 143) on asset retirement obligations;
- o Note 15 for a new accounting standard (SFAS No. 148) on stock-based compensation; and
- o Note 17 for a new interpretation (FIN No. 45) on guarantees.

9. Variable Interest Entities

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest Entities." FIN No. 46 requires that we consolidate a VIE if we have a majority of the risk of loss from the VIE's activities or we are entitled to receive a majority of the VIE's residual returns or both. A VIE is a corporation, partnership, trust or any other legal structure that either does not have equity investors with voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN No. 46 is effective immediately for any VIE created after January 31, 2003 and is effective July 1, 2003 for VIEs created before February 1, 2003.

In 1986, APS entered into agreements with three separate SPE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. Based on our preliminary assessment of FIN No. 46, we do not believe we will be required to consolidate the Palo Verde SPEs. However, we continue to evaluate the requirements of the new guidance to determine what impact, if any, it will have on our financial statements.

APS is exposed to losses under the Palo Verde sale-leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of March 31, 2003, APS would have been required to assume approximately \$285 million of debt and pay the equity participants approximately \$200 million.

10. Derivative Instruments and Energy Trading Activities

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 derivatives, including exchange-traded futures and options and over-the-counter forwards, options and swaps. As part of our risk management program, we enter into derivative transactions to hedge purchases and sales of electricity, fuels, and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities. 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.

For the twelve months ended March 31, 2002, we recorded a \$12 million after tax charge in net income and a \$8 million after tax credit in common stock equity (as a component of other comprehensive income (loss)), both as cumulative effects of a change in accounting for derivatives, as required by SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The charge primarily resulted from electricity option contracts. The credit resulted from unrealized gains on cash flow hedges.

We adopted the EITF 02-3 guidance for all contracts in the fourth quarter of 2002. In 2002, 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. Contracts that do not meet the definition of a derivative are accounted for on an accrual basis with the associated revenues and costs recorded at the time the contracted commodities are delivered or received. Additionally, 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 Condensed Consolidated Statements of Income on a net basis. Derivative instruments used for non-trading activities are accounted for in accordance with SFAS No. 133.

EITF 02-3 requires that derivatives held for trading purposes, whether settled financially or physically, be reported in the income statement on a net basis. Conversely, all non-trading contracts and derivatives are to be reported gross on the income statement.

The changes in derivative fair value of our system positions included in the Condensed Consolidated Statements of Income for the three and twelve months ended March 31, 2003 and 2002 are comprised of the following (dollars in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting (a)	\$ 2,778	\$ (2,548)	\$ 16,524	\$ (6,155)
Losses from the discontinuance of cash flow hedges	--	(44)	(8,776)	(3,561)
Losses from non-hedge derivatives	(106)	(855)	(3,575)	(6,864)
Prior period mark-to-market losses realized upon delivery of commodities	10,443	3,813	14,635	23,368
Total pretax gain	\$ 13,115	\$ 366	\$ 18,808	\$ 6,788

(a) Time value component of options excluded from assessment of hedge effectiveness.

As of March 31, 2003, the maximum length of time over which we are hedging our exposure to the variability in future cash flows for forecasted transactions is approximately six years. During the twelve months ending March 31, 2004, we estimate that a net loss of \$3 million before income taxes will be reclassified from accumulated other comprehensive loss as an offset to the effect on earnings of market price changes for the related hedged transactions.

The mark-to-market related to our risk management and trading activities are presented in two categories, consistent with our business segments:

o System - our regulated electricity business segment, which consists of non-trading derivative instruments that hedge our purchases and sales of electricity and fuel for APS' Native Load requirements; and

o Marketing and Trading - our non-regulated, competitive business segment, which includes both non-trading and trading derivative instruments.

The following table summarizes our assets and liabilities from risk management and trading activities at March 31, 2003 and December 31, 2002 (dollars in thousands):

March 31, 2003

	Current Assets	Investments	Current Liabilities	Other Liabilities	Net Asset/ (Liability)
	-----	-----	-----	-----	-----
Mark-to-Market: Marketing and Trading System	\$ 23,849 82,499	\$ 39,743 8,205	\$ (6,479) (86,595)	\$ (1,242) (26,890)	\$ 55,871 (22,781)
Emission allowances - at cost	--	52,261	--	(24,011)	28,250
Total	\$ 106,348 =====	\$ 100,209 =====	\$ (93,074) =====	\$ (52,143) =====	\$ 61,340 =====

December 31, 2002

	Current Assets	Investments	Current Liabilities	Other Liabilities	Net Asset/ (Liability)
	-----	-----	-----	-----	-----
Mark-to-Market: Marketing and Trading System	\$ 17,640 41,522	\$ 51,771 6,971	\$ (9,848) (60,819)	\$ (2,583) (36,678)	\$ 56,980 (49,004)
Emission allowances - at cost	--	63,594	--	(36,381)	27,213
Total	\$ 59,162 =====	\$ 122,336 =====	\$ (70,667) =====	\$ (75,642) =====	\$ 35,189 =====

Cash or collateral required to serve as collateral against our open positions on energy-related contracts is included in investments and other assets and current liabilities on the Condensed Consolidated Balance Sheet. No collateral was provided at March 31, 2003. Collateral provided was \$5 million at December 31, 2002. Collateral held was \$23 million at March 31, 2003 and \$22 million at December 31, 2002.

11. Comprehensive Income

Components of comprehensive income for the three and twelve months ended March 31, 2003 and 2002, are as follows (dollars in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Net income	\$ 25,298	\$ 53,757	\$ 120,949	\$ 306,473
Other comprehensive income (loss):				
Minimum pension liability adjustment, net of tax	31	--	(70,267)	(966)
Cumulative effect of a change in accounting for derivatives, net of tax	--	--	--	7,801
Unrealized gain (loss) on derivative instruments, net of tax (a)	15,806	26,826	32,920	(72,200)
Reclassification of realized (gain) loss to income, net of tax (b)	(4,351)	990	(5,702)	(8,809)
Total other comprehensive income (loss)	11,486	27,816	(43,049)	(74,174)
Comprehensive income	\$ 36,784	\$ 81,573	\$ 77,900	\$ 232,299

(a) These amounts primarily include unrealized gains and losses on contracts used to hedge our forecasted gas requirements to serve Native Load.

(b) These amounts primarily include the reclassification of unrealized gains and losses to realized for contracted commodities delivered during the period.

12. Commitments and Contingencies

CALIFORNIA ENERGY MARKET ISSUES AND REFUNDS IN THE PACIFIC NORTHWEST

In July 2001, the FERC ordered an expedited fact-finding hearing to calculate refunds for spot market transactions in California during a specified time frame. This order calls for a hearing, with findings of fact due to the FERC after the ISO and PX provide necessary historical data. The FERC directed an ALJ to make findings of fact with respect to: (1) the mitigated price in each hour of the refund period; (2) the amount of refunds owed by each supplier according to the methodology established in the order; and (3) the amount currently owed to each supplier (with separate quantities due from each entity) by the CAISO, the California Power Exchange, the investor-owned utilities and the State of California.

APS was a seller and a purchaser in the California markets at issue, and to the extent that refunds are ordered, APS should be a recipient as well as a payor of such amounts. On December 12, 2002, the ALJ issued Proposed Findings of Fact with respect to the refunds. On March 26, 2003, the FERC adopted the great majority of the proposed findings, revising only the calculation of natural gas prices for the final determination of mitigated prices in the California markets. Sellers who may actually have paid more for natural gas than the proxy prices adopted by the FERC have 40 days in which to submit necessary data to the FERC, after which a technical conference will be held. Finalization of refund amounts is expected in mid-2003. Subsequent to the foregoing refund decision by

the FERC, the California parties filed a request for rehearing asking the FERC to expand the time period and transactions covered by the refund proceeding and provide for approximately \$3 billion in additional refunds relating to sales by all sellers in the California markets. APS does not anticipate material changes in its exposure and still believes, subject to the finalization of the revised proxy prices, that it will be entitled to a net refund.

On November 20, 2002, the FERC reopened discovery in these proceedings pursuant to instructions of the United States Court of Appeals for the Ninth Circuit that the FERC permit parties to offer additional evidence of potential market manipulation for the period January 1, 2000 through June 20, 2001. Parties have submitted additional evidence and proposed findings, which the FERC continues to consider.

The FERC also ordered an evidentiary proceeding to discuss and evaluate possible refunds for the Pacific Northwest. The FERC required that the record establish the volume of the transactions, the identification of the net sellers and net buyers, the price and terms and conditions of the sales contracts and the extent of potential refunds. On September 24, 2001, an ALJ concluded that prices in the Pacific Northwest during the period December 25, 2000 through June 20, 2001 were the result of a number of factors in addition to price signals from the California markets, including the shortage of supply, excess demand, drought and increased natural gas prices. Under these circumstances, the ALJ ultimately concluded that the prices in the Pacific Northwest were not unreasonable or unjust and refunds should not be ordered in this proceeding. On December 19, 2002, the FERC opened a new discovery period to permit the parties to offer additional evidence for the period January 1, 2000 through June 20, 2001. Additional evidence has been submitted and a FERC decision on the newly submitted evidence is expected soon. Based on public comments from the FERC, it is anticipated that this case will be sent back to the ALJ for further proceedings on spot market and balance of month transactions.

Although the FERC has not yet made a final ruling in the Pacific Northwest matter nor calculated the specific refund amounts due in California, we do not expect that the resolution of these issues, as to the amounts alleged in the proceedings, will have a material adverse impact on our financial position, results of operations or liquidity.

On March 26, 2003, FERC made public a Final Report on Price Manipulation in Western Markets, prepared by its Staff and covering spot markets in the West in 2000 and 2001. The report stated that a significant number of entities who participated in the California markets during 2000 to 2001 time period, including APS, may potentially have been involved in arbitrage transactions that allegedly violated certain provisions of the ISO tariff. The report also recommended that the FERC issue an order to show cause why these transactions did not violate the ISO tariff with potential disgorgement of any unjust profits. Although APS is still attempting to determine and to review the transactions at issue, it believes that it was not engaged in any such improper transactions. Based on the information available, it also appears that such transactions would not have a material adverse impact on our financial position, results of operations or liquidity.

SCE and PG&E have publicly disclosed that their liquidity has been materially and adversely affected because of, among other things, their inability to pass on to ratepayers the prices each has paid for energy and ancillary services procured through the PX and the ISO. PG&E filed for bankruptcy protection in 2001.

We are closely monitoring developments in the California energy market and the potential impact of these developments on us and our subsidiaries. Based on our evaluations, we previously reserved \$10 million before income taxes for our credit exposure related to the California energy situation, \$5 million of which was recorded in the fourth quarter of 2000 and \$5 million of which was recorded in the first quarter of 2001. Our evaluations took into consideration our range of exposure of approximately zero to \$38 million before income taxes and review of likely recovery rates in bankruptcy situations.

In the second quarter of 2002, PG&E filed its Modified Second Amended Disclosure Statement and the CPUC filed its Alternative Plan of Reorganization. Both plans generally indicated that PG&E would, at the close of bankruptcy proceedings, be able to pay in full all outstanding, undisputed debts. As a result of these developments, the probable range of our total exposure now is approximately zero to \$27 million before income taxes, and our best estimate of the probable loss is now approximately \$6 million before income taxes. Consequently, we reversed \$4 million of the \$10 million reserve in the second quarter of 2002. We cannot predict with certainty, however, the impact that any future resolution or attempted resolution, of the California energy market situation may have on us, our subsidiaries or the regional energy market in general.

CALIFORNIA ENERGY MARKET LITIGATION On March 19, 2002, the State of California filed a complaint with the FERC alleging that wholesale sellers of power and energy, including the Company, failed to properly file rate information at the FERC in connection with sales to California from 2000 to the present. **STATE OF CALIFORNIA V. BRITISH COLUMBIA POWER EXCHANGE ET AL.**, Docket No. EL02-71-000. The complaint requests the FERC to require the wholesale sellers to refund any rates that are "found to exceed just and reasonable levels." This complaint has been dismissed by the FERC and the State of California is now appealing the matter to the Ninth Circuit Court of Appeals. In addition, the State of California and others have filed various claims, which have now been consolidated, against several power suppliers to California alleging antitrust violations. **WHOLESALE ELECTRICITY ANTITRUST CASES I AND II**, Superior Court in and for the County of San Diego, Proceedings Nos. 4204-00005 and 4204-00006. Two of the suppliers who were named as defendants in those matters, Reliant Energy Services, Inc. (and other Reliant entities) and Duke Energy and Trading, LLP (and other Duke entities), filed cross-claims against various other participants in the PX and ISO markets, including APS, attempting to expand those matters to such other participants. APS has not yet filed a responsive pleading in the matter, but APS believes the claims by Reliant and Duke as they relate to APS are without merit.

APS was also named in a lawsuit regarding wholesale contracts in California. **JAMES MILLAR, ET AL. V. ALLEGHENY ENERGY SUPPLY, ET AL.**, United States District Court in and for the District of Northern California, Case No. C02-2855 EMC. The complaint alleges basically that the contracts entered into were the result of an unfair and unreasonable market. The PX has filed a lawsuit against the State of California regarding the seizure of forward contracts and the State has filed a cross complaint against APS and numerous other PX participants. **CAL PX V. THE STATE OF CALIFORNIA** Superior Court in and for the County of Sacramento, JCCP No. 4203. Various preliminary motions are being filed and we cannot currently predict the outcome of this matter. The "United States Justice Foundation" is suing numerous wholesale energy contract suppliers to California, including us, as well as the California Department of Water

Resources, based upon an alleged conflict of interest arising from the activities of a consultant for Edison International who also negotiated long-term contracts for the California Department of Water Resources. *MCCLINTOCK, ET AL. V. YUDHRAJA*, Superior Court in and for the County of Los Angeles, Case No. GC 029447. The California Attorney General has indicated that an investigation by his office did not find evidence of improper conduct by the consultant. We believe the claims against APS and us in the lawsuits mentioned in this paragraph are without merit and will have no material adverse impact on our financial position, results of operations or liquidity.

POWER SERVICE AGREEMENT

By letter dated March 7, 2001, Citizens, which owns a utility in Arizona, advised APS that it believes APS overcharged Citizens by over \$50 million under a power service agreement. APS believes its charges under the agreement were fully in accordance with the terms of the agreement. In addition, in testimony filed with the ACC on March 13, 2002, Citizens acknowledged, based on its review, "if Citizens filed a complaint with FERC, it probably would lose the central issue in the contract interpretation dispute." APS and Citizens terminated the power service agreement effective July 15, 2001. In replacement of the power service agreement, the Company and Citizens entered into a power sale agreement under which the Company will supply Citizens with future specified amounts of electricity and ancillary services through May 31, 2008. This new agreement does not address issues previously raised by Citizens with respect to charges under the original power service agreement through June 1, 2001.

EL DORADO'S INVESTMENT IN NAC

Through our unregulated wholly-owned subsidiary, El Dorado, we own a majority interest in NAC, a company that develops, markets and contracts for the manufacture of cask designs for spent nuclear fuel storage and transportation. Prior to the third quarter of 2002, our investment in NAC was accounted for under the equity method and our share of NAC's earnings and losses was recorded in other income or expense in our Condensed Consolidated Statements of Income. Beginning in the third quarter of 2002, we fully consolidated NAC's financial statements after acquiring a controlling interest in NAC as a result of increased voting representation on NAC's Board of Directors. During the second and third quarters of 2002, we recorded cumulative losses of approximately \$21 million before tax (\$13 million after tax, \$0.15 per share) related to NAC, primarily as a result of expected losses under contracts with two customers, including a contract between NAC and Maine Yankee Atomic Power Company (Maine Yankee).

On January 15, 2003, Maine Yankee notified NAC of its intention to terminate its contract with NAC. We recorded additional NAC losses of approximately \$38 million before tax (\$23 million after tax, or \$0.27 per share) in the fourth quarter of 2002, the substantial majority of which relate to the termination of the Maine Yankee contract. As a result, in 2002, we recorded NAC losses of approximately \$59 million before tax (\$35 million after tax, or \$0.42 per share).

On March 4, 2003, Maine Yankee filed suit against Pinnacle West, NAC and a surety company in federal court in Portland, Maine. MAINE YANKEE

ATOMIC POWER COMPANY V. UNITED STATES FIRE INSURANCE COMPANY, Civil Action Docket No. 03-58-PC, United States District Court, District of Maine. The lawsuit and a related arbitration proceeding initiated by NAC were dismissed in April 2003 as part of a settlement among the parties. We reversed \$5 million of loss reserves in the first quarter of 2003 related to NAC's contract settlement. We believe we have reserved our exposure with respect to NAC's contracts in all material respects and, as a result, we consider these charges non-recurring. We do not expect material losses for the year 2003 related to NAC.

13. Asset Retirement Obligations

On January 1, 2003, we adopted SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 provides accounting requirements for the recognition and measurement of liabilities associated with the retirement of tangible long-lived assets. The standard requires that these liabilities be recognized at fair value as incurred and capitalized as part of the related tangible long-lived assets. Accretion of the liability due to the passage of time is an operating expense and the capitalized cost is depreciated over the useful life of the long-lived asset. Prior to January 1, 2003 we accrued asset retirement obligations over the life of the related asset through depreciation expense.

APS has asset retirement obligations for its Palo Verde nuclear facilities and certain other generation, transmission and distribution assets. The Palo Verde asset retirement obligation primarily relates to final plant decommissioning. This obligation is based on the NRC's requirements for disposal of radiated property or plant and agreements APS reached with the ACC for final decommissioning of the plant. The non-nuclear generation asset retirement obligations primarily relate to requirements for removing portions of those plants at the end of the plant life or lease term. Some of our transmission and distribution assets have asset retirement obligations because they are subject to right of way and easement agreements that require final removal. These agreements have a history of uninterrupted renewal that we expect will continue for the foreseeable future. As a result, APS cannot reasonably estimate the fair value of the asset retirement obligation related to such distribution and transmission assets. The asset retirement obligations associated with our non-regulated assets are immaterial.

On January 1, 2003, APS recorded a liability of \$219 million for its asset retirement obligations, including the accretion impacts; a \$67 million increase in the carrying amount of the associated assets; and a net reduction of \$192 million in accumulated depreciation related primarily to the reversal of previously recorded accumulated decommissioning and other removal costs related to these obligations. Additionally, APS recorded a net regulatory liability of \$40 million for the asset retirement obligations related to its regulated assets. This regulatory liability represents the difference between the amount currently being recovered in regulated rates and the amount calculated under SFAS No. 143. APS believes it can recover in regulated rates the transition costs and ongoing current period costs calculated in accordance with SFAS No. 143. The adoption of SFAS No. 143 did not have a material impact on our net income for the quarter ended March 31, 2003.

In accordance with SFAS No. 71, APS will continue to accrue for removal costs for its regulated assets, even if there is no legal obligation for removal. At March 31, 2003, accumulated depreciation shown on our Condensed Consolidated Balance Sheets included approximately \$360 million of estimated future removal costs that are not considered legal obligations.

The following schedule shows the change in our asset retirement obligations during the three-month period ended March 31, 2003 (dollars in millions):

Balance at January 1, 2003	\$ 219
Changes attributable to:	
Liabilities incurred	--
Liabilities settled	--
Accretion expense	4
Estimated cash flow revisions	--

Balance at March 31, 2003	\$ 223
	=====

The following schedule shows the change in our pro forma liability for the periods ended December 31, 2002 and 2001, as if we had recorded an asset retirement obligation based on the guidance in SFAS No. 143 (dollars in millions):

	2002	2001
	-----	-----
Balance at beginning of year	\$ 204	\$ 190
Accretion expense	15	14
	-----	-----
Balance at end of year	\$ 219	\$ 204
	=====	=====

The pro forma effects on net income for 2002 and 2001 are immaterial.

To fund the costs APS expects to incur to decommission the plant, APS established external decommissioning trusts in accordance with NRC regulations. APS invests the trust funds primarily in fixed income securities and domestic stock and classifies them as available for sale. The following table shows the cost and fair value of APS' nuclear decommissioning trust fund assets which are reported in investments and other assets on the Condensed Consolidated Balance Sheets at March 31, 2003 and December 31, 2002 (dollars in millions):

	March 31, 2003	December 31, 2002
	-----	-----
Trust fund assets - at cost		
Fixed income securities	\$ 115	\$ 113
Domestic stock	70	68
	-----	-----
Total	\$ 185	\$ 181
	=====	=====
Trust fund assets - at fair value		
Fixed income securities	\$ 124	\$ 117
Domestic stock	80	77
	-----	-----
Total	\$ 204	\$ 194
	=====	=====

14. Intangible Assets

The Company's gross intangible assets (which are primarily software) were \$233 million at March 31, 2003 and \$214 million at December 31, 2002. The related accumulated amortization was \$110 million at March 31, 2003 and \$104 million at December 31, 2002. Amortization expense for the three months ended March 31 was \$6 million in 2003 and \$4 million in 2002. Amortization expense for the twelve months ended March 31 was \$23 million in 2003 and \$21 million in 2002. Estimated amortization expense on existing intangible assets over the next five years is \$27 million in 2003, \$26 million in 2004, \$25 million in 2005, \$22 million in 2006 and \$14 million in 2007.

15. 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." In accordance with the transition requirements of SFAS No. 123, as amended by SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure," 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 March 31, 2003 (dollars in thousands, except per share amounts):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Net Income:				
As reported	\$ 25,298	\$ 53,757	\$120,949	\$306,473
Pro forma (fair value method)	24,998	53,385	119,626	304,382
Stock compensation expense (net of tax):				
As reported	152	--	452	--
Pro forma (fair value method)	300	372	1,323	2,091
Earnings per share - basic:				
As reported	\$ 0.28	\$ 0.63	\$ 1.40	\$ 3.62
Pro forma (fair value method)	\$ 0.27	\$ 0.63	\$ 1.38	\$ 3.59
Earnings per share - diluted:				
As reported	\$ 0.28	\$ 0.63	\$ 1.40	\$ 3.61
Pro forma (fair value method)	\$ 0.27	\$ 0.63	\$ 1.38	\$ 3.58

16. Other Income and Other Expense

The following table provides detail of other income and other expense for the three and twelve months ended March 31, 2003 and 2002 (dollars in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Other income:				
Environmental insurance recovery	\$ --	\$ --	\$ --	\$ 12,350
Investment gains - net	1,279	2,039	--	--
Interest income	713	1,178	3,957	7,371
SunCor joint venture earnings	3,244	916	9,605	3,423
Miscellaneous	485	1,028	2,664	3,952
Total other income	\$ 5,721	\$ 5,161	\$ 16,226	\$ 27,096
Other expense:				
Investment losses - net (a)	\$ --	\$ --	\$ (11,198)	\$ (4,138)
Non-operating costs - SunCor	--	--	--	(7,000)
Non-operating costs (b)	(3,538)	(3,882)	(19,086)	(16,362)
Miscellaneous	(659)	(1,207)	(3,235)	(5,364)
Total other expense	\$ (4,197)	\$ (5,089)	\$ (33,519)	\$ (32,864)

(a) Primarily related to El Dorado's investment in NAC in 2002 (see Note 12).

(b) As defined by the FERC, includes below-the-line non-operating utility costs (primarily community relations and environmental compliance).

17. Guarantees

On January 1, 2003 we adopted FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN No. 45 elaborates on the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees. It also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure provisions are effective for the year ended December 31, 2002. The initial recognition and measurement provisions of FIN No. 45 are effective on a prospective basis to guarantees issued or modified after December 31, 2002.

We have issued parental guarantees and letters of credit and obtained surety bonds on behalf of our unregulated subsidiaries. Our parental guarantees related to Pinnacle West Energy primarily consist of equipment and performance guarantees related to our generation construction program, transmission service guarantees for West Phoenix Units 4 and 5 and long-term service agreement guarantees for new power plants. Our credit support instruments enable APS Energy Services to provide commodity energy and energy-related products and enable El Dorado to support the activities of NAC. SunCor has a debt guarantee on behalf of an affiliated joint venture. Non-performance or payment under the

original contract by our unregulated subsidiaries would require us to perform under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West's guarantees on behalf of its subsidiaries. Our guarantees have no recourse (except NAC) or collateral provisions to allow us to recover amounts paid under the guarantee. The amounts and approximate terms of our guarantees and surety bonds for each subsidiary at March 31, 2003 are as follows (dollars in millions):

	Guarantees		Surety Bonds		Letters of Credit	
	Amount	Term (in years)	Amount	Term (in years)	Amount	Term (in years)
Parental:						
Pinnacle West Energy	\$106	1 to 2	\$ --	--	\$ 37	1 to 2
APS Energy Services	82	less than 2	49	less than 1	--	--
El Dorado (all NAC)	44	1 to 3	--	--	5	1
SunCor guarantees	33	1	--	--	--	--
	----		----		----	
Total	\$265		\$ 49		\$ 42	
	====		====		====	

At March 31, 2003, we had entered into approximately \$37 million of letters of credit which support various construction agreements. These letters of credit expire in 2003 and 2004. We intend to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

APS has entered into various agreements that require letters of credit for financial assurance purposes. At March 31, 2003, approximately \$200 million of letters of credit were outstanding to support existing pollution control bonds of approximately \$200 million. The letters of credit are available to fund the payment of principal and interest of such debt obligations. These letters of credit have expiration dates in 2003. APS has also entered into approximately \$113 million of letters of credit to support certain equity lessors in the Palo Verde sale-leaseback transactions. These letters of credit expire in 2005. Additionally, APS has approximately \$5 million of letters of credit related to counterparty collateral requirements and approximately \$5 million of letters of credit related to workers' compensation expiring in 2003. APS intends to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

In conjunction with our financing agreements, including our sale-leaseback transactions, we generally provide indemnifications relating to liabilities arising from or related to the agreements, except with certain limited exceptions depending on the particular agreement. APS has also provided indemnifications to the equity participants and other parties in the Palo Verde sale-leaseback transactions with respect to certain tax matters. Generally, a maximum obligation is not explicitly stated in the indemnification and therefore, the overall maximum amount of the obligation under such indemnifications cannot be reasonably estimated. Based on historical experience and evaluation of the specific indemnities, we do not believe that any material loss related to such indemnifications is likely and therefore no related liability has been recorded.

18. Earnings Per Share

The following table presents earnings per weighted average common share outstanding for the three and twelve months ended March 31, 2003 and 2002:

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Basic earnings per share:				
Income from continuing operations	\$ 0.22	\$ 0.63	\$ 2.00	\$ 3.76
Income from discontinued operations	0.06	--	0.16	--
Cumulative effect of change in accounting for derivatives	--	--	--	(0.14)
Cumulative effect of change in accounting for trading activities	--	--	(0.76)	--
Earnings per share - basic	\$ 0.28	\$ 0.63	\$ 1.40	\$ 3.62
	=====	=====	=====	=====
Diluted earnings per share:				
Income from continuing operations	\$ 0.22	\$ 0.63	\$ 2.00	\$ 3.75
Income from discontinued operations	0.06	--	0.16	--
Cumulative effect of change in accounting for derivatives	--	--	--	(0.14)
Cumulative effect of change in accounting for trading activities	--	--	(0.76)	--
Earnings per share - diluted	\$ 0.28	\$ 0.63	\$ 1.40	\$ 3.61
	=====	=====	=====	=====

The following table reconciles average common shares outstanding - basic to average common shares outstanding - diluted that are used in the earnings per share calculation in the Condensed Consolidated Statements of Income for the three and twelve months ended March 31, 2003 and 2002 (in thousands):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Average common shares outstanding - basic	91,256	84,735	86,509	84,719
Dilutive shares	103	149	118	191
Average common shares outstanding - diluted	91,359	84,884	86,627	84,910
	=====	=====	=====	=====

Options to purchase 2,245,211 shares for the three month period ended March 31, 2003 and 1,991,119 shares for the twelve month period ended March 31, 2003 were outstanding but were not included in the computation of earnings per share because the options' exercise prices were greater than the average market price of the common shares. Options to purchase shares of common stock that were not included in the computation of diluted earnings per share were 1,075,100 shares

for the three months ended March 31, 2002 and 635,761 shares for the twelve months ended March 31, 2002.

19. Real Estate Activities - Discontinued Operations

On January 1, 2002 we adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Among other things, SFAS No. 144 prescribes accounting for discontinued operations and defines certain real estate activities as discontinued operations.

In the first quarter of 2003, SunCor sold its water utility company, which resulted in an after tax gain of \$5 million (\$8 million pretax). The gain on the sale and operating income in the current and prior periods are classified as discontinued operations in our Condensed Consolidated Statements of Income.

In the second quarter of 2002, SunCor sold a retail center, but maintained a significant continuing involvement through a management contract. In the first quarter of 2003, this management contract was canceled. As a result, the gain on the 2002 sale and the operating income related to this property have been reclassified as discontinued operations. The income from discontinued operations of \$14 million (after income taxes) in the twelve months ended March 31, 2003 primarily reflects this sale and the sale of the water utility company.

The following chart provides a summary of the real estate segment's earnings (after income taxes) for the three and twelve months ended March 31, 2003 and 2002 (dollars in millions):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Income from continuing operations	\$ 1	\$ 1	\$ 9	\$ 4
Income from discontinued operations	5	1	14	1
Net income	\$ 6	\$ 2	\$ 23	\$ 5

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

INTRODUCTION

In this Item, we explain the results of operations, general financial condition and outlook for Pinnacle West and our subsidiaries: APS, Pinnacle West Energy, APS Energy Services, SunCor and El Dorado, including:

- o the changes in our earnings for the three and twelve months ended March 31, 2003 and 2002;
- o our capital needs, liquidity and capital resources;
- o our business outlook and major factors that affect our financial outlook (see Note 5 and "Business Outlook" below); and
- o our management of market risks.

We suggest this section be read along with the 2002 10-K. Throughout this Item, we refer to specific "Notes" in the Notes to Condensed Consolidated Financial Statements in this report. These Notes add further details to the discussion. Operating statistics for the three and twelve months ended March 31, 2003 and 2002 are available on our website (www.pinnaclewest.com) and in our Current Report on Form 8-K dated March 31, 2003.

OVERVIEW OF OUR BUSINESS

The Company owns all of the outstanding common stock of APS. APS is an 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. Electricity is delivered through a distribution system owned by APS. APS also generates, sells and delivers electricity to wholesale customers in the western United States. APS does not distribute any products. The marketing and trading segment sells, in the wholesale market, APS and Pinnacle West Energy generation output that is not needed for APS' Native Load, which includes loads for retail customers and traditional cost-of-service wholesale customers.

Our other major subsidiaries are:

- o Pinnacle West Energy, through which we conduct our competitive electricity generation operations;
- o APS Energy Services, which provides competitive commodity-related energy services (such as direct access commodity contracts, energy procurement and energy supply consultation) and energy-related products and services (such as energy master planning, energy use consultation and facility audits, cogeneration analysis and installation and project management) to commercial, industrial and institutional retail customers in the western United States;

o SunCor, a developer of residential, commercial and industrial real estate projects in Arizona, New Mexico and Utah; and

o El Dorado, which owns a majority interest in NAC (specializing in spent nuclear fuel technology) and holds miscellaneous small investments, including interests in Arizona community-based ventures.

EARNINGS CONTRIBUTIONS BY SUBSIDIARY AND BUSINESS SEGMENT

We have three principal business segments (determined by products, services and the regulatory environment):

o our regulated electricity segment, which consists of regulated traditional retail and wholesale electricity businesses and related activities and includes electricity generation, transmission and distribution;

o our marketing and trading segment, which consists of our competitive energy business activities, including wholesale marketing and trading and APS Energy Services' commodity-related energy services; and

o our real estate segment, which consists of SunCor's real estate development and investment activities.

The following tables summarize net income and segment details for the three and twelve months ended March 31, 2003 and the comparable prior periods for Pinnacle West and each of our subsidiaries (dollars in millions):

THREE MONTHS ENDED MARCH 31,	Total		Regulated Electricity		Marketing and Trading		Real Estate (a)		Other	
	2003	2002	2003	2002	2003	2002	2003	2002	2003	2002
Arizona Public Service (b)(c)	\$ 16	\$ 32	\$ 13	\$ 31	\$ 3	\$ 1	\$ --	\$ --	\$ --	\$ --
Pinnacle West Energy (b)	5	1	6	1	(1)	--	--	--	--	--
APS Energy Services (d)	8	2	--	--	6	1	--	--	2	1
SunCor	1	1	--	--	--	--	1	1	--	--
El Dorado (d)	3	--	--	--	--	--	--	--	3	--
Parent company (c)	(13)	17	(11)	(1)	--	18	--	--	(2)	--
Income from continuing operations	20	53	8	31	8	20	1	1	3	1
Income from discontinued operations - net of tax	5	1	--	--	--	--	5	1	--	--
Net income	\$ 25	\$ 54	\$ 8	\$ 31	\$ 8	\$ 20	\$ 6	\$ 2	\$ 3	\$ 1

TWELVE MONTHS ENDED MARCH 31,	Total		Regulated Electricity		Marketing and Trading		Real Estate (a)		Other	
	2003	2002	2003	2002	2003	2002	2003	2002	2003	2002
	-----	-----	-----	-----	-----	-----	-----	-----	-----	-----
Arizona Public Service (b)(c)	\$ 183	\$ 248	\$ 179	\$ 166	\$ 4	\$ 82	\$ --	\$ --	\$ --	\$ --
Pinnacle West Energy (b)(f)	(14)	19	(16)	19	2	--	--	--	--	--
APS Energy Services (d)	34	--	--	--	28	(2)	--	--	6	2
SunCor	9	4	--	--	--	--	9	4	--	--
El Dorado (d)	(52)	--	--	--	--	--	--	--	(52)	--
Parent company (c)	13	46	(16)	(6)	12	53	--	--	17	(1)
	-----	-----	-----	-----	-----	-----	-----	-----	-----	-----
Income from continuing operations	173	317	147	179	46	133	9	4	(29)	1
Income from discontinued operations - net of tax	14	1	--	--	--	--	14	1	--	--
Cumulative effect of change in accounting - net of tax (g) (h)	(66)	(12)	--	--	(66)	(12)	--	--	--	--
	-----	-----	-----	-----	-----	-----	-----	-----	-----	-----
Net income (loss)	\$ 121	\$ 306	\$ 147	\$ 179	\$ (20)	\$ 121	\$ 23	\$ 5	\$ (29)	\$ 1
	=====	=====	=====	=====	=====	=====	=====	=====	=====	=====

(a) See "Real Estate Activities" discussion below and Note 19.

(b) Consistent with APS' October 2001 ACC filing, APS entered into agreements with its affiliates to buy power through June 2003. The agreements reflect a price based on the fully-dispatchable dedication of the Pinnacle West Energy generating assets to APS' Native Load customers. See "Track B Order" in Note 5 for information about our competitive solicitation process for certain estimated capacity and energy requirements beginning July 1, 2003.

(c) In early 2003, we moved our marketing and trading division from Pinnacle West to APS for future marketing and trading activities (existing wholesale contracts will remain at Pinnacle West) as a result of the ACC's Track A Order prohibiting the previously required transfer of APS' generating assets to Pinnacle West Energy.

(d) APS Energy Services' net income prior to 2003 and El Dorado's net income are primarily reported before income taxes. The income tax expense or benefit for these subsidiaries was recorded at the parent company.

(e) Primarily includes activities related to El Dorado in the twelve months ended March 31, 2003, principally El Dorado's investment in NAC. For the twelve months ended March 31, 2003, we recorded a pretax loss of \$55 million related to NAC contracts with two customers. See Note 12.

(f) In the fourth quarter of 2002, Pinnacle West Energy recorded a charge related to the cancellation of Redhawk Units 3 and 4 of approximately \$30 million after income taxes (\$49 million pretax).

(g) We recorded a \$66 million after tax charge as of October 1, 2002 for the cumulative effect of a change in accounting for trading activities, for the early adoption of EITF 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

(h) APS recorded a \$12 million after tax charge in June 2001 for the cumulative effect of a change in accounting for derivatives related to the adoption of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities."

RESULTS OF OPERATIONS

GENERAL

Throughout the following explanations of our results of operations, we refer to "gross margin." With respect to our regulated electricity segment and our marketing and trading segment, gross margin refers to electric operating revenues less purchased power and fuel costs. Our real estate segment gross margin refers to real estate revenues less real estate operations costs of SunCor. Other gross margin refers to other operating revenues less other operating expenses, which includes El Dorado's investment in NAC, which we began consolidating in our financial statements in July 2002. Other gross margin also includes amounts related to APS Energy Services' energy consulting services.

OPERATING RESULTS - THREE-MONTH PERIOD ENDED MARCH 31, 2003 COMPARED WITH THREE-MONTH PERIOD ENDED MARCH 31, 2002

Our consolidated net income for the three months ended March 31, 2003 was \$25 million compared with \$54 million for the prior year. Included in 2003 income is \$5 million of after tax income related primarily to SunCor's sale of its water utility company accounted for as discontinued operations in our real estate segment (see "Real Estate Activities" below).

Our income from continuing operations for the three months ended March 31, 2003 was \$20 million compared with \$53 million for the comparable period in the prior year. The period-to-period decrease of \$33 million was primarily due to:

- o lower earnings contributions from our marketing and trading activities, reflecting lower liquidity and higher price volatility in the wholesale power markets in the western United States, partially offset by lower mark-to-market reversals due to the adoption of EITF 02-3 (\$17 million, after tax);

- o higher depreciation, operations and maintenance, and interest expenses related to new power plants in service (\$10 million, after tax);

- o higher operating costs primarily related to the timing of power plant overhauls and higher pension and other postretirement benefit costs (\$7 million, after tax);

- o decreased earnings contributions from our regulated electricity activities, reflecting retail electricity price decreases, the effects of milder weather and higher replacement power cost for plant outages, partially offset by retail customer growth, (\$5 million, after tax); and

- o other miscellaneous factors (\$2 million, after tax).

The above decreases were partially offset by:

o higher competitive retail sales in California by APS Energy Services (\$5 million, after tax); and

o the settlement of an NAC contract dispute involving Maine Yankee Atomic Power Company (see Note 12) (\$3 million, after tax).

For additional details, see the following discussion.

The major factors that increased (decreased) income from continuing operations were as follows (dollars in millions):

	Increase (Decrease)

Regulated electricity segment gross margin:	
Increased purchased power and fuel costs due to higher hedged gas and power prices	\$ (8)
Higher retail sales volumes due to customer growth, excluding weather effects	7
Change in mark-to-market for hedged natural gas and purchased power costs for future delivery	8
Effects of milder weather on retail sales	(6)
Retail electricity price reductions effective July 1, 2002	(5)
Higher replacement power costs from plant outages due to higher market prices and more unplanned outages	(4)

Net decrease in regulated electricity segment gross margin	(8)

Marketing and trading segment gross margin:	
Increase in generation sales other than Native Load due to higher sales volumes, partially offset by lower unit margins	1
Lower realized wholesale margins net of related mark-to-market reversals due to lower prices, partially offset by higher volumes	(12)
More competitive retail sales in California by APS Energy Services	8
Lower mark-to-market reversals due to the adoption of EITF 02-3	8
Lower mark-to-market gains for future delivery due to lower market liquidity and higher price volatility	(26)

Net decrease in marketing and trading segment gross margin	(21)

Net decrease in regulated electricity and marketing and trading segments' gross margins	(29)
Lower real estate segment gross margin primarily due to lower land sales (See "Real Estate Activities" below and Note 19)	(2)
Higher other gross margin primarily due to NAC's settlement of a contract dispute (see Note 12)	5
Higher operations and maintenance expense related to increased operating costs related to the timing of power plant overhauls, increased pension and other postretirement benefit costs and new power plants in service	(16)
Higher depreciation primarily related to new power plants and increased plant balances, partially offset by lower regulatory asset amortization	(6)
Higher net interest expense primarily due to higher debt balances and lower capitalized interest	(7)

Net decrease in income from continuing operations before income taxes	(55)
Lower income taxes primarily due to lower income	22

Net decrease in income from continuing operations	\$ (33)
	=====

REGULATED ELECTRICITY SEGMENT GROSS MARGIN

Regulated electricity segment revenues related to our regulated retail and wholesale electricity businesses were \$5 million higher in the three months ended March 31, 2003, compared with the same period in the prior year as a result of:

- o increased revenues related to traditional wholesale sales as a result of higher sales volumes and higher prices (\$1 million);
- o increased revenues related to retail load hedge management wholesale sales, primarily as a result of higher prices (\$3 million);
- o decreased retail revenues related to milder weather (\$11 million);
- o increased retail revenues related to customer growth, excluding weather effects (\$14 million);
- o decreased retail revenues related to a reduction in retail electricity prices (\$5 million); and
- o other miscellaneous factors (\$3 million, net increase).

Regulated electricity segment purchased power and fuel costs were \$13 million higher in the three months ended March 31, 2003, compared with the same period in the prior year as a result of:

- o increased costs related to traditional wholesale sales as a result of higher sales volumes and higher prices (\$1 million);
- o increased costs related to retail load hedge management wholesale sales, primarily as a result of higher prices (\$3 million);
- o decreased costs related to the effects of milder weather on retail sales (\$5 million);
- o increased costs related to retail sales growth, excluding weather effects (\$7 million);
- o increased replacement power costs for power plant outages due to higher market prices and more unplanned outages (\$4 million); and
- o other miscellaneous factors (\$3 million, net increase).

MARKETING AND TRADING SEGMENT GROSS MARGIN

Marketing and trading segment revenues were \$87 million higher in the three months ended March 31, 2003, compared with the same period in the prior year as a result of:

- o increased revenues from generation sales other than Native Load primarily due to higher prices and higher sales volumes (\$36 million);
- o higher realized wholesale revenues net of related mark-to-market reversals primarily due to higher volumes (\$41 million);
- o increased revenues from higher competitive retail sales in California by APS Energy Services (\$30 million);
- o higher revenues related to the adoption of EITF 02-3 (\$8 million); and
- o lower mark-to-market gains for future delivery primarily as a result of lower market liquidity and higher price volatility (\$28 million).

Marketing and trading segment purchased power and fuel costs were \$108 million higher in the three months ended March 31, 2003, compared to the same period in the prior year as a result of:

- o increased fuel costs related to generation sales other than Native Load primarily because of higher natural gas prices and higher sales volumes (\$35 million);
- o increased purchased power costs related to other realized marketing activities in the current period primarily due to higher volumes and higher prices (\$53 million);
- o increased purchased power costs related to higher competitive retail sales in California by APS Energy Services (\$22 million); and
- o change in mark-to-market fuel costs for future delivery (\$2 million decrease).

OTHER INCOME STATEMENT ITEMS

The decrease in real estate segment gross margin of \$2 million was primarily due to lower land sales. In addition, as discussed in "Real Estate Activities" below and Note 19, SunCor had an \$8 million (\$5 million after tax) gain on the sale of its water utility company which was reported as income from discontinued operations in the three months ended March 31, 2003.

The increase in other gross margin of \$5 million was primarily due to NAC's settlement of a contract dispute involving Maine Yankee Atomic Power Company. See Note 12.

The increase in operations and maintenance expense of \$16 million was due to increased operating costs related to the timing of power plant overhauls, increased pension and other postretirement benefit costs, new power plants in service and other costs.

The increase in depreciation and amortization expense of \$6 million primarily related to increased plant balances and new power plants, partially offset by lower regulatory asset amortization.

Net interest expense increased \$7 million primarily because of higher debt balances related to our generation construction program and lower capitalized interest on our generation construction program due to completion of Redhawk Units 1 and 2 in mid-2002.

OPERATING RESULTS - TWELVE-MONTH PERIOD ENDED MARCH 31, 2003 COMPARED WITH TWELVE-MONTH PERIOD ENDED MARCH 31, 2002

Our consolidated net income for the twelve months ended March 31, 2003 was \$121 million compared with \$306 million for the prior year. Included in the 2003 period was a \$66 million after tax charge for the cumulative effect of a change in accounting for trading activities for the early adoption of EITF 02-3 on October 1, 2002 and \$14 million of after tax income related to certain discontinued operations in our real estate segment (see "Real Estate Activities" below). Included in the 2002 period was a \$12 million after tax charge for the cumulative effect of a change in accounting for derivatives, as required by SFAS No. 133.

Our income from continuing operations for the twelve months ended March 31, 2003 was \$173 million compared with \$317 million for the prior year. The period-to-period decrease of \$144 million was primarily due to:

- o lower earnings contributions from our marketing and trading activities, reflecting lower liquidity and lower price volatility in the wholesale power markets in the western United States, partially offset by lower mark-to-market reversals due to the adoption of EITF 02-3 (\$104 million, after tax);

- o losses related to our investment in NAC (\$32 million, after tax);

- o higher operations and maintenance expenses related to the Redhawk Units 3 and 4 cancellation charge and 2002 severance costs, partially offset by lower generation reliability costs (\$32 million, after tax);

- o higher depreciation, operations and maintenance, and interest expenses related to new power plants in service (\$27 million, after tax);

- o higher pension and other postretirement benefit costs (\$7 million, after tax); and

- o miscellaneous factors, net (\$4 million, after tax).

The above decreases were partially offset by:

- o increased earnings contributions from our regulated electricity activities, reflecting lower replacement power costs for power plant outages, retail customer growth and higher average usage per customer, partially offset by the effects of milder weather and retail electricity price decreases (\$41 million, after tax); and

- o higher competitive retail sales in California by APS Energy Services (\$21 million, after tax).

For additional details, see the following discussion.

The major factors that increased (decreased) income from continuing operations were as follows (dollars in millions):

	Increase (Decrease)

Regulated electricity segment gross margin:	
Lower replacement power costs from plant outages due to lower market prices and fewer unplanned outages	\$ 74
Higher retail sales volumes due to customer growth and higher average usage, excluding weather effects	43
Effects of milder weather on retail sales	(40)
Retail electricity price reductions effective July 1, 2001 and July 1, 2002	(27)
2001 charges related to purchase power contracts with Enron	13
Increased purchased power and fuel costs due to higher hedged gas and power prices	(4)
Change in mark-to-market for hedged natural gas and purchased power costs for future delivery	15
Miscellaneous factors, net	(6)

Net increase in regulated electricity segment gross margin	68

Marketing and trading segment gross margin:	
Decrease in generation sales other than Native Load due to lower market prices, partially offset by higher sales volumes	(19)
Lower realized wholesale margins net of related mark-to-market reversals due to lower prices, partially offset by higher volumes	(68)
More competitive retail sales in California by APS Energy Services	35
Lower mark-to-market reversals due to the adoption of EITF 02-3	16
Lower mark-to-market gains for future delivery due to lower market liquidity and lower price volatility	(103)

Net decrease in marketing and trading segment gross margin	(139)

Net decrease in regulated electricity and marketing and trading segments' gross margins	(71)
Lower real estate segment gross margin primarily due to commercial and property management sales, partially offset by higher home and land sales (see "Real Estate Activities" below and Note 19)	(4)
Lower other gross margin primarily related to NAC losses (see Note 12)	(40)
Higher operations and maintenance expense related primarily to a \$47 million write-off of Redhawk Units 3 and 4 and 2002 severance costs of approximately \$36 million, partially offset by lower generation reliability costs	(78)
Higher depreciation primarily related to increased plant balances and new power plants, partially offset by lower regulatory asset amortization	(7)
Higher taxes other than income taxes due to increased property taxes on higher property balances	(7)
Lower other income primarily due to a 2001 insurance recovery of environmental remediation costs	(11)
Higher net interest expense primarily due to higher debt balances and lower capitalized interest	(25)
Miscellaneous factors, net	1

Net decrease in income from continuing operations before income taxes	(242)
Lower income taxes primarily due to lower income	98

Net decrease in income from continuing operations	\$ (144)
	=====

REGULATED ELECTRICITY SEGMENT GROSS MARGIN

Regulated electricity segment revenues related to our regulated retail and wholesale electricity businesses were \$512 million lower in the twelve months ended March 31, 2003, compared with the same period in the prior year as a result of:

- o decreased revenues related to traditional wholesale sales as a result of lower prices and lower sales volumes (\$39 million);
- o decreased revenues related to retail load hedge management wholesale sales, primarily as a result of lower prices and lower sales volumes (\$449 million);
- o decreased retail revenues related to milder weather (\$63 million);
- o increased retail revenues related to customer growth and higher average usage, excluding weather effects (\$67 million);
- o decreased retail revenues related to reductions in retail electricity prices (\$27 million); and
- o other miscellaneous factors (\$1 million net decrease).

Regulated electricity segment purchased power and fuel costs were \$580 million lower in the twelve months ended March 31, 2003, compared with the same period in the prior year as a result of:

- o decreased costs related to traditional wholesale sales as a result of lower prices and lower sales volumes (\$39 million);
- o decreased costs related to retail load hedge management wholesale sales, primarily as a result of lower prices and lower sales volumes (\$445 million);
- o charges in 2001 related to purchased power contracts with Enron and its affiliates (\$13 million net decrease);
- o decrease in mark-to-market for hedged natural gas and purchased power costs for future delivery (\$15 million);
- o decreased costs related to the effects of milder weather on retail sales (\$23 million);
- o increased costs related to retail sales growth, excluding weather effects (\$24 million);
- o decreased replacement power costs for power plant outages due to lower market prices and fewer unplanned outages (\$74 million); and
- o miscellaneous factors (\$5 million net increase).

MARKETING AND TRADING SEGMENT GROSS MARGIN

Marketing and trading segment revenues were \$56 million lower in the twelve months ended March 31, 2003, compared with the same period in the prior year as a result of:

- o increased revenues from generation sales other than Native Load primarily due to higher sales volumes, partially offset by lower market prices (\$17 million);

- o lower realized wholesale revenues net of related mark-to-market reversals primarily due to lower prices partially offset by higher volumes (\$112 million);
- o increased revenues from higher competitive retail sales in California by APS Energy Services (\$124 million);
- o higher revenues related to the adoption of EITF 02-3 (\$16 million); and
- o lower mark-to-market gains for future delivery primarily as a result of lower market liquidity and lower price volatility (\$101 million).

Marketing and trading segment purchased power and fuel costs were \$83 million higher in the twelve months ended March 31, 2003, compared to the same period in the prior year as a result of:

- o increased fuel costs related to generation sales other than Native Load primarily because of higher sales volumes (\$36 million);
- o decreased purchased power costs related to other realized marketing activities in the current period primarily due to lower prices partially offset by higher volumes (\$44 million);
- o increased purchased power costs related to higher competitive retail sales in California by APS Energy Services (\$89 million); and
- o change in mark-to-market fuel costs for future delivery (\$2 million increase).

OTHER INCOME STATEMENT ITEMS

The decrease in real estate segment gross margin of \$4 million was primarily due to lower commercial and property management sales partially offset by higher home and land sales activities. In addition, as discussed in "Real Estate Activities" below and Note 19, SunCor had a \$23 million (\$14 million after tax) gain on the sale of its water utility company and a retail center which was reported as income from discontinued operations in the twelve months ended March 31, 2003.

The decrease in other gross margin of \$40 million was primarily due to losses on El Dorado's investment in NAC. Losses for the twelve month period ended March 31, 2003 totaled approximately \$55 million on a pretax basis and were primarily related to NAC contracts with two customers (\$47 million was recorded in other gross margin and \$8 million was recorded in other expense). We reversed \$5 million of loss reserves in the first quarter of 2003 related to NAC's contract settlement. We believe we have reserved our exposure with respect to these contracts in all material respects and, as a result, we consider these charges to be non-recurring. See Note 12.

The increase in operations and maintenance expense of \$78 million was due to a \$47 million write-off related to the cancellation of Redhawk Units 3 and 4, severance costs of \$36 million related to a 2002 voluntary workforce reduction, increased pension and other postretirement benefit costs of \$12 million and other costs of \$13 million, partially offset by lower costs related to generation reliability, plant outages and maintenance costs of \$30 million.

The increase in depreciation and amortization expense of \$7 million primarily related to increased plant balances and new power plants, partially offset by lower regulatory amortization.

The increase in taxes other than income taxes of \$7 million is primarily due to increased property taxes on higher property balances.

Other income decreased \$11 million primarily due to an insurance recovery recorded in 2001 related to environmental remediation costs and other costs.

Net interest expense increased \$25 million primarily because of higher debt balances related to our generation construction program and lower capitalized interest on our generation construction program due to completion of Redhawk Units 1 and 2 in mid-2002.

REAL ESTATE ACTIVITIES

As discussed in our 2002 10-K, we have undertaken an aggressive effort to accelerate asset sales activities to approximately double SunCor's annual earnings in 2003 to 2005 compared with the \$19 million in earnings recorded in 2002.

Certain components of SunCor's real estate sales activities, which are included in the real estate segment, may be required to be reported as discontinued operations on our Consolidated Statements of Income in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Among other things, SFAS No. 144 prescribes accounting for discontinued operations and defines certain real estate activities as discontinued operations. We adopted SFAS No. 144 effective January 1, 2002 and determined that activities that would have required discontinued operations reporting in 2002, 2001 and 2000 were immaterial. We currently estimate that 20% to 40% of SunCor's net income in 2003 will be reported in discontinued operations; however, this ultimately depends on the specific properties sold.

In the first quarter of 2003, SunCor sold its water utility company, which resulted in an after tax gain of \$5 million (\$8 million pretax). The gain on the sale and operating income in the current and prior periods are classified as discontinued operations on our Condensed Consolidated Statements of Income.

In the second quarter of 2002, SunCor sold a retail center, but maintained a significant continuing involvement through a management contract. In the first quarter of 2003, this management contract was canceled. As a result, the gain on the 2002 sale and the operating income related to this property have been reclassified as discontinued operations. The income from discontinued operations of \$14 million (after income taxes) in the twelve months ended March 31, 2003 primarily reflects this sale and the sale of the water utility company.

The following chart provides a summary of SunCor's earnings (after income taxes) for the three and twelve months ended March 31, 2003 and the comparable prior periods (dollars in millions):

	Three Months Ended March 31,		Twelve Months Ended March 31,	
	2003	2002	2003	2002
Income from continuing operations	\$ 1	\$ 1	\$ 9	\$ 4
Income from discontinued operations	5	1	14	1
Net income	\$ 6	\$ 2	\$ 23	\$ 5

LIQUIDITY AND CAPITAL RESOURCES

CAPITAL EXPENDITURE REQUIREMENTS

The following table summarizes the actual capital expenditures for the three months ended March 31, 2003 and estimated capital expenditures for the next three years (dollars in millions):

	Three Months Ended March 31,	Estimated		
	2003	2003	2004	2005
APS				
Delivery	\$ 73	\$ 273	\$ 275	\$ 329
Generation (a)	35	123	99	164
Other	1	5	5	5
Subtotal	109	401	379	498
Pinnacle West Energy (a) (b)	61	268	31	20
SunCor (c)	15	64	23	20
Other (d)	5	17	13	14
Total	\$ 190	\$ 750	\$ 446	\$ 552

(a) As discussed in Note 5 under "APS General Rate Case and Retail Rate Adjustment Mechanisms," as part of its 2003 general rate case, APS intends to seek rate base treatment of certain power plants in Arizona currently owned by Pinnacle West Energy (specifically, Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3).

(b) See "Capital Resources and Cash Requirements - Pinnacle West Energy" below for further discussion of Pinnacle West Energy's generation construction program. These amounts do not include an expected reimbursement in 2004 by SNWA of about \$100 million, assuming SNWA exercises its option to purchase a 25% interest in the Silverhawk project at that time.

(c) Consists primarily of capital expenditures for land development and retail and office building construction reflected in the "Change in real estate investments" in the Condensed Consolidated Statements of Cash Flows.

(d) Primarily related to the parent company and APS Energy Services.

Delivery capital expenditures are comprised of T&D infrastructure additions and upgrades, capital replacements, new customer construction and related information systems and facility costs. Examples of the types of projects

included in the forecast include T&D lines and substations, line extensions to new residential and commercial developments and upgrades to customer information systems. In addition, APS began several major transmission projects in 2001. These projects are periodic in nature and are driven by strong regional customer growth. APS expects to spend about \$105 million on major transmission projects during the 2003 to 2005 time frame, and these amounts are included in "APS-Delivery" in the table above.

Generation capital expenditures are comprised of various improvements for APS' existing fossil and nuclear plants and the replacement of Palo Verde steam generators. Examples of the types of projects included in this category are additions, upgrades and capital replacements of various power plant equipment such as turbines, boilers and environmental equipment. Generation also contains nuclear fuel expenditures of approximately \$30 million annually for 2003 to 2005.

Replacement of the steam generators in Palo Verde Unit 2 is presently scheduled for completion during the fall outage of 2003. The Palo Verde owners have approved the manufacture of two additional sets of steam generators. We expect that these generators will be installed in Units 1 and 3 in the 2005 to 2007 time frame. Our portion of steam generator expenditures for Units 1, 2 and 3 is approximately \$145 million, which will be spent from 2003 through 2008. In 2003 through 2005, \$94 million of the costs are included in the generation capital expenditures table above and would be funded with internally-generated cash or external financings.

CAPITAL RESOURCES AND CASH REQUIREMENTS

CONTRACTUAL OBLIGATIONS The following table summarizes actual contractual requirements for the three months ended March 31, 2003 and estimated contractual commitments for the next five years and thereafter (dollars in millions):

	Actual		Estimated					There- after
	Three Months Ended March 31, 2003	2003	2004	2005	2006	2007		
Long-term debt payments:								
APS	\$ --	\$ --	\$ 205	\$ 400	\$ 84	\$ --	\$ 1,518	
Pinnacle West	--	275	215	--	300	--	--	
SunCor	33	--	106	--	3	--	2	
El Dorado	--	1	1	1	--	--	--	
Total long-term debt payments	33	276	527	401	387	--	1,520	
Capital lease payments	1	5	5	4	3	3	6	
Operating lease payments	5	70	66	64	63	63	478	
Purchase power and fuel commitments	64	202	85	28	31	17	162	
Total contractual commitments	\$ 103	\$ 553	\$ 683	\$ 497	\$ 484	\$ 83	\$ 2,166	

OFF-BALANCE SHEET ARRANGEMENTS

In January 2003, the FASB issued FIN No. 46, "Consolidation of Variable Interest Entities." FIN No. 46 requires that we consolidate a VIE if we have a majority of the risk of loss from the VIE's activities or we are entitled to receive a majority of the VIE's residual returns or both. A VIE is a corporation, partnership, trust or any other legal structure that either does not have equity investors with voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN No. 46 is effective immediately for any VIE created after January 31, 2003 and is effective July 1, 2003 for VIEs created before February 1, 2003.

In 1986, APS entered into agreements with three separate SPE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. Based on our preliminary assessment of FIN No. 46, we do not believe we will be required to consolidate the Palo Verde SPEs. However, we continue to evaluate the requirements of the new guidance to determine what impact, if any, it will have on our financial statements.

APS is exposed to losses under the Palo Verde sale-leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of March 31, 2003, APS would have been required to assume approximately \$285 million of debt and pay the equity participants approximately \$200 million.

GUARANTEES

We and certain of our subsidiaries have issued guarantees and letters of credit in support of our unregulated businesses. We have also obtained surety bonds on behalf of APS Energy Services. We have not recorded any liability on our Condensed Consolidated Balance Sheets with respect to these obligations. See Note 17 for additional information regarding guarantees.

CREDIT RATINGS

The ratings of securities of Pinnacle West and APS as of May 12, 2003 are shown below and are considered to be "investment-grade" ratings. The ratings reflect the respective views of the rating agencies, from which an explanation of the significance of their ratings may be obtained. There is no assurance that these ratings will continue for any given period of time. The ratings may be revised or withdrawn entirely by the rating agencies, if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely affect the market price of Pinnacle West's or APS' securities and serve to increase those companies' cost of and access to capital. All of Pinnacle West's and APS' credit ratings remain investment grade.

	Moody's -----	Standard & Poor's -----	Fitch -----
PINNACLE WEST			
Senior unsecured	Baa2	BBB-	BBB
Commercial paper	P-2	A-2	F-2
APS			
Senior secured	A3	A-	A-
Senior unsecured	Baa1	BBB	BBB+
Secured lease			
obligation bonds	Baa2	BBB	BBB
Commercial paper	P-2	A-2	F-2
OUTLOOK	Stable	Stable	Negative (a)

(a) This rating affects all of the above debt ratings with the exception of our commercial paper rating.

DEBT PROVISIONS

Pinnacle West's and APS' significant debt covenants related to their respective financing arrangements include a debt-to-total-capitalization ratio and an interest coverage test. Pinnacle West and APS are in compliance with such covenants and each anticipates it will continue to meet all the significant covenant requirement levels. The ratio of debt to total capitalization cannot exceed 65% for both the Company and APS. At March 31, 2003, the ratios are approximately 55% and 49% for the parent company and APS, respectively. The provisions regarding interest coverage require a minimum cash coverage of two times the interest requirements for both the Company and APS. The coverages are approximately 4 times for the parent company, 5 times for the APS bank agreements and 14 times for the APS mortgage indenture. Failure to comply with

such covenant levels would result in an event of default which, generally speaking, would require the immediate repayment of the debt subject to the covenants.

Neither Pinnacle West's nor APS' financing agreements contain "ratings triggers" that would result in an acceleration of the required interest and principal payments in the event of a ratings downgrade. However, in the event of a ratings downgrade, Pinnacle West and/or APS may be subject to increased interest costs under certain financing agreements.

All of Pinnacle West's bank agreements contain cross-default provisions that would result in defaults and the potential acceleration of payment under these agreements if Pinnacle West or APS were to default under other agreements. All of APS' bank agreements contain cross-default provisions that would result in defaults and the potential acceleration of payment under these bank agreements if APS were to default under other agreements. Pinnacle West's and APS' credit agreements generally contain provisions under which the lenders could refuse to advance loans in the event of a material adverse change in our financial condition or financial prospects.

PINNACLE WEST (PARENT COMPANY)

Our primary cash needs are for dividends to our shareholders; equity infusions into our subsidiaries, primarily Pinnacle West Energy; and interest payments and optional and mandatory repayments of principal on our long-term debt (see the table above for our contractual requirements, including our debt repayment obligations, but excluding optional repayments). The level of our common dividends and future dividend growth will be dependent on a number of factors including, but not limited to, payout ratio trends, free cash flow and financial market conditions.

Our primary sources of cash are dividends from APS, external financings and cash distributions from our other subsidiaries, primarily SunCor. For the years 2000 through 2002, total dividends from APS were \$510 million and total distributions from SunCor were \$33 million. We expect SunCor to make cash distributions to the parent company of \$80 to \$100 million annually in 2003 through 2005 due to anticipated accelerated asset sales activity.

On November 22, 2002, the ACC issued the Interim Financing Order, which permits APS to (a) make short-term advances to Pinnacle West in the form of an inter-affiliate line of credit in the amount of \$125 million, or (b) guarantee \$125 million of Pinnacle West's short-term debt, subject to certain conditions. As of March 31, 2003, there were no borrowings outstanding under this financing arrangement.

On April 4, 2003, the ACC issued the Financing Order, which permits 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. See "ACC Financing Orders" in Note 5 for additional information.

On May 12, 2003, APS issued \$500 million of debt as follows: \$300 million aggregate principal amount of its 4.650% Notes due 2015 and \$200 million aggregate principal amount of its 5.625% Notes due 2033. Also on May 12, 2003, APS made a \$500 million loan to Pinnacle West Energy, and Pinnacle West Energy distributed the net proceeds of that loan to us to fund our repayment of a portion of the debt incurred to finance the construction of the following Pinnacle West Energy power plants: Redhawk Units 1 and 2, West Phoenix Units 4 and 5, and Saguaro Unit 3. See "ACC Financing Orders" in Note 5 for additional information. With Pinnacle West Energy's distribution to us, on May 12, 2003, we repaid the outstanding balance (\$167 million) under a credit facility. We used a portion of the remaining proceeds to repay our short-term debt, with the balance being temporarily invested pending the planned optional repayment of our \$250 million Floating Rate Notes due 2003.

As part of a multi-employer pension plan sponsored by Pinnacle West, we contribute at least the minimum amount required under IRS regulations, but no more than the maximum tax-deductible amount. The minimum required funding takes into consideration the value of the fund assets and our pension obligation. We elected to contribute cash to our pension plan in each of the last five years; our minimum required contributions during each of those years was zero. Specifically, we contributed \$27 million for 2002, \$24 million for 2001, \$44 million for 2000, \$25 million for 1999 and \$14 million for 1998. APS and other subsidiaries fund their share of the pension contribution, of which APS represents approximately 90% of the total funding amounts described above. The assets in the plan are mostly domestic common stocks, bonds and real estate. We currently forecast a pension contribution in 2003 of approximately \$50 million, all or part of which may be required. If the fund performance continues to decline as a result of a continued decline in equity markets, larger contributions may be required in future years.

APS

APS' capital requirements consist primarily of capital expenditures and optional and mandatory redemptions of long-term debt. See "Business Outlook - Regulatory Matters" below and Notes 4 and 5 for discussion of the \$500 million financing arrangement between APS and Pinnacle West Energy authorized by the ACC pursuant to the Financing Order and APS' related issuance of \$500 million of debt. See "Pinnacle West (Parent Company)" above and Note 5 for discussion of a \$125 million interim financing arrangement between APS and Pinnacle West.

APS pays for its capital requirements with cash from operations and, to the extent necessary, external financings. APS has historically paid for its dividends to Pinnacle West with cash from operations.

In March 2003, APS deposited monies with its first mortgage bond trustee to redeem the entire \$33 million of outstanding First Mortgage Bonds, 8% Series due 2025 and the entire \$54 million of outstanding First Mortgage Bonds, 7.25% Series due 2023. On April 7, 2003, APS redeemed \$33 million of its First Mortgage Bonds, 8% Series due 2025. APS will redeem \$54 million of its First Mortgage Bonds, 7.25% Series due 2023, on August 1, 2003.

Although provisions in APS' first mortgage bond indenture, articles of incorporation and ACC financing orders establish maximum amounts of additional first mortgage bonds, debt and preferred stock that APS may issue, APS does not expect any of these provisions to limit its ability to meet its capital requirements.

PINNACLE WEST ENERGY

The costs of Pinnacle West Energy's construction of generating capacity from 2000 through 2004 are expected to be about \$1.4 billion. This does not reflect an expected reimbursement in 2004 by SNWA of about \$100 million of Pinnacle West Energy's cumulative capital expenditures in the Silverhawk project, assuming SNWA exercises its option to purchase a 25% interest in the project. Pinnacle West Energy is currently funding its capital requirements through capital infusions from Pinnacle West, which finances those infusions through debt and equity financings and internally-generated cash. See the capital expenditures table above for actual capital expenditures in the three months ended March 31, 2003 and projected capital expenditures for the next three years.

Pinnacle West Energy's generation construction plan is as follows:

- o A 650 MW combined cycle expansion of the West Phoenix Power Plant in Phoenix. The 120 MW West Phoenix Unit 4 began commercial operation in June 2001. The 530 MW West Phoenix Unit 5 is expected to begin commercial operation in mid-2003.
- o Development of the 570 MW Silverhawk combined-cycle plant 20 miles north of Las Vegas, Nevada. Construction of the plant began in August 2002, with an expected commercial operation date of mid-2004. Pinnacle West Energy has signed an agreement with Las Vegas-based SNWA under which SNWA has an option to purchase a 25% interest in the project for approximately \$100 million.
- o A Pinnacle West Energy affiliate is exploring the possibility of creating an underground natural gas storage facility on Company-owned land west of Phoenix. An analysis to determine the feasibility of the project is in progress.

See Notes 4 and 5 and "Pinnacle West (Parent Company)" above for a discussion of the \$500 million financing arrangement between APS and Pinnacle West Energy authorized by the ACC pursuant to the Financing Order.

OTHER SUBSIDIARIES

During the past three years, SunCor funded its cash requirements with cash from operations and its own external financings. SunCor's capital needs consist primarily of capital expenditures for land development and retail and office building construction. See the capital expenditures table above for actual capital expenditures in the three months ended March 31, 2003 and projected capital expenditures for the next three years. SunCor expects to fund its capital requirements with cash from operations and external financings.

We expect SunCor to make cash distributions to the parent company of \$80 to \$100 million annually in 2003 through 2005 due to anticipated accelerated asset sales activity. See "Real Estate Activities" above and Note 19.

El Dorado funded its cash requirements during the past three years, primarily for NAC in 2002, with cash infused by the parent company and with cash from operations. El Dorado expects minimal capital requirements over the next three years.

APS Energy Services' cash requirements during the past three years were funded with cash infusions from the parent company. APS Energy Services' capital expenditures and other cash requirements are increasingly funded by operations, with some funding from cash infused by Pinnacle West. See the capital expenditures table above regarding APS Energy Services' actual capital expenditures for the three months ended March 31, 2003 and projected capital expenditures for the next three years.

CRITICAL ACCOUNTING POLICIES

In preparing the financial statements in accordance with GAAP, management must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex, and actual results could differ from those estimates. Our most critical accounting policies include the impacts of regulatory accounting and the determination of the appropriate accounting for our pension and other postretirement benefits, derivatives and mark-to-market accounting. There have been no changes to our critical accounting policies since our 2002 10-K except for the discussion contained herein related to SFAS No. 143 (see Note 13). See "Critical Accounting Policies" in Item 7 of the 2002 10-K for further details about our critical accounting policies.

BUSINESS OUTLOOK

In this section we discuss a number of factors affecting our business outlook.

REGULATORY MATTERS

See "Electric Industry Restructuring - State" in Note 5 for a discussion of ACC regulatory matters, including the implementation of the Track B competitive procurement process and APS' upcoming general rate case.

WHOLESALE POWER MARKET CONDITIONS

The marketing and trading division, which we moved to APS in early 2003 for future marketing and trading activities (existing wholesale contracts will remain at Pinnacle West) as a result of the ACC's Track A Order prohibiting APS' transfer of generating assets to Pinnacle West Energy, focuses primarily on managing APS' purchased power and fuel risks in connection with its costs of serving retail customer demand. Additionally, the marketing and trading division, subject to specified parameters, markets, hedges and trades in electricity, fuels and emission allowances and credits. Our future earnings will be affected by the strength or weakness of the wholesale power market.

GENERATION CONSTRUCTION PLAN

See "Liquidity and Capital Resources - Pinnacle West Energy" for information regarding Pinnacle West Energy's generation construction plan. The planned additional generation is expected to increase revenues, fuel expenses, operating expenses and financing costs.

FACTORS AFFECTING OPERATING REVENUES

GENERAL Electric operating revenues are derived from sales of electricity in regulated retail markets in Arizona and from competitive retail and wholesale bulk power markets in the western United States. These revenues are expected to be affected by electricity sales volumes related to customer mix, customer growth and average usage per customer as well as electricity prices and variations in weather from period to period. Competitive sales of energy and energy-related products and services are made by APS Energy Services in western states that have opened to competitive supply.

CUSTOMER GROWTH Customer growth in APS' service territory averaged about 3.6% a year for the three years 2000 through 2002; we currently expect customer growth to average about 3.5% per year from 2003 to 2005. We currently estimate that retail electricity sales in kilowatt-hours will grow 3.5% to 5.5% a year in 2003 through 2005, before the retail effects of weather variations. The customer and sales growth referred to in this paragraph applies to energy delivery customers.

RETAIL RATE REDUCTIONS. As part of the 1999 Settlement Agreement, APS agreed to 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%. The final price reduction is to be implemented July 1, 2003. See "1999 Settlement Agreement" in Note 5 for further information.

OTHER FACTORS AFFECTING FUTURE FINANCIAL RESULTS

PURCHASED POWER AND FUEL COSTS Purchased power and fuel costs are impacted by our electricity sales volumes, existing contracts for purchased power and generation fuel, our power plant performance, prevailing market prices, new generating plants being placed in service and our hedging program for managing such costs.

OPERATIONS AND MAINTENANCE EXPENSES Operations and maintenance expenses are expected to be affected by sales mix and volumes, power plant additions and

operations, inflation, outages, higher trending pension and other postretirement benefit costs and other factors. In July 2002, we implemented a voluntary workforce reduction as part of our cost reduction program. We recorded \$36 million before taxes in voluntary severance costs in the second half of 2002.

DEPRECIATION AND AMORTIZATION EXPENSES Depreciation and amortization expenses are expected to be affected by net additions to existing utility plant and other property, changes in regulatory asset amortization and our generation construction program. West Phoenix Unit 4 was placed in service in June 2001. Redhawk Units 1 and 2 and the new Saguaro Unit 3 began commercial operations in July 2002. West Phoenix Unit 5 is expected to be on line in mid-2003 and Silverhawk is expected to be in service in mid-2004. The regulatory assets to be recovered under the 1999 Settlement Agreement are currently being amortized as follows (dollars in millions):

1999	2000	2001	2002	2003	2004	Total
----	----	----	----	----	----	-----
\$164	\$158	\$145	\$115	\$ 86	\$ 18	\$686

PROPERTY TAXES Taxes other than income taxes consist primarily of property taxes, which are affected by tax rates and the value of property in-service and under construction. The average property tax rate for APS, which currently owns the majority of our property, was 9.7% of assessed value for 2002 and 9.3% for 2001. We expect property taxes to increase primarily due to our generation construction program and our additions to existing facilities.

INTEREST EXPENSE Interest expense is affected by the amount of debt outstanding and the interest rates on that debt. The primary factors affecting borrowing levels in the next several years are expected to be our capital requirements and our internally generated cash flow. Capitalized interest offsets a portion of interest expense while capital projects are under construction. We stop recording capitalized interest on a project when it is placed in commercial operation. As noted above, we have placed new power plants in commercial operation in 2001 and 2002 and we expect to bring additional plants on-line in 2003 and 2004. Interest expense is also affected by interest rates on variable-rate debt and interest rates on the refinancing of the Company's future liquidity needs.

RETAIL COMPETITION The regulatory developments and legal challenges to the Rules discussed in Note 5 have raised considerable uncertainty about the status and pace of retail electric competition 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.

SUBSIDIARIES In the case of SunCor, we are undertaking an aggressive effort to accelerate asset sales activities to approximately double SunCor's annual earnings in 2003 to 2005 compared to the \$19 million in earnings recorded in 2002. A portion of these sales have been, and additional amounts may be required to be, reported as discontinued operations on the Condensed Consolidated Statements of Income. See "Real Estate Activities" above and Note 19 for further discussion.

The annual earnings contribution from APS Energy Services is expected to be positive over the next several years due primarily to a number of retail electricity contracts in California. APS Energy Services' had pretax earnings of \$28 million in 2002.

El Dorado's historical results are not necessarily indicative of future performance for El Dorado. In addition, we do not expect material losses for the year 2003 related to NAC.

GENERAL Our financial results may be affected by a number of broad factors. See "Forward-Looking Statements" below for further information on such factors, which may cause our actual future results to differ from those we currently seek or anticipate.

RISK FACTORS

Exhibit 99.4, which is hereby incorporated by reference, contains a discussion of risk factors involving the Company.

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements based on current expectations and we assume no obligation to update these statements or make any further statements on any of these issues, except as required by applicable law. Because actual results may differ materially from expectations, we caution readers not to place undue reliance on these statements. A number of factors could cause future results to differ materially from historical results or from results or outcomes currently expected or sought by us. These factors include the ongoing restructuring of the electric industry, including the introduction of retail electric competition in Arizona and decisions impacting wholesale competition; the outcome of regulatory and legislative proceedings relating to the restructuring; state and federal regulatory and legislative decisions and actions, including price caps and other market constraints imposed by the FERC; regional economic and market conditions, including the California energy situation and completion of generation and transmission construction in the region, which could affect customer growth and the cost of power supplies; the cost of debt and equity capital and access to capital markets; weather variations affecting local and regional customer energy usage; the effect of conservation programs on energy usage; power plant performance; the successful completion of our generation construction program; regulatory issues associated with generation construction, such as permitting and licensing; our ability to compete successfully outside traditional regulated markets (including the wholesale market); our ability to manage our marketing and trading activities and the use of derivative contracts in our business; technological developments in the electric industry; the performance of the stock market, which affects the amount of our required contributions to our pension plan and nuclear decommissioning trust funds; the strength of the real estate market in SunCor's market areas, which include Arizona, New Mexico and Utah; and other uncertainties, all of which are difficult to predict and many of which are beyond our control.

ITEM 3. MARKET RISKS

Our operations include managing market risks related to changes in interest rates, commodity prices and investments held by the nuclear decommissioning trust fund and our pension plans.

COMMODITY PRICE RISK

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 derivatives, including exchange-traded futures and options and over-the-counter forwards, options and swaps. The ERM, consisting of senior officers, oversees company-wide energy risk management activities and monitors the results of marketing and trading activities to ensure compliance with our stated energy risk management and trading policies. As part of our risk management program, we enter into derivative transactions to hedge purchases and sales of electricity, fuels, and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities. In addition, subject to specified risk parameters monitored by the ERM, we engage in marketing and trading activities intended to profit from market price movements.

We adopted the EITF 02-3 guidance for all contracts in the fourth quarter of 2002. Our energy trading contracts that are derivatives are accounted for at fair value under SFAS No. 133. Contracts that do not meet the definition of a derivative are accounted for on an accrual basis with the associated revenues and costs recorded at the time the contracted commodities are delivered or received. Additionally, 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 Condensed Consolidated Statements of Income on a net basis. Derivative instruments used for non-trading activities are accounted for in accordance with SFAS No. 133. See Note 10 for details on the change in accounting for energy trading contracts.

Both non-trading and trading derivatives are classified as assets and liabilities from risk management and trading activities in the Condensed Consolidated Balance Sheets. For non-trading derivative instruments that qualify for hedge accounting treatment, changes in the fair value of the effective portion are recognized in common stock equity (as a component of accumulated other comprehensive income (loss)). Non-trading derivatives, or any portion thereof, that are not effective hedges are adjusted to fair value through income. Gains and losses related to non-trading derivatives that qualify as cash flow hedges of expected transactions are recognized in revenue or purchased power and fuel expense as an offset to the related item being hedged when the underlying hedged physical transaction impacts earnings. If it becomes probable that a forecasted transaction will not occur, we discontinue the use of hedge accounting and recognize in income the unrealized gains and losses that were previously recorded in other comprehensive income (loss). In the event a non-trading derivative is terminated or settled, the unrealized gains and losses remain in other comprehensive income (loss) and are recognized in income when the underlying transaction impacts earnings.

Derivatives associated with trading activities are adjusted to fair value through income. Derivative commodity contracts for the physical delivery of purchase and sale quantities transacted in the normal course of business are exempt from the requirements of SFAS No. 133 under the normal purchase and sales exception and are not reflected on the balance sheet at fair value. Most of our non-trading electricity purchase and sales agreements qualify as normal purchases and sales and are exempted from recognition in the financial statements until the electricity is delivered.

Our assets and liabilities from risk management and trading activities are presented in two categories consistent with our business segments:

o System - our regulated electricity business segment, which consists of non-trading derivative instruments that hedge our purchases and sales of electricity and fuel for our Native Load requirements; and

o Marketing and Trading - our non-regulated, competitive business segment, which includes both non-trading and trading derivative instruments.

The following tables show the changes in mark-to-market of our system and marketing and trading derivative positions for the three months ended March 31, 2003 and 2002 (dollars in millions):

	Three Months Ended March 31, 2003		Three Months Ended March 31, 2002	
	System	Marketing and Trading	System	Marketing and Trading
Mark-to-market of net positions at beginning of period	\$ (49)	\$ 57	\$ (107)	\$ 138
Change in mark-to-market gains (losses) for future period deliveries	5	(8)	(1)	25
Changes in cash flow hedges recorded in OCI	13	13	44	--
Ineffective portion of changes in fair value recorded in earnings	2	1	(2)	--
Mark-to-market losses/(gains) realized during the period	6	(7)	5	(22)
Mark-to-market of net positions at end of period	\$ (23)	\$ 56	\$ (61)	\$ 141

The Company no longer reports non-derivative energy contracts or physical inventories at fair value. Since July 1, 2002, the Company has not recognized a dealer profit or unrealized gain or loss at the inception of a derivative unless the fair value of that instrument (in its entirety) is evidenced by quoted market prices or current market transactions. Prior to the change in our policy, we recorded net gains at inception of \$8 million in the three months ended March 31, 2002. These amounts included a reasonable marketing margin. No net gains at inception were recorded in the three months ended March 31, 2003.

The tables below show the maturities of our system and marketing and trading derivative positions at March 31, 2003 by the type of valuation that is performed to calculate the fair value of the contract (dollars in millions). See "Critical Accounting Policies - Mark-to-Market Accounting" in Item 7 of our 2002 10-K for more discussion on our valuation methods.

SYSTEM

Source of Fair Value	2003	2004	2005	2006	2007	Years thereafter	Total fair value
Prices actively quoted	\$ --	\$ (11)	\$ --	\$ --	\$ --	\$ --	\$ (11)
Prices provided by other external sources	(3)	(9)	--	--	--	--	(12)
Prices based on models and other valuation methods	--	--	--	--	--	--	--
Total by maturity	\$ (3)	\$ (20)	\$ --	\$ --	\$ --	\$ --	\$ (23)

MARKETING AND TRADING

Source of Fair Value	2003	2004	2005	2006	2007	Years thereafter	Total fair value
Prices actively quoted	\$ 19	\$ 4	\$ 6	\$ 4	\$ 3	\$ 7	\$ 43
Prices provided by other external sources	(4)	11	4	(4)	--	--	7
Prices based on models and other valuation methods	(3)	2	1	8	3	(5)	6
Total by maturity	\$ 12	\$ 17	\$ 11	\$ 8	\$ 6	\$ 2	\$ 56

The table below shows the impact hypothetical price movements of 10% would have on the market value of our risk management and trading assets and liabilities included on the Condensed Consolidated Balance Sheets at March 31, 2003 and 2002 (dollars in millions).

Commodity	March 31, 2003		March 31, 2002	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Mark-to-market changes reported in earnings (a):				
Electricity	\$ --	\$ 1	\$ (2)	\$ 2
Natural gas	(3)	3	(1)	1
Other	1	--	1	(1)
Mark-to-market changes reported in OCI (b):				
Electricity	32	(32)	--	--
Natural gas	23	(22)	26	(24)
Total	\$ 53	\$ (50)	\$ 24	\$ (22)

(a) These contracts are structured sales activities hedged with a portfolio of forward purchases that protects the economic value of the sales transactions.

(b) These contracts are hedges of our forecasted purchases of natural gas and electricity. The impact of these hypothetical price movements would substantially offset the impact that these same price movements would have on the physical exposures being hedged.

CREDIT RISK

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management and trading contracts with many counterparties, including two counterparties for which a worst case exposure represents approximately 40% of our \$207 million of risk management and trading assets as of March 31, 2003. Our risk management process assesses and monitors the financial exposure of these and all other counterparties. Despite the fact that the great majority of trading counterparties are rated as investment grade by the credit rating agencies, including the counterparties noted above, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. Counterparties in the portfolio consist principally of major energy companies, municipalities and local distribution companies. We maintain credit policies that we believe minimize overall credit risk to within acceptable limits. Determination of the credit quality of our counterparties is based upon a number of factors, including credit ratings and our evaluation of their financial condition. In many contracts, we employ collateral requirements and standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. Valuation adjustments are established representing our estimated credit losses on our overall exposure to counterparties. See "Critical Accounting Policies - Mark-to Market Accounting" in Item 7 of our 2002 10-K for more discussion on our valuation methods.

ITEM 4. CONTROLS AND PROCEDURES

As of a date within 90 days of the date of this report (the "Evaluation Date"), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer, and our Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon this evaluation, our Chief Executive Officer, and our Senior Vice President and Chief Financial Officer, concluded that, as of the Evaluation Date, our disclosure controls and procedures were adequate to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation, including any corrective actions with regard to significant deficiencies and internal weaknesses.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 12 of Notes to Condensed Consolidated Financial Statements in Part 1, Item 1 of this report for a discussion of the settlement of the NAC litigation.

ITEM 5. OTHER INFORMATION

CONSTRUCTION AND FINANCING PROGRAMS

See "Liquidity and Capital Resources" in Part I, Item 2 of this report for a discussion of construction and financing programs of the Company and its subsidiaries.

REGULATORY MATTERS

See Note 5 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report for a discussion of regulatory developments.

ENVIRONMENTAL MATTERS

The EPA had previously advised APS that the EPA considers APS to be a "potentially responsible party" in the Indian Bend Wash Superfund Site, South Area. See "Environmental Matters - Superfund" in Part I, Item 1 of the 2002 10-K. APS, the EPA, the United States Department of Justice, the Attorney General for the State of Arizona, and ADEQ have reached an agreement (in the form of a Consent Decree) to settle this matter. UNITED STATES OF AMERICA AND STATE OF ARIZONA, EX REL. V. ARIZONA PUBLIC SERVICE COMPANY, Civil Action No.

CIV03-767PHXPGR, In the United States District Court for the District of Arizona. Under the terms of the proposed Consent Decree, APS will pay \$2.72 million. Following the expiration of a thirty (30) day comment period, the Department of Justice will move for the Consent Decree to be approved by the Court, if appropriate in light of any public comment.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit No.	Description
-----	-----
10.1	Employment Agreement dated February 27, 2003 between APS and James M. Levine
10.2	Third Supplemental Indenture dated as of November 1, 2002
10.3	Third Amendment to the Pinnacle West Capital Corporation, Arizona Public Service Company, SunCor Development Company and El Dorado Investment Company Deferred Compensation Plan
12.1	Ratio of Earnings to Fixed Charges
99.1	Certification of William J. Post, the Registrant's principal executive officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.2	Certification of Donald E. Brandt, the Registrant's principal financial officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.3	ACC Decision No. 65796 dated April 4, 2003 (Financing Order)
99.4	Pinnacle West Risk Factors

In addition, the Company hereby incorporates the following Exhibits pursuant to Exchange Act Rule 12b-32 and Regulation ss.229.10(d) by reference to the filings set forth below:

Exhibit No.	Description	Originally Filed as Exhibit:	File No.(a)	Date Effective
3.1	Articles of Incorporation restated as of July 29, 1988	19.1 to the Company's September 30, 1988 Form 10-Q Report	1-8962	11-14-88

(a) Reports filed under File No. 1-8962 were filed in the office of the Securities and Exchange Commission located in Washington, D.C.

3.2	Bylaws, amended as of September 18, 2002 Form 10-Q Report	3.1 to the Company's September 30, 2002	1-8962	11-14-02
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(b) Reports on Form 8-K

During the quarter ended March 31, 2003, and the period from April 1 through May 14, 2003, we filed the following reports on Form 8-K:

Report dated December 31, 2002 regarding an ACC ALJ's recommended Track B order and exhibits comprised of financial information and earnings variance explanations.

Report dated January 15, 2003 regarding NAC losses and Pinnacle West's earnings outlook.

Report dated February 27, 2003 regarding the ACC Track B decision.

Report dated March 11, 2003 regarding an ACC ALJ's recommended approval, subject to certain conditions, of APS' financing application.

Report dated March 27, 2003, regarding ACC approval of the financing application.

Report dated March 31, 2003 containing exhibits comprised of financial information, earnings variance explanations and an earnings news release.

Report dated May 6, 2003 regarding the Track B Order and asset retirement obligations.

Report dated May 13, 2003 comprised of slides presented at analyst meetings.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PINNACLE WEST CAPITAL CORPORATION
(Registrant)

Dated: May 14, 2003

By: Donald E. Brandt

Donald E. Brandt
Senior Vice President and Chief
Financial Officer
(Principal Financial Officer
and Officer Duly Authorized
to sign this Report)

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

CERTIFICATIONS

I, William J. Post, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Pinnacle West Capital Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the period presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003.

William J. Post

William J. Post Title: Chairman of the Board and Chief Executive Officer

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

CERTIFICATIONS

I, Donald E. Brandt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Pinnacle West Capital Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the period presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003.

Donald E. Brandt

Donald E. Brandt Title: Senior Vice President and Chief Financial Officer

Exhibit 10.1

February 27, 2003

Jim Levine
4817 N. Greentree Dr. E.
Litchfield Park, AZ 85340

Dear Jim:

As a supplement to your Employment Agreement dated October 11, 2002 the following clarifies the benefit items that the Pinnacle West Board has approved for you:

o Pension - Add 5 years of service effective 1/2002 and each subsequent year 3% will be added to the percent of average monthly wage you'll receive until the 70% benefit is reached:

- 18 years of service in 2002 ($3\% \times 10 - 30\% + 2\% \times 8 = 16\%$), 46% pension benefit

- 2002 +5 years at 2% 46%
- 2002 +3% 49%
- 2003 +3% 52%
- 2004 +3% 55% age 55
- 2005 +3% 58%
- 2006 +3% 61%
- 2007 +3% 64%
- 2008 +3% 67%
- 2009 +3% 70% age 60

o Additional years of service will count towards the percentage of your premium costs for retiree medical coverage.

If you have any questions, please feel free to contact me.

Sincerely,

William J. Post

WP/DO/ch
cc: Armando Flores

ARIZONA PUBLIC SERVICE COMPANY

TO

THE BANK OF NEW YORK

TRUSTEE

Third Supplemental Indenture

Dated as of November 1, 2002

To

Indenture

Dated as of November 15, 1996

5.05% Senior Notes (Maricopa 2002 Series A) Due 2029

THIRD SUPPLEMENTAL INDENTURE, dated as of November 1, 2002, between Arizona Public Service Company, a corporation duly organized and existing under the laws of the State of Arizona (herein called the "Company"), having its principal office at 400 North Fifth Street, Phoenix, Arizona 85004, and The Bank of New York, a New York banking corporation, as Trustee (herein called the "Trustee") under the Indenture dated as of November 15, 1996 between the Company and the Trustee (the "Indenture").

RECITALS OF THE COMPANY

The Company has executed and delivered the Indenture to the Trustee to provide for the issuance from time to time of its Senior Notes (the "Notes"), said Notes to be issued in one or more series as in the Indenture provided.

The Company has executed and delivered to the Trustee two indentures supplemental to the Indenture, the First Supplemental Indenture dated as of November 15, 1996, and the Second Supplemental Indenture dated as of April 1, 1997 (collectively, the "Supplemental Indentures").

Pursuant to the terms of the Indenture, the Company desires to provide for the establishment of a new series of its Notes to be known as its 5.05% Senior Notes (Maricopa 2002 Series A) Due 2029 (herein called the "Series A Senior Notes"), the form and substance of such Series A Senior Notes and the terms, provisions, and conditions thereof to be set forth as provided in the Indenture and this Third Supplemental Indenture.

The Company has entered into a Loan Agreement, dated as of November 1, 2002 (as amended from time to time, the "Loan Agreement") between the Company and Maricopa County, Arizona Pollution Control Corporation (the "Issuer"), and the Issuer has issued the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 2002 Series A in the aggregate principal amount of \$90,000,000 (the "Series A Pollution Control Bonds") under that certain Indenture of Trust, dated as of November 1, 2002 (as amended from time to time, the "Maricopa Indenture") between the Issuer and The Bank of New York, as Trustee (together with its successors in such capacity, the "Maricopa Trustee") and loaned the proceeds thereof to the Company (the "Loan") to pay a portion of the costs of refunding through redemption of \$45,000,000 aggregate principal amount of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 1994 Series A and \$45,000,000 aggregate principal amount of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 1994 Series B.

All things necessary to make this Third Supplemental Indenture a valid agreement of the Company, and to make the Series A Senior Notes, when executed by the Company and authenticated and delivered by the Trustee, the valid obligations of the Company, have been done.

NOW, THEREFORE, THIS THIRD SUPPLEMENTAL INDENTURE WITNESSETH:

For and in consideration of the premises and the purchase of the Series A Senior Notes by the Holders thereof, and for the purpose of setting forth, as provided in the Indenture, the form and substance of the Series A Senior Notes

and the terms, provisions, and conditions thereof, it is mutually agreed, for the equal and proportionate benefit of all Holders of the Series A Senior Notes, as follows:

ARTICLE ONE

GENERAL TERMS AND CONDITIONS OF THE SERIES A SENIOR NOTES

SECTION 101. There shall be and is hereby authorized a series of Notes designated the "5.05% Senior Notes (Maricopa 2002 Series A) Due 2029," limited in aggregate principal amount to \$90,000,000, which amount shall be as set forth in any Company Order for the authentication and delivery of Series A Senior Notes. The Series A Senior Notes shall mature and the principal shall be due and payable together with all accrued and unpaid interest thereon (subject to the provisions for prior redemption hereinafter set forth) on May 1, 2029, shall be issued in certificated form, in the form of a single fully registered Series A Senior Note without coupons, and shall be registered in the name of the Maricopa Trustee.

SECTION 102. Subject to the provisions herein, the Series A Senior Notes shall bear interest from November 1, 2002 or from the most recent Interest Payment Date (as defined below) to which interest has been paid at the rate of 5.05% per annum (calculated on the basis of a 360-day year of twelve 30-day months), payable on May 1 and November 1 of each year (each an "Interest Payment Date"), commencing May 1, 2003, to the holders thereof of record on the April 15 or October 15, as the case may be, next preceding such Interest Payment Date.

Notwithstanding the above, to the extent required in Section 4.2 of the Loan Agreement at any time, all payments of interest on each Interest Payment Date and of principal on the maturity date of the Series A Senior Notes shall be due and payable not less than two (2) Business Days (as defined in the Maricopa Indenture) prior to each such Interest Payment Date and such maturity date.

SECTION 103. The principal of and interest on the Series A Senior Notes shall be payable by the Company to the Maricopa Trustee as pledgee and assignee of the Issuer, at the designated office of the Maricopa Trustee, which shall initially be in the City of New York, in such coin or currency of the United States of America as, at the respective times of payment, is legal tender for payment of public and private debts.

SECTION 104. The Company shall have no obligation to make payments with respect to the principal and/or interest on the Series A Senior Notes unless and until, and only to the extent that, payments shall be due and payable pursuant to the Series A Pollution Control Bonds. Any provision hereof to the contrary notwithstanding, the Company shall receive a credit against its obligation to make any payment of interest on the Series A Senior Notes in an amount equal to the amount, if any, held by the Maricopa Trustee under the Maricopa Indenture on deposit in the Bond Fund (as defined in the Maricopa Indenture) and available to make the corresponding payment on the Series A Pollution Control Bonds. In addition, the Company shall receive a credit against its obligation to make any payment of principal of the Series A Senior Notes, whether at maturity, upon redemption or otherwise, in an amount equal to the amount, if any, held by the

trustee under the Maricopa Indenture on deposit in said Bond Fund and available to make the corresponding payment on the Series A Pollution Control Bonds.

SECTION 105. In the manner and with the effect provided in Article 12 of the Indenture, the Series A Senior Notes will be subject to redemption prior to maturity, as follows:

(a) Series A Senior Notes are subject to redemption prior to maturity in whole or in part, by lot, at any time at a redemption price equal to the principal amount thereof plus accrued interest to the redemption date, in the event of the exercise by the Company of its rights to prepay the Loan in full or in part in accordance with Section 7.2 of the Loan Agreement upon the occurrence of any of certain extraordinary events specified in Section 4.01(a)(1) of the Maricopa Indenture.

(b) Series A Senior Notes are subject to redemption prior to maturity in whole or in part, by lot, on any date on or after November 1, 2012, in the event of the exercise by the Company of its rights to prepay the Loan in full or in part in accordance with Section 7.2 of the Loan Agreement and Section 4.01(a)(2) of the Maricopa Indenture at 100% of the principal amount of Series A Senior Notes to be redeemed, together with accrued interest to the date fixed for redemption

(c) Series A Senior Notes shall also be redeemable, in whole at any time, prior to maturity by the application of cash delivered to or deposited with the Trustee in the event of the exercise by the Company of its rights to prepay the Loan in full in accordance with Section 7.2 of the Loan Agreement and Section 4.01(a)(3) of the Maricopa Indenture, pursuant to the provisions of Section 87 of the First Mortgage (but only if and to the extent such Section is properly applicable to bona fide transactions), at the principal amount of the Series A Senior Notes to be redeemed together with accrued interest to the date fixed for redemption.

(d) Series A Senior Notes are subject to mandatory redemption prior to maturity in whole or in part, by lot, at a redemption price equal to the principal amount thereof plus accrued interest to the redemption date upon the mandatory prepayment of the Loan in full or in part in accordance with Section 7.3 of the Loan Agreement upon the occurrence of any of certain extraordinary events specified in Section 4.01(b) of the Maricopa Indenture.

Any notice given under the provisions of Section 4.03 of the Maricopa Indenture with respect to redemption of all or a part of the Series A Pollution Control Bonds or Section 7.5 of the Loan Agreement with respect to the prepayment of all or a part of the Loan will also constitute sufficient notice of the redemption of an amount of the Series A Senior Notes corresponding to the amount of the Series A Pollution Control Bonds to be redeemed.

SECTION 106. In all cases that Series A Senior Notes are redeemed pursuant to the provisions set forth above, the principal amount of Series A Senior Notes to be redeemed shall equal the principal amount of Series A Pollution Control Bonds concurrently redeemed and all applicable provisions of the Maricopa Indenture and the Loan Agreement shall be satisfied.

SECTION 107. The cancellation by the Maricopa Trustee under the Maricopa Indenture of Series A Pollution Control Bonds purchased by the Company or of Series A Pollution Control Bonds redeemed or purchased by the Issuer, with funds

other than payments on Series A Senior Notes, shall constitute payment of an amount of the Series A Senior Notes held by the Maricopa Trustee equal to the aggregate principal amount of the Series A Pollution Control Bonds so purchased or redeemed and cancelled. The Maricopa Trustee is required pursuant to Section 4.05 of the Maricopa Indenture to notify the Trustee of any such cancellation, and, notwithstanding the provisions of Section 1207 of the Indenture, the Maricopa Trustee under the Maricopa Indenture shall promptly make notation on the Series A Senior Notes held by it of such reduction of the principal amount thereof.

SECTION 108. Upon payment of the principal of and interest due on the Series A Pollution Control Bonds, whether at maturity or prior to maturity by redemption or otherwise, or upon provision for the payment thereof having been made in accordance with Article X of the Maricopa Indenture, Series A Senior Notes in a principal amount equal to the principal amount of Series A Pollution Control Bonds so paid or for which such provision for payment has been made shall be deemed fully paid, satisfied and discharged and the obligations of the Company thereunder shall be terminated and such Series A Senior Notes shall be surrendered to and cancelled by the Trustee.

SECTION 109. All payments by the Company on the Series A Senior Notes shall be made at or prior to the opening of business on the due date thereof. If the date for making any payment on the Loan provided in the Loan Agreement is a date other than the due date for a payment of principal or interest on the Series A Pollution Control Bonds, as described in Section 4.2 of the Loan Agreement, the "due date" hereunder will be the date payment on the Loan is due under said Section 4.2.

SECTION 110. No Series A Senior Notes shall be issued except to evidence, secure and provide for the repayment of the Loan and interest thereon.

SECTION 111. Series A Senior Notes shall be nonnegotiable and will be nontransferable except as required to effect assignment to the Maricopa Trustee under the Maricopa Indenture and to any successor trustee thereunder. Upon the appointment of a successor trustee under the Maricopa Indenture, the Trustee shall authenticate and the Company shall issue in the name of said successor trustee a new fully registered Series A Senior Note in the amount of the unpaid principal amount of the Series A Senior Notes then outstanding, and the Series A Senior Notes held by the Maricopa Trustee who has resigned or been discharged shall be surrendered to, and cancelled by, the Trustee.

The Maricopa Trustee, as the holder of the Series A Senior Notes, shall attend meetings of bondholders under the Senior Note Indenture or deliver its proxy in connection therewith. Either at such meeting, or otherwise when the consent of the holders of the Company's senior notes issued under the Senior Note Indenture is sought without a meeting, the Maricopa Trustee shall vote as the holder of the Series A Senior Notes, or shall consent with respect thereto; PROVIDED, HOWEVER, that the Maricopa Trustee shall not vote in favor of, or consent to, any modification of the Senior Note Indenture which is correlative to a modification of the Maricopa Indenture or the Loan Agreement which would require the approval of owners of Series A Pollution Control Bonds without the

approval of the owners of Series A Pollution Control Bonds which would be required for such correlative modification of such Maricopa Indenture or Loan Agreement.

SECTION 112. Series A Senior Notes acquired by the Company and submitted to the Trustee for cancellation, or redeemed, or paid at maturity by the Company shall forthwith be cancelled by the Trustee.

SECTION 113. The related series of Senior Note First Mortgage Bonds for the Series A Senior Notes is the Company's First Mortgage Bonds, Senior Notes Series C (the "Senior Note Series C Bonds").

SECTION 114. When the obligation of the Company to make payments with respect to the principal of and interest on all or any part of the Senior Note Series C Bonds shall be satisfied or deemed satisfied pursuant to Section 403 or Section 501 of the Indenture or pursuant to Section 105 of this Third Supplemental Indenture, the Trustee shall, upon written request of the Company and, if applicable, the receipt of the certificate of the Expert described in Section 404(b) of the Indenture (if such certificate is then required by Section 404(b) of the Indenture), deliver to the Company without charge therefor all of the Senior Note Series C Bonds so satisfied or deemed satisfied, together with such appropriate instruments of transfer or release as may be reasonably requested by the Company. All Senior Note Series C Bonds delivered to the Company in accordance with this Section 114 shall be delivered by the Company to the First Mortgage Trustee for cancellation.

ARTICLE TWO

ADDITIONAL COVENANTS

SECTION 201. (a) From and after the Release Date and so long as any Series A Senior Note is Outstanding, the Company will not issue, assume, or guarantee any Debt secured by any mortgage, security interest, pledge, or lien (herein referred to as a "mortgage") of or upon any Operating Property of the Company, whether owned at the date of the Indenture or thereafter acquired, and will not permit to exist any Debt secured by a mortgage on any Operating Property created on or prior to the Release Date, without in any such case effectively securing, on the later to occur of the issuance, assumption, or guarantee of any such Debt or the Release Date, the Outstanding Series A Senior Notes (together with, if the Company shall so determine, any other Note or Debt of or guaranteed by the Company ranking senior to, or equally with, the Notes) equally and ratably with such Debt; provided, however, that the foregoing restriction shall not apply to Debt secured by any of the following:

(1) mortgages on any property existing at the time of acquisition thereof;

(2) mortgages on property of a corporation existing at the time such corporation is merged into or consolidated with the Company, or at the time of a sale, lease, or other disposition of the properties of such corporation or a division thereof as an entirety or substantially as

an entirety to the Company, provided that such mortgage as a result of such merger, consolidation, sale, lease, or other disposition is not extended to property owned by the Company immediately prior thereto;

(3) mortgages on property to secure all or part of the cost of acquiring, constructing, developing, or substantially repairing, altering, or improving such property, or to secure indebtedness incurred to provide funds for any such purpose or for reimbursement of funds previously expended for any such purpose, provided such mortgages are created or assumed contemporaneously with, or within eighteen (18) months after, such acquisition or completion of construction, development, or substantial repair, alteration, or improvement or within six (6) months thereafter pursuant to a commitment for financing arranged with a lender or investor within such eighteen (18) month period;

(4) mortgages in favor of the United States of America or any State thereof, or any department, agency, or instrumentality or political subdivision of the United States of America or any State thereof, or for the benefit of holders of securities issued by any such entity, to secure any Debt incurred for the purpose of financing all or any part of the purchase price or the cost of constructing, developing, or substantially repairing, altering, or improving the property subject to such mortgages; or

(5) any extension, renewal or replacement (or successive extensions, renewals, or replacements), in whole or in part, of any mortgage referred to in the foregoing clauses (1) to (4), inclusive; provided, however, that the principal amount of Debt secured thereby and not otherwise authorized by said clauses (1) to (4), inclusive, shall not exceed the principal amount of Debt, plus any premium or fee payable in connection with any such extension, renewal, or replacement, so secured at the time of such extension, renewal, or replacement.

(b) Notwithstanding the provisions of Section 201(a), from and after the Release Date and so long as any Series A Senior Note is Outstanding, the Company may issue, assume, or guarantee Debt, or permit to exist Debt, secured by mortgages which would otherwise be subject to the restrictions of Section 201(a) up to an aggregate principal amount that, together with the principal amount of all other Debt of the Company secured by mortgages (other than mortgages permitted by Section 201(a) that would otherwise be subject to the foregoing restrictions) and the Value of all Sale and Lease-Back Transactions in existence at such time (other than any Sale and Lease-Back Transaction that, if such Sale and Lease-Back Transaction had been a mortgage, would have been permitted by Section 201(a), other than Sale and Lease-Back Transactions permitted by Section 202 because the commitment by or on behalf of the purchaser was obtained no later than eighteen (18) months after the later of events described in (i) or

(ii) of Section 202, and other than Sale and Lease-Back Transactions as to which application of amounts have been made in accordance with clause (z) of Section 202), does not at the time exceed the greater of ten percent (10%) of Net Tangible Assets or ten percent (10%) of Capitalization.

(c) If at any time the Company shall issue, assume, or guarantee any Debt secured by any mortgage and if Section 201(a) requires that the Outstanding Series A Senior Notes be secured equally and ratably with such Debt, the Company will promptly execute, at its expense, any instruments necessary to so equally and ratably secure the Outstanding Series A Senior Notes and deliver the same to the Trustee along with:

(1) An Officers' Certificate stating that the covenant of the Company contained in Section 201(a) has been complied with; and

(2) An Opinion of Counsel to the effect that the Company has complied with the covenant contained in Section 201(a), and that any instrument executed by the Company in the performance of such covenant complies with the requirements of such covenant.

In the event that the Company shall hereafter secure Outstanding Series A Senior Notes equally and ratably with any other obligation or indebtedness (including other Notes) pursuant to the provisions of this Section 201, the Trustee is hereby authorized to enter into an indenture or agreement supplemental hereto and to take such action, if any, as it may, in its sole and absolute discretion, deem advisable to enable it to enforce effectively the rights of the Holders of Outstanding Series A Senior Notes so secured, equally and ratably with such other obligation or indebtedness.

SECTION 202. From and after the Release Date and so long as any Series A Senior Note is outstanding, the Company will not enter into any Sale and Lease-Back Transaction with respect to any Operating Property and will not permit to remain in effect any Sale and Lease-Back Transaction entered into on or prior to the Release Date with respect to any Operating Property if, in any case, the commitment by or on behalf of the purchaser is or was obtained more than eighteen (18) months after the later of (i) the completion of the acquisition, construction, or development of such Operating Property or (ii) the placing in operation of such Operating Property or of such Operating Property as constructed, developed, or substantially repaired, altered, or improved, unless

(x) the Company would be entitled pursuant to Section 201(a) to issue, assume, or guarantee Debt secured by a mortgage on such Operating Property without equally and ratably securing the Series A Senior Notes or (y) the Company would be entitled pursuant to Section 201(b), after giving effect to such Sale and Lease-Back Transaction, to incur \$1.00 of additional Debt secured by mortgages (other than mortgages permitted by Section 201(a)) or (z) the Company shall apply or cause to be applied, in the case of a sale or transfer for cash, an amount equal to the net proceeds thereof (but not in excess of the net book value of such Operating Property at the date of such sale or transfer) and, in the case of a sale or transfer otherwise than for cash, an amount equal to the fair value (as determined by the Board of Directors) of the Operating Property so leased, to the retirement, within one hundred eighty (180) days after the

later to occur of the effective date of such Sale and Lease-Back Transaction or the Release Date, of Notes or other Debt of the Company ranking senior to, or equally with, the Series A Senior Notes; PROVIDED, HOWEVER, that any such retirement of Notes shall be in accordance with the terms and provisions of the Indenture and the Notes; PROVIDED, FURTHER, that the amount to be applied to such retirement of Notes or other Debt shall be reduced by an amount equal to the sum of (a) an amount equal to the redemption price with respect to Notes delivered within such one hundred eighty (180)-day period to the Trustee for retirement and cancellation and (b) the principal amount, plus any premium or fee paid in connection with any redemption in accordance with the terms of other Debt voluntarily retired by the Company within such one hundred eighty (180)-day period, excluding in each case retirements pursuant to mandatory sinking fund or prepayment provisions and payments at maturity.

SECTION 203. DEFINITIONS

For purposes of Section 201 and Section 202 of this Third Supplemental Indenture, the following terms shall have the following meanings:

"Capitalization" means the total of all the following items appearing on, or included in, the consolidated balance sheet of the Company: (i) liabilities for indebtedness maturing more than twelve (12) months from the date of determination; and (ii) common stock, preferred stock, premium on capital stock, capital surplus, capital in excess of par value, and retained earnings (however the foregoing may be designated), less, to the extent not otherwise deducted, the cost of shares of capital stock of the Company held in its treasury.

Subject to the foregoing, Capitalization shall be determined in accordance with generally accepted accounting principles and practices applicable to the type of business in which the Company is engaged and that are approved by independent accountants regularly retained by the Company, and may be determined as of a date not more than (sixty) 60 days prior to the happening of an event for which such determination is being made.

The term "Debt" means any outstanding debt for money borrowed evidenced by notes, debentures, bonds, or other securities.

The term "Net Tangible Assets" means the amount shown as total assets on the consolidated balance sheet of the Company, less the following: (i) intangible assets including, but without limitation, such items as goodwill, trademarks, trade names, patents, and unamortized debt discount and expense and other regulatory assets carried as an asset on the Company's consolidated balance sheet; and (ii) appropriate adjustments, if any, on account of minority interests.

Net Tangible Assets shall be determined in accordance with generally accepted accounting principles and practices applicable to the type of business in which the Company is engaged and that are approved by the independent accountants regularly retained by the Company, and may be determined as of a date not more than (sixty) 60 days prior to the happening of the event for which such determination is being made.

The term "Operating Property" means (i) any interest in real property owned by the Company and (ii) any asset owned by the Company that is depreciable in accordance with generally accepted accounting principles.

The term "Sale and Lease-Back Transaction" means any arrangement with any person providing for the leasing to the Company of any Operating Property (except for temporary leases for a term, including any renewal thereof, of not more than forty-eight (48) months), which Operating Property has been or is to be sold or transferred by the Company to such person.

The term "Value" means, with respect to a Sale and Lease-Back Transaction, as of any particular time, the amount equal to the greater of (1) the net proceeds to the Company from the sale or transfer of the property leased pursuant to such Sale and Lease-Back Transaction or (2) the net book value of such property, as determined in accordance with generally accepted accounting principles by the Company at the time of entering into such Sale and Lease-Back Transaction, in either case multiplied by a fraction, the numerator of which shall be equal to the number of full years of the term of the lease that is part of such Sale and Lease-Back Transaction remaining at the time of determination and the denominator of which shall be equal to the number of full years of such term, without regard, in any case, to any renewal or extension options contained in such lease.

SECTION 204. Amendment to Section 901 of the Indenture. For purposes of the Series A Senior Notes, clause (1) of Section 901 of the Indenture, shall be revised by deleting the words "For purposes of this Article Nine, the phrase `assets substantially as an entirety' shall mean 50% or more of the total assets of the Company as shown on the consolidated balance sheet of the Company as of the end of the calendar year immediately preceding the day of the year in which such determination is made and" replacing said words with the words "Notwithstanding this Section 901."

ARTICLE THREE

FORM OF SERIES A SENIOR NOTE

SECTION 301. The Series A Senior Notes and the Trustee's certificate of authentication to be endorsed are to be substantially in the following forms:

Form of Face of Note.

ARIZONA PUBLIC SERVICE COMPANY

5.05% Senior Notes (Maricopa 2002 Series A) Due 2029

No. 1 \$90,000,000

Arizona Public Service Company, a corporation duly organized and existing under the laws of Arizona (herein called the "Company", which term includes any successor Person under the Indenture hereinafter referred to), for value

received, hereby promises to pay to The Bank of New York, as Trustee under the Maricopa Indenture hereinafter referred to, as assignee of Maricopa County, Arizona Pollution Control Corporation under said Maricopa Indenture, or its successors in such capacity, the principal sum of Ninety Million Dollars on May 1, 2029, and to pay interest thereon from November 1, 2002 or from the most recent Interest Payment Date with respect to which interest has been paid or duly provided for, semi-annually on May 1 and November 1 in each year, commencing May 1, 2003, at the rate of 5.05% per annum, until the principal hereof is paid or made available for payment, from the dates such amounts are due until they are paid or made available for payment. The interest so payable, and punctually paid or duly provided for, on any Interest Payment Date will, as provided in such Indenture, be paid to the Person in whose name this Note (or one or more Predecessor Notes) is registered at the close of business on the Regular Record Date for such interest, which shall be the April 15 or October 15 (whether or not a Business Day), as the case may be, next preceding such Interest Payment Date.

Notwithstanding the above, to the extent required in Section 4.2 of the Loan Agreement (described below) at any time, all payments of interest on each Interest Payment Date and of principal on the maturity date of this Note shall be due and payable not less than two (2) Business Days (as defined in the Maricopa Indenture (described below)) prior to each such Interest Payment Date and such maturity date.

Rights to payment of this Note have been assigned by Maricopa County, Arizona Pollution Control Corporation (the "Issuer") to The Bank of New York, as trustee (the "Maricopa Trustee") under the Indenture of Trust dated as of November 1, 2002 (as amended and supplemented from time to time, herein called the "Maricopa Indenture") between the Maricopa Trustee and the Issuer, to evidence, secure and provide for the repayment of the loan (the "Loan") made by the Issuer to the Company under the Loan Agreement dated as of November 1, 2002 (the "Loan Agreement"), between the Company and the Issuer, from the proceeds of the issuance by the Issuer of \$90,000,000 of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 2002 Series A (the "Pollution Control Bonds") under the Maricopa Indenture, and such assignment has been duly registered.

Payment of the principal of and interest on this Note will be paid by the Company to the Maricopa Trustee at the designated office of the Maricopa Trustee, or to any successor trustee under the Maricopa Indenture at its designated office, in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts.

Reference is hereby made to the further provisions of this Note set forth below, which further provisions shall for all purposes have the same effect as if set forth at this place.

Unless the certificate of authentication hereon has been executed by the Trustee referred to on the reverse hereof by manual signature, this Note shall not be entitled to any benefit under the Indenture or be valid or obligatory for any purpose.

IN WITNESS WHEREOF, the Company has caused this instrument to be duly executed under its corporate seal.

ARIZONA PUBLIC SERVICE COMPANY

By _____

Attest:

Form of Reverse of Note.

This Note is one of a duly authorized issue of securities of the Company (herein called the "Notes"), issued and to be issued in one or more series under an Indenture, dated as of November 15, 1996, as supplemented and amended by the First Supplemental Indenture thereto dated as of November 15, 1996 and the Second Supplemental Indenture thereto dated as of April 1, 1997 (herein collectively called the "Indenture"), between the Company and The Bank of New York, as Trustee (herein called the "Trustee", which term includes any successor trustee under the Indenture), and reference is hereby made to the Indenture for a statement of the respective rights, limitations of rights, duties and immunities thereunder of the Company, the Trustee and the Holders of the Notes and of the terms upon which the Notes are, and are to be, authenticated and delivered. This Note is one of the series designated on the face hereof, limited in aggregate principal amount to \$90,000,000.

Prior to the Release Date (as hereinafter defined), this Note will be secured by First Mortgage Bonds, Senior Note Series C (the "Senior Note Series C Bonds") delivered by the Company to the Trustee for the benefit of the Holders of the series of Notes of which this Note is a part, issued under the Mortgage and Deed of Trust, dated as of July 1, 1946, from the Company to The Bank of New York, as successor trustee (the "Mortgage Trustee"), as supplemented and amended (the "First Mortgage"). Reference is made to the First Mortgage for a description of property mortgaged and pledged, the nature and extent of the security, the rights of the holders of the first mortgage bonds under the First Mortgage and of the Mortgage Trustee in respect thereof, the duties and immunities of the Mortgage Trustee and the terms and conditions upon which the Senior Note Series C Bonds are secured and the circumstances under which additional first mortgage bonds may be issued.

FROM AND AFTER SUCH TIME AS ALL FIRST MORTGAGE BONDS (OTHER THAN SENIOR NOTE FIRST MORTGAGE BONDS, AS SUCH TERM IS DEFINED IN THE INDENTURE) HAVE BEEN RETIRED THROUGH PAYMENT, REDEMPTION OR OTHERWISE AT, BEFORE OR AFTER THE

MATURITY THEREOF (THE "RELEASE DATE"), THE SENIOR NOTE FIRST MORTGAGE BONDS SHALL CEASE TO SECURE THE NOTES IN ANY MANNER.

This Note is nonnegotiable and nontransferable except as required to effect assignment to the Maricopa Trustee under the Maricopa Indenture and to any successor trustee thereunder. Upon the appointment of a successor trustee under the Maricopa Indenture, the Trustee shall authenticate and the Company shall issue in the name of said successor trustee a new fully registered Note of this series in the amount of the unpaid principal amount of this Note then outstanding, and this Note shall be surrendered to, and canceled by, the Trustee.

The Company shall have no obligation to make payments with respect to the principal and/or interest on the Notes of this series unless and until, and only to the extent that, payments shall be due and payable pursuant to the Pollution Control Bonds. Any provision hereof to the contrary notwithstanding, the Company shall receive a credit against its obligation to make any payment of interest on the Notes of this Series in an amount equal to the amount, if any, held by the Maricopa Trustee under the Maricopa Indenture on deposit in the Bond Fund (as defined in the Maricopa Indenture) and available to make the corresponding payment on the Pollution Control Bonds. In addition, the Company shall receive a credit against its obligation to make any payment of principal of the Notes of this Series, whether at maturity, upon redemption or otherwise, in an amount equal to the amount, if any, held by the Maricopa Trustee under the Maricopa Indenture on deposit in said Bond Fund and available to make the corresponding payment on the Pollution Control Bonds.

In the manner and with the effect provided in Article 12 of the Indenture, the Notes of this series will be subject to redemption prior to maturity, as follows:

(a) The Notes of this Series are subject to redemption prior to maturity in whole or in part, by lot, at any time at a redemption price equal to the principal amount of the Notes of this Series to be redeemed plus accrued interest to the redemption date in the event of the exercise by the Company of its rights to prepay the Loan in full or in part in accordance with Section 7.2 of the Loan Agreement upon the occurrence of any of certain extraordinary events specified in Section 4.01(a)(1) of the Maricopa Indenture.

(b) The Notes of this series are subject to redemption prior to maturity in whole or in part, by lot, on any date on or after November 1, 2012, in the event of the exercise by the Company of its rights to prepay the Loan in full or in part in accordance with Section 7.2 of the Loan Agreement and Section 4.01(a)(2) of the Maricopa Indenture at 100% of the principal amount of the Notes of this series to be redeemed, together with accrued interest to the date fixed for redemption

(c) The Notes of this series shall also be redeemable, in whole at any time, prior to maturity by the application of cash delivered to or deposited with the Trustee in the event of the exercise by the Company of its rights to prepay the Loan in full in accordance with Section 7.2 of the Loan Agreement and Section 4.01(a)(3) of the Maricopa Indenture, pursuant to the provisions of Section 87 of the First Mortgage (but only if and to the extent such Section is properly applicable to bona fide transactions), at 100% the principal amount of the Notes of this series to be redeemed together with accrued interest to the date fixed for redemption.

(d) The Notes of this series are subject to mandatory redemption prior to maturity in whole or in part, by lot, at a redemption price equal to 100% of the principal amount of the Notes of this series to be redeemed plus accrued interest to the redemption date upon the mandatory prepayment of the Loan in full or in part in accordance with Section 7.3 of the Loan Agreement upon the occurrence of any of certain extraordinary events specified in Section 4.01(b) of the Maricopa Indenture.

Any notice given under the provisions of Section 4.03 of the Maricopa Indenture with respect to redemption of all or a part of the Pollution Control Bonds or Section 7.5 of the Loan Agreement with respect to the prepayment of all or a part of the Loan will also constitute sufficient notice of the redemption of the principal amount of the Notes of this series corresponding to the amount of the Pollution Control Bonds to be redeemed.

In the event of redemption of this Note in part only, a new Note or Notes of this series and of like tenor for the unredeemed portion hereof will be issued in the name of the Holder hereof upon the cancellation hereof.

All payments by the Company on the Notes of this series shall be made at or prior to the opening of business on the due date thereof. If the corresponding date for making any payment provided in the Maricopa Indenture is to be determined in accordance with the provisions of Section 11.11 thereof, the "due date" hereunder will be determined in the same manner.

The Notes of this series will not be subject to any sinking fund.

If an Event of Default with respect to Notes of this series shall occur and be continuing, the principal of the Notes of this series may be declared due and payable in the manner and with the effect provided in the Indenture.

If an Event of Default with respect to Notes of this series shall occur and be continuing, the principal of the Notes may be declared due and payable in the manner and with the effect provided in the Indenture and, upon such declaration, the Trustee can demand the acceleration of the payment of principal of the Senior Note Series C Bonds as provided in the Indenture.

The Indenture permits, with certain exceptions as therein provided, the amendment thereof and the modification of the rights and obligations of the Company and the rights of the Holders of the Notes of each series to be affected under the Indenture at any time by the Company and the Trustee with the consent of the Holders of a majority in principal amount of the Notes at the time Outstanding of each series to be affected. The Indenture also contains provisions permitting the Holders of specified percentages in principal amount of the Notes of each series at the time Outstanding, on behalf of the Holders of all Notes of such series, to waive compliance by the Company with certain provisions of the Indenture and certain past defaults under the Indenture and their consequences. Any such consent or waiver by the Holder of this Note shall be conclusive and binding upon such Holder and upon all future Holders of this Note and of any Note issued upon the registration of transfer hereof or in exchange therefor or in lieu hereof, whether or not notation of such consent or waiver is made upon this Note.

As provided in and subject to the provisions of the Indenture, the Holder of this Note shall not have the right to institute any proceeding with respect to the Indenture or for the appointment of a receiver or trustee or for any other remedy thereunder, unless such Holder shall have previously given the Trustee written notice of a continuing Event of Default with respect to the Notes of this series, the Holders of not less than 25% in principal amount of the Notes of this series at the time Outstanding shall have made written request to the Trustee to institute proceedings in respect of such Event of Default as Trustee and offered the Trustee reasonable indemnity, and the Trustee shall not have received from the Holders of a majority in principal amount of Notes of this series at the time Outstanding a direction inconsistent with such request, and shall have failed to institute any such proceeding, for 60 days after receipt of such notice, request and offer of indemnity. The foregoing shall not apply to any suit instituted by the Holder of this Note for the enforcement of any payment of principal hereof or interest hereon on or after the respective due dates expressed herein.

No reference herein to the Indenture and no provision of this Note or of the Indenture shall alter or impair the obligation of the Company, which is absolute and unconditional, to pay the principal of and interest on this Note at the times, place and rate, and in the coin or currency, herein prescribed.

All terms used in this Note which are defined in the Indenture shall have the meanings assigned to them in the Indenture.

Form of Trustee's Certificate of Authentication.

CERTIFICATE OF AUTHENTICATION

This is one of the Notes of the series designated therein referred to in the within-mentioned Indenture.

Dated:

**THE BANK OF NEW YORK,
AS TRUSTEE**

By _____
AUTHORIZED SIGNATORY

ARTICLE FOUR

ORIGINAL ISSUE OF SERIES A SENIOR NOTES

SECTION 401. Series A Senior Notes in the aggregate principal amount of \$90,000,000, may, upon execution of this Third Supplemental Indenture, or from time to time thereafter, be executed by the Company and delivered to the Trustee for authentication, and the Trustee shall thereupon authenticate and deliver said Notes to or upon the written order of the Company, signed by its Chairman, its President, or any Vice President and its Treasurer or an Assistant Treasurer, without any further action by the Company.

ARTICLE FIVE

PAYING AGENT AND REGISTRAR

SECTION 501. The Bank of New York will be the Paying Agent and Note Registrar for the Series A Senior Notes.

ARTICLE SIX

SUNDRY PROVISIONS

SECTION 601. Except as otherwise expressly provided in this Third Supplemental Indenture or in the form of Series A Senior Notes or otherwise clearly required by the context hereof or thereof, all terms used herein or in said form of Series A Senior Notes that are defined in the Indenture shall have the several meanings respectively assigned to them thereby.

SECTION 602. The Indenture, as supplemented by this Third Supplemental Indenture, is in all respects ratified and confirmed, and this Third Supplemental Indenture shall be deemed part of the Indenture in the manner and to the extent herein and therein provided.

SECTION 603. The Trustee hereby accepts the trusts herein declared, provided, created, supplemented, or amended and agrees to perform the same upon the terms and conditions herein and in the Indenture, as heretofore supplemented and amended, set forth and upon the following terms and conditions:

The Trustee shall not be responsible in any manner whatsoever for or in respect of the validity or sufficiency of this Third Supplemental Indenture or for or in respect of the recitals contained herein, all of which recitals are made by the Company solely. In general, each and every term and condition contained in Article Seven of the Indenture shall apply to and form part of this Third Supplemental Indenture with the same force and effect as if the same were herein set forth in full with such omissions, variations, and insertions, if any, as may be appropriate to make the same conform to the provisions of this Third Supplemental Indenture.

This instrument may be executed in any number of counterparts, each of which so executed shall be deemed to be an original, but all such counterparts shall together constitute but one and the same instrument.

IN WITNESS WHEREOF, the parties hereto have caused this Third Supplemental Indenture to be duly executed, and their respective corporate seals to be hereunto affixed and attested, all as of the day and year first above written.

ARIZONA PUBLIC SERVICE COMPANY

By: Barbara M. Gomez

Barbara M. Gomez Treasurer

Attest:

Betsy A. Pregulman
Betsy A. Pregulman
Associate Secretary

THE BANK OF NEW YORK, as Trustee

By: Debra A. Schwalb
Vice President

Attest:

Thomas J. Provenzano
Vice President

STATE OF ARIZONA)
) ss:
COUNTY OF MARICOPA)

On the 1st day of November, 2002, before me personally came Barbara M. Gomez, to me known, who, being by me duly sworn, did depose and say that she is the Treasurer of Arizona Public Service Company, one of the corporations described in and which executed the foregoing instrument; that she knows the seal of said corporation; that the seal affixed to said instrument is such corporate seal; that it was so affixed by authority of the Board of Directors of said corporation; and that she signed her name thereto by like authority.

Debra L. Blondin
NOTARY PUBLIC

My Commission Expires:

June 7, 2004

STATE OF NEW JERSEY)
) ss:
COUNTY OF PASSAIC)

On the 1st day of November, 2002, before me personally came Debra A. Schwalb, to me known, who, being by me duly sworn, did depose and say that she is the Vice President of The Bank of New York, one of the corporations described in and which executed the foregoing instrument; that she knows the seal of said corporation; that the seal affixed to said instrument is such corporate seal; that it was so affixed by authority of the Board of Directors of said corporation; and that she signed her name thereto by like authority.

Ronald M. Mania
NOTARY PUBLIC

My Commission Expires:

10-4-06

**THIRD AMENDMENT TO
THE PINNACLE WEST CAPITAL CORPORATION
ARIZONA PUBLIC SERVICE COMPANY
SUNCOR DEVELOPMENT COMPANY
AND EL DORADO INVESTMENT COMPANY
DEFERRED COMPENSATION PLAN**

Effective January 1, 1992, Pinnacle West Capital Corporation (the "Company"), Arizona Public Service Company, SunCor Development Company and El Dorado Investment Company adopted the Pinnacle West Capital Corporation, Arizona Public Service Company, SunCor Development Company and El Dorado Investment Company Deferred Compensation Plan (the "Plan"). The Plan was thereafter amended several times and was amended and restated in its entirety on December 1, 1995, and thereafter amended September 15, 1999 and December 1, 1999.

By this instrument, and pursuant to the authority granted in the Section 11.2 of the Plan, the Company intends to amend the Plan to increase the threshold for automatic cashout of the Account balance of a terminated or retired Participant under certain circumstances, and to provide for the crediting of interest for a full month if a Participant works past the 15th of such month.

1. This Amendment shall amend only those Sections set forth herein and those Sections not amended hereby shall remain in full force and effect.

2. The third sentence of Section 3.5 is revised to read as follows:

In the event of Retirement, Disability, death or a Termination of Employment prior to the end of a Plan Year, the basis for that year's interest crediting will be a fraction of the full year's interest based on the Account Balance as of the end of the immediately preceding Plan Year, together with the amount actually deferred for the Plan Year as of the date of the Participant's Retirement, Disability, death or Termination of Employment and based further on the number of full months that the Participant was employed with or served as a Director of the Employer during the Plan Year prior to the occurrence of such event, and for this purpose, a Participant shall be deemed to be so employed or to have so served for a full month if he or she was employed with or served as a Director of the Employer past the 15th day of such month.

3. Section 5.4 is revised to read as follows:

5.4 AUTOMATIC DISTRIBUTION OF RETIREMENT BENEFITS.

Notwithstanding any provision of this Article 5 to the contrary, if the Account Balance of a Retired Participant does not exceed Twenty Thousand Dollars (\$20,000), the Participant's Retirement Benefit shall be distributed in a lump sum within sixty (60) days following his Retirement.

4. Section 7.2(c) is revised to read as follows:

(c) AUTOMATIC DISTRIBUTION OF TERMINATION BENEFITS.

Notwithstanding any provision of this Section 7.2 to the contrary, if, upon a Participant's Termination of Employment, his Account Balance, as determined pursuant to Section 7.1, does not exceed Twenty Thousand Dollars (\$20,000), the Participant's Termination Benefit shall be distributed in a lump sum within sixty (60) days following his Termination of Employment.

5. This Amendment shall be effective as of January 1, 2002.

IN WITNESS WHEREOF, the Company has caused this Amendment to be executed by its duly authorized officer this 22nd day of October, 2002.

PINNACLE WEST CAPITAL CORPORATION

By Armando Flores

Its Executive Vice President, Corporate Business Services

FORM OF CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(WILLIAM J. POST)

I, William J. Post, the Chairman of the Board and Chief Executive Officer of Pinnacle West Capital Corporation ("Pinnacle West"), certify, to the best of my knowledge, that: (a) the attached Quarterly Report on Form 10-Q of Pinnacle West for the fiscal quarter ended March 31, 2003 (the "March 2003 Form 10-Q") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (b) the information contained in the March 2003 Form 10-Q Report fairly presents, in all material respects, the financial condition and results of operations of Pinnacle West.

William J. Post

William J. Post Chairman of the Board and Chief Executive Officer

Date: May 14, 2003

FORM OF CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002
(DONALD E. BRANDT)

I, Donald E. Brandt, Senior Vice President and Chief Financial Officer, of Pinnacle West Capital Corporation ("Pinnacle West"), certify, to the best of my knowledge, that: (a) the attached Quarterly Report on Form 10-Q of Pinnacle West for the quarter ended March 31, 2003 (the "March 2003 Form 10-Q") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (b) the information contained in the March 2003 Form 10-Q Report fairly presents, in all material respects, the financial condition and results of operations of Pinnacle West.

Donald E. Brandt

Donald E. Brandt Senior Vice President and Chief Financial Officer

Date: May 14, 2003

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MARC SPITZER, Chairman
JIM IRVIN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON

IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR AN
ORDER OR ORDERS AUTHORIZING IT TO
ISSUE, INCUR, OR ASSUME EVIDENCES OF
LONG-TERM INDEBTEDNESS; TO ACQUIRE A
FINANCIAL INTEREST OR INTERESTS IN AN
AFFILIATE OR AFFILIATES; TO LEND MONEY
TO AN AFFILIATE OR AFFILIATES; AND TO
GUARANTEE THE OBLIGATIONS OF AN
AFFILIATE OR AFFILIATES.

DOCKET NO. E-01345A-02-0707

DECISION NO. 65796

OPINION AND ORDER

DATES OF HEARINGS: September 24, 2002 (procedural conference);
October 4, 2002 (procedural conference); January
3, 2003 (prehearing); January 8, 9, 10, 13, and
14, 2003

PLACE OF HEARINGS: Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE: Lyn Farmer

IN ATTENDANCE: William A. Mundell, Chairman Marc Spitzer,
Commissioner Jeff Hatch-Miller, Commissioner Mike
Gleason, Commissioner

APPEARANCES: Mr. Michael R. Engleman and Mr. Frederick D.
Ochsenhirt, DICKSTEIN, SHAPIRO, MORIN & OSHINSKY,
L.L.P., on behalf of Panda Gila River, LP;

Mr. Scott S. Wakefield, Chief Counsel, on behalf
of the Residential Utility Consumer Office;

Mr. Thomas L. Mumaw and Ms. Karilee Ramaley,
PINNACLE WEST CAPITAL CORPORATION; and Mr. Jeffrey
B. Guldner, SNELL & WILMER, P.L.C., on behalf of
Arizona Public Service Company;

Mr. James McGuire, ROSHKA, HEYMAN & DeWULF,
P.L.C., on behalf of Tucson Electric Power
Company;

Mr., Lawrence V. Robertson, Sr., MUNGER CHADWICK,
P.L.C.; and Mr. Theodore E. Roberts, SEMPRA
ENERGY, on behalf of Semptra Energy Resources and
Southwestern Power Group, II;

Mr. William P. Sullivan, MARTINEZ & CURTIS, P.C.,
on behalf of Reliant Energy Resources;

Mr. Walter W. Meek, President, on behalf of the
Arizona Utility Investors Association;

Mr. C. Webb Crockett, FENNEMORE CRAIG, P.C., on
behalf of the Arizonans for Electric Choice and
Competition;

Mr. Jay I. Moyes, MOYES STOREY, on behalf of PPL
Southwest Generating Holdings, LLC; PPL
EnergyPlus, LLC; and PPL Sundance Energy, LLC; and

Mr. Christopher C. Kempley, Chief Counsel, and Ms.
Janet F. Wagner, Staff Attorney, Legal Division,
on behalf of the Utilities Division of the Arizona
Corporation Commission.

BY THE COMMISSION:

On September 16, 2002, Arizona Public Service Company ("APS" or "Company") filed with Corporation Commission ("Commission") the above-captioned application for financing approval ("Application").

On September 20, 2002, Panda Gila River, L.P. ("Panda") filed a Motion for Leave to Intervene. On September 23, 2002, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene.

By Procedural Order issued September 23, 2002, a Procedural Conference was held on September 24, 2002, to discuss the procedures for processing this application. By Procedural Order issued September 25, 2002, a second Procedural Conference was scheduled. -

On October 4, 2002, the second Procedural Conference was held as scheduled and established procedural dates for the preparation and conduct of this matter and to consider the Motions to Intervene by Panda; Reliant Resources, Inc. ("Reliant"); the Harquahala Generating Company, LLC ("Harquahala"); PPL Southwest Generation Holdings, LLC; PPL Energy Plus, LLC; and PPL Sundance Energy, LLC (collectively "PPL entities"); the Arizona Utility Investors Association, Inc. ("AUIA"); Southwestern Power Group II, LLC and Bowie Power Station (collectively "SWPG/Bowie"); Sempra Energy Resources ("Sempra"); Arizona Competitive Power Alliance ("ACPA"); and Tucson Electric Power Company ("TEP").

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At the Procedural Conference, oral arguments were heard on the motions to intervene and the parties discussed their proposed procedural schedule for this matter. The motions to intervene were granted, and it was noted that the scope of the hearing would not be broadened by their participation.

By Procedural Order issued October 9, 2002, the hearing was set to commence on January 8, 2003. On October 10, 2002, APS filed an Emergency Motion to Modify the October 9, 2002 Procedural Order, and on October 15, 2002, the Commission's Utilities Division Staff ("Staff"), RUCO, and Panda responded to APS' Motion.

On October 16, 2002, APS filed a Motion for Protective Order ("Motion"). On October 21, 2002, Staff filed its Response; on October 23, 2002, RUCO filed its Response; on October 23, 2002, APS filed its Reply; and on October 29, 2002, Panda filed a Response to Staff's Response. On November 25, 2002, APS withdrew its Motion without prejudice. Intervention was granted to Arizonans for Electric Choice and Competition ("AECC") on November 18, 2002.

Notice of the hearing was published in the ARIZONA REPUBLIC, THE BISBEE DAILY REVIEW, THE CASA GRANDE DISPATCH, THE ARIZONA DAILY SUN (FLAGSTAFF), THE PRESCOTT COURIER, AND THE YUMA DAILY SUN.

The hearing commenced as scheduled in January 8, 2003 and witnesses for APS, AUIA, Panda, RUCO, and Staff testified and presented evidence during five days of hearing. Initial posthearing briefs were filed on January 27, 2003 and reply briefs were filed on February 6, 2003.

BACKGROUND

On May 20, 1994, the Commission opened Docket No. U-0000-94-165 to investigate the introduction of retail electric competition. On December 26, 1996, the Commission issued Decision No. 59943, which adopted A.A.C. R14-2-1601 through 1616, the Retail Electric Competition Rules. Hearings were held on generic stranded cost issues, and on June 28, 1998, the Commission issued Decision No. 60977 on Stranded Costs. On August 10, 1998, in Decision No. 61071, the Commission adopted amended rules on an emergency basis, and on December 11, 1998, adopted the emergency rules on a permanent basis in Decision No. 61272. On January 11, 1999, the Commission issued Decision No. 61311, which stayed the Retail Electric Competition Rules and related decisions, including Decision No. 60977.

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On April 27, 1999, the Commission issued Decision No. 61677, which amended Decision No. 60977, the Commission's prior Stranded Cost decision. Decision No. 61677 ordered the Hearing Division to issue a Procedural Order to set dates for consideration of stranded costs and unbundled tariffs for each Affected Utility. The revised Retail Electric Competition Rules were published on May 14, 1999 and public comment sessions were held. On May 18, 1999, APS filed for approval of a Settlement Agreement, a hearing was held, and the Commission issued Decision No. 61973 (October 6, 1999), approving the Settlement Agreement with changes. On September 29, 1999, the Commission issued Decision No. 61969, which approved the revised Retail Electric Competition Rules ("Electric Competition Rules"). In Decision No. 62924 (October 10, 2000) the Commission adopted clarifying revisions to the Electric Competition Rules.

The Settlement Agreement provided and Decision No. 61973 granted a two-year extension of time, until December 31, 2002, for APS to separate assets (A.A.C. 1615(A)(1)) and also granted a "similar two-year extension" for compliance with A.A.C. R14-2-1606(B)(2). APS planned to divest its competitive generation assets to a yet-to-be formed generation affiliate. The Addendum to APS' Settlement Agreement also provided that: "[a]fter the extensions granted in Section 4.1 have expired, APS shall procure generation for Standard Offer customers from the competitive market as provided for in the Electric Competition Rules. An affiliated generation company formed pursuant to this Section 4.1 may competitively bid for APS' Standard Offer load, but enjoys no automatic privilege outside of the market bid on account of its affiliation with APS."
(4.1(3))

On October 18, 2001, APS filed a Variance/Purchased Power Agreement ("PPA") application. The application stated that "adherence to the competitive bidding requirements of the Electric Competition Rules will not produce the intended result of reliable electric service for Standard Offer customers at reasonable rates," requested that the Commission grant a partial variance to R14-2-1606(B) that would otherwise obligate APS to acquire all of its customers' Standard Offer generation requirements from the competitive market, and sought Commission approval of a long term purchase power agreement with its parent, Pinnacle West Capital Corporation ("PWCC").

(1) A.A.C. R14-2-1615(A) provides: "All competitive generation assets and competitive services shall be separated from an Affected Utility prior to January 1, 2001. Such separation shall either be to an unaffiliated party or to a separate corporate affiliate or affiliates. If an Affected Utility chooses to transfer its competitive generation assets or competitive services to a competitive electric affiliate, such transfer shall be at a value determined by the Commission to be fair and reasonable." ("Rule 1615(A)")

(2) A.A.C. R14-2-1606(B) provides: "After January 1, 2001, power purchased by an investor owned Utility Distribution Company for Standard Offer Service shall be acquired from the competitive market through prudent, arm's length transactions, and with at least 50% through a competitive bid process."
("Rule 1606(B)")

By Procedural Order issued on May 2, 2002, a generic proceeding was established that set up Track A to resolve issues relating to market power, divestiture, codes of conduct/affiliate transactions and jurisdictional issues. It also established Track B to address competitive procurement. On September 10, 2002, the Commission issued Decision No. 65154 in the Track A proceeding. On September 16, 2002, APS filed this application. On November 8, 2002, APS filed an "Emergency Application" requesting a partial waiver of A.A.C. R14-2-804(B)(1) and (2) to allow APS to make short-term advances to PWCC in the form of an inter-affiliate line of credit, or alternatively, in the form of an APS guarantee of PWCC's short-term debt. In Decision No. 65434 (December 3, 2002), the Commission granted the request with conditions. On March 14, 2003, the Commission issued its Decision No. 65743 in Track B.

DISCUSSION

APS' parent, PWCC, has incurred approximately \$1 billion in debt in order to finance the construction of generating units(3) at Pinnacle West Energy Corporation ("PWEC"), its merchant subsidiary. PWCC used debt with short-term maturities(4) because it planned for PWEC to refinance the debt at an investment grade once the APS rate-based generation assets were transferred to PWEC. In Decision No. 65154 (September 10, 2002), the Commission ordered APS to cancel any plans to divest interests in any generating assets.(5) On September 16, 2002, APS filed this financing application. APS, on behalf of its parent and affiliate, claims that without the APS generation assets, PWEC does not have an investment grade credit rating and therefore cannot finance the PWEC generation assets. Further, APS claims on behalf of its parent and affiliate, that due to market conditions, PWEC cannot obtain project financing. PWCC's bridge debt begins coming due in August 2003.

In its application APS asks that the Commission:

- * Authorize the Company to assume, issue, or incur up to \$500,000,000 in aggregate principal amount of Recapitalization Debt;
- * Authorize the Company to determine the terms associated with the Recapitalization Debt, including whether any portion of the Recapitalization Debt will be secured by

(3) West Phoenix combined cycle generating units 4 & 5, Saguaro combustion turbine Unit No. 3 and Redhawk Units I & 2.

(4) This has been referred to as PWCC's "bridge debt".

(5) The Decision also provided that if "APS wishes to pursue the issue of acquiring PWEC's generation assets, it shall file the appropriate application(s) by September 15, 2002."

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all or a portion of the Company's assets;

- * Authorize the Company to provide the APS Guarantees in accordance with the Application;
- * Authorize the Company to determine the terms associated with the APS Guarantees, including whether any portion of the APS Guarantees will be secured by all or a portion of the Company's assets;
- * Provide that the Recapitalization Debt and the APS Guarantees will not be classified or counted as Continuing Debt;
- * Find that the issuance and incurrence of Recapitalization Debt, and the issuance of the APS Guarantees are reasonable necessary or appropriate for the purposes set forth in this Application and that such purposes are within those permitted by A.R.S. Section 40-301, ET SEQ.;
- * Permit such purposes to the extent they may be reasonably chargeable to operative expenses or to income and allow the payment of related expenses as contemplated herein;
- * Authorize APS to obtain a financial interest in PWEC or Pinnacle West in the form of an inter-affiliate loan, APS Guarantees, or a combination of the two up to a maximum aggregate principal amount of \$500,000,000;
- * Authorize APS to make such expenditures, sign and deliver such documents, and negotiate such terms and conditions with underwriters or selling agents, purchasers and/or lenders, including but not limited to those pertaining to terms, rates, and collateral requirements (if any), all as described herein, as may be reasonably necessary to economically effectuate the other authorizations granted herein; and
- * Grant the Company such additional relief as is appropriate under the circumstances.

The Company is requesting approval of either an inter-company loan, a guarantee, or a combination of both. The proceeds of the long-term debt incurred by APS would then be loaned to either PWEC or PWCC. The funds would be used to pay off an equivalent amount of PWCC debt previously incurred to finance construction of the PWEC assets.

Jack Davis, APS President and CEO, and PWCC President, testified that the following were benefits from granting the application: avoiding a downgrade of APS debt ratings; avoiding corresponding increases in the APS cost of capital; strengthening wholesale competition by maintaining PWEC as a viable competitor in the upcoming Track B solicitation; preserving the Commission's ability to consider rate base treatment of the PWEC assets in the 2003-2004 rate case; strengthening investor and rating agency confidence in the Commission; continuing a responsive and responsible regulatory environment; preserving the current Track B solicitation process; and resulting in settlement of most of the issues in the Track A legal appeals. (APS-8 at 4-5) Further, in its Initial

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Post-Hearing Brief, APS identified what it believes are additional benefits to it and its customers from approval of the application, including net interest income of between 7.5 to 13.2 million dollars per year, and with Staff conditions, there may be greater regulatory insulation for APS within the holding company structure.

APS witness, Arthur Tildesley, Managing Director, Salomon Smith Barney, Inc., testified that under current market conditions, PWEC would be unable to raise significant debt financing on a standalone or non-recourse basis. "Without the transfer of the APS generation assets or the establishment of some form of power purchase agreement ("PPA"), the business profile and credit quality of PWEC would be viewed as very weak." Mr. Tildesley testified that "APS business fundamentals and credit statistics are strong, and we believe that APS has significant capacity to provide an intercompany loan or guarantee to PWEC in the amount of \$500 million without impairing fundamental utility credit quality." Mr. Tildesley did not attempt to evaluate PWEC's ability to actually service the loan, and in fact, for purposes of determining the impact of a loan on APS, he assumed no repayment capacity at PWEC. (APS-3 pp 4 & 5)

AUIA

The AUIA urged the Commission to grant APS the authority it seeks and believes that this action would be in the public interest in safeguarding the financial integrity of APS and its parent. AUIA believes that if APS' credit cannot be used, "it is not inconceivable that a bankruptcy and/or a forced sale of some or all of the PWEC assets could occur. Of course, any sale in the near future would be into a market that is already glutted with the bad construction decisions of merchant generators." (AUIA-1 at 5). AUIA believes that such an impact on APS would not be positive as it is "increasingly difficult to insulate an affiliate from the fortunes of its holding company and vice versa and it is unrealistic to expect that APS would be immune from a financial meltdown at Pinnacle West." (Id.)

STAFF

Staff believes that APS could face a downgrade if PWCC is downgraded, that such a downgrade of APS could interfere with APS' ability to provide electric service to the public if it resulted in increases in the cost of capital, potential lack of access to the capital markets, potential

increases in collateral requirements, and an inability to do business with vendors. Staff believes that APS' requested financing will be compatible with the public interest if, by preventing a downgrade in APS' credit ratings, it prevents a substantial disintegration in APS' ability to provide service. For those reasons, Staff recommended that the Commission authorize APS to borrow \$500 million in order to loan the proceeds to PWEC.

Although Staff concludes that APS' proposed financing will likely serve the public interest, Staff believes that the transaction poses some risks to the Company and to its ratepayers, including the fact that issuing debt to loan to PWEC will diminish APS' ability to obtain its own required debt capital needed in the coming years, and that the proposed financing runs counter to the goal of insulating APS from its affiliates' unregulated activities. Staff believes that these considerations do not outweigh the need to prevent a downgrade to APS' credit rating, but require conditions to approval of the financing. Staff Conditions for approval include:

1. APS should be authorized to issue and sell no more than \$500,000,000 of debt in addition to its current authorizations;
2. The debt to be lent to PWEC should be no more than \$500,000,000 of secured callable notes from PWEC. The security interest shall be on the same terms as the security interest APS already has pursuant to the \$125,000,000 loan authorization from Decision No. 65434;
3. The PWEC secured note coupon shall be 264 basis points above the coupon on APS debt issued and sold on equivalent terms (including but not limited to maturity and security);
4. The difference in interest income and interest expense should be capitalized as a deferred credit and used to offset rates in the future. The deferred credit balance shall bear an interest rate of six percent;
5. The PWEC debt maturity shall not exceed four years, unless otherwise ordered by the Commission;
6. Any demonstrable increase in APS' cost of capital as a result of the transaction, such as from a decline in bond rating, will be extracted from future rate cases; and
7. APS shall maintain a minimum common equity of 40 percent and shall not be allowed to pay dividends if such payment would reduce its common equity ratio below this threshold, unless otherwise waived by the Commission. The Commission will process the waiver within sixty days, and for this sixty-day, period this condition shall be suspended. However, this condition shall not be permanently waived without an order of the Commission. During the hearing, Staff proposed two clarifications to Condition 7: that the condition should remain in effect indefinitely and that APS should file the capital structure calculation with the Commission within one week of filing a 10-Q or 10-K.

Staff's conditions 2 and 6 are designed to protect APS and its ratepayers from any harm that may result from this transaction. Condition 2 is necessary to ensure that APS' interests are protected if there were a default on the loan. Condition 6 puts the Company and its affiliates on notice that any negative credit effects to APS will not be borne by its ratepayers. Conditions 3 and 4 are designed to ensure that APS and its ratepayers are appropriately compensated for the risk associated with the transaction. Conditions 5 and 7 are intended to provide appropriate regulatory insulation between APS and its affiliates.

Staff believes that ordinarily, it would probably recommend denial of such a financing. However, Staff believes that the circumstances surrounding this application are "far from ordinary". "The financial markets are deteriorating, the energy sector is in disarray, electric utilities in neighboring states have suffered financial difficulties, and the wholesale market for electricity has been volatile. Against this backdrop, the Commission's policy should be aimed at ensuring that Arizona will continue to have financially sound electric utilities. Because of the potential risk of a downgrade to APS' credit rating, the Commission should approve APS' application; because of the potential risks inherent in this transaction, the Commission should condition its approval upon Staff's seven conditions." (Staff Initial Br. At 6).

Staff asserts that the Commission should not base its approval of this application upon APS' allegations that the Commission is at fault for PWCC's predicament. Staff states that throughout its presentation of its case, "APS has implied that the Commission is responsible for PWCC's dilemma, claiming that the Commission 'largely created' this problem 'in the first instance.' (Ex. APS-1 at 24). Over and over again, APS insinuates that the Commission's Track A order is largely to blame, (APS' Br. At 5, 7), and that the Commission is now responsible for repairing that order's 'loose ends.' (Tr. at 586). Finally, APS has stated that incurring the bridge debt was 'consistent with Commission guidance and directives,' (APS' Br. At 8), as if the Commission were the entity that decided to build the PWEC assets and to finance them through short term bridge debt. The Commission should not conclude that it is responsible for PWCC's problems, and it certainly should not base its approval of this application upon such claims." (Staff Reply Br. at 5).

Staff cites the existing turmoil in the financial markets and the volatility that has existed in the

wholesale electric market. Staff's witness testified that if the Commission had not stopped divestiture, given the current market situation, PWEC could have been facing an even worse problem than trying to finance now. Staff further noted that the "PWCC enterprise chose to build the assets at PWEC, chose to finance them at the holding company level, and chose the maturities of the debt. None of these decisions were made or sanctioned by the Commission. APS will argue that its code of conduct prevented it from building the PWEC assets at APS (Tr. at 520); nonetheless, an examination of that document does not clearly support that conclusion." (Staff Reply Brief at 5-6)

RUCO

RUCO recommends granting the financing application and also proposes that APS be required to file an application with the Commission within 45 days to transfer the PWEC generation assets to APS.

RUCO believes that because APS will use borrowed funds to protect its own credit rating, the financing is within the proper performance of its duties as a public service corporation. Based upon Moody's December 30, 2002 Opinion Update on APS and Standard and Poor's statement that "[e]ven on a stand-alone basis, APS' financial health remains solidly within the 'BBB' category even with the addition of \$500 million in debt" (Ex S-4), RUCO believes that the financing will not impair APS' ability to perform its public service obligations.

RUCO believes that with conditions, the financing is compatible with the public interest. According to RUCO, it will allow PWEC/APS to maintain the generation assets to the benefit of APS customers. RUCO notes that generally, a utility issuing debt to finance assets owned by an affiliate is not compatible with sound financial practices, however, RUCO believes that it and Staff have proposed conditions that would make the financing consistent with sound financial practices. RUCO recognizes that "[t]ransferring the PWEC assets to APS and including some or all in rate base could signal the death knell for wholesale competition", however, RUCO argues that "it is in the public interest for the Commission to take action to protect the public, even if that means returning to an integrated electric utility model at this time." (RUCO Reply Br. at 3) RUCO concludes that granting the APS application is "merely a stopgap measure to prevent PWCC from defaulting on its short-term debt obligations and going into bankruptcy" and that a "cohesive comprehensive plan to rebuild the

regulatory paradigm is necessary to return the electric industry in Arizona to functional viability." (RUCO Br. At 7)

PANDA

Panda recommends that the Commission deny the financing application, but if it does approve some form of credit support to an affiliate, that the Commission require that it be in the form of a guarantee of affiliate debt, but not a direct inter-company loan. Panda disagrees with APS' assertions that PWCC cannot refinance the debt itself; that PWCC will be downgraded if the financing application is denied; that APS will be downgraded if the financing application is denied; and that if the financing is approved, APS will not be harmed, even with the Staff conditions.

According to Panda, APS asserted two primary reasons for Commission approval of the financing. First, APS argues that the Commission's decision in the Track A harmed it and its parent and affiliate, and that the Commission should approve the financing as a remedy. Second, APS argues that PWEC is fundamentally different from other merchant generators and therefore, Commission should protect it.

Susan Abbott, a former Moody's analyst with twenty years experience rating utility companies, including APS, testified on behalf of Panda.

Panda argues that there is no evidence in the record that PWCC will suffer a downgrade if APS does not refinance the bridge debt. In its Initial Brief, Panda states "APS introduced NO written evidence that PWCC would be downgraded if it refinanced or renegotiated the bridge debt at the holding company level, nor any evidence that such a refinancing or renegotiation is impossible. Rather, Ms. Gomez relied on undocumented and unsubstantiated conversations she allegedly had with lenders and rating agency personnel during the course of which, or even after which, she failed to take a SINGLE note. Tr. at 114, lines 3-6 ... In short, Ms. Gomez could produce no evidence to back up her assertion that PWCC would be downgraded if it refinanced the bridge debt at the holding company level." (emphasis original) (Panda Initial Br. p. 11) Panda's witness testified that were she analyzing PWCC, she would not recommend a rating downgrade if PWCC refinanced the debt, because PWCC's credit metrics would remain within the BBB range. Ms. Abbott further noted that APS testified that PWCC could raise \$300 million over the next year for its Nevada generation

(Silverhawk).

Panda also argues that there is no evidence in the record that APS will suffer a downgrade if PWCC is downgraded. Panda's witness testified that a downgrade of a holding company can result in a downgrade of the utility subsidiary when the parent's debt load is so high as to require substantial dividends from the utility company in order for the parent to service the debt, but here, the debt load of the parent would not change, since it is a refinancing. Panda argues that any evidence that APS will not be downgraded if it assumes an additional \$500 million in debt is "either not credible or is entirely self-serving." (Initial Br. at 14) Panda's witness testified that the analysis of the rating agencies depends on what information was provided by the utility, and Panda argues that since APS sent its testimony (which says APS intends to seek rate base treatment of the PWEC generation assets) to the rating agencies but APS' witness cannot remember what she told the rating agencies, there is no way to know whether the analyses presume rate base treatment of the PWEC assets, and therefore would decline if the assets did not become rate based. Panda also argues that the relevance of prior rating agency statements are questionable "given that APS appears to have provided inaccurate information to the rating agencies and analysts in the past as well. Shortly after the 1999 Settlement and after PWEC proposed constructing generation assets, APS and PWEC told the rating agencies that PWEC and APS either had, or would, enter into a four-year Power Purchase Agreement ("PPA") for the supply of APS' power requirements, even though the final two years of the PPA would be AFTER the date when APS was required to procure 100% of its Standard Offer Service requirements from the competitive market rather than from its unregulated merchant affiliate. Exhs. P-23, 24 and 25. On cross-examination, Ms. Gomez admitted that there really was no such PPA, and that APS merely told the rating agencies that it 'expected' to sell power under just such a contract. Tr. at 145-146. The documents offer no such qualification, and it is reasonable to infer, therefore, that had the agencies been provided more accurate information, they likely would not have opined as they did." (Panda Initial Br. at 14-15)

Ms. Abbott testified that if additional leverage were to be placed on APS, it is difficult to believe that would not be reflected in a ratings downgrade by Moody's and Fitch, and by S&P at the first mortgage bond level. She found that APS' financial parameters would decline significantly, and

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although they are not the only concern for the rating agencies, they are important guideposts that have a heavy influence on ratings. Panda argued that even if APS is not downgraded as result of making a loan to its affiliate, its credit quality will suffer. Ms. Abbott testified that approval of the financing application would diminish APS' credit quality and that she would have not recommended keeping the rating the same based on her analysis and conclusion that the resulting financial metrics were more commensurate with those of other vertically integrated fully regulated utilities in the "B 11" range. (Tr. at 752) She expressed some surprise at Moody's December 30, 2002 statement, indicating that although ratings are not the sole product of financial metrics, it is not known what information APS provided to Moody's. APS Treasurer, Ms. Gomez testified that she did not keep records of her conversations.(6)

Another concern expressed by Ms. Abbott is that a loan or guarantee between APS and PWCC would make that relationship closer, and APS will be less protected from negative circumstances affecting PWCC. She concludes that there are negative consequences to APS ratepayers in the long run, including higher interest cost should APS be downgraded, and a less robust competitive market in Arizona leading to higher purchased power costs. Panda believes that the appropriate place to refinance the PWEC assets is at PWCC.

Panda cites the rulemaking docket and order that adopted the Public Utility Holding Companies and Affiliated Interests Rules A.A.C. R14-2-401 ET SEQ. ("Affiliated Interest Rules") to support its position that the application should not be granted. Panda quotes the Commission's

Concise Explanatory Statement:

The Rules were first promulgated in 1985 in response to the formation [of PWCC by APS] and to its acquisition one year later of MeraBank, a federal savings and loan institution. The Commission at the time expressed concerns that the transactions would prevent proper regulation and effect the establishment of rates for APS. In response, APS and its parent offered assurances to the Commission

(6) Q. I think you responded in response to data requests that, in fact, you have no written statements from any of the financing agencies; is that correct? As far as your discussions with them?

A. That's right. We don't keep documentation of the discussions with them.

Q. Why is that?

A. It's our practice to not keep documentation.

Q. Okay. So you keep no documentation of any of your discussions with Moody's, Fitch, Standard & Poor's?

A. No, I don't. The discussions happen frequently and I do not keep records of that. Gomez Tr. pp. 113-114. See also TR. At 117 & 298.

that the concerns were unfounded ... The huge capital losses which have recently been experienced by MeraBank and have forced Pinnacle West to the brink of financial collapse served as the catalyst for the Commission to again engage in rulemaking for the regulation of public utility holding company formation and affiliated transactions ... Article 8 is designed to ensure that utility ratepayers are insulated from the dangers proven to be inherent in holding company structure and diversification. Its singular purpose is to ensure that ratepayers do not pay rates for utility service that include costs associated with holding company structure, financially beleaguered affiliates, or sweetheart deals with affiliates intended to extract capital from the utility to subsidize non-utility operations.(7)

The Concise Explanatory Statement also stated that the Rules were intended to implement these principles: "First, utility funds must not be commingled with non-utility funds. Second, crosssubsidization of non-utility activities by utility ratepayers must be prohibited. Third, the financial credit of the utility must not be affected by non-utility activities. Fourth, the utility and its affiliate must provide the Commission with the information necessary to carry out regulatory responsibilities." (Id.)

Panda concludes that "APS's (sic) assertion that APS' credit rating will be adversely affected if it is not permitted to loan half a billion dollars to its non-regulated affiliate is clearly an action that the Affiliated Interest Rules were intended to prohibit." (Panda Initial Br. at 5-6)

Panda argues that APS failed to prove the elements required by the statutory and regulatory standards, but instead posed the "eight 'benefits'" it believes the financing provides.

Panda argues that the evidence demonstrates that PWEC assets were built to serve the wholesale market, not APS customers. (Panda Initial Brief pp 15-19)

Panda believes that if the Commission decides that it is in the public interest for APS to provide some credit support for its affiliate, it should be in the form of a guarantee, and not a loan.

Panda recommends that the Commission restrict any financing to an APS guarantee of PWEC's debt because it would: maintain the separation of regulated and unregulated assets; preserve to the greatest extent possible the goal of wholesale competition; not prejudice or call into question the issue of rate basing PWEC assets; allow PWEC to make an entry into the financial markets(8); and

(7) In the Matter of the Notice of Proposed Adoption of Rules for Regulation of Public Utility Companies with Unregulated Affiliates, Decision No. 56844, Attachment B at 2 (1990).

(8) APS' witness, Arthur Tildesley of Salomon Smith Barney testified that while the guarantee structure "may be perceived by investors as somewhat more complex and may be marginally more expensive than an intercompany loan, it has the benefit of the notes being issued directly by PWEC." (APS-3 at 9)

APS credit quality would not suffer as much, because there is no interest obligation on a guarantee.(9)

Panda believes that the Commission's goal should be to establish PWEC as a standalone entity as soon as possible, and a direct loan from APS to PWEC would perpetuate the relationship between regulated and unregulated entities, whereas a corporate guarantee would provide more of a degree of separation.

Panda argues that APS' new reason to prefer a loan to a guarantee is because the guarantee would be more difficult to undo if the PWEC assets are rate based. Panda states that the "Commission is faced with the choice of using a guarantee, which APS witnesses have testified advances the future potential of PWEC standing on its own two feet, or allowing an inter-company loan, the only benefit of which is that it makes APS' desire to rate base the PWEC assets easier. With these facts and the Commission's objective to preserve a viable competitive wholesale market, it should be an easy choice for the Commission to select the corporate guarantee over the interaffiliate loan." (Panda Initial Br. at 27) "Putting the PWEC assets in APS' rate base is the antithesis of promoting wholesale competition. As Jack Davis made clear, if the PWEC assets go into rate base they will all but eliminate APS' capacity and energy needs going forward. Tr. at 655 ... Based on Mr. Davis' testimony, there is little question that rate-basing the PWEC assets would decimate wholesale competition in Arizona. Hence, if approval of the loan option would make this rate-basing any more likely, it should be rejected in favor of the guarantee option." (Panda Initial Br. at pp 28-29).

Panda argues that the potential harm to wholesale competition can be created by the loan itself and by a default under the loan. APS has indicated its intent to transfer the PWEC assets to APS and seek rate base treatment, and defaulting on the loan could accomplish that goal. According to Panda, APS' assertions that the potential for cross-defaults would prevent a PWEC default would not suffice, because the PWCC debt that contains cross-defaults will expire, leaving only a \$25 million callable Prudential loan at the end of 2004. Further, even if new debt contains the cross-default provisions, Panda believes that since the cross-default language is discretionary (the lender MAY declare the debt

(9) APS testified that it proposed the guarantee option "because of its potentially reduced impact on APS and because it might provide PWEC some 'credit exposure' in the market that would be valuable in the future." (APS-2 at 7).

to become immediately due and payable) and that such provisions are routinely waived by lenders, a waiver would be expected in an inter-company transaction. Panda also believes that APS' assertion that Deeds of Trust would also prevent automatic transfer to APS upon PWEC default is without merit, as the Deeds of Trust allow APS to 'enter upon and take possession of the trust estate.' Deed of Trust at 9, paragraph 1.10." (Panda Initial Br. at 31). Panda argues that a direct inter-company loan has the potential to adversely affect wholesale competition because APS would have a strong incentive to prefer its affiliate in the Track B competitive solicitation, both to support payment of its loan and to establish a case for rate base treatment of the PWEC assets.

Panda also points out that the cost of a guarantee would have been evaluated when APS first proposed that alternative, and states that any costs of pursuing a guarantee would be borne by PWEC and would be of no consequence to APS or its customers.

Panda proposes what it believes are three critical terms to any guarantee: the PWEC assets must be pledged as collateral for the loan; the lender must execute on the assets prior to seeking payment from APS; and APS should not be permitted to bid on the assets in the event PWEC were to default and a sale of assets be held.

In response to APS' argument that under a guarantee, ratepayers will not have the benefit of the conditions Staff proposes, Panda argues that these are not "benefits" but ways to mitigate harm from the financing. Panda also argues that Staff's conditions only address the rate impacts of an increase in APS' cost of capital, and do not address other ways approval of a loan may harm APS ratepayers. Panda believes that loan approval will directly harm the competitive market by making it much more likely APS will ultimately be able to include the PWEC assets in APS rate base. Staff did not analyze the effect of loan approval on wholesale power rates, and Panda argues that therefore, Staff cannot be certain that approval of the application will not harm APS customers.

In response to Staffs assertion that a guarantee is inappropriate, Panda argues that if Staff still believes that a risk premium is appropriate to reflect the risk that APS would be called upon to pay the amount of difference between the underlying; PWEC debt and the value of the PWEC assets, the transaction could be structured to collect such a risk premium from PWEC. Panda states that Staffs concern about APS not having a primary security interest is misplaced unless the point of the security

interest is that APS ultimately owns the PWEC assets or if Staff believes that the PWEC assets are not worth at least \$500 million. This is because the security interest requirement is to make sure that ratepayers are protected by allowing an opportunity to exercise on the collateral to recover the loan. Under the guarantee, APS would bear no risk of making any payment unless and until PWEC defaults, and only then if the PWEC assets are sold for less than the deficiency amount. As far as Staff's assertion that a guarantee is impractical, Panda notes that it was APS that proposed the guarantee and has consistently agreed to use the guarantee if the Commission determined that it was appropriate; that APS has had time to any prepare and address any additional complexities; and that APS' own lender witness testified that his firm would be interested in placing the guarantee and underlying PWEC debt.

SEMPRA/SWPG/BOWIE

Sempra/SWPG/Bowie believes that the Commission should deny the financing for both policy and failure of proof reasons.

Sempra/SWPG/Bowie believes that serious questions exist as to whether APS has satisfactorily discharged its probative burden under A.R.S. ss. 40-301(C). Sempra/SWPG/Bowie argues that the analysis should look at "whether the proposed borrowing and loaning by APS is for a 'lawful purpose' directly related to each of the five (5) decision making standards set forth in A.R.S. ss. 40-301(C)." (emphasis original)(Reply Br. at 9)

Specifically, Sempra/SWPG/Bowie concluded that APS had not met its burden of showing that its proposed financial assistance to its affiliate is within its corporate powers and intended corporate purpose.

Sempra/SWPG/Bowie argues that the record contains no credible evidence that APS' creditworthiness or financial integrity would be impaired if the financing were denied. Sempra/SWPG/Bowie state that "[o]n the face of it, the use of its creditworthiness and financial resources by APS to prop up an unregulated generation affiliate, and to financially back-stop its unregulated corporate parent, would appear to have nothing to do with the proper performance of its role and obligations as a public service corporation" (Sempra/SWPG/Bowie Initial Br. at 11), a finding required under A.R.S. ss. 40-301(C). Sempra/SWPG/Bowie further stated that APS

acknowledges that it may be required to secure a loan with mortgage lien on APS assets and argues that "[t]he very existence of such a mortgage lien would, by its very nature, restrict APS' ability to use its assets to borrow or bond for its own needs from what would otherwise be the case." (Br. at 12) Sempra/SWPG/Bowie believes that given this uncertainty, APS is unable to show that its ability to properly perform its public service obligations might not be impaired at some future date.

Sempra/SWPG/Bowie suggests that when looking at whether the financing is in the public interest, the Commission may consider whether the purposes underlying APS' proposed borrowing and lending, or guarantee, are consistent with its purpose and responsibilities as a public service corporation and whether there is a risk that the results would be inconsistent with other "public interest" determinations previously made by the Commission. (Sempra/SWPG/Bowie Reply Br. at 11)

Sempra/SWPG/Bowie argued that it is imperative that this Decision not undercut or dilute the Commission's efforts to facilitate the development of a viable competitive wholesale electric market through the Track B proceeding or preposition the Commission as to how it may resolve any future APS request to acquire or rate base PWEC's generation assets.

In its Reply Brief, Sempra/SWPG/Bowie argues that APS continues to attribute a potential "liquidity crisis" that threatens its parent's financial integrity to Decision No. 65154. Sempra/SWPG/Bowie notes that the Track A proceeding was instituted in part in response to APS' Variance/PPA application; that it was APS' parent, PWCC, that decided how to finance the PWEC assets and chose the maturity dates for such financing; and that there is no suggestion that APS had any role in that decision or that the Commission was consulted. "Rather, it appears PWCC made the decision for its own financial gain, and with a view towards avoiding 'more expensive and restrictive financing' [APS Initial Brief, page 6, lines 4-7] However, now that PWCC and PWEC apprehend difficulty in arranging for permanent financing of these generation assets, they look to APS and its creditworthiness to 'bail' them out, although there is no evidence in the record that PWCC ever intended to share the benefits of its reduced interim financing costs with APS or its ratepayers." (Sempra/SWPG/Bowie Reply Br. at 3-4)

Sempra/SWPG/Bowie also notes the "failure of APS (and its unregulated parent and

generation affiliate) to avail itself of the Commission's invitation in Decision No. 65154 to file an application seeking approval to acquire PWEC's generation assets. Such an application was to be filed on or before September 15, 2002, if APS decided to pursue that course of action. Had it elected to do so, that matter might have been resolved by now; and, perhaps an entirely different scenario might have unfolded without a purported 'liquidity crisis'... It is very clear from the record in this proceeding that APS has the financial capacity to issue additional bonds and thus raise funds by which it could have acquired PWEC's generation assets, without the necessity of an accompanying rate increase." (Reply Br. at 4-5)

Sempra/SWPG/Bowie is also concerned by APS' acceptance of Staffs recommended condition that the term of the loan not exceed four years, because a four-year loan will not solve PWCC's purported need to arrange permanent financing for PWEC's generation assets, and APS' and PWCC's plan have no "exit strategy" if the Commission grants the financing but denies an APS application to rate base the generation assets. Sempra/SWPG/Bowie believes that APS and PWCC are actually seeking to put the Commission in a position of having no alternative but to approve an APS request for rate base treatment of PWEC assets.

AECC

AECC takes no position on approval of the financing application, but it is concerned about the effect approval will have, VIS A VIS a December 13, 2002 Memorandum from the Director of the Utilities Division to the Commissioners, with an attached document titled "Track 'A' Appeals Issues Principles For Resolution." ("Principles of Resolution") AECC argues that a Commission decision granting the financing without specifically rejecting certain provisions of the Principles of Resolution "will have the effect of: 1) breaking the Commission's reassurance in Decision No. 65154 not to undermine the benefits that the parties have bargained for under the APS Settlement Agreement; 2) amending Decision No. 61973 without complying with the provisions of A.R.S. ss. 40-252; and 3) may constitute "legal action" by settling litigation currently before the courts without proper notice under Arizona's open meeting law." (AECC Opening Br. at 2-3)

RELIANT

In its Opening Post-Hearing Brief, Reliant states that it intervened in this financing docket to

"guard against the possibility that the financing application might subvert the efforts of the Commission and numerous parties to develop a fair and open competitive wholesale generation market." (Reliant Br. at 3) Reliant requests that this Decision expressly find that neither the implementation of the Track B competitive solicitation process nor the Commission's consideration of whether to authorize APS to acquire PWEC generation assets or their rate base treatment will be prejudiced or adversely affected by this Decision..

APS indicates that granting this application will not give PWEC any advantage in meeting the credit requirements in the Track B process, because PWEC will remain without an investment grade rating.

ANALYSIS

The Company is requesting approval of either an inter-company loan, a guarantee, or a combination of both. The proceeds of the long-term debt incurred by APS would then be loaned to either PWEC or PWCC. The funds would be used to pay off an equivalent amount of PWCC debt previously incurred to finance construction of West Phoenix combined cycle generating units 4 & 5, Saguaro combustion turbine Unit No. 3 and Redhawk Units 1 & 2. As a supplement to a loan, or as an alternative, APS seeks authority to guarantee debt issued by PWEC or PWCC.

APPLICABLE STATUTES/REGULATIONS

Pursuant to Arizona Revised Statutes ss.40-285(A), "[a] public service corporation shall not sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, line, plant, or system necessary or useful in the performance of its duties to the public ... without first having secured from the commission an order authorizing it to do so."

A.R.S. ss. 40-301(C) sets forth the minimum requirements that the Commission must find to authorize APS' issuance of additional debt.

A.R.S. ss. 40-301

A. The power of public service corporations to issue stocks and stock certificates, bonds, notes and other evidences of indebtedness, and to create liens on their property located within this state is a special privilege, the right of supervision, restriction and control of which is vested in the state, and such power shall be exercised as provided by law and under rules, regulations and orders of the commission.

B. A public service corporation may issue stocks and stock certificates, bonds, notes and other evidences of indebtedness payable at periods of more than twelve months after the date thereof, only when authorized by an order of the commission.

C. The commission shall not make any order or supplemental order granting any application as provided by this article unless it finds that such issue is for lawful purposes which are within the corporate powers of the applicant, are compatible with the public interest, with sound financial practices, and with the proper performance by the applicant of service as a public service corporation and will not impair its ability to perform that service.

Pursuant to A.R.S. ss. 40-302, the Commission may grant or refuse to grant permission and may attach whatever conditions it deems reasonable and appropriate.

A.R.S. ss. 40-302

A. Before a public service corporation issues stocks and stock certificates, bonds, notes and other evidences of indebtedness, it shall first secure from the commission an order authorizing such issue and stating the amount thereof, the purposes to which the issue or proceeds thereof are to be applied, and that, in the opinion of the commission, the issue is reasonably necessary or appropriate for the purposes specified in the order, pursuant to ss. 40-301, and that, except as otherwise permitted in the order, such purposes are not wholly or in part, reasonably chargeable to operative expenses or to income

B. The commission may grant or refuse permission for the issue of evidences of indebtedness or grant the permission to issue them in a lesser amount, and may attach to its permission conditions it deems reasonable and necessary. The commission may authorize less than, equivalent to or greater than the authorized or subscribed capital stock of the corporation, and the provisions of the general laws of the state with reference thereto have no applications to public service corporations.

Pursuant to A.A.C. R14-2-804(B), APS cannot lend to any affiliate not regulated by the Commission or obtain a financial interest in any affiliate not regulated by the Commission, or guarantee, or assume the liabilities of the affiliate, without approval of the Commission. Pursuant to A.A.C. R14-2-804(B), the Commission will review the transactions "to determine if the transactions would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service."

OBLIGATIONS OF CERTIFICATED PUBLIC SERVICE CORPORATIONS

As a certificated public service corporation in Arizona, APS has a duty to provide reliable electric service to its customers at reasonable rates. In furtherance of that duty, APS should manage its business and operations to insure that it is financially capable of providing such service. It is in

the public interest that APS maintain healthy credit ratings so that APS has access to the capital markets at reasonable terms and rates, as those costs are reflected in rates paid by APS customers. Further, APS has a duty to comply with applicable statutes, regulations, and Commission decisions.

NEED FOR APS CREDIT SUPPORT

Much of the testimony focused upon who may be downgraded if the financing application is approved or denied. APS argued that neither PWCC nor PWEC can refinance the existing PWCC debt at reasonable terms without support from APS. APS further argues that PWCC will be downgraded if the application is denied and APS will be downgraded if PWCC is downgraded. APS argues that a downgrade would impair its ability to obtain credit to support its utility operations and possibly interfere with its ability to provide electric service. Staff and RUCO agreed with APS' conclusions. Panda argued that PWCC could refinance the debt and that if APS issues debt to loan to PWEC, it is likely to be downgraded, and at the very least, its credit quality will suffer.

Staff believes that a rating downgrade at APS could interfere with APS' ability to provide electric service to the public - it could result in increases in cost of capital, potential lack of access to the capital markets, potential increases in collateral requirements, and an inability to do business with vendors. Staff concluded that "there is some risk of ratings downgrade to PWCC, and as a consequence, to APS." (Staff Initial Br. at 3-4) Although Staff believes that "the evidence on this issue is clothed in conjecture and speculation, significant evidence nonetheless supports the conclusion that PWCC is at risk for credit downgrades. As a consequence, APS faces a similar risk." (Ibid at 4).

Rating agency reports indicating a potential for a PWCC downgrade include a December 2002 Fitch report stating "[f]ailure to obtain the inter-company loan or access alternate sources of funding would result in a downgrade of PNW" (APS-2, Ex. BMG-2R); Standard and Poor's November 4, 2002 report stating "[t]he stable outlook reflects the assumption that the ACC will approve the application by PWCC to issue up to \$500 million at APS to repay a portion of the \$750 million bridge financing at PWCC" (Staff Ex.4); and a December 30, 2002 Moody's report stating "PWCC's rating outlook is stable and incorporates the view that the ACC will adopt the staff recommendation concerning the APS financing application, which should allow for a successful

refinancing of PWCC debt." (APS Ex. 5).

The likelihood of an APS downgrade in the event of a PWCC downgrade is more speculative. Staff's witness testified that he could not state for a fact that APS would be downgraded, but cited the December 30, 2002 Moody's Opinion update (APS Ex. 5) which states: "APS' rating outlook is stable and incorporates the view that the ACC will adopt the staff recommendation concerning the APS financing application and other Track A issues. Moody's notes that while APS' coverages may decline if the financing application is approved, the resulting credit metrics should remain consistent with the current rating, particularly when one considers the benefits to bondholders of having APS remain vertically integrated." Staff acknowledges that the report is subject to interpretation, but believes that it implies that APS' ratings outlook is stable as long as the financing application is approved.

Panda's witness testified that APS acquiring additional debt to loan to PWEC should result in a downgrade of APS, whereas, PWCC refinancing its existing bridge debt should not result in a downgrade of PWCC or APS. Logically, this analysis makes sense. However, we do not know what APS told the rating agencies

- since Ms. Gomez sent them her testimony that indicates that APS seeks to rate base these assets, we do not know whether or how this information was factored into the agency opinions. Therefore, it is possible that APS may be downgraded if APS led the rating agencies to believe that the assets are going to be rate based, and that the assets had an assured cash flow.

This testimony and evidence on the need for APS credit support consists of speculation on actions that third parties may take as a result of our decision. Our foremost concern and guiding principle is what is in the best interest of the ratepayers of APS. Although it is not clear to us that APS would be downgraded if this financing application is denied, we are not willing to risk that since we believe that with appropriate conditions, we can minimize the effects of the financing on the ratepayers. Accordingly, APS should be authorized to provide credit support.

FORM OF APS CREDIT SUPPORT - LOAN AND/OR GUARANTEE

APS seeks either a loan and/or a guarantee. Staff supports only a loan, and Panda supports only a guarantee.

LOAN

Panda and other intervenors urge the Commission not to approve a loan because it does not maintain separation between APS and its affiliate; it would undermine wholesale competition; and because APS' credit quality would not suffer as much as with a guarantee.

We stated in Decision No. 65434 (December 3, 2002), that we would examine ways to improve the regulatory insulation between APS and its affiliates in this docket. We are also concerned about regulatory insulation, but find that Panda's concerns about a loan can be addressed in the conditions we place upon a loan, by monitoring subsequent events including the Track B solicitation, and through our Affiliated Interest Rules. (10) Further, we are not adopting RUCO's recommended requirement that APS file an application to acquire or rate base the PWEC assets, and none of the proceeds will be used for or to support PWEC's non-Arizona generation assets.

Although APS' witness Tildesley testified that for purposes of determining the impact on APS, he assumed no repayment capacity at PWEC, we are approving this financing based upon the testimony of President and Chief Executive Officer for APS and the President of PWCC, Jack Davis, that if PWEC did not win any bids in the Track B competitive procurement, that PWEC would sell its power out into the wholesale market, and that that would generate sufficient funds to pay the loan to APS. (Davis Tr. p. 641). Additionally, APS will soon be filing a rate case and we can take further action to protect ratepayers at that time, if necessary. Therefore, if there are any negative effects of the financing (in addition to Staff's identified capital cost concerns), we will insure that APS' ratepayers are held harmless. Further, we will require that APS notify the Commission in the event of a default on the loan, so that the Commission can take appropriate action. Staffs Condition 2 requires APS to obtain a security interest in the PWEC assets and only APS has such a lien, so APS would have the first priority in the event of a default. (Tr. 269-272)

APS generally agreed with Staff's conditions for a loan approval, but requested modification of Condition 3 to reduce the point spread from 264 to 150. APS believes that Staff's premium is excessive and "substantially overstates the risk undertaken by APS". APS' point spread corresponds

(10) See discussion and conditions hereinafter in the Affiliated Interest Rules section.

to the difference between APS' credit rating and the rating APS believes PWEC would have obtained absent Decision No. 65154. Staff believes that the loan should be priced at an appropriate market rate - PWEC's current status reflects a BB minus rating which is not investment grade. Staff's basis point risk premium is designed to insure that APS will be compensated for the actual risk associated with lending money to PWEC. We agree with Staff that APS should be compensated for the actual risk and given PWEC's acknowledgement that it could not obtain project financing even prior to Decision No. 65154,(11) believe that Staff's premium is appropriate.

APS proposes that the Commission adopt its clarification to Condition 7, by defining the calculation of the amount of common equity to mean calculated on a quarterly basis, using APS' 10-Q or 10-K filings with the Securities and Exchange Commission. Using the reported APS balance sheet accounts, APS' common equity would be divided by the sum of such common equity and APS long-term debt (including current maturities of such debt). Staff did not disagree with this method. However, it is not clear from APS' clarification if this new debt is to be included in the calculation,(12) so we will approve APS' clarification with the condition that the debt financing approved herein will be included in the calculation.

Accordingly, we will adopt Staff's recommended conditions to APS' financing, with the clarifications above.

GUARANTEE

In its Initial Brief, APS indicates that although it initially requested either a loan or a guarantee, if forced to choose between the two, it prefers the loan option, primarily because of timing - it believes that the financial markets are more familiar with APS debt so an APS loan would be easier and quicker than if potential lenders must do "market discovery" on PWEC. This is especially so if "it is determined that PWEC should register its debt with the SEC as an initial public offering rather than place debt privately." APS also believes that Staff's conditions would be difficult to implement with a guarantee. Further, APS believes that an APS loan would "reduce future issues involved in the determination by the Commission of the ultimate retaking treatment" of the PWEC

(11) Tr. At 211

(12) Staff recommends a maximum term of four years, which would likely not be included in long-term debt.

assets because "it minimizes any subsequent costs of assuming or refunding the PWEC debt being guaranteed by APS." (APS Initial Br. at 25) Further, a guarantee would be more costly to PWEC.

APS believes that Panda's three critical conditions on a guarantee should be rejected as impractical, unnecessary, and contrary to APS' customers' best interests. APS criticizes Panda's requirement that PWEC assets should be pledged to a third-party lender as directly conflicting with Staff's Condition No. 2; that a requirement that a third-party lender execute on PWEC assets before seeking payment from APS would make the financing unmarketable; and that precluding APS from bidding on PWEC assets in an auction would violate a fundamental principle in commercial secured transactions that "a creditor is entitled to protect its own equity in an investment by bidding at least its secured amount into any auction" (APS Closing Br. at 15); and would prevent the Commission from ever considering the used and usefulness of the plants.

Staff opposed APS' request to guarantee the debt issued by PWCC or PWEC because Staff believes that it is "undefined, impractical, ill suited by the circumstances of the case, and unsupported by the record." (Staff Initial Br. at

6) Even if a guarantee were well defined, Staff believes that a loan would better protect ratepayers because an explicit loan with a stated interest rate would set forth the APS risk exposure. Further, Staff is concerned with the timing and complexity of a guarantee and believes that a guarantee would interfere with Staff's condition that APS hold a security interest in the PWEC assets. In response to Panda's argument that a guarantee would maintain separation between APS and its affiliates, Staff states that although regulatory insulation is important, it would be unreasonable to structure this transaction around that single goal.

We believe that APS should have the flexibility to use the guarantee option if it would be in the best interests of ratepayers. Although none of the parties are as familiar with such a guarantee, we believe that it is possible to structure such a guarantee to address the concerns raised by Staff in its proposed conditions to the loan approval. Not all of the debt to be refinanced is due this summer, and it may be possible to use a combination of debt now and guarantee later. If APS chooses to use the guarantee option, it shall consult with Staff to make sure that the transaction's structure meets Staff's concerns. We find that Panda's proposed restriction limiting APS' ability to bid at auction to preserve its equity is not in the public interest.

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COMPLIANCE WITH A.R.S. ss. 40-301

In response to Sempra/SWPG/Bowie argument that the financing is not within its corporate powers, APS argues that its current Articles of Incorporation were adopted in 1988 under Title 10 of the Arizona Revised Statutes. A.R.S. ss. 10-054(A)(4) required all corporations to include in their articles of incorporation a brief statement of character of business the corporation intends to actually conduct, but the statement did not limit the character of business that the corporation ultimately conducted. Further, pursuant to A.R.S. ss. 10-301 & 302, corporations have the power to pledge property, borrow and lend monies, and engage in any lawful activity." APS argues that the language included in its Articles of Incorporation to comply with the then-applicable 1976 Arizona Business Corporation Act did not act as an implied limitation to the broad "purposes" paragraph of the Articles: We agree and find that the financing is for lawful purposes within APS' corporate powers.

Generally, a public service corporation borrowing funds to lend to an affiliate to refinance assets would not be considered to be in the public interest, to be consistent with sound financial practices, nor to be within the proper performance of its duties as a public service corporation. In fact, we adopted Affiliated Interest Rules in order to ensure that utility ratepayers are insulated from the dangers inherent in holding company structures and diversification. Their purpose is to make sure that ratepayers do not pay rates for utility service that include costs associated with the holding company structure, including financially beleaguered affiliates and "sweetheart deals with affiliates intended to extract capital from the utility to subsidize non-utility operations." However, we believe that with the conditions imposed in this decision, those goals can be met. Taking into account the events that have happened in the move to deregulate the electric industry, on both a national and local basis, including the current state of the financial markets, the public interest may require approval of some unusual requests that seemingly are not related to a utility's proper performance of its duties as a public service corporation. It is under this unique backdrop that we must analyze whether we can make the findings required by statute to approve this financing.

Approval of the financing will allow APS to use the borrowed funds to protect its own credit rating, and in that context, the financing is within the proper performance of its duties as a public service corporation. According to the rating agencies, APS' health will remain stable, even with the

additional debt. Although Staff found that APS has significant needs for capital for the regulated utility operations over the coming years and issuing debt to loan to PWEC would diminish APS' ability to obtain its own debt capital, the condition that the loan not exceed four years and APS' ability to fund capital expenditures from internally-generated funds together with the restriction on payment of dividends, will prevent the financing from impairing APS' ability to perform its service as a public service corporation. Generally, a utility issuing debt to finance assets owned by an affiliate is not consistent with sound financial practices, but with conditions of Staff, including the security interest in the PWEC assets and the interest premium paid by PWEC, there will be no "sweetheart deal" extracting capital from APS. Staff's witness testified that the financing is not obviously compatible with the public interest, but with conditions, it will protect APS' credit rating which will insure that APS can continue to provide electric service to its customers at a reasonable cost. We conclude that APS' financing with the conditions adopted herein, will be compatible with the public interest if, by preventing a downgrade in APS' credit rating, it prevents a substantial disintegration in APS' ability to provide service.

In December 2002, PWCC raised approximately \$200 million in net proceeds from the sale of common stock and the proceeds were used for debt reduction at PWCC. We believe that it is appropriate for PWCC to improve its overall financial health, but not at the expense of APS ratepayers. Accordingly, consistent with APS' argument that a downgrade to PWCC would result in a downgrade of APS, and in recognition of our approval of the financing, we expect that PWCC not take any actions (including issuing debt or equity) that would result in a downgrade to itself or to APS.

Through this financing application, PWCC is attempting to share the financial risks associated with the PWEC assets with APS. There is no evidence that APS analyzed the developing wholesale market and requested PWCC to build such assets⁽¹³⁾, and in fact, APS was obligated to purchase its power for Standard Offer customers from the competitive market, not through a PPA with its affiliate. PWCC's supposed claim "damages as a result of Decision No. 65154" rings hollow when

(13) Tr. p 281

one looks at the circumstances under which PWEC obtained its investment grade credit, especially against the background of our admonitions contained in Decision No. 61973,(14) and given APS' witness' testimony that by the time she started talking to bankers about refinancing options in the fall/winter of 2001(15), the options were basically the same as today. Nevertheless, we find ourselves in the situation where it appears that some action must be taken to prevent APS ratepayers from potential harm resulting from APS' parent's decision to build generation and to finance that generation with "bridge debt", in combination with the circumstances that currently exist in the financial markets. We believe that with the conditions contained herein, approval of the application is in the public interest.

CONTINUING LONG-TERM INDEBTEDNESS

As of June 30, 2002, APS had total outstanding long-term indebtedness in an aggregate principal amount of approximately \$2,206,780,000. Decision No. 55017 (May 6, 1987)(16) allows APS to have outstanding up to an aggregate principal amount of long-term indebtedness of \$2,698,917,000. Accordingly, APS has approximately \$492,137,000 in additional long-term debt authorization outstanding. APS views having such a debt margin as a "critical component of the financing flexibility afforded by the 1986 Order." (Application p. 10) APS requests that the Commission maintain the current margin under the Continuing Debt limit by not treating the new debt as Continuing Debt under the 1986 and 1984 Orders. Staff did not object to such treatment. Although we are not counting the new debt as continuing debt, we are including the \$500,000,000 in APS' capital structure for purposes of calculating the minimum 40 percent common equity ratio requirement for APS to issue dividends. Staff testified that "APS has significant needs for capital for regulated utility operations over the coming years" (Exhibit S-1, Thornton p. 1). APS' needs for capital for its regulated public utility service take precedence over PWCC's desire for dividends from APS. Accordingly, in the proper performance of its duties as a public service corporation, APS' financial decisions shall be governed by those duties, and not by the needs of its parent or affiliates.

(14) See Tr. p 275; pp 649-50

(15) Well before Decision No. 65154, issued in September 2002.

(16) The 1986 Order superseded the long-term indebtedness limitation granted APS in Decision No. 54230 (November 8, 1984) (1984 Order).

APS shall not forgo funding for needed utility operations so that it can pay dividends to its parent.

ASP DEBT - SECURED OR UNSECURED

On February 20, 2003, the Federal Energy Regulatory Commission ("FERC") issued a news release "Commission Sets New Conditions For Utility Debt Acquisition" and on February 21, 2003, issued its "Order Conditionally Granting Authorization to Issue Long-Term Unsecured Debt and Announcing New Policy on Conditioning Securities Authorizations" in Docket No. ES02-52-000, concerning Westar Energy, Inc.

Section 204 of the Federal Power Act ("FPA") provides that requests for authority to issue securities or assume liabilities shall be granted if FERC finds that the issuance:

(a) is for some lawful object, within the corporate purposes of the applicant, and compatible with the public interest, which is necessary or appropriate for or consistent with the proper performance by the applicant of service as a public utility and which will not impair its ability to perform that service, and (b) is reasonably necessary or appropriate for such purposes.

Section 204 of the FPA does not apply to a public utility organized and operating in a state where its securities issuances are regulated by a state commission. Accordingly, jurisdiction over APS' financing application is with this Commission. We note the similarities of Arizona's financing statutes with

Section 204 of the FPA and therefore, in addition to our consideration of state law, will consider and evaluate APS' application in light of FERC's newly announced conditions. Those conditions are:

* public utilities seeking authorization to issue debt backed by a utility asset must use the proceeds of the debt for utility purposes only;

* if any utility assets that secure debt issuances are 'spun off,' the debt must follow the asset and also be 'spun off'

* if any of the proceeds from unsecured debt are used for non-utility purposes, the debt must follow the non-utility assets. If the non-utility assets are 'spun off,' then proportionate share of the debt must follow the 'spun off' non-utility asset; and

* if utility assets financed by unsecured debt are 'spun off' to another entity, then a proportionate share of the debt must also be 'spun off'. The stated purpose of the conditions is "to prevent public utilities from borrowing substantial amounts of money and diverting the proceeds to finance non-utility businesses.

Under these FERC conditions, APS could not issue debt secured by its assets because the proceeds of the debt are not being used for a utility purpose, but are being used to lend funds to an affiliate to refinance affiliate debt. Further, if the funded non-utility assets are 'spun off', then the debt must follow the assets. Under this analysis, the non-utility assets are already divested or 'spun off' since they are owned by PWEC, and APS would essentially be acting as a secured lender. We believe that our condition to require APS to obtain a security interest in the PWEC assets assures that the debt follows the assets, and the interest premium paid by PWEC will compensate APS for its risk. We agree that it is not in the public interest for APS to use its assets to secure its debt and will limit the debt APS issues to unsecured debt only. As indicated hereinafter, we will further condition approval on APS and its affiliate's agreement to be bound by all the Affiliated Interest Rules, including those that APS obtained a waiver from in Decision No. 61973, during the terms of the loan and/or guarantee.

PRINCIPLES OF RESOLUTION

AECC believes that the Commission should reject certain provisions of the Principles of Resolution. Notwithstanding Staff and APS' agreement, any party may object to the inclusion of those issues in the rate case, and the presiding officer can determine the appropriate scope of the proceeding.⁽¹⁷⁾ However, as we said in Decision No. 65154, "[a]ccordingly, we will direct Staff to open a rulemaking docket to address any required changes to rules, and will keep this docket open for parties to file comments upon what other decisions/issues may need to be revisited." (p. 27) APS' ability to raise these issues may be limited by the Settlement Agreement, but until such time as that issue is before us, APS should comply with the terms of the Settlement Agreement if it seeks to modify issues resolved therein. Our approval of this financing application with the knowledge that Staff has filed its Principles of Resolution does not mean that we consider the Commission a party to the 1999 Settlement Agreement and have agreed to reopen the 1999 Settlement Agreement, nor is it intended to indicate our agreement that the issues set forth in the Principles of Resolution will be decided by us in the rate case. The Staff's Principles of Resolution is essentially an agreement by Staff not to object to APS' inclusion of these issues in the rate case, and does not eliminate APS'

⁽¹⁷⁾ It is possible that other parties may propose to address additional issues as well, such as APS' recovery of stranded costs from its ratepayers.

obligations to parties under the Settlement Agreement, or under A.R.S. ss. 40-252. As is clear in our discussion herein, our decision to approve the financing application with the conditions contained herein is not based upon APS' assertion that Decision No. 65154 "caused damages to APS" and is not related to settling the appeal filed by APS.

APS notes that it can withdraw portions of its Track A appeal on its own, with or without Commission action.

TRACK B - COMPETITIVE PROCUREMENT

As stated in the Company's application, "APS also wishes to make it clear that this Application does not affect nor is it intended to affect the Commission's consideration of, or the Company's position on, any of the 'Track B' issues identified in Commission Docket No. E-00000A02-0051. This too was an express part of the Commission's order in Decision No. 65154 (ID. at pp.33-34, Tenth Ordering Paragraph.)" (Application p. 4) APS indicates that granting this application will not give PWEC any advantage in meeting the credit requirements in the Track B process, because PWEC will remain without an investment grade rating.

Accordingly, the public interest requires that any improvement in PWEC's credit worthiness as a result of approval of this financing not be considered or used in the evaluation of bids/offers during APS' Track B competitive procurement. This will help neutralize possible "preference to an affiliate" incentives that may be created by approval of this financing. Further, we believe that we have structured the Track B proceeding to prevent favoritism.

Reliant requests that this Decision expressly find that neither the implementation of Track B competitive solicitation process nor the Commission's consideration of whether to authorize APS to acquire PWEC generation assets or the rate base treatment will be prejudiced or adversely affected by this Decision.

AFFILIATED INTERESTS RULES

Pursuant to Decision No. 61973 (October 6, 1999), APS was granted various waivers of the Commission's Public Utility Holding Companies and Affiliated Interests rules. Specifically, APS was granted waivers of:

* "R14-2-801(5) and R14-2-803, such that the term 'reorganization' does not include,

and no Commission approval is required for, corporate restructuring that does not directly involve the utility distribution company ('UCD') in the holding company. For example, the holding company may reorganize, form, buy or sell non-UDC affiliates, acquire or divest interests in non-UDC affiliates, etc., without Commission approval"; R14-2-805(A) "shall apply only to the UDC."

* R14-2-805(A)(2) R14-2-805(A)(6)

* R14-2-805(A)(9), (10),and (11).

R14-2-805(A) provides:

On or before April 15th of each calendar year, all public utilities meeting the requirements of R14-2-802 and public utility holding companies will provide the Commission with a description of diversification plans for the current calendar year that have been approved by the Boards of Directors. As part of these filings, each public utility meeting the requirements of R14-2-802 will provide the Commission the following information:

1. The name, home office location and description of the public utility's affiliates with whom transactions occur, their relationship to each other and the public utility, and the general nature of their business;

2 A BRIEF DESCRIPTION OF THE BUSINESS ACTIVITIES CONDUCTED BY THE UTILITY'S AFFILIATES WITH WHOM TRANSACTIONS OCCURRED DURING THE PRIOR YEAR, INCLUDING ANY NEW ACTIVITIES NOT PREVIOUSLY REPORTED;

3. A description of plans for the utility's subsidiaries to modify or change business activities, enter into new business ventures or to acquire, merge or otherwise establish a new business entity;

4. Copies of the most recent financial statements for each of the utility's subsidiaries;

5. An assessment of the effect of current and planned affiliated activities on the public utility's capital structure and the public utility's ability to attract capital at fair and reasonable rates;

6. THE BASES UPON WHICH THE PUBLIC UTILITY HOLDING COMPANY ALLOCATES PLANT, REVENUE AND EXPENSES TO AFFILIATES AND THE AMOUNTS INVOLVED; AN EXPLANATION OF THE DERIVATION OF THE FACTORS; THE REASONS SUPPORTING THAT METHODOLOGY AND THE REASONS SUPPORTING THE ALLOCATION;

7. An explanation of the manner in which the utility's capital structure, cost of capital and ability to raise capital at reasonable rates have been affected by the organization or reorganization of the public utility holding company;

8. The dollar amount transferred between the utility and each affiliate during the annual period, and the purpose of each transfer;

9. CONTRACTS OR AGREEMENTS TO RECEIVE, OR PROVIDE MANAGEMENT, ENGINEERING, ACCOUNTING, LEGAL, FINANCIAL OR OTHER SIMILAR SERVICES BETWEEN A PUBLIC UTILITY AND AN AFFILIATE;

10. CONTRACTS OR AGREEMENTS TO PURCHASE OR SELL GOODS OR REAL PROPERTY BETWEEN A PUBLIC UTILITY AND AN AFFILIATE; AND

11. CONTRACTS OR AGREEMENT TO LEASE GOODS OR REAL PROPERTY BETWEEN A PUBLIC UTILITY AND AN AFFILIATE.

We believe that as a condition to our approval of the financing herein, and in order to protect APS' security interests in PWEC's generation assets and to promote the public interest, neither

PWCC nor PWEC shall reorganize or restructure, acquire or divest assets, or form, buy or sell affiliates, or pledge or otherwise encumber the PWEC generation assets during the duration of the loan/guarantee without prior Commission approval. This requirement will apply to reorganizations and restructurings, including the formation, buying or selling of affiliates, acquisitions or divestitures of assets in the amount of \$100 million or greater, measured on a cumulative basis over the calendar year in which the transactions will be made. Further, those transactions identified in the Company's "recovery plan", including the accelerated sale of SunCor assets in the amount of \$80 - 100 million per year for 3 years; the sale of 25 percent of the Silverhawk generation project to the Southern Nevada Water Authority; and the payment of ongoing construction costs for the West Phoenix CC #5 and the Silverhawk generation plant in Nevada would not need prior Commission approval. Further, we believe that the public interest requires that during the term of the loan or guarantee, APS and its affiliates must comply with all the Affiliated Interest Rules. Compliance with the Rules is, subject to the provisions and limitations described in this paragraph, on a going forward basis, and the approval granted in Decision No. 65434 allowing APS' \$125 million credit line to PWCC is not affected. Accordingly, we will make this a condition to our approval of this financing application.

Further, we believe that a preliminary inquiry into APS, PWCC, and PWEC's actions related to the transition to electric competition, particularly compliance with our electric competition rules and with Decision No. 61973 and APS' activities with its affiliates should be undertaken by Staff. Of concern to us is testimony and evidence elicited during this hearing of the PWCC enterprise's possible use of APS (both its generation assets and captive ratepayers) to gain advantage in the developing competitive environment. One example is how APS' Treasurer described the way that PWEC was able to obtain an investment grade rating(18); another is APS' application for an air quality

(18) Information provided to the rating agencies by PWCC et al. By the Spring of 2001, PWEC obtained a contingent investment grade rating. (See Tr. At 281-282) Testimony and evidence indicate that PWEC made presentations to rating agencies indicating that PWEC was under contract to sell its output to APS under a four year purchase power agreement. (See Panda Exh. 4, 5, Gomez Tr. At 150, 276) In September, 2002, APS asked the credit rating agencies to withdraw PWEC's credit rating. APS would have been required to begin purchasing 100% of its standard offer power from the competitive market by January 1, 2001, if it had not obtained a 2 year waiver in its Settlement Agreement. During that 2 year period, APS' parent formed competitive affiliates, including PWEC, and PWCC/PWEC built 4 new generating units and obtained a contingent investment grade rating for PWEC. If the Commission had not stayed divestiture of its assets, on January 1, 2003, APS would have been acquiring 100% of its standard offer power from the competitive market, with no ability to change its rates until at least July, 2004. APS' position in this application that these assets were "dedicated.:

permit on behalf of PWEC. Although some may argue that our granting approval of the financing request is another example, we have carefully tried to neutralize any competitive advantage that may accrue to PWEC as a result of our approval. Nothing in this Decision condones actions taken by APS, PWEC, or PWCC, it is merely an attempt to prevent harm to APS ratepayers. Additionally, we are not intending our approval to constitute state action for the purposes of antitrust laws.

When asked whether Decision No. 61973 was presented as part of the presentation to the rating agencies, APS' Treasurer responded that: "[w]ell, we would have modeled what the Order required in our presentation, yes." (Gomez, Tr. p. 275) When asked whether she was familiar with the following quote from Decision No. 61973 at p. 10 which states: "[w]e share the concerns that the noncompetitive portion of APS not subsidize the spun-off competitive assets through an unfair financial arrangement", APS Treasurer Gomez stated that she was not familiar with that sentence. (Gomez, Tr. p. 275). Ms. Gomez testifies that there was no contract, but was a modeling assumption. She further testified that the investment grade rating was not based upon just the unification of assets, but it is also based upon the cash flow from those assets. (Gomez, Tr. pp. 277-278; 281-282) During cross-examination of Jack Davis, he testified about documents prepared by PWEC for a Rating Agency Presentation in February 2001.(19) Mr. Davis testified that the document discussed a "PPA between Pinnacle West Power Marketing & Trading, and Pinnacle West Energy" and also a PPA between APS and it "goes on to represent how Pinnacle West Marketing & Trading will make those deliveries to Arizona Public Service." Mr. Davis testified that a page entitled "PWEC Credit Strengths shows the first arrow indicates "Four year fixed price contract" and "The majority of generation is dedicated to APS load through 2004". (Tr. pp. 729-730)

The date of 2004 is significant, because the APS rates set in Decision No. 61973 were to remain in effect until at least June 30, 2004. However, from January 1, 2003 until June 30, 2004, APS was to be purchasing power from the competitive market (without an adjustor in place) and would have been exposed to the price difference between the "market price" and the APS Standard

to APS customers raises the issue of possible intended noncompliance with the Commission's electric competition rules and/or possible anti-competitive activity.

(19) Panda Exhibit 22 was admitted under seal, but the cross examination of Mr. Davis was not confidential. This discussion will refer only to the non-confidential testimony on that document.

Offer rates.

Decision No. 61973 provided that: "Such Code of Conduct should also include provisions to govern the supply of generation during the two-year period of delay for the transfer of generation assets so that APS doesn't give itself an undue advantage over the ESPs". (p. 12)

"Some parties were concerned that Sections 4.1 and 4.2 provide in effect that the Commission will have approved in advance any proposed financing arrangements associated with future transfers of `competitive services' assets to an affiliate. As a result, there was a recommendation that the Commission retain the right to review and approve or reject any proposed financing arrangements. In addition, some parties expressed concern that APS has not definitively described the assets it will retain and which it will transfer to an affiliate. We share the concerns that the non-competitive portion of APS not subsidize the spun-off competitive assets through an unfair financial arrangement. We want to make it clear that the Commission will closely scrutinize the capital structure of APS at its 2004 rate case and make any necessary adjustments." (Decision No. 61973 at p. 10)

Although APS asserts that under its Code of Conduct, the Electric Competition Rules, and Decision No. 61973, it could not construct generation, Staff, in its Responsive Brief, states that "APS will argue that its code of conduct prevented it from building the assets at APS, (Tr. at 520); nonetheless, an examination of that document does not clearly support that conclusion." (Staff Responsive Br. at 5).

MISCELLANEOUS

The issue transferring PWEC assets to APS is not before us in this application. RUCO recommended that we approve this financing and order APS to file an application to transfer the assets. APS indicated it would not be appropriate for the Commission to require a proceeding seeking transfer of the PWEC assets to APS at this time, and believes that Staff's Condition No. 2 provides essentially the same protection. We will not adopt RUCO's recommendation.

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

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FINDINGS OF FACT

1. APS is a public service corporation principally engaged in furnishing electricity in the State of Arizona. APS provides either retail or wholesale electric service to substantially all 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.
2. On September 16, 2002, APS filed an application requesting approval of financing in the form of either an inter-company loan and/or a guarantee of debt to allow PWCC or PWEC to refinance bridge debt incurred by PWCC in the construction of certain PWEC generation assets.
3. Notice of the application was provided in accordance with the law.
4. Intervention was granted to RUCO, Panda, Reliant, Harquahala, the PPL entities, AUIA, SWPG/Bowie, Sempra, AECC, ACPA and TEP.
5. The hearing commenced on January 8, 2003 and testimony and evidence was taken over five days of hearing. Initial Briefs were filed on January 27, 2003, and Reply Briefs were filed on February 6, 2003.
6. APS' parent, PWCC, has incurred approximately \$1 billion in debt financing the construction of generating units at PWEC, its merchant subsidiary.
7. PWCC used debt with short-term maturities because it planned for PWEC to refinance the debt at an investment grade once the APS rate-based generation assets were transferred to PWEC.
8. In the spring of 2001, PWCC made presentations to rating agencies on behalf of PWEC and obtained a contingent investment grade rating for PWEC.
9. By the fall of 2001, project financing for the PWEC generation assets was no longer available.
10. On October 18, 2001, APS filed an application for approval of a Variance/Purchased Power Agreement. The application stated that "adherence to the competitive bidding requirements of the Electric Competition Rules will not produce the intended result of reliable electric service for Standard Offer customers at reasonable rates," requested that the Commission grant a partial variance to R14-2-1606(B) that would otherwise obligate APS to acquire all of its customers' Standard Offer

generation requirements from the competitive market, and sought Commission approval of a long term purchase power agreement with its parent, PWCC.

11. By Procedural Order issued May 2, 2002, a generic proceeding was established that set up Track A to resolve issues relating to market power, divestiture, codes of conduct/affiliate transactions and jurisdictional issues, and Track B to address competitive procurement.

12. On September 10, 2002, the Commission issued Decision No. 65154 in the Track A proceeding wherein the Commission ordered APS to cancel any plans to divest interests in any generating assets:

13. On March 14, 2003, the Commission issued Decision No. 65743, the Decision in the Track B proceeding.

14. Currently, there is turmoil in the financial markets and the wholesale electric market is volatile.

15. APS seeks authorization to issue up to \$500 million of debt, and APS would loan the proceeds of that debt to PWCC or PWEC to be used to retire PWCC's existing debt.

16. In addition, or in the alternative, APS seeks approval to guarantee debt that may be issued by PWCC or PWEC to retire PWCC's existing debt.

17. The total amount of financing authority requested does not exceed \$500 million.

18. RUCO recommended approval of the loan with conditions, including that the Commission require APS to file an application to transfer the PWEC assets to APS.

19. Panda and various intervenors recommended that the Commission not grant the requested financing, but if some financing is approved, it should be in the form of a guarantee with certain conditions.

20. Staff recommended that the Commission authorize APS to borrow \$500 million in order to loan the proceeds to PWEC, with seven conditions.

21. As a certificated public service corporation, APS has a duty to provide reliable electric service to its customers at reasonable rates.

22. It is in the public interest that APS maintain healthy credit ratings so that it has access to the capital markets at reasonable terms and rates.

23. APS could face a downgrade if PWCC is downgraded, and such a downgrade of APS could interfere with APS' ability to provide electric service to the public at reasonable rates if it resulted in increases in the cost of capital, potential lack of access to the capital markets, potential increases in collateral requirements, and an inability to do business with vendors.

24. APS' requested financing will be compatible with the public interest if, by preventing a downgrade in APS' credit ratings, it prevents a substantial disintegration in APS' ability to provide reliable service at reasonable rates.

25. Because the transaction poses some risks to the Company and to its ratepayers, we will require conditions to approval of the financing, including Staff's seven conditions and conditions that the debt authorized herein will be included in the capital structure calculation to determine whether APS can issue dividends; that any guarantee shall meet the same concerns identified in Staff's seven conditions; APS shall inform the Commission in the event of a loan default so that the Commission can take appropriate action; APS' debt issuance be for unsecured debt only; that neither PWCC nor PWEC shall reorganize or restructure, acquire or divest assets, or form, buy or sell affiliates, or pledge or otherwise encumber the PWEC generation assets during the duration of the loan/guarantee without prior Commission approval and this requirement will apply to reorganizations and restructurings, including the formation, buying or selling of affiliates, acquisitions or divestitures of assets in the amount of \$100 million or greater, measured on a cumulative basis over the calendar year in which the transactions will be made. Further, those transactions identified in the Company's "recovery plan", including the accelerated sale of SunCor assets in the amount of \$80 - 100 million per year for 3 years, the sale of 25 percent of the Silverhawk generation project to the Southern Nevada Water Authority, and the payment of ongoing construction costs for the West Phoenix CC #5 and the Silverhawk generation plant in Nevada would not need prior Commission approval; and that during the term of the loan or guarantee, APS and its affiliates must comply with all the Affiliated Interest Rules. Compliance with the Rules is, subject to the provisions and limitations described in this paragraph, on a going forward basis, and the approval granted in Decision No. 65434 allowing APS' \$125 million credit line to PWCC is not affected.

26. Staffs Condition 2 requires APS to obtain a security interest in the PWEC assets and

only APS has such a lien, so APS would have the first priority in the event of a default.

27. APS shall immediately notify the Commission within five business days in the event of a default on the loan, so that the Commission can take appropriate action.

28. The public interest requires that any improvement in PWEC's creditworthiness as a result of approval of this financing not be considered or used in the evaluation of bids/offers during APS' Track B competitive procurement.

29. It is in the public interest to grant authority for both a loan and a guarantee with the conditions attached hereto, so that Arizona Public Service can structure the transaction in a manner that will provide the most protection for its ratepayers.

30. The issue of the purpose for which the PWEC assets were built is not before us in this proceeding, and we are making no determination as to whether or not those assets should be part of APS' rate base.

31. Testimony and evidence presented during the hearing merit a preliminary inquiry by Staff into APS' compliance with Decision No. 61973, the Electric Competition Rules, its Code of Conduct, and applicable law.

CONCLUSIONS OF LAW

1. Arizona Public Service Company is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. ss.ss. 40-285, -301, and 40-302 and A.A.C. R-14-2804.

2. The Commission has jurisdiction over Arizona Public Service Company and the subject matter of the application.

3. Notice of the application was provided in accordance with the law.

4. APS' application should be approved consistent with the Discussion, Analysis, and Findings of Fact herein.

5. The financing with the conditions approved herein is for lawful purposes within Arizona Public Service Company's corporate powers, is compatible with the public interest, with sound financial practices, and with the proper performance by Arizona Public Service Company of

service as a public service corporation, and with the conditions approved herein, will not impair Arizona Public Service Company's ability to perform that service.

6. The financing with the conditions approved herein is for the purposes stated in the application and is reasonably necessary for those purposes, and such purposes may, wholly or in part, be reasonably chargeable to operating expenses or to income.

7. The financing with the conditions approved herein will not impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service.

ORDER

IT IS THEREFORE ORDERED that the application for financing, with the conditions contained herein, is hereby approved and Arizona Public Service Company is hereby authorized to either issue non-secured debt in an amount not greater than \$500,000,000 and loan the proceeds to Pinnacle West Energy Corporation and/or guarantee the debt of Pinnacle West Energy Corporation in the amount of \$500,000,000, for the purposes set forth in the application and as modified herein, and in compliance with the conditions and restrictions contained in the discussion and findings herein.

IT IS FURTHER ORDERED that such debt will not be classified or treated as continuing debt in the context of the debt limits established by Decision Nos. 55017 and 54230.

IT IS FURTHER ORDERED that Arizona Public Service Company is hereby authorized to obtain a financial interest and/or a guarantee in its affiliate Pinnacle West Energy Corporation consistent with the terms, conditions, and restrictions of this Decision.

IT IS FURTHER ORDERED that Arizona Public Service Company is hereby authorized to engage in any transactions and to execute any document necessary to effectuate the authorization granted herein.

IT IS FURTHER ORDERED that such authority is expressly conditioned upon Arizona Public Service Company's compliance with the conditions set forth below in this ordering paragraph and upon the use of the proceeds for the purposes set forth in the application as modified herein. The conditions are:

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- 1) APS should be authorized to issue and sell no more than \$500,000,000 of debt in addition to its current authorizations;
- 2) The debt to be lent to PWEC should be no more than \$500,000,000 of secured callable notes from PWEC. The security interest shall be on the same terms as the security interest APS already has pursuant to the \$125,000,000 loan authorization from Decision No. 65434;
- 3) The PWEC secured note coupon shall be 264 basis points above the coupon on APS debt issued and sold on equivalent terms (including but not limited to maturity and security);
- 4) The difference in interest income and interest expense should be capitalized as a deferred credit and used to offset rates in the future. The deferred credit balance shall bear an interest rate of six percent;
- 5) The PWEC debt maturity shall not exceed four years, unless otherwise ordered by the Commission;
- 6) Any demonstrable increase in APS' cost of capital as a result of the transaction, such as from a decline in bond rating, will be extracted from future rate cases;
- 7) APS shall maintain a minimum common equity of 40 percent and shall not be allowed to pay dividends if such payment would reduce its common equity ratio below this threshold, unless otherwise waived by the Commission. This condition shall remain in effect indefinitely, and APS shall file with the Commission a calculation of capital structure within one week of filing a 10-Q or 10-K;
- 8) The debt authorized herein will be included in the capital structure calculation to determine whether APS can issue dividends;
- 9) Any guarantee shall meet the same concerns identified in Staff's seven conditions;
- 10) APS' debt issuance be for unsecured debt only;
- 11) Neither PWEC or PWCC shall reorganize or restructure, acquire or divest assets, or form buy or sell affiliates, or pledge or otherwise encumber the PWEC generation assets during the duration of the loan/guarantee without prior Commission approval and this requirement will apply to reorganizations and restructurings, including the formation, buying or selling of affiliates, acquisitions or divestitures of assets in the amount of \$100 million or greater, measured on a cumulative basis over the calendar year in which the transactions will be made. Further, those transactions identified in the Company's "recovery plan", including the accelerated sale of SunCor assets in the amount of \$80 - 100 million per year for 3 years; the sale of 25 percent of the Silverhawk generation project to the Southern Nevada Water Authority; and the payment of ongoing construction costs for the West Phoenix CC #5 and the Silverhawk generation plant in Nevada would not need prior Commission approval; and

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12) During the term of the loan or guarantee, APS and its affiliates must comply with all the Affiliated Interest Rules. Compliance with the Rules is, subject to the provisions and limitations described in this paragraph, on a going forward basis, and the approval granted in Decision No. 65434 allowing APS' \$125 million credit line to PWCC is not affected.

IT IS FURTHER ORDERED that with respect to any waiver sought by Arizona Public Service Company under Condition No. 7, the Commission shall process such waiver request within 60 days and, for this 60-day period, the condition shall be suspended. However, Condition No. 7 shall not be permanently waived without an order of the Commission.

IT IS FURTHER ORDERED that approval of the financing set forth herein does not constitute or imply approval or disapproval by the Commission of any particular expenditure of the proceeds derived thereby or any particular prior expenditure being refinanced for the purpose of establishing just and reasonable rates.

IT IS FURTHER ORDERED that Arizona Public Service Company shall file with the Commission copies of all executed financing documents setting forth the terms of the financing, within 30 days of obtaining such financing.

IT IS FURTHER ORDERED that Arizona Public Service Company shall not use any authority granted in this Decision to prejudice or adversely affect the implementation of the Track B competitive solicitation process.

IT IS FURTHER ORDERED that the issue of Arizona Public Service Company's acquisition of Pinnacle West Energy Corporation generation assets and rate base treatment is not presently before us, and we make no determination on those issues in this Decision.

IT IS FURTHER ORDERED that any improvement in Pinnacle West Energy Corporation's creditworthiness as a result of approval of this financing shall not be considered or used in the evaluation of bids/offers during Arizona Public Service Company's Track B competitive procurement.

IT IS FURTHER ORDERED that Arizona Public Service Company shall immediately notify the Commission within five business days in the event of a default on the loan, so that the Commission can take appropriate action.

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IT IS FURTHER ORDERED that Staff shall commence a preliminary inquiry into Arizona Public Service Company and its affiliate's compliance with the Electric Competition Rules, Decision No. 61973, its Code of Conduct, and applicable law.

IT IS FURTHER ORDERED that this Decision shall be come effective **immediately. BY ORDER OF THE ARIZONA CORPORATION COMMISSION.**

MARC SPITZER

JIM IRVIN

WILLIAM A. MUNDELL

CHAIRMAN

COMMISSIONER

COMMISSIONER

JEFF HATCH-MILLER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL,
Executive Secretary of the Arizona
Corporation Commission, have hereunto set my
hand and caused the official seal of the
Commission to be - fixed at the Capitol, in
the City of Phoenix, this 4th day of April,
2003.

BRIAN C. McNEIL

DISSENT Mike Gleason

LAF:dap

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DOCKET NOS.:

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E-01345A-02-0707

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DISSENT OF COMMISSIONER GLEASON

I respectfully dissent from my fellow Commissioners regarding the Commission's approval of APS's request to loan PWEC up to \$500 million. While I believe the record supports APS's claim that PWEC needs APS's credit support to refinance its debt, a guarantee is the only type of refinancing that is in the public interest.

By this order, the Commission approved a speculative loan from a regulated utility to an unregulated company with less than investment credit rating, which will put the utility over its mandated debt ceiling.

The following support this statement:

1. There is no list of collateral for this loan.
2. There is no appraisal of assets to be used as collateral for this loan.
3. The banks will not make the loan; thus it must be considered a speculative loan.
4. The exclusion of this loan from APS's continuing credit will, by testimony, put APS's debt over the mandated ceiling. This tacitly increases the debt limit when utilities are under pressure to conserve their financial debts.

Thus, the Commission authorized a speculative use of a regulated utilities fund which could put the ratepayers at risk of higher rates.

Furthermore, the fundamental principles of the Commission's Affiliated Interest Rules prohibit exactly this type of situation. To preserve competition and to maintain the integrity of our Affiliated Interest Rules, a lending institution needs to stand in between PWEC assets and APS.

The Order requires APS to refinance PWEC debt in a manner that is in the best interest of the ratepayers. To that end, it is my belief APS should choose a guarantee. Since the Order allows APS to select a loan, I must dissent.

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RISK FACTORS

Set forth below and in other documents we file with the Securities and Exchange Commission ("SEC") are risks and uncertainties that could affect our financial results.

WE ARE SUBJECT TO COMPLEX GOVERNMENT REGULATION WHICH MAY HAVE A NEGATIVE IMPACT ON OUR BUSINESS AND OUR RESULTS OF OPERATIONS.

We are, directly and through our subsidiaries, subject to governmental regulation which may have a negative impact on our business and results of operations. We are a "holding company" within the meaning of the Public Utility Holding Company Act ("PUHCA"); however, we are exempt from the provisions of PUHCA by virtue of our filing of an annual exemption statement with the SEC.

Arizona Public Service Company ("APS") is subject to comprehensive regulation by several federal, state and local regulatory agencies, which significantly influence its operating environment and may affect its ability to recover costs from utility customers. APS is required to have numerous permits, approvals and certificates from the agencies that regulate APS' business. The Federal Energy Regulatory Commission ("FERC"), the Nuclear Regulatory Commission ("NRC"), the Environmental Protection Agency ("EPA"), and the Arizona Corporation Commission ("ACC") regulate many aspects of our utility operations, including siting and construction of facilities, customer service and the rates that APS can charge customers. We believe the necessary permits, approvals and certificates have been obtained for APS' existing operations. However, we are unable to predict the impact on our business and operating results from the future regulatory activities of any of these agencies. Changes in regulations or the imposition of additional regulations could have an adverse impact on our results of operations.

WE CANNOT PREDICT THE OUTCOME OF THE GENERAL RATE CASE THAT APS WILL FILE WITH THE ACC ON OR BEFORE JUNE 30, 2003.

As required by a 1999 settlement agreement among APS and various parties (the "1999 Settlement Agreement"), on or before June 30, 2003, APS will file a general rate case with the ACC. In this rate case, APS will update its cost of service and rate design. In addition, APS expects to seek:

- * rate base treatment of certain power plants currently owned by Pinnacle West Energy Corporation, another one of our subsidiaries ("Pinnacle West Energy") (specifically, Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3);
- * recovery of the \$234 million pretax asset write-off recorded by APS as part of the 1999 Settlement Agreement (\$140 million extraordinary charge recorded on the 1999 Consolidated Statement of Income); and
- * recovery of costs incurred by APS in preparation for the previously required transfer of generation assets to Pinnacle West Energy.

The general rate case will also address 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 ACC retail electric competition rules described below. We assume that the ACC will make a decision in this general rate case by the end of 2004. We cannot predict the outcome of the rate case and the resulting levels of regulated revenues.

IF WE ARE NOT ABLE TO ACCESS CAPITAL AT COMPETITIVE RATES, OUR ABILITY TO IMPLEMENT OUR FINANCIAL STRATEGY WILL BE ADVERSELY AFFECTED.

We rely on access to both short-term money markets and longer-term capital markets as a significant source of liquidity and for capital requirements not satisfied by the cash flow from our operations. We believe that we will maintain sufficient access to these financial markets based upon current credit ratings. However, certain market disruptions or a downgrade of our credit rating may increase our cost of borrowing or adversely affect our ability to access one or more financial markets. Such disruptions could include:

- * an economic downturn;
- * capital market conditions generally;
- * the bankruptcy of an unrelated energy company;
- * market prices for electricity and gas;
- * terrorist attacks or threatened attacks on our facilities or those of unrelated energy companies; or
- * the overall health of the utility industry.

Changes in economic conditions could result in higher interest rates, which would increase our interest expense on our debt and reduce funds available to us for our current plans. Additionally, an increase in our leverage could adversely affect us by:

- * increasing the cost of future debt financing;
- * increasing our vulnerability to adverse economic and industry conditions;
- * requiring us to dedicate a substantial portion of our cash flow from operations to payments on our debt, which would reduce funds available to us for operations, future business opportunities or other purposes; and
- * placing us at a competitive disadvantage compared to our competitors that have less debt.

See the following Risk Factor for more information relating to this discussion.

A SIGNIFICANT REDUCTION IN OUR CREDIT RATINGS COULD MATERIALLY AND ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

We cannot be sure that any of our current ratings will remain in effect for any given period of time or that a rating will not be lowered or withdrawn entirely by a rating agency if, in its judgment, circumstances in the future so warrant. Any downgrade could increase our borrowing costs which would diminish our financial results. We would likely be required to pay a higher interest rate in future financings, and our potential pool of investors and funding sources could decrease. A downgrade could require additional support in the form of letters of credit or cash or other collateral and otherwise have a material adverse effect on our business, financial condition and results of operations. If our short-term ratings were to be lowered, it could limit our access to the commercial paper market. We note that the ratings from credit agencies are not recommendations to buy, sell or hold our securities and that each rating should be evaluated independently of any other rating.

DEREGULATION OR RESTRUCTURING OF THE ELECTRIC INDUSTRY MAY RESULT IN INCREASED COMPETITION, WHICH COULD HAVE A SIGNIFICANT ADVERSE IMPACT ON OUR BUSINESS AND OUR FINANCIAL RESULTS.

Retail competition could have a significant adverse financial impact on us due to an impairment of assets, a loss of retail customers, lower profit margins or increased costs of capital. In 1999, the ACC approved rules that provide a

framework for the introduction of retail electric competition in Arizona. Under the rules, as modified by the 1999 Settlement Agreement, APS was required to transfer all of its competitive electric assets and services to an unaffiliated party or parties or to a separate corporate affiliate or affiliates no later than December 31, 2002. Pursuant to an ACC order dated September 10, 2002, the ACC unilaterally modified the 1999 Settlement Agreement and directed APS to cancel any plans to divest interests in any of its generating assets. The ACC has further established a requirement that APS solicit bids for certain estimated capacity and energy requirements for periods beginning July 1, 2003. These regulatory developments and legal challenges to the rules have raised considerable uncertainty about the status and pace of retail electric competition in Arizona. Although some very limited retail competition existed in APS' service area in 1999 and 2000, there are currently no active retail competitors offering 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 a result of changes in federal law and regulatory policy, competition in the wholesale electricity market has greatly increased due to a greater participation by traditional electricity suppliers, non-utility generators, independent power producers, and wholesale power marketers and brokers. This increased competition could affect our load forecasts, plans for power supply and wholesale energy sales and related revenues. As a result of the changing regulatory environment and the relatively low barriers to entry, we expect wholesale competition to increase. As competition continues to increase, our financial position and results of operations could be adversely affected.

THE PROCUREMENT OF WHOLESALE POWER BY APS WITHOUT THE ABILITY TO ADJUST RETAIL RATES COULD HAVE AN ADVERSE IMPACT ON OUR BUSINESS AND FINANCIAL RESULTS.

The 1999 Settlement Agreement limits APS' ability to change retail rates until at least July 1, 2004, which could have a significant adverse financial impact on us if wholesale power prices significantly exceed the amount included for generation costs in APS' current bundled retail rates. Under the ACC's rules, APS is 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 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 of generation costs per kilowatt hour 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. The ACC has further established a requirement that APS solicit bids for certain estimated capacity and energy requirements for periods beginning July 1, 2003. This competitive procurement process may adversely affect the cost of APS' procurement of wholesale power. In sum, there can be no assurance that APS would be able to fully recover the costs of wholesale power under its present rate structure. Although APS could seek to adjust its rates under the emergency provisions of the settlement agreement discussed above, ACC approval of such an adjustment also cannot be assured.

RECENT EVENTS IN THE ENERGY MARKETS THAT ARE BEYOND OUR CONTROL MAY HAVE NEGATIVE IMPACTS ON OUR BUSINESS.

As a result of the energy crisis in California during the summer of 2001, the recent volatility of natural gas prices in North America, the filing of bankruptcy by the Enron Corporation, and investigations by governmental authorities into energy trading activities, companies generally in the regulated and unregulated utility businesses have been under an increased amount of public and regulatory scrutiny. The capital markets and ratings agencies also have increased their level of scrutiny. We believe that we are complying with all applicable laws, but it is difficult or impossible to predict or control what effect these or related issues may have on our business or our access to the capital markets.

OUR RESULTS OF OPERATIONS CAN BE ADVERSELY AFFECTED BY Milder WEATHER.

Weather conditions directly influence the demand for electricity and affect the price of energy commodities. Electric power demand is generally a seasonal business. In Arizona, demand for power peaks during the hot summer months, with market prices also peaking at that time. As a result, our overall operating results fluctuate substantially on a seasonal basis. In addition, we have historically sold less power, and consequently earned less income, when weather conditions are milder. As a result, unusually mild weather could diminish our results of operations and harm our financial condition.

THERE ARE INHERENT RISKS IN THE OPERATION OF NUCLEAR FACILITIES, SUCH AS ENVIRONMENTAL, HEALTH AND FINANCIAL RISKS AND THE RISK OF TERRORIST ATTACK.

Through APS, we have an ownership interest in and operate the Palo Verde Nuclear Generating Station ("Palo Verde"). Palo Verde is subject to environmental, health and financial risks such as the ability to dispose of spent nuclear fuel, the ability to maintain adequate reserves for decommissioning, potential liabilities arising out of the operation of these facilities, and the costs of securing the facilities against possible terrorist attacks. We maintain nuclear decommissioning trust funds and external insurance coverage to minimize our financial exposure to these risks; however, it is possible that damages could exceed the amount of insurance coverage.

The NRC has broad authority under federal law to impose licensing and safety-related requirements for the operation of nuclear generation facilities. In the event of noncompliance, the NRC has the authority to impose fines or shut down a unit, or both, depending upon its assessment of the severity of the situation, until compliance is achieved. In addition, although we have no reason to anticipate a serious nuclear incident at Palo Verde, if an incident did occur, it could materially and adversely affect our results of operations or financial condition. A major incident at a nuclear facility anywhere in the world could cause the NRC to limit or prohibit the operation or licensing of any domestic nuclear unit.

The operation of Palo Verde requires licenses that need to be periodically renewed and/or extended. We do not anticipate any problems renewing these licenses. However, as a result of potential terrorist threats and increased public scrutiny of utilities, the licensing process could result in increased licensing or compliance costs that are difficult or impossible to predict.

THE USE OF DERIVATIVE CONTRACTS IN THE NORMAL COURSE OF OUR BUSINESS COULD RESULT IN FINANCIAL LOSSES THAT NEGATIVELY IMPACT OUR RESULTS OF OPERATIONS.

Our operations include managing market risks related to commodity prices, changes in interest rates, and investments held by our pension plan and nuclear decommissioning trust funds. We are exposed to the impact of market fluctuations in the price and transportation costs of electricity, natural gas, coal, and emissions allowances and credits. We have established procedures to manage risks associated with these market fluctuations by utilizing various commodity derivatives, including exchange-traded futures and options and over-the-counter forwards, options, and swaps. As part of our overall risk management program, we enter into derivative transactions to hedge purchases and sales of electricity, fuels, and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodity.

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We use a risk management process to assess and monitor the financial exposure of all counterparties. Despite the fact that the majority of trading counterparties are rated as investment grade by the credit rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material adverse impact on our earnings for a given period.

Changing interest rates will affect interest paid on variable-rate debt and interest earned by our pension plan and nuclear decommissioning trust funds. Our policy is to manage interest rates through the use of a combination of fixed-rate and floating-rate debt. The pension plan and nuclear decommissioning trust funds also have risks associated with changing market values of equity investments. Most of the pension costs and all of the nuclear decommissioning costs are recovered in regulated electricity prices.

THE UNCERTAIN OUTCOME REGARDING THE CREATION OF REGIONAL TRANSMISSION ORGANIZATIONS, OR RTOS, MAY MATERIALLY IMPACT OUR OPERATIONS, CASH FLOWS OR FINANCIAL POSITION.

In a December 1999 order, the FERC set minimum characteristics and functions that must be met by utilities that participate in regional transmission organizations. The characteristics for an acceptable RTO include independence from market participants, operational control over a region large enough to support efficient and nondiscriminatory markets, and exclusive authority to maintain short-term reliability. On October 16, 2001, APS and other owners of electric transmission lines in the Southwest filed with the FERC a request for a declaratory order confirming that their proposal to form WestConnect RTO, LLC would satisfy the FERC's requirements for the formation of an RTO. On October 10, 2002, the FERC issued an order finding that the WestConnect proposal, if modified to address specified issues, could meet the FERC's RTO requirements and provide the basic framework for a standard market design for the Southwest. As of March 28, 2003, the FERC was considering various aspects of its order as a result of requests for clarification filed by the WestConnect applicants.

WE ARE SUBJECT TO NUMEROUS ENVIRONMENTAL LAWS AND REGULATIONS WHICH MAY INCREASE OUR COST OF OPERATIONS, IMPACT OUR BUSINESS PLANS, OR EXPOSE US TO ENVIRONMENTAL LIABILITIES.

We are subject to numerous environmental regulations affecting many aspects of our present and future operations, including air emissions, water quality, wastewater discharges, solid waste, and hazardous waste. These laws and regulations can result in increased capital, operating, and other costs, particularly with regard to enforcement efforts focused on power plant emissions obligations. These laws and regulations generally require us to obtain and comply with a wide variety of environmental licenses, permits, inspections and other approvals. Both public officials and private individuals may seek to enforce applicable environmental laws and regulations. We cannot predict the outcome (financial or operational) of any related litigation that may arise.

In addition, we may be a responsible party for environmental clean up at sites identified by a regulatory body. We cannot predict with certainty the amount and timing of all future expenditures related to environmental matters because of the difficulty of estimating clean-up costs. There is also uncertainty in quantifying liabilities under environmental laws that impose joint and several liability on all potentially responsible parties.

We cannot be sure that existing environmental regulations will not be revised or that new regulations seeking to protect the environment will not be adopted or become applicable to us. Revised or additional regulations that result in increased compliance costs or additional operating restrictions, particularly if those costs are not fully recoverable from APS' customers, could have a material adverse effect on our results of operations.

THE MARKET PRICE OF OUR COMMON STOCK MAY BE VOLATILE.

The market price of our common stock could be subject to significant fluctuations in response to factors such as the following, some of which are beyond our control:

- * variations in our quarterly operating results;
- * operating results that vary from the expectations of management, securities analysts and investors;
- * changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- * developments generally affecting industries in which we operate, particularly the energy distribution and energy generation industries;
- * announcements by us or our competitors of significant contracts, acquisitions, joint marketing relationships, joint ventures or capital commitments;
- * announcements by third parties of significant claims or proceedings against us;

- * favorable or adverse regulatory developments;
- * our dividend policy;
- * future sales of our equity or equity-linked securities; and
- * general domestic and international economic conditions.

In addition, the stock market in general has experienced extreme volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the market price of our common stock.

OUR STOCK PRICE COULD BE AFFECTED BECAUSE A SUBSTANTIAL NUMBER OF SHARES OF OUR COMMON STOCK COULD BE AVAILABLE FOR SALE IN THE FUTURE.

Sales in the public market of a substantial number of shares of common stock could depress the market price of the common stock and could impair our ability to raise capital through the sale of additional equity securities. Because of the number of shares of our common stock that we are authorized to issue under our articles of incorporation, a substantial number of shares of our common stock could be available for future sale.

OUR CASH FLOW AND ABILITY TO PAY DIVIDENDS LARGELY DEPENDS ON THE PERFORMANCE OF OUR SUBSIDIARIES.

We conduct our operations primarily through subsidiaries. Substantially all of our consolidated assets are held by such subsidiaries. Accordingly, our cash flow and our ability to pay dividends on our capital stock are largely dependent upon the earnings of these subsidiaries and the distribution or other payment of such earnings to us in the form of dividends, loans or advances or repayment of loans and advances from us. The subsidiaries are separate and distinct legal entities and have no obligation to pay dividends or to make any funds available for such payment.

The debt agreements of some of our subsidiaries may restrict their ability to pay dividends, make distributions or otherwise transfer funds to us. Section 39(III) of APS' mortgage requires APS to meet a financial covenant before paying common stock dividends. Under this covenant, APS may pay dividends on its common stock if there is a sufficient amount "available" from retained earnings and the excess of cumulative book depreciation (since the mortgage's inception) over mortgage depreciation, which is the cumulative amount of additional property pledged each year to address collateral depreciation. As of December 31, 2002, the amount "available" under the mortgage would have allowed APS to pay approximately \$3 billion of dividends compared to APS' current annual common stock dividends of \$170 million. As part of the ACC's approval of a \$500 million financing arrangement between APS and Pinnacle West Energy, the ACC required APS to maintain a common equity ratio of at least forty percent and prohibited APS from paying common stock dividends if such payment would reduce its common equity below that threshold.

WE HAVE AND MAY ENTER INTO CREDIT AND OTHER AGREEMENTS FROM TIME TO TIME THAT RESTRICT OUR ABILITY TO PAY DIVIDENDS.

Payment of dividends on the common stock may be restricted by loan agreements, indentures and other transactions entered into by us from time to time.