PINNACLE WEST CAPITAL CORP
Form 10-K405
March 27, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 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 85072-3999 (Address of principal executive offices, including zip code)	(602) 250-1000 (Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title Of Each Class	Name Of Each Exchange On Which Registered
Common Stock, No Par Value	New York Stock Exchange Pacific Stock Exchange

Title Of Each Class Of Voting Stock	Shares Outstanding As Of March 25, 2002	Aggregate Market Value Of Shares Held By Non-Affiliates As Of March 25, 2002
Common Stock, No Par Value	84,770,703	$3,751,951,315(a)

(a) Computed by reference to the closing price on the composite tape on March 25, 2002, as reported by the Wall Street Journal.

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 [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in any amendment to this Form 10-K. [X]

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement relating to its Annual Meeting of Shareholders to be held on May 22, 2002 are incorporated by reference into Part III hereof.

TABLE OF CONTENTS

GLOSSARY

ACC - Arizona Corporation Commission

ACC Staff - Staff of the Arizona Corporation Commission

ADEQ - Arizona Department of Environmental Quality

AISA - Arizona Independent Scheduling Administrator

ALJ - Administrative Law Judge

ANPP - Arizona Nuclear Power Project, also known as Palo Verde

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

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

CC&N - Certificate of Convenience and Necessity

Cholla - Cholla Power Plant

Citizens - Citizens Communications Company

Clean Air Act - the Clean Air Act, as amended

Company - Pinnacle West Capital Corporation

DOE - United States Department of Energy

EITF - Emerging Issues Task Force

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

EPA - United States Environmental Protection Agency

ERMC - Energy Risk Management Committee

FASB - Financial Accounting Standards Board

FERC - United States Federal Energy Regulatory Commission

FIP - Federal Implementation Plan

Four Corners - Four Corners Power Plant

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

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-hours, one million watts per hour

1999 Settlement Agreement - Settlement Agreement among APS and other parties related to the implementation of retail electric competition in Arizona

NOV - Notice of Violation

NRC - United States Nuclear Regulatory Commission

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

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

PRP - Potentially responsible parties under Superfund

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

SFAS - Statement of Financial Accounting Standards

SNWA - Southern Nevada Water Authority

SunCor - SunCor Development Company, a subsidiary of the Company

Superfund - Comprehensive Environmental Response, Compensation, and Liability Act

T&D - transmission and distribution

WestConnect - WestConnect RTO, LLC, a proposed RTO to be formed by owners of electric transmission lines in the southwestern United States

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PART I

ITEM 1. BUSINESS

OVERVIEW OF OUR BUSINESS

We were incorporated in 1985 under the laws of the State of Arizona and own all of the outstanding equity securities of APS. APS is Arizona's largest electric utility and provides either retail or wholesale electric service to substantially all of the state, with the major exceptions of the Tucson metropolitan area and about one-half of the Phoenix metropolitan area. APS also generates and, through our marketing and trading division, sells and delivers electricity to wholesale customers in the western United States.

Our other major subsidiaries are:

* Pinnacle West Energy, through which we conduct our unregulated electricity generation operations;

* APSES, which provides commodity energy and energy-related products to key customers in competitive markets in the western United States;

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

* El Dorado, an investment firm.

We discuss each of these subsidiaries in greater detail below.

Pinnacle West's marketing and trading division sells in the wholesale market APS and Pinnacle West Energy generation production output that is not needed for APS' native load, which includes loads for retail customers and traditional cost-of-service wholesale customers. The division also purchases electricity and natural gas in forward markets to hedge the costs of serving retail customer demand. Additionally, the marketing and trading division, subject to specific parameters established by the Board of Directors, markets, hedges and trades in electricity, fuels and emission allowances and credits. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 for information about the historical and prospective contribution of the marketing and trading activities to our financial results.

At December 31, 2001, we employed about 7,600 people, including the employees of our subsidiaries. Of these employees, 5,500 were employees of our major subsidiary, APS, and employees assigned to jointly-owned generating facilities for which APS serves as the generating facility manager. About 2,100 people were employed by Pinnacle West and our other subsidiaries. Our principal executive offices are located at 400 North Fifth Street, Phoenix, Arizona 85004 (telephone 602-250-1000).

See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 and Note 16 of Notes to Consolidated Financial Statements in Item 8 for a discussion of our business segments.

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ARIZONA REGULATORY DEVELOPMENTS - OVERVIEW

On September 21, 1999, the ACC approved Rules that provide a framework for the introduction of retail electric competition in Arizona. On September 23, 1999, the ACC approved a comprehensive Settlement Agreement among APS and various parties related to the implementation of retail electric competition in Arizona. See "Retail Electric Competition Rules" and "1999 Settlement Agreement" in Note 3 of Notes to Consolidated Financial Statements in Item 8 for additional information about the 1999 Settlement Agreement and the Rules, including outstanding legal challenges to the Rules.

Under the Rules, as modified by the 1999 Settlement Agreement, APS is required to transfer all of its competitive electric assets and services either to an unaffiliated party or to a separate corporate affiliate no later than December 31, 2002. Consistent with that requirement, APS has been addressing the legal and regulatory requirements necessary to complete the transfer of its generation assets to Pinnacle West Energy on or before that date. In anticipation of APS' transfer of generation assets, Pinnacle West Energy has completed, and is in the process of developing and planning, various generation expansion projects so that APS can reliably meet the energy requirements of its Arizona customers.

Following APS' transfer of its fossil-fueled generation assets and the receipt of certain regulatory approvals, Pinnacle West Energy expects to sell its power at wholesale to Pinnacle West's marketing and trading 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:

* 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 those requirements coming from a "competitive bidding" process) starting in 2003; and

* approve as just and reasonable a long-term purchase power agreement between APS and Pinnacle West.

APS requested these ACC actions to ensure ongoing reliable service to APS standard-offer, full-service customers in a volatile generation market and to recognize Pinnacle West Energy's significant investment to serve APS load. See "Proposed Rule Variance and Purchase Power Agreement" in Note 3 of Notes to Consolidated Financial Statements in Item 8 for additional information about APS' October 2001 filing.

On February 8, 2002, the ACC's Chief ALJ issued a procedural order which consolidated the ACC docket relating to APS' October 2001 filing with several other pending ACC dockets, including a "generic" docket requested by the ACC Chairman to "determine if changed circumstances require the [ACC] to take another look at restructuring in Arizona." Although the order consolidates several dockets, it states that a hearing on the APS matter will commence on April 29, 2002. The order went on to state that, contrary to APS' position, the ALJ was construing the October 2001 filing as a request by APS to amend the 1999 ACC order that approved the 1999 Settlement Agreement.

On March 22, 2002, the ACC Staff issued a report to the ACC recommending that the ACC address the following issues in the generic docket:

* The extent and manner of the ACC's involvement in monitoring market conditions and/or mitigating the development of market power for generation and transmission;

* The lack of guidance in the Rules regarding the mechanics of the "competitive bidding process" referenced above;

* The consideration of alternatives to the transfer of generation assets required by the Rules (the ACC Staff stated that such transfers would be "unwise" at the present time and recommended that "all transfer and separation of utilities' assets be stayed pending the completion of the generic docket");

* The consideration of transmission constraints that could impact the development of the wholesale power market;

* The reassessment of adjustor mechanisms for standard-offer rates in light of problems with the development of a wholesale power market; and

* The adequacy of customer "shopping credits" in the context of the development of a competitive retail market (a shopping credit is the cost a customer does not pay to a utility distribution company if the customer obtains generation from another party).

Although not a specific ACC Staff recommendation, the report was also critical of certain aspects of the proposed purchase power agreement between APS and Pinnacle West.

A modification to the electric competition Rules or the 1999 Settlement Agreement could, among other things, adversely affect APS' ability to transfer its generation assets to Pinnacle West Energy by December 31, 2002. Pinnacle West cannot predict the outcome of the consolidated docket or its effect on the specific requests in APS' October 2001 filing, the Rules or the 1999 Settlement Agreement.

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, including the introduction of retail electric competition in Arizona and APS' October 2001 ACC filing; the outcome of regulatory and legislative proceedings relating to the restructuring; state and federal regulatory and legislative decisions and actions, including the price mitigation plan adopted by the FERC in June 2001; regional economic and market conditions, including the California energy situation and completion of generation construction in the region, which could affect customer growth and the cost of power supplies; the cost of debt and equity capital; weather variations affecting local and regional customer energy usage; conservation programs;

power plant performance; the successful completion of our generation expansion program; regulatory issues associated with generation expansion, such as permitting and licensing; our ability to compete successfully outside traditional regulated markets (including the wholesale market); technological developments in the electric industry; and the strength of the real estate market in SunCor's market areas, which include Arizona, New Mexico and Utah.

REGULATION AND COMPETITION

RETAIL

The ACC regulates APS' retail electric rates and its issuance of securities. The ACC must also approve any transfer of APS' utility property and transactions between APS and affiliated parties. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Business Outlook - Other Factors Affecting Our Financial Outlook" in Item 7 and Note 3 of Notes to Consolidated Financial Statements in Item 8 for a discussion of the status of electric industry restructuring in Arizona.

APS is subject to varying degrees of competition from other utilities in its region (such as Tucson Electric Power Company, Southwest Gas Corporation, and Citizens Communications Company) as well as cooperatives, municipalities, electrical districts, and similar types of governmental organizations (principally Salt River Project). APS also faces competition from low-cost hydroelectric power and parties that have access to low-priced preferential federal power and other subsidies. In addition, some customers, particularly industrial and large commercial customers, may own and operate facilities to generate their own electric energy requirements.

WHOLESALE

GENERAL

The FERC regulates rates for wholesale power sales and transmission services. During 2001, approximately 54% of our electric operating revenues resulted from such sales and services. APS transferred most of the wholesale marketing and trading activities to Pinnacle West during 2001. Pinnacle West's marketing and trading division sells in the wholesale market APS and Pinnacle West Energy generation production output that is not needed for APS' native load and, in doing so, competes with other utilities, power marketers, and independent power producers. See "Management's Discussion and Analysis of

Financial Condition and Results of Operations" and Note 16 of Notes to Consolidated Financial Statements in Item 8 for additional information about our marketing and trading activities, including the historical and prospective contribution of marketing and trading activities to our financial results. See Note 10 of Notes to Consolidated Financial Statements in Item 8 for information regarding our generation expansion plans.

REGIONAL TRANSMISSION ORGANIZATIONS

On December 20, 1999, the FERC issued its Order No. 2000 regarding Regional Transmission Organizations. In its order, the FERC set minimum characteristics and functions that must be met by utilities that participate in RTOs. The order provides for an open, flexible structure for RTOs to meet the needs of the market and provides for the possibility of incentive ratemaking and other benefits for utilities that participate in an RTO.

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The characteristics for an acceptable RTO include independence from market participants, operational control over a region large enough to support efficient and nondiscriminatory markets, and exclusive authority to maintain short-term reliability. On October 16, 2001, APS and other owners of electric transmission lines in the Southwest filed with the FERC a request for a declaratory order confirming that their proposal to form WestConnect RTO, LLC would satisfy the FERC's requirements for the formation of an RTO. APS and the other filing parties have agreed to fund the start-up of WestConnect's operations, which are subject to FERC approval. WestConnect is projected to begin operations in 2004. WestConnect has been structured as a for-profit RTO and evolved from DesertSTAR, a not-for-profit corporation in which APS participated, which was originally designed to serve as an RTO for the southwestern United States.

The ACC retail electric competition Rules also required the formation and implementation of an Arizona Independent Scheduling Administrator. The purpose of the AISA is to oversee the application of operating protocols to ensure statewide consistency for transmission access. The AISA is anticipated to be a temporary organization until the implementation of an independent system operator or RTO. APS participated in the creation of the AISA, a not-for-profit entity, and the filing at the FERC for approval of its operating protocols. The operating protocols were partially rejected and the remainder are currently under review. On February 8, 2002, the ACC's Chief ALJ issued a procedural order which consolidated the ACC docket relating to the AISA with several other pending ACC dockets, including a "generic" docket requested by the ACC Chairman to "determine if changed circumstances require the [ACC] to take another look at restructuring in Arizona." See "Arizona Regulatory Developments - Overview" above and "Proposed Rule Variance and Purchase Power Agreement" in Note 3 of Notes to Consolidated Financial Statements in Item 8 for additional information about the consolidated ACC docket.

BUSINESS OF ARIZONA PUBLIC SERVICE COMPANY

Following is a discussion of the business of APS, our major subsidiary.

GENERAL

APS was incorporated in 1920 under the laws of Arizona and is Arizona's largest electric utility, with more than 874,000 customers. APS provides either retail or wholesale electric service to substantially all of the state of Arizona, with the major exceptions of the Tucson metropolitan area and about one-half of the Phoenix metropolitan area. APS also generates and, through our marketing and trading division, sells and delivers electricity to wholesale customers in the western United States. During 2001, no single purchaser or user of energy accounted for more than 2.3% of consolidated electric revenues.

At December 31, 2001, APS employed approximately 5,500 people, which includes employees assigned to jointly-owned generating facilities for which APS serves as the generating facility manager. APS' principal executive offices are located at 400 North Fifth Street, Phoenix, Arizona 85004 (telephone 602-250-1000).

GENERATING FUEL AND PURCHASED POWER

See "Properties - Accredited Capacity" in Item 2 for information about our power plants by fuel types.

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2001 ENERGY MIX

Our consolidated sources of energy during 2001 were: purchased power and interchange (net) - 45.6% (approximately 90% of which was for wholesale power operations); coal - 27.3%; nuclear -18.3%; gas - 8.2%; and other (includes oil, hydro and solar) - 0.6%.

COAL SUPPLY

CHOLLA Cholla is a coal-fired power plant located in northeastern Arizona. It is a jointly-owned facility operated by APS. APS purchases most of Cholla's coal requirements from a coal supplier that mines all of the coal under a long-term lease of coal reserves owned by the Navajo Nation, the federal government, and private landholders. Cholla has sufficient coal under current contracts to ensure a reliable fuel supply through 2005. APS purchases a portion of Cholla's coal requirements on the spot market to take advantage of competitive pricing options. Following expiration of current contracts, APS believes that numerous competitive fuel supply options will exist to ensure continuous plant operation. APS expects the current supplier to continue to provide most of Cholla's low sulfur coal requirements through the current contract. APS believes that there are sufficient reserves of low sulfur coal available from other suppliers to ensure the continued operation of Cholla for its useful life.

FOUR CORNERS Four Corners is a coal-fired power plant located in the northwest corner of New Mexico. It is a jointly-owned facility operated by APS. APS purchases all of Four Corners' coal requirements from a supplier with a long-term lease of coal reserves owned by the Navajo Nation. Four Corners is under contract for coal through 2004, with options to extend the contract through the plant site lease expiration in 2016. The Four Corners lease and related federal rights-of-way and easements include covenants to prevent the Navajo Nation from taxing or assessing Four Corners or the fuel used by the facility. These covenants expired in July 2001, and the Navajo Nation has assessed taxes in the form of a Business Activity Tax and a Possessory Interest Tax on the coal supplier and the plant. The tax paid by the coal supplier is passed on to the Four Corners participants through the fuel supply agreement. These amounts have been largely mitigated due to a New Mexico law which provides tax credits for coal purchased on the Navajo reservation. APS has contested, on jurisdictional grounds, the right of the Navajo Nation to assess these taxes on the plant. APS is currently engaged in negotiations with the Navajo Nation on a settlement that will provide for payments to the Navajo Nation that will allow the continued economic operation of Four Corners. However, a settlement has not been finalized and APS cannot currently predict the outcome of this matter.

NAVAJO GENERATING STATION The Navajo Generating Station is a coal-fired power plant located in northern Arizona. It is a jointly-owned facility operated by Salt River Project. The Navajo Generating Station's coal requirements are purchased from a supplier with long-term leases from the Navajo Nation and the Hopi Tribe. The Navajo Generating Station is under contract with its coal supplier through 2011, with options to extend through the plant site lease expiration in 2019. The Navajo Generating Station lease waives certain taxes through the lease expiration in 2019. The lease provides for the potential to renegotiate the coal royalty in 2007 and 2017, which may impact the fuel price.

See "Properties - Accredited Capacity" in Item 2 for information about APS' ownership interest in Cholla, Four Corners, and the Navajo Generating Station. See Note 10 of Notes to

Consolidated Financial Statements in Item 8 for information regarding our coal mine reclamation obligations.

NATURAL GAS SUPPLY

APS purchases the majority of its natural gas requirements for its gas-fired plants under contracts with a number of natural gas suppliers. APS' natural gas supply is transported pursuant to a firm transportation service contract with El Paso Natural Gas Company (see description below). We anticipate that the natural gas requirements for our generation expansion plans (see Note 10 of Notes to Consolidated Financial Statements in Item 8) will be met with these contracts. We continue to analyze the market to determine the most favorable source and method of meeting our natural gas requirements.

The gas supply for APS and Pinnacle West Energy gas-fired facilities located, and to be located (see Note 10 of Notes to Consolidated Financial Statements in Item 8), 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 Natural Gas Company 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 Natural Gas Company's existing contractual obligations and the 1996 settlement. The FERC has scheduled a public conference in April 2002 to discuss an appropriate mechanism for allocating capacity on the El Paso Natural Gas Company pipeline. We cannot currently predict the outcome of this matter.

NUCLEAR FUEL SUPPLY

PALO VERDE FUEL CYCLE Palo Verde is a nuclear power plant located about 50 miles west of Phoenix, Arizona. It is a jointly-owned facility operated by APS. The fuel cycle for Palo Verde is comprised of the following stages:

* mining and milling of uranium ore to produce uranium concentrates;
* conversion of uranium concentrates to uranium hexafluoride;
* enrichment of uranium hexafluoride;
* fabrication of fuel assemblies;
* utilization of fuel assemblies in reactors; and
* storage and disposal of spent fuel.

The Palo Verde participants have contracted for sufficient uranium concentrates to meet operational requirements through 2002. Spot purchases on the uranium market will be made, as appropriate, in lieu of any uranium that might be obtained through contractual options. Existing uranium concentrates contracts and options could be utilized to meet approximately 67% of requirements in 2003.

The Palo Verde participants have contracts and options for uranium conversion services that could be utilized to meet approximately 100% of requirements in 2002 and 2003. The Palo Verde

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participants have an enrichment services contract and an enriched uranium product contract that furnish enrichment services required for the operation of the three Palo Verde units through 2003.

The Palo Verde participants have a new enriched uranium product contract that will furnish up to 100% of Palo Verde's requirements for uranium concentrates, conversion services and enrichment services from 2004 through 2008. This contract could also provide 100% of enrichment services in 2009 and 2010.

In addition, existing contracts will provide 100% of fuel assembly fabrication services until at least 2015 for each Palo Verde unit.

SPENT NUCLEAR FUEL AND WASTE DISPOSAL Nuclear power plant operators are required to enter into spent fuel disposal contracts with DOE, and DOE is required to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by domestic power reactors. Although the Nuclear Waste Act required the DOE to develop a permanent repository for the storage and disposal of spent nuclear fuel by 1998, the DOE has announced that the repository cannot be completed before 2010 and that it does not intend to begin accepting spent fuel prior to that date. In November 1997, the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) issued a decision preventing the DOE from excusing its own delay, but refused to order the DOE to begin accepting spent nuclear fuel. Based on this decision and DOE's delay, a number of utilities filed damages lawsuits against DOE in the Court of Federal Claims.

In February 2002, the U.S. Secretary of Energy recommended to President Bush that the Yucca Mountain, Nevada site be developed as a permanent repository for spent nuclear fuel. The President transmitted this recommendation to Congress. A Congressional decision on this issue is expected sometime during mid-summer 2002. We cannot currently predict what further steps will be taken in this area.

Facility funding is a further complication. While all nuclear utilities pay into a so-called nuclear waste fund an amount calculated on the basis of the output of their respective plants, the annual Congressional appropriations for the permanent repository have been for amounts less than the amounts paid into the waste fund (the balance of which is being used for other purposes).

APS has existing fuel storage pools at Palo Verde and is in the process of completing construction of a new facility for on-site dry storage of spent fuel. With the existing storage pools and the addition of the new facility, APS believes that spent fuel storage or disposal methods will be available for use by Palo Verde to allow its continued operation through the term of the operating license for each Palo Verde unit. See "Palo Verde Nuclear Generating Station" in Note 10 of Notes to Consolidated Financial Statements in Item 8 for a discussion of interim spent fuel storage costs.

Although some low-level waste has been stored on-site in a low-level waste facility, APS is currently shipping low-level waste to off-site facilities. APS currently believes that interim low-level waste storage methods are or will be available for use by Palo Verde to allow its continued operation and to safely store low-level waste until a permanent disposal facility is available.

APS believes that scientific and financial aspects of the issues of spent fuel and low-level waste storage and disposal can be resolved satisfactorily. However, APS acknowledges that their ultimate resolution in a timely fashion will require political resolve and action on national and

regional scales which APS is less able to predict. APS expects to vigorously protect and pursue its rights related to this matter.

PURCHASED POWER AGREEMENTS

In addition to that available from its own generating capacity (see "Properties" in Item 2), APS purchases electricity under various arrangements. One of the most important of these is a long-term contract with Salt River Project. The amount of electricity available to APS is based in large part on customer demand within certain areas now served by APS pursuant to a related territorial agreement. The generating capacity available to APS pursuant to the contract was 329 MW from January through May 2001, and starting in June 2001, as part of a broad renegotiation of the agreement in light of the electric industry transition to a competitive generation market, it changed to 336 MW. In 2001, APS received approximately 1,741,000 MWh of energy under the contract and paid about $81.5 million for capacity availability and energy received. This contract may be canceled by Salt River Project on three years' notice, given no earlier than December 31, 2003. APS may also cancel the contract on five years' notice, given no earlier than December 31, 2006.

In September 1990, APS entered into a thirty-year seasonal capacity exchange agreement with PacifiCorp. Under this agreement, APS receives electricity from PacifiCorp during the summer peak season (from May 15 to September 15) and APS returns electricity to PacifiCorp during the winter season (from October 15 to February 15). Until 2020, APS and PacifiCorp each has 480 MW of capacity and a related amount of energy available to it under the agreement for their respective seasons. In 2001, APS received approximately 571,000 MWh of energy under the capacity exchange. APS must also make additional offers of energy to PacifiCorp each year through October 31, 2020. Pursuant to this requirement, during 2001, PacifiCorp received offers of 1,112,300 MWh and purchased about 434,000 MWh.

CONSTRUCTION PROGRAM

During the years 1999 through 2001, APS incurred approximately $1.3 billion in capital expenditures. APS' capital expenditures for the years 2002 through 2004 are expected to be primarily for expanding transmission and distribution capabilities to meet growing customer needs, for upgrading existing utility property, and for environmental purposes. APS' capital expenditures were $471 million in 2001. APS' capital expenditures, including expenditures for environmental control facilities, for the years 2002 through 2004 have been estimated as follows:

(dollars in millions)

BY YEAR	
2002	$ 498
2003	271
2004	280
Total	$1,049

BY MAJOR FACILITIES	
Production	$ 149
Transmission and Distribution	900
Total	$1,049

The amounts for 2002 through 2004 assume that APS' generation (production) assets are transferred to Pinnacle West Energy as of December 31, 2002. These amounts exclude capitalized interest costs and include capitalized property taxes and approximately $30 million (only in 2002) for nuclear fuel. APS conducts a continuing review of its construction program.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital Needs and Resources" in Item 7 for additional information about APS' construction program and for information about Pinnacle West Energy's generating expansion plans.

MORTGAGE REPLACEMENT FUND REQUIREMENTS

So long as any of its first mortgage bonds are outstanding, APS is required for each calendar year to deposit with the trustee under its mortgage cash in a formularized amount related to net additions to its mortgaged utility plant. APS may satisfy all or any part of this "replacement fund" requirement by using redeemed or retired bonds, net property additions, or property retirements. For 2001, the replacement fund requirement amounted to approximately $155 million. Certain of the bonds APS has issued under the mortgage that are callable prior to maturity are redeemable at their par value plus accrued interest with cash APS deposits in the replacement fund. These call provisions are subject in many cases to a period of time after the original issuance of the bonds during which they may not be redeemed in this manner. See Notes 6 and 18 of Notes to Consolidated Financial Statements in Item 8 for information regarding APS' first mortgage bonds.

ENVIRONMENTAL MATTERS

EPA ENVIRONMENTAL REGULATION

CLEAN AIR ACT We are subject to a number of requirements under the Clean Air Act. The Clean Air Act addresses, among other things:

* "acid rain";
* visibility in certain specified areas;
* hazardous air pollutants; and
* areas that have not attained national ambient air quality standards.

With respect to "acid rain," the Clean Air Act established a system of sulfur dioxide emissions "allowances" to offset each ton of sulfur dioxide emitted by affected power plants. Based on EPA allowance allocations, we will have sufficient allowances to permit continued operation of our plants at current levels without installing additional equipment. The Clean Air Act also requires the EPA to set nitrogen oxides emissions limitations for certain coal-fired units. The EPA rule allows emissions from all units in a plant to be averaged to demonstrate compliance with the emission limitation. Currently, nitrogen oxides emissions from all of our units are within the limitations specified under the EPA's rules. We do not currently expect this rule to have a material impact on our financial position, results of operations, or liquidity.

The Clean Air Act required the EPA to establish a Grand Canyon Visibility Transport Commission to complete a study on visibility impairment in sixteen "Class I Areas" (large national parks and wilderness areas) on the Colorado Plateau. The Navajo Generating Station, Cholla, and Four Corners are located near several Class I Areas on the Colorado Plateau. The Visibility Commission completed its study and on June 10, 1996 submitted its final recommendations to the EPA.

On April 22, 1999, the EPA announced final regional haze rules. These new regulations require states to submit, by 2008, implementation plans to eliminate all man-made emissions causing

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visibility impairment in certain specified areas, including Class I Areas in the Colorado Plateau. The 2008 implementation plans must also include consideration and potential application of best available retrofit technology for major stationary sources which came into operation between August 1962 and August 1977, such as the Navajo Generating Station, Cholla, and Four Corners.

The rules allow the nine western states and tribes that participated in the Visibility Commission process to follow an alternate implementation plan and schedule for the Class I Areas considered by the Visibility Commission. Under this option, those states and tribes would submit implementation plans by 2003, which would incorporate certain regional sulfur dioxide emissions milestones for the years 2003, 2008, 2013, and 2018 (which include the application of best available retrofit technology). If the regional emissions in those years were within those milestones, there would be no further emission reduction requirements, and if they were exceeded, then an emission trading program would be implemented to maintain the emissions within those milestones.

The EPA is currently reviewing an "Annex" to the Visibility Commission recommendations that specifies the regional sulfur dioxide emission milestones. The EPA's approval of the Annex would allow the Visibility Commission states and tribes to pursue the alternate implementation of the regional haze rules through 2018. Any states and tribes that implement this option would have to submit revised implementation plans in 2008 to address visibility in those Class I Areas which were not included in the Visibility Commission process. Because the Annex is not final and Arizona and the Navajo Nation have the discretion to choose between the national or the alternate options, the actual impact on APS cannot be determined at this time.

In July 1997, the EPA promulgated final National Ambient Air Quality Standards for ozone and particulate matter. Pursuant to these rules, the ozone standard is more stringent and a new ambient standard for very fine particles has been established. Congress has enacted legislation that could delay the implementation of regional haze requirements and the particulate matter ambient standard; however, the legislation does not preclude the Visibility Commission states and tribes from implementing the alternate regional haze rules discussed above. A federal court determined that the EPA's promulgation of the National Ambient Air Quality Standards violated the constitutional prohibition on delegation of legislative power. The court remanded the ozone standard, vacated the particulate matter standard, and invited the parties that challenged the standards to brief the court on vacating or remanding the very fine particulates standard. On February 27, 2001, the U.S. Supreme Court overruled the federal court's ruling. The Supreme Court further held that the EPA could not consider the cost of reducing harmful emissions when setting air quality standards. However, the Supreme Court found the EPA implementation policy for the revised ozone standards to be unlawful, and remanded this issue for consideration along with the other preserved challenges to the National Ambient Air Quality Standards. Because the actual level of emissions controls, if any, for any unit cannot be determined at this time, APS currently cannot estimate the capital expenditures, if any, which would result from the final rules. However, APS does not currently expect these rules to have a material adverse effect on its financial position, results of operations, or liquidity.

With respect to hazardous air pollutants emitted by electric utility steam generating units, the EPA recently determined that mercury emissions and other hazardous air pollutants from coal and oil-fired power plants will be regulated. We expect that the EPA will propose specific rules for this purpose in 2003 and finalize them by 2004, with compliance required by 2008. Because the ultimate requirements that the EPA may impose are not yet known, we cannot currently estimate the capital expenditures, if any, which may be required.

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Certain aspects of the Clean Air Act may require APS to make related expenditures, such as permit fees. APS does not expect any of these expenditures to have a material impact on its financial position, results of operations, or liquidity.

FEDERAL IMPLEMENTATION PLAN In September 1999, the EPA proposed a FIP to set air quality standards at certain power plants, including the Navajo Generating Station and Four Corners. The comment period on this proposal ended in November 1999. The FIP is similar to current Arizona regulation of the Navajo Generating Station and New Mexico regulation of Four Corners, with minor modifications. APS does not currently expect the FIP to have a material impact on its financial position, results of operations, or liquidity.

SUPERFUND The Comprehensive Environmental Response, Compensation, and Liability Act (Superfund) establishes liability for the cleanup of hazardous substances found contaminating the soil, water, or air. Those who generated, transported, or disposed of hazardous substances at a contaminated site are among those who are potentially responsible parties. PRPs may be strictly, and often jointly and severally, liable for clean-up. The EPA had previously advised APS that the EPA considers APS to be a PRP in the Indian Bend Wash Superfund Site, South Area. APS' Ocotillo Power Plant is located in this area. Based on the information to date, including available insurance coverage and an EPA estimate of cleanup costs, APS does not expect this matter to have a material impact on its financial position, results of operations, or liquidity.

MANUFACTURED GAS PLANT SITES APS is currently investigating properties which it now owns or which were previously owned by it or its corporate predecessors, that were at one time sites of, or sites associated with, manufactured gas plants. The purpose of this investigation is to determine if:

* waste materials are present;
* such materials constitute an environmental or health risk; and
* APS has any responsibility for remedial action.

Where appropriate, APS has begun clean-up of certain of these sites. APS does not expect these matters to have a material adverse effect on its financial position, results of operations, or liquidity.

ARIZONA DEPARTMENT OF ENVIRONMENTAL QUALITY

ADEQ issued to APS Notices of Violation (NOV), dated September 25, 2001 and October 15, 2001 alleging, among other things, burning of unauthorized materials and storage of hazardous waste without a permit at the Cholla Power Plant. Each Notice of Violation requires APS to achieve and document compliance with specific environmental requirements. APS has submitted responses to the NOVs as well as additional information requested by the agency. To date, ADEQ has not sought penalties or taken other enforcement actions against APS. APS does not expect these matters to have a material adverse effect on its financial position, results of operations, or liquidity.

NAVAJO NATION ENVIRONMENTAL ISSUES

Four Corners and the Navajo Generating Station are located on the Navajo Reservation and are held under easements granted by the federal government as well as leases from the Navajo Nation. APS is the Four Corners operating agent. APS owns a 100% interest in Four Corners Units 1, 2, and 3, and a 15% interest in Four Corners Units 4 and 5. APS owns a 14% interest in Navajo Generating Station Units 1, 2, and 3.

In July 1995, the Navajo Nation enacted the Navajo Nation Air Pollution Prevention and Control Act, the Navajo Nation Safe Drinking Water Act, and the Navajo Nation Pesticide Act (collectively, the Navajo Acts). The Navajo Acts purport to give the Navajo Nation Environmental Protection Agency authority to promulgate regulations covering air quality, drinking water, and pesticide activities, including those that occur at Four Corners and the Navajo Generating Station. The Four Corners and Navajo Generating Station participants dispute that purported authority, and by separate letters dated October 12 and October 13, 1995, the Four Corners participants and the Navajo Generating Station participants requested the United States Secretary of the Interior to resolve their dispute with the Navajo Nation regarding whether or not the Navajo Acts apply to operations of Four Corners and the Navajo Generating Station. On October 17, 1995, the Four Corners participants and the Navajo Generating Station participants each filed a lawsuit in the District Court of the Navajo Nation, Window Rock District, seeking, among other things, a declaratory judgment that:

* their respective leases and federal easements preclude the application of the Navajo Acts to the operations of Four Corners and the Navajo Generating Station; and

* the Navajo Nation and its agencies and courts lack adjudicatory jurisdiction to determine the enforceability of the Navajo Acts as applied to Four Corners and the Navajo Generating Station.

On October 18, 1995, the Navajo Nation and the Four Corners and Navajo Generating Station participants agreed to indefinitely stay these proceedings so that the parties may attempt to resolve the dispute without litigation. The Secretary and the Court have stayed these proceedings pursuant to a request by the parties. APS cannot currently predict the outcome of this matter.

In February 1998, the EPA issued regulations identifying those Clean Air Act provisions for which it is appropriate to treat Indian tribes in the same manner as states. The EPA has announced that it has not yet determined whether the Clean Air Act would supersede pre-existing binding agreements between the Navajo Nation and the Four Corners participants and the Navajo Generating Station participants that could limit the Navajo Nation's environmental regulatory authority over the Navajo Generating Station and Four Corners. APS believes that the Clean Air Act does not supersede these pre-existing agreements. APS cannot currently predict the outcome of this matter.

On August 8, 2000, the EPA signed an Eligibility Determination for the Navajo Nation for Grants Under Section 105 of the Clean Air Act in which the EPA determined that the Navajo Nation was eligible to receive grants under the Clean Air Act. On September 8, 2001, after learning of the eligibility determination, APS filed a Petition for Review of the EPA's decision in the United States Court of Appeals for the Ninth Circuit in order to ensure that the EPA's August 2000 determination not be construed to constitute a determination of the Navajo Nation's authority to regulate Four Corners and the Navajo Generating Station. APS V. UNITED STATES ENVIRONMENTAL PROTECTION AGENCY, No. 01-71577. APS, the EPA and other parties have requested that the Court stay any further briefing while they negotiate a settlement.

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In April 2000, the Navajo Tribal Council approved operating permit regulations under the Navajo Nation Air Pollution Prevention and Control Act. We believe that the regulations fail to recognize that the Navajo Nation did not intend to assert jurisdiction over Four Corners and the Navajo Generating Station. On July 12, 2000, the Four Corners participants and the Navajo Generating Station participants each filed a petition with the Navajo Supreme Court for review of the operating permit regulations. We cannot currently predict the outcome of this matter.

WATER SUPPLY

Assured supplies of water are important for our generating plants. At the present time, APS has adequate water to meet its needs. However, conflicting claims to limited amounts of water in the southwestern United States have resulted in numerous court actions.

Both groundwater and surface water in areas important to APS' operations have been the subject of inquiries, claims, and legal proceedings which will require a number of years to resolve. APS is one of a number of parties in a proceeding before a state court in New Mexico to adjudicate rights to a stream system from which water for Four Corners is derived. (STATE OF NEW MEXICO, IN THE RELATION OF S.E. REYNOLDS, STATE ENGINEER VS. UNITED STATES OF AMERICA, CITY OF FARMINGTON, UTAH INTERNATIONAL, INC., ET AL., SAN JUAN COUNTY, NEW MEXICO, District Court No. 75-184). An agreement reached with the Navajo Nation in 1985, however, provides that if Four Corners loses a portion of its rights in the adjudication, the Navajo Nation will provide, for a then-agreed upon cost, sufficient water from its allocation to offset the loss.

A summons served on APS in early 1986 required all water claimants in the Lower Gila River Watershed in Arizona to assert any claims to water on or before January 20, 1987, in an action pending in Maricopa County, Arizona, Superior Court. (IN RE THE GENERAL ADJUDICATION OF ALL RIGHTS TO USE WATER IN THE GILA RIVER SYSTEM AND SOURCE, Supreme Court Nos. WC-79-0001 through WC 79-0004 (Consolidated) [WC-1, WC-2, WC-3 and WC-4 (Consolidated)], Maricopa County Nos. W-1, W-2, W-3 and W-4 (Consolidated)). Palo Verde is located within the geographic area subject to the summons. APS' rights and the rights of the Palo Verde participants to the use of groundwater and effluent at Palo Verde are potentially at issue in this action. As project manager of Palo Verde, APS filed claims that dispute the court's jurisdiction over the Palo Verde participants' groundwater rights and their contractual rights to effluent relating to Palo Verde. Alternatively, APS seeks confirmation of such rights. Three of APS' other power plants and one of Pinnacle West Energy's power plants are also located within the geographic area subject to the summons. APS' claims dispute the court's jurisdiction over its groundwater rights with respect to these plants. Alternatively, APS seeks confirmation of such rights. In November 1999, the Arizona Supreme Court issued a decision confirming that certain groundwater rights may be available to the federal government and Indian tribes. In addition, in September 2000, the Arizona Supreme Court issued a decision affirming the lower court's criteria for resolving groundwater claims. Litigation on both of these issues will continue in the trial court. No trial date concerning APS' water rights claims has been set in this matter.

APS has also filed claims to water in the Little Colorado River Watershed in Arizona in an action pending in the Apache County, Arizona, Superior Court. (IN RE THE GENERAL ADJUDICATION OF ALL RIGHTS TO USE WATER IN THE LITTLE COLORADO RIVER SYSTEM AND SOURCE, Supreme Court No. WC-79-0006 WC-6, Apache County No. 6417). APS' groundwater resource utilized at Cholla is within the geographic area subject to the adjudication and is therefore potentially at issue in the case. APS' claims dispute the court's jurisdiction over its groundwater rights. Alternatively, APS seeks confirmation of such rights. A number of parties are in the process of settlement negotiations with respect to certain claims in this matter. Other claims have been identified as ready for litigation in motions filed with the court. No trial date concerning APS' water rights claims has been set in this matter.

Although the foregoing matters remain subject to further evaluation, APS expects that the described litigation will not have a material adverse impact on its financial position, results of operations or liquidity.

BUSINESS OF PINNACLE WEST ENERGY CORPORATION

Pinnacle West Energy was incorporated in 1999 under the laws of the State of Arizona and is engaged principally in the business of the development of generating plants and production of wholesale electricity. Pinnacle West Energy is the subsidiary through which we conduct our unregulated generation operations. Pinnacle West Energy had approximately 65 employees as of December 31, 2001. Pinnacle West Energy's principal offices are located at 400 North Fifth Street, Phoenix, Arizona 85004 (telephone (602) 250-4145).

Pinnacle West Energy's capital expenditures in 2001 were $533 million. Projected capital expenditures are $411 million in 2002; $362 million in 2003; and $212 million in 2004. The amounts include about $107 million in 2003 and $99 million in 2004 for capital improvements to existing generating facilities. These amounts exclude capitalized interest costs, and include capitalized property taxes and (only in 2003 and 2004) approximately $30 million a year for nuclear fuel. These amounts assume that APS' generation assets are transferred to Pinnacle West Energy as of December 31, 2002. In 2004, based on an agreement with SNWA, we expect SNWA to reimburse Pinnacle West Energy approximately $100 million of Pinnacle West Energy's cumulative capital expenditures on the Silverhawk project in exchange for the completion of SNWA's purchase of a 25% interest in the project. At December 31, 2001, Pinnacle West Energy had total assets of $781 million.

Pinnacle West Energy reported net income of $18 million in 2001 and a net loss of $2 million in 2000.

See "Arizona Regulatory Developments Overview" above and Note 3 of Notes to Consolidated Financial Statements in Item 8 for information regarding the pending transfer of APS' generation assets to Pinnacle West Energy. See Note 10 of Notes to Consolidated Financial Statements in Item 8 for information regarding Pinnacle West Energy's generation expansion plans.

BUSINESS OF APS ENERGY SERVICES COMPANY, INC.

APSES was incorporated in 1998 under the laws of the State of Arizona and provides commodity energy and energy-related products to key customers in competitive markets in the western United States. APSES had approximately 65 employees as of December 31, 2001. APSES' principal offices are located at 400 East Van Buren Street, Phoenix, Arizona 85004 (telephone (602) 250-5000).

During the first full two years of operations, APSES' pretax net losses were about $10 million in 2001 and $13 million in 2000. Income tax benefits related to APSES' pretax losses are

recorded by Pinnacle West because of filing consolidated income tax returns. At December 31, 2001, APSES had total assets of $70 million.

BUSINESS OF SUNCOR DEVELOPMENT COMPANY

SunCor was incorporated in 1965 under the laws of the State of Arizona and is a developer of residential, commercial and industrial real estate projects in Arizona, New Mexico and Utah. The principal executive offices of SunCor are located at 3838 North Central, Suite 1500, Phoenix, Arizona 85012 (telephone 602-285-6800). SunCor and its subsidiaries had approximately 900 full and part-time employees at December 31, 2001.

SunCor's assets consist primarily of land with improvements, commercial buildings, and other real estate investments. SunCor's largest project is the Palm Valley master-planned community, which has approximately 7,250 acres remaining to be developed west of Phoenix in the area of the towns of Avondale, Goodyear, and Litchfield Park, Arizona. SunCor has completed the master plan for development of Palm Valley. There has been significant residential and commercial development at Palm Valley by SunCor and by other developers that have acquired land from SunCor or entered into joint ventures with SunCor. Palm Valley currently includes residential subdivisions with golf courses, hotels, restaurants, commercial projects, retail stores, medical facilities, elementary and secondary schools, a community college, and a retirement community, known as PebbleCreek.

SunCor projects under development include seven master-planned communities and several commercial projects. The commercial projects and five of the master-planned communities are in Arizona. Other master-planned communities are located near St. George, Utah, and Santa Fe, New Mexico. Several of the master-planned communities and commercial projects are joint ventures with other developers, financial partners, or landowners. SunCor began two new projects in 2001 which will commence sales and leasing activity in 2002:

* Hayden Ferry Lakeside - an 18-acre, mixed-use commercial and residential project located in Tempe, Arizona will open its first office building in mid-2002; and

* StoneRidge - an 1,850-acre, master-planned community with a golf course in Prescott Valley, Arizona will open its initial phase of homes and lots sales and its golf course in 2002.

For the past three years, SunCor's operating revenues were about: $169 million in 2001; $158 million in 2000; and $130 million in 1999. For those same periods, SunCor's net income was about: $3 million in 2001; $11 million in 2000; and $6 million in 1999.

SunCor's capital needs consist primarily of capital expenditures for land development and home construction for SunCor's home-building subsidiary, Golden Heritage Homes, Inc. SunCor's capital expenditures were approximately $80 million in 2001. On the basis of projects currently under development, SunCor expects its capital needs over the next three years to be: $79 million in 2002; $48 million in 2003; and $52 million in 2004.

At December 31, 2001, SunCor had total assets of about $518 million. See Note 6 of Notes to Consolidated Financial Statements in Item 8 for information regarding SunCor's long-term debt.

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SunCor intends to continue its focus on real estate development of master-planned communities, mixed-use residential, commercial, office, and industrial projects.

See "Legal Proceedings" in Item 3 for information regarding a SunCor litigation matter that was settled during 2001.

BUSINESS OF EL DORADO INVESTMENT COMPANY

El Dorado was incorporated in 1983 under the laws of the State of Arizona and is an investment firm. El Dorado's short-term goal is to prudently realize the value of its existing investments. On a long-term basis, we may use El Dorado, when appropriate, as our subsidiary for investments that are strategic to our principal business of generating, distributing, and marketing electricity. At December 31, 2001, El Dorado held various investments, including: a company specializing in nuclear spent fuel technology, a company specializing in digital and fiber optic solutions for the control and measurement of high voltage electric power, an interest in a venture capital partnership, and interests in two professional sports teams. El Dorado's offices are located at 400 North Fifth Street, Phoenix, Arizona 85004 (telephone 602-250-3517).

For the past three years, El Dorado's net income was about: $0.2 million in 2001; $2 million in 2000; and $11 million in 1999. At December 31, 2001, El Dorado had total assets of $23 million.

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ITEM 2. PROPERTIES

ACCREDITED CAPACITY

APS

APS' present generating facilities have an accredited capacity as follows:

	Capacity(kW)
Coal:	
Units 1, 2, and 3 at Four Corners.........................	560,000
15% owned Units 4 and 5 at Four Corners...................	222,000
Units 1, 2, and 3 at Cholla Plant.........................	615,000
14% owned Units 1, 2, and 3 at the Navajo Plant...........	315,000
Subtotal	1,712,000
Gas or Oil:	
Two steam units at Ocotillo and two steam units at Saguaro.	430,000(1)
Eleven combustion turbine units...........................	493,000
Three combined cycle units................................	255,000
Subtotal	1,178,000
Nuclear:	
29.1% owned or leased Units 1, 2, and 3 at Palo Verde......	1,086,300
Hydro and Solar...	6,585
Total APS facilities..	3,982,885

PINNACLE WEST ENERGY

Pinnacle West Energy's present generating facility has an accredited capacity as follows:

Gas or Oil:	
One combined cycle unit..................................	112,000(2)
Total Consolidated Accredited Capacity	4,094,885

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(1) Does not include West Phoenix steam units (108,300 kW), which were removed from mothballs and placed in service for 2001 summer reliability.
(2) See Note 10 of Notes to Consolidated Financial Statements in Item 8 for information regarding Pinnacle West Energy's generation expansion plans.

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RESERVE MARGIN

APS' 2001 peak one-hour demand on its electric system was recorded on July 2, 2001 at 5,687,200 kW, compared to the 2000 peak of 5,478,500 kW recorded on July 25, 2000. Taking into account additional capacity then available to APS under long-term purchase power contracts as well as APS' and Pinnacle West Energy's generating capacity, APS' capability of meeting system demand on July 2, 2001, amounted to 5,180,600 kW, for an installed reserve margin of (11.1%). The power actually available to APS from its resources fluctuates from time to time due in part to planned outages and technical problems. The available capacity from sources actually operable at the time of the 2001 peak amounted to 3,234,500 kW, for a margin of (43.3%). Firm purchases, including short-term seasonal purchases and unit contingent purchases, totaling 2,490,000 kW were in place at the time of the peak ensuring the ability to meet the load requirement, with an actual reserve margin of 1.1%.

See "Business of Arizona Public Service Company - Purchased Power Agreements" in Item 1 for information about certain of APS' long-term power agreements.

PLANT SITES LEASED FROM NAVAJO NATION

The Navajo Generating Station and Four Corners are located on land held under easements from the federal government and also under leases from the Navajo Nation. These are long-term agreements with options to extend, and we do not believe that the risk with respect to enforcement of these easements and leases is material. The majority of coal contracted for use in these plants and certain associated transmission lines are also located on Indian reservations. See "Generating Fuel and Purchased Power - Coal Supply" in Item 1.

PALO VERDE NUCLEAR GENERATING STATION

PALO VERDE LEASES

See Note 8 of Notes to Consolidated Financial Statements in Item 8 for a discussion of three sale-leaseback transactions related to Palo Verde Unit 2.

REGULATORY

Operation of each of the three Palo Verde units requires an operating license from the NRC. The NRC issued full power operating licenses for Unit 1 in June 1985, Unit 2 in April 1986, and Unit 3 in November 1987. The full power operating licenses, each valid for a period of approximately 40 years, authorize APS, as operating agent for Palo Verde, to operate the three Palo Verde units at full power.

NUCLEAR DECOMMISSIONING COSTS

NRC rules on financial assurance requirements for the decommissioning of nuclear power plants provide that a licensee may use a trust as the exclusive financial assurance mechanism if the licensee recovers estimated total decommissioning costs through cost of service rates or through a "non-bypassable charge." Other mechanisms are prescribed, including prepayment, if the requirements for exclusive reliance on the external sinking fund mechanism are not met. APS currently relies on the external sinking fund mechanism to meet the NRC financial assurance requirements for its interests in Palo Verde Units 1, 2,

and 3. The decommissioning costs of Palo Verde Units 1, 2, and 3 are currently included in APS' ACC jurisdictional rates. ACC retail electric competition Rules provide that decommissioning costs would be recovered through a non-bypassable "system benefits" charge, which would allow APS to maintain its external sinking fund mechanism. See Note 11 of Notes to Consolidated Financial Statements in Item 8 for additional information about our nuclear decommissioning costs. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Business Outlook - Others Factors Affecting Our Financial Outlook" in Item 7 and Note 3 of Notes to Consolidated Financial Statements in Item 8 for additional information about the ACC retail electric competition Rules and the legal challenges to these Rules.

PALO VERDE LIABILITY AND INSURANCE MATTERS

See "Palo Verde Nuclear Generating Station" in Note 10 of Notes to Consolidated Financial Statements in Item 8 for a discussion of the insurance maintained by the Palo Verde participants, including APS, for Palo Verde.

OTHER INFORMATION REGARDING OUR PROPERTIES

See "Environmental Matters" and "Water Supply" in Item 1 with respect to matters having possible impact on the operation of certain of our power plants.

See "Construction Program" in Item 1 and "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources" in Item 7 for a discussion of our construction plans.

See Notes 6, 8, and 9 of Notes to Consolidated Financial Statements in Item 8 with respect to APS' property not held in fee or held subject to any major encumbrance.

INFORMATION REGARDING PROPERTIES OF PINNACLE WEST ENERGY AND SUNCOR

See "Business of Pinnacle West Energy Corporation" and "Business of SunCor Development Company" for information regarding Pinnacle West Energy's and SunCor's properties.

[MAP PAGE]

In accordance with Item 304 of Regulation S-T of the Securities Exchange Act of 1934, APS' Service Territory map contained in this Form 10-K is a map of the State of Arizona showing APS' service area, the location of its major power plants and principal transmission lines, the location of Pinnacle West Energy's power plant, and the location of transmission lines operated by APS for others. APS' major power plants shown on such map are the Navajo Generating Station located in Coconino County, Arizona; the Four Corners Power Plant located near

Farmington, New Mexico; the Cholla Power Plant, located in Navajo County, Arizona; the Yucca Power Plant, located near Yuma, Arizona; and the Palo Verde Nuclear Generating Station, located about 55 miles west of Phoenix, Arizona (each of which plants is reflected on such map as being jointly owned with other utilities), as well as the Ocotillo Power Plant and West Phoenix Power Plant, each located near Phoenix, Arizona, and the Saguaro Power Plant, located near Tucson, Arizona. Pinnacle West Energy's power plant shown on such map is Unit 4 of the West Phoenix Power Plant located near Phoenix, Arizona. APS' major transmission lines shown on such map are reflected as running between the power plants named above and certain major cities in the State of Arizona. The transmission lines operated for others shown on such map are reflected as running from the Four Corners Plant through a portion of northern Arizona to the California border.

ITEM 3. LEGAL PROCEEDINGS

See "Environmental Matters" and "Water Supply" in Item 1 in regard to pending or threatened litigation and other disputes. See Note 3 of Notes to Consolidated Financial Statements in Item 8 for a discussion of competition and the ACC retail electric competition Rules and related litigation. In December 1999, APS filed a lawsuit to protect its legal rights regarding the Rules, and in the complaint APS asked the Court for (i) a judgment vacating the retail electric competition Rules, (ii) a declaratory judgment that the Rules are unlawful because, among other things, they were entered into without proper legal authorization, and (iii) a permanent injunction barring the ACC from enforcing or implementing the Rules and from promulgating any other regulations without lawful authority. ARIZONA PUBLIC SERVICE COMPANY V. ARIZONA CORPORATION COMMISSION, CV 99-21907. On August 28, 1998, APS filed two lawsuits to protect its legal rights under the stranded cost order and in its complaints APS asked the Court to vacate and set aside the order. ARIZONA PUBLIC SERVICE COMPANY V. ARIZONA CORPORATION COMMISSION, CV 98-15728. ARIZONA PUBLIC SERVICE COMPANY V. ARIZONA CORPORATION COMMISSION, 1-CA-CC-98-0008. Consistent with its obligations under the 1999 Settlement Agreement, on January 7, 2002, APS and the ACC filed in Maricopa County, Arizona, Superior Court a stipulation to dismiss the foregoing litigation. On January 15, 2002, a Maricopa County Superior Court judge issued an order dismissing the litigation. See "1999 Settlement Agreement" in Note 3 of Notes to Consolidated Financial Statements in Item 8 for additional information about the 1999 Settlement Agreement and the resolution of legal challenges to the 1999 Settlement Agreement.

See Note 10 of Notes to Consolidated Financial Statements in Item 8 for information relating to FERC proceedings on California energy market issues and a claim by Citizens that APS overcharged Citizens under a power service agreement.

On March 15, 2001, a jury returned a verdict against SunCor in the amount of $28.6 million, $25.7 million of which represented a punitive damage award, in a lawsuit in Maricopa County, Arizona, Superior Court entitled SUNCOR DEVELOPMENT COMPANY V. BERGSTROM CORPORATION, CV 98-11472. 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. On December 14, 2001, the Court ruled that the jury award was constitutionally excessive and reduced the punitive damage award to $5 million. Following this ruling, SunCor settled the matter for an amount that did not have a material adverse impact on the Company's 2001 financial position, results of operations or liquidity.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

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SUPPLEMENTAL ITEM.
EXECUTIVE OFFICERS OF THE REGISTRANT

Our executive officers are as follows:

Name	Age at March 1, 2002	Position(s) at March 1, 2002
William J. Post	51	Chairman of the Board and Chief Executive Officer (1)
Jack E. Davis	55	President and President, APS Energy Delivery and Sales (1)
Robert S. Aiken	45	Vice President, Federal Affairs
John G. Bohon	56	Vice President, Corporate Services & Human Resources
Dennis L. Brown	51	Vice President and Chief Information Officer
Armando B. Flores	58	Executive Vice President, Corporate Business Services
Edward Z. Fox	48	Vice President, Communications, Environment & Safety
Chris N. Froggatt	44	Vice President & Controller
Barbara M. Gomez	47	Treasurer
David A. Hansen	42	Vice President, Bulk Power Marketing and Trading
James M. Levine	52	Executive Vice President, APS Generation and COO, Pinnacle West Energy
Nancy C. Loftin	48	Vice President & General Counsel
Michael V. Palmeri	43	Vice President, Finance
Donald G. Robinson	48	Vice President, Regulation and Planning
Martin L. Shultz	57	Vice President, Government Affairs
William L. Stewart	58	President, APS Generation and President, Pinnacle West Energy (1)
Steven M. Wheeler	53	Senior Vice President, Transmission, Regulation and Planning
Faye Widenmann	53	Vice President and Secretary

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(1) member of the Board of Directors

The executive officers of Pinnacle West are elected no less often than annually and may be removed by the Board of Directors at any time. The terms served by the named officers in their current positions and the principal occupations (in addition to those stated in the table) of such officers for the past five years have been as follows:

Mr. Post was elected Chairman of the Board effective February 2001, and Chief Executive Officer effective February 1999. He has served as an officer of Pinnacle West since 1995 in the following capacities: from August 1999 to February 2001 as President; from February 1997 to February 1999 as President; and from June 1995 to February 1997 as Executive Vice President. Mr. Post is also Chairman of the Board (since February 2001) and Chief Executive Officer

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(since February 1997) of APS. He was President of APS from February 1997 until

October 1998. In October 1998, he resigned as President and maintained the position of Chief Executive Officer of APS. He was APS' Chief Operating Officer (September 1994-February 1997). Mr. Post is also a director of APS, Pinnacle West Energy, Blue Cross-Blue Shield of Arizona, Nuclear Electric Insurance, Ltd. (NEIL), and Phelps Dodge Corporation.

Mr. Davis was elected to his present position effective February 2001. Prior to that time he was Chief Operating Officer and Executive Vice President of Pinnacle West (April 2000-February 2001), Executive Vice President, Commercial Operations of APS (September 1996-October 1998) and Vice President, Energy Delivery and Sales, Generation and Transmission of APS (June 1993-September 1996). Mr. Davis is President of APS (since October 1998) and a director of APS and Pinnacle West Energy.

Mr. Aiken was elected to his present position in July 1999. Prior to that time he was Pinnacle West's Manager, Federal Affairs (November 1986-July 1999).

Mr. Bohon was elected to his present position in July 1999. Prior to that time he was Vice President, Corporate Services and Human Resources of APS (October 1998-July 1999), Vice President, Procurement of APS (April 1997-October 1998) and Director, Corporate Services of APS (December 1989-April 1997).

Mr. Brown was elected to his present position in June 2001. Prior to that time he was Director, Information Technology of Pinnacle West (October 1999 - June 2001) and Global Solution Executive for IBM Utilities and Energy Services of IBM prior to that time.

Mr. Flores was elected to his present position in July 1999. Prior to that time, he was Executive Vice President, Corporate Business Services of APS (October 1998-July 1999), Senior Vice President, Corporate Business Services of APS (September 1996-October 1998) and Vice President, Human Resources of APS (December 1991-September 1996).

Mr. Fox was elected to his present position in July 1999. Prior to that time he was Vice President, Environmental/Health/Safety and New Technology Ventures of APS (October 1995-July 1999).

Mr. Froggatt was elected Controller in July 1999 and Vice President in August 1999. Prior to that time he was Controller of APS (July 1997-July 1999) and Director, Accounting Services of APS (December 1992-July 1997).

Ms. Gomez was elected to her present position in August 1999. Prior to that time, she was Manager, Treasury Operations of APS (1997-1999) and Manager, Financial Planning of APS (1994-1997). She was also elected Treasurer of APS in October 1999.

Mr. Hansen was elected to his present position in June 2001. Prior to that time he was Director, Pinnacle West Marketing and Trading for Pinnacle West and APS (since 1996).

Mr. Levine was elected to his present position in July 1999. Prior to that time he was Senior Vice President, Nuclear Generation of APS (September 1996-July 1999) and Vice President, Nuclear Production of APS (September 1989-September 1996). Mr. Levine is also Chief Operating Officer of Pinnacle West Energy.

Ms. Loftin was elected to her present position in July 1999. She was elected to the positions of Vice President and Chief Legal Counsel of APS in September 1996. Prior to that time, she was Secretary of APS (since April 1987) and Corporate Counsel of APS (since February 1989). She was also elected Vice President and General Counsel of APS in July 1999.

Mr. Palmeri was elected to his present position in August 1999. Prior to that time he was Treasurer of APS and Pinnacle West (July 1997-September 1999) and Assistant Treasurer of Pinnacle West (February 1994-July 1997). He also was elected Vice President, Finance of APS in October 1999.

Mr. Robinson was elected to his present position in June 2001. Prior to that time he was Director, Accounting, Planning and Regulation (January 2001 - June 2001); Director, Accounting and Planning (August 1999 - January 2001); and Director, Strategic Planning (October 1998 - August 1999) of Pinnacle West. Prior to that time he was Director, Regulatory Services (November 1997 - October 1998), and Director, Regulatory (December 1996 - November 1997) of APS.

Mr. Shultz was elected to his current position in July 1999. Prior to that time he held the position of Director of Government Relations for APS (1988-July 1999).

Mr. Stewart was elected to his present position in October 1998. Prior to that time he was Executive Vice President, Generation of APS (September 1996-October 1998) and Executive Vice President, Nuclear of APS (May 1994-September 1996). Mr. Stewart is also a director of APS and Pinnacle West, and a director and President of Pinnacle West Energy.

Mr. Wheeler was elected to his present position in June 2001. Prior to that time he was a partner with Snell & Wilmer L.L.P. Mr. Wheeler was also elected Senior Vice President, Transmission, Regulation and Planning of APS in June 2001.

Ms. Widenmann was elected to her current position in July 1999. Prior to that time, she held the position of Secretary (since 1985) and Vice President of Corporate Relations and Administration (since November 1986). She was also elected Vice President and Secretary of APS in July 1999.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Our common stock is publicly held and is traded on the New York and Pacific Stock Exchanges. At the close of business on March 25, 2002, our common stock was held of record by approximately 38,021 shareholders.

See "Quarterly Stock Prices and Dividends" in Item 6 for a description of the common stock price ranges on the composite tape, as reported in the Wall Street Journal for 2001 and 2000, and the dividends declared during each of the four quarters for 2001 and 2000.

ITEM 6. SELECTED CONSOLIDATED DATA

	2001	2000	1999	1998
OPERATING RESULTS	(dollars in thousands, except per share amounts)			
Operating revenues				
Electric	$ 4,382,465	$ 3,531,810	$ 2,293,184	$ 2,006,398

Real estate	168,908	158,365	130,169	124,188
Income from continuing operations	$ 327,367	$ 302,332	$ 269,772	$ 242,892
Discontinued operations (a)	--	--	38,000	--
Extraordinary charge - net of income taxes (b)	--	--	(139,885)	--
Cumulative effect of change in accounting-net of income taxes (c)	(15,201)	--	--	--
Net income	$ 312,166	$ 302,332	$ 167,887	$ 242,892
COMMON STOCK DATA				
Book value per share - year-end	$ 29.46	$ 28.09	$ 26.00	$ 25.50
Earnings (loss) per weighted average common share outstanding				
Continuing operations - basic	$ 3.86	$ 3.57	$ 3.18	$ 2.87
Discontinued operations	--	--	0.45	--
Extraordinary charge	--	--	(1.65)	--
Cumulative effect of change in accounting	(0.18)	--	--	--
Net income - basic	$ 3.68	$ 3.57	$ 1.98	$ 2.87
Continuing operations - diluted	$ 3.85	$ 3.56	$ 3.17	$ 2.85
Net income - diluted	$ 3.68	$ 3.56	$ 1.97	$ 2.85
Dividends declared per share	$ 1.525	$ 1.425	$ 1.325	$ 1.225
Indicated annual dividend rate per share - year-end	$ 1.60	$ 1.50	$ 1.40	$ 1.30
Weighted-average common shares outstanding - basic	84,717,649	84,732,544	84,717,135	84,774,218
Weighted-average common shares outstanding - diluted	84,930,140	84,935,282	85,008,527	85,345,946
BALANCE SHEET DATA				
Total assets	$ 7,981,748	$ 7,162,985	$ 6,608,506	$ 6,824,546
Liabilities and equity:				
Long-term debt less current maturities	$ 2,673,078	$ 1,955,083	$ 2,206,052	$ 2,048,961
Other liabilities	2,809,347	2,825,188	2,196,721	2,516,993
Total liabilities	5,482,425	4,780,271	4,402,773	4,565,954
Minority interests				
Non-redeemable preferred stock of APS	--	--	--	85,840
Redeemable preferred stock of APS	--	--	--	9,401
Common stock equity	2,499,323	2,382,714	2,205,733	2,163,351
Total liabilities and equity	$ 7,981,748	$ 7,162,985	$ 6,608,506	$ 6,824,546

(a) Tax benefit stemming from the resolution of income tax matters related to a former subsidiary MeraBank, A Federal Savings Bank. See Note 4.

(b) Charges associated with a regulatory disallowance. See Note 3.

(c) Change in accounting standards related to derivatives. See Note 17.

ELECTRIC OPERATING REVENUES	2001	2000	1999	1998
	(dollars in thousands)			
Retail				
Residential	$ 914,711	$ 880,468	$ 805,173	$ 766,378
Business	952,627	935,214	911,449	889,244
Total retail	1,867,338	1,815,682	1,716,622	1,655,622
Wholesale revenue on delivered electricity:				
Traditional contracts	73,305	120,618	60,486	58,184
Retail load hedge management	577,784	560,493	108,153	--
Marketing and trading - delivered:				
Generation other than native load (a)	148,316	115,476	29,551	--
Other delivered electricity (a)	1,560,185	874,619	345,067	258,058
Total delivered marketing and trading	1,708,501	990,095	374,618	258,058
Total delivered wholesale electricity	2,359,590	1,671,206	543,257	316,242
Other marketing and trading:				
Realized margins on delivered commodities other than electricity	(13,646)	(8,789)	2,483	7,192
Prior period mark-to-market (gains) losses on contracts delivered during current period	(1,059)	(2,079)	--	--
Change in mark-to-market for future period deliveries	126,580	13,831	975	--
Total other marketing and trading	111,875	2,963	3,458	7,192
Transmission for others	25,971	14,765	11,348	11,058
Other miscellaneous services	17,691	27,194	18,499	16,284
Total electric operating revenues	$ 4,382,465	$ 3,531,810	$ 2,293,184	$ 2,006,398

(a) The break-out of generation other than native load is not available for 1997 through 1998.

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	2001	2000	1999	1998
ELECTRIC SALES (MWH)				
Retail:				

Residential	10,334,860	9,780,680	8,774,822	8,310,689
Business	13,064,152	12,753,844	12,299,748	12,152,394
Total retail	23,399,012	22,534,524	21,074,570	20,463,083
Wholesale electricity delivered:				
Traditional contracts	1,213,704	1,610,032	1,421,522	1,410,392
Retail load hedge management	3,039,905	6,673,658	630,945	--
Marketing and trading - delivered:				
Generation other than native load (a)	1,387,860	1,494,299	1,267,349	--
Other delivered electricity (a)	14,612,997	12,219,368	12,374,018	8,906,999
Total delivered marketing and trading	16,000,857	13,713,667	13,641,367	8,906,999
Total delivered wholesale electricity	20,254,466	21,997,357	15,693,834	10,317,391
Total electric sales	43,653,478	44,531,881	36,768,404	30,780,474
ELECTRIC CUSTOMERS - AVERAGE				
Retail:				
Residential	776,339	749,285	719,774	689,871
Business	98,198	94,128	90,496	87,831
Total retail	874,537	843,413	810,270	777,702
Wholesale	66	67	69	60
Total customers	874,603	843,480	810,339	777,762

(a) The break-out of generation other than native load is not available for 1997 through 1998.

See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 for a discussion of certain information in the tables above.

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QUARTERLY STOCK PRICES AND DIVIDENDS PER SHARE
STOCK SYMBOL: PNW

2001	High	Low	Close	Dividends Per Share
1st Quarter	$47.96	$39.06	$45.87	$0.375
2nd Quarter	50.70	45.20	47.40	0.375
3rd Quarter	49.93	37.65	39.70	0.375
4th Quarter	43.50	38.00	41.85	0.400

2000	High	Low	Close	Dividends Per Share
1st Quarter	$32.31	$26.25	$28.19	$0.350
2nd Quarter	35.88	27.88	33.88	0.350

3rd Quarter	51.31	33.81	50.89	0.350
4th Quarter	52.22	40.89	47.63	0.375

ITEM 7. 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 Capital Corporation and our subsidiaries: Arizona Public Service Company (APS), Pinnacle West Energy Corporation (Pinnacle West Energy), APS Energy Services Company, Inc. (APSES), SunCor Development Company (SunCor), and El Dorado Investment Company (El Dorado), including:

* the changes in our earnings from 2000 to 2001 and from 1999 to 2000;
* our capital needs, liquidity and capital resources;
* our marketing and trading activities;
* our financial outlook;
* our critical accounting policies;
* major factors that affect our financial outlook; and
* our management of market risks.

OVERVIEW OF OUR BUSINESS

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

Our other major subsidiaries are:

* Pinnacle West Energy, through which we conduct our unregulated electricity generation operations;
* APSES, which provides commodity energy and energy-related products to key customers in competitive markets in the western United States;
* SunCor, a developer of residential, commercial, and industrial real estate projects in Arizona, New Mexico, and Utah; and
* El Dorado, an investment firm.

Pinnacle West's marketing and trading division sells in the wholesale market APS and Pinnacle West Energy generation production output that is not needed for APS' native load, which includes loads for retail customers and traditional cost-of-service wholesale customers. Subject to specified risk

parameters established by our Board of Directors, the marketing and trading division also engages in activities to hedge purchases and sales of electricity, fuels, and emissions allowance and credits and to profit from market price movements. We explain in detail below the historical and prospective contribution of marketing and trading activities to our financial results.

APS is required to transfer its competitive electric assets and services to one or more corporate affiliates no later than December 31, 2002. Consistent with that requirement, APS has been addressing the legal and regulatory requirements necessary to complete the transfer of its generation assets to Pinnacle West Energy before that date. As we discuss in greater detail below under "Business Outlook - Other Factors Affecting Our Financial Outlook," recent Arizona regulatory developments have raised uncertainty about the status and pace of retail electric competition in Arizona, including APS' transfer of generation assets to Pinnacle West Energy.

BUSINESS SEGMENTS

We have two principal business segments (determined by products, services and regulatory environment), which consist of regulated retail electricity business and related activities (retail business segment) and competitive business activities (marketing and trading segment). Our retail business segment currently includes activities related to electricity transmission and distribution, as well as electricity generation. Our marketing and trading segment currently includes activities related to wholesale marketing and trading and APSES' competitive energy services.

These reportable segments reflect a change in the reporting of our segment information. Before the fourth quarter of 2001, we had two segments (generation and delivery). The "generation segment" information combined our marketing and trading activities with our generation of electricity activities. The "delivery segment" included transmission and distribution activities.

In the fourth quarter, APS filed with the ACC a request for a proposed rule variance and approval of a purchase power agreement (see Note 3) that inherently views our business in the new reportable segments described as presented herein. Internal management reporting has been changed to reflect this alignment. See "Business Segments" in Note 16 for more information about our business segments.

The following is a summary of net income by business segment for 2001, 2000, and 1999 (dollars in millions):

	2001	2000	1999
Retail	$ 152	$ 225	$ 246
Marketing and trading	172	63	5
Other	3	14	19
Income from continuing operations	327	302	270
Income tax benefit from discontinued operations	--	--	38
Extraordinary charge - net of income taxes	--	--	(140)
Cumulative effect of change in accounting - net of income taxes	(15)	--	--
Net income	$ 312	$ 302	$ 168

Throughout this section, we refer to specific "Notes" in the Notes to Consolidated Financial Statements that begin on page 66. These Notes add further details to the discussion.

RESULTS OF OPERATIONS

The following is a summary of our net income by legal entity for 2001, 2000 and 1999 (dollars in millions):

	2001	2000	1999
APS	$ 281	$ 307	$ 267
Pinnacle West Energy	18	(2)	--
APSES	(10)	(13)	(9)
SunCor	3	11	6
El Dorado	--	2	11
Parent company (a)	35	(3)	(5)
Income from continuing operations	327	302	270
Income tax benefit from discontinued operations	--	--	38
Extraordinary charge - net of income taxes	--	--	(140)
Cumulative effect of change in accounting - net of income taxes	(15)	--	--
Net income	$ 312	$ 302	$ 168

(a) The 2001 amount primarily includes marketing and trading activities. APS also includes some marketing and trading activities. (See Note 16 for further discussion of our business segments.)

2001 COMPARED WITH 2000

Our consolidated net income for the year ended December 31, 2001 was $312 million compared with $302 million for the year ended December 31, 2000. In 2001, we recognized a $15 million after-tax loss in net income as a cumulative effect of a change in accounting for derivatives. See Note 17 for further discussion on accounting for derivatives.

Income from continuing operations for the year ended December 31, 2001 was $327 million compared with $302 million for the year ended December 31, 2000. The year-to-year comparison benefited from strong marketing and trading results, including significant benefits in the 2001 third quarter from structured trading activities, and retail customer growth. These factors were partially offset by higher purchased power and fuel costs, due in part to increased power plant maintenance; generation reliability measures; continuing retail electricity price decreases; and a charge related to Enron and its affiliates. The major factors that increased (decreased) income from continuing operations were as follows (dollars in millions):

	Increase (Decrease)
Increases (decreases) in electric revenues, net of purchased power and fuel expense due to:	
Marketing and trading activities:	
Increase from generation sales other than native load due to higher market prices	$ 25
Increase in other realized marketing and trading in current period primarily due to more transactions	45
Change in prior period mark-to-market value for losses	

transferred to realized margin in current period	16	(a)
Change in prior period mark-to-market value related to trading with Enron and its affiliates	(8)	(b)
Increase in mark-to-market value related to future periods	113	(a)
Net increase in marketing and trading	191	
Higher replacement power costs for plant outages related to higher market prices	(70)	
Retail price reductions (see Note 3)	(27)	
Charges related to purchased power contracts with Enron and its affiliates	(13)	(b)
Higher retail sales primarily related to customer growth	35	
Miscellaneous revenues	3	
Total increase in revenues, net of purchased power and fuel expense	119	
Decrease in real estate contributions	(8)	
Higher operations and maintenance expense related to 2001 generation reliability program	(42)	
Higher operations and maintenance expense related primarily to employee benefits, plant outage and maintenance; and other costs	(38)	
Lower net interest expense primarily due to higher capitalized interest	17	
Higher other net expense	(5)	
Miscellaneous items, net	1	
Net increase in income from continuing operations before income taxes	44	
Higher income taxes primarily due to higher income	(19)	
Net increase in income from continuing operations	$ 25	

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

(b) We recorded charges totaling $21 million before income taxes for exposure to Enron and its affiliates in the fourth quarter of 2001.

Electric operating revenues increased approximately $850 million because of:

* changes in marketing and trading revenues ($827 million, net increase):
  - increased revenues related to generation sales other than native load as a result of higher average market prices ($32 million);
  - increased realized revenues related to other marketing and trading in current period primarily due to more transactions ($681 million);

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  - decreased prior period mark-to-market value related to trading with Enron and its affiliates ($8 million);
  - increased prior period mark-to-market value for losses transferred to realized margin in current period ($9 million);
  - increased mark-to-market value for future periods primarily as a result of more forward sales volumes ($113 million);
* decreased revenues related to other wholesale sales and miscellaneous revenues as a result of sales volumes ($28 million);
* increased retail revenues primarily related to higher sales volumes

primarily due to customer growth ($78 million); and
* decreased retail revenues related to reductions in retail electricity prices ($27 million).

Purchased power and fuel expenses increased approximately $731 million primarily because of:

* changes in marketing and trading purchased power and fuel costs ($636 million, net increase) due to:
  - increased fuel costs related to generation sales other than native load as a result of higher fuel prices ($7 million);
  - increased fuel and purchased power costs related to other realized marketing and trading in current period primarily due to more transactions ($636 million);
  - decreased mark-to-market fuel costs related to accounting for derivatives ($7 million) (see Note 17);
* decreased costs related to other wholesale sales as a result of lower volumes ($31 million);
* higher replacement power costs primarily due to higher market prices and increased plant outages ($70 million), including costs of $12 million related to a Palo Verde outage extension to replace fuel control element assemblies;
* higher costs related to retail sales volumes due to customer growth ($43 million); and
* charges related to purchased power contracts with Enron and its affiliates ($13 million).

The decrease in real estate profits of $8 million resulted primarily from decreases in sales of land and homes by SunCor.

The increase in operations and maintenance expenses of $80 million primarily related to the 2001 generation summer reliability program (the addition of generating capability to enhance reliability for the summer of 2001 ($42 million)) and increased employee benefit costs, plant outage and maintenance, and other costs ($38 million). The comparison reflects Pinnacle West's $10 million provision for our credit exposure related to the California energy situation, $5 million of which was recorded in the fourth quarter of 2000 and $5 million of which was recorded in the first quarter of 2001.

Net other expense increased $5 million primarily because of a change in the market value of El Dorado's investment in a technology-related venture capital partnership in 2000 (see Note 1) and other nonoperating costs partially offset by an insurance recovery of environmental remediation costs.

Interest expense decreased by $17 million primarily because of increased capitalized interest resulting from our generation expansion plan partially offset with higher interest expense due to higher debt balances.

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2000 COMPARED WITH 1999

Our consolidated net income for the year ended December 31, 2000 was $302 million compared with $168 million for the year ended December 31, 1999. Our 2000 net income increased $134 million over 1999 primarily because of a $140 million after-tax extraordinary charge that we recorded in 1999. This charge reflected a regulatory disallowance resulting from an ACC-approved Settlement Agreement related to the implementation of retail electric competition. The resulting increase in our 2000 net income was partially offset by the absence of a $38 million income tax benefit from discontinued operations that we also recorded in 1999. See "Regulatory Agreements" below and Notes 1 and 3 for additional information about the 1999 Settlement Agreement and the resulting regulatory disallowance. See Note 4 for additional information about the income tax benefit from discontinued operations.

Income from continuing operations for the year ended December 31, 2000 was $302 million compared with $270 million for the year ended December 31, 1999. The year-to-year comparison benefited from strong wholesale and retail electric sales and real estate profits. These positive factors more than offset decreases resulting from the completion of ITC amortization in 1999, reductions in retail electricity prices, lower earnings from El Dorado, and miscellaneous factors. See "Regulatory Agreements" below and Note 3 for information on the price reductions. See "Regulatory Agreements" below and Note 4 for additional information about ITC amortization. The major factors that increased (decreased) income from continuing operations were as follows (dollars in millions):

	Increase (Decrease)
Increases (decreases) in electric revenues, net of purchased power and fuel expense due to:	
Marketing and trading activities:	
Increase from generation sales other than native load due to higher market prices	$ 47
Increase in other realized marketing and trading in current period primarily due to more transactions	51
Change in prior period mark-to-market value for gains transferred to realized margin in current period	(2)(a)
Increase in mark-to-market value related to future periods	13 (a)
Net increase in marketing and trading	109
Retail price reductions (see Note 3)	(28)
Higher retail sales primarily related to customer growth	9
Miscellaneous revenues	10
Total increase in revenues, net of purchased power and fuel expense	100
Increase in real estate contributions	13
Higher operations and maintenance expense related primarily to customer growth substantially offset by $20 million of other items recorded in 1999	(4)
Higher other net expense primarily related to El Dorado	(10)
Higher depreciation and amortization expense	(11)
Miscellaneous items, net	(3)
Net increase in income from continuing operations before income taxes	85
Higher income taxes due to higher income in 2000 and higher ITC amortization in 1999	(53)
Net increase in income from continuing operations	$ 32

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

Electric operating revenues increased approximately $1.24 billion because of:

* changes in marketing and trading revenues ($616 million, net increase):
  - increased revenues related to generation sales other than native load as a result of higher market prices ($86 million);
  - increased realized revenues related to other marketing and trading in current period primarily due to more transactions and higher market prices ($519 million);
  - decreased prior period mark-to-market value for gains transferred to realized margin in current period ($2 million);
  - increased mark-to-market value for future periods primarily as a result of more forward sales volumes ($13 million);
* increased revenues related to increased volumes and higher market prices for other wholesale sales resulting from retail load hedging activities and miscellaneous revenues ($523 million);
* increased retail revenues primarily related to higher sales volumes due to customer growth ($127 million); and
* decreased retail revenues related to reductions in retail electricity prices ($28 million).

Purchased power and fuel expenses increased approximately $1.14 billion primarily due to:

* changes in marketing and trading purchased power and fuel costs ($507 million, increase) due to:
  - increased fuel costs related to generation sales other than native load as a result of higher fuel prices ($39 million);
  - increased fuel and purchased power costs related to other realized marketing and trading in current period primarily due to more transactions ($468 million);
* increased costs related to increased volumes and higher market prices for wholesale sales resulting from retail hedging activities ($513 million); and
* higher costs related to retail sales volumes due to customer growth and increased fuel and purchased power prices ($118 million).

The increase in real estate profits of $13 million resulted primarily from increases in sales of land and homes by SunCor.

The increase in operations and maintenance expenses of $4 million primarily related to customer growth was substantially offset by $20 million of other items recorded in 1999.

The increase in depreciation and amortization of $11 million primarily related to higher plant in service balances offset by lower regulatory asset amortization.

Net other expense decreased $10 million primarily because of changes in 2000 in the market value of El Dorado's investment in a technology-related venture capital partnership. See Note 1 for additional information about the valuation of El Dorado's investments.

REGULATORY AGREEMENTS

Regulatory agreements approved by the ACC affect the results of APS' operations. The following discussion focuses on three agreements approved by the ACC, each of which included retail electricity price reductions:

* The 1999 Settlement Agreement to implement retail electric competition;

* A 1996 agreement that accelerated the amortization of APS' regulatory assets; and

* A 1994 settlement that accelerated the amortization of APS' deferred ITCs.

1999 SETTLEMENT AGREEMENT

As part of the 1999 Settlement Agreement, APS agreed to reduce retail electricity prices for standard-offer, full-service customers with loads less than three megawatts in a series of annual decreases of 1.5% on 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 required by the 1996 regulatory agreement (see below). For customers having loads three megawatts or greater, standard-offer rates will be reduced in annual increments that total 5% in the years 1999 through 2002.

The 1999 Settlement Agreement also removed, as a regulatory disallowance, $234 million before income taxes ($183 million net present value) from ongoing regulatory cash flows. APS recorded this regulatory disallowance as a net reduction of regulatory assets and reported it as a $140 million after-tax extraordinary charge on the 1999 income statement.

Under the 1996 regulatory agreement, APS was recovering substantially all of its regulatory assets through accelerated amortization over an eight-year period that would have ended June 30, 2004. For more details, see Note 1. The regulatory assets to be recovered under the 1999 Settlement Agreement are currently being amortized as follows (dollars in millions):

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

See Note 3 and "Business Outlook - Electric Competition (Retail)" below for additional information regarding the 1999 Settlement Agreement.

1996 REGULATORY AGREEMENT

As part of the 1996 regulatory agreement, APS reduced its retail electricity prices by 3.4% effective July 1, 1996. This reduction decreased electric revenue by about $49 million annually ($29 million after income taxes).

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APS also agreed to share future cost savings with its customers during the term of this agreement, which resulted in the following additional retail price reductions:

* $18 million annually ($11 million after income taxes), or 1.2%, effective July 1, 1997;

* $17 million annually ($10 million after income taxes), or 1.1%, effective July 1, 1998; and

* $11 million annually ($7 million after income taxes), or 0.7%, effective July 1, 1999 (as noted above, this reduction was included in the July 1, 1999 price reduction under the 1999 Settlement Agreement).

1994 RATE SETTLEMENT

As part of a 1994 rate settlement, APS accelerated amortization of substantially all of its ITCs over a five-year period that ended on December 31, 1999. The amortization of ITCs decreased annual consolidated income tax expense by about $24 million. Beginning in 2000, no further benefits were reflected in income tax expense related to the acceleration of the ITCs (see Note 4).

LIQUIDITY AND CAPITAL RESOURCES

CAPITAL NEEDS AND RESOURCES

CAPITAL EXPENDITURE REQUIREMENTS

The following table summarizes the actual capital expenditures for the year ended December 31, 2001 and estimated capital expenditures for the next three years.

CAPITAL EXPENDITURES
(dollars in millions)

	(actual)	(estimated)		
	2001	2002	2003	2004
APS				
Delivery	$ 354	$ 349	$ 271	$ 280
Existing generation (a)	117	149	--	--
Subtotal	471	498	271	280
Pinnacle West Energy (b)				
Generation expansion	533	411	255	113(e)
Existing generation (a)	--	--	107	99
Subtotal	533	411	362	212
SunCor (c)	80	79	48	52
Other (d)				