

ARIZONA PUBLIC SERVICE CO

Form 10-Q

August 03, 2010

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2010**

**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	Exact Name of Each Registrant as specified in its charter; State of Incorporation; Address; and Telephone Number	IRS Employer Identification No.
1-8962	<b>PINNACLE WEST CAPITAL CORPORATION</b> (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0512431
1-4473	<b>ARIZONA PUBLIC SERVICE COMPANY</b> (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0011170

Indicate by check mark whether each 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.

PINNACLE WEST CAPITAL CORPORATION	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

PINNACLE WEST CAPITAL CORPORATION	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting

company in Rule 12b-2 of the Exchange Act.

PINNACLE WEST CAPITAL CORPORATION

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐  
 ARIZONA PUBLIC SERVICE COMPANY

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐  
 Indicate by check mark whether each registrant is a shell company (as defined in Exchange Act Rule 12b-2).

PINNACLE WEST CAPITAL Yes No  
 CORPORATION ☐ ☐  
 ARIZONA PUBLIC SERVICE Yes No  
 COMPANY ☐ ☐

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

PINNACLE WEST CAPITAL CORPORATION

Number of shares of common stock, no par value,  
 outstanding as of July 28, 2010: 108,642,028

ARIZONA PUBLIC SERVICE COMPANY

Number of shares of common stock, \$2.50 par value,  
 outstanding as of July 28, 2010: 71,264,947

**Arizona Public Service Company meets the conditions set forth in General Instruction H(1)(a) and (b) of Form 10-Q and is therefore filing this form with the reduced disclosure format allowed under that General Instruction.**

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**This combined Form 10-Q is separately provided by Pinnacle West Capital Corporation ( Pinnacle West ) and Arizona Public Service Company ( APS ). Any use of the words Company, we, and our refer to Pinnacle West**

Each registrant is providing on its own behalf all of the information contained in this Form 10-Q that relates to such registrant and, where required, its subsidiaries. Except as stated in the preceding sentence, neither registrant is providing any information that does not relate to such registrant, and therefore makes no representation as to any such information. The information required with respect to each company is set forth within the applicable items. Item 1 of this report includes Condensed Consolidated Financial Statements of Pinnacle West and Condensed Consolidated Financial Statements of APS. Item 1 also includes Notes to Pinnacle West's Condensed Consolidated Financial Statements, the majority of which also relates to APS, and Supplemental Notes, which only relate to APS' Condensed Consolidated Financial Statements. Item 2 of this report is divided into two sections - Pinnacle West Consolidated and APS. The Pinnacle West Consolidated section describes Pinnacle West and its subsidiaries on a consolidated basis, including discussions of Pinnacle West's regulated utility and non-utility operations.

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**FORWARD-LOOKING STATEMENTS**

This document contains forward-looking statements based on current expectations, and neither Pinnacle West nor APS assumes any obligation to update these statements, even if our internal estimates change, except as required by applicable law. These forward-looking statements are often identified by words such as estimate, predict, may, believe, plan, expect, require, intend, assume and similar words. 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 outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Item 1A of the Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2009 ( 2009 Form 10-K ) and in Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations herein, these factors include, but are not limited to:

- regulatory and judicial decisions, developments and proceedings;
- our ability to achieve timely and adequate rate recovery of our costs;
- our ability to reduce capital expenditures and other costs while maintaining reliability and customer service levels;
- variations in demand for electricity, including those due to weather, the general economy, customer and sales growth (or decline), and the effects of energy conservation measures;
- power plant performance and outages;
- volatile fuel and purchased power costs;
- fuel and water supply availability;
- new legislation or regulation relating to greenhouse gas emissions, renewable energy mandates and energy efficiency standards;
- our ability to meet renewable energy requirements and recover related costs, including returns on debt and equity capital;
- risks inherent in the operation of nuclear facilities, including spent fuel disposal uncertainty;
- competition in retail and wholesale power markets;
- the duration and severity of the economic decline in Arizona and current credit, financial and real estate market conditions;
- the cost of debt and equity capital and the ability to access capital markets when required;
- restrictions on dividends or other burdensome provisions in our credit agreements and Arizona Corporation Commission ( ACC ) orders;
- our ability, or the ability of our subsidiaries, to meet debt service obligations;
- changes to our credit ratings;
- the investment performance of the assets of our nuclear decommissioning trust, pension, and other postretirement benefit plans and the resulting impact on future funding requirements;
- the liquidity of wholesale power markets and the use of derivative contracts in our business;
- potential shortfalls in insurance coverage;
- new accounting requirements or new interpretations of existing requirements;
- transmission and distribution system conditions and operating costs;
- the ability to meet the anticipated future need for additional baseload generation and associated transmission facilities in our region;
- the ability of our counterparties and power plant participants to meet contractual or other obligations;
- technological developments in the electric industry; and
- economic and other conditions affecting SunCor Development Company's ( SunCor ) ability to dispose of its remaining assets and satisfy its debt obligations.

These and other factors are discussed in Risk Factors described in Item 1A of our 2009 Form 10-K, which readers should review carefully before placing any reliance on our financial statements or disclosures.



**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PINNACLE WEST CAPITAL CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

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

	Three Months Ended June 30,	
	2010	2009
<b>OPERATING REVENUES</b>		
Regulated electricity segment	\$ 799,416	\$ 812,510
Other revenues	21,178	6,078
<b>Total</b>	<b>820,594</b>	<b>818,588</b>
<b>OPERATING EXPENSES</b>		
Regulated electricity segment fuel and purchased power	251,800	291,699
Operations and maintenance	215,104	215,545
Depreciation and amortization	103,017	100,980
Taxes other than income taxes	31,684	32,766
Other expenses	15,716	5,704
<b>Total</b>	<b>617,321</b>	<b>646,694</b>
<b>OPERATING INCOME</b>	<b>203,273</b>	<b>171,894</b>
<b>OTHER INCOME (DEDUCTIONS)</b>		
Allowance for equity funds used during construction	5,504	4,730
Other income (Note 11)	933	6,252
Other expense (Note 11)	(5,660)	(4,187)
<b>Total</b>	<b>777</b>	<b>6,795</b>
<b>INTEREST EXPENSE</b>		
Interest charges	60,741	59,884
Allowance for borrowed funds used during construction	(3,104)	(3,225)
<b>Total</b>	<b>57,637</b>	<b>56,659</b>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<b>146,413</b>	<b>122,030</b>
<b>INCOME TAXES</b>	<b>51,829</b>	<b>41,000</b>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<b>94,584</b>	<b>81,030</b>
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS</b>		
Net of income tax expense (benefit) of \$16,281 and \$(5,213) (Note 14)	24,982	(8,184)
<b>NET INCOME</b>	<b>119,566</b>	<b>72,846</b>
Less: Net income attributable to noncontrolling interests (Notes 7 and 16)	4,769	4,499



NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS		\$ 114,797	\$ 68,347
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC	107,355		101,109
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED	107,764		101,193
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING			
Income from continuing operations attributable to common shareholders basic	\$ 0.84	\$ 0.76	
Net income attributable to common shareholders basic	1.07	0.68	
Income from continuing operations attributable to common shareholders diluted	0.83	0.75	
Net income attributable to common shareholders diluted	1.07	0.68	
DIVIDENDS DECLARED PER SHARE	\$ 1.05	\$ 0.525	
AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:			
Income from continuing operations, net of tax	\$ 89,806	\$ 76,379	
Discontinued operations, net of tax	24,991	(8,032)	
Net income attributable to common shareholders	\$ 114,797	\$ 68,347	

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

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**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

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

	Six Months Ended June 30,	
	2010	2009
<b>OPERATING REVENUES</b>		
Regulated electricity segment	\$ 1,410,841	\$ 1,415,088
Other revenues	30,108	10,878
<b>Total</b>	<b>1,440,949</b>	<b>1,425,966</b>
<b>OPERATING EXPENSES</b>		
Regulated electricity segment fuel and purchased power	467,340	539,087
Operations and maintenance	422,946	412,371
Depreciation and amortization	203,670	201,058
Taxes other than income taxes	63,408	66,773
Other expenses	22,644	10,829
<b>Total</b>	<b>1,180,008</b>	<b>1,230,118</b>
<b>OPERATING INCOME</b>	<b>260,941</b>	<b>195,848</b>
<b>OTHER INCOME (DEDUCTIONS)</b>		
Allowance for equity funds used during construction	10,893	9,722
Other income (Note 11)	1,819	3,292
Other expense (Note 11)	(7,134)	(10,529)
<b>Total</b>	<b>5,578</b>	<b>2,485</b>
<b>INTEREST EXPENSE</b>		
Interest charges	121,446	117,148
Allowance for borrowed funds used during construction	(6,151)	(6,969)
<b>Total</b>	<b>115,295</b>	<b>110,179</b>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<b>151,224</b>	<b>88,154</b>
<b>INCOME TAXES</b>	<b>44,657</b>	<b>27,816</b>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<b>106,567</b>	<b>60,338</b>
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS</b>		
Net of income tax expense (benefit) of \$7,891 and \$(90,094) (Note 14)	12,102	(153,562)
<b>NET INCOME (LOSS)</b>	<b>118,669</b>	<b>(93,224)</b>
Less: Net income (loss) attributable to noncontrolling interests (Notes 7 and 16)	9,886	(5,061)
<b>NET INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDERS</b>	<b>\$ 108,783</b>	<b>\$ (88,163)</b>

WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING	BASIC	104,431	101,048
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING	DILUTED	104,857	101,048
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING			
Income from continuing operations attributable to common shareholders	basic	\$ 0.93	\$ 0.51
Net income (loss) attributable to common shareholders	basic	1.04	(0.87)
Income from continuing operations attributable to common shareholders	diluted	0.92	0.51
Net income (loss) attributable to common shareholders	diluted	1.04	(0.87)
DIVIDENDS DECLARED PER SHARE		\$ 1.575	\$ 1.05
AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:			
Income from continuing operations, net of tax		\$ 96,661	\$ 51,037
Discontinued operations, net of tax		12,122	(139,200)
Net income (loss) attributable to common shareholders		\$ 108,783	\$ (88,163)

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

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**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(unaudited)  
(dollars in thousands)

	June 30, 2010	December 31, 2009
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 50,502	\$ 145,378
Customer and other receivables	283,991	301,915
Accrued unbilled revenues	162,441	110,971
Allowance for doubtful accounts	(6,380)	(6,153)
Materials and supplies (at average cost)	172,091	176,020
Fossil fuel (at average cost)	29,597	39,245
Deferred income taxes	187,216	53,990
Income tax receivable		26,005
Assets from risk management activities (Note 8)	60,111	50,619
Assets held for sale (Notes 14 and 16)	102,674	
Other current assets	44,543	30,747
Total current assets	1,086,786	928,737
<b>INVESTMENTS AND OTHER ASSETS</b>		
Real estate investments net (Note 16)		119,989
Assets from risk management activities (Note 8)	44,205	28,855
Nuclear decommissioning trust (Note 15)	424,260	414,576
Other assets	109,788	110,091
Total investments and other assets	578,253	673,511
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	12,932,366	12,848,138
Accumulated depreciation and amortization	(4,400,416)	(4,340,645)
Net	8,531,950	8,507,493
Construction work in progress	496,457	467,700
Palo Verde sale leaseback, net of accumulated depreciation (Note 7)	142,335	146,722
Intangible assets, net of accumulated amortization	168,233	164,380
Nuclear fuel, net of accumulated amortization	136,151	118,243
Total property, plant and equipment	9,475,126	9,404,538
<b>DEFERRED DEBITS</b>		
Regulatory assets	850,001	813,161

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Income tax receivable (Note 6)	65,103	65,103
Other	102,931	101,274
Total deferred debits	1,018,035	979,538
 TOTAL ASSETS	 \$ 12,158,200	 \$ 11,986,324

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

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**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(unaudited)  
(dollars in thousands)

	June 30, 2010	December 31, 2009
<b>LIABILITIES AND EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 261,203	\$ 240,637
Accrued taxes (Note 6)	153,552	104,011
Accrued interest	54,184	54,596
Common dividends payable	56,938	
Short-term borrowings	4,616	153,715
Current maturities of long-term debt (Note 2)	458,756	303,476
Customer deposits	69,181	71,026
Liabilities from risk management activities (Note 8)	63,567	55,908
Other current liabilities	105,112	125,574
<b>Total current liabilities</b>	<b>1,227,109</b>	<b>1,108,943</b>
<b>LONG-TERM DEBT LESS CURRENT MATURITIES</b>		
Long-term debt less current maturities (Note 2)	3,213,145	3,370,524
Palo Verde sale leaseback lessor notes (Notes 2 and 7)	113,379	126,000
<b>Total long-term debt less current maturities</b>	<b>3,326,524</b>	<b>3,496,524</b>
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	1,696,990	1,496,095
Deferred fuel and purchased power regulatory liability (Note 3)	97,047	87,291
Other regulatory liabilities	651,146	679,072
Liability for asset retirements	317,980	301,783
Liabilities for pension and other postretirement benefits (Note 4)	728,934	811,338
Liabilities from risk management activities (Note 8)	86,580	62,443
Customer advances	133,112	136,595
Coal mine reclamation	92,557	92,060
Unrecognized tax benefits (Note 6)	76,760	142,099
Other	130,458	144,077
<b>Total deferred credits and other</b>	<b>4,011,564</b>	<b>3,952,853</b>
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		
<b>EQUITY (Note 9)</b>		
Common stock, no par value	2,411,597	2,153,295

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Treasury stock	(2,734)	(3,812)
Total common stock	2,408,863	2,149,483
Retained earnings	1,239,865	1,298,213
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(53,421)	(50,892)
Derivative instruments	(115,759)	(80,695)
Total accumulated other comprehensive loss	(169,180)	(131,587)
Total shareholders' equity	3,479,548	3,316,109
Noncontrolling interests (Note 7)	113,455	111,895
Total equity	3,593,003	3,428,004
 TOTAL LIABILITIES AND EQUITY	 \$ 12,158,200	 \$ 11,986,324

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

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**PINNACLE WEST CAPITAL CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 118,669	\$ (93,224)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Gain on sale of district cooling business	(41,973)	
Depreciation and amortization including nuclear fuel	229,964	222,790
Deferred fuel and purchased power	65,249	13,144
Deferred fuel and purchased power amortization	(55,494)	66,163
Allowance for equity funds used during construction	(10,893)	(9,722)
Real estate impairment charges	16,731	222,055
Deferred income taxes	50,972	77,588
Change in mark-to-market valuations	2,396	(401)
Changes in current assets and liabilities:		
Customer and other receivables	(7,133)	37,447
Accrued unbilled revenues	(51,470)	(44,309)
Materials, supplies and fossil fuel	13,577	(21,628)
Other current assets	(13,796)	(1,432)
Accounts payable	45,313	(49,711)
Accrued taxes and income tax receivable-net	75,546	(169,754)
Other current liabilities	(22,719)	(15,795)
Expenditures for real estate investments	(458)	(1,560)
Gains and other changes in real estate assets	(2,931)	7,135
Change in margin and collateral accounts assets	656	(2,457)
Change in margin and collateral accounts liabilities	(90,694)	(91,856)
Change in unrecognized tax benefits	(62,630)	14,386
Change in other long-term assets	(5,542)	(8,023)
Change in other long-term liabilities	(51,926)	51,560
Net cash flow provided by operating activities	201,414	202,396
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(378,579)	(393,682)
Contributions in aid of construction	15,163	33,371
Allowance for borrowed funds used during construction	(6,395)	(7,145)
Proceeds from sale of district cooling business	100,300	
Proceeds from nuclear decommissioning trust sales	329,796	244,858
Investment in nuclear decommissioning trust	(342,004)	(255,754)
Trust fund for bond redemptions		(163,975)
Other	3,850	990



Net cash flow used for investing activities	(277,869)	(541,337)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt		840,630
Repayment of long-term debt	(15,221)	(202,372)
Short-term borrowings and payments net	(149,099)	(279,971)
Dividends paid on common stock	(106,522)	(102,439)
Common stock equity issuance	254,612	1,707
Noncontrolling interests	(3,286)	(3,393)
Other	1,095	(2,871)
Net cash flow (used for) provided by financing activities	(18,421)	251,291
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	(94,876)	(87,650)
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	145,378	105,245
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	\$ 50,502	\$ 17,595
<b>Supplemental disclosure of cash flow information</b>		
Cash paid during the period for:		
Income taxes, net of (refunds)	\$ (3,944)	\$ 17,602
Interest, net of amounts capitalized	\$ 115,722	\$ 97,524
See Notes to Pinnacle West's Condensed Consolidated Financial Statements.		

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

**1. Consolidation and Nature of Operations**

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our subsidiaries: APS, SunCor, APS Energy Services Company, Inc. ( APSES ), and El Dorado Investment Company ( El Dorado ). Intercompany accounts and transactions between the consolidated companies have been eliminated. The unaudited condensed consolidated financial statements for APS include the accounts of APS and the Palo Verde sale leaseback variable interest entities (see Note 7 for further discussion). Our accounting records are maintained in accordance with accounting principles generally accepted in the United States of America ( GAAP ). The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Weather conditions cause significant seasonal fluctuations in our revenues; therefore, results for interim periods do not necessarily represent results expected for the year.

In preparing the condensed consolidated financial statements, we have evaluated the events that have occurred after December 31, 2009 through the date the financial statements were issued. Our condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments except as otherwise disclosed in the notes) that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. The December 31, 2009 condensed consolidated balance sheet data was derived from audited financial statements, but does not include disclosures required by GAAP for audited annual statements. This quarterly report should be reviewed in conjunction with the audited financial statements included in the 2009 Form 10-K. These condensed consolidated financial statements and notes have been prepared consistently with the 2009 Form 10-K with the exception of the reclassification of certain prior-year amounts on our Condensed Consolidated Statements of Income, Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Cash Flows in accordance with accounting requirements for reporting discontinued operations (see Note 14) and amended accounting guidance on consolidation of variable interest entities ( VIEs ) (see Note 7). The following tables show the impacts of the reclassifications to prior year (previously reported) amounts (dollars in thousands):

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

	As	Reclassifications as a result of the adoption of new VIE	Reclassifications for discontinued operations	Amount reported after adoption of amended VIE accounting guidance and discontinued operations
	previously reported	accounting guidance		
<b>Statement of Income for the Three Months Ended June 30, 2009</b>				
<b>Operating Revenues</b>				
Real estate segment	\$ 12,680	\$	\$ (12,680)	\$
Other revenues	10,782		(4,704)	6,078
<b>Operating Expenses</b>				
Real estate segment operations	19,429		(19,429)	
Real estate impairment charge	(4,062)		4,062	
Operations and maintenance	226,245	(9,914)	(786)	215,545
Depreciation and amortization	100,034	1,925	(979)	100,980
Taxes other than income taxes	32,887		(121)	32,766
Other expenses	7,733		(2,029)	5,704
<b>Other</b>				
Other income	6,608		(356)	6,252
<b>Interest Expense</b>				
Interest charges	58,863	3,338	(2,317)	59,884
Allowance for borrowed funds used under construction	(3,311)		86	(3,225)
<b>Income Taxes</b>	39,579		1,421	41,000
<b>Income From Continuing Operations</b>	74,027	4,651	2,352	81,030
<b>Loss From Discontinued Operations</b>	(5,832)		(2,352)	(8,184)
<b>Net Income</b>	68,195	4,651		72,846
<b>Net Income (Loss) Attributable To Noncontrolling Interests</b>	(152)	4,651		4,499
<b>Statement of Income for the Six Months Ended June 30, 2009</b>				
<b>Operating Revenues</b>				
Real estate segment	\$ 27,520	\$	\$ (27,520)	\$
Other revenues	19,231		(8,353)	10,878
<b>Operating Expenses</b>				
Real estate segment operations	46,339		(46,339)	
Real estate impairment charge	204,418		(204,418)	
Operations and maintenance	433,776	(19,829)	(1,576)	412,371
Depreciation and amortization	199,920	3,851	(2,713)	201,058

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Taxes other than income taxes	67,015		(242)	66,773
Other expenses	14,200		(3,371)	10,829
<b>Other</b>				
Other income	3,746		(454)	3,292
<b>Interest Expense</b>				
Interest charges	114,559	6,677	(4,088)	117,148
Allowance for borrowed funds used under construction	(7,145)		176	(6,969)
<b>Income Taxes</b>	(55,425)		83,241	27,816
<b>Income (Loss) From Continuing Operations</b>	(91,966)	9,301	143,003	60,338
<b>Loss From Discontinued Operations</b>	(10,559)		(143,003)	(153,562)
<b>Net Loss</b>	(102,525)	9,301		(93,224)
<b>Net Loss Attributable To Noncontrolling Interests</b>	(14,362)	9,301		(5,061)

	As previously reported	Reclassifications as a result of the adoption of new VIE accounting guidance	Amount reported after adoption of amended VIE accounting guidance
<b>Balance Sheets December 31, 2009</b>			
Property, Plant and Equipment Palo Verde sale leaseback, net of accumulated depreciation	\$	\$ 146,722	\$ 146,722
Deferred Debits Regulatory assets	781,714	31,447	813,161
Current Liabilities Current maturities of long-term debt	277,693	25,783	303,476
Long-Term Debt Less Current Maturities Palo Verde sale leaseback lessor notes		126,000	126,000
Deferred Credits and Other Other	200,015	(55,938)	144,077
Equity Noncontrolling Interests	29,571	82,324	111,895

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	As previously reported	Reclassifications as a result of the adoption of the new VIE accounting guidance	Amounts reported after adoption of amended VIE accounting guidance
<b>Statement of Cash Flows for the Six Months Ended June 30, 2009</b>			
<b>Cash Flows from Operating Activities</b>			
Net loss	\$ (102,525)	\$ 9,301	\$ (93,224)
Depreciation and amortization including nuclear fuel	218,939	3,851	222,790
Other current liabilities	(7,977)	(7,818)	(15,795)
Other long-term assets	(8,025)	2	(8,023)
Other long-term liabilities	46,898	4,662	51,560
<b>Cash Flows from Financing Activities</b>			
Repayment and acquisition of long-term debt	(195,767)	(6,605)	(202,372)
Noncontrolling interests		(3,393)	(3,393)
<b>Supplemental Disclosure of Cash Flow Information</b>			
Cash paid for Interest, Net of Amounts Capitalized	90,847	6,677	97,524

**2. Long-term Debt and Liquidity Matters**

The following table shows principal payments due on Pinnacle West's and APS' total long-term debt and capitalized lease requirements as of June 30, 2010 (dollars in millions):

Year	Consolidated Pinnacle West	Consolidated APS
2010	\$ 271	\$ 181
2011	632	457
2012	478	478
2013	92	92
2014	503	503
Thereafter	1,816	1,816
Total	\$ 3,792	\$ 3,527

**Credit Facilities, Debt and Equity Issuances**

Pinnacle West and APS maintain committed revolving credit facilities in order to enhance liquidity and provide credit support for their commercial paper programs. During the first quarter of 2010, Pinnacle West and APS refinanced existing revolving credit facilities that would have otherwise matured in December 2010. Since March 2010, Pinnacle West and APS have accessed the commercial paper markets, which neither company had utilized since the third quarter of 2008 due to negative market conditions.



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***Pinnacle West***

On February 12, 2010, Pinnacle West refinanced its \$283 million revolving credit facility that would have matured in December 2010, and decreased the size of the facility to \$200 million. The new facility matures in February 2013. Pinnacle West has the option to increase the amount of the facility up to a maximum of \$300 million upon the satisfaction of certain conditions and with the consent of the lenders. Pinnacle West will use the facility for general corporate purposes, commercial paper support and for the issuance of letters of credit. Interest rates are based on Pinnacle West's senior unsecured debt credit ratings. As a result of the downsized credit facility, the Company also reduced the size of its commercial paper program to \$200 million from \$250 million.

At June 30, 2010, the \$200 million credit facility was available to support the issuance of up to \$200 million in commercial paper or for bank borrowings, including issuances of letters of credit up to \$100 million. At June 30, 2010, Pinnacle West had no outstanding borrowings under this credit facility, no commercial paper borrowings and no outstanding letters of credit.

In April 2010, Pinnacle West issued 6,900,000 shares of common stock at an offering price of \$38.00 per share, resulting in net proceeds of approximately \$253 million. Pinnacle West contributed all of the net proceeds from this offering into APS in the form of equity infusions. APS has used these contributions to repay short-term indebtedness, to finance capital expenditures and for other general corporate purposes.

In June 2010, Pinnacle West received approximately \$100 million related to the sale of APSES' district cooling business. The net proceeds were used to repay short-term indebtedness.

***APS***

On February 12, 2010, APS refinanced its \$377 million credit facility that would have matured in December 2010, and increased the size of the facility to \$500 million. The new credit facility terminates in February 2013. APS has the option to increase the amount of the facility up to a maximum of \$700 million upon the satisfaction of certain conditions and with the consent of the lenders. APS will use the facility for general corporate purposes, commercial paper support and for the issuance of letters of credit. Interest rates are based on APS' senior unsecured debt credit ratings.

At June 30, 2010, APS had two credit facilities totaling \$989 million, including the \$500 million credit facility described above and a \$489 million facility that terminates in September 2011. These facilities are available either to support the issuance of up to \$250 million in commercial paper or for bank borrowings, including issuances of letters of credit up to \$739 million. At June 30, 2010, APS had no borrowings outstanding under any of its credit facilities and no outstanding commercial paper. A \$20 million letter of credit was issued under APS' \$489 million credit facility in the second quarter of 2010.

On July 13, 2010, APS changed the interest rate mode for the approximately \$33 million of Coconino County, Arizona Pollution Control Corporation Pollution Control Revenue Bonds (Arizona Public Service Company Navajo Project) 1994 Series A, due 2029. The rate period for the bonds changed from a daily rate mode, supported by a letter of credit, to a three-year term rate mode that will bear interest at a rate of 3.625% per annum for three years. The letter of credit was terminated in connection with this change, and there is no bank or other third-party credit support for the bonds in the term rate mode.

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On January 1, 2010, due to the adoption of amended accounting guidance relating to VIEs, APS began consolidating the Palo Verde Lessor Trusts (see Note 7) and, as a result of consolidation of these VIEs, APS has reported the Lessor Trusts' long-term debt on its Condensed Consolidated Balance Sheets. Interest rates on these debt instruments are 8% and are fixed for the remaining life of the debt. As of June 30, 2010, approximately \$30 million was classified as current maturities of long-term debt and \$113 million was classified as long-term debt relating to these VIEs. These debt instruments mature on December 30, 2015 and have sinking fund features that are serviced by the lease payments. See Note 7 for additional discussion of the VIEs.

***SunCor***

In July, SunCor sold land parcels, commercial assets and a master planned home-building community for approximately \$70 million, which approximated the carrying value of these assets, resulting in a net gain of zero. In connection with this sale, SunCor negotiated a restructuring of certain of its credit facilities, including its principal loan facility. The debt restructuring resulted in an after-tax gain of approximately \$9 million, which will be recognized in the third quarter of 2010.

At June 30, 2010, SunCor had approximately \$103 million of assets on its balance sheet classified as assets held for sale. These assets consisted of the \$70 million of assets sold in July as discussed above, \$25 million of consolidated VIEs (see Note 7), master planned home-building communities and golf courses. Because it is expected that SunCor will dispose of these assets within the next 12 months, they are classified as assets held for sale on the balance sheet. At June 30, 2010, SunCor had \$94 million of debt outstanding under various credit facilities, all of which was in default. After the sale and debt restructuring discussed above, \$6 million remains outstanding. Neither Pinnacle West nor any of its other subsidiaries has guaranteed any SunCor indebtedness. A SunCor debt default would not result in a cross-default of any of the debt of Pinnacle West or any of its other subsidiaries. While there can be no assurances as to the ultimate outcome of this matter, Pinnacle West does not believe that SunCor's inability to repay remaining debt outstanding would have a material adverse impact on Pinnacle West's cash flows or liquidity.

As of June 30, 2010, SunCor could not transfer any cash dividends to Pinnacle West. This restriction does not affect Pinnacle West's ability to meet its ongoing capital requirements.

**Debt Provisions**

An existing ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At June 30, 2010, APS' common equity ratio, as defined, was 52%. Its total shareholder equity was approximately \$3.6 billion, and total capitalization was approximately \$7.0 billion. APS would be prohibited from paying dividends if the payment would reduce its common equity below approximately \$2.8 billion, assuming APS' total capitalization remains the same. This restriction does not materially affect Pinnacle West's ability to meet its ongoing capital requirements.



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**3. Regulatory Matters**

**2008 General Retail Rate Case Impacts**

On December 30, 2009, the ACC issued an order approving a settlement agreement ( Settlement Agreement ) entered into by APS and twenty-one other parties to its general retail rate case, which was originally filed in March 2008. The Settlement Agreement contains on-going requirements, commitments and authorizations, including the following:

Revenue accounting treatment for line extension payments received for new or upgraded service from January 1, 2010 through year end 2012 (or until new rates are established in APS next general rate case, if that is before the end of 2012), which resulted in projected estimates of increased revenues of \$23 million, \$25 million and \$49 million, respectively;

An authorized return on common equity of 11%;

A capital structure comprised of 46.2% debt and 53.8% common equity;

A commitment from APS to reduce average annual operational expenses by at least \$30 million from 2010 through 2014;

Authorization and requirements of equity infusions into APS of at least \$700 million during the period beginning June 1, 2009 through December 31, 2014 (\$253 million of which was infused into APS from proceeds of a Pinnacle West equity issuance in the second quarter of 2010 (see Note 2)); and

Various modifications to the existing energy efficiency, demand-side management and renewable energy programs that require APS to, among other things, expand its conservation and demand-side management programs and its use of renewable energy, as well as allow for concurrent recovery of renewable energy expenses and provide for more concurrent recovery of demand-side management costs and incentives.

The parties also agreed to a rate case filing plan in which APS is prohibited from filing its next two general rate cases until on or after June 1, 2011 and June 1, 2013, respectively, unless certain extraordinary events occur. Subject to the foregoing, APS may not request its next general retail rate increase to be effective prior to July 1, 2012. APS currently expects it will file its next rate case in June 2011. The parties agreed to use good faith efforts to process these subsequent rate cases within twelve months of sufficiency findings from the ACC staff, which generally occur within 30 days after the filing of a rate case.

**Cost Recovery Mechanisms**

APS has received regulatory decisions that allow for more timely recovery of certain costs through the following recovery mechanisms.

**Renewable Energy Standard.** In 2006, the ACC approved the Arizona Renewable Energy Standard and Tariff ( RES ). Under the RES, electric utilities that are regulated by the ACC must supply an increasing percentage of their retail electric energy sales from eligible renewable resources, including solar, wind, biomass, biogas and geothermal technologies. In order to achieve these requirements, the ACC allows APS to include a RES surcharge on customer bills to recover the approved amounts for use on renewable energy projects. Each year APS is required to file a five-year implementation plan with the ACC and seek approval for the upcoming year s RES funding amount.

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During 2009, APS filed its annual RES implementation plan, covering the 2010-2014 timeframe and requesting 2010 RES funding approval. The plan provided for the acquisition of renewable generation in compliance with requirements through 2014, and requested RES funding of \$86.7 million for 2010, which was later approved by the ACC. APS also sought various other determinations in its plan, including approval of the AZ Sun Program and the Community Power Project in Flagstaff, Arizona described below.

On March 3, 2010, the ACC approved the AZ Sun Program, which contemplates the addition of 100 megawatts ( MW ) of APS-owned solar resources through 2014. Through this program, APS plans to invest up to \$500 million in solar photovoltaic projects across Arizona, which APS will acquire through competitive procurement processes. The costs associated with the first 50 MW under this program will be recovered initially through the RES until such time as the costs are recovered in base rates. The costs of the second 50 MW will be recovered through a mechanism to be determined in APS' next retail rate case.

On April 1, 2010, the ACC approved the Community Power Project, a pilot program in which APS will own, operate and receive energy from approximately 1.5 MW of solar panels on the rooftops of up to 200 residential and business customers located within a certain test area. Third party developers may also own systems that participate in the pilot. Costs of the program will be recovered through the RES until such time as the costs are recovered in base rates.

On July 1, 2010, APS filed its annual RES implementation plan, covering the 2011-2015 timeframe and requesting 2011 RES funding of \$96.4 million. The 2011 Plan includes two components to address issues that have arisen in the past year: 1) enhancements to the residential distributed energy incentive program based on high customer participation; and 2) two programs offered in response to ACC workshops on feed-in tariffs, which provide opportunities for streamlined development of certain renewable projects. APS expects the ACC to vote on the 2011 Plan in the fourth quarter of 2010.

***Demand-Side Management Adjustor Charge ( DSMAC )***. The Settlement Agreement requires APS to submit an annual Energy Efficiency Implementation Plan for review by and approval of the ACC. On July 15, 2009, APS filed its initial Energy Efficiency Implementation Plan, requesting approval by the ACC of programs and program elements for which APS had estimated a budget in the amount of \$49.9 million for 2010. APS received ACC approval of all of its proposed programs and implemented the new DSMAC on March 1, 2010. A surcharge was added to customer bills in order to recover these estimated amounts for use on certain demand-side management programs. The surcharge allows for the recovery of energy efficiency expenses and any earned incentives.

The ACC approved recovery of all 2009 program costs plus incentives. The change from program cost recovery on a historical basis to recovery on a concurrent basis, as authorized in the Settlement Agreement, resulted in this one-time need to address two years (2009 and 2010) of cost recovery. As requested by APS, 2009 program cost recovery is to be spread over a three-year period.

On June 1, 2010, APS filed its 2011 Energy Efficiency Implementation Plan. In order to meet the energy efficiency goal for 2011 established by the Settlement Agreement of annual energy savings of 1.25%, expressed as a percent of total energy resources to meet retail load, APS proposed a total budget for 2011 of \$78.9 million. If this plan is approved by the ACC as proposed, and when added to the amortization of 2009 costs discussed above less the \$10 million already being recovered in general rates, the DSMAC would recover approximately \$74.5 million over a twelve month period beginning March 1, 2011.

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**PSA Mechanism and Balance.** The power supply adjustor ( PSA ) provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs from the Base Fuel Rate, which is currently \$0.0376 per kilowatt-hour ( kWh ). The following table shows the changes in the deferred fuel and purchased power regulatory asset (liability) for the six-month periods ended June 30, 2010 and 2009 (dollars in millions):

	Six Months Ended June 30,	
	2010	2009
Beginning balance	\$ (87)	\$ 8
Deferred fuel and purchased power costs-current period	(65)	(13)
Amounts refunded (recovered)	55	(66)
Ending balance	\$ (97)	\$ (71)

The PSA rate for the current PSA Year is (\$0.0045) per kWh. Since the 2010 PSA adjustment was a reduction of the PSA rate, the ACC accelerated the 2010 adjustment from the standard PSA year start date of February 1<sup>st</sup> to January 1<sup>st</sup> to coincide with the increase in retail rates resulting from the ACC's decision in the general retail rate case, causing a minimal net impact on residential bills. This accelerated 2010 adjustment will remain in effect until February 1, 2011. The regulatory liability at June 30, 2010 reflects lower average prices and the seasonal nature of fuel and purchased power costs. Any uncollected (overcollected) deferrals during the 2010 PSA Year will be included in the historical component of the PSA rate for the PSA Year beginning February 1, 2011.

The PSA rate for the PSA Year that began February 1, 2009 was \$0.0053 per kWh. The PSA rate may not be increased or decreased more than \$0.004 per kWh in a year without permission of the ACC.

**Transmission Rates and Transmission Cost Adjustor.** In July 2008, the United States Federal Energy Regulatory Commission ( FERC ) approved an Open Access Transmission Tariff for APS to move from fixed rates to a formula rate-setting methodology in order to more accurately reflect and recover the costs that APS incurs in providing transmission services. A large portion of the rate represents charges for transmission services to serve APS' retail customers ( Retail Transmission Charges ). In order to recover the Retail Transmission Charges, APS must file an application with, and obtain approval from, the ACC under the transmission cost adjustor ( TCA ) mechanism, by which changes in Retail Transmission Charges can be reflected in APS' retail rates.

The formula rate is updated each year effective June 1 on the basis of APS' actual cost of service, as disclosed in APS' FERC Form 1 report for the previous fiscal year. Items to be updated include actual capital expenditures made as compared with previous projections, transmission revenue credits and other items. The resolution of proposed adjustments can result in significant volatility in the revenues to be collected. APS reviews the proposed formula rate filing amounts with the ACC staff. Any items or adjustments which are not agreed to by APS and the ACC staff can remain in dispute until settled or litigated at FERC. Settlement or litigated resolution of disputed issues could require an extended period of time and have a significant effect on the Retail Transmission Charge because any adjustment, though applied prospectively, may be calculated to account for previously over-collected amounts.

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Effective June 1, 2010, APS' annual wholesale transmission rates for all users of its transmission system were reduced by approximately \$12 million in accordance with the FERC- approved formula as a result of lower costs reflected in the formula. Approximately \$10 million of this revenue reduction relates to transmission services used for APS' retail customers. On May 20, 2010, APS filed with the ACC an application for the related reduction of its TCA rate. The ACC approved the TCA reduction on July 27, 2010.

**4. Retirement Plans and Other Benefits**

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a non-qualified supplemental excess benefit retirement plan, and other postretirement benefit plans for the employees of Pinnacle West and our subsidiaries. Pinnacle West uses a December 31 measurement date for its pension and other postretirement benefit plans. The market-related value of our plan assets is their fair value at the measurement date.

On March 23, 2010, the President signed into law comprehensive health care reform legislation under the Patient Protection and Affordable Care Act (the "Act"). One feature of the Act is the elimination of the tax deduction for prescription drug costs that are reimbursed as part of the Medicare Part D subsidy. Although this tax increase does not take effect until 2013, we are required to recognize the full accounting impact in our financial statements in the period in which the Act is signed. In accordance with accounting for regulated companies, the loss of this deduction is substantially offset by a regulatory asset that will be recovered through future electric revenues. In the first quarter of 2010, Pinnacle West charged regulatory assets and liabilities for a total of \$42 million, with a corresponding increase in accumulated deferred income tax liabilities, to reflect the impact of this change in tax law.

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The following table provides details of the plans' net periodic benefit costs and the portion of these costs charged to expense (including administrative costs and excluding amounts capitalized as overhead construction or billed to electric plant participants) (dollars in millions):

	Pension Benefits				Other Benefits			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009	2010	2009	2010	2009
Service cost – benefits earned during the period	\$ 13	\$ 13	\$ 28	\$ 27	\$ 5	\$ 4	\$ 10	\$ 9
Interest cost on benefit obligation	30	30	61	59	10	9	21	19
Expected return on plan assets	(31)	(29)	(62)	(58)	(10)	(8)	(20)	(17)
Amortization of:								
Transition obligation					(1)	1		2
Prior service cost			1	1				
Net actuarial loss	4	4	10	7	2	2	5	5
<b>Net periodic benefit cost</b>	<b>\$ 16</b>	<b>\$ 18</b>	<b>\$ 38</b>	<b>\$ 36</b>	<b>\$ 6</b>	<b>\$ 8</b>	<b>\$ 16</b>	<b>\$ 18</b>
<b>Portion of cost charged to expense</b>	<b>\$ 8</b>	<b>\$ 9</b>	<b>\$ 19</b>	<b>\$ 17</b>	<b>\$ 3</b>	<b>\$ 4</b>	<b>\$ 8</b>	<b>\$ 9</b>
<b>APS' share of cost charged to expense</b>	<b>\$ 8</b>	<b>\$ 8</b>	<b>\$ 19</b>	<b>\$ 16</b>	<b>\$ 3</b>	<b>\$ 4</b>	<b>\$ 8</b>	<b>\$ 8</b>

**Contributions**

The required minimum contribution to our pension plan is zero in 2010. During the first quarter of 2010, we made a voluntary contribution of \$100 million to our pension plan. The contribution to our other postretirement benefit plans in 2010 is estimated to be approximately \$15 million. APS and other subsidiaries fund their share of the contributions. APS' share is approximately 98% of both plans.

**5. Business Segments**

Pinnacle West's two reportable business segments are:

our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily retail and wholesale sales supplied to traditional cost-based rate regulation ( "Native Load " ) customers) and related activities and includes electricity generation, transmission and distribution; and

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

In July, SunCor sold land parcels, commercial assets and a master planned home-building community. It is expected that SunCor will dispose of its remaining assets within the next 12 months. As a result, they are classified as assets held for sale on the balance sheet at June 30, 2010 and all of SunCor's operations have been reclassified to discontinued operations. While segment reporting is not required for discontinued operations, Pinnacle West continues to provide the information below, due to the significant impacts of real estate impairments in 2009. See Note 14 Discontinued Operations.



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Financial data for the three and six months ended June 30, 2010 and 2009 and at June 30, 2010 and December 31, 2009 is provided as follows (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Operating revenues:				
Regulated electricity segment	\$ 800	\$ 813	\$ 1,411	\$ 1,415
All other (a)	21	6	30	11
Total	\$ 821	\$ 819	\$ 1,441	\$ 1,426
Net income (loss) attributable to common shareholders:				
Regulated electricity segment	\$ 88	\$ 78	\$ 95	\$ 58
Real estate segment	(1)	(9)	(15)	(140)
All other (a)	28	(1)	29	(6)
Total	\$ 115	\$ 68	\$ 109	\$ (88)

	As of June 30, 2010	As of December 31, 2009
Assets:		
Regulated electricity segment	\$ 11,974	\$ 11,691
Real estate segment	115	161
All other (a)	69	134
Total	\$ 12,158	\$ 11,986

(a) Includes activities related to APSES and El Dorado. None of the activities of either of these companies constitutes a reportable segment. All other also includes the sale of APSES

district cooling  
business, which  
resulted in an  
after-tax gain of  
\$25 million in  
the period ended  
June 30, 2010.  
See Note 14  
Discontinued  
Operations.

## **6. Income Taxes**

Pinnacle West expects to receive approximately \$132 million of cash tax benefits related to SunCor's strategic asset sales (see Note 16), which will not be fully realized until all of the asset sales are completed. Approximately \$7 million of these benefits were recorded in the six months ended June 30, 2010 as reductions to income tax expense related to the current impairment charges. The additional \$125 million of tax benefits were recorded as reductions to income tax expense related to SunCor impairment charges recorded on or before December 31, 2009.

The \$65 million long-term income tax receivable on the Condensed Consolidated Balance Sheets represents the anticipated refunds related to an APS tax accounting method change approved by the Internal Revenue Service ( IRS ) in the third quarter of 2009.



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During the first quarter of 2010, the Company reached a settlement with the IRS with regard to the examination of tax returns for the years ended December 31, 2005 through 2007. As a result of this settlement, net uncertain tax positions decreased \$62 million, including approximately \$3.5 million which decreased our effective tax rate. Additionally, the settlement resulted in the recognition of net interest benefits of approximately \$3 million through the effective tax rate.

As of June 30, 2010, the tax year ended December 31, 2008 and all subsequent tax years remain subject to examination by the IRS. With few exceptions, we are no longer subject to state income tax examinations by tax authorities for years before 1999.

**7. Variable Interest Entities**

On January 1, 2010 we adopted amended accounting guidance relating to VIEs. This amended guidance significantly changed the consolidation model for VIEs. Under the prior guidance the consolidation model considered risk absorption using a quantitative approach when determining the primary beneficiary. The consolidation model under the new guidance requires a qualitative assessment and focuses on the power to direct activities of the VIE when determining the primary beneficiary. As a result of applying this qualitative assessment, we have determined that APS is the primary beneficiary of certain VIEs, and is therefore required to consolidate these VIEs. Prior to adopting this new guidance, APS was not considered the primary beneficiary of these VIEs and did not consolidate these entities. We have adopted this guidance using retrospective application and have adjusted prior periods presented to reflect consolidation of the VIEs in those periods. Further discussion follows regarding the impact of the consolidation.

**APS VIEs**

In 1986, APS entered into agreements with three separate VIE lessor trusts in order to sell and lease back interests in Palo Verde Nuclear Generating Station ( Palo Verde ) Unit 2 and related common facilities. The VIE lessor trusts are single-asset leasing entities. APS will pay approximately \$49 million per year for the years 2010 to 2015 related to these leases. The leases do not contain fixed price purchase options or residual value guarantees. However, the lease agreements include fixed rate renewal periods which may have a significant impact on the VIEs economic performance. We have concluded that these fixed rate renewal periods may give APS the ability to utilize the asset for a significant portion of the asset s economic life, and therefore provide APS with the power to direct activities of the VIEs that most significantly impact the VIEs economic performance. In addition to the fixed rate renewal periods, our primary beneficiary analysis also considered that we are the operating agent for Palo Verde, are obligated to decommission the leased assets and have fair value purchase options.

Under the previous quantitative VIE consolidation model, APS was not considered the primary beneficiary of the lessor trusts, as APS did not absorb the majority of the entities expected losses or did not receive a majority of the residual returns. The arrangements were previously accounted for as operating leases.

Consolidation of these VIEs eliminates the lease accounting we previously reported and results in changes in our consolidated assets, debt, equity, and net income. Assets of the VIEs are restricted and may only be used to settle the VIEs debt obligations and for payment to the noncontrolling interest holders. The creditors of the VIEs have no recourse to the assets of APS or Pinnacle West. As a result of consolidation we have eliminated rent expense, and have recognized depreciation and interest expense, resulting in an increase in net income for the three and six months ended June 30, 2010 of \$5 million and of \$10 million, respectively, entirely attributable to the noncontrolling interests. Income attributable to Pinnacle West shareholders remains the same. Consolidation of these VIEs also results in changes to our Condensed Consolidated Statements of Cash Flows, but does not impact net cash flows.

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Our Condensed Consolidated Balance Sheets at June 30, 2010 include the following amounts relating to the VIEs (in millions):

	June 30, 2010
Property plant and equipment, net of accumulated depreciation	\$ 142
Long-term debt including current maturities	143
Equity- Noncontrolling interests	89

For regulatory ratemaking purposes the leases continue to be treated as operating leases, and as a result we have recorded a regulatory asset of \$32 million as of June 30, 2010.

APS is exposed to losses relating to these lessor trust VIEs upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the Nuclear Regulatory Commission ( NRC ) issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to make specified payments to the VIEs noncontrolling equity participants, assume the VIEs debt, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of June 30, 2010, APS would have been required to pay the noncontrolling equity participants approximately \$152 million and assume \$143 million of debt. Since APS now consolidates the VIEs, the debt APS would be required to assume is already reflected in our Condensed Consolidated Balance Sheets.

We also have certain long-term purchased power agreements to purchase substantially all of an entity s output from a specified facility for a specified period. We have evaluated these arrangements under the VIE accounting guidance and have determined that these agreements do not represent variable interests. If these agreements had been deemed variable interests, we would not be considered the primary beneficiary, as we do not have the power to direct the entities activities in a manner that would significantly impact their economic performance and, therefore, would not consolidate the entities. The adoption of the amended accounting guidance has not changed how we account for these arrangements.

**SunCor VIEs**

SunCor is the primary beneficiary of certain land development trust arrangements and, accordingly, consolidates these VIEs. We have determined that SunCor is the primary beneficiary of these VIEs because SunCor controls the activities related to the development of the land held in the trusts. Our adoption of amended VIE accounting guidance has not changed our accounting treatment of the SunCor VIEs. Our Condensed Consolidated Balance Sheets reflect \$25 million of assets and \$25 million of noncontrolling equity interests relating to these arrangements at June 30, 2010. Our Condensed Consolidated Balance Sheets reflect \$29 million of assets and \$29 million of noncontrolling equity interests related to these arrangements at December 31, 2009. The assets relating to these VIEs consist strictly of land, all of which is restricted and may only be used for payment to the noncontrolling interests. We have not provided, and are not required to provide, financing or other financial support to these entities.

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**8. Derivative and Energy Trading Accounting**

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas, coal, emissions allowances and in interest rates. We manage risks associated with these market fluctuations by utilizing various derivative instruments, including futures, forwards, options and swaps. As part of our overall risk management program, we may use such instruments to hedge purchases and sales of electricity, fuels, and emissions allowances and credits. Derivative instruments that are designated as cash flow hedges are used to limit our exposure to cash flow variability on forecasted transactions. The changes in market value of such contracts have a high correlation to price changes in the hedged transactions.

Our derivative instruments are accounted for at fair value and are presented on the Condensed Consolidated Balance Sheets as Assets/Liabilities from Risk Management Activities (see Note 15 for a discussion of fair value measurements). Derivative instruments for the physical delivery of purchase and sale quantities transacted in the normal course of business qualify for the normal purchase and sales scope exception and are accounted for under the accrual method of accounting. Due to the scope exception, these derivative instruments are excluded from our derivative instrument discussion and disclosures below.

We enter into derivative instruments for economic hedging purposes. While we believe the economic hedges mitigate exposure to fluctuations in commodity prices, some of these instruments may not meet the specific hedge accounting requirements and are not designated as accounting hedges. Economic hedges not designated as accounting hedges are recorded at fair value on our balance sheet with changes in fair value recognized in the statement of income as incurred. These instruments are included in the non-designated hedges discussion and disclosure below.

Hedge effectiveness is the degree to which the derivative instrument contract and the hedged item are correlated and is measured based on the relative changes in fair value between the derivative instrument contract and the hedged item over time. We assess hedge effectiveness both at inception and on a continuing basis. These assessments exclude the time value of certain options. For accounting hedges that are deemed an effective hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of accumulated other comprehensive income ( AOCI ) and reclassified into earnings in the same period during which the hedged transaction affects earnings. We recognize in current earnings the gains and losses representing hedge ineffectiveness, and the gains and losses on any hedge components which are excluded from our effectiveness assessment. As of June 30, 2010, we hedged the majority of certain exposures to the price variability of commodities for a maximum of 39 months.

In the electricity business, some contracts to purchase energy are netted against other contracts to sell energy. This is called book-out and usually occurs in contracts that have the same terms (quantities and delivery points) and for which power does not flow. We net these book-outs, which reduces both revenues and fuel and purchased power costs in our Condensed Consolidated Statements of Income, but this does not impact our financial condition, net income or cash flows.

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For its regulated operations, APS defers for future rate treatment approximately 90% of unrealized gains and losses on certain derivatives pursuant to the PSA mechanism that would otherwise be recognized in income. Realized gains and losses on derivatives are deferred in accordance with the PSA to the extent the amounts are above or below the portion of APS retail base rates attributable to fuel and purchased power costs ( Base Fuel Rate ), which is currently \$0.0376 per kWh (see Note 3). Gains and losses from derivatives in the following tables represent the amounts reflected in income before the effect of PSA deferrals.

As of June 30, 2010, we had the following outstanding gross notional amount of derivatives, which represent both purchases and sales (does not reflect net position):

<b>Commodity</b>		<b>Quantity</b>
Power	16,004,799	megawatt hours
Gas	166,950,111	MMBTU (a)

(a) MMBTU is one million British thermal units.

**Derivative Instruments in Designated Accounting Hedging Relationships**

The following table provides information about gains and losses from derivative instruments in designated accounting hedging relationships and their impact on our Condensed Consolidated Statements of Income during the three and six months ended June 30, 2010 and 2009 (dollars in thousands):

	Financial Statement Location	Three Months Ended June 30,		Six Months Ended June 30,	
Commodity Contracts		2010	2009	2010	2009
Amount of Gain (Loss) Recognized in AOCI on Derivative Instruments (Effective Portion)	Accumulated other comprehensive loss-derivative instruments	\$ (8,588)	\$ 5,554	\$ (100,255)	\$ (132,994)
Amount of Loss Reclassified from AOCI into Income (Effective Portion Realized)	Regulated electricity segment fuel and purchased power	(29,143)	(47,964)	(42,329)	(73,330)
Amount of Gain (Loss) Recognized in Income from Derivative Instruments (Ineffective Portion and Amount Excluded from Effectiveness Testing) (a)	Regulated electricity segment fuel and purchased power	11,899	(4,900)	1,432	(3,908)

(a) During the three and six months ended June 30, 2010 and 2009, we had no amounts reclassified

from AOCI to  
earnings related  
to discontinued  
cash flow  
hedges.

During the next twelve months, we estimate that a net loss of \$101 million before income taxes will be reclassified from AOCI as an offset to the effect of market price changes for the related hedged transactions. Approximately 90% of the amounts related to derivatives subject to the PSA will be recorded as either a regulatory asset or liability and have no effect on earnings.

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**Derivative Instruments Not Designated as Accounting Hedges**

The following table provides information about gains and losses from derivative instruments not designated as accounting hedging instruments and their impact on our Condensed Consolidated Statements of Income during the three and six months ended June 30, 2010 and 2009 (dollars in thousands):

Commodity Contracts	Financial Statement Location	Three Months Ended June 30,		Six Months Ended June 30,	
		2010	2009	2010	2009
Amount of Net Gain Recognized in Income from Derivative Instruments	Regulated electricity segment revenue	\$ 426	\$ 766	\$ 595	\$ 337
Amount of Net Gain (Loss) Recognized in Income from Derivative Instruments	Regulated electricity segment fuel and purchased power expense	(29,260)	22,242	(64,228)	(41,722)
Total		\$ (28,834)	\$ 23,008	\$ (63,633)	\$ (41,385)

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**Fair Values of Derivative Instruments in the Condensed Consolidated Balance Sheets**

The following table provides information about the fair value of our derivative instruments, margin account and cash collateral reported on a gross basis. Transactions with counterparties that have master netting arrangements are reported net on the balance sheet. These amounts are located in the assets and liabilities from risk management activities lines of our Condensed Consolidated Balance Sheets. Amounts are as of June 30, 2010 (dollars in thousands):

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Total Assets (Liabilities)
Commodity Contracts					
Derivatives designated as accounting hedging instruments:					
Assets	\$ 10	\$	\$ 14	\$ 70	\$ 94
Liabilities	(188)	(1,285)	(115,010)	(98,430)	(214,913)
Total hedging instruments	(178)	(1,285)	(114,996)	(98,360)	(214,819)
Derivatives not designated as accounting hedging instruments:					
Assets	36,271	45,490	38,470	33,213	153,444
Liabilities	(1,955)		(101,349)	(100,856)	(204,160)
Total non-hedging instruments	34,316	45,490	(62,879)	(67,643)	(50,716)
Total derivatives	34,138	44,205	(177,875)	(166,003)	(265,535)
Margin account	20,344		1,458		21,802
Collateral provided to counterparties	10,235		112,727	79,423	202,385
Collateral provided from counterparties	(4,500)		(1,250)		(5,750)
Prepaid option premiums	(106)		1,373		1,267
Balance Sheet Total	\$ 60,111	\$ 44,205	\$ (63,567)	\$ (86,580)	\$ (45,831)

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The following table provides information about the fair value of our derivative instruments, margin account and cash collateral reported on a gross basis at December 31, 2009 (dollars in thousands):

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Total Assets (Liabilities)
Commodity Contracts					
Derivatives designated as accounting hedging instruments:					
Assets	\$ 329	\$	\$ 3,242	\$ 75	\$ 3,646
Liabilities	(3,436)	(256)	(72,899)	(77,953)	(154,544)
Total hedging instruments	(3,107)	(256)	(69,657)	(77,878)	(150,898)
Derivatives not designated as accounting hedging instruments:					
Assets	31,220	29,807	34,645	44,631	140,303
Liabilities	(4,123)	(696)	(81,722)	(71,408)	(157,949)
Total non-hedging instruments	27,097	29,111	(47,077)	(26,777)	(17,646)
Total derivatives	23,990	28,855	(116,734)	(104,655)	(168,544)
Margin account	8,643		12,464	104	21,211
Collateral provided to counterparties	17,986		49,412	42,108	109,506
Collateral provided from counterparties			(1,050)		(1,050)
Balance Sheet Total	\$ 50,619	\$ 28,855	\$ (55,908)	\$ (62,443)	\$ (38,877)

**Credit Risk and Credit-Related Contingent Features**

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management contracts with many counterparties, including one counterparty for which our exposure represents approximately 34% of Pinnacle West's \$104 million of risk management assets as of June 30, 2010. This exposure relates to a long-term traditional wholesale contract with a counterparty that has very high credit quality. Our risk management process assesses and monitors the financial exposure of all counterparties. Despite the fact that the great majority of our trading counterparties' debt is rated as investment grade by the credit rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. Counterparties in the portfolio consist principally of financial institutions, major energy companies, municipalities and local distribution companies. We maintain credit policies that we believe minimize overall credit risk to within acceptable limits. Determination of the credit quality of our counterparties is based upon a number of factors, including credit ratings and our evaluation of their financial condition. To manage credit risk, we employ collateral



requirements and standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. Valuation adjustments are established representing our estimated credit losses on our overall exposure to counterparties.

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Certain of our derivative instrument contracts contain credit-risk-related contingent features including, among other things, investment grade credit rating provisions, credit-related cross default provisions, and adequate assurance provisions. Adequate assurance provisions allow a counterparty with reasonable grounds for uncertainty to demand additional collateral based on subjective events and/or conditions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that were in a liability position on June 30, 2010 was \$390 million, for which we had posted collateral of \$192 million in the normal course of business.

For those derivative instruments in a net liability position, with investment grade credit contingencies, the counterparties could demand additional collateral if our debt credit rating were to fall below investment grade (below BBB- for Standard & Poor's Ratings Services (Standard & Poor's) or Fitch, Inc. (Fitch) or Baa3 for Moody's Investors Service, Inc. (Moody's)), which would be a violation of the credit rating provisions. If the investment grade contingent features underlying these agreements had been triggered on June 30, 2010, after off-setting asset positions under master netting arrangements we would have been required to post approximately an additional \$90 million of collateral to our counterparties; this amount includes those contracts which qualify for scope exceptions, which are excluded from the derivative details in the above footnote. We also have energy related non-derivative instrument contracts with investment grade credit-related contingent features which could also require us to post additional collateral of approximately \$200 million if our debt credit ratings were to fall below investment grade.

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**9. Changes in Equity**

The following tables show Pinnacle West's changes in shareholders' equity and changes in equity of noncontrolling interests for the three and six months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Common Shareholders	Noncontrolling Interests	Total	Common Shareholders	Noncontrolling Interests	Total
Beginning balance, April 1	\$ 3,213,933	\$ 116,067	\$ 3,330,000	\$ 3,162,902	\$ 116,617	\$ 3,279,519
Net income	114,797	4,769	119,566	68,347	4,499	72,846
Other comprehensive income (loss):						
Net unrealized gains (losses) on derivative instruments (a)	(8,588)		(8,588)	5,554		5,554
Net reclassification of realized losses to income (b)	29,143		29,143	47,964		47,964
Reclassification of pension and other postretirement benefits to income	1,362		1,362	1,253		1,253
Net unrealized losses related to pension and other postretirement benefits	(6,933)		(6,933)	(4,204)		(4,204)
Net income tax expense related to items of other comprehensive income (loss)	(5,914)		(5,914)	(19,844)		(19,844)
Total other comprehensive income	9,070		9,070	30,723		30,723
Total comprehensive income	123,867	4,769	128,636	99,070	4,499	103,569
Issuance of capital stock	255,480		255,480	2,717		2,717
Purchase of treasury stock, net of reissuances				5		5
Other (primarily stock compensation)	140		140	(4,820)		(4,820)
	(113,872)		(113,872)	(53,069)		(53,069)

Dividends on common stock							
Net capital activities by noncontrolling interests		(7,381)	(7,381)		(8,439)	(8,439)	
Ending balance, June 30	\$ 3,479,548	\$ 113,455	\$ 3,593,003	\$ 3,206,805	\$ 112,677	\$ 3,319,482	

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	Six Months Ended June 30, 2010			Six Months Ended June 30, 2009		
	Common Shareholders	Noncontrolling Interests	Total	Common Shareholders	Noncontrolling Interests	Total
Beginning balance, January 1	\$ 3,316,109	\$ 111,895	\$ 3,428,004	\$ 3,445,979	\$ 124,990	\$ 3,570,969
Net income (loss)	108,783	9,886	118,669	(88,163)	(5,061)	(93,224)
Other comprehensive income (loss):						
Net unrealized losses on derivative instruments (a)	(100,255)		(100,255)	(132,994)		(132,994)
Net reclassification of realized losses to income (b)	42,329		42,329	73,330		73,330
Reclassification of pension and other postretirement benefits to income	2,755		2,755	2,506		2,506
Net unrealized losses related to pension and other postretirement benefits	(6,933)		(6,933)	(4,204)		(4,204)
Net income tax benefit related to items of other comprehensive income (loss)	24,511		24,511	24,157		24,157
Total other comprehensive loss	(37,593)		(37,593)	(37,205)		(37,205)
Total comprehensive income (loss)	71,190	9,886	81,076	(125,368)	(5,061)	(130,429)
Issuance of capital stock	258,160		258,160	5,346		5,346
Purchase of treasury stock, net of reissuances	1,078		1,078	(1,546)		(1,546)
Other (primarily stock compensation)	142		142	(11,527)		(11,527)
Dividends on common stock	(167,131)		(167,131)	(106,079)		(106,079)
Net capital activities by noncontrolling interests		(8,326)	(8,326)		(7,252)	(7,252)

Ending balance, June 30	\$ 3,479,548	\$ 113,455	\$ 3,593,003	\$ 3,206,805	\$ 112,677	\$ 3,319,482
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(a) These amounts primarily include unrealized gains and losses on contracts used to hedge our forecasted electricity and natural gas requirements to serve Native Load. These changes are primarily due to changes in forward natural gas prices and wholesale electricity prices.

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

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**10. Commitments and Contingencies**

**Palo Verde Nuclear Generating Station**

***Spent Nuclear Fuel and Waste Disposal***

Nuclear power plant operators are required to enter into spent fuel disposal contracts with the United States Department of Energy ( DOE ), and the 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 Policy Act required the DOE to develop a permanent repository for the storage and disposal of spent nuclear fuel by 1998, the DOE announced that it would not be able to open the repository by 1998 and sought to excuse its performance under the contract. 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 the DOE s delay, a number of utilities, including APS (on behalf of itself and the other Palo Verde owners), filed damages actions against the DOE in the Court of Federal Claims. APS pursued a damages claim for costs incurred through December 2006 in a trial that began on January 28, 2009. On June 18, 2010, the court awarded APS and the other Palo Verde owners approximately \$30 million. APS share of this amount is approximately \$9 million. Because the appeal period for this decision has not yet passed, APS has not recorded this amount on its financial statements.

APS currently estimates it will incur \$132 million (in 2010 dollars) over the current life of Palo Verde for its share of the costs related to the on-site interim storage of spent nuclear fuel. At June 30, 2010, APS had a regulatory liability of \$38 million that represents amounts recovered in retail rates in excess of amounts spent for on-site interim spent fuel storage.

**Fuel and Purchased Power Commitments**

APS is party to various fuel and purchased power contracts with terms expiring between 2010 and 2042 that include required purchase provisions. APS estimates the contract requirements to be approximately \$637 million in 2010; \$347 million in 2011; \$377 million in 2012; \$479 million in 2013; \$506 million in 2014; and \$6.8 billion thereafter. However, these amounts may vary significantly pursuant to certain provisions in such contracts that permit us to decrease required purchases under certain circumstances. These amounts have increased since the 2009 Form 10-K due to increased solar contracts to meet our increasing renewable energy requirements.

**FERC Market Issues**

APS reached a settlement on previously disputed matters resulting from its involvement in the California energy market during specified time frames in the early 2000s. The settlement was approved by the FERC in an order issued on June 30, 2008. The resolution of the claims related to the parties involved in this settlement had no material adverse impact on APS financial position, results of operations or cash flows.

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On July 25, 2001, the FERC ordered an evidentiary proceeding to discuss and evaluate possible refunds for wholesale sales in the Pacific Northwest. The FERC affirmed the administrative law judge's conclusion that the prices in the Pacific Northwest were not unreasonable or unjust and refunds should not be ordered in this proceeding. This decision was appealed to the U.S. Court of Appeals for the Ninth Circuit. On August 24, 2007, the Ninth Circuit issued an opinion that remanded the proceeding to the FERC for further consideration. Although the FERC has not yet determined whether any refunds will ultimately be required, we do not expect that the resolution of these issues will have a material adverse impact on our financial position, results of operations or cash flows.

**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 under Superfund ( PRPs ). PRPs may be strictly, and often are jointly and severally, liable for clean-up. On September 3, 2003, the United States Environmental Protection Agency ( EPA ) advised APS that the EPA considers APS to be a PRP in the Motorola 52<sup>nd</sup> Street Superfund Site, Operable Unit 3 ( OU3 ) in Phoenix, Arizona. APS has facilities that are within this Superfund site. APS and Pinnacle West have agreed with the EPA to perform certain investigative activities of the APS facilities within OU3. In addition, on September 23, 2009, APS agreed with the EPA and one other PRP to voluntarily assist with the funding and management of the site-wide groundwater remedial investigation and feasibility study work plan. We estimate that our costs related to this investigation and study will be approximately \$1.2 million, which is reserved as a liability on our financial statements. We anticipate incurring additional expenditures in the future, but because the overall investigation is not complete and ultimate remediation requirements are not yet finalized, at the present time we cannot accurately estimate our total expenditures.

**Landlord Bankruptcy**

On April 16, 2009, the landlord for our corporate headquarters building announced that it is seeking relief under Chapter 11 of the United States Bankruptcy Code. At June 30, 2010, we have several assets on our books related to our landlord, the most significant of which is an asset related to levelized rent payments for the building of approximately \$69 million which is included in other deferred debits on the Condensed Consolidated Balance Sheets. This amount will continue to increase to approximately \$94 million as a result of the lease terms until 2015, when this amount will begin to decrease over the remaining life of the lease. We are monitoring this matter and, while there can be no assurances as to the ultimate outcome of the matter due to the complexity of the bankruptcy proceedings, we currently do not expect that it will have a material adverse effect on our financial position, results of operations, or cash flows.

**Nuclear Insurance**

The Palo Verde participants are insured against public liability for a nuclear incident up to \$12.6 billion per occurrence. As required by the Price Anderson Nuclear Industries Indemnity Act, Palo Verde maintains the maximum available nuclear liability insurance in the amount of \$375 million, which is provided by commercial insurance carriers. The remaining balance of \$12.2 billion is provided through a mandatory industry wide retrospective assessment program. If losses at any nuclear power plant covered by the program exceed the accumulated funds, APS could be assessed retrospective premium adjustments. The maximum assessment per reactor under the program for each nuclear incident is approximately \$118 million, subject to an annual limit of \$18 million per incident, to be periodically adjusted for inflation. Based on APS' interest in the three Palo Verde units, APS' maximum potential assessment per incident for all three units is approximately \$103 million, with an annual payment limitation of approximately \$15 million.



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The Palo Verde participants maintain all risk (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of \$2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. APS has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen accidental outage of any of the three units. The property damage, decontamination, and replacement power coverages are provided by Nuclear Electric Insurance Limited ( NEIL ). APS is subject to retrospective assessments under all NEIL policies if NEIL's losses in any policy year exceed accumulated funds. The maximum amount APS could incur under the current NEIL policies totals approximately \$16 million for each retrospective assessment declared by NEIL's Board of Directors due to losses. In addition, NEIL policies contain rating triggers that would result in APS providing approximately \$44 million of collateral assurance within 20 business days of a rating downgrade to non-investment grade. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

**11. Other Income and Other Expense**

The following table provides detail of other income and other expense for the three and six months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Other income:				
Interest income	\$ 625	\$ 386	\$ 1,499	\$ 634
Investment gains net		3,398		
Miscellaneous	308	2,468	320	2,658
Total other income	\$ 933	\$ 6,252	\$ 1,819	\$ 3,292
Other expense:				
Non-operating costs	\$ (1,247)	\$ (3,248)	\$ (3,042)	\$ (4,855)
Investment losses net	(3,561)		(2,339)	(3,832)
Miscellaneous	(852)	(939)	(1,753)	(1,842)
Total other expense	\$ (5,660)	\$ (4,187)	\$ (7,134)	\$ (10,529)

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**12. Guarantees**

We have issued parental guarantees and obtained surety bonds on behalf of our subsidiaries including credit support instruments enabling APSES to offer energy-related products and surety bonds at APS, principally related to self-insured workers' compensation. Non-performance or non-payment under the underlying contract by our subsidiaries would result in a payment liability on our part under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West's current outstanding guarantees and surety bonds on behalf of our subsidiaries. At June 30, 2010, we had no outstanding claims for payment under any of these guarantees. Our guarantees and surety bonds have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees or surety bonds from our subsidiaries. The amounts and approximate terms of our guarantees and surety bonds for each subsidiary at June 30, 2010 are as follows (dollars in millions):

	Guarantees		Surety Bonds	
	Amount	Term (in years)	Amount	Term (in years)
APSES	\$ 5	1	\$ 30	1
APS	3	1	9	1
Total	\$ 8		\$ 39	

APS has entered into various agreements that require letters of credit for financial assurance purposes. At June 30, 2010, approximately \$227 million of letters of credit were outstanding to support existing pollution control bonds of approximately \$223 million. The letters of credit are available to fund the payment of principal and interest of such debt obligations. In connection with the change of interest rate mode and termination of a corresponding letter of credit for certain pollution control bonds described in Note 2, the letters of credit outstanding have decreased since June 30, 2010. Currently, there are approximately \$194 million of letters of credit outstanding to support existing pollution control bonds of approximately \$190 million. These letters of credit expire in 2010 and 2011. APS has also entered into approximately \$62 million of letters of credit to support certain equity lessors in the Palo Verde sale leaseback transactions (see Note 7 for further details on the Palo Verde sale leaseback transactions). These letters of credit were amended and extended in April 2010, and will expire in 2013.

We enter into agreements that include indemnification provisions relating to liabilities arising from or related to certain of our agreements; most significantly, APS has agreed to indemnify the equity participants and other parties in the Palo Verde sale leaseback transactions with respect to certain tax matters. Generally, a maximum obligation is not explicitly stated in the indemnification provisions and, therefore, the overall maximum amount of the obligation under such indemnification provisions cannot be reasonably estimated. Based on historical experience and evaluation of the specific indemnities, we do not believe that any material loss related to such indemnification provisions is likely.

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

**13. Earnings Per Share**

The following table presents earnings per weighted average common share outstanding for the three and six months ended June 30, 2010 and 2009:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Basic earnings per share:				
Income from continuing operations attributable to common shareholders	\$ 0.84	\$ 0.76	\$ 0.93	\$ 0.51
Income (loss) from discontinued operations	0.23	(0.08)	0.11	(1.38)
Earnings per share basic	\$ 1.07	\$ 0.68	\$ 1.04	\$ (0.87)
Diluted earnings per share:				
Income from continuing operations attributable to common shareholders	\$ 0.83	\$ 0.75	\$ 0.92	\$ 0.51
Income (loss) from discontinued operations	0.24	(0.07)	0.12	(1.38)
Earnings per share diluted	\$ 1.07	\$ 0.68	\$ 1.04	\$ (0.87)

Dilutive stock options and performance shares (which are contingently issuable) increased average diluted common shares outstanding by approximately 409,000 shares and 84,000 shares for the three months ended June 30, 2010 and 2009, respectively, and by approximately 426,000 shares for the six months ended June 30, 2010. For the six months ended June 30, 2009 the weighted average common shares outstanding were the same for both basic and diluted shares.

Options to purchase 387,800 shares of common stock for the three-month period ended June 30, 2010, and 599,324 shares for the three-month period ended June 30, 2009 were outstanding but were excluded from the computation of diluted earnings per share because the options exercise prices were greater than the average market price of the common shares. Options to purchase 387,800 shares and 612,424 shares of common stock for the six-month periods ended June 30, 2010 and June 30, 2009, respectively, were outstanding but were excluded from the computation of diluted earnings per share because the options exercise prices were greater than the average market price of the common shares.

**14. Discontinued Operations**

**SunCor** (real estate segment) In July, SunCor sold land parcels, commercial assets and a master planned home-building community for approximately \$70 million, which approximated the carrying value of these assets, resulting in a net gain of zero. At June 30, 2010, SunCor had approximately \$103 million of assets on its balance sheet classified as assets held for sale. These assets consist of the \$70 million of assets sold in July as discussed above, \$25 million of consolidated VIEs (see Note 7), master planned home-building communities and golf courses. Because it is expected that SunCor will dispose of these assets within the next 12 months, they are classified as assets held for sale on the balance sheet. As a result, for the three and six months ended June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations. Prior comparative period income statement amounts related to these properties were reclassified from continuing operations to discontinued operations. In addition, see Note 16 Real Estate Impairment Charge.



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**PINNACLE WEST CAPITAL CORPORATION**  
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**APSES** (other) On June 22, 2010, our subsidiary, APSES, sold its district cooling business consisting of operations in downtown Phoenix, Tucson, and on certain Arizona State University campuses. As a result of the sale, we recorded an after-tax gain from discontinued operations of approximately \$25 million. Prior period income statement amounts related to this sale and the associated revenues and costs were reclassified to discontinued operations in 2010 and 2009.

The following table provides revenue, income (loss) before income taxes and income (loss) after taxes classified as discontinued operations in Pinnacle West's Condensed Consolidated Statements of Income for the three and six months ended June 30, 2010 and 2009 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenue:				
SunCor	\$ 11	\$ 17	\$ 21	\$ 36
APSES	4	5	7	8
Total revenue	\$ 15	\$ 22	\$ 28	\$ 44
Income (loss) before taxes:				
SunCor	\$ (2)	\$ (14)	\$ (24)	\$ (231)
APSES	43	1	44	2
Total income (loss) before taxes	\$ 41	\$ (13)	\$ 20	\$ (229)
Income (loss) after taxes:				
SunCor (a)	\$ (1)	\$ (9)	\$ (15)	\$ (140)
APSES	26	1	27	1
Total income (loss) after taxes	\$ 25	\$ (8)	\$ 12	\$ (139)

(a) Includes a tax benefit recognized by the parent company in accordance with an intercompany tax sharing agreement of \$1 million and \$5 million for the three months ended June 30, 2010, and 2009,

respectively;  
\$9 million and  
\$93 million for  
the six months  
ended June 30,  
2010 and 2009,  
respectively.

#### **15. Fair Value Measurements**

We disclose the fair value of certain assets and liabilities according to a fair value hierarchy. This hierarchy ranks the quality and reliability of the inputs used to determine fair values, which are then classified and disclosed in one of three categories. The three levels of the fair value hierarchy are:

Level 1 Quoted prices in active markets for identical assets or liabilities. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide information on an ongoing basis. This category includes derivative instruments that are exchange-traded such as futures, cash equivalents invested in exchange-traded money market funds, exchange-traded equities, and investments in Treasury securities.

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Level 2 Quoted prices in active markets for similar assets or liabilities; quoted prices in markets that are not active; and model-derived valuations whose inputs are observable. This category includes nonexchange-traded derivative instruments such as forwards, options, and swaps. This category also includes investments in common and commingled funds that are redeemable and valued based on the funds' net asset values.

Level 3 Model-derived valuations with significant unobservable inputs that are supported by little or no market activity. Instruments in this category include long-dated derivative transactions where models are required due to the length of the transaction, certain options, transactions in locations where observable market data does not exist, and common and collective trusts with significant restrictions on our ability to transact in the fund. The valuation models we employ utilize spot prices, forward prices, historical market data and other factors to forecast future prices. The primary valuation technique we use to calculate the fair value of contracts where price quotes are not available is based on the extrapolation of forward pricing curves using observable market data for more liquid delivery points in the same region and actual transactions at the more illiquid delivery points.

Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. We maximize the use of observable inputs and minimize the use of unobservable inputs. If market data is not readily available, inputs may reflect our own assumptions about the inputs market participants would use. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. Thus, a valuation may be classified in Level 3 even though the valuation may include significant inputs that are readily observable. We assess whether a market is active by obtaining observable broker quotes, reviewing actual market transactions, and assessing the volume of transactions. We consider broker quotes observable inputs when the quote is binding on the broker, we can validate the quote with market transactions, or we can determine that the inputs the broker used to arrive at the quoted price are observable.

**Recurring Fair Value Measurements**

We apply recurring fair value measurements to derivative instruments, nuclear decommissioning trusts, certain cash equivalents and plan assets held in our retirement and other benefit plans.

***Cash Equivalents***

Cash equivalents represent short-term investments in exchange-traded money market funds that are valued using quoted prices in active markets.

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***Risk Management Activities***

Exchange-traded contracts are valued using quoted prices in active markets. For non-exchange traded contracts, we calculate fair market value based on the average of the bid and offer price, discounted to reflect net present value. We maintain certain valuation adjustments for a number of risks associated with the valuation of future commitments. These include valuation adjustments for liquidity and credit risks based on the financial condition of counterparties. The liquidity valuation adjustment represents the cost that would be incurred if all unmatched positions were closed-out or hedged.

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

Some of our derivative instrument transactions are valued based on unobservable inputs due to the long-term nature of contracts or the unique location of the transactions. Our long-dated energy transactions consist of observable valuations for the near-term portion and unobservable valuations for the long-term portions of the transaction. When the unobservable portion is significant to the overall valuation of the transaction, the entire transaction is classified as Level 3. Our classification of instruments as Level 3 is primarily reflective of the long-term nature of our energy transactions, and is not reflective of material inactive markets.

***Nuclear Decommissioning Trust***

The nuclear decommissioning trust invests in fixed income securities directly and equity securities indirectly through commingled funds. The commingled equity funds are valued based on the fund's net asset value and are classified within Level 2. We may transact in the fund on a semi-monthly basis. Our trustee provides valuation of our nuclear decommissioning trust assets by using pricing services to determine fair market value. We assess these valuations and verify that pricing can be supported by actual recent market transactions. The trust fund investments have been established to satisfy APS' nuclear decommissioning obligations.



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***Fair Value Tables***

The following table presents the fair value at June 30, 2010 of our assets and liabilities that are measured at fair value on a recurring basis (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (a) (Level 3)	Counterparty Netting & Other (b)	Balance at June 30, 2010
<b>Assets</b>					
Risk management activities:					
Commodity contracts	\$	\$ 97	\$ 56	\$ (49)	\$ 104
Nuclear decommissioning trust:					
Equity securities:					
U.S. commingled funds		136			136
Fixed income securities:					
U.S. Treasury	56				56
Corporate		57			57
Mortgage-backed		61			61
Municipality		68			68
Other		57		(11)	46
Total	\$ 56	\$ 476	\$ 56	\$ (60)	\$ 528
<b>Liabilities</b>					
Risk management activities:					
Commodity contracts	\$ (2)	\$ (319)	\$ (98)	\$ 269	\$ (150)

(a) Primarily consists of long-dated electricity contracts.

(b) Primarily represents netting under master netting arrangements, including margin and collateral. See Note 8.



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

The following table presents the fair value at December 31, 2009 of our assets and liabilities that are measured at fair value on a recurring basis (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (a) (Level 3)	Counterparty Netting & Other (b)	Balance at December 31, 2009
<b>Assets</b>					
Cash equivalents	\$ 97	\$	\$	\$	\$ 97
Risk management activities:					
Commodity contracts	1	100	42	(64)	79
Nuclear decommissioning trust:					
Equity securities:					
U.S. commingled funds		167			167
Fixed income securities:					
U.S. Treasury	55				55
Corporate		62			62
Mortgage-backed		60			60
Municipality		49			49
Other		21		1	22
<b>Total</b>	<b>\$ 153</b>	<b>\$ 459</b>	<b>\$ 42</b>	<b>\$ (63)</b>	<b>\$ 591</b>
<b>Liabilities</b>					
Risk management activities:					
Commodity contracts	\$ (14)	\$ (246)	\$ (52)	\$ 194	\$ (118)

(a) Primarily consists of long-dated electricity contracts.

(b) Primarily represents netting under master netting arrangements, including margin and collateral. See Note 8.



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

The following table shows the changes in fair value for assets and liabilities that are measured at fair value on a recurring basis using Level 3 inputs for the three and six months ended June 30, 2010 and 2009 (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Commodity Contracts				
Net derivative balance at beginning of period	\$ (31)	\$ (23)	\$ (10)	\$ (7)
Total net gains (losses) realized/unrealized:				
Included in earnings	(1)		(2)	2
Included in OCI	(3)		(9)	(1)
Deferred as a regulatory asset or liability	(12)	9	(24)	6
Settlements	3	3	3	3
Transfers into Level 3 from Level 2	8	(7)	8	(21)
Transfers from Level 3 into Level 2	(6)	2	(8)	2
Net derivative balance at end of period	\$ (42)	\$ (16)	\$ (42)	\$ (16)

Net unrealized gains (losses) included in earnings related to instruments still held at end of period \$ (1) \$ 2

Amounts included in earnings are recorded in either regulated electricity segment revenue or regulated electricity segment fuel and purchased power depending on the nature of the underlying contract.

Transfers reflect the fair market value at the beginning of the period and are triggered by a change in the lowest significant input as of the end of the period. We had no significant Level 1 transfers to or from any other hierarchy level. Transfers in or out of Level 3 are typically related to our long-dated energy transactions that extend beyond available quoted periods.

**Nonrecurring Fair Value Measurements**

We may be required to record other assets at fair value on a nonrecurring basis. These nonrecurring fair value measurements typically involve write-downs of individual assets due to impairment.

We apply nonrecurring fair value measurements to certain real estate assets. These adjustments to fair value are the result of write-downs of individual assets due to impairment. Our real estate assets have been impaired due to the distressed real estate market. The majority of our real estate assets reflect the expected sales price less cost to sell at June 30, 2010. Due to these unobservable inputs, the valuation of real estate assets are considered Level 3 measurements.

As of June 30, 2010, the fair value of our impaired real estate assets that are measured at fair value on a nonrecurring basis was \$68 million, all of which was valued using significant unobservable inputs (Level 3). Total impairment charges included in net income for the three and six months ended June 30, 2010 were approximately \$2 million and \$17 million, respectively. See Note 16 for additional information.

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

**Financial Instruments Not Carried at Fair Value**

The carrying value of our net accounts receivable, accounts payable and short-term borrowings approximate fair value. Our long-term debt fair value estimates are based on quoted market prices of the same or similar issues. Certain of our debt instruments contain third-party credit enhancements and, in accordance with GAAP, we do not consider the effect of these credit enhancements when determining fair value.

The following table represents the carrying amount and estimated fair value of our long-term debt, including current maturities (dollars in millions):

	As of June 30, 2010		As of December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Pinnacle West	\$ 175	\$ 179	\$ 175	\$ 180
APS	3,521	3,821	3,530	3,667
SunCor (a)	89	89	95	95
Total	\$ 3,785	\$ 4,089	\$ 3,800	\$ 3,942

(a) See Note 2 for further discussion related to SunCor's debt and liquidity matters.

**Nuclear Decommissioning Trust**

To fund the costs APS expects to incur to decommission Palo Verde, APS established external decommissioning trusts in accordance with NRC regulations. Third-party investment managers are authorized to buy and sell securities per their stated investment guidelines. The trust funds are invested in a tax efficient manner in fixed income securities and domestic equity securities. APS classifies investments in decommissioning trust funds as available for sale, and therefore, we record the decommissioning trust funds at their fair value on our Condensed Consolidated Balance Sheets. Because of the ability of APS to recover decommissioning costs in rates and in accordance with the regulatory treatment for decommissioning trust funds, we have recorded the offsetting amount of gains or losses on investment securities in other regulatory liabilities or assets. The following table summarizes the fair value of APS' nuclear decommissioning trust fund assets at June 30, 2010 and December 31, 2009 (dollars in millions):

	Fair Value	Total Unrealized Gains	Total Unrealized Losses
June 30, 2010			
Equity securities	\$ 136	\$ 22	\$ (10)
Fixed income securities	299	15	
Net payables (a)	(11)		
Total	\$ 424	\$ 37	\$ (10)

- (a) Net payables  
relate to  
pending  
securities sales  
and purchases.

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

	Fair Value	Total Unrealized Gains	Total Unrealized Losses
December 31, 2009			
Equity securities	\$ 167	\$ 37	\$ (6)
Fixed income securities	247	11	(1)
Net receivables (a)	1		
Total	\$ 415	\$ 48	\$ (7)

(a) Net receivables relate to pending securities sales and purchases.

The costs of securities sold are determined on the basis of specific identification. The following table sets forth approximate realized gains and losses and proceeds from the sale of securities by the nuclear decommissioning trust funds (dollars in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Realized gains	\$ 2	\$ 3	\$ 14	\$ 5
Realized losses	(1)	(3)	(3)	(5)
Proceeds from the sale of securities (a)	171	115	330	245

(a) Proceeds are reinvested in the trust.

The fair value of fixed income securities, summarized by contractual maturities, at June 30, 2010 is as follows (dollars in millions):

	Fair Value
Less than one year	\$ 27
1 year - 5 years	64
5 years - 10 years	88
Greater than 10 years	120
Total	\$ 299



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

**16. Real Estate Impairment Charge**

In 2009, SunCor undertook and completed a review of its assets and strategies within its various markets as a result of the distressed conditions in real estate and credit markets. Based on the results of the review, on March 27, 2009, SunCor's Board of Directors authorized a series of strategic transactions to dispose of SunCor's homebuilding operations, master-planned communities, land parcels, commercial assets and golf courses in order to reduce SunCor's outstanding debt. In July, SunCor sold land parcels, commercial assets and a master planned home-building community for approximately \$70 million, which approximated the carrying value of these assets, resulting in a net gain of zero. It is expected that SunCor will dispose of its other assets within the next 12 months. As a result, they are classified as assets held for sale on the balance sheet at June 30, 2010. As a result of the discussion above, as of June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations. The detail of the impairment charges are as follows (dollars in millions, and before income taxes):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Discontinued Operations:				
Homebuilding and master-planned communities	\$	\$ 4	\$ 1	\$ 150
Land parcels and commercial assets	2	2	11	54
Golf courses			1	18
Other			4	
Subtotal	2	6	17	222
Less noncontrolling interests				(14)
Total	\$ 2	\$ 6	\$ 17	\$ 208

See Note 2 for a discussion of SunCor's debt and liquidity matters.

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**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)  
(dollars in thousands)

	Three Months Ended June 30,	
	2010	2009
ELECTRIC OPERATING REVENUES	\$ 799,467	\$ 812,587
OPERATING EXPENSES		
Fuel and purchased power	251,800	291,699
Operations and maintenance	211,310	211,214
Depreciation and amortization	102,970	100,923
Income taxes	55,688	45,862
Taxes other than income taxes	31,450	32,515
Total	653,218	682,213
OPERATING INCOME	146,249	130,374
OTHER INCOME (DEDUCTIONS)		
Income taxes	1,654	1,432
Allowance for equity funds used during construction	5,504	4,730
Other income (Note S-2)	1,827	4,958
Other expense (Note S-2)	(6,091)	(4,973)
Total	2,894	6,147
INTEREST EXPENSE		
Interest on long-term debt	53,220	53,994
Interest on short-term borrowings	2,879	1,293
Debt discount, premium and expense	1,118	1,256
Allowance for borrowed funds used during construction	(3,072)	(3,217)
Total	54,145	53,326
NET INCOME	94,998	83,195
Less: Net income attributable to noncontrolling interests (Note 7)	4,778	4,651
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER	\$ 90,220	\$ 78,544

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

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**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2010	2009
ELECTRIC OPERATING REVENUES	\$ 1,410,943	\$ 1,415,247
OPERATING EXPENSES		
Fuel and purchased power	467,340	539,087
Operations and maintenance	415,191	402,399
Depreciation and amortization	203,579	200,860
Income taxes	50,248	39,118
Taxes other than income taxes	62,901	66,295
Total	1,199,259	1,247,759
OPERATING INCOME	211,684	167,488
OTHER INCOME (DEDUCTIONS)		
Income taxes	2,497	2,614
Allowance for equity funds used during construction	10,893	9,722
Other income (Note S-2)	2,445	4,050
Other expense (Note S-2)	(8,552)	(8,008)
Total	7,283	8,378
INTEREST EXPENSE		
Interest on long-term debt	107,972	103,728
Interest on short-term borrowings	3,721	4,268
Debt discount, premium and expense	2,255	2,445
Allowance for borrowed funds used during construction	(6,091)	(6,941)
Total	107,857	103,500
NET INCOME	111,110	72,366
Less: Net income attributable to noncontrolling interests (Note 7)	9,906	9,301
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER	\$ 101,204	\$ 63,065

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

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**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(unaudited)  
(dollars in thousands)

	June 30, 2010	December 31, 2009
<b>ASSETS</b>		
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	\$ 12,927,660	\$ 12,781,256
Accumulated depreciation and amortization	(4,396,895)	(4,326,908)
Net	8,530,765	8,454,348
Construction work in progress	496,457	460,748
Palo Verde sale leaseback, net of accumulated depreciation (Note 7)	142,335	146,722
Intangible assets, net of accumulated amortization	168,078	164,183
Nuclear fuel, net of accumulated amortization	136,151	118,243
Total property, plant and equipment	9,473,786	9,344,244
<b>INVESTMENTS AND OTHER ASSETS</b>		
Nuclear decommissioning trust (Note 15)	424,260	414,576
Assets from risk management activities (Note 8)	44,205	28,855
Other assets	67,765	68,839
Total investments and other assets	536,230	512,270
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	35,602	120,798
Customer and other receivables	263,201	280,226
Accrued unbilled revenues	162,441	110,971
Allowance for doubtful accounts	(6,223)	(6,063)
Materials and supplies (at average cost)	172,091	176,020
Fossil fuel (at average cost)	29,597	39,245
Assets from risk management activities (Note 8)	60,111	50,619
Deferred income taxes	74,134	53,990
Other current assets	41,966	25,724
Total current assets	832,920	851,530
<b>DEFERRED DEBITS</b>		
Regulatory assets	850,001	813,161
Income tax receivable (Note 6)	65,498	65,498
Unamortized debt issue costs	19,679	20,959

Other	79,263	73,909
Total deferred debits	1,014,441	973,527
 TOTAL ASSETS	 \$ 11,857,377	 \$ 11,681,571

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

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**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(unaudited)  
(dollars in thousands)

	June 30, 2010	December 31, 2009
<b>LIABILITIES AND EQUITY</b>		
<b>CAPITALIZATION</b>		
Common stock	\$ 178,162	\$ 178,162
Additional paid-in capital	2,379,696	2,126,863
Retained earnings	1,195,031	1,250,126
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(31,858)	(29,114)
Derivative instruments	(115,739)	(80,682)
Total shareholder equity	3,605,292	3,445,355
Noncontrolling interests (Note 7)	88,944	82,324
Total equity	3,694,236	3,527,679
Long-term debt less current maturities (Note 2)	3,213,109	3,180,406
Palo Verde sale leaseback lessor notes (Notes 2 and 7)	113,379	126,000
Total capitalization	7,020,724	6,834,085
<b>CURRENT LIABILITIES</b>		
Current maturities of long-term debt (Note 2)	194,082	222,959
Accounts payable	232,537	213,833
Accrued taxes (Note 6)	155,452	158,051
Common dividends payable	56,900	
Accrued interest	53,215	54,099
Customer deposits	69,088	70,780
Liabilities from risk management activities (Note 8)	63,567	55,908
Other current liabilities	100,241	124,995
Total current liabilities	925,082	900,625
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	1,677,864	1,582,945
Deferred fuel and purchased power regulatory liability (Note 3)	97,047	87,291
Other regulatory liabilities	651,146	679,072
Liability for asset retirements	317,980	301,783
Liabilities for pension and other postretirement benefits (Note 4)	688,012	766,378
Customer advances	133,112	136,595
Liabilities from risk management activities (Note 8)	86,580	62,443
Coal mine reclamation	92,557	92,060



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Unrecognized tax benefits (Note 6)	75,796	140,638
Other	91,477	97,656
Total deferred credits and other	3,911,571	3,946,861

COMMITMENTS AND CONTINGENCIES (SEE NOTES)

TOTAL LIABILITIES AND EQUITY	\$ 11,857,377	\$ 11,681,571
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See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

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**ARIZONA PUBLIC SERVICE COMPANY**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 111,110	\$ 72,366
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	228,513	219,815
Deferred fuel and purchased power	65,249	13,144
Deferred fuel and purchased power amortization	(55,494)	66,163
Allowance for equity funds used during construction	(10,893)	(9,722)
Deferred income taxes	58,225	75,096
Change in mark-to-market valuations	2,396	(401)
Changes in current assets and liabilities:		
Customer and other receivables	(4,062)	23,252
Accrued unbilled revenues	(51,470)	(44,309)
Materials, supplies and fossil fuel	13,577	(21,628)
Other current assets	(16,242)	(4,687)
Accounts payable	43,451	(44,577)
Accrued taxes	(2,599)	(60,839)
Other current liabilities	(27,330)	(16,412)
Change in margin and collateral accounts assets	656	(2,856)
Change in margin and collateral accounts liabilities	(90,694)	(91,856)
Change in unrecognized tax benefits	(62,198)	14,639
Change in other long-term assets	(7,203)	(21,693)
Change in other long-term liabilities	(40,738)	51,624
Net cash flow provided by operating activities	154,254	217,119
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Trust fund for bond redemptions		(163,975)
Capital expenditures	(378,239)	(388,526)
Contributions in aid of construction	15,163	33,371
Allowance for borrowed funds used during construction	(6,091)	(6,941)
Proceeds from nuclear decommissioning trust sales	329,796	244,858
Investment in nuclear decommissioning trust	(342,004)	(255,754)
Other	1,074	990
Net cash flow used for investing activities	(380,301)	(535,977)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt		837,193

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Repayment of long-term debt	(9,296)	(186,105)
Short-term borrowings and payments-net		(312,464)
Equity infusion	252,833	
Dividends paid on common stock	(99,400)	(85,000)
Noncontrolling interests	(3,286)	(3,393)
Net cash flow provided by financing activities	140,851	250,231
NET DECREASE IN CASH AND CASH EQUIVALENTS	(85,196)	(68,627)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	120,798	71,544
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 35,602	\$ 2,917

Supplemental disclosure of cash flow information

Cash paid during the period for:

Income taxes, net of (refunds)	\$ 65,498	\$ 13,704
Interest, net of amounts capitalized	\$ 106,485	\$ 86,943

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

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Certain notes to APS' Condensed Consolidated Financial Statements are combined with the Notes to Pinnacle West's Condensed Consolidated Financial Statements. Listed below are the Condensed Consolidated Notes to Pinnacle West's Condensed Consolidated Financial Statements, the majority of which also relate to APS' Condensed Consolidated Financial Statements. In addition, listed below are the Supplemental Notes that are required disclosures for APS and should be read in conjunction with Pinnacle West's Condensed Consolidated Notes.

	Condensed Consolidated Note Reference	APS Supplemental Note Reference
Consolidation and Nature of Operations	Note 1	
Long-term Debt and Liquidity Matters	Note 2	
Regulatory Matters	Note 3	
Retirement Plans and Other Benefits	Note 4	
Business Segments	Note 5	
Income Taxes	Note 6	
Variable Interest Entities	Note 7	
Derivative and Energy Trading Accounting	Note 8	
Changes in Equity	Note 9	Note S-1
Commitments and Contingencies	Note 10	
Other Income and Other Expense	Note 11	Note S-2
Guarantees	Note 12	
Earnings Per Share	Note 13	
Discontinued Operations	Note 14	
Fair Value Measurements	Note 15	
Real Estate Impairment Charge	Note 16	

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**ARIZONA PUBLIC SERVICE COMPANY**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Changes In Equity****S-1. Changes in Equity**

The following tables show APS changes in shareholder equity and changes in equity of noncontrolling interests for the three and six months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Shareholder	Noncontrolling		Shareholder	Noncontrolling	
	Equity	Interests	Total	Equity	Interests	Total
Beginning balance, April 1	\$ 3,366,986	\$ 87,452	\$ 3,454,438	\$ 3,217,841	\$ 82,251	\$ 3,300,092
Net income	90,220	4,778	94,998	78,544	4,651	83,195
Other comprehensive income (loss):						
Net unrealized gains (losses) on derivative instruments (a)	(8,588)		(8,588)	5,554		5,554
Net reclassification of realized gains to income (b)	29,143		29,143	47,964		47,964
Reclassification of pension and other postretirement benefits to income	1,264		1,264	1,005		1,005
Net unrealized losses related to pension benefits	(6,862)		(6,862)	(3,774)		(3,774)
Net income tax expense related to items of other comprehensive income (loss)	(5,905)		(5,905)	(20,066)		(20,066)
Total other comprehensive income	9,052		9,052	30,683		30,683
Total comprehensive income	99,272	4,778	104,050	109,227	4,651	113,878
Dividends on common stock	(113,800)		(113,800)	(42,500)		(42,500)
Equity infusion	252,833		252,833			
Other	1	(3,286)	(3,285)		(3,393)	(3,393)
Ending balance, June 30	\$ 3,605,292	\$ 88,944	\$ 3,694,236	\$ 3,284,568	\$ 83,509	\$ 3,368,077

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**ARIZONA PUBLIC SERVICE COMPANY**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Six Months Ended June 30, 2010			Six Months Ended June 30, 2009		
	Shareholder Equity	Noncontrolling Interests	Total	Shareholder Equity	Noncontrolling Interests	Total
Beginning balance, January 1	\$ 3,445,355	\$ 82,324	\$ 3,527,679	\$ 3,339,150	\$ 77,601	\$ 3,416,751
Net income	101,204	9,906	111,110	63,065	9,301	72,366
Other comprehensive income (loss):						
Net unrealized losses on derivative instruments (a)	(100,255)		(100,255)	(132,994)		(132,994)
Net reclassification of realized losses to income (b)	42,329		42,329	73,330		73,330
Reclassification of pension and other postretirement benefits to income	2,328		2,328	1,993		1,993
Net unrealized losses related to pension benefits	(6,862)		(6,862)	(3,774)		(3,774)
Net income tax benefit related to items of other comprehensive income (loss)	24,659		24,659	24,295		24,295
Total other comprehensive loss	(37,801)		(37,801)	(37,150)		(37,150)
Total comprehensive income	63,403	9,906	73,309	25,915	9,301	35,216
Dividends on common stock	(156,300)		(156,300)	(85,000)		(85,000)
Equity infusion	252,833		252,833	4,503		4,503
Other	1	(3,286)	(3,285)		(3,393)	(3,393)
Ending balance, June 30	\$ 3,605,292	\$ 88,944	\$ 3,694,236	\$ 3,284,568	\$ 83,509	\$ 3,368,077

(a) These amounts  
primarily  
include

unrealized gains  
and losses on  
contracts used  
to hedge our  
forecasted  
electricity and  
natural gas  
requirements to  
serve Native  
Load. These  
changes are  
primarily due to  
changes in  
forward natural  
gas prices and  
wholesale  
electricity  
prices.

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

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**ARIZONA PUBLIC SERVICE COMPANY**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## Other Income And Other Expenses

**S-2. Other Income and Other Expense**

The following table provides detail of APS other income and other expense for the three and six months ended June 30, 2010 and 2009 (dollars in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Other income:				
Interest income	\$ 143	\$ 159	\$ 211	\$ 342
Investment gains net		3,062		1,739
Miscellaneous	1,684	1,737	2,234	1,969
Total other income	\$ 1,827	\$ 4,958	\$ 2,445	\$ 4,050
Other expense:				
Non-operating costs (a)	\$ (1,751)	\$ (3,177)	\$ (3,708)	\$ (4,512)
Investment losses net	(2,700)		(1,535)	
Miscellaneous	(1,640)	(1,796)	(3,309)	(3,496)
Total other expense	\$ (6,091)	\$ (4,973)	\$ (8,552)	\$ (8,008)

(a) As defined by the FERC, includes below-the-line non-operating utility income and expense (items excluded from utility rate recovery).



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

**INTRODUCTION**

The following discussion should be read in conjunction with Pinnacle West's Condensed Consolidated Financial Statements and Arizona Public Service Company's Condensed Consolidated Financial Statements and the related Notes that appear in Item 1 of this report. For purposes of this report, a "Note" refers to a Note to Pinnacle West's Condensed Consolidated Financial Statements in Item 1 of this report. For information on the broad factors that may cause our actual future results to differ from those we currently seek or anticipate, see "Forward-Looking Statements" at the front of this report and "Risk Factors" in Item 1A of the 2009 Form 10-K.

**OVERVIEW**

Pinnacle West owns all of the outstanding common stock of APS. APS is a vertically-integrated electric utility that provides retail and wholesale electric service to most of the state of Arizona, with the major exceptions of about one-half of the Phoenix metropolitan area, the Tucson metropolitan area and Mohave County in northwestern Arizona. APS accounts for substantially all of our revenues and earnings, and is expected to continue to do so.

**Areas of Business Focus**

***Nuclear.*** APS operates and is a joint-owner of the Palo Verde Nuclear Generating Station. With a focus on safely and efficiently generating electricity for the long-term, APS applied for twenty-year renewals of its operating licenses for each of the three Palo Verde units, and is making preparations to secure necessary resources to operate the plant during this extended period of time.

***Coal and Related Environmental Matters.*** APS is a joint-owner of three coal-fired power plants and acts as operating agent for two of the plants. APS is focused on the impacts on its coal fleet that may result from potential legislation and increased regulation concerning greenhouse gas emissions. Recent concern over climate change and other emission-related issues could have a significant impact on APS' capital expenditures and operating costs in the form of taxes, emissions allowances or required equipment upgrades for these plants. APS is closely monitoring its long range capital management plans, understanding that the resulting legislation and regulation could impact the economic viability of certain plants, as well as the willingness or ability of power plant participants to fund any such equipment upgrades. In particular, Southern California Edison, a participant in the Four Corners Power Plant ("Four Corners"), has indicated that certain California legislation may prohibit it from making emission control expenditures at the plant.

***Transmission and Delivery.*** APS' 2010 transmission plan projects that it will invest approximately \$520 million in new transmission over the next ten years, which includes 270 miles of new lines. APS is working closely with regulators to identify and plan for transmission needs resulting from the current focus on renewable energy. APS is also working to establish and expand smart grid technology throughout its service territory designed to provide a variety of benefits both to APS and its customers. This technology is designed to allow customers to better monitor their energy use and needs, minimize system outage durations and the number of customers that experience outages, and facilitate cost savings to APS through improved reliability and the automation of certain distribution functions, including remote meter reading and remote connects and disconnects.

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**Renewable Energy.** APS is committed to increasing the amount of energy produced by renewable energy resources. The ACC adopted a renewable energy standard several years ago, recognizing the importance of renewable energy to our state. In the Settlement Agreement for the 2008 general retail rate case, APS agreed to exceed these standards, committing that approximately 10% of APS' energy will come from renewable resources by the year 2015. A variety of other provisions in the Settlement Agreement reinforce APS' dedication to renewable energy through initiatives such as building photovoltaic solar plants, installing solar rooftop panels on schools and government buildings and seeking an Arizona wind generation project.

On March 3, 2010, the ACC approved the AZ Sun Program, under which APS plans to own 100 MW of photovoltaic power plants across Arizona by investing up to \$500 million through 2014. APS expects to acquire these resources through competitive procurement processes, with projects being placed into service in the 2011 to 2014 timeframe. The ultimate timing depends on the outcome of current and future procurement processes. See Note 3 for additional details of this program, including the related cost recovery.

In the first half of 2010, APS issued three requests for proposals ( RFPs ) for renewable resources. These RFPs are part of the process for procuring the additional renewable resources required under the rate case settlement. The first RFP is for wind projects between 15 and 100 MW to be located within Arizona. As a result of this RFP, on July 22, 2010, APS signed a long-term power purchase agreement for all of the energy from a 99 MW wind farm to be located near Williams, Arizona. This energy will help APS meet the ACC-mandated Renewable Energy Standard, as well as the Arizona-based wind provision included in APS' rate case settlement. The agreement is subject to various conditions, including ACC approval of the agreement and successful siting, permitting and interconnection of the project to the state's electric grid. If these conditions are met, commercial operation is expected in late 2011 or 2012.

The second RFP is for utility-scale solar photovoltaic projects between 15 and 50 MW. This RFP serves as the first procurement step for implementing the AZ Sun Program. APS is currently in formal negotiations regarding this RFP. The third RFP, the 2010 Small Generation RFP, serves as the first in a series of solicitations that will define APS Small Generation Program. This program will focus on renewable projects between 2 and 15 MW.

**Energy Efficiency.** Arizona regulators are placing an increased focus on energy efficiency and demand side management programs to encourage customers to conserve energy, while incentivizing utilities to aid in these efforts that ultimately reduce the demand for energy. In December 2009, the ACC initiated Energy Efficiency rulemaking, with a proposed Energy Efficiency Standard of 22% annual energy savings by 2020. The 22% figure represents the cumulative reduction in future energy usage through 2020 attributable to energy efficiency initiatives. On July 27, 2010, the proposed Energy Efficiency Standard was approved by the ACC subject to review and approval by the Arizona Attorney General, which should be completed before the end of 2010. An ambitious standard, such as that approved by the ACC, will increase participation by APS customers in these conservation and energy efficiency programs, which in turn will impact Arizona's future energy resource needs.

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**Rate Matters.** APS needs timely recovery through rates of its capital and operating expenditures to maintain adequate financial health. APS' retail rates are regulated by the ACC and its wholesale electric rates (primarily for transmission) are regulated by the FERC. At the end of 2009, the ACC approved a settlement agreement entered into by APS and twenty-one of the twenty-three other parties to APS' general retail rate case, with modifications that did not materially affect the overall economic terms of the agreement. The rate case settlement should strengthen APS' financial condition by allowing for rate stability and a greater level of cost recovery and return on investment. It also authorizes and requires equity infusions into APS of at least \$700 million prior to the end of 2014 (\$253 million of which was infused into APS from proceeds of a Pinnacle West equity issuance in the second quarter of 2010 (see Note 2)). The settlement demonstrates cooperation among APS, the ACC staff, the Residential Utility Consumer Office and other intervenors to the rate case, and establishes a future rate case filing plan that allows APS the opportunity to help shape Arizona's energy future outside of continual rate cases. See Note 3 for a discussion of the Settlement Agreement terms and information on APS' FERC rates.

APS has several recovery mechanisms in place that provide more timely recovery to APS of its fuel and transmission costs, and costs associated with the promotion and implementation of its energy efficiency, demand-side management and renewable energy efforts and customer programs. These mechanisms are described more fully in Note 3.

**Financial Strength and Flexibility.** Pinnacle West and APS currently have ample borrowing capacity under their respective credit facilities and have been able to access these facilities as well as the commercial paper market, ensuring adequate liquidity for each company. In early February 2010, APS entered into a \$500 million revolving credit facility, replacing its \$377 million facility that would have otherwise terminated in December 2010. At that same time, Pinnacle West entered into a \$200 million revolving credit facility that replaced its \$283 million facility that also would have otherwise terminated in December 2010. Since March 2010, Pinnacle West and APS have accessed the commercial paper markets, which neither company had utilized since the third quarter of 2008 due to negative market conditions.

In April 2010, Pinnacle West issued 6,900,000 shares of common stock at an offering price of \$38.00 per share, resulting in net proceeds of approximately \$253 million. Pinnacle West contributed all of the net proceeds from this offering into APS in the form of equity infusions. APS has used these capital contributions to repay short-term indebtedness, to finance capital expenditures and for other general corporate purposes.

**SunCor Real Estate Operations.** As a result of the distressed conditions in the real estate markets, during 2009 SunCor undertook a program to dispose of its homebuilding operations, master-planned communities, land parcels, commercial assets and golf courses in order to reduce its outstanding debt. In July, SunCor sold land parcels, commercial assets and a master planned home-building community for approximately \$70 million, which approximated the carrying value of these assets, resulting in a net gain of zero. In connection with this sale, SunCor negotiated a restructuring of certain of its credit facilities, including its principal loan facility. The debt restructuring resulted in an after-tax gain of approximately \$9 million, which will be recognized in the third quarter of 2010. At June 30, 2010, SunCor had approximately \$103 million of assets on its balance sheet classified as assets held for sale. These assets consisted of the \$70 million of assets sold in July as discussed above, \$25 million of consolidated VIEs (see Note 7), master planned home-building communities and golf courses. Because it is expected that SunCor will dispose of these assets within the next 12 months, they are classified as assets held for sale on the balance sheet. See

Pinnacle West Consolidated Liquidity and Capital Resources Other Subsidiaries SunCor below for a discussion of SunCor's outstanding debt and related matters and Note 16 for a discussion of related impairment charges.

**District Cooling Business Sale.** On June 22, 2010, our subsidiary, APSES, sold its district cooling business consisting of operations in downtown Phoenix, Tucson, and on certain Arizona State University campuses. The sale resulted in an after-tax gain of approximately \$25 million. Following this sale, APSES plans to focus on its core business of energy conservation and renewable energy contracting services.

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**Other Subsidiary Matters.** The operations of APSES and our other first tier subsidiary, El Dorado, are not expected to have any material impact on our financial results, or to require any material amounts of capital, over the next three years.

### **Key Financial Drivers**

In addition to the continuing impact of the matters described above, many factors influence our financial results and our future financial outlook, including those listed below. We closely monitor these factors to plan for the Company's current needs, and to adjust our expectations, financial budgets and forecasts appropriately.

**Regulated Electricity Segment Revenues.** For the years 2007 through 2009, retail electric revenues comprised approximately 94% of our total electric operating revenues. Our electric operating revenues are affected by customer growth, variations in weather from period to period, customer mix, average usage per customer and the impacts of energy efficiency programs, electricity rates and tariffs, the recovery of PSA deferrals and the operation of other recovery mechanisms. Off-system sales of excess generation output, purchased power and natural gas are included in regulated electricity segment revenues and related fuel and purchased power because they are credited to APS' retail customers through the PSA. These revenue transactions are affected by the availability of excess generation or other energy resources and wholesale market conditions, including competition, demand and prices.

**Customer and Sales Growth.** Customer growth in APS' service territory for the six-month period ended June 30, 2010 was 0.6% compared with the prior year period. For the three years 2007 through 2009, APS' customer growth averaged 1.8% per year. We currently expect annual customer growth to average about 1% for 2010 through 2012 due to economic conditions both nationally and in Arizona. Retail sales in kilowatt-hours, adjusted to exclude the effects of weather variations, for the six-month period ended June 30, 2010 declined 0.4% compared to the same period in the prior year, reflecting the poor economic conditions and the effects of our energy efficiency programs. For the three years 2007 through 2009, APS' actual retail electricity sales in kilowatt-hours, adjusted to exclude the effects of weather variations, grew at an average annual rate of 0.2%. We currently estimate that total annual retail electricity sales in kilowatt-hours will remain flat on average during 2010 through 2012, including the effects of APS' energy efficiency programs, but excluding the effects of weather variations. A continuation of the economic downturn, or the failure of the Arizona economy to rebound in the near future, could further impact these estimates. The customer and sales growth referred to in this paragraph apply to Native Load customers.

Actual sales growth, excluding weather-related variations, may differ from our projections as a result of numerous factors, such as economic conditions, customer growth, usage patterns, impacts of energy efficiency programs and responses to retail price changes. Our experience indicates that a reasonable range of variation in our kilowatt-hour sales projection attributable to such economic factors under normal business conditions can result in increases or decreases in annual net income of up to \$10 million.

**Weather.** In forecasting the retail sales growth numbers provided above, we assume normal weather patterns based on historical data. Historical extreme weather variations have resulted in annual variations in net income in excess of \$20 million. However, our experience indicates that the more typical variations from normal weather can result in increases or decreases in annual net income of up to \$10 million.

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**Fuel and Purchased Power Costs.** Fuel and purchased power costs included on our Condensed Consolidated Statements of Income are impacted by our electricity sales volumes, existing contracts for purchased power and generation fuel, our power plant performance, transmission availability or constraints, prevailing market prices, new generating plants being placed in service in our market areas, our hedging program for managing such costs and PSA deferrals and the related amortization.

**Operations and Maintenance Expenses.** Operations and maintenance expenses are impacted by growth, power plant operations, maintenance of utility plant (including generation, transmission, and distribution facilities), inflation, outages, higher-trending pension and other postretirement benefit costs, renewable energy and demand side management related expenses (which are offset by the same amount of regulated electricity segment operating revenues) and other factors. In its retail rate case settlement, APS committed to operational expense reductions from 2010 through 2014 and received approval to defer certain pension and other postretirement benefit cost increases to be incurred in 2011 and 2012.

**Depreciation and Amortization Expenses.** Depreciation and amortization expenses are impacted by net additions to utility plant and other property (such as new generation, transmission, and distribution facilities), and changes in depreciation and amortization rates. The Capital Expenditures section below provides information regarding the planned additions to our facilities. We have also applied to the NRC for renewed operating licenses for each of the Palo Verde units. If the NRC grants the extension, we estimate that our annual pretax depreciation expense will decrease by approximately \$34 million at the later of the license extension date or January 1, 2012.

**Property Taxes.** Taxes other than income taxes consist primarily of property taxes, which are affected by the value of property in-service and under construction, assessment ratios, and tax rates. The average property tax rate for APS, which currently owns the majority of our property, was 7.5% of the assessed value for 2009 and 7.8% of the assessed value for 2008. We expect property taxes to increase as we add new utility plant (including new generation, transmission and distribution facilities described below under Capital Additions ) and as we improve our existing facilities.

**Income Taxes.** Income taxes are affected by the amount of pre-tax book income, income tax rates, and certain non-taxable items, such as the allowance for equity funds used during construction. In addition, income taxes may also be affected by the settlement of issues with taxing authorities.

**Interest Expense.** Interest expense is affected by the amount of debt outstanding and the interest rates on that debt (see Note 2.) The primary factors affecting borrowing levels are expected to be our capital expenditures, long-term debt maturities, and internally generated cash flow. An allowance for borrowed funds offsets a portion of interest expense while capital projects are under construction. We stop accruing the allowance for borrowed funds on a project when it is placed in commercial operation.

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**PINNACLE WEST CONSOLIDATED RESULTS OF OPERATIONS**

Our results of operations, provided below, are based upon our two reportable business segments:

our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily retail and wholesale sales supplied to traditional cost-based rate regulation ( Native Load ) customers) and related activities and includes electricity generation, transmission and distribution; and

our real estate segment, which consists of SunCor's real estate development and investment activities. As of June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations (see Notes 5 and 14). The real estate segment activities are presented separately in the period-over-period discussions that follow.

**Operating Results Three-month period ended June 30, 2010 compared with three-month period ended June 30, 2009**

Our consolidated net income attributable to common shareholders for the three months ended June 30, 2010 was \$115 million, compared with net income of \$68 million for the comparable prior-year period. The improved results reflect an increase of approximately \$10 million in regulated electricity segment net income primarily due to increased revenues related to APS' retail rate increases and other factors, partially offset by milder weather in 2010.

In addition, our consolidated results for 2010 include a gain of \$25 million after income taxes related to the sale of APSES' district cooling business.

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The following table presents net income attributable to common shareholders by business segment compared with the prior-year period:

	Three Months Ended June 30,		Increase (Decrease) in Net Income Attributable to Common Shareholders
	2010	2009	
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$ 548	\$ 521	\$ 27
Operations and maintenance	(213)	(213)	
Depreciation and amortization	(103)	(101)	(2)
Taxes other than income taxes	(32)	(33)	1
Other income (expenses), net	(3)	3	(6)
Interest charges, net of capitalized financing costs	(53)	(52)	(1)
Income taxes	(51)	(42)	(9)
Noncontrolling interests (Note 7)	(5)	(5)	
Regulated electricity segment net income	88	78	10
All Other (a)	2	(2)	4
<b>Income from Continuing Operations Attributable to Common Shareholders</b>	<b>90</b>	<b>76</b>	<b>14</b>
Real Estate Segment:			
Real estate impairment charges (Note 16)	(2)	(6)	4
Other real estate operations		(9)	9
Income taxes	1	6	(5)
Real estate segment net loss	(1)	(9)	8
All other (a)	26	1	25
<b>Income (Loss) from Discontinued Operations Attributable to Common Shareholders</b>	<b>25</b>	<b>(8)</b>	<b>33</b>
<b>Net Income Attributable to Common Shareholders</b>	<b>\$ 115</b>	<b>\$ 68</b>	<b>\$ 47</b>

(a) Includes  
activities related

to APSES and  
El Dorado.

None of the  
activities of  
either of these  
companies  
constitutes a  
reportable  
segment.

Income from  
discontinued  
operations for  
the period ended  
June 30, 2010  
includes a gain  
of \$25 million  
after income  
taxes related to  
the sale of  
APSES district  
cooling  
business.



**Table of Contents****Regulated electricity segment**

This section includes a discussion of major variances in income and expense amounts for the regulated electricity segment.

**Operating revenues less fuel and purchased power expenses**

Regulated electricity segment operating revenues less fuel and purchased power expenses were \$27 million higher for the three months ended June 30, 2010 compared with the prior-year period. The following table describes the major components of this change:

	Operating revenues	Increase (Decrease) Purchased power and fuel expenses (dollars in millions)	Net change
Retail regulatory settlement effective January 1, 2010:			
Retail base rate increases, net of deferrals	\$ 68	\$ 31	\$ 37
Line extension revenues (Note 3)	4		4
Transmission rate increases	5		5
Higher demand-side management and renewable energy surcharges (substantially offset in operations and maintenance expense)	8		8
Lower retail revenues related to recovery of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense	(67)	(68)	1
Effects of weather on retail sales, primarily due to milder weather in 2010	(39)	(12)	(27)
Miscellaneous items, net	8	9	(1)
Total	\$ (13)	\$ (40)	\$ 27

**Operations and maintenance** Operations and maintenance expense variances for the three months ended June 30, 2010 compared with the prior-year period include:

An increase of \$7 million related to demand-side management and renewable energy programs, which are primarily offset in operating revenues; and

A decrease of \$7 million due to miscellaneous adjustments related primarily to employee benefits.

**Other income (expenses), net** Other income (expenses), net, decreased earnings by \$7 million for the three months ended June 30, 2010 compared with the prior-year period primarily due to net investment losses related to certain nonqualified employee benefit plans. Other income (expenses), net, is comprised of the regulated electricity segment portions of the line items other income and other expense from the Condensed Consolidated Statements of Income.

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**Income taxes** Income taxes were \$9 million higher for the three months ended June 30, 2010 compared with the prior-year period primarily because of higher pretax income in the current-year period.

**Real estate segment**

As of June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations. The real estate segment net loss attributable to common shareholders was \$8 million lower for the three months ended June 30, 2010 compared with the prior-year period primarily because of:

A decrease in real estate impairment charges of \$4 million;

A decrease in the loss from other real estate operations of \$9 million; and

A decrease in income tax benefits of \$5 million primarily because of a lower net loss for the 2010 period.

**All Other**

All other earnings from discontinued operations were \$25 million higher for the three months ended June 30, 2010 compared to the prior-year period primarily because of a gain of \$25 million after income taxes related to the sale of APSES' district cooling business in 2010.

**Operating Results Six-month period ended June 30, 2010 compared with six-month period ended June 30, 2009**

Our consolidated net income attributable to common shareholders for the six months ended June 30, 2010 was \$109 million, compared with a net loss of \$88 million for the comparable prior-year period. The improved results were primarily due to lower real estate impairment charges recorded in 2010 compared with the prior-year period by SunCor, the Company's real estate subsidiary.

In addition, regulated electricity segment net income increased approximately \$37 million from the prior-year period primarily due to increased revenues related to APS' retail rate increases and other factors, partially offset by milder weather in 2010. Our consolidated results for 2010 also include a gain of \$25 million after income taxes related to the sale of APSES' district cooling business.

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The following table presents net income (loss) attributable to common shareholders by business segment compared with the prior-year period:

	Six Months Ended June 30,		Increase (Decrease) in Net Income Attributable to Common Shareholders
	2010	2009	
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$ 944	\$ 876	\$ 68
Operations and maintenance	(420)	(408)	(12)
Depreciation and amortization	(204)	(201)	(3)
Taxes other than income taxes	(63)	(67)	4
Other income (expenses), net	(5)	(1)	(4)
Interest charges, net of capitalized financing costs	(104)	(100)	(4)
Income taxes	(43)	(32)	(11)
Noncontrolling interests (Note 7)	(10)	(9)	(1)
Regulated electricity segment net income	95	58	37
All Other (a)	2	(7)	9
<b>Income from Continuing Operations Attributable to Common Shareholders</b>	<b>97</b>	<b>51</b>	<b>46</b>
Real Estate Segment:			
Real estate impairment charges (Note 16)	(17)	(208)	191
Other real estate operations	(7)	(23)	16
Income taxes	9	91	(82)
Real estate segment net loss	(15)	(140)	125
All other (a)	27	1	26
<b>Income from Discontinued Operations Attributable to Common Shareholders</b>	<b>12</b>	<b>(139)</b>	<b>151</b>
<b>Net Income (Loss) Attributable to Common Shareholders</b>	<b>\$ 109</b>	<b>\$ (88)</b>	<b>\$ 197</b>

(a)

Includes activities related to APSES and El Dorado. None of the activities of either of these companies constitutes a reportable segment. Income from discontinued operations for the period ended June 30, 2010 includes a gain of \$25 million after income taxes related to the sale of APSES district cooling business.

**Table of Contents****Regulated electricity segment**

This section includes a discussion of major variances in income and expense amounts for the regulated electricity segment.

**Operating revenues less fuel and purchased power expenses**

Regulated electricity segment operating revenues less fuel and purchased power expenses were \$68 million higher for the six months ended June 30, 2010 compared with the prior-year period. The following table describes the major components of this change:

	Operating revenues	Increase (Decrease) Purchased power and fuel expenses (dollars in millions)	Net change
Retail regulatory settlement effective January 1, 2010:			
Retail base rate increases, net of deferrals	\$ 119	\$ 57	\$ 62
Line extension revenues (Note 3)	8		8
Transmission rate increases	9		9
Higher demand-side management and renewable energy surcharges (substantially offset in operations and maintenance expense)	15		15
Lower retail revenues related to recovery of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense	(122)	(125)	3
Effects of weather on retail sales, primarily due to milder weather in the second quarter 2010	(33)	(10)	(23)
Miscellaneous items, net		6	(6)
Total	\$ (4)	\$ (72)	\$ 68

**Operations and maintenance** Operations and maintenance expenses increased \$12 million for the six months ended June 30, 2010 compared with the prior-year period primarily because of:

An increase of \$13 million related to demand-side management and renewable energy programs, which are primarily offset in operating revenues;

An increase of \$7 million related to customer service and other costs; and

A decrease of \$8 million in generation costs, including timing of fossil-plant planned maintenance.

**Income taxes** Income taxes were \$11 million higher for the six months ended June 30, 2010 compared with the prior-year period primarily because of higher pretax income in the current-year period, partially offset by \$9 million related to a reduction in the Company's 2010 effective income tax rate. See Note 6.

**Table of Contents****All Other**

All other earnings from continuing operations were \$9 million higher for the six months ended June 30, 2010 compared to the prior-year period primarily because of improved margins from APSES products and services business and investment losses at El Dorado in 2009.

**Real estate segment**

During the first quarter of 2009, SunCor's Board of Directors authorized a series of strategic transactions to dispose of SunCor's assets. This decision resulted in impairment charges of approximately \$208 million pretax in the first six months of 2009. As of June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations (see Note 2). The real estate segment net loss attributable to common shareholders was \$125 million lower for the six months ended June 30, 2010 compared with the prior-year period primarily because of:

A decrease in real estate impairment charges of \$191 million;

A decrease in the loss from other real estate operations of \$16 million; and

A decrease in income tax benefits of \$82 million primarily because of a lower net loss for the 2010 period.

**All Other**

All other earnings from discontinued operations were \$26 million higher for the six months ended June 30, 2010 compared to the prior-year period primarily because of a gain of \$25 million after income taxes related to the sale of APSES district cooling business in 2010.

**PINNACLE WEST CONSOLIDATED LIQUIDITY AND CAPITAL RESOURCES****Cash Flows**

The following table presents net cash provided by (used for) operating, investing and financing activities for the six months ended June 30, 2010 and 2009 (dollars in millions):

	Six Months Ended June 30,	
	2010	2009
Net cash flow provided by operating activities	\$ 201	\$ 202
Net cash flow used for investing activities	(278)	(541)
Net cash flow provided by (used for) financing activities	(18)	251
The decrease of approximately \$1 million in net cash provided by operating activities is primarily due to a voluntary pension contribution in 2010 of approximately \$100 million partially offset by changes in working capital.		

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The decrease of approximately \$263 million in net cash used for investing activities is primarily due to the timing of APS \$164 million of pollution control auction rate securities redemptions in 2009 (related to a corresponding amount in the financing activities section) and approximately \$100 million of proceeds from the sale of the district cooling business in June 2010.

The decrease of approximately \$269 million in net cash provided by financing activities is primarily due to APS issuance of \$500 million of unsecured senior notes in 2009 and APS issuance of \$343 million of pollution control bonds in 2009 (a portion of which was used to redeem \$179 million of APS existing pollution control bonds, with the remainder deposited in a restricted trust fund for redemption of auction rate securities in 2009, as noted above). This was partially offset by proceeds of approximately \$253 million from the issuance of equity in April 2010 and lower levels of repayment of short-term borrowings in 2010.

**Liquidity****Capital Expenditure Requirements**

The following table summarizes the actual capital expenditures for the six months ended June 30, 2009 and 2010 and the estimated capital expenditures for the next three years:

**CAPITAL EXPENDITURES**

(dollars in millions)

	Six Months Ended June 30,		Estimated for the Year Ended December 31,		
	2009	2010	2010	2011	2012
APS					
Generation:					
Nuclear Fuel	\$ 39	\$ 51	\$ 63	\$ 68	\$ 65
Renewables (a)			7	151	100
Environmental	28	2	20	80	220
Other Generation	64	71	178	147	134
Distribution	121	120	268	333	328
Transmission	93	61	142	160	192
Other (b)	15	26	77	60	49
Subtotal	360	331	755	999	1,088
Other	7	3	3		
Total	\$ 367	\$ 334	\$ 758	\$ 999	\$ 1,088

(a) Estimated 2010 capital expenditures are lower than the estimate in the 2009 Form 10-K, primarily due to the timing of renewable expenditures.

(b)

Primarily  
information  
systems and  
facilities  
projects.

Generation capital expenditures are comprised of various improvements to APS existing fossil and nuclear plants. Examples of the types of projects included in this category are additions, upgrades and capital replacements of various power plant equipment, such as turbines, boilers and environmental equipment. We are also monitoring the status of certain environmental matters, which, depending on their final outcome, could require modification to our environmental expenditures. (See Business of Arizona Public Service Company Environmental Matters EPA Environmental Regulation Regional Haze Rules in Item 1 of the 2009 Form 10-K and Environmental Matters Mercury and Other Hazardous Air Pollutants in Part II, Item 5 below.)



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Distribution and transmission capital expenditures are comprised of infrastructure additions and upgrades, capital replacements, new customer construction, related information systems and facility costs. Examples of the types of projects included in the forecast include power lines, substations, line extensions to new residential and commercial developments and upgrades to customer information systems.

Capital expenditures will be funded with internally generated cash and external financings, which may include issuances of long-term debt and Pinnacle West common stock.

### ***Pinnacle West (Parent Company)***

Our primary cash needs are for dividends to our shareholders and principal and interest payments on our short-term and long-term debt. The level of our common stock dividends and future dividend growth will be dependent on a number of factors including, but not limited to, payout ratio trends, free cash flow and financial market conditions. On June 22, 2010, the Pinnacle West Board of Directors declared a quarterly dividend of \$0.525 per share of common stock, payable on September 1, 2010, to shareholders of record on August 2, 2010.

An existing ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At June 30, 2010, APS' common equity ratio, as defined, was 52%. Its total common equity was approximately \$3.6 billion, and total capitalization was approximately \$7.0 billion. APS would be prohibited from paying dividends if the payment would reduce its common equity below approximately \$2.8 billion, assuming APS' total capitalization remains the same.

Pinnacle West and APS maintain committed revolving credit facilities in order to enhance liquidity and provide credit support for their commercial paper programs. During the first quarter of 2010, Pinnacle West and APS refinanced existing credit facilities that would have otherwise matured in December 2010.

On February 12, 2010, Pinnacle West refinanced its \$283 million revolving credit facility that would have matured in December 2010, and decreased the size of the facility to \$200 million. The new facility matures in February 2013.

Pinnacle West has the option to increase the amount of the facility up to a maximum of \$300 million upon the satisfaction of certain conditions and with the consent of the lenders. Pinnacle West will use the facility for general corporate purposes, commercial paper support and for the issuance of letters of credit. Interest rates are based on Pinnacle West's senior unsecured debt credit ratings. As a result of the downsized credit facility, the Company also reduced the size of its commercial paper program to \$200 million from \$250 million.

At June 30, 2010, the \$200 million credit facility was available to support the issuance of up to \$200 million in commercial paper or for bank borrowings, including issuances of letters of credit up to \$100 million. At June 30, 2010, Pinnacle West had no outstanding borrowings under its revolving credit facility, no commercial paper borrowings and no outstanding letters of credit.

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In April 2010, Pinnacle West issued 6,900,000 shares of common stock at an offering price of \$38.00 per share, resulting in net proceeds of approximately \$253 million. Pinnacle West contributed all of the net proceeds from this offering into APS in the form of equity infusions. APS has used these contributions to repay short-term indebtedness to finance capital expenditures and for other general corporate purposes. Pinnacle West intends to issue equity to provide most of the funds for the equity infusions into APS required by the retail rate case settlement. Such equity issuances may occur at any time in the period through 2014, in Pinnacle West's discretion. See Note 3.

In June 2010, Pinnacle West received approximately \$100 million related to the sale of APSES' district cooling business. The net proceeds were used to repay short-term indebtedness.

Pinnacle West expects to receive approximately \$132 million of cash tax benefits related to SunCor's strategic asset sales (see Note 16), which will not be fully realized until all of the asset sales are completed. Approximately \$7 million of these benefits were recorded in the six months ended June 30, 2010 as reductions to income tax expense related to the current impairment charges. The additional \$125 million of tax benefits were recorded as reductions to income tax expense related to SunCor impairment charges recorded on or before December 31, 2009.

The \$65 million long-term income tax receivable on the Condensed Consolidated Balance Sheets represents the anticipated refunds related to an APS tax accounting method change approved by the IRS in the third quarter of 2009. Pinnacle West sponsors a qualified defined benefit and account balance pension plan and a non-qualified supplemental excess benefit retirement plan for the employees of Pinnacle West and our subsidiaries. IRS regulations require us to contribute a minimum amount to the qualified plan. We contribute at least the minimum amount required under IRS regulations, but no more than the maximum tax-deductible amount. The minimum required funding takes into consideration the value of plan assets and our pension obligation. The assets in the plan are comprised of fixed-income, equity and short-term investments. Future year contribution amounts are dependent on plan asset performance and plan actuarial assumptions. We made no contribution to our pension plan in 2009. We currently estimate that our pension contributions could average around \$100 million for several years, assuming the discount rate remains at approximately current levels. During the first quarter of 2010, we made a voluntary contribution of approximately \$100 million to our pension plan. The contribution to our other postretirement benefit plans in 2010 is estimated to be approximately \$15 million. APS and other subsidiaries fund their share of the contributions. APS share is approximately 98% of both plans.

### **APS**

APS' capital requirements consist primarily of capital expenditures and maturities of long-term debt. APS funds its capital requirements with cash from operations and, to the extent necessary, equity infusions from Pinnacle West and external financings. See Pinnacle West (Parent Company) above for a discussion of the common equity ratio that APS must maintain in order to pay dividends to Pinnacle West.

On February 12, 2010, APS refinanced its \$377 million credit facility that would have matured in December 2010, and increased the size of the facility to \$500 million. The new credit facility terminates in February 2013. APS has the option to increase the amount of the facility up to a maximum of \$700 million upon the satisfaction of certain conditions and with the consent of the lenders. APS will use the facility for general corporate purposes, commercial paper support and for the issuance of letters of credit. Interest rates are based on APS' senior unsecured debt credit ratings.

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At June 30, 2010, APS had two credit facilities totaling \$989 million, including the \$500 million credit facility described above and a \$489 million facility that terminates in September 2011. These facilities are available either to support the issuance of up to \$250 million in commercial paper or for bank borrowings, including issuances of letters of credit up to \$739 million. At June 30, 2010, APS had no borrowings outstanding under any of its credit facilities and no outstanding commercial paper. A \$20 million letter of credit was issued under APS \$489 million credit facility in the second quarter of 2010.

On July 13, 2010, APS changed the interest rate mode for the approximately \$33 million of Coconino County, Arizona Pollution Control Corporation Pollution Control Revenue Bonds (Arizona Public Service Company Navajo Project) 1994 Series A, due 2029. The rate period for the bonds changed from a daily-rate mode, supported by a letter of credit, to a three-year term rate mode that will bear interest at a rate of 3.625% per annum for three years. The letter of credit was terminated in connection with this change, and there is no bank or other third-party credit support for the bonds in the term rate mode.

On January 1, 2010, due to the adoption of amended accounting guidance relating to VIEs, APS began consolidating the Palo Verde Lessor Trusts (see Note 7) and, as a result of consolidation of these VIEs, APS has reported the Lessor Trusts long-term debt on its Condensed Consolidated Balance Sheets. Interest rates on these debt instruments are 8% and are fixed for the remaining life of the debt. As of June 30, 2010 approximately \$30 million was classified as current maturities of long-term debt and \$113 million was classified as long-term debt relating to these VIEs. These debt instruments mature on December 30, 2015 and have sinking fund features that are serviced by the lease payments. See Note 7 for additional discussion of the VIEs.

*Other Financing Matters* See Note 3 for information regarding the PSA approved by the ACC. Although APS defers actual retail fuel and purchased power costs on a current basis, APS recovery of the deferrals from its ratepayers is subject to annual and, if necessary, periodic PSA adjustments.

See Note 3 for information regarding the retail rate case settlement, which includes ACC authorization and requires equity infusions into APS of at least \$700 million by December 31, 2014.

See Note 8 for information related to the change in our margin accounts.

### ***Other Subsidiaries***

*SunCor* In July, SunCor sold land parcels, commercial assets and a master planned home-building community for approximately \$70 million, which approximated the carrying value of these assets, resulting in a net gain of zero. In connection with this sale, SunCor negotiated a restructuring of certain of its credit facilities, including its principal loan facility. The debt restructuring resulted in an after-tax gain of approximately \$9 million, which will be recognized in the third quarter of 2010.

At June 30, 2010, SunCor had approximately \$103 million of assets on its balance sheet classified as assets held for sale. These assets consist of the \$70 million of assets sold in July as discussed above, \$25 million of consolidated VIEs (see Note 7), master planned home-building communities and golf courses. Because it is expected that SunCor will dispose of these assets within the next 12 months, they are classified as assets held for sale on the balance sheet.

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At June 30, 2010, SunCor had \$94 million outstanding debt under various credit facilities, all of which was in default. After the sale discussed above, \$6 million remains outstanding. Neither Pinnacle West nor any of its other subsidiaries has guaranteed any SunCor indebtedness. A SunCor debt default would not result in a cross-default of any of the debt of Pinnacle West or any of its other subsidiaries. While there can be no assurances as to the ultimate outcome of this matter, Pinnacle West does not believe that SunCor's inability to repay remaining debt outstanding would have a material adverse impact on Pinnacle West's cash flows or liquidity.

As of June 30, 2010, SunCor could not transfer any cash dividends to Pinnacle West. This restriction does not affect Pinnacle West's ability to meet its ongoing capital requirements.

*El Dorado* El Dorado expects minimal capital requirements over the next three years and intends to focus on prudently realizing the value of its existing investments.

*APSES* APSES expects minimal capital expenditures over the next three years.

### ***Debt Provisions***

Pinnacle West's and APS' debt covenants related to their respective bank financing arrangements include maximum debt to capitalization ratios. Certain of APS' bank financing arrangements also include an interest coverage test. Pinnacle West and APS comply with these covenants and each anticipates it will continue to meet these and other significant covenant requirements. For both Pinnacle West and APS, these covenants require that the ratio of consolidated debt to total consolidated capitalization not exceed 65%. At June 30, 2010, the ratio was approximately 51% for Pinnacle West and 50% for APS. The provisions regarding interest coverage require minimum cash coverage of two times the interest requirements. The interest coverage was approximately 4.4 times as of June 30, 2010. Failure to comply with such covenant levels would result in an event of default which, generally speaking, would require the immediate repayment of the debt subject to the covenants and could cross-default other debt. See further discussion of cross-default provisions below.

Neither Pinnacle West's nor APS' financing agreements contain rating triggers that would result in an acceleration of the required interest and principal payments in the event of a rating downgrade. However, our bank financial agreements contain a pricing grid in which the interest costs we pay for borrowings thereafter are determined by our current credit ratings.

All of Pinnacle West's loan agreements contain cross-default provisions that would result in defaults and the potential acceleration of payment under these loan agreements if Pinnacle West or APS were to default under certain other material agreements. All of APS' bank agreements contain cross-default provisions that would result in defaults and the potential acceleration of payment under these bank agreements if APS were to default under certain other material agreements. Pinnacle West and APS do not have a material adverse change restriction for credit facility borrowings. See Note 2 for further discussions of liquidity matters.

**Table of Contents*****Credit Ratings***

The ratings of securities of Pinnacle West and APS as of August 2, 2010 are shown below. The ratings reflect the respective views of the rating agencies, from which an explanation of the significance of their ratings may be obtained. There is no assurance that these ratings will continue for any given period of time. The ratings may be revised or withdrawn entirely by the rating agencies if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely affect the market price of Pinnacle West's or APS' securities and serve to increase the cost of and limit access to capital. It may also require substantial additional cash or other collateral requirements related to certain derivative instruments, insurance policies, natural gas transportation, fuel supply, and other energy-related contracts. At this time, we believe we have sufficient liquidity to cover a downward revision to our credit ratings.

	Moody's	Standard & Poor's	Fitch
<b>Pinnacle West</b>			
Senior unsecured (a)	Baa3 (P)	BB+ (prelim)	N/A
Commercial paper	P-3	A-3	F3
Outlook	Stable	Positive	Stable
<b>APS</b>			
Senior unsecured	Baa2	BBB-	BBB
Secured lease obligation bonds	Baa2	BBB-	BBB
Commercial paper	P-2	A-3	F3
Outlook	Stable	Positive	Stable

(a) Pinnacle West has a shelf registration under SEC Rule 415. Pinnacle West currently has no outstanding, rated senior unsecured securities. However, Moody's assigned a provisional (P) rating and Standard & Poor's assigned a preliminary (prelim) rating to the senior unsecured securities that can be issued under such shelf registration.

***Off-Balance Sheet Arrangements***

On January 1, 2010 we adopted amended accounting guidance relating to VIEs and, as a result, we have consolidated certain entities which were previously not consolidated. The consolidation of these entities has impacted our consolidated financial statement results. See Note 7 for a discussion of these impacts.

***Guarantees and Letters of Credit***

We have issued parental guarantees and obtained surety bonds on behalf of our subsidiaries including credit support instruments enabling APSES to offer energy-related products and surety bonds at APS, principally related to self-insured workers' compensation. Non-performance or non-payment under the underlying contract by our subsidiaries would result in a payment liability on our part under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West's current outstanding guarantees and surety bonds on behalf of our subsidiaries. At June 30, 2010, we had no outstanding claims for payment under any of these guarantees. Our guarantees and surety bonds have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees or surety bonds from our subsidiaries. We generally agree to indemnification provisions related to liabilities arising from or related to certain of our agreements, with limited exceptions depending on the particular agreement. See Note 12 for additional information regarding guarantees and letters of credit.

**Table of Contents****Contractual Obligations**

Our future contractual obligations, including contingent obligations, related to purchased power and fuel contracts, have increased from approximately \$8.4 billion at December 31, 2009 to \$9.1 billion at June 30, 2010 as follows (dollars in billions):

2010	2011-2012	2013-2014	Thereafter	Total
\$ 0.6	\$ 0.7	\$ 1.0	\$ 6.8	\$ 9.1

These amounts have increased since the 2009 Form 10-K primarily due to increased solar contracts associated with meeting the Renewable Energy Standards.

See Note 2 for a list of payments due on total long-term debt and capitalized lease requirements.

**CRITICAL ACCOUNTING POLICIES**

In preparing the financial statements in accordance with GAAP, management must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex, and actual results could differ from those estimates. There have been no changes to our critical accounting policies since our 2009 Form 10-K. See Critical Accounting Policies in Item 7 of the 2009 Form 10-K for further details about our critical accounting policies.

**OTHER ACCOUNTING MATTERS**

On January 1, 2010 we adopted amended accounting guidance relating to VIEs, and as a result we have consolidated certain entities which were previously not consolidated. The consolidation of these entities has impacted our consolidated financial statement results. See Notes 1 and 7 for a discussion of these impacts.

**MARKET AND CREDIT RISKS****Market Risks**

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

**Interest Rate and Equity Risk**

We have exposure to changing interest rates. Changing interest rates will affect interest paid on variable-rate debt and the market value of fixed income securities held by our nuclear decommissioning trust fund (see Note 15). The nuclear decommissioning trust fund also has risks associated with the changing market value of its investments. Nuclear decommissioning costs are recovered in regulated electricity prices.

**Table of Contents****Commodity Price Risk**

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity and natural gas. Our risk management committee, consisting of officers and key management personnel, oversees company-wide energy risk management activities to ensure compliance with our stated energy risk management policies. We manage risks associated with these market fluctuations by utilizing various commodity instruments that qualify as derivatives, including exchange-traded futures and options and over-the-counter forwards, options and swaps. As part of our risk management program, we use such instruments to hedge purchases and sales of electricity and fuels. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities.

The following table shows the net pretax changes in mark-to-market of our derivative positions for the six months ended June 30, 2010 and 2009 (dollars in millions):

	Six Months Ended June 30,	
	2010	2009
Mark-to-market of net positions at beginning of period	\$ (169)	\$ (282)
Recognized in earnings:		
Change in mark-to-market losses for future period deliveries	(4)	(4)
Mark-to-market losses realized including ineffectiveness during the period	2	5
Increase in regulatory asset	(37)	
Recognized in other comprehensive income (OCI):		
Change in mark-to-market losses for future period deliveries (a)	(100)	(133)
Mark-to-market losses realized during the period	42	73
Change in valuation techniques		
Mark-to-market of net positions at end of period	\$ (266)	\$ (341)

(a) The changes in mark-to-market recorded in OCI are due primarily to changes in forward natural gas prices.

The table below shows the fair value of maturities of our derivative contracts (dollars in millions) at June 30, 2010 by maturities and by the type of valuation that is performed to calculate the fair values. See Note 1, Derivative Accounting and Fair Value Measurements, in Item 8 of our 2009 Form 10-K and Note 15 for more discussion of our valuation methods.

Source of Fair Value	2010	2011	2012	2013	2014	Years thereafter	Total fair value
Prices actively quoted	\$ (1)	\$ (1)	\$	\$	\$	\$	\$ (2)
Prices provided by other external sources	(89)	(100)	(27)	(6)			(222)
Prices based on models and other valuation	(8)	(8)	(4)	(6)	(5)	(11)	(42)



methods

Total by maturity	\$	(98)	\$	(109)	\$	(31)	\$	(12)	\$	(5)	\$	(11)	\$	(266)
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The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management assets and liabilities included on Pinnacle West's Condensed Consolidated Balance Sheets at June 30, 2010 and December 31, 2009 (dollars in millions):

	June 30, 2010		December 31, 2009	
	Gain (Loss)		Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Mark-to-market changes reported in:				
Earnings				
Electricity	\$ 1	\$ (1)	\$ 1	\$ (1)
Natural gas	1	(1)	1	(1)
Regulatory asset, liability or OCI (a)				
Electricity	21	(21)	21	(21)
Natural gas	48	(48)	59	(59)
Total	\$ 71	\$ (71)	\$ 82	\$ (82)

- (a) These contracts are hedges of our forecasted purchases of natural gas and electricity. The impact of these hypothetical price movements would substantially offset the impact that these same price movements would have on the physical exposures being hedged. To the extent the amounts are eligible for inclusion in the PSA, the amounts are recorded as either a regulatory asset or liability.

### **Credit Risk**

We are exposed to losses in the event of non-performance or non-payment by counterparties. See Note 15 Fair Value Measurements for a discussion of our credit valuation adjustment policy. See Note 8 for a further discussion of credit risk.

### **ARIZONA PUBLIC SERVICE COMPANY RESULTS OF OPERATIONS**

#### **Operating Results Three-month period ended June 30, 2010 compared with three-month period ended June 30, 2009**

APS consolidated net income attributable to common shareholder for the three months ended June 30, 2010 was \$90 million, compared with net income of \$79 million for the comparable prior-year period. Net income increased approximately \$11 million from the prior-year period primarily due to increased revenues related to APS retail rate increases and other factors, partially offset by milder weather in 2010.

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The following table presents net income attributable to common shareholder compared with the prior-year period:

	Three Months Ended June 30,		Increase (Decrease) in Net Income Attributable to Common Shareholder
	2010	2009	
	(dollars in millions)		
Operating revenues less fuel and purchased power expenses	\$ 548	\$ 521	\$ 27
Operations and maintenance	(211)	(211)	
Depreciation and amortization	(103)	(101)	(2)
Taxes other than income taxes	(32)	(33)	1
Other income (expenses), net	(4)		(4)
Interest charges, net of capitalized financing costs	(49)	(48)	(1)
Income taxes	(54)	(44)	(10)
Noncontrolling interests (Note 7)	(5)	(5)	
<b>Net Income Attributable to Common Shareholder</b>	<b>\$ 90</b>	<b>\$ 79</b>	<b>\$ 11</b>

**Table of Contents****Operating revenues less fuel and purchased power expenses**

Electric operating revenues less fuel and purchased power expenses were \$27 million higher for the three months ended June 30, 2010 compared with the prior-year period. The following table describes the major components of this change:

	Operating revenues	Increase (Decrease) Purchased power and fuel expenses (dollars in millions)	Net change
Retail regulatory settlement effective January 1, 2010:			
Retail base rate increases, net of deferrals	\$ 68	\$ 31	\$ 37
Line extension revenues (Note 3)	4		4
Transmission rate increases	5		5
Higher demand-side management and renewable energy surcharges (substantially offset in operations and maintenance expense)	8		8
Lower retail revenues related to recovery of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense	(67)	(68)	1
Effects of weather on retail sales, primarily due to milder weather in 2010	(39)	(12)	(27)
Miscellaneous items, net	8	9	(1)
Total	\$ (13)	\$ (40)	\$ 27

**Operations and maintenance** Operations and maintenance variances for the three months ended June 30, 2010 compared with the prior-year period primarily include:

An increase of \$7 million related to demand-side management and renewable energy programs, which are primarily offset in operating revenues; and

A decrease of \$7 million due to miscellaneous adjustments related primarily to employee benefits.

**Other income (expenses), net** Other income (expenses), net, decreased earnings by \$4 million for the three months ended June 30, 2010 compared with the prior-year period primarily due to net investment losses related to certain nonqualified employee benefit plans. Other income (expenses), net, is comprised of the line items other income and other expense from the Condensed Consolidated Statements of Income.

**Income taxes** Income taxes were \$10 million higher for the three months ended June 30, 2010 compared with the prior-year period primarily because of higher pretax income in the current-year period.

**Operating Results Six-month period ended June 30, 2010 compared with six-month period ended June 30, 2009**

APS consolidated net income attributable to common shareholder for the six months ended June 30, 2010 was \$101 million, compared with a net income of \$63 million for the comparable prior-year period.

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Net income increased approximately \$38 million from the prior-year period primarily due to increased revenues related to APS retail rate increases and other factors, partially offset by milder weather in 2010.

The following table presents net income attributable to common shareholder compared with the prior-year period:

	Six Months Ended June 30,		Increase (Decrease) in Net Income Attributable to Common Shareholder
	2010	2009	
	(dollars in millions)		
Operating revenues less fuel and purchased power expenses	\$ 944	\$ 876	\$ 68
Operations and maintenance	(415)	(402)	(13)
Depreciation and amortization	(204)	(201)	(3)
Taxes other than income taxes	(63)	(66)	3
Other income (expenses), net	(6)	(4)	(2)
Interest charges, net of capitalized financing costs	(97)	(94)	(3)
Income taxes	(48)	(37)	(11)
Noncontrolling interests (Note 7)	(10)	(9)	(1)
<b>Net Income Attributable to Common Shareholder</b>	<b>\$ 101</b>	<b>\$ 63</b>	<b>\$ 38</b>

**Table of Contents****Operating revenues less fuel and purchased power expenses**

Electric operating revenues less fuel and purchased power expenses were \$68 million higher for the six months ended June 30, 2010 compared with the prior-year period. The following table describes the major components of this change:

	Operating revenues	Increase (Decrease) Purchased power and fuel expenses (dollars in millions)	Net change
Retail regulatory settlement effective January 1, 2010:			
Retail base rate increases, net of deferrals	\$ 119	\$ 57	\$ 62
Line extension revenues (Note 3)	8		8
Transmission rate increases	9		9
Higher demand-side management and renewable energy surcharges (substantially offset in operations and maintenance expense)	15		15
Lower retail revenues related to recovery of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense	(122)	(125)	3
Effects of weather on retail sales, primarily due to milder weather in the second quarter 2010	(33)	(10)	(23)
Miscellaneous items, net		6	(6)
Total	\$ (4)	\$ (72)	\$ 68

**Operations and maintenance** Operations and maintenance expenses increased \$13 million for the six months ended June 30, 2010 compared with the prior-year period primarily because of:

An increase of \$13 million related to demand-side management and renewable energy programs, which are primarily offset in operating revenues;

An increase of \$8 million related to customer service and other costs; and

A decrease of \$8 million in generation costs, including timing of fossil-plant planned maintenance.

**Income taxes** Income taxes were \$11 million higher for the six months ended June 30, 2010 compared with the prior-year period primarily because of higher pretax income in the current-year period, partially offset by \$9 million related to a reduction in the Company's 2010 effective income tax rate. See Note 6.

**Table of Contents****ARIZONA PUBLIC SERVICE COMPANY LIQUIDITY AND CAPITAL RESOURCES****Cash Flows**

The following table presents net cash provided by (used for) operating, investing and financing activities for the six months ended June 30, 2010 and 2009 (dollars in millions):

	Six Months Ended June 30,	
	2010	2009
Net cash flow provided by operating activities	\$ 154	\$ 217
Net cash flow used for investing activities	(380)	(536)
Net cash flow provided by financing activities	141	250

The decrease of approximately \$63 million in net cash provided by operating activities is primarily due to the payment of income taxes in 2010 and a voluntary pension contribution in 2010 of approximately \$100 million, partially offset by other changes in working capital.

The decrease of approximately \$156 million in net cash used for investing activities is primarily due to APS' timing of \$164 million of pollution control auction rate securities redemptions in 2009 (related to a corresponding amount in the financing activities' section).

The decrease of approximately \$109 million in net cash provided by financing activities is primarily due to APS' issuance of \$500 million of unsecured senior notes in 2009 and APS' issuance of \$343 million of pollution control bonds in 2009 (a portion of which was used to redeem \$179 million of APS' existing pollution control bonds, with the remainder deposited in a restricted trust fund for bond redemption of auction rate securities in 2009, as noted above). This was partially offset by the reduction of short-term borrowings in 2009 and proceeds of approximately \$253 million from the infusion of equity from Pinnacle West in 2010.

**Contractual Obligations**

APS' future contractual obligations, including contingent obligations, related to purchased power and fuel contracts have increased from approximately \$8.4 billion at December 31, 2009 to \$9.1 billion at June 30, 2010 as follows (dollars in billions):

2010	2011-2012	2013-2014	Thereafter	Total
\$ 0.6	\$ 0.7	\$ 1.0	\$ 6.8	\$ 9.1

These amounts have increased since the 2009 Form 10-K primarily due to increased solar contracts associated with meeting the Renewable Energy Standard.

See Note 2 for a list of payments due on total long-term debt and capitalized lease requirements.



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**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

See Key Financial Drivers and Market and Credit Risks in Item 2 above for a discussion of quantitative and qualitative disclosures about market risks.

**Item 4. CONTROLS AND PROCEDURES**

**(a) Disclosure Controls and Procedures**

The term disclosure controls and procedures means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (the Exchange Act ) (15 U.S.C. 78a *et seq.*), is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to a company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Pinnacle West's management, with the participation of Pinnacle West's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of Pinnacle West's disclosure controls and procedures as of June 30, 2010. Based on that evaluation, Pinnacle West's Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, Pinnacle West's disclosure controls and procedures were effective.

APS' management, with the participation of APS' Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of APS' disclosure controls and procedures as of June 30, 2010. Based on that evaluation, APS' Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, APS' disclosure controls and procedures were effective.

**(b) Changes in Internal Control Over Financial Reporting**

The term internal control over financial reporting (defined in SEC Rule 13a-15(f)) refers to the process of a company that is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

No change in Pinnacle West's or APS' internal control over financial reporting occurred during the fiscal quarter ended June 30, 2010 that materially affected, or is reasonably likely to materially affect, Pinnacle West's or APS' internal control over financial reporting.

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**Part II OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS**

See Environmental Matters in Item 5 below and in Part II, Item 5 of the Pinnacle West/APS Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 ( First Quarter 10-Q ) and Business of Arizona Public Service Company Environmental Matters in Item 1 of the 2009 Form 10-K in regard to pending or threatened litigation or other disputes. See Note 10 with regard to a lawsuit brought by APS on behalf of itself and the other Palo Verde owners against the DOE, for information relating to FERC proceedings on California and Pacific Northwest energy market issues and for information regarding bankruptcy proceedings involving the landlord for our corporate headquarters building.

**Item 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in the 2009 Form 10-K, which could materially affect the business, financial condition, cash flows or future results of Pinnacle West and APS. The risks described in the 2009 Form 10-K are not the only risks facing Pinnacle West and APS. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect the business, financial condition, cash flows and/or operating results of Pinnacle West and APS.

**Item 5. OTHER INFORMATION**

**Environmental Matters**

**Superfund**

See Superfund in Note 10 for a discussion of a Superfund site.

**Climate Change**

See Environmental Matters Climate Change in Part II, Item 5 of the First Quarter 10-Q for a discussion of recent climate change matters, including legislative and regulatory initiatives, regional initiatives, and the Company's response to climate change initiatives. Updates to certain regulatory matters and climate change related lawsuits are discussed below.

**Regulatory Initiative EPA Endangerment Finding and Tailoring Rule.** In December 2009, the EPA determined that greenhouse gas emissions endanger public health and welfare. This determination was made in response to a 2007 United States Supreme Court ruling that greenhouse gases fit within the Clean Air Act's broad definition of air pollutant and, as a result, the EPA has the authority to regulate greenhouse gas emissions of new motor vehicles under the Clean Air Act. As a result of the endangerment finding, the EPA determined that the Clean Air Act required new regulatory requirements for new and modified major greenhouse gas emitting sources, including power plants. On June 3, 2010, the EPA issued a rule under the Clean Air Act, known as the tailoring rule, establishing new greenhouse gas emissions thresholds that determine when sources, including power plants, must obtain air operating permits or New Source Review permits. The tailoring rule became effective on August 2, 2010 and will apply to power plants starting January 1, 2011. Several groups have filed lawsuits challenging the EPA's endangerment finding and the tailoring rule.

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APS does not expect the tailoring rule to have a significant impact on its current operations. The rule will require APS to consider the impact of greenhouse gas emissions as part of its traditional New Source Review analysis for new sources and major modifications to existing plants. At the present time, APS cannot predict what other rules or regulations may ultimately result from the EPA's endangerment finding, whether the parties challenging the endangerment finding or the tailoring rule will be successful, and what impact other potential rules or regulations will have on APS' operations.

***Climate Change Lawsuits.*** In February 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in federal court in the Northern District of California against nine oil companies, fourteen power companies (including Pinnacle West), and a coal company, alleging that the defendants' emissions of carbon dioxide contribute to global warming and constitute a public and private nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village and they are seeking an unspecified amount of monetary damages. In June 2008, the defendants filed motions to dismiss the action, which were granted. The plaintiffs filed an appeal with the court in November 2009 and Pinnacle West filed its reply on June 30, 2010. We believe the action is without merit and intend to continue to defend against the claims.

A similar nuisance lawsuit is currently pending in the 2nd Circuit and another such lawsuit was recently dismissed by the 5th Circuit on procedural grounds. These climate change lawsuits raise political and legal considerations, including whether the courts can or should be making climate change policy decisions. We are not a party to either of these two lawsuits, but will monitor these developments and their potential industry impacts.

### **Mercury and Other Hazardous Air Pollutants**

In early 2008, the U.S. Court of Appeals for the D.C. Circuit vacated the Clean Air Mercury Rule (CAMR), which was adopted by the EPA to regulate mercury emissions from coal fired power plants. As a result, the law in effect prior to the adoption of the CAMR became the applicable law, and the EPA is now required to adopt final maximum achievable control technology emissions (MACT) standards. Under a consent decree that was finalized on April 15, 2010, the EPA has agreed to issue final MACT standards for mercury and other hazardous air pollutants by November 2011. Under the terms of the consent decree, APS will have three years after the EPA issues its final rule to achieve compliance, which would likely require APS to install additional pollution control equipment.

APS has installed, and continues to install, certain of the equipment necessary to meet the anticipated standards. The estimated costs expected to be incurred over the next three years for such equipment are included in our environmental expenditure estimates (see Management's Discussion and Analysis of Financial Condition and Results of Operations Pinnacle West Consolidated Liquidity and Capital Resources Capital Expenditure Requirements in Item 2).

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### **Federal Implementation Plan ( FIP )**

In September 1999, the EPA proposed FIPs to set air quality standards at certain power plants, including Four Corners and the Navajo Plant, which it later revised in 2006. The FIP for Four Corners was finalized in 2009 and the FIP for the Navajo Plant was finalized in April 2010. We do not believe compliance with the required limits established in either FIP will have a material adverse impact on our financial position, results of operations or cash flows.

### **Coal Combustion Waste**

On June 21, 2010, the EPA released its proposed regulations governing the handling and disposal of coal combustion residuals ( CCRs ), such as fly ash and bottom ash. APS currently disposes of CCRs in ash ponds and dry storage areas at Cholla and Four Corners, and also sells a portion of its fly ash for beneficial reuse as a constituent in concrete production. The EPA proposes regulating CCRs as either non-hazardous waste or hazardous waste and is seeking comment on three different alternatives. The hazardous waste proposal would phase out the use of ash ponds for disposal of CCRs. The other two proposals regulate CCRs as non-hazardous waste and impose performance standards for ash disposal. One of these proposals would require retrofitting or closure of currently unlined ash ponds, while the other proposal would not require the installation of liners or pond closures. The EPA has not yet indicated a preference for any of the alternatives.

APS intends to file comments on the proposed rule during a 90-day comment period. We do not know when the EPA will issue a final rule, including required compliance dates. We cannot currently predict the outcome of the EPA's actions or whether such actions will have a material adverse impact on our financial position, results of operations or cash flows.

### **Notice of Intent to Sue**

As disclosed in the 2009 Form 10-K, on April 6, 2009, APS received a request from the EPA under Section 114 of the Clean Air Act for information regarding projects at and operations of Four Corners. This request was part of an EPA enforcement initiative under the New Source Review provisions of the Clean Air Act. APS responded to the request in August 2009. On May 7, 2010, APS received a Notice of Intent to Sue from Earthjustice, on behalf of several environmental organizations, related to alleged violations of the Clean Air Act at Four Corners (the Notice ). The Notice alleges New Source Review-related violations and New Source Performance Standard violations. Under the Clean Air Act, a citizens group is required to provide 60 days advance notice of its intent to file a lawsuit. Within that 60-day time period, the EPA may step in and file a lawsuit regarding the allegations. If the EPA does so, the citizens group is precluded from filing its own lawsuit, but it may still intervene in the EPA's lawsuit, if it so desires. The 60-day period lapsed in early July, and the EPA did not take any action. At this time, we cannot predict whether or when Earthjustice might file a lawsuit.

**Table of Contents****Item 6. EXHIBITS****(a) Exhibits**

<i><b>Exhibit No.</b></i>	<i><b>Registrant(s)</b></i>	<i><b>Description</b></i>
3.1	Pinnacle West	Pinnacle West Capital Corporation Bylaws, amended as of May 19, 2010
10.1	Pinnacle West	Form of Performance Share Agreement under the Pinnacle West Capital Corporation 2007 Long-Term Incentive Plan
10.2	Pinnacle West	Form of Restricted Stock Unit Agreement under the Pinnacle West Capital Corporation 2007 Long-Term Incentive Plan
12.1	Pinnacle West	Ratio of Earnings to Fixed Charges
12.2	APS	Ratio of Earnings to Fixed Charges
12.3	Pinnacle West	Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements
31.1	Pinnacle West	Certificate of Donald E. Brandt, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Pinnacle West	Certificate of James R. Hatfield, Senior Vice President and Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.3	APS	Certificate of Donald E. Brandt, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.4	APS	Certificate of James R. Hatfield, Senior Vice President and Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32.1*	Pinnacle West	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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<b><i>Exhibit No.</i></b>	<b><i>Registrant(s)</i></b>	<b><i>Description</i></b>
32.2*	APS	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS*	Pinnacle West APS**	XBRL Instance Document
101.SCH*	Pinnacle West APS**	XBRL Taxonomy Extension Schema Document
101.CAL*	Pinnacle West APS**	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB*	Pinnacle West APS**	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	Pinnacle West APS**	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF*	Pinnacle West APS**	XBRL Taxonomy Definition Linkbase Document
*   Furnished herewith as an Exhibit.		
**   Furnished voluntarily.		

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

<i><b>Exhibit No.</b></i>	<i><b>Registrant(s)</b></i>	<i><b>Description</b></i>	<i><b>Previously Filed as Exhibit<sup>1</sup></b></i>	<i><b>Date Filed</b></i>
3.2	Pinnacle West	Articles of Incorporation, restated as of May 21, 2008	3.1 to Pinnacle West/APS June 30, 2008 Form 10-Q Report, File Nos. 1-8962 and 1-4473	8-7-08
3.3	APS	Articles of Incorporation, restated as of May 25, 1988	4.2 to APS Form S-3 Registration Nos. 33-33910 and 33-55248 by means of September 24, 1993 Form 8-K Report, File No. 1-4473	9-29-93
3.4	APS	Arizona Public Service Company Bylaws, amended as of December 16, 2008	3.4 to Pinnacle West/APS December 31, 2008 Form 10-K, File Nos. 1-8962 and 1-4473	2-20-09

<sup>1</sup> Reports filed under File Nos. 1-4473 and 1-8962 were filed in the office of the Securities and Exchange Commission located in Washington, D.C.

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SIGNATURES

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

PINNACLE WEST CAPITAL  
CORPORATION  
(Registrant)

Dated: August 3, 2010

By: /s/ James R. Hatfield  
James R. Hatfield  
Sr. Vice President and Chief Financial  
Officer  
(Principal Financial Officer and  
Officer Duly Authorized to sign this  
Report)

ARIZONA PUBLIC SERVICE COMPANY  
(Registrant)

Dated: August 3, 2010

By: /s/ James R. Hatfield  
James R. Hatfield  
Sr. Vice President and Chief Financial  
Officer  
(Principal Financial Officer and  
Officer Duly Authorized to sign this  
Report)