

PINNACLE WEST CAPITAL CORP

FORM 10-Q (Quarterly Report)

Filed 11/06/01 for the Period Ending 09/30/01

| | |
|-------------|---|
| 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 11/6/2001 For Period Ending 9/30/2001

| | |
|-------------|--|
| 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

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

For the quarterly period ended September 30, 2001

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 2, 2001: 84,642,939

Glossary

ACC - Arizona Corporation Commission

ACC Staff - Staff of the Arizona Corporation Commission

ADEQ - Arizona Department of Environmental Quality

APS - Arizona Public Service Company, a subsidiary of the Company

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

Bookout - one party appears more than once in a contract path for the purchase and sale of a commodity, resulting in an unplanned net settlement

CC&N - Certificate of Convenience and Necessity

Citizens - Citizens Communications Company

Company - Pinnacle West Capital Corporation

EITF - Emerging Issues Task Force

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

El Paso - El Paso Natural Gas Company

ERMC - Energy Risk Management Committee

FASB - Financial Accounting Standards Board

FERC - United States Federal Energy Regulatory Commission

Four Corners - Four Corners Power Plant

GWh - gigawatt-hour, one billion watts per hour

ISO - California Independent System Operator

ITC - investment tax credit

KW - kilowatt, one thousand watts

KWh - kilowatt-hour, one thousand watts per hour

MW - megawatt, one million watts

MWh - megawatt-hour, one million watts per hour

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

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

Palo Verde - Palo Verde Nuclear Generating Station

PG&E - PG&E Corp.

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

PPA - Purchase Power Agreement between APS and the Company

PX - California Power Exchange

RTO - regional transmission organization

Rules - ACC retail electric competition rules

Salt River Project - Salt River Project Agricultural Improvement and Power District

SCE - Southern California Edison Company

SFAS - Statement of Financial Accounting Standards

SunCor - SunCor Development Company, a subsidiary of the Company

2000 10-K - Pinnacle West Capital Corporation Annual Report on Form 10-K for the fiscal year ended December 31, 2000

WestConnect - WestConnect RTO, LLC

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

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

(dollars in thousands, except per share amounts)

| | Three Months Ended September 30, | |
|---|-------------------------------------|--------------|
| | 2001 | 2000 |
| Operating Revenues | | |
| Electric | \$ 1,531,005 | \$ 1,567,960 |
| Real estate | 43,024 | 39,396 |
| Total | 1,574,029 | 1,607,356 |
| Operating Expenses | | |
| Purchased power and fuel | 949,436 | 1,078,860 |
| Operations and maintenance | 150,916 | 113,519 |
| Real estate operations | 37,803 | 33,980 |
| Depreciation and amortization | 107,932 | 114,092 |
| Taxes other than income taxes | 29,336 | 25,641 |
| Total | 1,275,423 | 1,366,092 |
| Operating Income | 298,606 | 241,264 |
| Other Income (Expense) | (1,930) | (14,833) |
| Income Before Interest and Income Taxes | 296,676 | 226,431 |
| Interest Expense | | |
| Interest charges | 42,531 | 41,684 |
| Capitalized interest | (12,450) | (5,240) |
| Total | 30,081 | 36,444 |
| Income Before Income Taxes | 266,595 | 189,987 |
| Income Taxes | 104,096 | 73,938 |
| Income Before Accounting Change | 162,499 | 116,049 |
| Cumulative Effect of a Change in Accounting for Derivatives - Net of Income Tax Benefit of \$8,099 | (12,446) | -- |
| Net Income | \$ 150,053 | \$ 116,049 |
| Average Common Shares Outstanding - Basic | 84,721 | 84,745 |
| Average Common Shares Outstanding - Diluted | 84,909 | 85,012 |
| Earnings Per Average Common Share Outstanding | | |
| Income Before Accounting Change - Basic | \$ 1.92 | \$ 1.37 |
| Net Income - Basic | 1.77 | 1.37 |
| Income Before Accounting Change - Diluted | 1.91 | 1.37 |
| Net Income - Diluted | 1.77 | 1.37 |
| Dividends Declared Per Share | \$ 0.375 | \$ 0.35 |

See Notes to Condensed Consolidated Financial Statements.

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

(dollars in thousands, except per share amounts)

| | Nine Months Ended September 30, | |
|---|------------------------------------|--------------|
| | 2001 | 2000 |
| Operating Revenues | | |
| Electric | \$ 3,698,857 | \$ 2,734,362 |
| Real estate | 107,813 | 117,659 |
| Total | 3,806,670 | 2,852,021 |
| Operating Expenses | | |
| Purchased power and fuel | 2,324,617 | 1,493,535 |
| Operations and maintenance | 408,305 | 331,301 |
| Real estate operations | 101,248 | 101,374 |
| Depreciation and amortization | 318,842 | 325,393 |
| Taxes other than income taxes | 80,101 | 76,643 |
| Total | 3,233,113 | 2,328,246 |
| Operating Income | 573,557 | 523,775 |
| Other Income (Expense) | 569 | 13,620 |
| Income Before Interest and Income Taxes | 574,126 | 537,395 |
| Interest Expense | | |
| Interest charges | 129,103 | 123,283 |
| Capitalized interest | (35,404) | (13,875) |
| Total | 93,699 | 109,408 |
| Income Before Income Taxes | 480,427 | 427,987 |
| Income Taxes | 188,866 | 167,967 |
| Income Before Accounting Change | 291,561 | 260,020 |
| Cumulative Effect of a Change in Accounting for Derivatives - Net of Income Tax Benefit of \$9,892 | (15,201) | -- |
| Net Income | \$ 276,360 | \$ 260,020 |
| Average Common Shares Outstanding - Basic | 84,731 | 84,735 |
| Average Common Shares Outstanding - Diluted | 84,972 | 84,901 |
| Earnings Per Average Common Share Outstanding | | |
| Income Before Accounting Change - Basic | \$ 3.44 | \$ 3.07 |
| Net Income - Basic | 3.26 | 3.07 |
| Income Before Accounting Change - Diluted | 3.43 | 3.06 |
| Net Income - Diluted | 3.25 | 3.06 |
| Dividends Declared Per Share | \$ 1.125 | \$ 1.05 |

See Notes to Condensed Consolidated Financial Statements.

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

(dollars in thousands, except per share amounts)

| | Twelve Months Ended September 30, | |
|---|--------------------------------------|--------------|
| | 2001 | 2000 |
| Operating Revenues | | |
| Electric | \$ 4,496,305 | \$ 3,234,499 |
| Real estate | 148,519 | 163,958 |
| | 4,644,824 | 3,398,457 |
| Operating Expenses | | |
| Purchased power and fuel | 2,763,873 | 1,653,139 |
| Operations and maintenance | 527,206 | 458,715 |
| Real estate operations | 134,296 | 142,497 |
| Depreciation and amortization | 424,678 | 427,496 |
| Taxes other than income taxes | 103,238 | 100,221 |
| | 3,953,291 | 2,782,068 |
| Operating Income | 691,533 | 616,389 |
| Other Income (Expense) | (13,463) | 25,256 |
| | 678,070 | 641,645 |
| Income Before Interest and Income Taxes | | |
| Interest Expense | | |
| Interest charges | 172,265 | 162,913 |
| Capitalized interest | (43,167) | (15,286) |
| | 129,098 | 147,627 |
| Income Before Income Taxes | 548,972 | 494,018 |
| Income Taxes | 215,099 | 189,197 |
| | 333,873 | 304,821 |
| Income Before Accounting Change | | |
| Cumulative Effect of a Change in Accounting for Derivatives - Net of Income Tax Benefit of \$9,892 | (15,201) | -- |
| Net Income | \$ 318,672 | \$ 304,821 |
| Average Common Shares Outstanding - Basic | 84,730 | 84,732 |
| Average Common Shares Outstanding - Diluted | 84,984 | 84,898 |
| Earnings Per Average Common Share Outstanding | | |
| Income Before Accounting Change - Basic | \$ 3.94 | \$ 3.60 |
| Net Income - Basic | 3.76 | 3.60 |
| Income Before Accounting Change - Diluted | 3.93 | 3.59 |
| Net Income - Diluted | 3.75 | 3.59 |
| Dividends Declared Per Share | \$ 1.50 | \$ 1.40 |

See Notes to Condensed Consolidated Financial Statements.

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS
(dollars in thousands)

| | September 30, 2001 | December 31, 2000 |
|--|-----------------------|----------------------|
| | ----- | ----- |
| | (unaudited) | |
| Current Assets | | |
| Cash and cash equivalents | \$ 25,337 | \$ 10,363 |
| Trust fund for bond redemption | 72,370 | -- |
| Customer and other receivables--net | 625,794 | 513,822 |
| Accrued utility revenues | 102,951 | 74,566 |
| Materials and supplies | 81,304 | 71,966 |
| Fossil fuel | 24,833 | 19,405 |
| Deferred income taxes | 5,793 | 5,793 |
| Assets from risk management and trading activities | 152,939 | 17,506 |
| Other current assets | 86,948 | 80,492 |
| | ----- | ----- |
| Total current assets | 1,178,269 | 793,913 |
| | ----- | ----- |
| Investments and Other Assets | | |
| Real estate investments--net | 405,497 | 371,323 |
| Other assets | 712,481 | 318,249 |
| | ----- | ----- |
| Total investments and other assets | 1,117,978 | 689,572 |
| | ----- | ----- |
| Property, Plant and Equipment | | |
| Plant in service and held for future use | 8,128,669 | 7,809,566 |
| Less accumulated depreciation and amortization | 3,339,977 | 3,188,302 |
| | ----- | ----- |
| Total | 4,788,692 | 4,621,264 |
| | ----- | ----- |
| Construction work in progress | 777,039 | 464,540 |
| Nuclear fuel, net of amortization | 54,853 | 47,389 |
| | ----- | ----- |
| Net property, plant and equipment | 5,620,584 | 5,133,193 |
| | ----- | ----- |
| Deferred Debits | | |
| Regulatory assets | 370,943 | 469,867 |
| Other deferred debits | 75,088 | 62,606 |
| | ----- | ----- |
| Total deferred debits | 446,031 | 532,473 |
| | ----- | ----- |
| Total Assets | \$8,362,862 | \$7,149,151 |
| | ===== | ===== |

See Notes to Condensed Consolidated Financial Statements.

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

LIABILITIES AND EQUITY
(dollars in thousands)

| | September 30, 2001 | December 31, 2000 |
|---|-----------------------|----------------------|
| | ----- | ----- |
| | (unaudited) | |
| Current Liabilities | | |
| Accounts payable | \$ 412,226 | \$ 375,805 |
| Accrued taxes | 343,982 | 89,246 |
| Accrued interest | 28,039 | 42,954 |
| Short-term borrowings | 199,400 | 82,775 |
| Current maturities of long-term debt | 400,266 | 463,469 |
| Customer deposits | 29,468 | 26,189 |
| Liabilities from risk management and trading activities | 197,495 | 37,179 |
| Other current liabilities | 46,530 | 73,681 |
| | ----- | ----- |
| Total current liabilities | 1,657,406 | 1,191,298 |
| | ----- | ----- |
| Long-Term Debt Less Current Maturities | 2,349,677 | 1,955,083 |
| | ----- | ----- |
| Deferred Credits and Other | | |
| Deferred income taxes | 1,030,870 | 1,143,040 |
| Unamortized gain - sale of utility plant | 65,204 | 68,636 |
| Other | 768,384 | 408,380 |
| | ----- | ----- |
| Total deferred credits and other | 1,864,458 | 1,620,056 |
| | ----- | ----- |
| Commitments and contingencies (Notes 6, 7, 9 and 12) | | |
| Common Stock Equity | | |
| Common stock, no par value | 1,527,026 | 1,532,831 |
| Accumulated other comprehensive loss | (66,609) | -- |
| Retained earnings | 1,030,904 | 849,883 |
| | ----- | ----- |
| Total common stock equity | 2,491,321 | 2,382,714 |
| | ----- | ----- |
| Total Liabilities and Equity | \$ 8,362,862 | \$ 7,149,151 |
| | ===== | ===== |

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, | |
|--|------------------------------------|------------|
| | 2001 | 2000 |
| | ----- | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Income before accounting change | \$ 291,561 | \$ 260,020 |
| Items not requiring cash | | |
| Depreciation and amortization | 318,842 | 325,393 |
| Nuclear fuel amortization | 22,221 | 23,139 |
| Deferred income taxes--net | (58,936) | (69,086) |
| Other--net | -- | (3,350) |
| Changes in current assets and liabilities | | |
| Customer and other receivables--net | (111,972) | (425,259) |
| Accrued utility revenues | (28,385) | (38,396) |
| Materials, supplies and fossil fuel | (14,766) | 3,787 |
| Other current assets | (6,456) | (10,969) |
| Accounts payable | 30,729 | 308,407 |
| Accrued taxes | 254,736 | 161,228 |
| Accrued interest | (14,915) | (6,843) |
| Risk management and trading activities - net | (196,032) | 17,934 |
| Other current liabilities | (23,872) | 6,911 |
| Change in El Dorado partnership investment | 966 | (11,897) |
| Increase in land held for sale | (31,481) | (21,073) |
| Other--net | 6,486 | 33,033 |
| | ----- | ----- |
| Net Cash Flow Provided By Operating Activities | 438,726 | 552,979 |
| | ----- | ----- |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Trust fund for bond redemption | (72,370) | -- |
| Capital expenditures | (685,307) | (398,994) |
| Capitalized interest | (35,404) | (13,875) |
| Other--net | 22,939 | 20,259 |
| | ----- | ----- |
| Net Cash Flow Used For Investing Activities | (770,142) | (392,610) |
| | ----- | ----- |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Issuance of long-term debt | 744,500 | 494,000 |
| Short-term borrowings--net | 116,625 | (36,316) |
| Dividends paid on common stock | (95,341) | (88,963) |
| Repayment of long-term debt | (413,589) | (461,157) |
| Other--net | (5,805) | (956) |
| | ----- | ----- |
| Net Cash Flow Provided by /(Used for) Financing Activities | 346,390 | (93,392) |
| | ----- | ----- |
| Net Cash Flow | 14,974 | 66,977 |
| Cash and Cash Equivalents at Beginning of Period | 10,363 | 20,705 |
| | ----- | ----- |
| Cash and Cash Equivalents at End of Period | \$ 25,337 | \$ 87,682 |
| | ===== | ===== |
| Supplemental Disclosure of Cash Flow Information: | | |
| Cash paid during the period for: | | |
| Interest, net of amounts capitalized | \$ 101,072 | \$ 109,778 |
| Income taxes | \$ 32,349 | \$ 127,013 |

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.
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 2000 10-K.
3. Weather conditions and trading and wholesale power marketing activities can have significant impacts on our results for interim periods. Results for interim periods do not necessarily represent results to be expected for the year.
4. See "Liquidity and Capital Resources" in Part I, Item 2 of this report for changes in capitalization for the nine months ended September 30, 2001.
5. Regulatory Accounting

APS is regulated by the ACC and FERC. The accompanying 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.

During 1997, the EITF of the FASB issued EITF 97-4. EITF 97-4 requires that SFAS No. 71 be discontinued no later than when legislation is passed or a rate order is issued that contains sufficient detail to determine its effect on the portion of the business being deregulated, which could result in write-downs or write-offs of physical and/or regulatory assets. Additionally, the EITF determined that regulatory assets should not be written off if they are to be recovered from a portion of the entity which continues to apply SFAS No. 71.

The 1999 Settlement Agreement was approved by the ACC in September 1999 (see Note 6 for a discussion of the agreement). Consequently, we have discontinued the application of SFAS No. 71 for our generation operations. As a result, we tested the generation assets for impairment and determined that the generation assets were not impaired. Pursuant to the 1999 Settlement Agreement, a regulatory disallowance removed \$234 million pretax (\$183 million net present value) from ongoing regulatory cash flows and was recorded as a net reduction of regulatory assets. This reduction (\$140 million after income taxes, or \$1.65 per basic or diluted share) was reported as an extraordinary charge on the income statement during the third quarter of 1999. Prior to the 1999 Settlement

Agreement, under the 1996 regulatory agreement (see Note 6), the ACC accelerated the amortization of substantially all of our regulatory assets to an eight-year period that would have ended June 30, 2004.

The regulatory assets to be recovered under the 1999 Settlement Agreement are now being amortized through June 30, 2004 as follows (dollars in millions):

| 1999 | 2000 | 2001 | 2002 | 2003 | 1/1 - 6/30 2004 | Total |
|-------|-------|-------|-------|------|--------------------|-------|
| ---- | ---- | ---- | ---- | ---- | ---- | ----- |
| \$164 | \$158 | \$145 | \$115 | \$86 | \$18 | \$686 |

The majority of our remaining regulatory assets relate to deferred income taxes and rate synchronization cost deferrals.

The consolidated balance sheets include the amounts listed below for generation assets not subject to SFAS No. 71 (for additional generation information see Note 8):

(dollars in thousands)

| | September 30, 2001 | December 31, 2000 |
|---|-----------------------|----------------------|
| | ----- | ----- |
| Electric plant in service and held for future use | \$ 3,967,771 | \$ 3,856,600 |
| Accumulated depreciation and amortization | (1,771,158) | (1,693,079) |
| Construction work in progress | 595,383 | 304,992 |
| Nuclear fuel, net of amortization | 54,853 | 47,389 |

6. Regulatory Matters

ELECTRIC INDUSTRY RESTRUCTURING

STATE

1999 SETTLEMENT AGREEMENT. On May 14, 1999, APS entered into a comprehensive Settlement Agreement with various parties, including representatives of major consumer groups, related to the implementation of retail electric competition. On September 23, 1999, the ACC voted to approve the 1999 Settlement Agreement, with some modifications. On December 13, 1999, two parties filed lawsuits challenging the ACC's approval of the 1999 Settlement Agreement. Each party bringing the lawsuits appealed the ACC's order approving the 1999 Settlement Agreement directly to the Arizona Court of Appeals, as provided by Arizona law. In one of the appeals, on December 26, 2000, the Arizona Court of Appeals affirmed the ACC's approval of the 1999 Settlement Agreement. This decision was not appealed and has become final. In the other appeal, on April 5, 2001, the Arizona Court of Appeals again affirmed the ACC's approval of the 1999 Settlement Agreement. The Arizona Consumers Council, which filed that appeal, petitioned the Arizona Supreme Court for review of the Court of Appeals' decision. On October 5, 2001, the Arizona Supreme Court agreed to hear the appeal on the singular issue of whether the ACC could itself become a party to the Settlement Agreement by virtue of its

approval of the Settlement Agreement. The Supreme Court has not yet set a date for oral argument on this matter.

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 the July 1, 1999 retail price decrease of approximately \$11 million (\$7 million after income taxes) related to the 1996 regulatory agreement. See "1996 Regulatory Agreement" below. 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, and approximately \$27 million (\$16 million after taxes), or 1.5%, effective July 1, 2001. For customers having loads three MW or greater, standard offer rates will be 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, or material changes in APS' cost of service for ACC-regulated services resulting from federal, tribal, state or local laws, regulatory requirements, judicial decisions, actions or orders.

* APS will be permitted to defer for later recovery prudent and reasonable costs of complying with the ACC electric competition 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 electric competition 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.

* Prior to the 1999 Settlement Agreement, APS was recovering substantially all of its regulatory assets through July 1, 2004, pursuant to the 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 generating assets and competitive services at book value as of the date of transfer, and will complete the transfer no later than December 31, 2002. Accordingly, APS plans to complete the move of such assets and services from APS to the parent company or to Pinnacle West Energy by the end of 2002, as required. 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.

* When the 1999 Settlement Agreement approved by the ACC is no longer subject to judicial review, APS will move to dismiss all of its litigation pending against the ACC as of the date APS entered into the 1999 Settlement Agreement. To protect its rights, APS has several lawsuits pending on ACC orders relating to stranded cost recovery and the adoption and amendment of the ACC's electric competition rules, which would be voluntarily dismissed at the appropriate time under this provision.

As discussed in Note 5 above, we have discontinued the application of SFAS No. 71 for our generation operations.

PROPOSED RULE VARIANCE AND PURCHASE POWER AGREEMENT. As authorized by the 1999 Settlement Agreement, APS intends to move substantially all of its generation assets to Pinnacle West Energy no later than December 31, 2002. Commencing upon the transfer of the fossil-fueled generating assets and the receipt of certain regulatory approvals, Pinnacle West Energy expects to sell its power at wholesale to the Company's power marketing division, which, in turn, is expected to sell power to APS and to non-affiliated power purchasers. In a filing with the ACC on October 18, 2001, APS requested the ACC to (a) grant APS a partial variance from an ACC rule that would obligate APS to acquire all of its customers' standard offer generation requirements from the competitive market (with at least 50% of that coming from a "competitive bidding" process) starting in 2003 and (b) approve as just and reasonable a long-term purchase power agreement (PPA) between APS and the Company. APS has requested these ACC actions to ensure continued reliable service to APS standard offer customers in a volatile generation market and to recognize Pinnacle West Energy's significant investment to serve APS load. The following are the major provisions of the PPA:

- * The PPA would run through 2015, with three optional five-year renewal terms, which renewals would occur automatically unless notice is given by either APS or the Company.
- * The PPA would provide for all of APS' anticipated standard offer generation needs, including any necessary reserves, except for (a) those provided by APS itself through renewable resources or other generation assets retained by APS; (b) amounts that APS is obligated by law to purchase from "qualified facilities" and other forms of distributed generation; and (c) any purchased power agreements that APS cannot transfer to Pinnacle West Energy.
- * The Company would assume contractual responsibility for reliability and would supplement any potential shortfall even after full utilization of Pinnacle West Energy's dedicated generating resources.
- * The Company would supply APS standard offer requirements through a combination of (a) APS generation assets transferred to Pinnacle West Energy; (b) certain of Pinnacle West Energy's new Arizona generation projects to be constructed during the 2001-2004 period to reliably serve APS load requirements; (c) power procured by the Company under certain "dedicated contracts"; and (d) power procured on the open market, including a competitively-bid component described below.
- * Beginning in 2003, the Company would acquire 270 MW of APS standard offer requirements on the open market through a competitive bidding process. This competitive bid obligation would be increased by an additional 270 MW each year through 2008 (representing approximately 23% of estimated 2008 peak load).
- * The Company would charge APS based on (a) a combination of fixed and variable price components for the Pinnacle West Energy assets, subject to periodic adjustment, and (b) a pass-through of the Company's costs to procure power from the remaining sources.
- * The PPA would take effect on the latest of the following events: (a) transfer of non-nuclear generating assets from APS to Pinnacle West Energy; (b) ACC approval of the rule variance and the PPA; and (c) FERC acceptance of the PPA and the companion agreement between the Company and Pinnacle West Energy.

PROVIDER OF LAST RESORT OBLIGATION. Although the Rules allow retail customers to have access to competitive providers of energy and energy services (see "Retail Electric Competition Rules" below), APS is the "provider of last resort" for standard offer customers under rates that have been approved by the ACC. Energy prices in the western wholesale market vary and, during the course of the last year, have been volatile. At various times, prices in the spot wholesale market have significantly exceeded the amount included in APS' current retail rates. APS expects that the market may continue to be volatile. We believe that through a combination of hedging and our current generation portfolio, we will be able to adequately manage our exposure to the volatility of the power market. However, in the event of shortfalls due to unforeseen increases in load demand or generation 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.

RETAIL ELECTRIC COMPETITION RULES. On September 21, 1999, the ACC voted to approve rules that provide a framework for the introduction of retail electric competition in Arizona. 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 December 8, 1999, APS filed a lawsuit to protect its legal rights regarding the Rules. This lawsuit is pending, along with several other lawsuits on ACC orders relating to stranded cost recovery (including those described above involving APS), the adoption or amendment of the Rules, and the certification of competitive electric service providers.

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 case has been appealed to the Arizona Supreme Court, where a decision is pending.

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

- * They apply to virtually all Arizona electric utilities regulated by the ACC, including APS.
- * 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 non-competitive 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 generation assets and services either to an unaffiliated party or to a separate corporate affiliate. Under the 1999 Settlement Agreement, APS received a waiver to allow transfer of its generation and other competitive assets and services to affiliates no later than December 31, 2002. APS plans to complete the move of such assets by the end of 2002, as required.

1996 REGULATORY AGREEMENT. In April 1996, the ACC approved a regulatory agreement between the ACC Staff and APS. Based on the price reduction formula authorized in the agreement, the ACC approved retail price decreases (approximate) as follows (dollars in millions):

| Annual Electric Revenue Decrease | Percentage Decrease | Effective Date |
|-------------------------------------|------------------------|------------------|
| \$49 | 3.4% | July 1, 1996 |
| \$18 | 1.2% | July 1, 1997 |
| \$17 | 1.1% | July 1, 1998 |
| \$11 | 0.7% | July 1, 1999 (a) |

(a) Included in the first rate reduction under the 1999 Settlement Agreement (see above).

The regulatory agreement also required that we infuse \$200 million of common equity into APS in annual payments of \$50 million from 1996 through 1999. All of these equity infusions were made by December 31, 1999.

LEGISLATION. In May 1998, a law was enacted to facilitate implementation of retail electric competition in Arizona. The law includes the following major provisions:

* Arizona's largest government-operated electric utility (Salt River Project) and, at their option, smaller municipal electric systems must (i) make at least 20% of their 1995 retail peak demand available to electric service providers by December 31, 1998 and for all retail customers by December 31, 2000; (ii) decrease rates by at least 10% over a ten-year period beginning as early as January 1, 1991; (iii) implement procedures and public processes comparable to those already applicable to public service corporations for establishing the terms, conditions, and pricing of electric services as well as certain other decisions affecting retail electric competition;

* describes the factors which form the basis of consideration by Salt River Project in determining stranded costs; and

* metering and meter reading services must be provided on a competitive basis during the first two years of competition only for customers having demands in excess of one MW (and that are eligible for competitive generation services), and thereafter for all customers receiving competitive electric generation.

GENERAL

We cannot accurately predict the impact of full retail competition on our financial position, cash flows, results of operations, or liquidity. 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.

FEDERAL

The 1992 Energy Act and recent rulemakings by FERC have promoted increased competition in the wholesale energy markets. We do not expect these rules to have a material impact on our financial statements.

In June 2001, 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 remains in effect until September 30, 2002. The Company cannot accurately predict the overall financial impact of the plan on the various aspects of its business, including its wholesale and purchased power activities.

7. Nuclear Insurance

The Palo Verde participants have insurance for public liability payments 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' 29.1% interest in the three Palo Verde units, APS' maximum potential assessment per incident 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 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.

8. Business Segments

We have two principal business segments (determined by products, services and regulatory environment), which consist of activities related to the transmission and distribution of electricity (delivery business segment) and the generation of electricity and wholesale and power trading (generation business segment).

These reportable segments reflect a change in the reporting of our functional activities. Before January 1, 2001, our reported segment information combined transmission and distribution activities with wholesale and power trading activities. Our current operational activities are more closely based on the strong integration of our wholesale and power trading activities with our generation of electricity, and have been combined for segment reporting purposes. The corresponding information for earlier periods has been restated.

Beginning in 2001, we changed our method of allocating revenues between the delivery business segment and the generation business segment to reflect the seasonal impact of market prices. This change had the impact of decreasing delivery segment income and increasing generation segment income in all the periods presented when compared to the prior comparable periods. The after-tax change is \$45 million in the three-month period and \$2 million in the nine- and twelve-month periods.

The other amounts include activity relating to the parent company and other subsidiaries, including APS Energy Services, SunCor and El Dorado. Eliminations primarily relate to intersegment sales of electricity. Segment information for the three, nine and twelve months ended September 30, 2001 and 2000 is as follows (dollars in millions):

| | 3 Months Ended September 30, | | 9 Months Ended September 30, | | 12 Months Ended September 30, | |
|-------------------------------------|---------------------------------|----------|---------------------------------|----------|----------------------------------|----------|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 |
| Operating Revenues: | | | | | | |
| Delivery | \$ 612 | \$ 683 | \$ 1,577 | \$ 1,563 | \$ 1,984 | \$ 1,963 |
| Generation | 1,355 | 1,194 | 3,001 | 1,886 | 3,601 | 2,169 |
| Other | 46 | 41 | 116 | 120 | 154 | 166 |
| Eliminations | (439) | (311) | (887) | (717) | (1,094) | (900) |
| Total | \$ 1,574 | \$ 1,607 | \$ 3,807 | \$ 2,852 | \$ 4,645 | \$ 3,398 |
| Income Before Accounting Change: | | | | | | |
| Delivery | \$ 6 | \$ 28 | \$ 95 | \$ 84 | \$ 116 | \$ 115 |
| Generation | 156 | 95 | 204 | 168 | 234 | 172 |
| Other | -- | (7) | (8) | 8 | (16) | 18 |
| Total | \$ 162 | \$ 116 | \$ 291 | \$ 260 | \$ 334 | \$ 305 |

| | As of September 30, 2001 | As of December 31, 2000 |
|------------|-----------------------------|----------------------------|
| | ----- | ----- |
| Assets: | | |
| Delivery | \$ 3,950 | \$ 3,987 |
| Generation | 4,029 | 2,687 |
| Other | 384 | 475 |
| | ----- | ----- |
| Total | \$ 8,363 | \$ 7,149 |
| | ===== | ===== |

9. Accounting Matters

In July 2001, the FASB issued 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 are currently evaluating the impacts of the new standard and do not expect it to have a material impact on our financial statements. We have no goodwill. This standard is effective for the year beginning January 1, 2002.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." The standard requires the estimated present value of the cost of decommissioning and certain other removal costs to be recorded as a liability, along with an offsetting plant asset when a decommissioning or other removal obligation is incurred. We are currently evaluating the impacts of the new standard, which is effective for the year beginning January 1, 2003.

In October 2001, the FASB issued 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. SFAS No. 144 is effective for the year beginning January 1, 2002. We are currently evaluating the impacts of the new standard and do not expect it to have a material impact on our financial statements.

10. Derivative Instruments

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/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 the ERM, we engage in trading activities intended to profit from market price movements.

Effective January 1, 2001, we adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 requires that entities recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair 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. Hedge effectiveness is measured based on the relative changes in fair value between the derivative contract and the hedged item over time. Any change in the fair value resulting from ineffectiveness is recognized immediately in net income. This new standard may result in additional volatility in our net income and comprehensive income.

In June 2001, the FASB determined that certain electricity contracts, including those with option characteristics and those subject to "bookout," would qualify for the normal purchases and sales exception if certain criteria were met. Prior to the issuance of the guidance, we accounted for electricity contracts with characteristics of options and those subject to "bookout" as normal purchases and sales. As a result, we did not previously mark these contracts to their fair market values each reporting period. The effective date of this new guidance was July 1, 2001.

As a result of adopting SFAS No. 133, we recognized \$118 million of derivative assets and \$16 million of derivative liabilities in our balance sheet as of January 1, 2001. Also as of January 1, 2001, we recorded a \$3 million after-tax loss, or \$0.03 per basic or diluted share, in net income as a cumulative effect of a change in accounting principle and a \$65 million after-tax gain in equity (as a component of other comprehensive income). The gain resulted from unrealized gains on cash flow hedges.

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. These adjustments resulted primarily from contracts with characteristics of options that did not meet the new criteria for the normal purchases and sales exception. The impact of the new guidance is reflected as a cumulative effect of a change in accounting principle. In October 2001, FASB again revised its guidance for option-like contracts. We are currently in the process of evaluating the effect, if any, of this revised guidance.

The change in derivative fair value in the consolidated statements of income for the three, nine and twelve months ending September 30, 2001 and 2000 is comprised of the following (dollars in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Twelve Months Ended September 30, | |
|--|-------------------------------------|-------|------------------------------------|-------|--------------------------------------|-------|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 |
| Ineffective portion of derivatives qualifying for hedge accounting (a) | \$ (1,879) | \$ -- | \$ (8,063) | \$ -- | \$ (8,063) | \$ -- |
| Discontinuance of cash flow hedges for forecasted transactions that will not occur | (1,367) | -- | (9,692) | -- | (9,692) | -- |
| Reclassification of mark-to-market to realized | 19,880 | -- | 26,359 | -- | 26,359 | -- |
| Total | \$ 16,634 | \$ -- | \$ 8,604 | \$ -- | \$ 8,604 | \$ -- |

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

As of September 30, 2001, the maximum length of time over which we are hedging our exposure to the variability in future cash flows for forecasted transactions is thirty-nine months. During the twelve months ending September 30, 2002, we estimate that a net loss of \$23 million before income taxes will be reclassified from accumulated other comprehensive income as an offset to the effect on earnings of market price changes for the related hedged transaction.

Net gains and losses on derivatives utilized for trading activities are recognized in power marketing revenues on a current basis (the mark-to-market method). Trading positions are measured at fair value as of the balance sheet date. The mark-to-market gains recognized in power marketing revenues were the following for the three, nine and twelve months ended September 30, 2001 and 2000 (dollars in millions):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Twelve Months Ended September 30, | |
|-------------------------------|-------------------------------------|---------|------------------------------------|---------|--------------------------------------|---------|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 |
| Mark-to-market gains (losses) | \$ 92 | \$ (45) | \$ 187 | \$ (18) | \$ 214 | \$ (17) |
| Realized gains (losses) | (4) | 66 | 6 | 80 | (27) | 83 |
| Total trading gains | \$ 88 | \$ 21 | \$ 193 | \$ 62 | \$ 187 | \$ 66 |

11. Comprehensive Income

Components of comprehensive income for the three, nine and twelve months ended September 30, 2001 and 2000, are as follows (dollars in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Twelve Months Ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|------------|--------------------------------------|------------|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 |
| Net income | \$ 150,053 | \$ 116,049 | \$ 276,360 | \$ 260,020 | \$ 318,672 | \$ 304,821 |
| Other comprehensive income(loss), net of tax: | | | | | | |
| Cumulative effect of change in accounting for derivatives | 7,801 | -- | 72,501 | -- | 72,501 | -- |
| Unrealized holding losses arising during period | (11,353) | -- | (109,281) | -- | (109,281) | -- |
| Reclassification adjustment for derivatives | (11,145) | -- | (29,829) | -- | (29,829) | -- |
| Total other comprehensive loss | (14,697) | -- | (66,609) | -- | (66,609) | -- |
| Comprehensive income | \$ 135,356 | \$ 116,049 | \$ 209,751 | \$ 260,020 | \$ 252,063 | \$ 304,821 |

12. Generation Expansion

PINNACLE WEST ENERGY

Pinnacle West Energy has announced plans to build about 3,277 MW of natural gas-fired generating capacity from 2001-2006 at an estimated cost of about \$1.7 billion.

| Site | MW |
|-----------------------------|-------|
| West Phoenix 4 - In Service | 120 |
| West Phoenix 5 | 530 |
| Redhawk 1 | 530 |
| Redhawk 2 | 530 |
| Redhawk 3 | 530 |
| Redhawk 4 | 530 |
| Saguaro 3 | 80 |
| Silverhawk* | 427 |
| TOTAL | 3,277 |

* 75% Pinnacle West Energy Share of 570 MW Unit

Pinnacle West Energy is currently funding its capital requirements through capital infusions from the parent company, which finances those infusions through debt financings and internally generated cash. As Pinnacle West Energy develops and obtains additional generation assets, Pinnacle West Energy expects to fund its capital requirements through internally generated cash and its own debt issuances.

Pinnacle West Energy has completed or is currently planning the following projects:

* A 650 MW expansion of the West Phoenix Power Plant in Phoenix. The 120 MW West Phoenix Unit 4 began commercial operation on June 1, 2001. Construction has begun on the 530 MW West Phoenix Unit 5, with commercial operation expected to begin in mid-2003.

* The construction of a four-unit generating station near Palo Verde, called Redhawk. Redhawk Units 1 and 2 will be combined-cycle units. Construction began in December 2000, and commercial operation is currently scheduled for the Summer of 2002. Pinnacle West Energy is evaluating initially constructing Redhawk Units 3 and 4 as simple-cycle units, to be converted to combined-cycle units at a later date.

* Pinnacle West Energy is also constructing an 80 MW simple-cycle power plant at Saguaro in Southern Arizona. Commercial operation is currently scheduled for the Summer of 2002.

* Pinnacle West Energy plans to develop an electric generating station 20 miles north of Las Vegas, Nevada. Construction of the 570 MW Silverhawk combined-cycle plant is expected to begin in the Spring of 2002 with an expected commercial operation date of mid-2004. The Company has signed a memorandum of understanding with Las Vegas-based Southern Nevada Water Authority for them to be a 25-percent owner of the plant.

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. Results are expected by the end of 2001.

13. El Dorado Partnership Investment Income

Net other income has consisted primarily of El Dorado's share in the earnings of a venture capital partnership. We record our share of the earnings from the partnership as the partnership adjusts the value of its investment. In 2001, El Dorado received a distribution of securities representing substantially all of El Dorado's investment in the partnership. The securities were sold in the first quarter of 2001 and a gain was recognized in other income.

14. California Energy Market Issues and Refunds in the Pacific Northwest

We are closely monitoring developments in the California energy market and the potential impact of those 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 power marketing exposures. Based on our current evaluations, we have reserved \$10 million before income taxes for our credit exposure related to the California energy situation. 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 or our subsidiaries or the regional energy market in general.

In July 2001, 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 FERC after the California ISO provides necessary historical data. FERC also ordered an evidentiary proceeding to discuss and evaluate possible refunds for the Pacific Northwest. The Administrative Law Judge at 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 FERC Commissioners. Although FERC has not yet made a final ruling in the Pacific Northwest matter or calculated the specific refund amounts due in California, we do not expect that the resolution of these issues will have a material adverse impact on our financial position, results of operations or liquidity.

15. Legal Proceedings

SunCor is a party to a lawsuit pending in Maricopa County, Arizona, Superior Court entitled SUNCOR DEVELOPMENT COMPANY V. BERGSTROM CORPORATION, CV 98-11472. On March 15, 2001, a jury returned a verdict against SunCor in the amount of \$28.6 million, \$25.7 million of which represents a punitive damage award. The verdict was based on the Bergstrom Corporation's claims that it was defrauded in connection with the acquisition of approximately ten acres of land in a SunCor commercial development and a subsequent settlement agreement relating to those claims. SunCor believes that the verdict is neither supported by the evidence or the law and has filed post-trial motions to that effect and, if necessary, will appeal. On September 27, 2001, the Court denied SunCor's motions for a new trial and for a reduction of the compensatory damage award, but ruled that it was not

yet in a position to rule on the amount of the punitive damages award and requested additional information from the parties on this issue. We do not expect this litigation to have a material adverse impact on our financial position, results of operations or liquidity.

16. Power Service Agreement

By letter dated March 7, 2001, Citizens advised APS that it believes APS has 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. 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.

17. 2001 Generation Summer Reliability Program

We recently added over 500 MW of generating capability to enhance reliability for the summer of 2001 in light of market conditions in the western United States. The additional capacity included the 120 MW West Phoenix Unit 4 (see Note 12) and approximately 200 MW of gas-fired portable generators leased for the summer of 2001 by Pinnacle West Energy. Additionally, APS restored approximately 100 MW of previously mothballed gas-fired steam units at the West Phoenix Power Plant and refurbished the entire fossil plant fleet during the spring of 2001 (which resulted in additional capability of approximately 110 MW).

SUPPLEMENTAL ITEM. SELECTED CONSOLIDATED DATA

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Twelve Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|--------------------------------------|----------|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 |
| ELECTRIC OPERATING REVENUES (dollars in millions) | | | | | | |
| Retail | | | | | | |
| Residential | \$ 328 | \$ 324 | \$ 735 | \$ 708 | \$ 907 | \$ 872 |
| Business | 276 | 275 | 733 | 724 | 945 | 940 |
| Total retail | 604 | 599 | 1,468 | 1,432 | 1,852 | 1,812 |
| Sales for resale | 816 | 934 | 2,025 | 1,188 | 2,432 | 1,292 |
| Transmission for others | 9 | 4 | 19 | 11 | 22 | 13 |
| Miscellaneous services | 102 | 31 | 187 | 103 | 190 | 117 |
| Net electric operating revenues | \$ 1,531 | \$ 1,568 | \$ 3,699 | \$ 2,734 | \$ 4,496 | \$ 3,234 |
| ELECTRIC SALES (GWh) | | | | | | |
| Retail | | | | | | |
| Residential | 3,597 | 3,506 | 8,187 | 7,753 | 10,215 | 9,633 |
| Business | 3,724 | 3,674 | 9,993 | 9,790 | 12,957 | 12,722 |
| Total retail | 7,321 | 7,180 | 18,180 | 17,543 | 23,172 | 22,355 |
| Sales for resale | 5,692 | 10,144 | 14,654 | 17,004 | 19,162 | 20,513 |
| Total sales | 13,013 | 17,324 | 32,834 | 34,547 | 42,334 | 42,868 |
| POWER PLANT PERFORMANCE (capacity factors) | | | | | | |
| Nuclear | 97% | 98% | 92% | 94% | 91% | 93% |
| Coal | 85% | 88% | 84% | 83% | 84% | 83% |
| Gas and Oil | 38% | 40% | 46% | 24% | 39% | 23% |
| ELECTRIC CUSTOMERS (end of period) | | | | | | |
| Retail | | | | | | |
| Residential | 776,000 | 750,918 | | | | |
| Business | 99,339 | 95,165 | | | | |
| Total retail | 875,339 | 846,083 | | | | |
| Sales for resale | 66 | 67 | | | | |
| Total electric customers | 875,405 | 846,150 | | | | |
| BOOK VALUE PER SHARE (end of period) | | | | | | |
| | \$ 29.37 | \$ 28.01 | | | | |

Additional operating statistics for the periods ended September 30, 2001 and September 30, 2000 are available on the Company's website and in a Form 8-K Report dated October 18, 2001.

PINNACLE WEST CAPITAL CORPORATION

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, 2001 and 2000;
- * the effects of regulatory agreements on our results and outlook;
- * our capital needs and resources;
- * major factors that affect our financial outlook; and
- * our management of market risks.

We suggest this section be read along with the 2000 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.

OVERVIEW OF OUR BUSINESS

Pinnacle West owns all of the outstanding common stock of APS. APS is Arizona's largest electric utility and provides retail and wholesale electric service to the entire state with the exception of Tucson and about one-half of the Phoenix area. APS also generates and, directly or through our power marketing division, sells and delivers electricity to wholesale customers in the western United States.

Our other major subsidiaries are wholly-owned and are:

- * Pinnacle West Energy, through which we intend to conduct our unregulated generation operations;
- * APS Energy Services, which sells energy and energy-related products and services in competitive retail markets in the western United States;
- * SunCor, which is a developer of residential, commercial, and industrial real estate projects in Arizona, New Mexico, and Utah; and
- * El Dorado, which is an investment firm.

We have two principal business segments, determined by products, services, and regulatory environment:

- * The electricity delivery business segment, which consists of the transmission and distribution of electricity activities; and
- * The generation business segment, which consists of our generation, wholesale and power trading activities.

See "Business Segments" in Note 8 for more information about our business segments.

OPERATING RESULTS

The following table summarizes net income for the three, nine and twelve months ended September 30, 2001 and the comparable prior year periods for Pinnacle West and each of its subsidiaries (dollars in millions):

| | 3 Months Ended September 30, | | 9 Months Ended September 30, | | 12 Months Ended September 30, | |
|---|---------------------------------|--------|---------------------------------|--------|----------------------------------|--------|
| | 2001 | 2000 | 2001 | 2000 | 2001 | 2000 |
| APS | \$ 108 | \$ 124 | \$ 242 | \$ 253 | \$ 296 | \$ 288 |
| Pinnacle West Energy | 13 | (1) | 14 | (2) | 14 | (1) |
| APS Energy Services | (3) | -- | (10) | (4) | (19) | (8) |
| SunCor | 2 | 2 | 3 | 8 | 6 | 11 |
| El Dorado | -- | (9) | -- | 7 | (5) | 18 |
| Parent Company(a) | 42 | -- | 42 | (2) | 42 | (3) |
| Income before accounting change | 162 | 116 | 291 | 260 | 334 | 305 |
| Cumulative effect of a change in accounting - net of income taxes | (12) | -- | (15) | -- | (15) | -- |
| Net income | \$ 150 | \$ 116 | \$ 276 | \$ 260 | \$ 319 | \$ 305 |

(a) The 2001 amount primarily includes power trading activities.

OPERATING RESULTS - THREE-MONTH PERIOD ENDED SEPTEMBER 30, 2001 COMPARED WITH THREE-MONTH PERIOD ENDED SEPTEMBER 30, 2000

Our consolidated net income for the three months ended September 30, 2001 was \$150 million compared with \$116 million for the same period in the prior year. In July 2001, we recognized a \$12 million after-tax loss in net income as a cumulative effect of a change in accounting for derivatives as required by SFAS No. 133. See Note 10 for further discussion.

Income before accounting change for the three months ended September 30, 2001 was \$162 million compared with \$116 million for the same period in the prior year. The major factors that increased (decreased) income before accounting change were as follows (dollars in millions):

| | Increase/ (Decrease) |
|---|-------------------------|
| | ----- |
| Increased margin on structured power trading activities | \$ 52 |
| Increased margin on power marketing, other trading and wholesale activities | 33 |
| Higher margin from retail sales | 5 |
| Retail price reductions | (9) |
| Higher replacement power costs on plant outages | (6) |
| SFAS No. 133 accounting adjustment | 17 |
| | ----- |
| Increase in revenues, net of purchased power and fuel expense | 92 |
| Higher operations and maintenance expense primarily related to generation summer reliability program | (37) |
| Higher other income primarily related to El Dorado | 13 |
| Miscellaneous items, net | 8 |
| | ----- |
| Net increase in income before income taxes | 76 |
| Higher income taxes primarily due to higher income | (30) |
| | ----- |
| Net increase in income before accounting change | \$ 46 |
| | ===== |

Electric operating revenues decreased approximately \$37 million primarily because of:

- * change in power marketing, trading and wholesale revenues (\$42 million, net decrease):
- * increased trading revenues related to structured power trading activities (\$128 million);
- * decreased wholesale revenues primarily related to generation sales other than for Native Load (\$2 million);
- * decreased power marketing revenues related to other trading and other wholesale activities (\$168 million);
- * increased retail revenues primarily related to higher sales volumes due to weather impacts and customer growth, partially offset by lower average usage per customer (\$14 million); and
- * decreased retail revenues related to the reduction in retail electricity prices (\$9 million). See Note 6 for information on the price reductions.

Purchased power and fuel expenses decreased approximately \$129 million primarily because of:

- * changes related to power marketing, trading and wholesale sales (\$127 million, net decrease):
- * increased trading costs related to structured power trading activities (\$76 million);
- * decreased costs related to generation other than Native Load (\$5 million);
- * decreased power marketing costs related to other trading and other wholesale activities (\$198 million);
- * decreased costs for a SFAS No. 133 adjustment related to changes in electricity and gas market prices (\$17 million). See Note 10 for additional information on SFAS No. 133;
- * increased costs related to higher retail sales volumes and associated higher purchased power and fuel prices (\$9 million); and
- * higher replacement power costs primarily for increased plant outages (\$6 million).

The increase in operations and maintenance expenses of \$37 million primarily related to the generation summer reliability program (the addition of approximately 500 MW of generating capability to enhance reliability for the summer of 2001, particularly the leasing of gas-fired portable generators) (\$29 million) and other costs (\$8 million). See Note 17 for additional information on the generation summer reliability program.

Depreciation and amortization decreased \$6 million primarily because of lower regulatory asset amortization.

Net other income increased \$13 million primarily because of a change in the market value of El Dorado's investment in a technology-related venture capital partnership in the prior-year period (see Note 13).

Interest expense decreased by \$6 million primarily because of increased capitalized interest resulting from our generation expansion plan. See Note 12 for additional information on the generation expansion plan.

**OPERATING RESULTS - NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2001 COMPARED
WITH NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2000**

Our consolidated net income for the nine months ended September 30, 2001 was \$276 million compared with \$260 million for the same period in the prior year. In 2001, we recognized a \$15 million after-tax loss in net income as a cumulative effect of a change in accounting for derivatives, as required by SFAS No. 133. See Note 10 for further discussion.

Income before accounting change for the nine months ended September 30, 2001 was \$291 million compared with \$260 million for the same period in the prior year. The major factors that increased (decreased) income before accounting change were as follows (dollars in millions):

| | Increase/ (Decrease) |
|---|-------------------------|
| | ----- |
| Increased margin on generation sales other than Native Load | \$ 118 |
| Increased margin on power marketing, other trading and wholesale activities | 80 |
| Increased margin on structured power trading activities | 52 |
| Lower margin from retail sales | (10) |
| Retail price reductions | (22) |
| SFAS No. 133 accounting adjustments | 9 |
| Higher replacement power costs for plant outages | (94) |
| | ----- |
| Increase in revenues, net of purchased power and fuel expense | 133 |
| Higher operations and maintenance expenses primarily related to generation and other costs | (77) |
| Lower other income primarily related to El Dorado | (13) |
| Miscellaneous items, net | 9 |
| | ----- |
| Net increase in income before income taxes | 52 |
| Higher income taxes primarily due to higher income | (21) |
| | ----- |
| Net increase in income before accounting change | \$ 31 |
| | ===== |

Electric operating revenues increased approximately \$964 million primarily because of:

- * change in power marketing, trading and wholesale revenues (\$928 million, net increase):
- * increased trading revenues related to structured power trading activities (\$128 million);
- * increased wholesale revenues primarily related to generation sales other than for Native Load (\$182 million);
- * increased power marketing revenues related to other trading and other wholesale activities (\$618 million);
- * increased retail revenues primarily related to higher sales volumes due to weather impacts and customer growth, partially offset by lower average usage per customer (\$58 million); and
- * decreased retail revenues related to reductions in retail electricity prices (\$22 million). See Note 6 for information on the price reductions.

Purchased power and fuel expenses increased approximately \$831 million primarily because of:

- * changes related to power marketing, trading and wholesale sales (\$678 million, net increase):
- * increased trading costs related to structured power trading activities (\$76 million);
- * increased costs related to generation other than Native Load (\$64 million);
- * increased power marketing costs related to other trading and other wholesale activities (\$538 million);
- * higher replacement power costs primarily for increased plant outages (\$94 million), including costs of \$12 million related to the Palo Verde outage extension to replace fuel control element assemblies;
- * increased costs related to higher retail sales volumes and associated higher purchased power and fuel prices (\$68 million); and
- * decreased costs related to SFAS No. 133 adjustments related to changes in electricity and gas market prices (\$9 million). See Note 10 for additional information on SFAS No. 133.

The increase in operations and maintenance expenses of \$77 million primarily related to the generation summer reliability program (the addition of approximately 500 MW of generating capability to enhance reliability for the summer of 2001) and increased power plant maintenance (\$56 million), increased pension and other costs (\$16 million) and a provision for credit exposure related to the California energy situation (\$5 million). See Note 17 for additional information on the generation summer reliability program. See Note 14 for additional information related to the California energy situation.

Depreciation and amortization decreased \$7 million primarily because of lower regulatory asset amortization.

Net other income decreased by \$13 million primarily because of a change in the market value of El Dorado's investment in a technology-related venture capital partnership

in the prior year period (see Note 13) and other non-operating costs, partially offset by an insurance recovery of environmental remediation costs.

Interest expense decreased by \$16 million primarily because of increased capitalized interest resulting from our generation expansion plan. See Note 12 for additional information on the generation expansion plan.

OPERATING RESULTS - TWELVE-MONTH PERIOD ENDED SEPTEMBER 30, 2001 COMPARED WITH TWELVE-MONTH PERIOD ENDED SEPTEMBER 30, 2000

Our consolidated net income for the twelve months ended September 30, 2001 was \$319 million compared with \$305 million for the same period in the prior year. In 2001, we recognized a \$15 million after-tax loss in net income as a cumulative effect of a change in accounting for derivatives, as required by SFAS No.133. See Note 10 for further discussion.

Income before accounting change for the twelve months ended September 30, 2001 was \$334 million compared with \$305 million for the same period in the prior year. The major factors that increased (decreased) income before accounting change were as follows (dollars in millions):

| | Increase/ (Decrease) |
|--|-------------------------|
| | ----- |
| Increased margin on generation sales other than Native Load | \$ 163 |
| Increased margin on power marketing, other trading and wholesale activities | 83 |
| Increased margin on structured power trading activities | 52 |
| Retail price reductions | (27) |
| Lower margin from retail sales | (13) |
| SFAS 133 accounting adjustments | 9 |
| Higher replacement power costs for plant outages | (116) |
| | ----- |
| Increase in revenues, net of purchased power and fuel expense | 151 |
| Higher operations and maintenance expense primarily related to generation and other costs | (68) |
| Lower other income primarily related to El Dorado | (39) |
| Miscellaneous items, net | 11 |
| | ----- |
| Net increase in income before income taxes | 55 |
| Higher income taxes primarily due to higher income | (26) |
| | ----- |
| Net increase in income before accounting change | \$ 29 |
| | ===== |

Electric operating revenues increased approximately \$1.26 billion because of:

- * change in power marketing, trading and wholesale revenues (\$1.22 billion, net increase):
- * increased trading revenues related to structured power trading activities (\$128 million);
- * increased wholesale revenues primarily related to generation sales other than for Native Load (\$269 million);
- * increased power marketing revenues related to other trading and other wholesale activities (\$825 million);

- * increased retail revenues primarily related to higher sales volumes due to weather impacts and customer growth, partially offset by lower average usage per customer (\$67 million); and
- * decreased retail revenues related to the reduction in retail electricity prices (\$27 million). See Note 6 for information on the price reductions.

Purchased power and fuel expenses increased approximately \$1.11 billion primarily because of:

- * changes related to power marketing, trading and wholesale sales (\$924 million, net increase):
- * increased trading costs related to structured power trading activities (\$76 million);
- * increased costs related to generation other than Native Load (\$106 million);
- * increased power marketing costs related to other trading and other wholesale activities (\$742 million);
- * higher replacement power costs primarily for increased plant outages (\$116 million), including costs of \$12 million related to the Palo Verde outage extension to replace fuel control element assemblies;
- * higher costs related to retail sales volumes and associated purchased power and fuel prices (\$80 million); and
- * decreased costs for SFAS No. 133 adjustments related to changes in electricity and gas market prices (\$9 million). See Note 10 for additional information on SFAS No. 133.

The increase in operations and maintenance expenses of \$68 million primarily related to generation summer reliability programs (the addition of approximately 500 MW of generating capability to enhance reliability for the summer of 2001) and increased power plant maintenance (\$61 million), increased pension and other costs (\$10 million), and provisions for credit exposure related to the California energy situation (\$10 million), partially offset by approximately \$13 million of non-recurring items recorded in the fourth quarter of 1999. See Note 17 for information on the generation summer reliability program. See Note 14 for additional information related to the California energy situation.

Net other income decreased \$39 million primarily because of a change in the market value of El Dorado's investment in a technology-related venture capital partnership in the prior year period (see Note 13) and other non-operating costs offset by an insurance recovery of environmental remediation costs.

Interest expense decreased by \$19 million primarily because of increased capitalized interest resulting from our generation expansion plan. See Note 12 for additional information on the generation expansion plan.

LIQUIDITY AND CAPITAL RESOURCES

CAPITAL EXPENDITURE REQUIREMENTS

The following table summarizes the actual capital expenditures for the nine months ended September 30, 2001 and estimated capital expenditures for the next three years:

CAPITAL EXPENDITURES
(dollars in millions)

| | (actual) | | (estimated) | |
|--------------------------|-----------------------|----------|----------------------|--------|
| | Nine-months ended | | Years ending | |
| | September 30, 2001 | 2001 | December 31, 2002 | 2003 |
| APS | | | | |
| Delivery | \$ 256 | \$ 340 | \$ 333 | \$ 305 |
| Existing generation (a) | 84 | 121 | 154 | -- |
| Subtotal | 340 | 461 | 487 | 305 |
| Pinnacle West Energy | | | | |
| Generation expansion (b) | 333 | 527 | 368 | 336 |
| Existing generation (a) | -- | -- | -- | 119 |
| Subtotal | 333 | 527 | 368 | 455 |
| SunCor (c) | 45 | 84 | 66 | 27 |
| Other (d) | 18 | 24 | 15 | 8 |
| Total | \$ 736 | \$ 1,096 | \$ 936 | \$ 795 |

(a) Pursuant to the 1999 Settlement Agreement, APS is required to move its generating assets and competitive services no later than December 31, 2002.

(b) See Note 12 and "Capital Resources and Cash Requirements - Pinnacle West Energy" below.

(c) Consists primarily of capital expenditures for land development and retail and office building construction.

(d) Primarily APS Energy Services.

CAPITAL RESOURCES AND DEBT FINANCING

PINNACLE WEST

The parent company's cash requirements and its ability to fund those requirements are discussed under "Capital Needs and Resources" in Management's Discussion and Analysis of Financial Condition and Results of Operation in Part II, Item 7 of the 2000 10-K.

During the nine-months ended September 30, 2001, the parent company increased its outstanding indebtedness by about \$400 million. During the nine-month period ended September 30, 2001, the parent company issued \$550 million in long-term debt and \$122 million in short-term borrowings and repaid \$275 million of long- and short-term debt. The majority of these borrowings were used to fund Pinnacle West Energy capital expenditures.

APS

APS' long-term debt redemption requirements, including optional repayments on long-term debt are: \$384 million in 2001; \$125 million in 2002; and zero in 2003. During 2001, APS expects to satisfy its long-term debt redemption requirements with cash from operations and long and short-term borrowings. Through September 2001, APS redeemed

\$62 million of its long-term debt. APS has also deposited \$72 million, plus interest, with the trustee for redemption in December 2001 of its First Mortgage Bonds, 9% Series due 2021. On October 5, 2001, APS issued \$400 million of 6.375% Notes due 2011. Based on market conditions and optional call provisions, APS may make optional redemptions of long-term debt from time to time.

Although provisions in APS' first mortgage bond indenture, articles of incorporation, and ACC financing orders establish maximum amounts of additional first mortgage bonds 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

See Note 12 of Notes to Condensed Consolidated Financial Statements for a discussion of construction and financing programs relating to Pinnacle West Energy.

OTHER SUBSIDIARIES

SunCor and El Dorado each fund all of their cash requirements with cash from operations and, in the case of SunCor, its own external financings. APS Energy Services funds its cash requirements with cash infusions from the parent company.

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 for the nine months ended September 30, 2001 and projected capital expenditures through 2003. SunCor expects to fund its capital requirements from internally generated cash and its own external financings.

El Dorado intends to focus on the realization of the value of its existing investments and does not have any capital requirements over the next three years. El Dorado's future investments are expected to be limited to opportunities related to the energy sector.

BUSINESS OUTLOOK

This section describes several major factors affecting our financial outlook.

COMPETITION AND ELECTRIC INDUSTRY RESTRUCTURING

See "Business Outlook - Competition and Industry Restructuring" in Item 7 of the 2000 10-K and Note 6 above for a discussion of developments affecting retail and wholesale electric competition. See Note 5 for a discussion of regulatory accounting.

GENERATION EXPANSION

See Note 12 for information regarding our generation expansion plans. The planned additional generation is expected to increase revenues, fuel expenses, operating expenses, and financing costs.

CALIFORNIA ENERGY MARKET ISSUES AND REFUNDS IN THE PACIFIC NORTHWEST

See Note 14 for information regarding California energy market issues and possible Pacific Northwest refunds.

FACTORS AFFECTING OPERATING REVENUES

Electric operating revenues are derived from sales of electricity in regulated retail markets in Arizona and in 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.

In APS' regulated retail market area, APS will provide electricity services to standard-offer, full-service customers and to energy delivery customers who have chosen another provider for their electricity commodity needs (unbundled customers). Customer growth in APS' service territory averaged 4.1% a year for the three years 1998 through 2000; we currently expect customer growth to average 3% to 4% a year for 2001 through 2003. We currently estimate that retail electricity sales in kilowatt-hours will grow 3% to 4.5% a year in 2001 through 2003, 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.

Wholesale activities will be affected by electricity prices and costs of available fuel and purchased power in the western United States, as well as competitive market conditions and regulatory and legislative changes in various state and federal jurisdictions, including the price mitigation plan adopted by FERC in June 2001 (see Note 6). These factors have significantly affected our trading and wholesale power activities and their resultant earnings contributions over the last several years. We cannot predict future contributions from trading and wholesale activities. See Note 10 and Item 3 below for additional information.

Competitive sales of energy and energy-related products and services are made by APS Energy Services in western states that have opened to competitive supply. Such activities are currently not material to our consolidated financial results.

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, and our hedging program for managing such costs. See "Natural Gas Supply" in Part II for additional information on gas transportation costs.

Operations and maintenance expenses are expected to be affected by sales mix and volumes, power plant operations, inflation, and other factors.

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. See Note 5 for the regulatory asset amortization that is being recorded in 1999 through 2004 pursuant to the 1999 Settlement Agreement.

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. 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.

The annual earnings contribution from our real estate subsidiary, SunCor, is expected to remain modest over the next several years.

El Dorado's historical results are not necessarily indicative of future performance for El Dorado. See Note 13 for additional information regarding El Dorado. El Dorado's strategies focus on realization of the value of its existing investments. Any future investments are expected to be related to the energy business.

We cannot accurately predict the impact of full retail competition on our financial position, cash flows, results of operations, or liquidity. 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.

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

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.

RATE MATTERS

See Note 6 for a discussion of a price reduction effective as of July 1, 2001, 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.

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements based on current expectations and we assume no obligation to update these statements. 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; 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 FERC in June 2001; regional economic and market conditions, including the California energy situation, 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; and 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 commodity prices, interest rates, 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 our 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 these derivative transactions to ensure that we have enough energy for our customers and limit our exposure to volatile wholesale prices for power and fuel. In addition, we engage in trading activities intended to profit from favorable movements of market prices.

As of September 30, 2001, a hypothetical adverse price movement of 10% in the market price of our commodity derivative portfolio would decrease the fair market value of these contracts by approximately \$20 million. This analysis does not include the favorable impact this same hypothetical price move would have on the underlying physical exposures being hedged with the commodity derivative portfolio. We plan to complete the move of our wholesale power marketing and trading activities from APS to the parent company by the end of 2002.

We are exposed to credit losses in the event of non-performance or non-payment by counterparties. We use a credit management process to assess and monitor the financial exposure of counterparties. Despite the fact that the great majority of our 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 impact on consolidated earnings for a given period.

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

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

RETAIL. See Note 6 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report for a discussion of competition and the rules regarding the introduction of retail electric competition in Arizona and a settlement agreement with the ACC.

WHOLESALE. On October 16, 2001, APS and other owners of electric transmission lines in the Southwest filed with FERC a request for a declaratory order confirming that their proposal to form WestConnect would satisfy FERC's requirements for the formation of a regional transmission organization. APS and the other filing parties have agreed to fund the start-up of WestConnect's operations, which are projected to begin in 2004, subject to FERC approval. WestConnect has been structured as a for-profit RTO and evolved from DesertSTAR, a non-profit corporation in which APS participated, which was originally designed to serve as an RTO for the southwestern United States.

ENVIRONMENTAL MATTERS

The Arizona Department of Environmental Quality issued to APS Notices of Violation, dated September 25, 2001 and October 15, 2001 alleging, among other things, burning of unauthorized materials and storage of hazardous waste without a permit. Each Notice of Violation requires APS to achieve and document compliance with specific environmental requirements. Although ADEQ may still seek civil penalties or take other enforcement action against APS, APS does not expect these matters to have a material adverse effect on its financial position, results of operations, or liquidity.

NATURAL GAS SUPPLY

The gas supply for APS and Pinnacle West Energy gas-fired facilities located, and to be located (see Note 12), in Pinal, Maricopa and Yuma Counties in Arizona, is transported pursuant to a firm, Full Requirements Transportation Service Agreement with El Paso Natural Gas Company. The transportation agreement features a 10 year rate moratorium established in a comprehensive rate case settlement entered into in 1996.

In a pending FERC proceeding, El Paso has proposed allocating its gas pipeline capacity in such a way that APS' (and other companies' with the same contract type) gas transportation rights could be significantly impacted. Various parties, including APS and Pinnacle West Energy, have challenged this allocation as being inconsistent with El Paso's existing contractual obligations and the 1996 settlement. At this time, there are ongoing discussions among FERC, El Paso and other affected parties to resolve these issues. We cannot currently predict the outcome of this matter.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

| Exhibit No. ----- | Description ----- |
|----------------------|------------------------------------|
| 12.1 | Ratio of Earnings to Fixed Charges |

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 |
| 3.2 | Bylaws, amended as of December 15, 1999 | 4.1 to the Company's Registration Statement on Form S-8 No. 333-95035 | 1-8962 | 1-20-00 |

(b) Reports on Form 8-K

During the quarter ended September 30, 2001, and the period from October 1 through November 5, 2001, we filed the following reports on Form 8-K:

Report dated September 26, 2001 containing Regulation FD disclosure regarding operating statistics and market, weather, and economic indicators.

Report dated October 22, 2001 containing Regulation FD disclosure relating to written materials to be presented at an analyst conference on October 23, 2001.

Report dated October 18, 2001 regarding (i) financial information for the periods ended September 30, 2001 and 2000; (ii) the Arizona Supreme Court's decision to review a lower court decision affirming the 1999 Settlement Agreement; (iii) APS' October 18, 2001 filing with the ACC requesting ACC approval of a rule variance and a purchase power agreement with the Company; and (iv) Regulation FD disclosure relating to operating statistics and market, weather, and economic indicators.

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

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 5, 2001

By: Chris N. Froggatt

Chris N. Froggatt
Vice President and Controller
(Principal Accounting Officer
and Officer Duly Authorized
to sign this Report)

PINNACLE WEST CAPITAL CORPORATION
COMPUTATION OF EARNINGS TO FIXED CHARGES(a)
 (THOUSANDS OF DOLLARS)

| | Nine Months Ended | Twelve Months Ended December 31 | | | | |
|--|----------------------|------------------------------------|----------------|----------------|----------------|----------------|
| | 9/30/01 | 2000 | 1999 | 1998 | 1997 | 1996 |
| Earnings: | | | | | | |
| Income from Continuing Operations | \$291,561 | \$302,332 | \$269,772 | \$242,892 | \$235,856 | \$211,059 |
| Income Taxes | 188,866 | 194,200 | 141,592 | 138,589 | 126,943 | 99,224 |
| Fixed Charges | 156,213 | 202,804 | 194,070 | 201,184 | 215,201 | 230,978 |
| Total | 636,640 | 699,336 | 605,434 | 582,665 | 578,000 | 541,261 |
| Fixed Charges: | | | | | | |
| Interest Expense | 129,103 | 166,447 | 157,142 | 163,975 | 177,383 | 192,705 |
| Estimated Interest Portion of Annual Rents | 27,110 | 36,357 | 36,928 | 37,209 | 37,818 | 38,273 |
| Total Fixed Charges | 156,213 | 202,804 | 194,070 | 201,184 | 215,201 | 230,978 |
| Ratio of Earnings to Fixed Charges (rounded down) | 4.07 | 3.44 | 3.11 | 2.89 | 2.68 | 2.34 |

(a) We have reclassified certain prior year amounts to conform to the current year presentation.

End of Filing

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