

# PINNACLE WEST CAPITAL CORP

## FORM 10-Q (Quarterly Report)

Filed 11/14/02 for the Period Ending 09/30/02

Address	400 NORTH FIFTH STREET MS8695 PHOENIX, AZ 85004
Telephone	602 250 1000
CIK	0000764622
Symbol	PNW
SIC Code	4911 - Electric Services
Industry	Electric Utilities
Sector	Utilities
Fiscal Year	12/31

# PINNACLE WEST CAPITAL CORP

## FORM 10-Q (Quarterly Report)

Filed 11/14/2002 For Period Ending 9/30/2002

Address	400 NORTH FIFTH STREET . PHOENIX, Arizona 85004
Telephone	602-379-2500
CIK	0000764622
Industry	Electric Utilities
Sector	Utilities
Fiscal Year	12/31

**FORM 10-Q**  
**Securities and Exchange Commission**  
Washington, D.C. 20549

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

For the quarterly period ended September 30, 2002

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 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 November 12, 2002: 84,755,377

## Glossary

**ACC - Arizona Corporation Commission**

**ACC Staff - Staff of the Arizona Corporation Commission**

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 - the Company's Energy Risk Management Committee**

**FASB - Financial Accounting Standards Board**

**FERC - United States Federal Energy Regulatory Commission**

Financing Application - APS application filed with the ACC on September 16, 2002

**Fitch - Fitch, Inc.**

**Four Corners - Four Corners Power Plant**

GAAP - Generally accepted accounting principles in the United States

Interim Financing Application - APS application filed with the ACC on November 8, 2002

**IRS - Internal Revenue Service**

**ISO - California Independent System Operator**

June 2002 10-Q - Pinnacle West Capital Corporation Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2002

**Moody's - Moody's Investors Service**

MW - megawatt, one million watts

MWh - megawatt 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

**Palo Verde - Palo Verde Nuclear Generating Station**

**Pinnacle West - Pinnacle West Capital Corporation, the Company**

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

**PG&E - PG&E Corp.**

**PX - California Power Exchange**

Rules - ACC retail electric competition rules

**SCE - Southern California Edison**

**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

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

2001 10-K - Pinnacle West Capital Corporation Annual Report on Form 10-K for the fiscal year ended December 31, 2001

**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 September 30,	
	2002	2001
Operating Revenues		
Electric retail segment	\$ 719,361	\$ 973,398
Marketing and trading segment	87,258	141,674
Real estate	45,108	43,024
Other revenues	21,224	2,682
Total	872,951	1,160,778
Operating Expenses		
Electric retail segment purchased power and fuel	257,484	499,789
Marketing and trading segment purchased power and fuel	43,361	33,714
Operations and maintenance	144,438	150,916
Real estate operations	44,928	37,803
Depreciation and amortization	108,812	107,932
Taxes other than income taxes	26,757	29,336
Other expenses	34,146	2,536
Total	659,926	862,026
Operating Income	213,025	298,752
Other		
Other income (Note 16)	3,038	1,527
Other expense (Note 16)	(10,713)	(3,603)
Total	(7,675)	(2,076)
Interest Expense		
Interest charges	49,465	42,531
Capitalized interest	(11,015)	(12,450)
Total	38,450	30,081
Income Before Income Taxes	166,900	266,595
Income Taxes	65,984	104,096
Income Before Accounting Change	100,916	162,499
Cumulative Effect of a Change in Accounting for Derivatives		
- Net of Income Tax Benefit of \$8,099	--	(12,446)
Net Income	\$ 100,916	\$ 150,053
Weighted-Average Common Shares Outstanding - Basic	84,768	84,721
Weighted-Average Common Shares Outstanding - Diluted	84,797	84,909
Earnings Per Weighted-Average Common Share Outstanding		
Income Before Accounting Change - Basic	\$ 1.19	\$ 1.92
Net Income - Basic	1.19	1.77
Income Before Accounting Change - Diluted	1.19	1.91
Net Income - Diluted	1.19	1.77
Dividends Declared Per Share	\$ 0.40	\$ 0.375

**See Notes to Condensed Consolidated Financial Statements.**

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

(in thousands, except per share amounts)

	Nine Months Ended September 30,	
	2002	2001
Operating Revenues		
Electric retail segment	\$ 1,596,440	\$ 2,125,522
Marketing and trading segment	212,576	633,811
Real estate	155,445	107,813
Other revenues	28,382	5,878
Total	1,992,843	2,873,024
Operating Expenses		
Electric retail segment purchased power and fuel	423,611	1,064,238
Marketing and trading segment purchased power and fuel	109,626	320,855
Operations and maintenance	390,864	408,305
Real estate operations	138,499	101,248
Depreciation and amortization	310,812	318,842
Taxes other than income taxes	81,147	80,101
Other expenses	39,115	4,027
Total	1,493,674	2,297,616
Operating Income	499,169	575,408
Other		
Other income (Note 16)	10,313	18,826
Other expense (Note 16)	(26,782)	(20,108)
Total	(16,469)	(1,282)
Interest Expense		
Interest charges	141,149	129,103
Capitalized interest	(39,143)	(35,404)
Total	102,006	93,699
Income Before Income Taxes	380,694	480,427
Income Taxes	150,656	188,866
Income Before Accounting Change	230,038	291,561
Cumulative Effect of a Change in Accounting for Derivatives - Net of Income Tax Benefit of \$9,892	--	(15,201)
Net Income	\$ 230,038	\$ 276,360
Weighted-Average Common Shares Outstanding - Basic	84,768	84,731
Weighted-Average Common Shares Outstanding - Diluted	84,859	84,972
Earnings Per Weighted-Average Common Share Outstanding		
Income Before Accounting Change - Basic	\$ 2.71	\$ 3.44
Net Income - Basic	2.71	3.26
Income Before Accounting Change - Diluted	2.71	3.43
Net Income - Diluted	2.71	3.25
Dividends Declared Per Share	\$ 1.20	\$ 1.125

**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 September 30,	
	2002	2001
Operating Revenues		
Electric retail segment	\$ 2,033,006	\$ 2,581,094
Marketing and trading segment	229,996	816,413
Real estate	216,540	148,519
Other revenues	34,275	6,640
Total	2,513,817	3,552,666
Operating Expenses		
Electric retail segment purchased power and fuel	520,236	1,191,788
Marketing and trading segment purchased power and fuel	122,980	473,288
Operations and maintenance	512,654	527,206
Real estate operations	190,713	134,296
Depreciation and amortization	419,873	424,678
Taxes other than income taxes	102,114	103,238
Other expenses	45,463	4,510
Total	1,914,033	2,859,004
Operating Income	599,784	693,662
Other		
Other income (Note 16)	17,903	23,108
Other expense (Note 16)	(40,251)	(38,700)
Total	(22,348)	(15,592)
Interest Expense		
Interest charges	187,868	172,265
Capitalized interest	(51,601)	(43,167)
Total	136,267	129,098
Income Before Income Taxes	441,169	548,972
Income Taxes	175,325	215,099
Income Before Accounting Change	265,844	333,873
Cumulative Effect of a Change in Accounting for Derivatives		
- Net of Income Tax Benefit of \$9,892	--	(15,201)
Net Income	\$ 265,844	\$ 318,672
Weighted-Average Common Shares Outstanding - Basic	84,746	84,730
Weighted-Average Common Shares Outstanding - Diluted	84,851	84,984
Earnings Per Weighted-Average Common Share Outstanding		
Income Before Accounting Change - Basic	\$ 3.14	\$ 3.94
Net Income - Basic	3.14	3.76
Income Before Accounting Change - Diluted	3.13	3.93
Net Income - Diluted	3.13	3.75
Dividends Declared Per Share	\$ 1.60	\$ 1.50

**See Notes to Condensed Consolidated Financial Statements.**



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

**ASSETS**

	September 30, 2002	December 31, 2001
	-----	-----
	(unaudited)	
Current Assets		
Cash and cash equivalents	\$ 28,099	\$ 28,619
Customer and other receivables--net	458,702	367,241
Accrued utility revenues	103,773	76,131
Materials and supplies (at average cost)	80,868	81,215
Fossil fuel (at average cost)	30,632	27,023
Assets from risk management and trading activities	53,389	66,973
Other current assets	91,259	80,203
	-----	-----
Total current assets	846,722	727,405
	-----	-----
Investments and Other Assets		
Real estate investments--net	424,237	418,673
Assets from risk management and trading activities - long-term	206,261	200,351
Other assets	252,634	304,453
	-----	-----
Total investments and other assets	883,132	923,477
	-----	-----
Property, Plant and Equipment		
Plant in service and held for future use	8,965,104	8,030,847
Less accumulated depreciation and amortization	3,447,463	3,290,097
	-----	-----
Total	5,517,641	4,740,750
Construction work in progress	754,241	1,047,072
Intangible assets, net of accumulated amortization	100,561	86,782
Nuclear fuel, net of accumulated amortization	54,770	49,282
	-----	-----
Net property, plant and equipment	6,427,213	5,923,886
	-----	-----
Deferred Debits		
Regulatory assets	267,104	342,383
Other deferred debits	83,905	64,597
	-----	-----
Total deferred debits	351,009	406,980
	-----	-----
Total Assets	\$8,508,076	\$7,981,748
	=====	=====

See Notes to Condensed Consolidated Financial Statements.

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

**LIABILITIES AND EQUITY**

	September 30, 2002	December 31, 2001
	-----	-----
	(unaudited)	
Current Liabilities		
Accounts payable	\$ 271,297	\$ 269,124
Accrued taxes	102,285	96,729
Accrued interest	45,116	48,806
Short-term borrowings	317,811	405,762
Current maturities of long-term debt	260,303	126,140
Customer deposits	54,659	30,232
Deferred income taxes	3,244	3,244
Liabilities from risk management and trading activities	30,396	35,994
Other current liabilities	123,912	74,898
	-----	-----
Total current liabilities	1,209,023	1,090,929
	-----	-----
Long-Term Debt Less Current Maturities	2,879,055	2,673,078
	-----	-----
Deferred Credits and Other		
Liabilities from risk management and trading activities - long-term	92,907	207,576
Deferred income taxes	1,222,260	1,064,993
Unamortized gain - sale of utility plant	60,628	64,060
Other	381,673	381,789
	-----	-----
Total deferred credits and other	1,757,468	1,718,418
	-----	-----
Commitments and Contingencies (Note 12)		
Common Stock Equity		
Common stock, no par value	1,534,025	1,531,038
Retained earnings	1,161,157	1,032,850
Accumulated other comprehensive loss	(32,652)	(64,565)
	-----	-----
Total common stock equity	2,662,530	2,499,323
	-----	-----
Total Liabilities and Equity	\$ 8,508,076	\$ 7,981,748
	=====	=====

**See Notes to Condensed Consolidated Financial Statements.**

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

(dollars in thousands)

	Nine Months Ended September 30,	
	2002	2001
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Income before accounting change	\$ 230,038	\$ 291,561
Items not requiring cash		
Depreciation and amortization	310,812	318,842
Nuclear fuel amortization	23,639	22,221
Deferred income taxes--net	141,024	(58,936)
Change in mark-to-market--trading	(20,937)	(185,521)
Change in mark-to-market--system	(1,226)	(8,604)
Changes in current assets and liabilities		
Customer and other receivables--net	(65,092)	(111,972)
Accrued utility revenues	(27,642)	(28,385)
Materials, supplies and fossil fuel	(3,262)	(14,766)
Other current assets	(12,590)	(6,456)
Accounts payable	(14,413)	30,729
Accrued taxes	7,446	254,736
Accrued interest	(3,690)	(14,915)
Other current liabilities	69,827	(23,872)
Change in real estate investments	(5,008)	(31,481)
Increase in regulatory assets	(8,709)	(10,565)
Change in risk management and trading investments - at cost	(36,385)	(1,907)
Customer advances	17,132	28,069
Change in long term assets	(24,416)	(16,155)
Change in long term liabilities	(22,994)	6,162
	553,554	438,785
<b>Net Cash Flow Provided By Operating Activities</b>	<b>553,554</b>	<b>438,785</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Trust fund for bond redemption	--	(72,370)
Capital expenditures	(689,580)	(692,553)
Capitalized interest	(39,143)	(35,404)
Other--net	41,724	30,126
	(686,999)	(770,201)
<b>Net Cash Flow Used For Investing Activities</b>	<b>(686,999)</b>	<b>(770,201)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt	613,757	744,500
Short-term borrowings and payments--net	(95,416)	116,625
Dividends paid on common stock	(101,727)	(95,341)
Repayment of long-term debt	(286,676)	(413,589)
Other--net	2,987	(5,805)
	132,925	346,390
<b>Net Cash Flow Provided By Financing Activities</b>	<b>132,925</b>	<b>346,390</b>
Net Cash Flow	(520)	14,974
Cash and Cash Equivalents at Beginning of Period	28,619	10,363
	\$ 28,099	\$ 25,337
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ 28,099</b>	<b>\$ 25,337</b>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash paid during the period for:		
Interest, net of amounts capitalized	\$ 100,573	\$ 101,072
Income taxes	\$ 47,450	\$ 32,349

**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 the Company and its subsidiaries: APS, Pinnacle West Energy, APS Energy Services, SunCor, and El Dorado. All significant intercompany accounts and transactions have been eliminated. We have reclassified certain prior year amounts to conform to the current year presentation (see Note 8).
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 (see Note 10). 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 2001 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. On February 8, 2002, Pinnacle West issued \$215 million of 4.5% Notes due 2004. On March 1, 2002, APS issued \$375 million of 6.5% Notes due 2012. On March 15, 2002, APS redeemed at maturity \$125 million of its First Mortgage Bonds, 8.125% Series due 2002. On April 15, 2002, APS redeemed \$122 million of its First Mortgage Bonds, 8.75% Series due 2024. SunCor's long-term indebtedness decreased \$11 million during the nine months ended September 30, 2002. El Dorado's long-term indebtedness increased \$9 million during the nine months ended September 30, 2002, due to its consolidation of NAC for financial reporting purposes (see Note 14). The above items represent the primary changes in capitalization for the nine months ended September 30, 2002.

On November 1, 2002, Maricopa County, Arizona Pollution Control Corporation issued \$90 million of 5.05% Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 2002 Series A, due 2029, and loaned the proceeds to APS pursuant to a loan agreement. The bonds were issued to refinance \$90 million of outstanding pollution control bonds. In addition, see "ACC Applications" in Note 5 for a discussion of APS applications requesting the ACC to permit APS to make inter-affiliate loans to, or guarantees in favor of, Pinnacle West Energy and Pinnacle West.

#### 5. Regulatory Matters

### ELECTRIC INDUSTRY RESTRUCTURING

#### STATE

OVERVIEW. On September 21, 1999, the ACC approved Rules that provide a framework for the introduction of retail electric competition in Arizona. On September 23, 1999, the ACC approved a comprehensive settlement agreement among APS and various parties related to the implementation 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. Consistent with that requirement, APS had been addressing the legal and regulatory requirements necessary to complete the transfer of its generation assets to Pinnacle West Energy on or before that date. The Rules also obligated APS to acquire all of its customers' standard-offer, full-service generation requirements from the competitive market (with at least 50% of those requirements coming from a "competitive bidding process") starting in 2003.

On August 27, 2002, the ACC held an open meeting to consider various issues relating to retail electric competition in Arizona. At that meeting, the ACC determined, among other things, that APS would not be permitted to transfer its generation assets. The ACC stayed indefinitely the competitive bidding requirements described in the preceding paragraph. Instead, the ACC required that APS competitively procure, at a minimum, any power needed for its retail customers that it cannot produce from its existing generation assets. The ACC ordered the ACC Staff and interested parties to develop a competitive procurement process by March 1, 2003. For purposes of this competitive procurement process, the ACC stated that the Pinnacle West Energy generation assets "shall not be counted as APS assets in determining the amount, timing, and manner of the competitive solicitation." The ACC ordered the development of a competitive solicitation process that can begin by March 1, 2003.

On September 16, 2002, APS filed an application with the ACC requesting the ACC to allow APS to borrow up to \$500 million and to lend the proceeds to Pinnacle West Energy or to the Company; to guarantee up to \$500 million of Pinnacle West Energy's or the Company's debt; or a combination of both, not to exceed \$500 million in the aggregate. In its application, APS stated that the ACC's reversal of the generation asset transfer requirement and the resulting bifurcation of generation assets between APS and Pinnacle West Energy under different regulatory regimes result in Pinnacle West Energy being unable to attain investment-grade credit ratings. This, in turn, precludes Pinnacle West Energy from accessing capital markets to refinance the bridge financing provided by the Company to fund the construction of Pinnacle West Energy generation assets or from effectively competing in the wholesale markets. APS noted that Pinnacle West Energy had previously received investment-grade credit ratings contingent upon its receipt of APS generation assets and that the Company's credit ratings could be adversely affected if Pinnacle West Energy is unable to finance its capital requirements. On November 4, 2002, Standard & Poor's lowered the Company's senior unsecured debt rating from "BBB" to "BBB-". On November 8, 2002, APS filed an Interim Financing Application with the ACC requesting the ACC 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.

These regulatory developments and legal challenges to the Rules have raised considerable uncertainty about the status and pace of retail electric competition in Arizona. These matters are discussed in more detail below.

1999 SETTLEMENT AGREEMENT. The following are the major provisions of the 1999 Settlement Agreement, as approved:

\* 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% beginning July 1, 1999 through

July 1, 2003, for a total of 7.5%. The first reduction of approximately \$24 million (\$14 million after income taxes) included a July 1, 1999 retail price decrease of approximately \$11 million (\$7 million after income taxes) related to a 1996 regulatory agreement. Based on the price reductions authorized in the 1999 Settlement Agreement, there were also retail price decreases of approximately \$28 million (\$17 million after taxes), or 1.5%, effective July 1, 2000; approximately \$27 million (\$16 million after taxes), or 1.5%, effective July 1, 2001; and approximately \$28 million (\$17 million after taxes), or 1.5%, effective July 1, 2002. The final 1.5% 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.

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

\* There 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.

\* 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.

\* 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 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.

\* 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. APS will not be allowed to recover \$183 million net present value of the above amounts. The 1999 Settlement Agreement provides that APS will have the opportunity to recover \$350 million net present value 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.

\* 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, sixty-seven percent of its costs to accomplish the required transfer of generation assets to an affiliate. However, as noted above and discussed in greater detail below, 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:

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

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

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

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

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

\* Absent an ACC waiver, prior to January 1, 2001, each affected utility (except certain electric cooperatives) must transfer all competitive electric assets and services to an unaffiliated party or parties or to a separate corporate affiliate or affiliates. Under the 1999 Settlement Agreement, APS received a waiver to allow transfer of its

competitive electric assets and services to affiliates no later than December 31, 2002. However, as noted above and discussed in greater detail below, 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. 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.

**GENERIC DOCKET.** In January 2002, the ACC opened a "generic" docket to "determine if changed circumstances require the [ACC] to take another look at electric restructuring in Arizona." In February 2002, the ACC docket relating to APS' October 2001 filing was consolidated with several other pending ACC dockets, including the generic docket. On May 2, 2002, the ACC issued a procedural order stating that hearings would begin on June 17, 2002 on various issues ("Track A Issues"), including APS' planned divestiture of generation assets to Pinnacle West Energy and associated market and affiliate issues. The



procedural order also stated that consideration of the competitive bidding process (the "Track B Issues") required by the Rules would proceed concurrently with the Track A Issues.

### **TRACK A ORDER**

On September 10, 2002, the ACC issued the Track A Order, which documents decisions made by the ACC at an open meeting on August 27, 2002. The major provisions of the Track A Order include, among other things:

Provisions related to the reversal of the generation asset transfer requirement:

- \* The ACC 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
- \* the ACC 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.

Provisions related to the wholesale competitive energy procurement process ("Track B" issues):

- \* The ACC stayed indefinitely the requirement of the Rules that APS acquire 100% of its energy needs for its standard offer customers from the competitive market, with at least 50% obtained through a competitive bid process;
- \* the ACC established a requirement that APS competitively procure, at a minimum, any required power that it cannot produce from its existing assets in accordance with the ultimate outcome of the Track B proceedings;
- \* the ACC directed the parties to develop a competitive procurement ("bidding") process that can begin by March 1, 2003; and
- \* the ACC stated that "the [Pinnacle West Energy] generating assets that APS may acquire from [Pinnacle West Energy] shall not be counted as APS assets in determining the amount, timing and manner of the competitive solicitation" for Track B purposes, thereby bifurcating the regulatory treatment of the existing APS assets and the Pinnacle West Energy assets.

On September 30, 2002, APS filed a Motion for Reconsideration of the Track A Order and on October 17, 2002, the ACC voted to deny that motion. APS intends to appeal the Track A Order or otherwise seek restitution for the ACC's reversal of the 1999 Settlement Agreement. Such restitution will also be addressed in APS' 2003 rate filing with the ACC.

The ACC Staff has conducted workshops on the Track B issues with various parties to determine and define the appropriate process to be used for competitive power procurement. On October 25, 2002, the ACC Staff issued its report proposing a process by which APS would procure power not supplied by its own resources. Under the ACC Staff's proposal, we believe APS will be required to competitively bid for about 1,500 MW of energy on peak. As described above, the ACC has directed the parties to complete the Track B proceedings such

that the competitive procurement process can begin by March 1, 2003. The ACC Staff also proposes that Pinnacle West Energy would be able to bid. In addition to the ACC Staff workshop process, the ACC will conduct evidentiary hearings to make its final determination on the Track B proceedings. The hearing is scheduled to begin on November 21, 2002.

## **ACC APPLICATIONS**

On September 16, 2002, APS filed a Financing Application requesting the ACC to allow APS to borrow up to \$500 million and to lend the proceeds to Pinnacle West Energy or the Company; to guarantee up to \$500 million of Pinnacle West Energy's or the Company's debt; or a combination of both, not to exceed \$500 million in the aggregate. The loan and/or the guarantee would be used to refinance debt incurred to fund the construction of Pinnacle West Energy generation assets. The ACC has established a procedural schedule with a hearing to begin January 8, 2003.

The Financing Application addresses, among other things, the following matters:

\* APS noted that its April 19, 2002 filing with the ACC had sought unification of "[Pinnacle West Energy] Assets" (West Phoenix Combined Cycle Units 4 and 5, Redhawk Units 1 and 2, and Saguaro Combustion Turbine Unit 3) and APS generation assets under a common financial and regulatory regime. APS further noted that the Track A Order's language regarding the treatment of the Pinnacle West Energy Assets for Track B purposes (see the last bullet point under "Track A Order" above) appears to postpone a decision regarding the inclusion of the Pinnacle West Energy Assets in APS' rate base, thereby effectively precluding the consolidation of the Pinnacle West Energy Assets at APS under a common financial and regulatory regime at the present time.

\* APS stated that it did not intend or desire to foreclose the possibility that it would acquire all or part of the Pinnacle West Energy Assets or that it may propose that the Pinnacle West Energy Assets be included in APS' rate base or afforded cost-of-service regulatory treatment to the extent the Pinnacle West Energy Assets are used by APS customers. APS stated that these issues would be appropriate topics in APS' 2003 general rate case and noted that the Track A Order specifically stated that the ACC would not pre-judge the eventual rate treatment of the Pinnacle West Energy Assets.

\* APS stated that the Track A Order's reversal of the generation asset transfer requirement and the resulting bifurcation of generation assets between APS and Pinnacle West Energy under different regulatory regimes result in Pinnacle West Energy being unable to attain investment-grade credit ratings. This, in turn, precludes Pinnacle West Energy from accessing capital markets to refinance the bridge financing provided by the Company to fund the construction of the Pinnacle West Energy Assets or from effectively competing in the wholesale markets. APS noted that Pinnacle West Energy had previously received investment-grade credit ratings contingent upon its receipt of APS generation assets and that the Company's credit ratings could be adversely affected if Pinnacle West Energy is unable to finance its

capital requirements. On November 4, 2002, Standard & Poor's lowered the Company's senior unsecured debt rating from BBB to BBB-.

\* APS stated that the amount of the requested loan and/or guarantee is APS' present estimate of the amount of credit support necessary through APS to restore Pinnacle West Energy and the Company to their credit status prior to the ACC's issuance of the Track A Order. APS further stated that if the requested amount proves to be inadequate, APS reserves the right to submit a second financing application seeking additional credit support.

In mid-2003, the Company will need to refinance approximately \$550 million of parent company indebtedness. If the ACC does not grant the approvals requested in the Financing Application in a timely fashion, the Company would anticipate taking the following steps, to the extent necessary, in priority order, although the timing of the Company's liquidity needs may affect the order of the steps taken:

\* The reduction of capital expenditures through plant delay and cancellation;

\* The sale of non-core assets; and

\* The issuance of new debt and, if appropriate, new equity.

Although we believe it would be inappropriate to discuss specific amounts for each of the foregoing categories, we estimate the sum of these steps to be approximately equivalent to the current outstanding debt at the parent company, which totaled approximately \$1.1 billion as of September 30, 2002.

On November 8, 2002, APS filed an Interim Financing Application with the ACC requesting a waiver of certain ACC rules to permit APS to (a) make short-term advances to Pinnacle West in the form of an inter-affiliate line of credit or (b) guarantee Pinnacle West's short-term debt. In either case, the waiver would be limited to a maximum aggregate principal amount of \$125 million and for a maximum term of 364 days. In the Interim Financing Application APS stated that Pinnacle West was facing short-term liquidity needs as a result of the pending expiration of a \$125 million bank facility, which is used as part of the backup for the Company's \$250 million commercial paper program, on November 29, 2002. As of November 12, 2002, the Company had \$100 million of commercial paper outstanding. APS further stated that many of Pinnacle West's lenders have advised Pinnacle West that they will not renew the expiring facility because they are unwilling to assume the regulatory risk that the ACC will act on the Financing Application in a timely and favorable manner, particularly in light of Standard & Poor's recent lowering of Pinnacle West's senior unsecured debt rating. APS stressed that Pinnacle West's need for the short-term line of credit or guarantee was a direct result of the regulatory developments giving rise to the Financing Application (see above) and stated that the line of credit or guarantee was designed as a pure liquidity backstop and would be the last borrowing choice for Pinnacle West. The Company is also evaluating other options to ensure adequate liquidity. APS requested that the Interim Financing Application be decided by the ACC on an emergency basis at its November 19, 2002 meeting.

## **FEDERAL**

In June 2001, 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 plan, which has a price cap of approximately \$90 per MWh and was originally ordered to remain in effect until September 30, 2002, was extended to remain in place until October 31, 2002. FERC has adopted a price cap for the period thereafter of \$250 per MWh.

On July 31, 2002, the FERC issued a Notice of Proposed Rulemaking for Standard Market Design for wholesale electric markets. 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.

## GENERAL

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 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 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 \$200 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 upon 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 two principal business segments (determined by products, services and the regulatory environment), which consist of our regulated retail electricity business, regulated traditional wholesale electricity business, and related activities (electric retail business segment) and our competitive business activities (marketing and trading business segment). Our electric retail business segment includes activities related to electricity transmission and distribution, as well as electricity generation. Our marketing and trading business segment includes activities related to wholesale marketing and trading and APS Energy Services' commodity-related energy services. The other amounts include activities related to SunCor and El Dorado. Certain parent company costs, other than marketing and trading, are included in our electric retail segment. Financial data for the Company's business segments follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2002	2001	2002	2001	2002	2001
Operating Revenues:						
Electric retail	\$ 720	\$ 973	\$ 1,597	\$ 2,125	\$ 2,033	\$ 2,581
Marketing and trading	87	142	213	634	230	817
Other	66	46	183	114	251	155
	-----	-----	-----	-----	-----	-----
Total	\$ 873	\$ 1,161	\$ 1,993	\$ 2,873	\$ 2,514	\$ 3,553
	=====	=====	=====	=====	=====	=====
Income Before Accounting Change:						
Electric retail	\$ 88	\$ 99	\$ 185	\$ 112	\$ 222	\$ 145
Marketing and trading	24	61	49	175	46	187
Other	(11)	2	(4)	4	(2)	2
	-----	-----	-----	-----	-----	-----
Total	\$ 101	\$ 162	\$ 230	\$ 291	\$ 266	\$ 334
	=====	=====	=====	=====	=====	=====

	As of September 30, 2002	As of December 31, 2001
	-----	-----
Assets:		
Electric retail	\$ 7,568	\$ 7,077
Marketing and trading	428	417
Other	512	488
	-----	-----
Total	\$ 8,508	\$ 7,982
	=====	=====

#### 8. Accounting Matters

In June 2002, the FASB's EITF issued certain guidance related to energy trading activities in EITF 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities." The new guidance, which was effective July 1, 2002, required that all energy trading activities within the scope of EITF 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," be presented on a net basis in revenues and that prior period amounts be restated.

In October 2002, the EITF reached a consensus that gains and losses on derivative instruments within the scope of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" should be shown net in the income statement if the derivative is held for trading purposes. This decision effectively supersedes the guidance provided at the June meeting. Beginning in the third quarter of 2002, we have netted all of our energy trading activities on the income statement and have restated prior amounts.

In the October 2002 meeting, the EITF also rescinded EITF 98-10. This guidance is effective immediately for all new contracts and on January 1, 2003 for existing contracts. As such, energy trading contracts will be accounted for on an accrual basis with the associated revenues and costs recorded at the time the contracted commodities are delivered or received, unless the contracts are required to be marked to market as derivatives under SFAS No. 133 or if allowed by other guidance. For existing contracts, we will record a cumulative effect adjustment in net income for the previously recorded accumulated unrealized mark-to-market on energy trading contracts that do not meet the definition of a derivative under SFAS No. 133. We are currently evaluating the impact of this guidance on our consolidated financial statements.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which we will adopt January 1, 2003. The standard requires the fair value of asset retirement obligations to be recorded as a liability, along with an offsetting plant asset, when the obligation is incurred. Accretion of the liability due to the passage of time will be an operating expense and the capitalized cost will be depreciated over the useful life of the long-lived asset.

We determined that we have asset retirement obligations for our nuclear facilities (nuclear decommissioning) and certain other fossil generation, transmission, and distribution assets. The standard is not expected to have a material impact on net income because the assets with significant retirement obligations are regulated. We expect to establish a regulatory asset or liability to offset the impacts of this standard on the regulated assets.

In 2001, the American Institute of Certified Public Accountants issued an exposure draft of a proposed Statement of Position, "Accounting for Certain Costs Related to Property, Plant, and Equipment." This proposed Statement of Position, which would be effective for us in 2004, 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. The American Institute of Certified Public Accountants plans to issue the final Statement of Position in early 2003.

In the third quarter of 2002, we changed to the fair value method of accounting for stock-based compensation, as provided for in SFAS No. 123, "Accounting for Stock-Based Compensation". The fair value method of accounting is the preferred method. In accordance with the transition requirements of SFAS No. 123, we applied the fair value method prospectively, beginning with 2002 stock grants. We expect to record approximately \$500,000 in stock option expense before income taxes in our consolidated income statement for 2002, approximately

one-half of which was recorded in the third quarter of 2002. This amount may not be reflective of the stock option expense we record in future years because stock options typically vest over several years and additional grants are generally made each year.

On January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets." This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." We have no goodwill recorded and have separately disclosed other intangible assets in our condensed consolidated balance sheets. This new standard has no material impact on our financial statements, and the required disclosures are provided in Note 13.

On January 1, 2002, we adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions for the disposal of a segment of a business. This standard did not impact our financial statements at adoption.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements Nos. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" which, among other things, supersedes previous guidance for reporting gains and losses from extinguishment of debt and accounting for leases. The portion of the statement relating to the early extinguishment of debt is effective for us beginning in 2003. We do not believe the adoption of this statement will have a material impact on our financial statements.

In July 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The standard requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. The guidance should be applied prospectively to exit or disposal activities initiated after December 31, 2002.

See Note 9 for accounting developments related to special-purpose entities.

#### 9. Off-Balance Sheet Financing

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. In July 2002, the FASB issued an exposure draft related to SPEs. It is expected that the FASB will issue final guidance on accounting for SPEs during the fourth quarter of 2002, with an immediate effective date for newly-created entities and for all other entities as of the beginning of the first fiscal period beginning on or after April 1, 2003. We are currently evaluating the impacts of the exposure draft and we may be required to consolidate the Palo Verde SPEs in our financial statements.

If consolidation were required, the assets and liabilities of the SPEs that relate to the sale-leaseback transactions would be reflected on our condensed consolidated balance sheet at fair value on the date of implementation. We are currently evaluating the impact of including the related fair value of

assets and liabilities. The secured lease obligation bonds that are not reflected on our condensed consolidated balance sheet at September 30, 2002 total approximately \$285 million. The rating agencies have already considered this debt when evaluating our credit ratings. This is our only significant off-balance sheet financing activity.

#### 10. Derivative Instruments and Energy Trading Activities

We are exposed to the impact of market fluctuations in the price and transportation costs of electricity, natural gas, coal and emissions allowances. We employ 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 commodities. In addition, subject to specified risk parameters established by our Board of Directors and monitored by our ERM, we engage in trading activities intended to profit from market price movements.

Effective January 1, 2001, we adopted SFAS No. 133. SFAS No. 133 requires that entities recognize all derivatives as either assets or liabilities on the balance sheets and measure those instruments at fair value. Changes in the fair value of derivative financial instruments are either recognized periodically in income or shareholders' equity (as a component of other comprehensive income), depending on whether or not the derivative meets specific hedge accounting criteria. We use cash flow hedges to limit our exposure to cash flow variability on forecasted transactions. Hedge effectiveness is related to the degree to which the derivative contract and the hedged item are correlated. It is measured based on the relative changes in fair value between the derivative contract and the hedged item over time. We exclude the time value of certain options from our assessment of hedge effectiveness. Any change in the fair value resulting from "ineffectiveness", or the amount by which the derivative contract and the hedge commodity are not directly correlated, is recognized immediately in net income.

On January 1, 2001, we recorded a \$3 million after-tax loss in net income and a \$65 million after-tax gain in equity (as a component of other comprehensive income), both as cumulative effects of a change in accounting principle. The gain resulted from unrealized gains on cash flow hedges.

In June 2001, the FASB issued new guidance related to electricity contracts. The effective date of this new guidance was July 1, 2001. As of July 1, 2001, we recorded an additional \$12 million after-tax loss in net income and an additional \$8 million after-tax gain in equity (as a component of other comprehensive income), as a result of adopting the new guidance related to electricity contracts. The loss resulted primarily from electricity options contracts. The gain resulted from unrealized gains on cash flow hedges. The impact of the new guidance was reflected in consolidated net income and other comprehensive income as cumulative effects of a change in accounting principle.

In December 2001, the FASB issued revised guidance on the accounting for electricity contracts with option characteristics and the accounting for contracts that combine a forward contract and a purchased option contract. The effective date for the revised guidance was April 1, 2002. The impact of this guidance was immaterial to our financial statements.



The changes in derivative fair value included in the condensed consolidated statements of income for the three, nine and twelve months ended September 30, 2002 and 2001 are comprised of the following (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2002	2001	2002	2001	2002	2001
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$ 42	\$ (1,879)	\$ 1,965	\$ (5,748)	\$ 1,657	\$ (5,748)
Gains (losses) from the discontinuance of cash flow hedges	--	(2,417)	(45)	(5,273)	546	(5,273)
Gains (losses) from non-hedge derivatives	(5,513)	1,050	(7,092)	(6,733)	(7,516)	(6,733)
Prior period mark-to-market losses realized upon delivery of commodities	376	19,880	6,398	26,358	5,986	26,358
Total pretax gain (loss)	\$ (5,095)	\$ 16,634	\$ 1,226	\$ 8,604	\$ 673	\$ 8,604

As of September 30, 2002, the maximum length of time over which we are hedging our exposure to the variability in future cash flows for forecasted transactions is twenty-seven months. During the twelve months ending September 30, 2003, we estimate that a net loss of \$14 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 following table summarizes our assets and liabilities from risk management and trading activities related to trading and system (retail and traditional wholesale activities) as of September 30, 2002 (dollars in thousands):

	Current Assets	Investments	Current Liabilities	Other Liabilities	Net Asset/ (Liability)
	-----	-----	-----	-----	-----
Mark-to- market:					
Trading	\$ 37,506	\$ 133,886	\$ (2,613)	\$ (10,009)	\$ 158,770
System	15,883	3	(27,783)	(41,865)	(53,762)
Cost: Emission allowances and other	--	72,372(a)	--	(41,033)	31,339
	-----	-----	-----	-----	-----
Total	\$ 53,389	\$ 206,261	\$ (30,396)	\$ (92,907)	\$ 136,347
	=====	=====	=====	=====	=====

(a) Includes \$12 million required to counterparties to serve as collateral against our open positions on energy-related contracts. The Standard & Poor's rating action on November 4, 2002 did not significantly change our collateral requirements with counter-parties.

## 11. Comprehensive Income

Components of comprehensive income for the three, nine and twelve months ended September 30, 2002 and 2001, are as follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	-----	-----	-----	-----	-----	-----
	2002	2001	2002	2001	2002	2001
	-----	-----	-----	-----	-----	-----
Net income	\$ 100,916	\$ 150,053	\$ 230,038	\$ 276,360	\$ 265,844	\$ 318,672
Other comprehensive income (loss):						
Minimum pension liability, net of tax	--	--	(1,835)	--	(2,801)	--
Cumulative effect of change in accounting for derivatives, net of tax	--	7,801	--	72,501	--	72,501
Unrealized gains (losses) on hedging derivatives, net of tax (a)	1,446	(11,353)	20,731	(92,493)	22,758	(92,493)
Reclassification of hedging derivatives net realized (gains) losses to income, net of tax (b)	2,364	(11,145)	13,017	(46,617)	14,000	(46,617)
	-----	-----	-----	-----	-----	-----
Total other comprehensive income (loss)	3,810	(14,697)	31,913	(66,609)	33,957	(66,609)
	-----	-----	-----	-----	-----	-----
Comprehensive income	\$ 104,726	\$ 135,356	\$ 261,951	\$ 209,751	\$ 299,801	\$ 252,063
	=====	=====	=====	=====	=====	=====

(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 also ordered an evidentiary proceeding to discuss and evaluate possible refunds for the Pacific Northwest. The administrative law judge at the FERC in charge of that evidentiary proceeding made an initial finding that no refunds were appropriate. The Pacific Northwest issues will now be addressed by the FERC commissioners. 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.

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. We have evaluated, among other things, SCE's role as a Palo Verde and Four Corners participant; APS' transactions with the PX and the ISO; contractual relationships with SCE and PG&E; APS Energy Services' retail transactions involving SCE and PG&E; and marketing and trading exposures. 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. After review with legal counsel and review of bond pricing, the \$10 million reserve was our best estimate of our losses.

In the first quarter of 2002, SCE paid all of its outstanding debts to APS Energy Services. 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 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 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 that 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 that, 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 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.

### 13. Intangible Assets

On January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets." This statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." The Company's gross intangible assets (which are primarily software) were \$203 million at September 30, 2002 and \$175 million at December 31, 2001. The related accumulated amortization was \$102 million at September 30, 2002 and \$88 million at December 31, 2001. Amortization expense for the three month period ended September 30 was \$6 million in 2002 and 2001. Amortization expense for the nine month period ended September 30 was \$14 million in 2002 and \$16 million in 2001. Amortization expense for the twelve-month period ended September 30 was \$20 million in 2002 and \$22 million in 2001. Estimated amortization expense on existing intangible assets over the next five years is \$17 million in 2002, \$16 million in 2003, \$15 million in 2004, \$13 million in 2005 and \$11 million in 2006.

### 14. El Dorado's Investment in NAC

NAC develops, markets and contracts for the manufacture of cask designs for spent nuclear fuel storage and transportation. Prior to the third quarter 2002, El Dorado's investment in NAC was accounted for under the equity method and El Dorado's share of earnings and losses through June 2002 were recorded in other income or expense in the condensed consolidated income statement. Beginning in the third quarter of 2002, El Dorado 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. El Dorado consolidated a pretax loss of \$13 million in the third quarter of 2002 related to NAC. In addition, Pinnacle West provided guarantees for credit support related to NAC in the cumulative amount of \$43 million as of September 30, 2002.

## 15. Earnings Per Share

The following table presents earnings per weighted average common share outstanding (EPS):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2002	2001	2002	2001	2002	2001
<b>Basic EPS:</b>						
Income before accounting change	\$ 1.19	\$ 1.92	\$ 2.71	\$ 3.44	\$ 3.14	\$ 3.94
Cumulative effect of change in accounting	--	(0.15)	--	(0.18)	--	(0.18)
<b>Earnings per share - basic</b>	<b>\$ 1.19</b>	<b>\$ 1.77</b>	<b>\$ 2.71</b>	<b>\$ 3.26</b>	<b>\$ 3.14</b>	<b>\$ 3.76</b>
<b>Diluted EPS:</b>						
Income before accounting change	\$ 1.19	\$ 1.91	\$ 2.71	\$ 3.43	\$ 3.13	\$ 3.93
Cumulative effect of change in accounting	--	(0.14)	--	(0.18)	--	(0.18)
<b>Earnings per share - diluted</b>	<b>\$ 1.19</b>	<b>\$ 1.77</b>	<b>\$ 2.71</b>	<b>\$ 3.25</b>	<b>\$ 3.13</b>	<b>\$ 3.75</b>

The following table reconciles average common shares outstanding - basic to average common shares outstanding - diluted that are used in the EPS calculation in the condensed consolidated income statement (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2002	2001	2002	2001	2002	2001
Average common shares outstanding - basic	84,768	84,721	84,768	84,731	84,746	84,730
Dilutive stock options	29	188	91	241	105	254
<b>Average common shares outstanding - diluted</b>	<b>84,797</b>	<b>84,909</b>	<b>84,859</b>	<b>84,972</b>	<b>84,851</b>	<b>84,984</b>

Options to purchase 2,118,994 shares for the three-month period ended September 30, 2002, 1,281,721 shares for the nine-month period ended September 30, 2002 and 1,284,063 shares for the twelve-month period ended September 30, 2002 were outstanding but were not included in the computation of EPS 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 EPS were 637,872 shares for the three-month period September 30, 2001, 213,358 shares for the nine-month period September 30, 2001

and 214,006 shares for the twelve-month period September 30, 2001.

## 16. Other Income and Other Expense

The following table provides detail of other income and other expense for the three, nine and twelve months ended September 30, 2002 and 2001 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Twelve Months Ended September 30,	
	2002	2001	2002	2001	2002	2001
Other income						
Environmental insurance recovery	\$ --	\$ --	\$ --	\$ 10,947	\$ 1,402	\$ 10,947
Interest income	1,863	889	3,749	4,037	6,945	6,951
SunCor joint venture earnings	123	188	3,522	2,669	2,040	3,607
Miscellaneous	1,052	450	3,042	1,173	7,516	1,603
Total other income	\$ 3,038	\$ 1,527	\$ 10,313	\$ 18,826	\$ 17,903	\$ 23,108
Other expense:						
Investment losses - net (a)	\$ (4,256)	\$ (605)	\$ (8,371)	\$ (3,083)	\$ (10,071)	\$ (10,745)
Non-operating costs - SunCor	--	--	--	(4,500)	(2,500)	(4,500)
Non-operating costs (b)	(3,884)	(2,641)	(13,696)	(9,620)	(18,386)	(15,403)
Miscellaneous	(2,573)	(357)	(4,715)	(2,905)	(9,294)	(8,052)
Total other expense	\$ (10,713)	\$ (3,603)	\$ (26,782)	\$ (20,108)	\$ (40,251)	\$ (38,700)

(a) Primarily related to El Dorado's investments in NAC in 2002 (see Note 14).

(b) Primarily below-the-line non-operating utility costs.

## 17. 2002 Severance Charges

In July 2002, we announced cost containment measures that included a voluntary workforce reduction. We recorded \$25 million before taxes in voluntary severance costs in the third quarter of 2002. We expect to record up to \$12 million before taxes for additional severance costs in the fourth quarter of 2002.

## 18. 2002 IRS Tax Refund

As a result of a change in IRS guidance, we claimed a tax deduction related to an APS tax accounting method change on the 2001 Federal consolidated income tax return. The accelerated deduction has resulted in a \$200 million reduction in current tax liability.

## 19. Regulatory Accounting

APS is regulated by the ACC and the FERC. The accompanying condensed consolidated financial statements reflect the ratemaking policies of these commissions. For regulated operations, we prepare our financial statements in accordance with SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 requires a cost-based, rate-regulated enterprise to reflect the impact of regulatory decisions in its financial statements. EITF 97-4 requires that SFAS No. 71 be discontinued no later than when legislation is passed or a rate order is used that contains sufficient detail to determine its effect on the portion of the business being deregulated. In 1999, we discontinued the application of SFAS No. 71 for APS' generation operations due to the 1999 Settlement Agreement with the ACC. See Note 5 for a discussion of the 1999 Settlement Agreement. In the Track A order, the ACC determined that APS would not be able to transfer its generation assets as provided for in the 1999 Settlement Agreement (see Note 5). Accordingly, we now consider APS generation to be cost-based, rate-regulated and subject to the requirements of SFAS No. 71. The impacts of this change were immaterial to our financial statements.



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

**Introduction**

In this section, 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:

- \* the changes in our earnings for the three, nine and twelve months ended September 30, 2002 and 2001;
- \* the effects of regulatory agreements and developments on our results and outlook;
- \* our capital needs, liquidity and capital resources;
- \* our business outlook; and
- \* our management of market risks.

We suggest this section be read along with the 2001 10-K. Throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations, 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 periods ended September 30, 2002 and September 30, 2001 are available on our website ([www.pinnaclewest.com](http://www.pinnaclewest.com)) and in our Current Report on Form 8-K dated September 30, 2002.

**OVERVIEW OF OUR BUSINESS**

The Company owns all of the outstanding common stock of APS. APS is an electric utility that provides retail and 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 provided through a distribution system owned by APS.

APS also generates and, through the Company's marketing and trading division, sells and delivers electricity to wholesale customers in the western United States. Pinnacle West's marketing and trading division currently sells into the wholesale market, the 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. Subject to specified risk parameters established by our Board of Directors and the ERM, the marketing and trading division also has engaged in activities to hedge purchases and sales of electricity, fuels, and emissions allowances and credits and to profit from market price movements. However, as discussed in Note 5, the ACC has ordered the ACC Staff and interested parties to develop a competitive procurement process by March 1, 2003 by which APS will competitively procure, at a minimum, any power needed for its retail customers that it cannot produce from its existing generation assets. For purposes of this competitive procurement process, Pinnacle West Energy generation assets are not counted as APS generation assets. The draft ACC Staff report proposing a competitive procurement process provides that Pinnacle West Energy would be able to bid.

Our other major subsidiaries are:

- \* Pinnacle West Energy, through which we conduct our unregulated electricity generation operations;
- \* APS Energy Services, which provides 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;

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

\* El Dorado, an investment firm.

## **EARNINGS CONTRIBUTIONS BY SUBSIDIARY AND BUSINESS SEGMENT**

We have two principal business segments (determined by products, services and the regulatory environment), which consist of our regulated retail electricity business, regulated traditional wholesale electricity business and related activities (electric retail segment) and our competitive business activities (marketing and trading segment). Our electric retail business segment includes activities related to electricity transmission and distribution, as well as electricity generation. Our marketing and trading business segment includes activities related to wholesale marketing and trading and APS Energy Services' commodity related energy services. The other amounts primarily include activities related to SunCor and El Dorado. Certain parent company costs, other than marketing and trading, are included in our electric retail segment.

The following tables summarize net income and segment details for the three, nine and twelve months ended September 30, 2002 and the comparable prior year periods for Pinnacle West and each of our subsidiaries (dollars in millions):

THREE MONTHS ENDED SEPTEMBER 30,	Total		Electric Retail		Marketing and Trading		Other	
	2002	2001	2002	2001	2002	2001	2002	2001
	-----	-----	-----	-----	-----	-----	-----	-----
Arizona Public Service (a)	\$ 87	\$ 108	\$ 86	\$ 87	\$ 1	\$ 21	\$ --	\$ --
Pinnacle West Energy (a)	10	13	10	13	--	--	--	--
APS Energy Services	7	(3)	--	--	7	(3)	--	--
SunCor	(1)	2	--	--	--	--	(1)	2
El Dorado	(15)	--	--	--	--	--	(15)	--
Parent company	13	42	(8)	(1)	16	43	5	--
	-----	-----	-----	-----	-----	-----	-----	-----
Income before accounting change	101	162	88	99	24	61	(11)	2
Cumulative effect of change in accounting net of income taxes (b)	--	(12)	--	(12)	--	--	--	--
	-----	-----	-----	-----	-----	-----	-----	-----
Net Income	\$ 101	\$ 150	\$ 88	\$ 87	\$ 24	\$ 61	\$ (11)	\$ 2
	=====	=====	=====	=====	=====	=====	=====	=====

NINE MONTHS ENDED SEPTEMBER 30,	Total		Electric Retail		Marketing and Trading		Other	
	2002	2001	2002	2001	2002	2001	2002	2001
	-----	-----	-----	-----	-----	-----	-----	-----
Arizona Public Service (a)	\$ 183	\$ 242	\$ 182	\$ 103	\$ 1	\$ 139	\$ --	\$ --
Pinnacle West Energy (a)	12	14	12	14	--	--	--	--
APS Energy Services	20	(10)	--	--	18	(11)	2	1
SunCor	9	3	--	--	--	--	9	3
El Dorado	(18)	--	--	--	--	--	(18)	--
Parent company	24	42	(9)	(5)	30	47	3	--
	-----	-----	-----	-----	-----	-----	-----	-----
Income before accounting change	230	291	185	112	49	175	(4)	4
Cumulative effect of change in accounting net of income taxes (b)	--	(15)	--	(15)	--	--	--	--
	-----	-----	-----	-----	-----	-----	-----	-----
Net Income	\$ 230	\$ 276	\$ 185	\$ 97	\$ 49	\$ 175	\$ (4)	\$ 4
	=====	=====	=====	=====	=====	=====	=====	=====

TWELVE MONTHS ENDED SEPTEMBER 30,	Total		Electric Retail		Marketing and Trading		Other	
	2002	2001	2002	2001	2002	2001	2002	2001
	-----	-----	-----	-----	-----	-----	-----	-----
Arizona Public Service (a)	\$ 222	\$ 296	\$ 218	\$ 136	\$ 4	\$ 160	\$ --	\$ --
Pinnacle West Energy (a)	15	14	15	14	--	--	--	--
APS Energy Services	21	(19)	--	--	20	(21)	1	2
SunCor	10	6	--	--	--	--	10	6
El Dorado	(19)	(5)	--	--	--	--	(19)	(5)
Parent company	17	42	(11)	(5)	22	48	6	(1)
	-----	-----	-----	-----	-----	-----	-----	-----
Income before accounting change	266	334	222	145	46	187	(2)	2
Cumulative effect of change in accounting net of income taxes (b)	--	(15)	--	(15)	--	--	--	--
	-----	-----	-----	-----	-----	-----	-----	-----
Net Income	\$ 266	\$ 319	\$ 222	\$ 130	\$ 46	\$ 187	\$ (2)	\$ 2
	=====	=====	=====	=====	=====	=====	=====	=====

(a) Consistent with APS' October 2001 ACC filing, in which APS requested approval of a purchase power agreement with the Company to ensure ongoing reliable service to APS customers in a volatile generation market, during 2002 APS entered into agreements with its affiliates to buy power. The agreements, which expire December 31, 2002, reflect a price based on the fully-dispatchable dedication of the Pinnacle West Energy generating assets to APS' Native Load customers.

(b) APS recorded the cumulative effects of a change in accounting for derivatives related to the adoption in 2001 of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities."

## **EARNINGS VARIANCE EXPLANATIONS**

Throughout these explanations, we refer to "gross margin." With respect to our electric retail segment and marketing and trading segment, gross margin refers to electric operating revenues less purchased power and fuel costs. In June and October 2002, the EITF provided certain guidance related to energy trading activities in EITF 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" (see Note 8). Beginning in the third quarter of 2002, we have netted all of our energy trading activities on the income statement and have restated prior period amounts. Real estate gross margin refers to real estate revenues less real estate operations costs. Other gross margin refers to other operating revenues less other operating expenses, which includes El Dorado's investment in NAC, which we began consolidating on our financial statements in July 2002 (see Note 14). It also includes amounts related to APS Energy Services' energy consulting services.

### **OPERATING RESULTS - THREE-MONTH PERIOD ENDED SEPTEMBER 30, 2002 COMPARED WITH THREE-MONTH PERIOD ENDED SEPTEMBER 30, 2001**

Our consolidated net income for the three months ended September 30, 2002 was \$101 million compared with \$150 million for the same period in the prior year. We recognized a \$12 million after-tax loss in the three months ended September 30, 2001 as a cumulative effect of a change in accounting for derivatives, as required by SFAS No. 133.

Our income before accounting change for the three months ended September 30, 2002 was \$101 million compared with \$162 million for the same period in the prior year. The period-to-period decrease was primarily the result of lower earnings contributions from our marketing and trading activities, severance costs of \$25 million pretax recorded in the third quarter of 2002 related to a voluntary workforce reduction (see Note 17) and losses at El Dorado primarily related to its investment in NAC in the third quarter of 2002 (see Note 14). The comparison for marketing and trading activities reflects lower prices in the wholesale power markets in the western United States. The regulated retail comparison was negatively impacted by higher costs for purchased power and gas, weather impacts and the 1.5% electric retail price reduction that took effect July 1, 2002. These factors were offset by lower replacement costs for power plant outages, lower operating costs related to generation reliability, customer growth of 3.1% and higher average usage per customer for the third quarter of 2002.

The major factors that increased (decreased) income before accounting change were as follows (dollars in millions):

	Increase (Decrease)
Marketing and trading segment gross margin:	
Increase in realized marketing and trading in the current period primarily due to higher volumes	\$ 3(a)
Change related to prior period mark-to-market gains on contracts delivered during the current period (b)	39(a)
Lower mark-to-market gains for future period deliveries (b)	(106)
	-----
Net decrease in marketing and trading segment gross margin	(64)
	-----
Electric retail segment gross margin:	
Lower replacement power costs for plant outages due to lower market prices and fewer unplanned outages	15
Lower hedge management margin, partially offset by lower purchased power and fuel costs due to lower spot market prices	(14)
Effects of weather on retail sales	(10)
Higher retail sales volumes due to customer growth and higher average usage, excluding weather effects	22
Retail price reduction effective July 1, 2002	(9)
Change in mark-to-market for hedged natural gas and purchased power costs for future period deliveries (see Note 10)	(10)
Miscellaneous factors, net	(6)
	-----
Net decrease in electric retail segment gross margin	(12)
	-----
Total decrease in electric retail and marketing and trading segments' gross margins	(76)
Lower other gross margin primarily related to losses recorded on El Dorado's investment in NAC (see Note 14)	(13)
Lower operations and maintenance expense primarily related to lower generation reliability costs, partially offset by 2002 severance costs of \$25 million (see Note 17) and other costs	6
Higher other expense	(7)
Higher net interest expense primarily due to higher debt balances	(8)
Miscellaneous items, net	(1)
	-----
Decrease in income before income taxes	(99)
Lower income taxes primarily due to lower pretax income	38
	-----
Decrease in income before accounting change	\$ (61)
	=====

(a) Net recognized marketing and trading gains (excluding the effects of generation sales other than Native Load) increased \$42 million.

(b) Essentially all of our marketing and trading activities are structured activities. This means our portfolio of forward sales positions is economically hedged with a portfolio of forward purchases that protects the economic value of the sales transactions.

## **MARKETING AND TRADING SEGMENT GROSS MARGIN**

Marketing and trading segment revenues were \$54 million lower in the three-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* increased revenues from generation sales other than Native Load due to higher sales volumes (\$4 million);
- \* increased realized revenues from other realized marketing and trading in the current period primarily due to higher sales volumes (\$10 million);
- \* change in prior period mark-to-market gains on contracts delivered during the current period due to lower unit margins on higher volumes being delivered (\$40 million increase); and
- \* lower mark-to-market gains for future period deliveries primarily as a result of lower market liquidity and lower price volatility, resulting in lower volumes (\$108 million).

Marketing and trading segment purchased power and fuel costs were \$10 million higher in the three-month period ended September 30, 2002, compared to the same period in the prior year as a result of:

- \* increased fuel costs related to generation sales other than Native Load primarily because of higher sales volumes and higher natural gas prices (\$4 million);
- \* increased purchased power costs related to other realized marketing activities in the current period primarily due to higher sales volumes (\$7 million); and
- \* other miscellaneous factors (\$1 million decrease).

## **ELECTRIC RETAIL SEGMENT GROSS MARGIN**

Revenues related to our regulated retail and wholesale electricity businesses were \$254 million lower in the three-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased revenues related to wholesale sales for retail load hedge management, as a result of lower prices (\$265 million);
- \* decreased retail revenues related to milder weather (\$15 million);
- \* increased retail revenues related to customer growth and higher average usage, excluding weather effects (\$33 million);
- \* decreased retail revenues related to a reduction in retail electricity prices (\$9 million); and
- \* other miscellaneous factors (\$2 million net increase).

Electric retail segment purchased power and fuel costs were \$242 million lower in the three-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased costs related to lower prices for hedged natural gas and purchased power (\$251 million);
- \* decreased costs related to the effects of milder weather on retail sales (\$5 million);

- \* increased costs related to retail sales growth, excluding weather effects (\$11 million);
- \* change in mark-to-market for hedged natural gas and purchased power costs for future period deliveries (see Note 10) (\$10 million increase);
- \* decreased replacement power costs for power plant outages due to lower market prices and fewer unplanned nuclear and coal plant outages (\$15 million); and
- \* other miscellaneous factors (\$8 million net increase).

The decrease in other gross margin of \$13 million was primarily due to losses recorded on El Dorado's investment in NAC (see Note 14).

The decrease in operations and maintenance expense of \$6 million was due to lower costs related to generation reliability, plant outages and maintenance costs of \$24 million. These factors were partially offset by severance costs of \$25 million related to a 2002 voluntary workforce reduction (see Note 17) and other costs.

Other expense increased \$7 million primarily due to higher net investment losses in the current period and higher miscellaneous non-operating costs.

Interest expense, net of amounts capitalized, increased \$8 million primarily due to higher debt balances.

### **OPERATING RESULTS - NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2002 COMPARED WITH NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2001**

Our consolidated net income for the nine months ended September 30, 2002 was \$230 million compared with \$276 million for the same period in the prior year. We recognized a \$15 million after-tax loss in the nine months ended September 30, 2001 as a cumulative effect of a change in accounting for derivatives, as required by SFAS No. 133.

Our income before accounting change for the nine months ended September 30, 2002 was \$230 million compared with \$291 million for the same period in 2001. The period-to-period decrease was the result of lower earnings contributions from our marketing and trading activities, severance costs of \$25 million pretax recorded in the third quarter of 2002 related to a voluntary workforce reduction (see Note 17) and losses related to El Dorado's investment in NAC (see Note 14), partially offset by increased earnings contributions from our regulated retail electricity and real estate operations. The regulated retail comparison was favorably impacted by lower replacement costs for power plant outages, customer growth and higher average usage per customer, lower costs for purchased power and gas related to lower market prices, and lower generation reliability expenses, partially offset by the effects of milder weather and retail electricity price decreases. The real estate results benefited primarily from more sales activities. The comparison for marketing and trading activities reflects lower volumes and prices in the wholesale power markets in the western United States.

The major factors that increased (decreased) income before accounting change were as follows (dollars in millions):

	Increase (Decrease)
	-----
Marketing and trading segment gross margin:	
Decrease in generation sales other than Native Load due to lower market prices and resulting lower sales volumes	\$ (72)
Increase in other realized marketing and trading in the current period primarily due to higher unit margins on increased volumes	35(a)
Change in prior period mark-to-market gains on contracts delivered during the current period (b)	(55)(a)
Lower mark-to-market gains for future period deliveries (b)	(118)
	-----
Net decrease in marketing and trading segment gross margin	(210)
	-----
Electric retail segment gross margin:	
Lower replacement power costs for plant outages due to lower market prices and fewer unplanned outages	123
Lower purchased power and fuel costs related to lower prices, net of hedge management sales	2
Effects of weather on retail sales	(21)
Higher retail sales volumes due to 3.1% customer growth and higher average usage, excluding weather effects	37
Retail price reductions effective July 1, 2001 and July 1, 2002	(22)
Change in mark-to-market for hedged natural gas and purchased power costs for future period deliveries (see Note 10)	5
Miscellaneous factors, net	(12)
	-----
Net increase in electric retail segment gross margin	112
	-----
Total decrease in electric retail and marketing and trading segments' gross margins	(98)
Higher real estate margin primarily due to increased sales activities	10
Lower other gross margin primarily related to losses recorded on El Dorado's investment in NAC (see Note 14)	(13)
Lower operations and maintenance expense primarily related to lower generation reliability costs, partially offset by 2002 severance costs of \$25 million (see Note 17) and other costs	17
Lower depreciation and amortization expense primarily due to lower regulatory asset amortization, partially offset by higher depreciation on higher plant balances	8
Lower other income	(9)
Higher other expense	(7)
Higher net interest expense primarily due to higher debt balances, partially offset by lower interest rates	(8)
Miscellaneous factors, net	1
	-----
Decrease in income before income taxes	(99)
Lower income taxes primarily due to lower pretax income	38
	-----
Decrease in income before accounting change	\$ (61)
	=====



(a) Net recognized marketing and trading gains (excluding the effects of generation sales other than Native Load) decreased \$20 million.

(b) Essentially all of our marketing and trading activities are structured activities. This means our portfolio of forward sales positions is economically hedged with a portfolio of forward purchases that protects the economic value of the sales transactions.

### **MARKETING AND TRADING SEGMENT GROSS MARGIN**

Marketing and trading segment revenues were \$421 million lower in the nine-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased revenues from generation sales other than Native Load due to lower market prices and resulting lower sales volumes (\$124 million);
- \* decreased revenues from other realized marketing and trading in the current period primarily due to lower prices (\$132 million);
- \* change in prior period mark-to-market gains on contracts delivered during the current period due to higher volumes being delivered (\$47 million decrease); and
- \* lower mark-to-market gains for future period deliveries primarily as a result of lower market liquidity and lower price volatility, resulting in lower volumes (\$118 million).

Marketing and trading segment purchased power and fuel costs were \$211 million lower in the nine-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased fuel costs related to generation sales other than Native Load primarily because of lower natural gas prices and lower sales volumes (\$52 million);
- \* decreased purchased power costs related to other realized marketing activities in the current period primarily due to lower prices (\$167 million); and
- \* change in prior period mark-to-market fuel costs for current period deliveries (\$8 million net increase).

### **ELECTRIC RETAIL SEGMENT GROSS MARGIN**

Revenues related to our regulated retail and wholesale electricity businesses were \$529 million lower in the nine-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased revenues related to traditional wholesale sales as a result of lower sales volumes and lower prices (\$65 million);
- \* decreased revenues related to wholesale sales for retail load hedge management, as a result of lower prices and lower sales volumes (\$439 million);
- \* decreased retail revenues related to milder weather (\$50 million);
- \* increased retail revenues related to customer growth and higher average usage, excluding weather effects (\$68 million);
- \* decreased retail revenues related to reductions in retail electricity prices (\$22 million); and

\* other miscellaneous factors (\$21 million net decrease).

Electric retail segment purchased power and fuel costs were \$641 million lower in the nine-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased costs related to traditional wholesale sales as a result of lower sales volumes and lower prices (\$65 million);
- \* decreased costs related to lower prices for hedged natural gas and purchased power (\$441 million);
- \* decreased costs related to the effects of milder weather on retail sales (\$29 million);
- \* increased costs related to retail sales growth, excluding weather effects (\$31 million);
- \* change in mark-to-market for hedged natural gas and purchased power costs for future period deliveries (see Note 10) (\$5 million decrease);
- \* decreased replacement power costs for power plant outages due to lower market prices and fewer unplanned nuclear and coal plant outages (\$123 million); and
- \* other miscellaneous factors (\$9 million net decrease).

The increase in real estate gross margin of \$10 million was primarily due to increased sales activities.

The decrease in other gross margin of \$13 million was primarily due to losses recorded on El Dorado's investment in NAC (see Note 14).

The decrease in operations and maintenance expense of \$17 million was primarily due to lower costs related to generation reliability, plant outages and maintenance costs of \$38 million. Operation and maintenance expense was also lower as a result of the reversal of \$4 million of a \$10 million reserve recorded in the prior period for the California energy situation (see Note 12). These decreases were partially offset by severance costs of \$25 million related to a 2002 voluntary workforce reduction (see Note 17) and other costs.

The decrease in depreciation and amortization expense of \$8 million primarily related to lower regulatory asset amortization, in accordance with APS' 1999 regulatory settlement, partially offset by increased depreciation on higher plant balances.

Other income decreased \$9 million primarily due to an insurance recovery recorded in the prior period related to environmental remediation costs.

Other expense increased \$7 million primarily due to losses recorded on El Dorado's investments in the current period, partially offset by lower miscellaneous non-operating costs.

Interest expense increased \$8 million primarily due to higher debt balances, partially offset by lower interest rates.

**OPERATING RESULTS - TWELVE-MONTH PERIOD ENDED SEPTEMBER 30, 2002 COMPARED  
WITH TWELVE-MONTH PERIOD ENDED SEPTEMBER 30, 2001**

Our consolidated net income for the twelve months ended September 30, 2002 was \$266 million compared with \$319 million for the same period in the prior year. We recognized a \$15 million after-tax loss in the twelve months ended September 30, 2001 as a cumulative effect of a change in accounting for derivatives, as required by SFAS No. 133.

Our income before accounting change for the twelve months ended September 30, 2002 was \$266 million compared with \$334 million for the same period a year earlier. The period-to-period comparison was lower due to lower earnings contributions from our marketing and trading activities, severance costs of \$25 million pretax recorded in the third quarter of 2002 relating to a voluntary workforce reduction (see Note 17), and losses related to El Dorado's investment in NAC (see Note 14), partially offset by increased earnings contributions from our regulated retail electricity and real estate operations. The regulated retail comparison was favorably impacted by lower replacement costs for power plant outages, lower costs for purchased power and gas related to lower market prices, customer growth and higher average usage per customer, partially offset by the effects of milder weather and retail electricity price decreases. The real estate results benefited primarily from more sales activities. The comparison for marketing and trading activities reflects lower volumes and prices in the wholesale power markets in the western United States.

The major factors that increased (decreased) income before accounting change were as follows (dollars in millions):

	Increase (Decrease)
	-----
Marketing and trading segment gross margin:	
Decrease in generation sales other than Native Load due to lower market prices and resulting lower sales volumes	\$ (108)
Increase in other realized marketing and trading in the current period primarily due to higher unit margins on increased volumes	91(a)
Change in prior period mark-to-market gains on contracts delivered during the current period (b)	(114)(a)
Lower mark-to-market gains for future period deliveries (b)	(105)
	-----
Net decrease in marketing and trading segment gross margin	(236)
	-----
Electric retail segment gross margin:	
Lower replacement power costs for plant outages due to lower market prices and fewer unplanned outages	148
Lower hedge management margins, partially offset by lower purchased power and fuel costs due to lower market prices	(12)
Effects of milder weather on retail sales	(21)
Higher retail sales volumes due to customer growth and higher average usage, excluding weather effects	39
Retail price reductions effective July 1, 2001 and July 1, 2002	(28)
Change in mark-to-market for hedged natural gas and purchase power costs for future period deliveries (see Note 10)	4
Miscellaneous factors, net	(7)
	-----
Net increase in electric retail segment gross margin	123
	-----
Total decrease in electric retail and marketing and trading segments' gross margins	(113)
Higher real estate gross margin primarily due to increased sales activities	12
Lower other gross margin primarily related to losses recorded on El Dorado's investment in NAC (see Note 14)	(13)
Lower operations and maintenance expense primarily related to lower generation reliability costs, partially offset by 2002 severance costs of \$25 million (see Note 17) and other costs	15
Lower depreciation and amortization primarily due to lower regulatory asset amortization, partially offset by increased depreciation and amortization on higher property, plant and equipment balances	5
Lower other income	(5)
Higher net interest expense primarily due to higher debt balances, partially offset by higher capitalized interest and lower interest rates	(7)
Miscellaneous factors, net	(2)
	-----
Decrease in income before income taxes	(108)
Lower income taxes primarily due to lower income	40
	-----
Decrease in income before accounting change	\$ (68)
	=====

(a) Net marketing and trading gains (excluding the effects of generation sales other than Native Load) recognized for the current period decreased \$23 million.

(b) Essentially all of our marketing and trading activities are structured activities. This means our portfolio of forward sales positions is economically hedged with a portfolio of forward purchases that protects the economic value of the sales transactions.

### **MARKETING AND TRADING SEGMENT GROSS MARGIN**

Marketing and trading segment revenues were \$586 million lower in the twelve-month period ended September 30, 2002, compared to the same period in the prior year as a result of:

- \* decreased revenues from generation sales other than Native Load due to lower market prices and resulting lower sales volumes (\$198 million);
- \* decreased revenues from other realized marketing and trading in the current period primarily due to lower prices (\$176 million);
- \* change in prior period mark-to-market gains on contracts delivered during the current period due to higher volumes being delivered (\$107 million decrease); and
- \* lower mark-to-market gains for future period deliveries primarily as a result of lower market liquidity and lower price volatility, resulting in lower volumes (\$105 million).

Marketing and trading segment purchased power and fuel costs were \$350 million lower in the twelve-month period ended September 30, 2002, compared to the same period in the prior year as a result of:

- \* decreased fuel costs related to generation sales other than Native Load primarily because of lower sales volumes and lower natural gas prices (\$90 million);
- \* decreased purchased power costs related to other realized marketing activities in the current period primarily due to lower prices (\$267 million); and
- \* change in prior period mark-to-market fuel costs for current period deliveries (\$7 million increase).

### **ELECTRIC RETAIL SEGMENT GROSS MARGIN**

Revenues related to our regulated retail and wholesale electricity businesses were \$548 million lower in the twelve-month period ended September 30, 2002, compared to the same period in the prior year as a result of:

- \* decreased revenues related to traditional wholesale sales as a result of lower sales volumes and lower prices (\$79 million);
- \* decreased revenues related to retail load hedge management wholesale sales, as a result of lower sales volumes and lower prices (\$458 million);
- \* decreased retail revenues related to milder weather (\$50 million);
- \* increased retail revenues related to customer growth and higher average usage, excluding weather effects (\$82 million);
- \* decreased retail revenues related to reductions in retail electricity prices (\$28 million); and

\* other miscellaneous factors (\$15 million net decrease).

Electric retail segment purchased power and fuel costs were \$671 million lower in the twelve-month period ended September 30, 2002, compared with the same period in the prior year as a result of:

- \* decreased costs related to traditional wholesale sales as a result of lower sales volumes and lower prices (\$79 million);
- \* decreased costs related to lower prices for hedged natural gas and purchased power prices (\$446 million);
- \* decreased costs related to the effects of milder weather on retail sales (\$29 million);
- \* increased costs related to retail sales growth, excluding weather effects (\$43 million);
- \* change in mark-to-market for hedged natural gas and purchased power costs for future period deliveries (see Note 10) (\$4 million decrease);
- \* decreased replacement power costs for power plant outages due to lower market prices and fewer unplanned outages (\$148 million); and
- \* miscellaneous factors (\$8 million net decrease).

The increase in real estate gross margin of \$12 million was primarily due to increased sales activities.

The decrease in other gross margin of \$13 million was primarily due to losses on El Dorado's investment in NAC (see Note 14).

The decrease in operations and maintenance expense of \$15 million was primarily due to lower costs related to generation reliability, plant outages and maintenance costs of \$37 million. Operations and maintenance expense was also lower as a result of the reversal of \$4 million of a \$10 million reserve recorded in the prior period for the California energy situation (see Note 12), partially offset by severance costs of \$25 million related to a 2002 voluntary workforce reduction (see Note 17) and other costs.

The decrease in depreciation and amortization expenses of \$5 million primarily related to lower regulatory asset amortization, in accordance with APS' 1999 regulatory settlement, partially offset by increased depreciation and amortization on higher property, plant and equipment balances.

Other income decreased \$5 million primarily due to an insurance recovery recorded in the prior period related to environmental remediation costs and other costs.

Net interest expense increased \$7 million primarily because of higher debt balances related to our generation expansion program, partially offset by the increase in capitalized interest on our generation expansion program and lower interest rates.

## LIQUIDITY AND CAPITAL RESOURCES

### CAPITAL EXPENDITURE REQUIREMENTS

The following table summarizes the actual capital expenditures for the nine months ended September 30, 2002 and estimated capital expenditures for the next three years (dollars in millions):

	Nine Months	Estimated		
	Ended September 30, 2002	2002	2003	2004
APS				
Delivery	\$ 270	\$ 347	\$ 270	\$ 267
Existing generation (a)	106	149	116	89
Subtotal	376	496	386	356
Pinnacle West Energy (b)	306	411	257	109 (e)
SunCor (c)	55	79	48	52
Other (d)	22	38	22	21
Total	\$ 759	\$1,024	\$ 713	\$ 538

(a) This table assumes that APS and Pinnacle West Energy generation assets remain separated, consistent with the ACC's Track A Order (see Note 5).

(b) See further discussion of Pinnacle West Energy's generation expansion program in "Capital Resources and Cash Requirements - Pinnacle West Energy" below.

(c) Consists primarily of capital expenditures for land development and retail and office building construction and is included in the "Increase in real estate investments" in the condensed consolidated statements of cash flows.

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

(e) This amount does not include an expected reimbursement by SNWA of approximately \$100 million of these costs in 2004 in exchange for SNWA's option to purchase a 25% interest in the Silverhawk project at that time.

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 \$150 million on major transmission projects during the 2002 to 2004 time frame.

Existing generation capital expenditures are comprised of multiple improvements for our existing fossil and nuclear plants and the replacement of 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. The existing generation also contains nuclear fuel expenditures of approximately \$30 million annually in 2002, 2003, and 2004.

Several years ago APS and the other Palo Verde participants decided to replace Palo Verde Unit 2 steam generators, which replacement is presently scheduled to be completed in the fall of 2003. APS and the other Palo Verde participants are currently considering issues related to replacement of the steam generators in Units 1 and 3. Although a final determination of whether Units 1 and 3 will require steam generator replacement to operate over their current full licensed lives has not yet been made, APS and the other participants have approved fabrication of one set of spare steam generators. APS' portion of this expenditure is approximately \$27 million, which will be spent from 2002 to 2005. Existing generation in the capital expenditure table above includes \$21 million of the costs in 2002 through 2004. If the Palo Verde participants decide to proceed with steam generator replacement at both Units 1 and 3, APS has estimated that its portion of the fabrication and installation costs and associated power uprate modifications would be approximately \$130 million over the next seven years, which would be funded with internally-generated cash or external financings.

## CAPITAL RESOURCES AND CASH REQUIREMENTS

### CONTRACTUAL COMMITMENTS

The following table summarizes actual contractual cash commitments for the nine months ended September 30, 2002 and estimated contractual commitments for the next five years and thereafter (dollars in millions):

	Nine Months Ended September 30, 2002	Estimated					There- after
		Years Ended December 31,					
		2002	2003	2004	2005	2006	
Long-term debt payments							
APS	\$ 247	\$ 247	\$ --	\$ 205	\$ 400	\$ 84	\$1,518
Pinnacle West	--	1	276	216	--	300	--
SunCor	11	11	117	--	--	3	16
Total long-term debt payments	258	259	393	421	400	387	1,534
Operating leases payments	47	68	66	65	64	63	550
Fuel and purchase power commitments	258	338	134	82	65	68	170
Total cash commitments (a)	563	\$ 665	\$ 593	\$ 568	\$ 529	\$ 518	\$2,254

(a) Total cash commitments are approximately \$5.1 billion. The total net present value of these cash commitments is approximately \$3.0 billion.



## CONTINGENT COMMITMENTS

We have issued parental guarantees and obtained surety bonds on behalf of our unregulated subsidiaries. The credit support instruments enable Pinnacle West Energy to continue its generation expansion plan (primarily equipment and performance guarantees), enable APS Energy Services to provide commodity energy and energy-related products and enable El Dorado to support the activities of NAC. The amounts as of September 30, 2002 are listed as follows (dollars in millions):

	Guarantees	Surety Bonds
Pinnacle West Energy	\$ 250	\$ --
APS Energy Services	72	39
El Dorado	43	--

In addition, as of September 30, 2002, SunCor had outstanding guarantees of approximately \$29 million on behalf of affiliated joint ventures.

## CREDIT RATINGS

The ratings of securities of Pinnacle West and APS as of the date of this report are shown below and reflect the respective views of the rating agencies, from whom 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 or that they will not be revised or withdrawn entirely by the rating agencies, if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely effect the market price of Pinnacle West's or APS' securities and serve to increase those companies' cost of capital, and access to capital.

	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

On November 4, 2002 Standard & Poor's affirmed the APS debt ratings in the above chart, but lowered Pinnacle West's senior unsecured debt rating from BBB to BBB- "because of the structural subordination of this debt as compared to the unsecured debt at APS." On that same date, Standard & Poor's lowered APS' corporate credit rating from BBB+ to BBB and affirmed the BBB corporate credit rating of Pinnacle West. All of Pinnacle West's and APS' credit ratings remain investment grade. Standard & Poor's assigned a stable outlook to the ratings.

## 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 that it will continue to meet all the significant covenant requirement levels. 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. We are unable to quantify the effects, if any, that Standard & Poor's lowering of Pinnacle West's senior unsecured debt rating may have on Pinnacle West's borrowing costs in 2002 through 2004 or whether the lower rating will affect the timing or nature of the Company's capital requirements.

All of Pinnacle West's bank agreements contain "cross-default" provisions under which a default by it or APS in a specified amount under another agreement would result in a default and the potential acceleration of payment under the agreements. All of APS' bank agreements contain cross-default provisions under which a default by APS in a specified amount under another agreement would result in a default and the potential acceleration of payment under the 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 the borrower's business or financial condition.

### PINNACLE WEST (PARENT COMPANY)

Our primary cash needs are for dividends to our shareholders; equity infusions into our subsidiaries, primarily Pinnacle West Energy; interest payments; and optional and mandatory repayments of principal on our long-term debt (see the table above for the Company's contractual cash commitments, including our debt repayment obligations). On October 23, 2002, the Company's board of directors increased the common stock dividend to an indicated annual rate of \$1.70 per share from \$1.60 per share, effective with the December 1, 2002 dividend payment. The Company currently intends to continue growing the common dividends in the future; such 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, our marketing and trading operations, external financings, and cash distributions from our other subsidiaries, primarily SunCor. For the years 1999 through 2001, total dividends from APS were \$510 million. For the nine months ended September 30, 2002, dividends from APS were approximately \$128 million. We expect SunCor to make cash distributions to the Company of \$80 million to \$100 million annually in 2003 through 2005 due to anticipated accelerated asset sales activity.

On February 8, 2002, we issued \$215 million of 4.5% Notes due 2004. On July 31, 2002, we completed a \$300 million bank credit facility. The borrowings are LIBOR-based and can be drawn upon as needed, and are expected to be used primarily to fund Pinnacle West Energy capital requirements. The facility matures on July 30, 2003. The majority of these borrowings were used to fund Pinnacle West Energy capital expenditures.

The Company has financed Pinnacle West Energy's generation expansion program premised upon Pinnacle West Energy's receipt of APS' generation assets by the end of 2002. As discussed in Note 5, on September 16, 2002, APS filed a Financing Application requesting the ACC to allow APS to borrow up to \$500 million and to lend the proceeds to Pinnacle West Energy or to the Company; to guarantee up to \$500 million of Pinnacle West Energy's debt or of the Company's debt; or a combination of both, not to exceed \$500 million in the aggregate. In the Financing Application, APS stated that the ACC's reversal of the generation asset transfer requirement and the resulting bifurcation of generation assets between APS and Pinnacle West Energy under different regulatory regimes results in Pinnacle West Energy being unable to attain investment-grade credit ratings. This, in turn, precludes Pinnacle West Energy from accessing capital markets to refinance the bridge financing provided by the Company to fund the construction of Pinnacle West Energy generation assets or from effectively competing in the wholesale markets. APS noted that Pinnacle West Energy had previously received investment-grade credit ratings contingent upon its receipt of APS generation assets, and that the Company's credit ratings could be adversely affected if Pinnacle West Energy is unable to finance its capital requirements. On November 4, 2002, Standard & Poor's lowered the Company's senior unsecured debt rating from BBB to BBB-. See "Credit Ratings" above. On November 8, 2002, APS filed an Interim Financing Application with the ACC requesting the ACC 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. See "ACC Applications" in Note 5.

The parent company's outstanding debt was approximately \$1.1 billion at September 30, 2002. At September 30, 2002, we had credit commitments from various banks totaling \$250 million, which were available to support the issuance of commercial paper or to be used as bank borrowings. At September 30, 2002, we had about \$206 million of commercial paper outstanding and \$35 million of short-term borrowings. In addition, as noted above, we had an additional \$300 million of borrowing capacity under a credit facility with various banks, under which \$45 million had been borrowed as of September 30, 2002.

In mid-2003, the Company will need to refinance approximately \$550 million of parent company indebtedness, including a total of \$300 million we expect to borrow under the credit facility referenced in the preceding paragraph. If the ACC does not grant the approvals requested in

the Financing Application in a timely fashion, the Company would anticipate taking the following steps, to the extent necessary in priority order, although the timing of the Company's liquidity needs may affect the order of the steps taken:

- \* The reduction of capital expenditures through plant delay and cancellation;
- \* The sale of non-core assets; and
- \* The issuance of new debt and, if appropriate, new equity.

Although we believe it would be inappropriate to discuss specific amounts for each of the foregoing categories, we estimate the sum of these steps to approximate the current outstanding debt at the Company, which, as noted above, totaled approximately \$1.1 billion as of September 30, 2002. We believe, even in this scenario, if the parent company's near-term debt maturities were paid in full, that the Company's common stock dividend would remain intact.

As part of a multi-employer pension plan sponsored by Pinnacle West, we contribute at least the minimum amount required under Internal Revenue Service 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 have voluntarily contributed cash to our pension plan in each of the last four years; our minimum required contributions during each of those years was zero. Specifically, we contributed \$24 million for 2001, \$44 million for 2000, \$25 million for 1999 and \$14 million for 1998. We again plan to voluntarily contribute \$27 million in 2002. 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-\$80 million, all or part of which may be required depending on 2002 fund performance. If the fund performance continues to decline as a result of a continued decline in equity markets, we may be required to make contributions in future years.

As a result of change in IRS guidance, we claimed a tax deduction related to an APS tax accounting method change on the 2001 Federal consolidated income tax return. The accelerated deduction has resulted in a \$200 million reduction in current tax liability.

#### **APS**

APS' capital requirements consist primarily of capital expenditures and optional and mandatory redemptions of long-term debt. On September 16, 2002, APS filed a Financing Application with the ACC requesting the ACC to allow APS to borrow up to \$500 million and to lend the proceeds to Pinnacle West Energy or to the Company; to guarantee up to \$500 million of Pinnacle West Energy's or the Company's debt; or a combination of both, not to exceed \$500 million in the aggregate. On November 8, 2002, APS filed an Interim Financing Application with the ACC requesting the ACC 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. See "ACC Applications" in Note 5 for a discussion of the Financing Application and the Interim Financing Application. See the table above for APS' cash commitments, including its debt repayment obligations; that table does not take into account any funds that APS may lend to Pinnacle West Energy, or the Company consistent with the Interim Financing Application or the Financing Application.

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

On March 1, 2002, APS issued \$375 million of 6.5% Notes due 2012.

On November 1, 2002, Maricopa County, Arizona Pollution Control Corporation issued \$90 million of 5.05% Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 2002 Series A, due 2029 and loaned the proceeds to APS pursuant to a loan agreement. The bonds were issued to refinance \$90 million of outstanding pollution control bonds.

On March 15, 2002, APS redeemed at maturity \$125 million of its First Mortgage Bonds, 8.125% Series due 2002. On April 15, 2002, APS redeemed \$122 million of its First Mortgage Bonds, 8.75% Series due 2024. See the cash commitments table above for APS' debt repayments. Based on market conditions and optional call provisions, APS may make optional redemptions of long-term debt from time to time.

At September 30, 2002, APS had credit commitments from various banks totaling about \$250 million, which were available either to support the issuance of commercial paper or to be used as bank borrowings. At September 30, 2002, APS had about \$25 million of commercial paper outstanding and no bank borrowings.

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**

Pinnacle West Energy has completed or announced plans to build about 3,420 MW of natural gas-fired generating capacity from 2001 through 2007 at an estimated cost of about \$1.9 billion. This does not reflect an expected reimbursement in 2004 by SNWA of approximately \$100 million of Pinnacle West Energy's cumulative capital expenditures in the Silverhawk project in exchange for SNWA's option to purchase a 25% interest in the project. Our expansion plan will be sized to meet cash flow and market conditions. Pinnacle West Energy is currently funding its capital requirements through capital infusions from Pinnacle West, which finances those infusions through debt financings and internally-generated cash. See the capital expenditures table above for actual capital expenditures through September 30, 2002 and projected capital expenditures for the next three years.

As discussed under "ACC Applications" in Note 5, APS has filed a Financing Application with the ACC requesting the ACC to allow APS to borrow up to \$500 million and to lend the proceeds to Pinnacle West Energy or the Company; to guarantee up to \$500 million of Pinnacle West Energy's or the Company's debt; or a combination of both, not to exceed \$500 million in the aggregate. In the Financing Application, APS stated that the ACC's reversal of the generation

asset transfer requirement and the resulting bifurcation of generation assets between APS and Pinnacle West Energy under different regulatory regimes results in Pinnacle West Energy being unable to attain investment grade credit ratings. This, in turn, precludes Pinnacle West Energy from accessing capital markets to refinance the bridge financing provided by the Company to fund the construction of Pinnacle West Energy generation assets or from effectively competing in the wholesale markets. On November 8, 2002, APS filed an Interim Financing Application with the ACC requesting the ACC 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.

Pinnacle West Energy has completed or is currently planning the following natural gas-fired plants and other projects:

- \* 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. Construction has begun on the 530 MW West Phoenix Unit 5, with commercial operation expected to begin in mid-2003.
- \* The Redhawk Power Plant Units 1 and 2 are each 530 MW combined cycle units, near Palo Verde. Commercial operations began in July 2002 for Units 1 and 2. The Company is evaluating whether to construct Redhawk Units 3 and 4. Pinnacle West Energy has procured four gas turbines for Redhawk Units 3 and 4. The cancellation cost for these turbines would be approximately \$50 million until September 2003.
- \* The construction of an 80 MW simple cycle power plant at Saguaro in Southern Arizona. Commercial operation began in July 2002.
- \* 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 in mid-2004. As noted above, 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.
- \* A Pinnacle West Energy affiliate is exploring the possibility of creating an underground natural gas storage facility on Company-owned land west of Phoenix. A feasibility study is in progress to determine if the proposed acreage can support a natural gas storage cavern.

#### **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 nine months ended September 30, 2002 and projected capital expenditures for the next three years. SunCor expects to fund its

capital requirements with cash from operations and external financings. SunCor's long-term indebtedness decreased \$11 million in the nine months ended September 30, 2002. SunCor has provided guarantees of approximately \$29 million on behalf of affiliated joint ventures.

We expect SunCor to make cash distributions to the parent company of \$80 million to \$100 million annually in 2003 through 2005 due to anticipated accelerated asset sales activity.

El Dorado funded its cash requirements during the past three years with cash from operations and with cash infused by the parent company, primarily for NAC in 2002. El Dorado expects minimal capital requirements over the next three years. El Dorado intends to focus on prudently realizing the value of its existing investments. El Dorado's future investments are expected to be related to the energy sector. El Dorado's long-term indebtedness increased \$9 million during the nine months ended September 30, 2002, due to its consolidation of NAC for financial reporting purposes.

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' capital expenditures.

See "Business Outlook" below for information about the expected earnings contributions of SunCor, El Dorado and APS Energy Services.

## **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 determination of the appropriate accounting for our derivative instruments, mark-to-market accounting (see Note 8) and the impacts of regulatory accounting (see Note 19) on our consolidated financial statements. See Note 1 in the 2001 10-K.

## **BUSINESS OUTLOOK**

### **COMPETITION AND ELECTRIC INDUSTRY RESTRUCTURING**

See "Business Outlook - Competition and Industry Restructuring" in Item 7 of the 2001 10-K and Note 5 above for a discussion of developments affecting retail and wholesale electric competition.

## GENERATION EXPANSION

See "Capital Resources and Cash Requirements - Pinnacle West Energy" above for information regarding our generation expansion plans. The planned additional generation is expected to increase revenues, fuel expenses, operating expenses, and financing costs.

### FACTORS AFFECTING OPERATING REVENUES

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.

Customer growth in APS' service territory averaged about 4% a year for the three years 1999 through 2001; we currently expect customer growth to be about 3.1% in 2002 and between 3.5% and 4.0% a year in 2003 and 2004. We currently estimate that retail electricity sales in kilowatt-hours will grow 3.5% to 5.5% a year in 2002 through 2004, before the retail effects of weather variations. The customer growth and sales growth referred to in this paragraph apply to energy delivery customers. As industry restructuring evolves in the regulated market area, we cannot predict the number of APS' standard-offer customers that will switch to unbundled service, although recent regulatory developments and legal challenges to the Rules have raised considerable uncertainty about the status and pace of retail electric competition in Arizona (see Note 5). As previously noted, under the 1999 Settlement Agreement, we agreed to retail electricity price reductions of 1.5% annually through July 1, 2003 (see Note 5).

Competitive sales of energy and energy-related products and services are made by APSES in western states that have opened to competitive supply.

### OTHER FACTORS AFFECTING FUTURE FINANCIAL RESULTS

Purchased power and fuel costs are impacted by our electricity sales volumes, existing contracts for generation fuel and purchased power, 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 are expected to be affected by sales mix and volumes, power plant operations, inflation, outages, higher trending pension and other post-retirement costs and other factors. We implemented a voluntary workforce reduction program announced in July 2002. We recorded \$25 million before taxes in voluntary severance costs in the third quarter of 2002. We expect to record up to \$12 million before taxes for additional severance costs in the fourth quarter of 2002 (See Note 17). In addition, we are expecting to produce annual operating expense savings of approximately \$30 million beginning in 2003.

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 expansion program. As noted above, West Phoenix Unit 4 was placed in service in June 2001, Redhawk Units 1 and 2 and the new Saguaro unit 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	1/1 - 6/30 2004	Total
----	----	----	----	----	----	-----
\$164	\$158	\$145	\$115	\$ 86	\$ 18	\$686

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 9.32% of assessed value for 2001 and 9.16% for 2000. We expect property taxes to increase primarily due to our generation expansion program and our additions to existing facilities.

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 generation expansion program 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. We are continuing to evaluate our generation expansion program.

If we decide not to construct Redhawk Units 3 and 4, we would expect to record a pretax charge of approximately \$50 million related to the cancellation of gas turbine contracts.

The regulatory developments and legal challenges to the Rules discussed in Note 5 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 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 competition in the electric industry continues to evolve, we will continue to evaluate strategies and alternatives that will position us to compete effectively in a restructured industry.

In the case of SunCor, we are undertaking an aggressive effort to accelerate asset sales activities to approximately double SunCor's annual earnings in the 2003-2005 period compared to the approximate \$20 million in earnings expected for 2002.

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' pretax losses were \$10 million in 2001 and \$13 million in 2000.

El Dorado's historical results are not necessarily indicative of future performance for El Dorado. El Dorado's strategies focus on prudently realizing the value of its existing investments. Any future investments are expected to be related to the energy sector.

Our financial results may be affected by the application of SFAS No. 133. See Note 10 for further information.

On October 25, 2002, the EITF voted to rescind EITF 98-10 (see Note 8). We are evaluating the current effect of the rescission on our financial results.

On November 4, 2002, Standard & Poor's lowered the Company's senior unsecured debt rating from BBB to BBB-. See "Credit Ratings" above. We are unable to quantify the effects, if any, that Standard & Poor's lowering of

Pinnacle West's senior unsecured debt rating may have on Pinnacle West's borrowing costs or whether the lower rating will affect the timing or nature of the Company's capital requirements.

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.

The Company's current 2002 adjusted debt to total capitalization ratio, adjusted as per rating agency methodology to include debt and equity related to Palo Verde SPE's (see Note 9), is approximately 60%. The Company expects to decrease the adjusted debt to total capitalization ratio to approximately 55% over the next several years.

## **RATE MATTERS**

See Note 5 for a discussion of a price reduction effective as of July 1, 2002, and for a discussion of the 1999 Settlement Agreement that will, among other things, result in five annual price reductions over a four-year period ending July 1, 2003.

## **RISK FACTORS**

Exhibit 99.3, which is hereby incorporated by reference, contains a discussion of risk factors involving the Company.

## **FORWARD-LOOKING STATEMENTS**

The above discussion contains forward-looking statements based on current expectations and we assume no obligation to update these statements or to make any further statements on any of these issues, except as required by applicable laws. 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; the outcome of regulatory and legislative proceedings relating to the restructuring; state and federal regulatory and legislative decisions and actions, including the price mitigation plan adopted by the FERC; regional economic and market conditions, including the California energy situation and completion of generation construction in the region, which could affect customer growth and the cost of power supplies; the cost of debt and equity capital; weather variations affecting local and regional customer energy usage; conservation programs; power plant performance; the successful completion of our generation expansion program; regulatory issues associated with generation expansion, such as permitting and licensing; our ability to compete successfully outside traditional regulated markets (including the wholesale market); 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 the strength of the real estate market in SunCor's market areas, which include Arizona, New Mexico and Utah.

These factors and the other matters discussed above may cause future results to differ materially from historical results or from results or outcomes we currently expect or seek.

### ITEM 3. MARKET RISKS

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

We are exposed to the impact of market fluctuations in the price and transportation costs of electricity, natural gas, coal, and emissions allowances. We employ 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.

In addition, subject to specified risk parameters established by the Board of Directors and monitored by our ERM, we engage in trading activities intended to profit from market price movements. In accordance with EITF 98-10, "Accounting For Contracts Involved in Energy Trading and Risk Management Activities," such trading positions are marked-to-market. These trading activities are part of our marketing and trading activities and are reflected in the marketing and trading segment revenues and expenses. See Note 8 for a discussion of the EITF's decision to rescind EITF 98-10.

The following schedule shows the changes in mark-to-market on our trading positions during the three, nine and twelve months ended September 30, 2002 (dollars in millions):

	Periods Ended September 30, 2002		
	Three Months Ended	Nine Months Ended	Twelve Months Ended
Mark-to-market of net trading positions at beginning of period	\$ 133	\$ 138	\$ 198
Prior period mark-to-market (gains) losses realized during the period	3	(34)	(96)
Change in mark-to-market gains for future period deliveries	23	55	57
Change in valuation techniques	--	--	--
Mark-to-market of net trading positions at end of period	\$ 159	\$ 159	\$ 159

Net gains at inception were approximately zero for the three months ended September 30, 2002. Net gains at inceptions were approximately \$10 million for

the nine months ended September 30, 2002 and \$11 million for the twelve months ended September 30, 2002, these amounts included a reasonable marketing margin. See Note 10 for mark-to-market on system hedges and for disclosure of risk management activities recorded on the condensed consolidated balance sheets.

The table below shows the maturities of our trading positions as of September 30, 2002, by the type of valuation that is performed to calculate the fair value of the contract (dollars in millions):

SOURCE OF FAIR VALUE	2002	2003	2004	2005	2006	Years there- after	Total fair value
	-----	-----	-----	-----	-----	-----	-----
Prices actively quoted	\$ (7)	\$ 8	\$ 5	\$ 6	\$ 3	\$ 9	\$ 24
Prices provided by other external sources	(1)	(3)	(8)	4	5	--	(3)
Prices based on models and other valuation methods	20	26	38	20	18	16	138
	-----	-----	-----	-----	-----	-----	-----
Total by maturity	\$ 12	\$ 31	\$ 35	\$ 30	\$ 26	\$ 25	\$ 159
	=====	=====	=====	=====	=====	=====	=====

The table below shows the impact that 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 September 30, 2002 (dollars in millions):

Commodity	September 30, 2002	
	Gain(Loss)	
	Price Up 10%	Price Down 10%
-----	-----	-----
Trading (a):		
Electricity	\$ (1)	\$ 2
Natural gas	(1)	1
Other	1	--
System (b):		
Natural gas hedges	17	(15)
	-----	-----
Total	\$ 16	\$ (12)
	=====	=====

(a) Essentially all of our marketing and trading activities are structured activities. This means our portfolio of forward sales positions is 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. 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.

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 one counterparty for which a worst case exposure represents approximately 47% of our \$260 million of risk management and trading assets as of September 30, 2002. We use a risk management process to assess and monitor the financial exposure of this and all other counterparties. Despite the fact that the great majority of our trading counterparties are rated as investment grade by the credit rating agencies, including the counterparty 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.

Changing interest rates will affect interest paid on variable-rate debt and interest earned by our pension 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 and nuclear decommissioning trust funds also have risks associated with changing market values of equity investments. Pension and nuclear decommissioning costs are recovered in regulated electricity prices.

#### **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 President and Chief Executive Officer and our Vice President, Finance, 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 President and Chief Executive Officer and our Vice President, Finance, 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 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.

#### **COMPETITION AND ELECTRIC INDUSTRY RESTRUCTURING**

See Note 5 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report for a discussion of regulatory developments regarding the introduction of retail electric competition in Arizona and related matters.

#### **REGIONAL TRANSMISSION ORGANIZATIONS**

As previously reported, 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 a regional transmission organization ("RTO"). See "Regulation and Competition - Wholesale - Regional Transmission Organizations" in Part I, Item 1 of the 2001 10-K. 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. In its order, the FERC also stated that its approval of various WestConnect provisions addressed in the order would not be overturned or affected by the final rule the FERC intends to ultimately adopt in response to its July 31, 2002 Notice of Proposed Rulemaking regarding a standard market design for the electric utility industry (see "Federal" in Note 5 for additional information regarding the Notice of Proposed Rulemaking). FERC did not address all of the proposed WestConnect provisions in its order and some could still be affected by a final rule in the pending rulemaking proceeding. We cannot currently predict what, if any, impact there may be to the WestConnect proposal or to us if the FERC adopts the proposed SMD rule. On November 12, 2002, APS and other owners filed a request for rehearing and clarification on portions of the October 10 order.

#### **NATURAL GAS SUPPLY**

As previously reported on May 31, 2002, the FERC issued an order requiring the conversion of all Full Requirements contracts to Contract Demand contracts. See "Natural Gas Supply" in Part II, Item 5 of the June 10-Q. On September 20, 2002, the FERC issued another order clarifying the capacity allocation methodology, extending the conversion implementation date from November 1, 2002 to May 1, 2003 and approving reallocation of costs for service. APS and other Full Requirement contract holders have sought rehearings of the FERC orders. We currently do not expect this to have a material adverse impact on our financial position, results of operations or liquidity.

## COAL SUPPLY

Because covenants under the Four Corners lease and related federal rights-of-way and grants expired in July 2001, the Navajo Nation assessed taxes on the coal supplier and the plant. See "Coal Supply" in Part II, Item 5 of the June 2002 10-Q. In July 2002, APS and the Navajo Nation negotiated a settlement agreement relating to the plant pursuant to which APS will make settlement payments to the Navajo Nation and that settlement agreement was executed in August 2002. Pursuant to the terms of the settlement agreement, APS does not expect the payments to have a material adverse impact on its financial position, results of operations or liquidity.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits

Exhibit No. -----	Description -----
3.1	Pinnacle West Bylaws, amended as of September 18, 2002
3.2	APS Bylaws, amended as of September 18, 2002
10.1	Employment Agreement effective as of October 1, 2002 between APS and James M. Levine
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 Michael V. Palmeri, the Registrant's principal financial officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.3	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

(b) Reports on Form 8-K

During the quarter ended September 30, 2002, and the period from October 1 through November 14, 2002, we filed the following reports on Form 8-K:

Report dated June 30, 2002 regarding exhibits comprised of financial information and earnings variance explanations.

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



Report dated July 11, 2002 regarding a letter APS filed with the ACC.

Report dated July 23, 2002 regarding an ACC Administrative Law Judge's recommendation on Track A issues.

Report dated August 13, 2002 filing certifications of the Company's principal executive officer and principal financial officer.

Report dated August 27, 2002 regarding the ACC's decision on Track A issues.

Report dated September 10, 2002 regarding the ACC's Track A Order and APS' filing of the Financing Application.

Report dated September 30, 2002 regarding exhibits comprised of financial information and earnings variance explanations.

Report dated October 17, 2002 regarding the Company's earnings outlook and a slide presentation for use at an analyst conference.

## 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: November 14, 2002

By: Michael V. Palmeri

-----  
Michael V. Palmeri  
Vice President, Finance  
(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 officers 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 officers 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 officers 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: November 14, 2002.

**William J. Post**

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

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER**

**CERTIFICATIONS**

I, Michael V. Palmeri, 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 officers 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 officers 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 officers 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: November 14, 2002.

**Michael V. Palmeri**

Michael V. Palmeri Title: Vice President, Finance

**BYLAWS**

**OF**

**PINNACLE WEST CAPITAL CORPORATION**  
(AMENDED AS OF SEPTEMBER 18, 2002)

**I. REFERENCES; SENIORITY**

1.01. REFERENCES. Any reference herein made to law will be deemed to refer to the law of the State of Arizona, including any applicable provision or provisions of Chapters 1-17 and Chapter 23 of Title 10, Arizona Revised Statutes (or its successor), as at any given time in effect. Any reference herein made to the Articles will be deemed to refer to the applicable provision or provisions of the Articles of Incorporation of the Company, and all amendments thereto, as at any given time on file with the Arizona Corporation Commission (this reference to that Commission being intended to include any successor to the incorporating and related functions being performed by that Commission at the date of the initial adoption of these Bylaws).

1.02. SENIORITY. Except as indicated in Part X of these Bylaws, the law and the Articles (in that order of precedence) will in all respects be considered senior and superior to these Bylaws, with any inconsistency to be resolved in favor of the law and the Articles (in that order of precedence), and with these Bylaws to be deemed automatically amended from time to time to eliminate any such inconsistency which may then exist.

1.03. SHAREHOLDERS OF RECORD. Except as otherwise required by law and subject to any procedure established by the Company pursuant to Arizona Revised Statutes Section 10-723 (or any comparable successor provision), the word "SHAREHOLDER" as used herein shall mean one who is a holder of record of shares in the Company.

**II. SHAREHOLDERS MEETINGS**

2.01. ANNUAL MEETINGS. An annual meeting of shareholders shall be held for the election of directors at such date, time and place, either within or without the State of Arizona, as may be designated by resolution of the Board of Directors from time to time. Any other proper business may be transacted at the annual meeting. A special meeting may be called and held in lieu of an annual meeting pursuant to the provisions of Section 2.02 below, and the same proceedings (including the election of directors) may be conducted thereat as at a regular meeting. Any director elected at any annual meeting, or special meeting in lieu of an annual meeting, will continue in office until the election of his or her successor, subject to his or her (a) earlier resignation pursuant to Section 6.01 below, (b) removal pursuant to Section 3.13 below, or (c) death or disqualification.

2.02. SPECIAL MEETINGS. Except as otherwise required by law, special meetings of the shareholders may be held whenever and wherever called by the Chairman of the Board, the President, or a majority of the Board of Directors, but such special meetings may not be called by any other person or persons. Business transacted at any special meeting of shareholders shall be limited to the purposes stated in the notice.

2.03. NOTICE. Notice of any meeting of the shareholders will be given as provided by law to each shareholder entitled to vote at such meeting and, if required by law, to each other shareholder of the Company. Any such notice may be waived as provided by law.

2.04. RIGHT TO VOTE. For each meeting of the shareholders, the Board of Directors will fix in advance a record date as contemplated by law, and the shares of stock and the shareholders "ENTITLED TO VOTE" (as that or any similar term is herein used) at any meeting of the shareholders will be determined as of the applicable record date. The Secretary (or in his or her absence an Assistant Secretary) will see to the making and production of any record of shareholders entitled to vote or otherwise entitled to notice of shareholders meetings, in either case which is required by law. Any voting entitlement may be exercised through proxy, or in such other manner as specifically provided by law, in accordance with the applicable law. In the event of contest, the burden of proving the validity of any undated or irrevocable proxy will rest with the person seeking to exercise the same. A telegram, cablegram, or facsimile appearing to have been transmitted by a shareholder (or by his or her duly authorized attorney-in-fact) or other means of voting by telephone or electronic transmission may be accepted as a sufficiently written and executed proxy if otherwise permitted by law.

#### 2.05. NOTICE OF SHAREHOLDER BUSINESS AND NOMINATIONS.

(a) Annual Meetings of Shareholders. (1) Nominations of persons for election to the Board of Directors of the Company and the proposal of business to be considered by the shareholders may be made at an annual meeting of shareholders only (i) pursuant to the Company's notice of meeting (or any supplement thereto), (ii) by or at the direction of the Board of Directors or (iii) by any shareholder of the Company who was a shareholder at the time the respective notice provided for in this Section 2.05 is delivered to the Secretary of the Company, who is entitled to vote at the meeting and who complies with the notice procedures set forth in this Section 2.05.

(2) For nominations or other business to be properly brought before an annual meeting by a shareholder pursuant to clause (iii) of paragraph (a)(1) of this Section 2.05, the shareholder must have given timely notice thereof in writing to the Secretary of the Company and any such proposed business other than the nominations of persons for election to the Board of Directors must constitute a proper matter for shareholder action. To be timely, a shareholder notice shall be delivered to the Secretary at the principal executive offices of the Company not later than the close of business (a) with respect to business to be brought before the meeting, on the ninetieth day or not earlier than the close of business on the one hundred twentieth day prior to the first anniversary of the preceding year's annual meeting (provided, however, that in the event that the date of the annual meeting has been changed by more than thirty days from such anniversary date, notice by the shareholder must be so delivered not later than the close of business on the tenth day following the day on which public announcement of the date of such meeting was mailed or public disclosure of the annual meeting was made,

whichever first occurs), and (b) with respect to nominations of persons to be elected to the Board of Directors, the one-hundred and eightieth day prior to the date of the meeting at which the election is to occur. In no event shall the public announcement of an adjournment or postponement of an annual meeting commence a new time period (or extend any time period) for the giving of a shareholder's notice as described above. Such shareholder's notice shall set forth: (a) as to each person whom the shareholder proposes to nominate for election as a director, all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended (the "EXCHANGE ACT"), and Rule 14a-11 thereunder (and such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected);

(b) as to any other business that the shareholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the text of the proposal or business (including the text of any resolutions proposed for consideration and, in the event that such business includes a proposal to amend the Bylaws of the Company, the language for the proposed amendment), the reasons for conducting such business at the meeting, and any material interest in such business of such shareholder and the beneficial owner, if any, on whose behalf the proposal is made; and (c) as to the shareholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made, (i) the name and address of such shareholder, as they appear on the Company's books, and of such beneficial owner, (ii) the class and number of shares of capital stock of the Company that are owned beneficially and of record by such shareholder and such beneficial owner, (iii) a representation that the shareholder is a holder of record of stock of the Company entitled to vote at such meeting and intends to appear in person or by proxy at the meeting to propose such business or nomination, and (iv) a representation whether the shareholder or the beneficial owner, if any, intends or is part of a group that intends (a) to deliver a proxy statement and/or form of proxy to holders of at least the percentage of the Company's outstanding capital stock required to approve or adopt the proposal or elect the nominee and/or (b) otherwise to solicit proxies from shareholders in support of such proposal or nomination. The Company may require any proposed nominee to furnish such other information as it may reasonably require to determine the eligibility of such proposed nominee to serve as a director of the Company.

(b) Special Meetings of Shareholders. Only such business shall be conducted at a special meeting of shareholders as shall have been brought before the meeting pursuant to the Company's notice of meeting.

(c) General. (1) Only such persons who are nominated in accordance with the procedures set forth in this Section 2.05 shall be eligible to be elected at an annual or special meeting of shareholders of the Company to serve as directors and only such business shall be conducted at a meeting of shareholders as shall have been brought before the meeting in accordance with the procedures set forth in this Section 2.05. Except as otherwise provided by law, the Chairman of the meeting shall have the power and duty (a) to determine whether a nomination or any business proposed to be brought before the meeting was made or proposed, as the case may be, in accordance with the procedures set forth in this Section 2.05 (including whether the shareholder or beneficial owner, if any, on whose behalf the nomination or proposal is made solicited (or is part of a group that solicited) or did not so solicit, as the case may be, proxies in support of such shareholder's nominee or proposal in compliance with such shareholder's representation as required by clause (a)(2)(c)(iv) of this Section 2.05) and (b) if any proposed nomination or business was not made or proposed in compliance with this Section 2.05, to declare that such nomination shall be disregarded or that such proposed business shall not be transacted.

(2) For purposes of this Section 2.05, "PUBLIC ANNOUNCEMENT" shall mean disclosure in a press release reported by the Dow Jones News Service, Associated Press or comparable national news service or in a document publicly filed by the Company with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Exchange Act.

(3) Notwithstanding the foregoing provisions of this Section 2.05, a shareholder shall also comply with all applicable requirements of the Exchange Act and the rules and regulations thereunder with respect to the matters set forth in this Section 2.05. Nothing in this Section 2.05 shall be deemed to affect any rights (a) of shareholders to request inclusion of proposals in the Company's proxy statement pursuant to Rule 14a-8 of the Exchange Act or (b) of the holders of any series of Preferred Stock to elect directors pursuant to any applicable provisions of the Articles.

2.06. RIGHT TO ATTEND. Except only to the extent of persons designated by the Board of Directors or the Chairman of the meeting to assist in the conduct of the meeting (as referred to in Sections 2.08 and 2.09 below) and except as otherwise permitted by the Board or such Chairman, the persons entitled to attend any meeting of shareholders may be confined to (i) shareholders entitled to vote thereat and other shareholders entitled to notice of the meeting and (ii) the persons upon whom proxies valid for purposes of the meeting have been conferred or their duly appointed substitutes (if the related proxies confer a power of substitution); provided, however, that the Board of Directors or the Chairman of the meeting may establish rules limiting the number of persons referred to in clause (ii) as being entitled to attend on behalf of any shareholder so as to preclude such an excessively large representation of such shareholder at the meeting as, in the judgment of the Board or such Chairman, would be unfair to other shareholders represented at the meeting or be unduly disruptive of the orderly conduct of business at such meeting (whether such



representation would result from fragmentation of the aggregate number of shares held by such shareholder for the purpose of conferring proxies, from the naming of an excessively large proxy delegation by such shareholder or from employment of any other device). A person otherwise entitled to attend any such meeting will cease to be so entitled if, in the judgment of the Chairman of the meeting, such person engages thereat in disorderly conduct impeding the proper conduct of the meeting in the interests of all shareholders as a group.

2.07. QUORUM. Except as otherwise provided by law, the Articles or these Bylaws, at each meeting of shareholders the presence in person or by proxy of the holders of a majority in voting power of the outstanding shares of stock entitled to vote at the meeting shall be necessary and sufficient to constitute a quorum.

2.08. ELECTION INSPECTORS. The Board of Directors, in advance of any shareholders meeting may appoint an election inspector or inspectors to act at such meeting (and any adjournment thereof). If an election inspector or inspectors are not so appointed, the Chairman of the meeting may or, upon the request of any person entitled to vote at the meeting will, make such appointment. If any person appointed as an inspector fails to appear or to act, a substitute may be appointed by the Chairman of the meeting. If appointed, the election inspector or inspectors (acting through a majority of them if there be more than one) will determine the number of shares outstanding, the authenticity, validity and effect of proxies, the credentials of persons purporting to be shareholders or persons named or referred to in proxies, and the number of shares represented at the meeting in person and by proxy; they will receive and count votes, ballots and consents and announce the results thereof; they will hear and determine all challenges and questions pertaining to proxies and voting; and, in general, they will perform such acts as may be proper to conduct elections and voting with complete fairness to all shareholders. No such election inspector need be a shareholder of the Company.

2.09. ORGANIZATION AND CONDUCT OF MEETINGS. Each shareholders meeting will be called to order and thereafter chaired by the Chairman of the Board if there then is one; or, if not, or if the Chairman of the Board is absent or so requests, then by the President; or if both the Chairman of the Board and the President are unavailable, then by such other officer of the Company or such shareholder as may be appointed by the Board of Directors. The Secretary (or in his or her absence an Assistant Secretary) of the Company will act as secretary of each shareholders meeting; if neither the Secretary nor an Assistant Secretary is in attendance, the Chairman of the meeting may appoint any person (whether a shareholder or not) to act as secretary thereat. After calling a meeting to order, the Chairman thereof may require the registration of all shareholders intending to vote in person, and the filing of all proxies, with the election inspector or inspectors, if one or more have been appointed (or, if not, with the secretary of the meeting). After the announced time for such filing of proxies has ended, no further proxies or changes, substitutions or revocations of proxies will be accepted. If directors are to be elected, a tabulation of the proxies so filed will, if any person entitled to vote in such election so requests, be announced at the meeting (or adjournment thereof) prior to the closing of the election polls.

Absent a showing of bad faith on his or her part, the Chairman of a meeting will, among other things, have absolute authority to determine the order of business to be conducted at such meeting and to establish rules for, and appoint

personnel to assist in, preserving the orderly conduct of the business of the meeting (including any informal, or question and answer, portions thereof). Rules, regulations or procedures regarding the conduct of the business of a meeting, whether adopted by the Board of Directors or prescribed by the Chairman of the meeting, may include, without limitation, the following: (i) the establishment of an agenda or order of business for the meeting; (ii) rules and procedures for maintaining order at the meeting and the safety of those present; (iii) limitations on attendance at or participation in the meeting to shareholders of record of the Company, their duly authorized and constituted proxies (subject to Section 2.06) or such other persons as the Chairman of the meeting shall determine; (iv) restrictions on entry to the meeting after the time fixed for the commencement thereof; and (v) limitations on the time allotted to questions or comments by participants. Unless and to the extent determined by the Board of Directors or the Chairman of the meeting, meetings of shareholders shall not be required to be held in accordance with the rules of parliamentary procedure. Any informational or other informal session of shareholders conducted under the auspices of the Company after the conclusion of or otherwise in conjunction with any formal business meeting of the shareholders will be chaired by the same person who chairs the formal meeting, and the foregoing authority on his or her part will extend to the conduct of such informal session.

2.10. VOTING. The number of shares voted on any matter submitted to the shareholders which is required to constitute their action thereon or approval thereof will be determined in accordance with applicable law, the Articles, and these Bylaws, if applicable. No ballot or change of vote will be accepted after the polls have been declared closed following the ending of the announced time for voting.

2.11. SHAREHOLDER APPROVAL OR RATIFICATION. The Board of Directors may submit any contract or act for approval or ratification at any duly constituted meeting of the shareholders, the notice of which either includes mention of the proposed submittal or is waived as provided in Section 2.03 above. Except as otherwise required by law (e.g., Arizona Revised Statutes Section 10-863), if any contract or act so submitted is approved or ratified by a majority of the votes cast thereon at such meeting, the same will be valid and as binding upon the Company and all of its shareholders as it would be if approved and ratified by each and every shareholder of the Company.

2.12. CONTROL SHARE ACT. The provisions of Section 10-2721 through and including Section 10-2727 of the Arizona Revised Statutes shall not apply to the Company.

2.13. ADJOURNMENTS. Any meeting of shareholders, annual or special, may adjourn from time to time to reconvene at the same or some other place, and notice need not be given of any such adjourned meeting if the time and place thereof are announced at the meeting at which the adjournment is taken. At the adjourned meeting the Company may transact any business that might have been transacted at the original meeting. If the adjournment is for more than one hundred and twenty days, or if after the adjournment a new record date is fixed for the adjourned meeting, notice of the adjourned meeting shall be given to each shareholder of record entitled to vote at the meeting.

### III. BOARD OF DIRECTORS

3.01. MEMBERSHIP. The Board of Directors of the corporation shall consist of not less than nine (9) nor more than twenty-one (21) shareholders of the Company or of any parent corporation thereof (except that it shall not be a requirement that any member of the initial Board of Directors be a shareholder of the Company or of any parent corporation thereof), and shall be divided into three classes in the manner provided in the Articles (Art. Fifth). The Board will have the exclusive power to increase or decrease its size within such limits. Any vacancy occurring in the Board, whether by reason of death, resignation, disqualification or otherwise, may be filled by the directors as contemplated by law and as provided in the Articles (Art. Fifth). Any such increase in the size of the Board, and the filling of any vacancy created thereby, will require action by a majority of the whole membership of the Board as comprised immediately before such increase.

3.02. QUALIFICATIONS. In order to qualify as a director, a person must be the owner of one or more shares of the capital stock of the Company or of any parent corporation thereof at the time of assuming office (except as may otherwise be provided in these Bylaws or in the Articles) and for so long thereafter as such person remains in office. A person will cease to qualify as a director if he or she (i) is in good faith determined by a majority of the other directors then in office to be physically or mentally incapable of competent performance as a director for a period, starting with inception of the incapacity, that has extended or is likely to extend for more than six months or (ii) has failed to attend six successive regular meetings of the Board (as determined in accordance with Section 3.03 below) unless and to the extent such failure is waived by a majority of the other directors then in office; however, disqualification pursuant to clause (i) or (ii) of this sentence will not preclude the subsequent election or appointment of such person as a director by the shareholders or the Board if a majority of the directors in office immediately prior to the submission of such person for election or appointment shall determine that his or her prior incapacity or principal reason for prior non-attendance no longer exists. A person will not qualify for election or appointment as a director, whether initially or on re-election and whether by the shareholders at their annual meeting or by the Board of Directors as contemplated in Section 3.01 above, if such person's 70th birthday occurs on or has occurred before the date of such election, appointment or re-election. A person who has been a full-time employee of the Company within twelve months prior to the date of any election will not qualify for election as a director on that date unless he or she then remains a full-time employee of the Company or unless the Board of Directors specifically authorizes the election of such person (but it is not intended that any such authorization will extend a person's service on the Board beyond the age limitation set out in the preceding sentence). A person who has qualified by age or employment status for his or her most recent election as a director may serve throughout the term for which such person was elected, notwithstanding the occurrence of his or her 70th birthday or cessation of full-time employment by the Company between the date of such election and the end of such term, subject, however, to his or her otherwise remaining qualified for such office.

3.03. REGULAR MEETINGS. A regular annual meeting of the directors is to be held as soon as practicable after the adjournment of each annual shareholders meeting either at the place of the shareholders meeting or at such other place as the directors elected at the shareholders meeting may have been informed of at or before the time of their election. Regular meetings, other than the annual

ones, may be held at such intervals at such places and at such times as the Board of Directors may provide.

3.04. SPECIAL MEETINGS. Special meetings of the Board of Directors may be held whenever and wherever called for by the Chairman of the Board, the President or the number of directors which would be required to constitute a quorum.

3.05. NOTICE. No notice need be given of regular meetings of the Board of Directors. Notice of the time and place (but not necessarily the purpose or all of the purposes) of any special meeting will be given to each director in person or by telephone, or via mail, telegram, facsimile, or other electronic transmission addressed in the manner appearing on the Company's records. Notice to any director of any such special meeting will be deemed given sufficiently in advance when (i) if given by mail, the same is deposited in the United States mail at least four days before the meeting date, with postage thereon prepaid, (ii) if given by telegram, the same is delivered to the telegraph office for fast transmittal at least 48 hours prior to the convening of the meeting, (iii) if given by facsimile or other electronic transmission, the same is received by the director or an adult member of his or her office staff or household, at least 24 hours prior to the convening of the meeting, or (iv) if personally delivered or given by telephone, the same is handed, or the substance thereof is communicated over the telephone to the director or to an adult member of his or her office staff or household, at least 24 hours prior to the convening of the meeting. Any such notice may be waived as provided by law. No call or notice of a meeting of directors will be necessary if each of them waives the same in writing or by attendance. Any meeting, once properly called and noticed (or as to which call and notice have been waived as aforesaid) and at which a quorum is formed, may be adjourned to another time and place by a majority of those in attendance.

3.06. QUORUM; VOTING. A quorum for the transaction of business at any meeting or adjourned meeting of the directors will consist of a majority of those then in office. Any matter submitted to a meeting of the directors will be resolved by a majority of the votes cast thereon, except as otherwise required by these Bylaws (ss.ss. 3.01 and 3.02 above and ss. 3.07 below), by law or by any applicable Article. However, in case of an equality of votes, the Chairman of the meeting will have a second or deciding vote. Where action by a majority of the whole membership is required, such requirement will be deemed to relate to a majority of the directors in office at the time the action is taken. In computing any such majority, whether for purposes of determining the presence of a quorum or the adequacy of the vote on any proposed action, any unfilled vacancies at the time existing in the membership of the Board will be excluded from the computation.

3.07. EXECUTIVE COMMITTEE. The Board of Directors may, by resolution adopted by a majority of the whole Board, name three or more of its members as an Executive Committee. Such Executive Committee will have and may exercise the powers of the Board of Directors in the management of the business and affairs of the Company while the Board is not in session, except only as precluded by law or where action other than by a majority of the votes cast is required by these Bylaws, or the law (all as referred to in Section 3.06 above), and subject to such limitations as may be included in any applicable resolution passed by a majority of the whole membership of the Board. A majority of those named to the Executive Committee will constitute a quorum.

3.08. OTHER COMMITTEES. The Board of Directors may designate one or more additional committees, each committee to consist of one or more of the directors of the Company. The Board of Directors may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. Any such committee, to the extent permitted by law and to the extent provided in the resolution of the Board of Directors, shall have and may exercise all the powers and authority of the Board of Directors in the management of the business and affairs of the Company, and may authorize the seal of the Company to be affixed to all papers that may require it.

3.09. COMMITTEE FUNCTIONING. Notice requirements and related waiver provisions for meetings of the Executive Committee and other committees of the Board will be the same as those set forth in Section 3.05 above for meetings of the Board of Directors. Except as provided in the next two succeeding sentences, a majority of those named to the Executive Committee or any other committee of the Board will constitute a quorum at any meeting thereof (with the effect of departure of committee members from a meeting and the computation of a majority of committee members to be in accordance with the applicable policies of Section 3.06 above), and any matter submitted to a meeting of any such committee will be resolved by a majority of the votes cast thereon. No distinction will be made among ex-officio or other members of any such committee for quorum, voting or other purposes, except that the membership of any committee (including the Executive Committee), in performing any function vested in it as herein contemplated, may be deemed to exclude any officer or employee of the Company, in either case, or other person having a direct or indirect personal interest in any proposed exercise of such function, whose exclusion for that purpose is deemed appropriate by a majority of the other members of such committee proposing to perform such function. All committees are to keep regular minutes of the transactions of their meetings.

3.10. ACTION BY TELEPHONE OR CONSENT. Any meeting of the Board or any committee thereof may be held by conference telephone or similar communications equipment as permitted by law, in which case any required notice of such meeting may generally describe the arrangements (rather than the place) for the holding thereof, and all other provisions herein contained or referred to will apply to such meeting as though it were physically held at a single place. Action may also be taken by the Board or any committee thereof without a meeting if the members thereof consent in writing thereto as contemplated by law.

3.11. PRESUMPTION OF ASSENT. A director of the Company who is present at a meeting of the Board of Directors, or of any committee when corporate action is taken is deemed to have assented to the action taken unless either (i) the director objects at the beginning of the meeting or promptly on the director's arrival to holding it or transacting business at the meeting; (ii) the director's dissent or abstention from the action taken is entered in the minutes of the meeting; or (iii) the director delivers written notice of the director's dissent or abstention to the presiding officer of the meeting before its adjournment or to the Company before 5:00 P.M. on the next business day after the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

3.12. COMPENSATION. By resolution of the Board, the directors may be paid their expenses, if any, of attendance at each meeting of the Board of Directors, or of any committee, and may be paid a fixed sum for attendance at each such meeting and/or a stated salary as a director or committee member. No such

payment will preclude any director from serving the Company in any other capacity and receiving compensation therefor.

3.13. REMOVAL. Any director or the entire Board of Directors may be removed with or without cause, only at a special meeting of shareholders called for that purpose, by the affirmative vote of sixty-six and two-thirds percent (66 2/3%) of the issued and outstanding shares of stock then entitled to vote on the election of directors, except that if less than the entire Board of Directors is to be removed, no one of the directors may be removed if the votes cast against the director's removal would be sufficient to elect the director if then cumulatively voted at an election for the class of directors of which the director is a part.

#### IV. OFFICERS - GENERAL

4.01. ELECTIONS AND APPOINTMENTS. The directors may elect or appoint one or more of the officers of the Company contemplated in Part V below. Any such election or appointment will regularly take place at the annual meeting of the directors, but elections of officers may be held at any other meeting of the Board. A person elected or appointed to any office will continue to hold that office until the election or appointment of his or her successor, subject to action earlier taken pursuant to Section 4.04 or 6.01 below. Any person may hold more than one office.

4.02. ADDITIONAL APPOINTMENTS. In addition to the officers contemplated in Part V below, the Board of Directors may create other corporate positions, and appoint persons thereto, with such authority to perform such duties as may be prescribed from time to time by the Board of Directors, by the President or by the superior officer of any person so appointed. Notwithstanding such additional appointments, only those persons whose offices are described in Part V are to be considered an officer of the Company unless the resolution or other Board action appointing such person expressly states that such person is to be considered an officer of the Company. Each of such persons (in the order designated by the Board or the superior officer of such person) will be vested with all of the powers and charged with all of the duties of his or her superior officer in the event of such superior officer's absence or disability.

4.03. BONDS AND OTHER REQUIREMENTS. The Board of Directors may require any officer or other appointee to give bond to the Company (with sufficient surety, and conditioned upon the faithful performance of the duties of his or her office or position) and to comply with such other conditions as may from time to time be required of him or her by the Board.

4.04. REMOVAL OR DELEGATION. Provided that a majority of the whole membership thereof concurs therein, the Board of Directors may remove any officer of the Company as provided by law and declare his or her office or offices vacant or abolished or, in the case of the absence or disability of any officer or for any other reason considered sufficient, may temporarily delegate his or her powers and duties to any other officer or to any director. Similar action may be taken by the Board of Directors in regard to appointees designated pursuant to Section 4.02 above.

4.05. SALARIES. Officer salaries may from time to time be fixed by the Board of Directors or (except as to his or her own) be left to the discretion of the Chief Executive Officer or the President. No officer will be prevented from

receiving a salary by reason of the fact that he or she is also a director of the Company.

## **V. SPECIFIC OFFICERS, FUNCTIONS AND POWERS**

5.01. **CHAIRMAN OF THE BOARD.** The Board of Directors may elect a Chairman to serve as a general executive officer of the Company and, if specifically designated as such by the Board, as the Chief Executive Officer of the Company. If elected, the Chairman will preside at all meetings of the directors and be vested with such other powers and duties as the Board may from time to time delegate to him or her.

5.02. **CHIEF EXECUTIVE OFFICER.** Subject to the control of the Board of Directors exercised as hereinafter provided, the Chief Executive Officer of the Company will supervise its business and affairs and the performance of their respective duties by all other officers, by appointees designated pursuant to

Section 4.02 above, and by such additional appointees to such additional positions (corporate, divisional or otherwise) as the Chief Executive Officer may designate, with authority on his or her part to delegate the foregoing duty of supervision to such extent and to such person or persons as may be determined by the Chief Executive Officer. Except as otherwise indicated from time to time by resolution of the Board of Directors, its management of the business and affairs of the Company will be implemented through the office of the Chief Executive Officer.

5.03. **PRESIDENT AND VICE PRESIDENTS.** Unless specified to the contrary by resolution of the Board of Directors, the President will be the Chief Executive Officer of the Company. In addition to the supervisory functions above set forth on the part of the Chief Executive Officer or in lieu thereof if a contrary specification is made by the Board relative to the Chief Executive Officer, the President will be vested with such powers and duties as the Board may from time to time designate. Vice Presidents may be elected by the Board of Directors to perform such duties as may be designated by the Board or be assigned or delegated to them by their respective superior officers. The Board may identify (i) one or more Vice Presidents as "Executive" or "Senior" Vice Presidents and (ii) the President or any Vice President as "General Manager" of the Company and the title of any Vice President may include words indicative of his or her particular area of responsibility and authority. Vice Presidents will succeed to the responsibilities and authority of the President, in the event of his or her absence or disability, in the order consistent with their respective titles or regular duties or as specifically designated by the Board of Directors.

5.04. **TREASURER AND SECRETARY.** The Treasurer and Secretary each will perform all such duties normally associated with his or her office (including, in the case of the Secretary, the giving of notice and the preparation and retention of minutes of corporate proceedings and the custody of corporate records and the seal of the Company) as are not assigned to a Vice President of the Company, along with such other duties as may be designated by the Board or be assigned or delegated to them by their respective superior officers. The Board may appoint one or more Assistant Treasurers or Assistant Secretaries, each of whom (in the order designated by the Board or their respective superior officers) will be vested with all of the powers and charged with all of the duties of the Treasurer or the Secretary (as the case may be) in the event of his or her absence or disability.

5.05. SPECIFIC POWERS. Except as may otherwise be specifically provided in a resolution of the Board of Directors, any of the officers referred to in this Part V will be a proper officer to authenticate records of the Company and to sign on behalf of the Company any deed, bill of sale, assignment, option, mortgage, pledge, note, bond, debenture, evidence of indebtedness, application, consent (to service of process or otherwise), agreement, indenture or other instrument of importance to the Company. Any such officer may represent the Company at any meeting of the shareholders or members of any corporation, association, partnership, joint venture or other entity in which this Company then has an interest, and may vote such interest in person or by proxy appointed by him or her, provided that the Board of Directors may from time to time confer the foregoing authority upon any other person or persons.

## VI. RESIGNATIONS AND VACANCIES

6.01. RESIGNATIONS. Any director, committee member or officer may resign from his or her office at any time by written notice as specified in accordance with Arizona Revised Statutes Sections 10-807 and 10-843. The acceptance of a resignation will not be required to make it effective.

6.02. VACANCIES. If the office of any director, committee member or officer becomes vacant by reason of his or her death, resignation, disqualification, removal or otherwise, the Board of Directors may choose a successor to hold office for the unexpired term.

## VII. INDEMNIFICATION AND RATIFICATION

7.01. INDEMNIFICATION. In order to induce qualified persons to serve the Company (and any other corporation, joint venture, partnership, trust or other enterprise at the request of the Company) as directors and officers, the Company shall indemnify any and all of its directors and officers, or former directors and officers to the fullest extent permitted by applicable law as it presently exists or may hereafter be amended.

7.02. RATIFICATION; SPECIAL COMMITTEE. Any transaction involving the Company, any of its subsidiary corporations or any of its directors, officers, employees or agents which at any time is questioned in any manner or context (including a shareholders derivative suit), on the ground of lack of authority, conflict of interest, misleading or omitted statement of fact or law, nondisclosure, miscomputation, improper principles or practices of accounting, inadequate records, defective or irregular execution or any similar ground, may be investigated and/or ratified (before or after judgment), or an election may be made not to institute or pursue a claim or legal proceedings on account thereof or to accept or approve a negotiated settlement with respect thereto (before or after the institution of legal proceedings), by the Board of Directors or by a special committee thereof comprised of one or more disinterested directors (that is, a director or directors who did not participate in the questioned transaction with actual knowledge of the questioned aspect or aspects thereof). Such a special committee may be validly formed and fully empowered to act, in accordance with the purposes and duties assigned thereto, by resolution or resolutions of the Board of Directors, notwithstanding (i) the inclusion of Board members who are not disinterested as aforesaid among those who form a quorum at the meeting or meetings at which one or more members of such special committee are elected or appointed to the Board or to such special committee or at which such committee is formed or empowered,



or their inclusion among the directors who vote upon or otherwise participate in taking any of the foregoing actions, or (ii) the taking of any of such actions by the disinterested members of the Board (or a majority of such members) whose number is not sufficient to constitute a quorum or a majority of the membership of the full Board. Any such special committee so comprised will, to the full extent consistent with its purposes and duties as expressed in such resolution or resolutions, have all of the authority and powers of the full Board and its Executive Committee (the same as though it were the full Board and/or its Executive Committee in carrying out such purposes and duties) and will function in accordance with Section 3.09 above. No other provisions of these Bylaws which may at any time appear to conflict with any provisions of this Section 7.02, and no defect or irregularity in the formation, empowering or functioning of any such special committee, will serve to impede, impair or bring into question any action taken or purported to be taken by such committee or the validity of any such action. Any ratification of a transaction pursuant to this Section 7.02 will have the same force and effect as if the transaction has been duly authorized originally. Any such ratification, and any election made pursuant to this Section 7.02 with respect to claims, legal proceedings or settlements, will be binding upon the Company and its shareholders and will constitute a bar to any claim or the execution of any judgment in respect of the transaction involved in such ratification or election.

## VIII. SEAL

8.01. FORM THEREOF. The seal of the Company will have inscribed thereon the name of the Company, the state and year of its incorporation and the words "SEAL".

## IX. STOCK CERTIFICATES

9.01. FORM THEREOF. Each certificate representing stock of the Company will be in such form conforming to law as may from time to time be approved by the Board of Directors, and will bear the manual facsimile signatures and seal of the Company as required or permitted by law.

9.02. OWNERSHIP. The Company will be entitled to treat the registered owner of any share as the absolute owner thereof and accordingly, will not be bound to recognize any beneficial, equitable or other claim to, or interest in, such share on the part of any other person, whether or not it has notice thereof, except as may expressly be provided by Chapter 8 of Title 47, Arizona Revised Statutes (or its successor), as at the time in effect, or other applicable law.

9.03. TRANSFERS. Transfer of stock will be made on the books of the Company only upon surrender of the certificate therefor, duly endorsed by an appropriate person, with such assurance of the genuineness and effectiveness of the endorsement as the Company may require, all as contemplated by Chapter 8 of Title 47, Arizona Revised Statutes (or its successor), as at the time in effect, and/or upon submission of any affidavit, other document or notice which the Company considers necessary.

9.04. LOST CERTIFICATES. In the event of the loss, theft or destruction of any certificate representing capital stock of this Company, the Company may issue (or, in the case of any such stock as to which a transfer agent and/or registrar have been appointed, may direct such transfer agent and/or registrar to countersign, register and issue) a replacement certificate in lieu of that

alleged to be lost, stolen or destroyed, and cause the same to be delivered to the owner of the stock represented thereby, provided that the owner shall have submitted such evidence showing the circumstances of the alleged loss, theft or destruction, and his or her ownership of the certificate as the Company considers satisfactory, together with any other factors which the Company considers pertinent, and further provided that an indemnity agreement and/or indemnity bond shall have been provided in form and amount satisfactory to the Company and to its transfer agent and/or registrar, if applicable.

## **X. EMERGENCY BYLAWS**

10.01. **EMERGENCY CONDITIONS.** The emergency Bylaws provided in this Part X will be as effective in the event of an emergency as prescribed in Arizona Revised Statutes Section 10-207.D. To the extent not inconsistent with the provisions of this Part X, these Bylaws will remain in effect during such emergency and upon its termination these emergency Bylaws will cease to be operative.

10.02. **BOARD MEETINGS.** During any such emergency, a meeting of the Board of Directors or any of its committees may be called by any officer or director of the Company. Notice of the time and place of the meeting will be given by the person calling the same to those of the directors whom it may be feasible to reach by any available means of communication. Such notice will be given so much in advance of the meeting as circumstances permit in the judgment of the person calling the same. At any Board or committee meeting held during any such emergency, a quorum will consist of a majority of those who could reasonably be expected to attend the meeting if they were willing to do so, but in no event more than a majority of those to whom notice of such meeting is required to have been given as above provided.

10.03. **CERTAIN ACTIONS.** The Board of Directors, either before or during any such emergency, may provide and from time to time modify lines of succession in the event that during such an emergency any or all officers, appointees, employees or agents of the Company are for any reason rendered incapable of discharging their duties. The Board, either before or during any such emergency, may, effective in the emergency, change the head office or designate several alternative head offices of the Company, or authorize the officers to do so.

10.04. **LIABILITY.** No director, officer, appointee, employee or agent acting in accordance with these emergency Bylaws will be liable except for willful misconduct.

10.05. **MODIFICATIONS.** These emergency Bylaws will be subject to repeal or change by further action of the Board of Directors, but no such repeal or change will modify the provisions of Section 10.04 with respect to action taken prior to the time of such repeal or change. Any amendment of these emergency Bylaws may make any further or different provisions that may be practical and necessary for the circumstances of the emergency.

## **XI. DIVIDENDS**

11.01. **DECLARATION.** Subject to such restrictions or requirements as may be imposed by law or the Company's Articles or as may otherwise be binding upon the Company, the Board of Directors may from time to time declare dividends on stock of the Company outstanding on the dates of record fixed by the Board, to be paid

in cash, in property or in shares of the Company's stock on or as of such payment or distribution dates as the Board may prescribe.

## XII. BUSINESS COMBINATIONS

12.01. DEFINITIONS. In these Bylaws, the following definitions shall apply:

1. "Affiliate" means a person that directly or indirectly controls, is controlled by, or is under common control with a specified person.
2. "Announcement date," when used in reference to any business combination, means the date of the first public announcement of the final, definitive proposal for the business combination.
3. "Associate," when used to indicate a relationship with any person, means any of the following:
  - (a) Any corporation or organization of which the person is an officer, director, or partnership or is, directly or indirectly, the beneficial owner of ten percent (10%) or more of any class or series of shares entitled to vote or other equity interest;
  - (b) Any trust or estate in which the person has a substantial beneficial interest or as to which the person serves as trustee or personal representative or in a similar fiduciary capacity; or
  - (c) Any relative or spouse of the person, or any relative of the spouse, residing in the home of the person.
4. "Beneficial owner," when used with respect to shares or other securities, includes any person who, directly or indirectly through any agreement, arrangement, relationship, understanding, or otherwise, whether or not in writing, has or shares the power to vote, or direct the voting of the shares or securities or has or shares the power to dispose of or direct the disposition of the shares or securities, except that:
  - (a) A person is not deemed the beneficial owner of shares or securities tendered pursuant to a tender or exchange offer made by the person or any of the person's affiliates or associates until the tendered shares or securities are accepted for purchase or exchange; and
  - (b) A person is not deemed the beneficial owner of shares or securities with respect to which the person has the power to vote or direct the voting arising solely from a revocable proxy given in response to a proxy solicitation required to be made and made in accordance with the applicable rules and regulations under the Securities Exchange Act of 1934, as amended, and is not then reportable under that act on a Schedule 13D or comparable report.

5. "Beneficial ownership" includes the right to acquire shares or securities through the exercise of options, warrants, or rights, the conversion of convertible securities, or otherwise. The shares or securities subject to the options, warrants, rights, or conversion privileges held by a person are deemed to be outstanding for the purpose of computing the percentage of outstanding shares or securities of the class or series owned by the person but are not deemed to be outstanding for the purpose of computing the percentage of the class or series owned by any other person. A person is deemed the beneficial owner of shares and securities beneficially owned by the spouse of the person or any relative of the spouse residing in the home of the person, any trust or estate in which the person owns ten percent (10%) or more of the total beneficial interest or serves as trustee or personal representative, any corporation or entity in which the person owns ten percent (10%) or more of the equity and any affiliate of the person.

6. "Business combination," when used in reference to the Company and any interested shareholder of the Company, means any of the following:

(a) Any merger or consolidation of the Company or any subsidiary of the Company with either:

(i) The interested shareholder; or

(ii) Any other domestic or foreign corporation, whether or not itself an interested shareholder of the Company, that is, or after the merger would be, an affiliate or associate of the interested shareholder, except that the foregoing does not include the merger of a wholly-owned subsidiary of the Company into the Company or the merger of two or more wholly-owned subsidiaries of the Company.

(b) Any exchange, pursuant to a plan of exchange under the laws of the State of Arizona or a comparable statute of any other state or jurisdiction, of shares of the Company or any subsidiary of the Company for shares of either:

(i) The interested shareholder; or

(ii) Any other domestic or foreign corporation, whether or not itself an interested shareholder of the Company, that is, or after the exchange would be, an affiliate or associate of the interested shareholder.

(c) Any sale, lease, exchange, mortgage, pledge, transfer, or other disposition, in a single transaction or a series of transactions, to or with the interested shareholder or any affiliate or associate of the interested shareholder, of

assets of the Company or any subsidiary of the Company to which any of the following applies:

- (i) Has an aggregate market value equal to ten percent (10%) or more of the aggregate market value of all the assets, determined on a consolidated basis, of the Company.
- (ii) Has an aggregate market value equal to ten percent (10%) or more of the aggregate market value of all the outstanding shares of the Company.
- (iii) Represents ten percent (10%) or more of the earning power or net income, determined on a consolidated basis, of the Company.
- (d) The issuance or transfer by the Company or any subsidiary of the Company, in a single transaction or a series of transactions, of any shares of the Company or any subsidiary of the Company that have an aggregate market value equal to five percent (5%) or more of the aggregate market value of all the outstanding shares of the Company to the interested shareholder or any affiliate or associate of the interested shareholder, except pursuant to the exercise of warrants or rights to purchase shares offered or a dividend or distribution paid or made pro rata to all shareholders of the Company.
- (e) The adoption of any plan or proposal for the liquidation or dissolution of the Company, or any reincorporation of the Company in another state or jurisdiction, proposed by, on behalf of, or pursuant to any agreement, arrangement, or understanding, whether or not in writing, with the interested shareholder or any affiliate or associate of the interested shareholder.
- (f) Any reclassification of securities, including any share dividend or split, reverse share split, or other distribution of shares in respect of shares, recapitalization of the Company, merger or consolidation of the Company with any subsidiary of the Company exchange of shares of the Company with any subsidiary of the Company or other transaction, whether or not with or into or otherwise involving the interested shareholder, proposed by, on behalf of, or pursuant to any agreement, arrangement, or understanding, whether or not in writing, with the interested shareholder or any affiliate or associate of the interested shareholder that has the effect, directly or indirectly, of increasing the proportionate share of the outstanding shares of any class or series of shares entitled to vote, or securities that are exchangeable for or convertible into or that carry a right to acquire shares entitled to vote, of the Company or any subsidiary of the

Company that is, directly or indirectly, owned by the interested shareholder or any affiliate or associate of the interested shareholder, except as a result of immaterial changes due to fractional share adjustments.

(g) Any receipt by the interested shareholder or any affiliate or associate of the interested shareholder of the benefit, directly or indirectly, except proportionately as a shareholder of the Company, of any loans, advances, guarantees, pledges, or other financial assistance or any tax credits or other tax advantages provided by or through the Company or any subsidiary of the Company (other than expense account advances made in the ordinary course of business).

7. "Consummation date," with respect to any business combination, means the date of consummation of the business combination or, in the case of a business combination as to which a shareholder vote is taken, the later of:

(i) The business day before the vote; or

(ii) Twenty (20) days before the date of consummation of the business combination.

8. "Control," "controlling," "controlled by" or "under common control with" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. A person's beneficial ownership of ten percent (10%) or more of the voting power of the Company's outstanding shares entitled to vote in the election of directors creates a presumption that the person has control of the Company. A person is not considered to have control of the Company if the person holds voting power, in good faith and not for the purpose of avoiding any provision of law as an agent, bank, broker, nominee, custodian, or trustee for one or more beneficial owners who do not individually or as a group have control of the Company.

9. "Interested shareholder," when used in reference to the Company means any person, other than the Company or any subsidiary of the Company, that is either:

(a) The beneficial owner, directly or indirectly, of ten percent (10%) or more of the voting power of the outstanding shares entitled to vote of the Company; or

(b) An affiliate or associate of the Company.

10. "Interested shares" means the shares of the Company with respect to which any of the following persons may exercise or direct the exercise of voting power in the election of directors of the Company:

- (a) An interested shareholder;
- (b) Any officer of the Company; or
- (c) Any director of the Company.

11. "Market value," when used in reference to shares or property of the Company, means the following:

(a) In the case of shares, the highest closing sale price during the thirty (30) day period immediately preceding the date in question of a share on the composite tape for New York Stock Exchange listed shares or, if the shares are not quoted on the composite tape or not listed on the New York Stock Exchange, on the principal United States securities exchange registered under the Securities Exchange Act of 1934, as amended, on which the share are listed or, if the shares are not listed on any such exchange, on the National Association of Securities Dealers, Inc. Automated Quotations National Market System or, if the shares are not quoted on the National Association of Securities Dealers, Inc. Automated Quotations National Market System, the highest closing bid quotation during the thirty (30) day period preceding the date in question of a share on the National Association of Securities Dealers, Inc. Automated Quotations System or any system then in use or, if no such quotation is available, the fair market value on the date in question of a share as determined in good faith by the Board of the Company, subject to arbitration.

(b) In the case of property other than cash or shares, the fair market value of the property on the date in question as determined in good faith by the Board of the Company, subject to arbitration.

12. "Person" means any natural person, partnership, corporation, group, association, venture, firm, or other entity (other than the Company, any subsidiary of the Company, or a trustee or fiduciary holding stock for the benefit of the employees of the Company or its subsidiaries or any one of its subsidiaries, pursuant to one or more employee benefit plans). If two or more persons act as a partnership, limited partnership, syndicate, or other group pursuant to any agreement, arrangement, relationship, understanding, or otherwise, whether or not in writing, for the purposes of acquiring, owning, or voting shares of the Company, all members of the partnership, syndicate, or other group shall be deemed a person. Person does not include a licensed broker, dealer, or underwriter that purchases shares of the Company

solely for purposes of resale to the public that is not acting in concert with an interested shareholder.

13. "Share acquisition date," with respect to any person and the Company, means the date that the person first becomes an interested shareholder of the Company.

#### 12.02. BUSINESS COMBINATION WITH INTERESTED SHAREHOLDERS; APPROVED BY DIRECTORS.

1. Except as set forth in these Bylaws, the Company may not engage in any business combination or vote, consent or otherwise act to authorize a subsidiary of the Company to engage in any business combination with respect to, proposed by, or on behalf of, or pursuant to any agreement, arrangement or understanding, whether or not in writing, with any interested shareholder of the Company or any affiliate or associate of the interested shareholder for a period of three (3) years after the interested shareholder's share acquisition date, unless the business combination or the acquisition of shares made by the interested shareholder on the interested shareholder's share acquisition date is approved by a committee of the Board of Directors of the Company before the interested shareholder's share acquisition date. The committee shall be formed in accordance with subsection 4 of this Section 12.02.

2. If a good faith definitive proposal regarding a business combination is made in writing to the Board of Directors of the Company, a committee of the Board formed in accordance with subsection 4 of this Section 12.02 shall consider and take action on the proposal and respond in writing within forty-five (45) days after receipt of the proposal by the Company, setting forth its decision regarding the proposal.

3. If a good faith definitive proposal to acquire shares is made in writing to the Board of Directors of the Company, a committee of the Board of Directors formed in accordance with subsection 4 of this Section 12.02 shall consider and take action on the proposal. Unless the committee responds affirmatively in writing within forty-five (45) days after receipt of the proposal by the Company, the committee shall be considered to have disapproved the share acquisition.

4. When a business combination or acquisition of shares is proposed pursuant to this Section 12.02, the Board of Directors shall promptly form a committee composed of all of the Board's disinterested Directors. The committee shall take action on the proposal by the affirmative vote of a simple majority of the committee members. The committee is not subject to any direction or control by the Board with respect to the committee's consideration of or any action concerning a business combination or acquisition of shares pursuant to this Section 12.02. A committee formed pursuant to this subsection shall be composed of one or more members. Only disinterested Directors may be members



of a committee formed pursuant to this subsection. However, if the Board of Directors has no disinterested Directors, the Board shall select three or more disinterested persons to be committee members. For purposes of this subsection, a Director or person is disinterested if the Director or person is not an interested shareholder or an affiliate thereof or a present or former officer or employee of the Company or an affiliate or associate of the Company.

12.03. Requirements after Three Years. Except for the provisions of Sections 12.02 and 12.04, the Company may not engage at any time in any business combination or vote, consent, or otherwise act to authorize a subsidiary of the Company to engage in any business combination with respect to, proposed by, on behalf of, or pursuant to any agreement, arrangement, or understanding, whether or not in writing, with an interested shareholder of the Company or any affiliate or associate of the interested shareholder other than a business combination meeting all the requirements of this Article XII, the Articles, and the requirements specified in any of the following:

1. A business combination with respect to which the consummation date is no less than three years after the share acquisition date, approved by the Board of Directors of the Company before the interested shareholder's share acquisition date, or as to which the acquisition of shares made by the interested shareholder on the interested shareholder's acquisition date had been approved by the Board of Directors before the interested shareholder's share acquisition date.

2. A business combination approved by the affirmative vote of the holders of a majority of the outstanding shares entitled to vote not beneficially owned by the interested shareholder proposing the business combination or any affiliate or associate of the interested shareholder proposing the business combination at a meeting called for that purpose no earlier than three years after the interested shareholder's share acquisition date.

3. A business combination, with respect to which the consummation date is no earlier than three years after the interested shareholder's share acquisition date, that meets all of the following conditions:

(a) The aggregate amount of the cash and the market value as of the consummation date of consideration other than cash to be received per share by holders of outstanding common shares of the Company in the business combination is at least equal to the higher of the following:

(i) The highest per share price paid by the interested shareholder, at a time when the interested shareholder was the beneficial owner, directly or indirectly, of five percent (5%) or more of the outstanding shares entitled to vote of the Company, for any common shares of the same class or series acquired by it within the

three (3) year period immediately before the announcement date with respect to the business combination or within the three (3) year period immediately before, or in, the transaction in which the interested shareholder became an interested shareholder, whichever is higher, plus, in either case, interest compounded annually from the earliest date on which the highest per share acquisition price was paid through the consummation date at the rate for one year United States treasury obligations from time to time in effect less the aggregate amount of any cash dividends paid, and the market value of any dividends paid other than in cash, per common share since the earliest date, up to the amount of the interest.

(ii) The market value per common share on the announcement date with respect to the business combination or on the interested shareholder's share acquisition date, whichever is higher, plus interest compounded annually from that date through the consummation date at the rate for one year United States treasury obligations from time to time in effect less the aggregate amount of any cash dividends paid and the market value of any dividends paid other than in cash, per common share since that date, up to the amount of the interest.

(b) The aggregate amount of the cash and the market value as of the consummation date of consideration other than cash to be received per share by holders of outstanding shares of any class or series of shares, other than common shares, of the Company in the business combination is at least equal to the highest of the following, whether or not the interested shareholder has previously acquired any shares of the class or series:

(i) The highest per share price paid by the interested shareholder, at a time when the interested shareholder was the beneficial owner, directly or indirectly, of five percent (5%) or more of the outstanding shares entitled to vote of the Company, for any shares of the class or series acquired by it within the three (3) year period immediately before the announcement date with respect to the business combination or within the three (3) year period immediately before, or in, the transaction in which the interested shareholder became an interested shareholder, whichever is higher, plus, in either case, interest compounded annually from the

earliest date on which the highest per share acquisition price was paid through the consummation date at the rate for one year United States treasury obligations from time to time in effect less the aggregate amount of any cash dividends paid and the market value of any dividends paid other than in cash, per share of the class or series since such earliest date, up to the amount of the interest.

(ii) The highest preferential amount per share to which the holders of shares of the class or series are entitled in the event of any voluntary liquidation, dissolution, or winding up of the Company, plus the aggregate amount of any unpaid dividends declared or due as to which the holders are entitled before payment of dividends on some other class or series of shares, unless the aggregate amount of the dividends is included in the preferential amount.

(iii) The market value per share of the class or series on the announcement date with respect to the business combination or on the interested shareholder's share acquisition date, whichever is higher, plus interest compounded annually from that date through the consummation date at the rate for one year United States treasury obligations from time to time in effect less the aggregate amount of any cash dividends paid and the market value of any dividends paid other than in cash, per share of the class or series since that date, up to the amount of the interest.

(c) The consideration to be received by holders of a particular class or series of outstanding shares, including common shares, of the Company in the business combination is in cash or in the same form as the interested shareholder has used to acquire the largest number of shares of the class or series of shares previously acquired by it and the consideration is distributed promptly.

(d) The holders of all outstanding shares of the Company not beneficially owned by the interested shareholder immediately before the consummation date with respect to the business combination are entitled to receive in the business

combination cash or other consideration for the shares in compliance with subdivisions (a), (b) and (c).

(e) After the interested shareholder's share acquisition date and before the consummation date with respect to the business combination, the interested shareholder has not become the beneficial owner of any additional shares entitled to vote of the Company except:

(i) As part of the transaction that resulted in the interested shareholder becoming an interested shareholder;

(ii) By virtue of proportionate share splits, share dividends, or other distributions of shares in respect of shares not constituting a business combination;

(iii) Through a business combination meeting all of the conditions of Section 12.02 and this paragraph; or

(iv) Through purchase by the interested shareholder at any price that, if the price had been paid in an otherwise permissible business combination the announcement date and consummation date of which were the date of the purchase, would have satisfied the requirements of subdivisions (a), (b) and (c) of this Section.

12.04. APPLICATION. This Article XII does not apply to any business combination of the Company with an interested shareholder of the Company who became an interested shareholder inadvertently, if the interested shareholder both:

1. As soon as practicable, divests itself of a sufficient amount of the shares entitled to vote of the Company so that it no longer is the beneficial owner, directly or indirectly, of ten percent (10%) or more of the outstanding shares entitled to vote of the Company.

2. Would not at any time within the three (3) year period preceding the announcement date with respect to the business combination have been an interested shareholder except for the inadvertent acquisition.

### XIII. LIMITATION ON SHARE REPURCHASES

13.01. LIMITATION ON SHARE REPURCHASES. The Company shall not, directly or indirectly, purchase or agree to purchase any shares entitled to vote from a person, or two or more persons who act as a partnership, limited partnership, syndicate or other group pursuant to any agreement, arrangement, relationship, understanding or otherwise, whether or not in writing, for the purpose of

acquiring, owning or voting shares of the Company who beneficially owns more than five per cent (5%) of the voting stock of the Company for more than the "average market price" of the shares if the shares have been beneficially owned by the person or persons for less than three (3) years, unless the purchase or agreement to purchase is approved at a meeting of shareholders by the affirmative vote of the holders of a majority of the voting stock entitled to vote and not beneficially owned by such person or persons from whom the proposed repurchase is to be made or the Company makes an offer, of at least equal value per share, to all holders of shares of such class or series and to all holders of any class or series into which the shares may be converted.

13.02. DEFINITIONS. For the purposes of this Article, "AVERAGE MARKET PRICE" means the average closing sale price during the thirty trading days immediately preceding the purchase of the shares in question, or if the person or persons have commenced a tender offer or have announced an intention to seek control of the Company, during the thirty trading days preceding the earlier of the commencement of the tender offer or the making of the announcement, of a share on the composite tape for New York Stock Exchange listed shares or, if the shares are not quoted on the composite tape or not listed on the New York Stock Exchange, on the principal United States securities exchange registered under the Securities Exchange Act of 1934, as amended, on which the shares are listed or, if the shares are not listed on any such exchange, on the National Association of Securities Dealers, Inc. Automated Quotations National Market System or, if the shares are not quoted on the National Association of Securities Dealers, Inc. Automated Quotations National Market System, the average closing bid quotation, during the thirty trading days preceding the purchase of the shares in questions of a share on the National Association of Securities Dealers, Inc. Automated Quotations System or any system then in use, or if the person or persons have commenced a tender offer or have announced an intention to seek control of the issuing public corporation, during the thirty trading days preceding the earlier of the commencement of the tender offer or the making of the announcement, except that if no quotation is available the average market price is the fair market value on the date of purchase of the shares in question of a share as determined in good faith by the Board of Directors of the Company.

#### XIV. AMENDMENTS

14.01. AMENDMENT OF ARTICLES AND BYLAWS. Notwithstanding any other provision of these Bylaws, Article Fifth of the Articles (Restated As of July 29, 1988) and Sections 2.02, 3.01, and 3.13 and Articles XII, XIII, and XIV of these Bylaws shall not be altered, amended, supplemented, repealed, or temporarily or permanently suspended, in whole or in part, or replacement Bylaw provisions adopted without: (I) the affirmative vote of a majority of the directors then in office; or (ii) the affirmative vote of seventy-five percent (75%) or more of the outstanding shares of the Company entitled to vote generally.

**CERTIFICATE**

I, FAYE WIDENMANN, Vice President and Secretary of Pinnacle West Capital Corporation, an Arizona corporation, do HEREBY CERTIFY that the foregoing is a true and correct copy of the Company's Bylaws, as amended, and that they are in full force and effect as of the date hereof.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the seal of the corporation this 18th day of September 2002.

**Faye Widenmann**  
**FAYE WIDENMANN**  
**Vice President and Secretary**

**BYLAWS  
OF  
ARIZONA PUBLIC SERVICE COMPANY  
(AMENDED AS OF SEPTEMBER 18, 2002)**

**I. REFERENCES; SENIORITY**

1.01. REFERENCES. Any reference herein made to law will be deemed to refer to the law of the State of Arizona, including any applicable provision or provisions of Chapters 1-17 and Chapter 23 of Title 10, Arizona Revised Statutes (or its successor), as at any given time in effect. Any reference herein made to the Articles will be deemed to refer to the applicable provision or provisions of the Articles of Incorporation of the Company, and all amendments thereto, as at any given time on file with the Arizona Corporation Commission (this reference to that Commission being intended to include any successor to the incorporating and related functions being performed by that Commission at the date of the initial adoption of these Bylaws).

1.02. SENIORITY. Except as indicated in Part X of these Bylaws, the law and the Articles (in that order of precedence) will in all respects be considered senior and superior to these Bylaws, with any inconsistency to be resolved in favor of the law and the Articles (in that order of precedence), and with these Bylaws to be deemed automatically amended from time to time to eliminate any such inconsistency which may then exist.

1.03. SHAREHOLDERS OF RECORD. Except as otherwise required by law and subject to any procedure established by the Company pursuant to Arizona Revised Statutes Section 10-723 (or any comparable successor provision), the word "shareholder" as used herein shall mean one who is a holder of record of shares in the Company.

**II. SHAREHOLDERS MEETINGS**

2.01. ANNUAL MEETINGS. An annual meeting of shareholders shall be held for the election of directors at such date, time and place, either within or without the State of Arizona, as may be designated by resolution of the Board of Directors from time to time. Any other proper business may be transacted at the annual meeting. A special meeting may be called and held in lieu of an annual meeting pursuant to the provisions of Section 2.02 below, and the same proceedings (including the election of directors) may be conducted thereat as at a regular meeting. Any director elected at any annual meeting, or special meeting in lieu of an annual meeting, will continue in office until the election of his or her successor, subject to his or her (a) earlier resignation pursuant to Section 6.01 below, (b) removal pursuant to Section 3.12 below, or (c) death or disqualification.

2.02. SPECIAL MEETINGS. Except as otherwise required by law, special meetings of the shareholders may be held whenever and wherever called by the Chairman of the Board, the President, or a majority of the Board of Directors. A special meeting of shareholders shall also be called by the President or the Secretary at the written request of the holder or holders of not less than seventy-five percent (75%) of all outstanding votes entitled to be cast on any matter to be voted on at the meeting. Any such written request by shareholders

shall state the purpose or purposes of the proposed meeting, and business to be transacted at any such meeting shall be confined to the purposes stated in the notice thereof and to such additional matters as the chairman of the meeting may rule to be germane to such purposes.

2.03. NOTICE. Notice of any meeting of the shareholders will be given as provided by law to each shareholder entitled to vote at such meeting and, if required by law, to each other shareholder of the Company. Any such notice may be waived as provided by law.

2.04. RIGHT TO VOTE. For each meeting of the shareholders, the Board of Directors will fix in advance a record date as contemplated by law, and the shares of stock and the shareholders "entitled to vote" (as that or any similar term is herein used) at any meeting of the shareholders will be determined as of the applicable record date. If no record date is so fixed by the Board of Directors, the record date for determination of shareholders shall be as provided by law. The Secretary (or in his or her absence an Assistant Secretary) will see to the making and production of any record of shareholders entitled to vote or otherwise entitled to notice of shareholders meetings, in either case which is required by law. Any voting entitlement may be exercised through proxy, or in such other manner as specifically provided by law, in accordance with the applicable law. In the event of contest, the burden of proving the validity of any undated or irrevocable proxy will rest with the person seeking to exercise the same. A telegram, cablegram, or facsimile appearing to have been transmitted by a shareholder (or by his or her duly authorized attorney-in-fact) or other means of voting by telephone or electronic transmission may be accepted as a sufficiently written and executed proxy if otherwise permitted by law.

2.05. RIGHT TO ATTEND. Except only to the extent of persons designated by the Board of Directors or the Chairman of the meeting to assist in the conduct of the meeting (as referred to in Sections 2.07 and 2.08 below) and except as otherwise permitted by the Board or such Chairman, the persons entitled to attend any meeting of shareholders may be confined to (i) shareholders entitled to vote thereat and other shareholders entitled to notice of the meeting and (ii) the persons upon whom proxies valid for purposes of the meeting have been conferred or their duly appointed substitutes (if the related proxies confer a power of substitution); provided, however, that the Board of Directors or the Chairman of the meeting may establish rules limiting the number of persons referred to in clause (ii) as being entitled to attend on behalf of any shareholder so as to preclude such an excessively large representation of such shareholder at the meeting as, in the judgment of the Board or such Chairman, would be unfair to other shareholders represented at the meeting or be unduly disruptive of the orderly conduct of business at such meeting (whether such representation would result from fragmentation of the aggregate number of shares held by such shareholder for the purpose of conferring proxies, from the naming of an excessively large proxy delegation by such shareholder or from employment of any other device). A person otherwise entitled to attend any such meeting will cease to be so entitled if, in the judgment of the Chairman of the meeting, such person engages thereat in disorderly conduct impeding the proper conduct of the meeting in the interests of all shareholders as a group.

2.06. QUORUM. Except as otherwise provided by law, the Articles or these Bylaws, at each meeting of shareholders the presence in person or by proxy of the holders of a majority in voting power of the outstanding shares of stock



entitled to vote at the meeting shall be necessary and sufficient to constitute a quorum.

2.07. ELECTION INSPECTORS. The Board of Directors, in advance of any shareholders meeting may appoint an election inspector or inspectors to act at such meeting (and any adjournment thereof). If an election inspector or inspectors are not so appointed, the Chairman of the meeting may or, upon the request of any person entitled to vote at the meeting will, make such appointment. If any person appointed as an inspector fails to appear or to act, a substitute may be appointed by the Chairman of the meeting. If appointed, the election inspector or inspectors (acting through a majority of them if there be more than one) will determine the number of shares outstanding, the authenticity, validity and effect of proxies, the credentials of persons purporting to be shareholders or persons named or referred to in proxies, and the number of shares represented at the meeting in person and by proxy; they will receive and count votes, ballots and consents and announce the results thereof; they will hear and determine all challenges and questions pertaining to proxies and voting; and, in general, they will perform such acts as may be proper to conduct elections and voting with complete fairness to all shareholders. No such election inspector need be a shareholder of the Company.

2.08. ORGANIZATION AND CONDUCT OF MEETINGS. Each shareholders meeting will be called to order and thereafter chaired by the Chairman of the Board if there then is one; or, if not, or if the Chairman of the Board is absent or so requests, then by the President; or if both the Chairman of the Board and the President are unavailable, then by such other officer of the Company or such shareholder as may be appointed by the Board of Directors. The Secretary (or in his or her absence an Assistant Secretary) of the Company will act as secretary of each shareholders meeting; if neither the Secretary nor an Assistant Secretary is in attendance, the Chairman of the meeting may appoint any person (whether a shareholder or not) to act as secretary thereat. After calling a meeting to order, the Chairman thereof may require the registration of all shareholders intending to vote in person, and the filing of all proxies, with the election inspector or inspectors, if one or more have been appointed (or, if not, with the secretary of the meeting). After the announced time for such filing of proxies has ended, no further proxies or changes, substitutions or revocations of proxies will be accepted. If directors are to be elected, a tabulation of the proxies so filed will, if any person entitled to vote in such election so requests, be announced at the meeting (or adjournment thereof) prior to the closing of the election polls.

Absent a showing of bad faith on his or her part, the Chairman of a meeting will, among other things, have absolute authority to determine the order of business to be conducted at such meeting and to establish rules for, and appoint personnel to assist in, preserving the orderly conduct of the business of the meeting (including any informal, or question and answer, portions thereof). Rules, regulations or procedures regarding the conduct of the business of a meeting, whether adopted by the Board of Directors or prescribed by the Chairman of the meeting, may include, without limitation, the following: (i) the establishment of an agenda or order of business for the meeting; (ii) rules and procedures for maintaining order at the meeting and the safety of those present; (iii) limitations on attendance at or participation in the meeting to shareholders of record of the Company, their duly authorized and constituted proxies (subject to Section 2.05) or such other persons as the Chairman of the meeting shall determine; (iv) restrictions on entry to the meeting after the time fixed for the commencement thereof; and (v) limitations on the time

allotted to questions or comments by participants. Unless and to the extent determined by the Board of Directors or the Chairman of the meeting, meetings of shareholders shall not be required to be held in accordance with the rules of parliamentary procedure. Any informational or other informal session of shareholders conducted under the auspices of the Company after the conclusion of or otherwise in conjunction with any formal business meeting of the shareholders will be chaired by the same person who chairs the formal meeting, and the foregoing authority on his or her part will extend to the conduct of such informal session.

2.09. VOTING. The number of shares voted on any matter submitted to the shareholders which is required to constitute their action thereon or approval thereof will be determined in accordance with applicable law, the Articles, and these Bylaws, if applicable. No ballot or change of vote will be accepted after the polls have been declared closed following the ending of the announced time for voting.

2.10. SHAREHOLDER APPROVAL OR RATIFICATION. The Board of Directors may submit any contract or act for approval or ratification at any duly constituted meeting of the shareholders, the notice of which either includes mention of the proposed submittal or is waived as provided in Section 2.03 above. Except as otherwise required by law (e.g., Arizona Revised Statutes Section 10-863), if any contract or act so submitted is approved or ratified by a majority of the votes cast thereon at such meeting, the same will be valid and as binding upon the Company and all of its shareholders as it would be if approved and ratified by each and every shareholder of the Company.

2.11. ADJOURNMENTS. Any meeting of shareholders, annual or special, may adjourn from time to time to reconvene at the same or some other place, and notice need not be given of any such adjourned meeting if the time and place thereof are announced at the meeting at which the adjournment is taken. At the adjourned meeting the Company may transact any business that might have been transacted at the original meeting. If the adjournment is for more than one hundred and twenty days, or if after the adjournment a new record date is fixed for the adjourned meeting, notice of the adjourned meeting shall be given to each shareholder of record entitled to vote at the meeting.

2.12. SHAREHOLDER ACTION BY WRITTEN CONSENT. Any action required or permitted to be taken at a meeting of the shareholders may be taken without a meeting if one (1) or more consents in writing, setting forth the action so taken, shall be signed by all of the shareholders entitled to vote with respect to the subject matter thereof. The consents shall be delivered to the Company for inclusion in the minutes or filing with the Company's records. Action taken by consent is effective when the last shareholder signs the consent, unless the consent specifies a different effective date, except that if, by law, the action to be taken requires that notice be given to shareholders who are not entitled to vote on the matter, the effective date shall not be prior to ten (10) days after the Company shall give such shareholders written notice of the proposed action, which notice shall contain or be accompanied by the same material that would have been required if a formal meeting had been called to consider the action. A consent signed under this section has the effect of a meeting vote and may be described as such in any document.

### III. BOARD OF DIRECTORS

3.01. **MEMBERSHIP AND QUALIFICATION.** The Board of Directors will have the exclusive power to increase or decrease its size within the limits fixed in the Articles (Art. Fifth). Any vacancy occurring in the Board, whether by reason of death, resignation, disqualification or otherwise, may be filled by the directors as contemplated by law and as provided in the Articles (Art. Fifth). Any such increase in the size of the Board, and the filling of any vacancy created thereby, will require action by a majority of the whole membership of the Board as comprised immediately before such increase. A person will not qualify for election or appointment as a director, whether initially or on re-election and whether by the shareholders at their annual meeting or by the Board of Directors as contemplated in this Section 3.01, if such person's 70th birthday occurs on or has occurred before the date of such election, appointment or re-election. A person who has been a full-time employee of the Company within twelve months prior to the date of any election will not qualify for election as a director on that date unless he or she then remains a full-time employee of the Company or unless the Board of Directors specifically authorizes the election of such person (but it is not intended that any such authorization will extend a person's service on the Board beyond the age limitation set out in the preceding sentence). A person who has qualified by age or employment status for his or her most recent election as a director may serve throughout the term for which such person was elected, notwithstanding the occurrence of his or her 70th birthday or cessation of full-time employment by the Company between the date of such election and the end of such term, subject, however, to his or her otherwise remaining qualified for such office.

3.02. **REGULAR MEETINGS.** A regular annual meeting of the directors is to be held as soon as practicable after the adjournment of each annual shareholders meeting either at the place of the shareholders meeting or at such other place as the directors elected at the shareholders meeting may have been informed of at or before the time of their election. Regular meetings, other than the annual ones, may be held at such intervals at such places and at such times as the Board of Directors may provide.

3.03. **SPECIAL MEETINGS.** Special meetings of the Board of Directors may be held whenever and wherever called for by the Chairman of the Board, the President or the number of directors which would be required to constitute a quorum.

3.04. **NOTICE.** No notice need be given of regular meetings of the Board of Directors. Notice of the time and place (but not necessarily the purpose or all of the purposes) of any special meeting will be given to each director in person or by telephone, or via mail, telegram, facsimile, or other electronic transmission addressed in the manner appearing on the Company's records. Notice to any director of any such special meeting will be deemed given sufficiently in advance when (i) if given by mail, the same is deposited in the United States mail at least four days before the meeting date, with postage thereon prepaid, (ii) if given by telegram, the same is delivered to the telegraph office for fast transmittal at least 48 hours prior to the convening of the meeting, (iii) if given by facsimile or other electronic transmission, the same is received by the director or an adult member of his or her office staff or household, at least 24 hours prior to the convening of the meeting, or (iv) if personally delivered or given by telephone, the same is handed, or the substance thereof is communicated over the telephone to the director or to an adult member of his or her office staff or household, at least 24 hours prior to the convening of the

meeting. Any such notice may be waived as provided by law. No call or notice of a meeting of directors will be necessary if each of them waives the same in writing or by attendance. Any meeting, once properly called and noticed (or as to which call and notice have been waived as aforesaid) and at which a quorum is formed, may be adjourned to another time and place by a majority of those in attendance.

3.05. QUORUM; VOTING. A quorum for the transaction of business at any meeting or adjourned meeting of the directors will consist of a majority of those then in office. Any matter submitted to a meeting of the directors will be resolved by a majority of the votes cast thereon, except as otherwise required by these Bylaws (ss. 3.01 above and ss. 3.06 below), by law or by any applicable Article. However, in case of an equality of votes, the Chairman of the meeting will have a second or deciding vote. Where action by a majority of the whole membership is required, such requirement will be deemed to relate to a majority of the directors in office at the time the action is taken. In computing any such majority, whether for purposes of determining the presence of a quorum or the adequacy of the vote on any proposed action, any unfilled vacancies at the time existing in the membership of the Board will be excluded from the computation.

3.06. EXECUTIVE COMMITTEE. The Board of Directors may, by resolution adopted by a majority of the whole Board, name three or more of its members as an Executive Committee. Such Executive Committee will have and may exercise the powers of the Board of Directors in the management of the business and affairs of the Company while the Board is not in session, except only as precluded by law or where action other than by a majority of the votes cast is required by these Bylaws, or the law (all as referred to in Section 3.05 above), and subject to such limitations as may be included in any applicable resolution passed by a majority of the whole membership of the Board. A majority of those named to the Executive Committee will constitute a quorum.

3.07. OTHER COMMITTEES. The Board of Directors may designate one or more additional committees, each committee to consist of one or more of the directors of the Company. The Board of Directors may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. Any such committee, to the extent permitted by law and to the extent provided in the resolution of the Board of Directors, shall have and may exercise all the powers and authority of the Board of Directors in the management of the business and affairs of the Company, and may authorize the seal of the Company to be affixed to all papers that may require it.

3.08. COMMITTEE FUNCTIONING. Notice requirements (and related waiver provisions) for meetings of the Executive Committee and other committees of the Board will be the same as those set forth in Section 3.04 above for meetings of the Board of Directors. Except as provided in the next two succeeding sentences, a majority of those named to the Executive Committee or any other committee of the Board will constitute a quorum at any meeting thereof (with the effect of departure of committee members from a meeting and the computation of a majority of committee members to be in accordance with the applicable policies of Section 3.05 above), and any matter submitted to a meeting of any such committee will be resolved by a majority of the votes cast thereon. No distinction will be made among ex-officio or other members of any such committee for quorum, voting or other purposes, except that the membership of any committee (including the

Executive Committee), in performing any function vested in it as herein contemplated, may be deemed to exclude any officer or employee of the Company, in either case, or other person, having a direct or indirect personal interest in any proposed exercise of such function, whose exclusion for that purpose is deemed appropriate by a majority of the other members of such committee proposing to perform such function. All committees are to keep regular minutes of the transactions of their meetings.

3.09. ACTION BY TELEPHONE OR CONSENT. Any meeting of the Board or any committee thereof may be held by conference telephone or similar communications equipment as permitted by law in which case any required notice of such meeting may generally describe the arrangements (rather than the place) for the holding thereof, and all other provisions herein contained or referred to will apply to such meeting as though it were physically held at a single place. Action may also be taken by the Board or any committee thereof without a meeting if the members thereof consent in writing thereto as contemplated by law.

3.10. PRESUMPTION OF ASSENT. A director of the Company who is present at a meeting of the Board of Directors, or of any committee when corporate action is taken is deemed to have assented to the action taken unless either (i) the director objects at the beginning of the meeting or promptly on the director's arrival to holding it or transacting business at the meeting; (ii) the director's dissent or abstention from the action taken is entered in the minutes of the meeting; or (iii) the director delivers written notice of the director's dissent or abstention to the presiding officer of the meeting before its adjournment or to the Company before 5:00 P.M. on the next business day after the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

3.11. COMPENSATION. By resolution of the Board, the directors may be paid their expenses, if any, of attendance at each meeting of the Board of Directors, or of any committee, and may be paid a fixed sum for attendance at each such meeting and/or a stated salary as a director or committee member. No such payment will preclude any director from serving the Company in any other capacity and receiving compensation therefor.

3.12. REMOVAL. Any director or the entire Board of Directors may be removed with or without cause, only at a special meeting of shareholders called for that purpose, by the affirmative vote of sixty-six and two-thirds percent (66 2/3%) of the issued and outstanding shares of stock then entitled to vote on the election of directors, except that if less than the entire Board of Directors is to be removed, no one of the directors may be removed if the votes cast against the director's removal would be sufficient to elect the director if then cumulatively voted at an election for the class of directors of which the director is a part.

#### IV. OFFICERS - GENERAL

4.01. ELECTIONS AND APPOINTMENTS. The directors may elect or appoint one or more of the officers of the Company contemplated in Part V below. Any such election or appointment will regularly take place at the annual meeting of the directors, but elections of officers may be held at any other meeting of the Board. A person elected or appointed to any office will continue to hold that office until the election or appointment of his or her successor, subject to action earlier taken pursuant to Section 4.04 or 6.01 below. Any person may hold more than one office.

4.02. **ADDITIONAL APPOINTMENTS.** In addition to the officers contemplated in Part V below, the Board of Directors may create other corporate positions, and appoint persons thereto, with such authority to perform such duties as may be prescribed from time to time by the Board of Directors, by the President or by the superior officer of any person so appointed. Notwithstanding such additional appointments, only those persons whose offices are described in Part V are to be considered an officer of the Company unless the resolution or other Board action appointing such person expressly states that such person is to be considered an officer of the Company. Each of such persons (in the order designated by the Board or the superior officer of such person) will be vested with all of the powers and charged with all of the duties of his or her superior officer in the event of such superior officer's absence or disability.

4.03. **BONDS AND OTHER REQUIREMENTS.** The Board of Directors may require any officer or other appointee to give bond to the Company (with sufficient surety, and conditioned upon the faithful performance of the duties of his or her office or position) and to comply with such other conditions as may from time to time be required of him or her by the Board.

4.04. **REMOVAL OR DELEGATION.** Provided that a majority of the whole membership thereof concurs therein, the Board of Directors may remove any officer of the Company as provided by law and declare his or her office or offices vacant or abolished or, in the case of the absence or disability of any officer or for any other reason considered sufficient, may temporarily delegate his or her powers and duties to any other officer or to any director. Similar action may be taken by the Board of Directors in regard to appointees designated pursuant to Section 4.02 above.

4.05. **SALARIES.** Officer salaries may from time to time be fixed by the Board of Directors or (except as to his or her own) be left to the discretion of the Chief Executive Officer or the President. No officer will be prevented from receiving a salary by reason of the fact that he or she is also a director of the Company.

## **V. SPECIFIC OFFICERS, FUNCTIONS AND POWERS**

5.01. **CHAIRMAN OF THE BOARD.** The Board of Directors may elect a Chairman to serve as a general executive officer of the Company and, if specifically designated as such by the Board, as the Chief Executive Officer of the Company. If elected, the Chairman will preside at all meetings of the directors and be vested with such other powers and duties as the Board may from time to time delegate to him or her.

5.02. **CHIEF EXECUTIVE OFFICER.** Subject to the control of the Board of Directors exercised as hereinafter provided, the Chief Executive Officer of the Company will supervise its business and affairs and the performance of their respective duties by all other officers, by appointees designated pursuant to Section 4.02 above, and by such additional appointees to such additional positions (corporate, divisional or otherwise) as the Chief Executive Officer may designate, with authority on his or her part to delegate the foregoing duty of supervision to such extent and to such person or persons as may be determined by the Chief Executive Officer. Except as otherwise indicated from time to time by resolution of the Board of Directors, its management of the business and affairs of the Company will be implemented through the office of the Chief Executive Officer.

5.03. **PRESIDENT AND VICE PRESIDENTS.** Unless specified to the contrary by resolution of the Board of Directors, the President will be the Chief Executive Officer of the Company. In addition to the supervisory functions above set forth on the part of the Chief Executive Officer or in lieu thereof if a contrary specification is made by the Board relative to the Chief Executive Officer, the President will be vested with such powers and duties as the Board may from time to time designate. Vice Presidents may be elected by the Board of Directors to perform such duties as may be designated by the Board or be assigned or delegated to them by their respective superior officers. The Board may identify (i) one or more Vice Presidents as "Executive" or "Senior" Vice Presidents and (ii) the President or any Vice President as "General Manager" of the Company and the title of any Vice President may include words indicative of his or her particular area of responsibility and authority. Vice Presidents will succeed to the responsibilities and authority of the President, in the event of his or her absence or disability, in the order consistent with their respective titles or regular duties or as specifically designated by the Board of Directors.

5.04. **TREASURER AND SECRETARY.** The Treasurer and Secretary each will perform all such duties normally associated with his or her office (including, in the case of the Secretary, the giving of notice and the preparation and retention of minutes of corporate proceedings and the custody of corporate records and the seal of the Company) as are not assigned to a Vice President of the Company, along with such other duties as may be designated by the Board or be assigned or delegated to them by their respective superior officers. The Board may appoint one or more Assistant Treasurers or Assistant Secretaries, each of whom (in the order designated by the Board or their respective superior officers) will be vested with all of the powers and charged with all of the duties of the Treasurer or the Secretary (as the case may be) in the event of his or her absence or disability.

5.05. **SPECIFIC POWERS.** Except as may otherwise be specifically provided in a resolution of the Board of Directors, any of the officers referred to in this Part V will be a proper officer to authenticate records of the Company and to sign on behalf of the Company any deed, bill of sale, assignment, option, mortgage, pledge, note, bond, debenture, evidence of indebtedness, application, consent (to service of process or otherwise), agreement, indenture or other instrument of importance to the Company. Any such officer may represent the Company at any meeting of the shareholders or members of any corporation, association, partnership, joint venture or other entity in which this Company then has an interest, and may vote such interest in person or by proxy appointed by him or her, provided that the Board of Directors may from time to time confer the foregoing authority upon any other person or persons.

## VI. RESIGNATIONS AND VACANCIES

6.01. **RESIGNATIONS.** Any director, committee member or officer may resign from his or her office at any time by written notice as specified in accordance with Arizona Revised Statutes Sections 10-807 and 10-843. The acceptance of a resignation will not be required to make it effective.

6.02. **VACANCIES.** If the office of any director, committee member or officer becomes vacant by reason of his or her death, resignation, disqualification, removal or otherwise, the Board of Directors may choose a successor to hold office for the unexpired term.

## VII. INDEMNIFICATION AND RATIFICATION

7.01. INDEMNIFICATION. In order to induce qualified persons to serve the Company (and any other corporation, joint venture, partnership, trust or other enterprise at the request of the Company) as directors and officers, the Company shall indemnify any and all of its directors and officers, or former directors and officers to the fullest extent permitted by applicable law as it presently exists or may hereafter be amended.

7.02. RATIFICATION; SPECIAL COMMITTEE. Any transaction involving the Company, any of its subsidiary corporations or any of its directors, officers, employees or agents which at any time is questioned in any manner or context (including a shareholders derivative suit), on the ground of lack of authority, conflict of interest, misleading or omitted statement of fact or law, nondisclosure, miscalculation, improper principles or practices of accounting, inadequate records, defective or irregular execution or any similar ground, may be investigated and/or ratified (before or after judgment), or an election may be made not to institute or pursue a claim or legal proceedings on account thereof or to accept or approve a negotiated settlement with respect thereto (before or after the institution of legal proceedings), by the Board of Directors or by a special committee thereof comprised of one or more disinterested directors (that is, a director or directors who did not participate in the questioned transaction with actual knowledge of the questioned aspect or aspects thereof). Such a special committee may be validly formed and fully empowered to act, in accordance with the purposes and duties assigned thereto, by resolution or resolutions of the Board of Directors, notwithstanding (i) the inclusion of Board members who are not disinterested as aforesaid among those who form a quorum at the meeting or meetings at which one or more members of such special committee are elected or appointed to the Board or to such special committee or at which such committee is formed or empowered, or their inclusion among the directors who vote upon or otherwise participate in taking any of the foregoing actions, or (ii) the taking of any of such actions by the disinterested members of the Board (or a majority of such members) whose number is not sufficient to constitute a quorum or a majority of the membership of the full Board. Any such special committee so comprised will, to the full extent consistent with its purposes and duties as expressed in such resolution or resolutions, have all of the authority and powers of the full Board and its Executive Committee (the same as though it were the full Board and/or its Executive Committee in carrying out such purposes and duties) and will function in accordance with Section 3.08 above. No other provisions of these Bylaws which may at any time appear to conflict with any provisions of this Section 7.02, and no defect or irregularity in the formation, empowering or functioning of any such special committee, will serve to impede, impair or bring into question any action taken or purported to be taken by such committee or the validity of any such action. Any ratification of a transaction pursuant to this Section 7.02 will have the same force and effect as if the transaction has been duly authorized originally. Any such ratification, and any election made pursuant to this Section 7.02 with respect to claims, legal proceedings or settlements, will be binding upon the Company and its shareholders and will constitute a bar to any claim or the execution of any judgment in respect of the transaction involved in such ratification or election.

## VIII. SEAL

8.01. FORM THEREOF. The seal of the Company will have inscribed thereon the name of the Company, the state and year of its incorporation and the words "SEAL".



## IX. STOCK CERTIFICATES

9.01. FORM THEREOF. Each certificate representing stock of the Company will be in such form conforming to law as may from time to time be approved by the Board of Directors, and will bear the manual facsimile signatures and seal of the Company as required or permitted by law.

9.02. OWNERSHIP. The Company will be entitled to treat the registered owner of any share as the absolute owner thereof and accordingly, will not be bound to recognize any beneficial, equitable or other claim to, or interest in, such share on the part of any other person, whether or not it has notice thereof, except as may expressly be provided by Chapter 8 of Title 47, Arizona Revised Statutes (or its successor), as at the time in effect, or other applicable law.

9.03. TRANSFERS. Transfer of stock will be made on the books of the Company only upon surrender of the certificate therefor, duly endorsed by an appropriate person, with such assurance of the genuineness and effectiveness of the endorsement as the Company may require, all as contemplated by Chapter 8 of Title 47, Arizona Revised Statutes (or its successor), as at the time in effect, and/or upon submission of any affidavit, other document or notice which the Company considers necessary.

9.04. LOST CERTIFICATES. In the event of the loss, theft or destruction of any certificate representing capital stock of this Company, the Company may issue (or, in the case of any such stock as to which a transfer agent and/or registrar have been appointed, may direct such transfer agent and/or registrar to countersign, register and issue) a replacement certificate in lieu of that alleged to be lost, stolen or destroyed, and cause the same to be delivered to the owner of the stock represented thereby, provided that the owner shall have submitted such evidence showing the circumstances of the alleged loss, theft or destruction, and his or her ownership of the certificate as the Company considers satisfactory, together with any other factors which the Company considers pertinent, and further provided that an indemnity agreement and/or indemnity bond shall have been provided in form and amount satisfactory to the Company and to its transfer agent and/or registrar, if applicable.

## X. EMERGENCY BYLAWS

10.01. EMERGENCY CONDITIONS. The emergency Bylaws provided in this Part X will be effective in the event of an emergency as prescribed in Arizona Revised Statutes Section 10-207.D. To the extent not inconsistent with the provisions of this Part X, these Bylaws will remain in effect during such emergency and upon its termination these emergency Bylaws will cease to be operative.

10.02. BOARD MEETINGS. During any such emergency, a meeting of the Board of Directors or any of its committees may be called by any officer or director of the Company. Notice of the time and place of the meeting will be given by the person calling the same to those of the directors whom it may be feasible to reach by any available means of communication. Such notice will be given so much in advance of the meeting as circumstances permit in the judgment of the person calling the same. At any Board or committee meeting held during any such emergency, a quorum will consist of a majority of those who could reasonably be expected to attend the meeting if they were willing to do so, but in no event

more than a majority of those to whom notice of such meeting is required to have been given as above provided.

10.03. CERTAIN ACTIONS. The Board of Directors, either before or during any such emergency, may provide and from time to time modify lines of succession in the event that during such an emergency any or all officers, appointees, employees or agents of the Company are for any reason rendered incapable of discharging their duties. The Board, either before or during any such emergency, may, effective in the emergency, change the head office or designate several alternative head offices of the Company, or authorize the officers to do so.

10.04. LIABILITY. No director, officer, appointee, employee or agent acting in accordance with these emergency Bylaws will be liable except for willful misconduct.

10.05. MODIFICATIONS. These emergency Bylaws will be subject to repeal or change by further action of the Board of Directors, but no such repeal or change will modify the provisions of Section 10.04 with respect to action taken prior to the time of such repeal or change. Any amendment of these emergency Bylaws may make any further or different provisions that may be practical and necessary for the circumstances of the emergency.

## XI. DIVIDENDS

11.01. DECLARATION. Subject to such restrictions or requirements as may be imposed by law or the Company's Articles or as may otherwise be binding upon the Company, the Board of Directors may from time to time declare dividends on stock of the Company outstanding on the dates of record fixed by the Board, to be paid in cash, in property or in shares of the Company's stock on or as of such payment or distribution dates as the Board may prescribe.

## XII. AMENDMENTS

12.01. PROCEDURE. These Bylaws may be amended, supplemented, repealed or temporarily or permanently suspended, in whole or in part, or new bylaws may be adopted, at any duly constituted meeting of the Board of Directors, the notice of which meeting either includes mention of the proposed action relative to the Bylaws or is waived as provided in Section 3.04 above. If, however, the chairman of any such meeting or a majority of directors in attendance thereat in good faith determines that any such action has arisen as a matter of necessity at the meeting and is otherwise proper, no notice of such action will be required.

12.02. AMENDMENT OF BYLAWS. Notwithstanding any other provision of these Bylaws, Sections 2.02, 3.01, and 3.12 and Article XII of these Bylaws shall not be altered, amended, supplemented, repealed, or temporarily or permanently suspended, in whole or in part, or replacement Bylaw provisions adopted without:

(i) the affirmative vote of a majority of the directors then in office; and (ii) the affirmative vote of seventy-five percent (75%) or more of the outstanding shares of the Company entitled to vote generally.

**CERTIFICATE**

I, FAYE WIDENMANN, Vice President and Secretary of ARIZONA PUBLIC SERVICE COMPANY, an Arizona corporation, do HEREBY CERTIFY that the foregoing is a true and correct copy of the Company's Bylaws, as amended and that such Bylaws, as amended, are in full force and effect as of the date hereof.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed the seal of said corporation as of this 18th day of September, 2002.

**Faye Widenmann**  
**FAYE WIDENMANN**  
**Vice President and Secretary**

## EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT executed this 11 day of October, 2002, and effective as of October 1, 2002, by and between ARIZONA PUBLIC SERVICE COMPANY, an Arizona corporation (hereinafter referred to as the "Company" or "Employer") and JAMES M. LEVINE (hereinafter referred to as the "Employee");

### RECITALS

- A. The Company desires to employ Employee in the position of Executive Vice President APS Generation.
- B. The Company desires to insure, insofar as possible, that it will continue to have the benefit of the Employee's services over the Employment Term and to protect its confidential information and good will.
- C. Employer is engaged in the business of generation, construction, and acquisition of electrical power, and the transmission and distribution of electrical power.

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants and agreements hereinafter set forth, the parties hereto mutually covenant and agree as follows:

### AGREEMENTS

- 1. TITLE. The Company does hereby employ the Employee as Executive Vice President APS Generation, and the Employee does hereby accept and agree to such employment.
- 2. EMPLOYMENT TERM.
  - (a) The Employee shall be employed by the Company in the position set forth in Section 1 for a five (5) year period commencing on October 1, 2002 and ending on October 1, 2007 (the "Employment Term").
  - (b) The parties may renew this Employment Agreement for additional periods on mutually acceptable terms and conditions, but neither the Company nor the Employee is under any obligation to agree to such extensions.
  - (c) In the event of a "Change of Control" [as defined in the Employee's Key Executive Employment Severance Agreement ("KEESA")] the terms of the KEESA are controlling.
- 3. COMPENSATION. Employer agrees to pay Employee an annual salary in the amount of \$550,000.00.
- 4. BONUSES AND OTHER COMPENSATION.

All incentive plans are subject to change or termination at the Board of Director's sole discretion.

(a) INCENTIVE PAY. Employer agrees to award Employee an incentive bonus of up to 60% of base salary with a target level of 40% of base salary under the Officer Incentive Plan if corporate, departmental and individual targets are met, all in accordance with the terms of that Plan.

(b) PERFORMANCE SHARES AND STOCK OPTIONS. Employer agrees to request the Human Resources Committee ("the Committee") to grant Employee Performance Shares in an amount equivalent to 65% - 85% of the amount awarded to a member of the Office of the President under the Stock Incentive Plan. The Employer also agrees to request the Committee to grant Performance Accelerated Stock Options under the Stock Incentive Plan equal to five times the number of Performance Shares granted under this Paragraph (b).

(c) ADDITIONAL PERFORMANCE SHARES. In addition to (b) above, Employer agrees to request the Committee to grant Employee 2000 Performance Shares each year under the 2002 Stock Incentive Plan (the "2002 Plan") without any matching requirement, all in accordance with the terms of the 2002 Plan and as previously agreed upon by the parties.

(d) PENSION. Employee's pension benefit that was agreed upon effective January 1, 2002 will remain the same.

(e) OTHER PAYMENTS.

i. Employee is eligible for incentive payments based on Palo Verde Nuclear Generating Station maintenance of specified federal and nuclear oversight program ratings, nuclear safety, and for successful outage results.

ii. The Company agrees to pay for a Country Club membership for Employee's use. The Company will purchase the membership and Employee will assume payment of the monthly dues.

## 5. BENEFITS AND OBLIGATIONS.

(a) The Employee shall be included to the extent eligible in any and all plans providing general benefits to the Company's employees and which shall be made available on the same terms and conditions as to other employees of comparable status and position.

(b) The Employee agrees that if, during the Employment Period, the Company terminates his employment or he voluntarily quits, the Employee shall not, for a period commencing on the date of termination and ending after one (1) year, (i) directly own, manage, operate, control, be employed by, participate in, finance, consult, advise, or be connected in any manner whatsoever with the ownership, management, operation, control or financing of any business, person, corporation, partnership, or other entity which directly or indirectly engages in electric power generation, in competition with the Company, or (ii) engage in any other activity involving competition with the Company in the foregoing industry without the prior written approval of the Company's Board of Directors; provided, however, that nothing in this Section shall prohibit the Employee from owning stock or other securities of a competitor amounting to less than twenty

percent (20%) of the stated capital of such competitor. For purposes of this provision, if a Court of competent jurisdiction should rule that a one (1) year period is unenforceable then the period shall be six (6) months.

(c) The Employee covenants and agrees, during the Employee's employment by the Company and following his Termination Date, to hold in strict confidence any and all information in the Employee's possession as a result of the Employee's employment; provided that nothing in this Employment Agreement shall be construed to prohibit the Employee from reporting or disclosing any suspected instance of illegal activity of any nature, any nuclear safety concerns, any workplace safety concerns or any public safety concerns to the United States Nuclear Regulatory Commission ("NRC"), United States Department of Labor ("DOL"), or any federal, state, or local governmental agency or court. This Employment Agreement shall not be construed to prohibit the Employee from providing information to the NRC, DOL, or any other federal or state governmental agency or governmental officials, or testifying in any civil or criminal proceedings, even if such information or testimony being provided relates to the claims or matters covered by this Employment Agreement. This Employment Agreement shall not be construed as a waiver or withdrawal of any safety concerns which Employee has or may have reported to the NRC or DOL, or withdrawal of any participation by Employee in any NRC or DOL proceedings. Notwithstanding anything to the contrary in this paragraph, Employee hereby waives and releases any right to receive any relief as a result of Employee's participation in any investigation or proceeding of the NRC, DOL, or any federal, state or local government agency or court.

6. **TERMINATION.** This Employment Agreement shall automatically terminate on the expiration of the initial Employment Term described in Section 2(a) without any notice from either party, unless the parties mutually agree to extend this Employment Agreement in writing for additional periods of time. The Company retains the right to terminate this Agreement for cause at any time prior to the expiration of the Employment Term.

7. **ARBITRATION.** All claims, disputes and other matters in question between the parties arising under this Employment Agreement, other than Sections 5(b) and (c) which may be enforced by the Company through injunctive relief, shall be decided by arbitration in accordance with the rules of the American Arbitration Association, unless the parties mutually agree otherwise. Such arbitration shall take place in Phoenix, Arizona. The Company shall pay the cost of such arbitration. The award by the arbitrator shall be final, and judgment may be entered upon it in accordance with applicable law in any state or Federal court having jurisdiction thereof.

8. **SEVERABILITY.** In the event that a court of competent jurisdiction determines that any portion of this Employment Agreement is in violation of any statute or public policy, then only the portions of this Employment Agreement which violate such statute or public policy shall be stricken. All portions of this Employment Agreement which do not violate any statute or public policy shall continue in full force and effect. Further, any court order striking any portion of this Employment Agreement shall modify the stricken terms as narrowly as possible to give as much effect as possible to the intentions of the parties under this Employment Agreement.

9. GOVERNING LAW. This Employment Agreement shall be governed in all respects, whether as to validity, construction, capacity, performance, or otherwise, by the laws of the State of Arizona, and no action involving this Employment Agreement may be brought except in the Superior Court for the State of Arizona or the Federal District Court for the District of Arizona, subject to Section 7.

10. AMENDMENT OR TERMINATION. This Employment Agreement and the KEESA embody the entire agreement of the parties respecting the matters within its scope and may be modified only in writing.

11. ASSIGNMENT. This Agreement may be assigned by Employer and shall be fully binding on any such assignee and shall not be assignable by Employee.

IN WITNESS WHEREOF, the parties have executed this Agreement.

**ARIZONA PUBLIC SERVICE COMPANY**

By: William J. Post

William J. Post Pinnacle West Capital Corporation Its Chief Executive Officer and Chairman of the Board Date: 10-11-02

**EMPLOYEE**  
**James M. Levine**

James M. Levine Date: 10-11-02





**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 quarterly period ended September 30, 2002 (the "September 2002 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 September 2002 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: November 14, 2002

**FORM OF CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**  
(MICHAEL V. PALMERI)

I, Michael V. Palmeri, Vice President, Finance, 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 quarterly period ended September 30, 2002 (the "September 2002 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 September 2002 Form 10-Q Report fairly presents, in all material respects, the financial condition and results of operations of Pinnacle West.

**Michael V. Palmeri**

Michael V. Palmeri Vice President, Finance

Date: November 14, 2002

## **RISK FACTORS**

### **THE DEBT SECURITIES WILL BE STRUCTURALLY SUBORDINATED TO THE DEBT**

#### **SECURITIES AND OTHER OBLIGATIONS OF OUR SUBSIDIARIES.**

Because we are structured as a holding company, all existing and future debt and other liabilities of our subsidiaries will be effectively senior in right of payment to our debt securities. Neither of the indentures under which we may issue debt securities limits our ability or the ability of our subsidiaries to incur additional debt in the future. The assets and cash flows of our subsidiaries will be available, in the first instance, to service their own debt and other obligations. Our ability to have the benefit of their assets and cash flows, particularly in the case of any insolvency or financial distress affecting our subsidiaries, would arise only through our equity ownership interests in our subsidiaries and only after their creditors have been satisfied.

#### **THE CONSTRUCTION COSTS OF THE GENERATION FACILITIES OF PINNACLE WEST ENERGY CORPORATION ("PINNACLE WEST ENERGY") COULD NEGATIVELY IMPACT OUR RESULTS OF OPERATIONS.**

Pinnacle West Energy, another one of our wholly-owned subsidiaries, has completed or has under construction about 1,700 MW of natural gas-fired generating capacity at an estimated cost of about \$1 billion. In addition, Pinnacle West Energy has begun construction of the 570 MW Silverhawk plant in Nevada at an estimated cost of approximately \$400 million. Finally, Pinnacle West Energy has announced plans to build approximately 1,000 MW of capacity at Redhawk Units 3 and 4 at an estimated cost of approximately \$500 million. The Company is evaluating whether to construct Redhawk Units 3. Pinnacle West Energy has procured four gas turbines for Redhawk Units 3 and 4. The cancellation cost for these turbines is approximately \$50 million until September 2003. Pinnacle West Energy's expansion plans will be sized to meet cash flow and market conditions.

Pinnacle West Energy is currently funding its capital requirements through capital infusions from us. We finance those infusions through debt financings and internally generated cash. We financed Pinnacle West Energy's generation expansion program premised upon Pinnacle West Energy's receipt of APS' generation assets by the end of 2002, as previously required by the Arizona Corporation Commission's ("ACC") electric competition rules and the 1999 settlement agreement. As a result of recent ACC actions prohibiting APS from transferring its generation assets, APS filed an application with the ACC requesting the ACC to allow APS to borrow up to \$500 million and to lend the proceeds to Pinnacle West Energy or to us; to guarantee up to \$500 million of Pinnacle West Energy's or our debt, or a combination of both, not to exceed \$500 million in the aggregate. On November 8, 2002 APS filed an Interim Financing Application with the ACC requesting the ACC 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.

The ACC's reversal of the generation asset transfer requirement results in Pinnacle West Energy being unable to obtain investment grade credit ratings. This, in turn, precludes Pinnacle West Energy from accessing capital markets to refinance the bridge financing provided by us to fund the construction of Pinnacle West Energy generation assets or from effectively competing in the wholesale markets. Our credit ratings could be adversely affected if Pinnacle West Energy is unable to finance its capital requirements. On November 4, 2002 Standard and Poor's Corporation lowered the Company's senior unsecured debt rating from BBB to BBB-. See the following two Risk Factors.

**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 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 preceding and following Risk Factors.

**ANY 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 from letters of credit or cash 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. See the preceding two Risk Factors.

**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 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. We employ 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 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 and nuclear decommissioning funds also have risks associated with changing market values of equity investments. Pension and nuclear decommissioning costs are recovered in regulated electricity prices.

**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 Securities and Exchange Commission ("SEC").

APS, our wholly-owned electric utility 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. 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 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.

The Federal Energy Regulatory Commission ("FERC"), the Nuclear Regulatory Commission ("NRC"), the Environmental Protection Agency ("EPA"), and the 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 are unable to predict the impact on our business and operating results from future regulatory activities of these federal, state and local agencies. Changes in regulations or the imposition of additional regulations could have a negative impact on our business and results of operations.

**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 and the unbundling of regulated energy 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 a 1999 settlement agreement among APS and various parties, 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. On 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 further established a requirement that APS competitively procure, at a minimum, any power required for its retail customers that APS cannot produce from its existing generating assets. The ACC ordered the ACC staff and interested parties to develop a competitive procurement process by March 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. These matters are discussed in detail in the documents filed by us with the SEC.

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 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 RTOs. 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. In its order, the FERC also stated that its approval of various WestConnect provisions addressed in the order would not be overturned or affected by the final rule the FERC intends to ultimately adopt in response to its July 31, 2002 Notice of Proposed Rulemaking regarding a standard market design for the electric utility industry. FERC did not address all of the proposed WestConnect provisions in its order and some could still be affected by a final rule in the pending rulemaking proceeding. We cannot currently predict what, if any, impact there may be to the WestConnect proposal or to us if the FERC adopts the proposed rule. On November 12, 2002, APS and other owners filed a request for rehearing and clarification on portions of the October 10 order.

**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.

**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 decommissioning trusts 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.