PINNACLE WEST CAPITAL CORP
Form 10-Q
August 07, 2007

Table of Contents

**FORM 10-Q**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

(Mark One)

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

**For the quarterly period ended June 30, 2007**

**OR**

o **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 | **PINNACLE WEST CAPITAL CORPORATION**<br>(an Arizona corporation)<br>400 North Fifth Street, P.O. Box 53999<br>Phoenix, Arizona 85072-3999<br>(602) 250-1000 | 86-0512431 |
| 1-4473 | **ARIZONA PUBLIC SERVICE COMPANY**<br>(an Arizona corporation)<br>400 North Fifth Street, P.O. Box 53999<br>Phoenix, Arizona 85072-3999<br>(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 þ | No o |
| ARIZONA PUBLIC SERVICE COMPANY | Yes þ | No o |

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

PINNACLE WEST CAPITAL CORPORATION
Large accelerated filer þ Accelerated filer o Non-accelerated filer o

ARIZONA PUBLIC SERVICE COMPANY
Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether each registrant is a shell company (as defined in Exchange Act Rule 12b-2).

| | | |
|---|---|---|
| PINNACLE WEST CAPITAL CORPORATION | Yes o | No þ |
| ARIZONA PUBLIC SERVICE COMPANY | Yes o | No þ |

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 August 3, 2007: 100,309,188 |
| ARIZONA PUBLIC SERVICE COMPANY | Number of shares of common stock, $2.50 par value, outstanding as of August 3, 2007: 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.**

This combined Form 10-Q is separately filed by Pinnacle West Capital Corporation and Arizona Public Service Company. Each registrant is filing 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 filing any information that does not relate to such registrant, and therefore makes no representation as to any such information.

**TABLE OF CONTENTS**

**Table of Contents**

## GLOSSARY

ACC Arizona Corporation Commission
ADEQ Arizona Department of Environmental Quality
ALJ Administrative Law Judge
APS Arizona Public Service Company, a subsidiary of the Company
APS Energy Services APS Energy Services Company, Inc., a subsidiary of the Company
Base Fuel Rate the $0.0325 per kWh base rate for fuel and purchased power established by the ACC in its June 28, 2007 rate case order
Clean Air Act Clean Air Act, as amended
Company Pinnacle West Capital Corporation
DOE United States Department of Energy
El Dorado El Dorado Investment Company, a subsidiary of the Company
EPA United States Environmental Protection Agency
ERMC Energy Risk Management Committee
FASB Financial Accounting Standards Board
FERC United States Federal Energy Regulatory Commission
FIP Federal Implementation Plan
FIN FASB Interpretation Number
Fitch Fitch, Inc.
Four Corners Four Corners Power Plant
GAAP accounting principles generally accepted in the United States of America
IRS United States Internal Revenue Service
kWh kilowatt-hour, one thousand watts per hour
Moody s Moody s Investors Service
MWh megawatt-hour, one million watts per hour
Native Load retail and wholesale sales supplied under traditional cost-based rate regulation
Note a Note to Pinnacle West s Condensed Consolidated Financial Statements in Item 1 of this report
NRC United States Nuclear Regulatory Commission
OCI other comprehensive income
Off-System Sales sales of electricity from generation owned or contracted by the Company that is over and above the amount required to serve APS retail customers and traditional wholesale contracts
Palo Verde Palo Verde Nuclear Generating Station

**Table of Contents**

Pinnacle West Pinnacle West Capital Corporation, the Company
Pinnacle West Energy Pinnacle West Energy Corporation, a subsidiary of the Company, dissolved as of August 31, 2006
Pinnacle West Marketing & Trading Pinnacle West Marketing & Trading Co., LLC, a subsidiary of the Company
PRP potentially responsible parties under Superfund
PSA power supply adjustor
Salt River Project Salt River Project Agricultural Improvement and Power District
SEC United States Securities and Exchange Commission
SFAS Statement of Financial Accounting Standards
Silverhawk Silverhawk Power Station
Standard & Poor s Standard & Poor s Corporation
SunCor SunCor Development Company, a subsidiary of the Company
Superfund Comprehensive Environmental Response, Compensation and Liability Act
2005 Deferrals PSA deferrals related to 2005 replacement power costs associated with unplanned Palo Verde outages
2006 Deferrals PSA deferrals related to 2006 replacement power costs associated with unplanned outages or reduced power operations at Palo Verde
2006 Form 10-K Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2006
VIE variable interest entity

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, | |
|---|---|---|
| | 2007 | 2006 |
| OPERATING REVENUES | | |
| Regulated electricity segment | $ 711,293 | $ 712,718 |
| Real estate segment | 48,352 | 112,603 |
| Marketing and trading | 92,637 | 89,925 |
| Other revenues | 11,153 | 9,782 |
| Total | 863,435 | 925,028 |
| OPERATING EXPENSES | | |
| Regulated electricity segment fuel and purchased power | 270,337 | 263,944 |
| Real estate segment operations | 46,174 | 98,412 |
| Marketing and trading fuel and purchased power | 74,533 | 72,716 |
| Operations and maintenance | 177,310 | 168,332 |
| Depreciation and amortization | 92,835 | 89,297 |
| Taxes other than income taxes | 34,757 | 32,700 |
| Other expenses | 8,803 | 8,430 |
| Total | 704,749 | 733,831 |
| OPERATING INCOME | 158,686 | 191,197 |
| OTHER | | |
| Allowance for equity funds used during construction | 5,195 | 3,633 |
| Other income (Note 14) | 5,869 | 12,022 |
| Other expense (Note 14) | (3,269) | (5,815) |
| Total | 7,795 | 9,840 |
| INTEREST EXPENSE | | |
| Interest charges | 52,967 | 45,882 |
| Capitalized interest | (5,213) | (4,959) |
| Total | 47,754 | 40,923 |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 118,727 | 160,114 |
| INCOME TAXES | 40,231 | 49,271 |
| INCOME FROM CONTINUING OPERATIONS | 78,496 | 110,843 |

| | | |
|---|---|---|
| INCOME FROM DISCONTINUED OPERATIONS | | |
| Net of income tax expense of $310 and $855 (Note 17) | 498 | 1,311 |
| NET INCOME | $ 78,994 | $ 112,154 |
| WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC | 100,229 | 99,221 |
| WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED | 100,779 | 99,640 |
| EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING | | |
| Income from continuing operations basic | $ 0.78 | $ 1.12 |
| Net income basic | 0.79 | 1.13 |
| Income from continuing operations diluted | 0.78 | 1.11 |
| Net income diluted | 0.78 | 1.13 |
| DIVIDENDS DECLARED PER SHARE | $ 0.525 | $ |

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

4

Table of Contents

**PINNACLE WEST CAPITAL CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**
(unaudited)
(dollars and shares in thousands, except per share amounts)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| OPERATING REVENUES | | |
| Regulated electricity segment | $ 1,247,344 | $ 1,178,844 |
| Real estate segment | 125,602 | 220,457 |
| Marketing and trading | 165,108 | 174,927 |
| Other revenues | 20,516 | 21,006 |
| Total | 1,558,570 | 1,595,234 |
| OPERATING EXPENSES | | |
| Regulated electricity segment fuel and purchased power | 473,690 | 421,339 |
| Real estate segment operations | 107,617 | 169,742 |
| Marketing and trading fuel and purchased power | 132,477 | 146,891 |
| Operations and maintenance | 348,888 | 346,759 |
| Depreciation and amortization | 182,456 | 176,918 |
| Taxes other than income taxes | 69,476 | 68,273 |
| Other expenses | 17,291 | 16,952 |
| Total | 1,331,895 | 1,346,874 |
| OPERATING INCOME | 226,675 | 248,360 |
| OTHER | | |
| Allowance for equity funds used during construction | 9,639 | 7,434 |
| Other income (Note 14) | 8,642 | 17,489 |
| Other expense (Note 14) | (7,883) | (10,356) |
| Total | 10,398 | 14,567 |
| INTEREST EXPENSE | | |
| Interest charges | 103,959 | 93,408 |
| Capitalized interest | (10,020) | (8,983) |
| Total | 93,939 | 84,425 |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 143,134 | 178,502 |
| INCOME TAXES | 48,840 | 56,064 |
| INCOME FROM CONTINUING OPERATIONS | 94,294 | 122,438 |
| INCOME FROM DISCONTINUED OPERATIONS | | |
| Net of income tax expense of $789 and $1,412 (Note 17) | 1,230 | 2,171 |

| | | | | |
|---|---|---|---|---|
| NET INCOME | $ | 95,524 | $ | 124,609 |
| | | | | |
| WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC | | 100,138 | | 99,168 |
| WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED | | 100,718 | | 99,562 |
| | | | | |
| EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING | | | | |
| Income from continuing operations basic | $ | 0.94 | $ | 1.23 |
| Net income basic | | 0.95 | | 1.26 |
| Income from continuing operations diluted | | 0.94 | | 1.23 |
| Net income diluted | | 0.95 | | 1.25 |
| DIVIDENDS DECLARED PER SHARE | $ | 1.05 | $ | 1.00 |

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

Table of Contents

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

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 23,472 | $ 87,210 |
| Investment in debt securities | | 32,700 |
| Customer and other receivables | 504,318 | 501,628 |
| Allowance for doubtful accounts | (5,375) | (5,597) |
| Materials and supplies (at average cost) | 139,743 | 125,802 |
| Fossil fuel (at average cost) | 31,527 | 21,973 |
| Deferred income taxes | 20,600 | 982 |
| Assets from risk management and trading activities (Note 10) | 197,275 | 641,040 |
| Assets held for sale (Note 17) | 21,485 | |
| Other current assets | 60,477 | 68,924 |
| Total current assets | 993,522 | 1,474,662 |
| INVESTMENTS AND OTHER ASSETS | | |
| Real estate investments net | 585,967 | 526,008 |
| Assets from long-term risk management and trading activities (Note 10) | 113,619 | 167,211 |
| Decommissioning trust accounts (Note 18) | 362,484 | 343,771 |
| Other assets | 112,794 | 111,388 |
| Total investments and other assets | 1,174,864 | 1,148,378 |
| PROPERTY, PLANT AND EQUIPMENT | | |
| Plant in service and held for future use | 11,392,309 | 11,154,919 |
| Less accumulated depreciation and amortization | 3,882,224 | 3,797,475 |
| Net | 7,510,085 | 7,357,444 |
| Construction work in progress | 447,221 | 368,284 |
| Intangible assets, net of accumulated amortization | 89,228 | 96,100 |
| Nuclear fuel, net of accumulated amortization | 71,420 | 60,100 |
| Total property, plant and equipment | 8,117,954 | 7,881,928 |
| DEFERRED DEBITS | | |
| Deferred fuel and purchased power regulatory asset (Note 5) | 136,989 | 160,268 |
| Other regulatory assets | 592,564 | 686,016 |
| Other deferred debits (Note 8) | 165,821 | 104,691 |

| | | |
|---|---|---|
| Total deferred debits | 895,374 | 950,975 |
| TOTAL ASSETS | $ 11,181,714 | $ 11,455,943 |

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

Table of Contents

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

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| LIABILITIES AND COMMON STOCK EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | $ 338,725 | $ 346,047 |
| Accrued taxes (Note 8) | 326,253 | 263,935 |
| Accrued interest | 50,317 | 48,746 |
| Short-term borrowings | 140,344 | 35,750 |
| Current maturities of long-term debt (Note 4) | 66,315 | 1,596 |
| Customer deposits | 74,763 | 70,168 |
| Liabilities from risk management and trading activities (Note 10) | 156,570 | 558,195 |
| Other current liabilities | 116,475 | 134,123 |
| Total current liabilities | 1,269,762 | 1,458,560 |
| LONG-TERM DEBT LESS CURRENT MATURITIES (NOTE 4) | 3,232,661 | 3,232,633 |
| DEFERRED CREDITS AND OTHER | | |
| Deferred income taxes | 1,236,002 | 1,225,798 |
| Regulatory liabilities | 658,102 | 635,431 |
| Liability for asset retirements | 272,977 | 268,389 |
| Liabilities for pension and other postretirement benefits (Note 6) | 605,111 | 588,852 |
| Liabilities from long-term risk management and trading activities (Note 10) | 59,596 | 171,170 |
| Unamortized gain sale of utility plant | 38,894 | 41,182 |
| Other | 385,396 | 387,812 |
| Total deferred credits and other | 3,256,078 | 3,318,634 |
| COMMITMENTS AND CONTINGENCIES (NOTES 5, 8, 12, 13 and 15) | | |
| COMMON STOCK EQUITY | | |
| Common stock, no par value | 2,126,244 | 2,114,550 |
| Treasury stock | (2,463) | (449) |
| Total common stock | 2,123,781 | 2,114,101 |
| Accumulated other comprehensive income (loss) (Note 11): | | |
| Pension and other postretirement benefits | (46,056) | (19,263) |
| Derivative instruments | 38,003 | 31,531 |

| | | |
|---|---|---|
| Total accumulated other comprehensive income | (8,053) | 12,268 |
| Retained earnings | 1,307,485 | 1,319,747 |
| Total common stock equity | 3,423,213 | 3,446,116 |
| TOTAL LIABILITIES AND COMMON STOCK EQUITY | $ 11,181,714 | $ 11,455,943 |

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

**Table of Contents**

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

| | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net Income | $ 95,524 | $ 124,609 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization including nuclear fuel | 198,893 | 188,863 |
| Deferred fuel and purchased power | (132,016) | (94,565) |
| Deferred fuel and purchased power amortization | 140,925 | 92,656 |
| Deferred fuel and purchased power regulatory disallowance | 14,370 | |
| Allowance for equity funds used during construction | (9,639) | (7,434) |
| Deferred income taxes | (3,333) | 16,481 |
| Change in mark-to-market valuations | 2,324 | 11,730 |
| Changes in current assets and liabilities: | | |
| Customer and other receivables | 21,925 | (764) |
| Materials, supplies and fossil fuel | (23,495) | 580 |
| Other current assets | 3,810 | 3,806 |
| Accounts payable | (13,644) | (91,543) |
| Collateral | (46,703) | (155,354) |
| Other current liabilities | 64,091 | 55,828 |
| Proceeds from the sale of real estate assets | 19,808 | 15,482 |
| Real estate investments | (73,697) | (61,758) |
| Change in risk management and trading assets | 11,029 | 64,893 |
| Change in risk management and trading liabilities | 15,883 | (132,448) |
| Change in other long-term assets | (20,138) | 4,532 |
| Change in other long-term liabilities | 24,403 | 20,631 |
| Net cash flow provided by operating activities | 290,320 | 56,225 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Capital expenditures | (437,784) | (363,795) |
| Capitalized interest | (10,020) | (8,983) |
| Proceeds from the sale of Silverhawk | | 207,620 |
| Purchases of investment securities | (36,525) | (280,527) |
| Proceeds from sale of investment securities | 69,225 | 280,527 |
| Proceeds from nuclear decommissioning trust sales | 133,463 | 114,875 |
| Investment in nuclear decommissioning trust | (143,834) | (125,246) |
| Other | (2,981) | 1,618 |
| Net cash flow used for investing activities | (428,456) | (173,911) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |

| | | |
|---|---|---|
| Issuance of long-term debt | 133,060 | 255,984 |
| Repayment of long-term debt | (68,801) | (353,549) |
| Short-term borrowings and payments net | 104,594 | 158,336 |
| Dividends paid on common stock | (105,110) | (99,227) |
| Common stock equity issuance | 17,930 | 8,910 |
| Other | (7,275) | 8,837 |
| Net cash flow provided by (used for) financing activities | 74,398 | (20,709) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (63,738) | (138,395) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 87,210 | 154,003 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $ 23,472 | $ 15,608 |
| Supplemental disclosure of cash flow information | | |
| Cash paid during the period for: | | |
| Income taxes paid, net of refunds | $ 40,714 | $ 251 |
| Interest paid, net of amounts capitalized | $ 89,916 | $ 87,290 |

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

8

Table of Contents

## 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, Pinnacle West Energy (dissolved as of August 31, 2006), APS Energy Services, SunCor, El Dorado and Pinnacle West Marketing & Trading. All significant intercompany accounts and transactions between the consolidated companies have been eliminated. Our accounting records are maintained in accordance with 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.

### 2. Condensed Consolidated Financial Statements

Our unaudited condensed consolidated financial statements reflect all adjustments that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. We suggest that these condensed consolidated financial statements and notes to condensed consolidated financial statements be read along with the consolidated financial statements and notes to consolidated financial statements included in our 2006 Form 10-K. We have condensed certain prior year amounts on our condensed consolidated statements of cash flows to conform to current year presentations.

### 3. Quarterly Fluctuations

Weather conditions cause significant seasonal fluctuations in our revenues. In addition, real estate and trading and wholesale marketing activities can have significant impacts on our results for interim periods. For these reasons, results for interim periods do not necessarily represent results to be expected for the year.

### 4. Changes in Liquidity

On January 4, 2007, the FERC issued an order permitting Pinnacle West to transfer its market-based rate tariff and wholesale power sales agreements to a newly-created Pinnacle West subsidiary, Pinnacle West Marketing & Trading. Pinnacle West completed the transfer on February 1, 2007, which resulted in Pinnacle West no longer being a public utility under the Federal Power Act. As a result, Pinnacle West is no longer subject to FERC jurisdiction in connection with its issuance of securities or its incurrence of long-term debt.

SunCor entered into a secured construction loan on April 13, 2007, in the amount of $60 million, of which $26 million was outstanding at June 30, 2007. The loan matures on April 19, 2009, and may be extended one year if certain conditions are met.

In May 2007, Pinnacle West infused approximately $40 million of equity into APS, consisting of the proceeds of stock issuances in 2006 under Pinnacle West s Investors Advantage Plan (direct stock purchase and dividend reinvestment plan) and employee stock plans.

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

The following table shows principal payments due on Pinnacle West s and APS total long-term debt and capitalized lease requirements (dollars in millions) as of June 30, 2007:

| Year | Consolidated Pinnacle West | APS |
|---|---|---|
| 2007 | $ 1 | $ |
| 2008 | 218 | 1 |
| 2009 | 27 | 1 |
| 2010 | 224 | 224 |
| 2011 | 578 | 401 |
| Thereafter | 2,260 | 2,260 |
| Total | $ 3,308 | $ 2,887 |

**5. Regulatory Matters**

**APS General Rate Case and Power Supply Adjustor**

**Retail Rate Increase**

On June 19, 2007, the ACC rendered its decision in APS general retail rate case pursuant to which APS had requested a 20.4%, or $435 million, increase in its annual retail electricity revenues. APS request was designed to recover approximately $315 million in fuel-related expenses and approximately $120 million in non-fuel related expenses. The ACC order, which was formally issued on June 28, 2007, increased APS annual retail base revenues by approximately $322 million, effective July 1, 2007, which includes a fuel-related increase of approximately $315 million (excluding the PSA surcharge for 2005 Deferrals discussed below), or 15.1%, and non-fuel related increases of approximately $7 million. The interim PSA adjustor approved by the ACC on May 1, 2006, which was designed to recover a portion of APS fuel and purchased power costs deferred under the PSA, terminated effective with the rate increase, resulting in a net retail rate increase of approximately 6.8%. The base rate increase is premised on a return on equity of 10.75%; a 45%/55% long-term debt/common equity capital structure; a weighted-average cost of capital of 8.32%; an original cost rate base of $4.4 billion as of September 30, 2005; and a base rate for fuel and purchased power costs of $0.0325 per kWh (the Base Fuel Rate ).

**PSA Modifications**

The ACC order modified the PSA in various respects, effective July 1, 2007. The PSA, which the ACC initially approved in 2005 as a part of APS 2003 rate case, provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs. As modified by the ACC s recent order, the PSA is subject to specified parameters and procedures, including the following:

- APS records deferrals for recovery or refund to the extent actual retail fuel and purchased power costs vary from the Base Fuel Rate;

- the deferrals continue to be subject to a 90/10 sharing arrangement in which APS must absorb 10% of the retail fuel and purchased power costs above the Base Fuel

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

Rate and may retain 10% of the benefit from the retail fuel and purchased power costs that are below the Base Fuel Rate, excluding certain costs, such as renewable energy resources and the capacity components of long-term purchase power agreements acquired through competitive procurement;

the adjustment is made annually each February 1st and goes into effect automatically unless suspended by the ACC;

the PSA now uses a forward-looking estimate of fuel and purchased power costs (instead of historical deferred costs, as under the prior PSA) to set the annual PSA rate, which will be reconciled to actual costs experienced for each PSA Year (see the following bullet point);

the PSA rate includes (a) a Forward Component, under which APS recovers or refunds differences between expected PSA Year fuel and purchased power costs and those embedded in the Base Fuel Rate; (b) an Historical Component, under which the differences between the PSA Year s actual fuel and purchased power costs and those recovered through the combination of the Base Fuel Rate and the Forward Component are recovered during the next PSA Year; and (c) a Transition Component under which APS may seek mid-year PSA changes due to large variances between actual fuel and purchased power costs and the combination of the Base Fuel Rate and the Forward Component;

amounts to be recovered or refunded through the sum of the PSA components discussed in the preceding bullet point are limited to a maximum plus or minus $0.004 per kWh change in the PSA rate in any PSA Year (February 1 through January 31);

the Base Fuel Rate established in the ACC order reflects projected 2007 fuel and purchased power costs; as a result, the Forward Component for the PSA Year ending January 31, 2008 will be zero; and

the PSA adjustor that took effect on February 1, 2007 ($0.004 per kWh), and that was scheduled to expire on January 31, 2008, will remain in effect as long as necessary after January 31, 2008 to collect the $46 million of 2007 fuel and purchased power costs deferred as a result of the mid-year implementation of the new Base Fuel Rate.

**PSA Deferrals Related to Palo Verde Outages**

APS recorded $45 million of 2005 Deferrals and $79 million of 2006 Deferrals. The ACC order (a) disallowed approximately $14 million, including accrued interest ($8 million after income taxes), of the 2005 Deferrals because the ACC found that the outage costs giving rise to those amounts resulted from APS imprudence, and (b) approved APS recovery of the balance of the 2005 Deferrals (approximately $34 million, including accrued interest) through a temporary PSA surcharge over a twelve-month period effective July 1, 2007. In connection with the interim PSA adjustor approved on May 1, 2006, the ACC directed the ACC staff to conduct a prudence audit of

Table of Contents

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

2006 Palo Verde outage costs. The prudence audit has not yet been completed. APS believes these costs were prudently incurred and that the 2006 Deferrals are therefore recoverable.

**PSA Balance**

The following table shows the changes in the deferred fuel and purchase power regulatory asset for the six months ended June 30, 2007 and 2006 (dollars in millions):

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| Beginning balance | $ 160 | $ 173 |
| Deferred fuel and purchased power costs-current period | 129 | 91 |
| Regulatory disallowance | (14) | |
| Interest on deferred fuel and purchased power | 3 | 4 |
| Amounts recovered through revenues | (141) | (93) |
| Ending balance | $ 137 | $ 175 |

**Other Matters**

The ACC order approved an environmental improvement surcharge ( EIS ) to recover capital costs incurred for environmental improvements made by APS in compliance with federal and state laws or regulatory requirements. The EIS will be set initially at $0.00016 per kWh, designed to produce approximately $4.5 million of cash per year until further order of the ACC.

The ACC order requires APS and the ACC staff to work to prepare a nuclear performance standard that the ACC can consider in a separate proceeding.

Pursuant to the ACC order, APS was not allowed to recover the pension costs associated with the supplemental excess benefit retirement plan through the rate-making process. See Note 6.

The ACC did not adopt APS recommendations related to accelerated depreciation, inclusion of construction work in progress in rate base, and an attrition adjustment .

**APS Financing Authorization**

On December 15, 2006, APS filed a financing application with the ACC requesting an (a) increase in APS current short-term debt authorization (7% of APS capitalization) to 7% of APS capitalization plus $500 million in order to meet its growing cash requirements, including cash requirements for natural gas and power purchases, and (b) increase in APS current long-term debt authorization (approximately $3.2 billion) to approximately $4.2 billion in light of the projected growth of APS and its customer base and the resulting projected future financing needed to fund APS capital expenditure and maintenance program and other cash requirements. An ACC ALJ conducted a hearing on this matter on July 23, 2007, at which the ACC staff recommended approval of APS requests, subject to specified parameters and procedures that APS generally supports. The ACC will consider this matter at an open meeting on a date that has not yet been set.

Table of Contents

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

**Federal**

**Price Mitigation Plan**

In July 2002, the FERC adopted a price mitigation plan that constrains the price of electricity in the wholesale spot electricity market in the western United States. The FERC adopted a price cap of $250 per MWh for the period subsequent to October 31, 2002. On February 13, 2006, the FERC increased this price cap to $400 per MWh for prospective sales. Sales at prices above the cap must be justified and are subject to potential refund. We do not expect this price cap to have a material impact on our financial statements.

**FERC Order**

On August 11, 2004, Pinnacle West, APS, Pinnacle West Energy, and APS Energy Services (collectively, the Pinnacle West Companies ) submitted to the FERC an update to their three-year market-based rate review pursuant to the FERC s order implementing a new generation market power analysis. On December 20, 2004, the FERC issued an order approving the Pinnacle West Companies market-based rates for control areas other than those of APS, Public Service Company of New Mexico ( PNM ) and Tucson Electric Power Company ( TEP ). The FERC staff required the Pinnacle West Companies to submit additional data with respect to these control areas, and the Pinnacle West Companies did so.

On April 17, 2006, the FERC issued an order revoking the Pinnacle West Companies market-based rate authority in the APS control area (the April 17 Order ). The FERC found that the Pinnacle West Companies failed to provide the necessary information about the calculation of transmission imports into the APS control area to allow the FERC to make a determination regarding FERC s generation market power screens in the APS control area. The FERC found that the Pinnacle West Companies may charge market-based rates in the PNM and TEP control areas.

As a result of the April 17 Order, the Pinnacle West Companies must charge cost-based rates, rather than market-based rates, in the APS control area for sales occurring after the date of the order, April 17, 2006. The Pinnacle West Companies are required to refund any amounts collected that exceed the default cost-based rates for all market rate sales within the APS control area from February 27, 2005 to April 17, 2006.

The Pinnacle West Companies filed a Request for Rehearing and Clarification of the April 17 Order on May 17, 2006 and submitted a supplemental compliance filing on July 28, 2006. On December 21, 2006, the FERC issued an order granting clarification and provided additional details on what steps the Pinnacle West Companies could take to correct the transmission import study previously submitted. The Pinnacle West Companies complied with this order and filed additional transmission import studies and generation market power analyses on February 20, 2007.

Based upon an analysis of the April 17 Order and preliminary calculations of the refund obligations, at this time, neither Pinnacle West nor APS believes that the April 17 Order will have a material adverse effect on its financial position, results of operations or cash flows.

Table of Contents

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

**FERC Rate Case**

On July 10, 2007, APS submitted a revised Open Access Transmission Tariff (OATT) filing with the FERC to move from a fixed rate to a formula rate in order to more accurately reflect the costs that APS incurs in providing transmission and ancillary services. The requested formula rate would result in an estimated $37 million increase in annual transmission revenues to become effective October 1, 2007. The proposed formula rate would be updated each year on June 1 on the basis of APS actual cost of service, as disclosed in APS FERC Form 1 reports, and projected capital expenditures. The FERC is expected to issue its initial order on this matter within 60 days of APS filing. Approximately $30 million of the requested increase represents charges for transmission services to serve APS retail customers ( Retail Transmission Charges ) and, as a result, would not affect APS earnings until such time as APS retail rates are adjusted to include these charges. As part of a retail rate case settlement order in 2005, the ACC approved a mechanism by which changes in Retail Transmission Charges can be reflected in APS retail rates. APS is currently addressing the appropriate procedure to implement the retail rate change if the requested Retail Transmission Charges are permitted to become effective by FERC.

**6. Retirement Plans and Other Benefits**

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a nonqualified supplemental excess benefit retirement plan ( SEBRP ), 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.

Pursuant to the ACC s June 28, 2007 order in APS general rate case, APS was not allowed to recover the pension costs associated with the SEBRP through the ratemaking process. Therefore, the amounts that were previously recorded as a regulatory asset, approximately $45 million ($27 million, net of income taxes), were charged to other comprehensive income at June 30, 2007 (see Notes 11 and S-2). This treatment is consistent with the accounting for this type of plan by our unregulated entities.

The following table provides details of the plans benefit costs for the three and six months ended June 30, 2007 and 2006. Also included is the portion of these costs charged to expense, including administrative costs and excluding amounts billed to electric plant participants or capitalized as overhead construction (dollars in millions):

**Table of Contents**

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

| | Pension Benefits | | | | Other Benefits | | | |
|---|---|---|---|---|---|---|---|---|
| | Three Months Ended June 30, | | Six Months Ended June 30, | | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 | 2007 | 2006 |
| Service cost-benefits earned during the period | $ 12 | $ 9 | $ 25 | $ 24 | $ 3 | $ 2 | $ 9 | $ 10 |
| Interest cost on benefit obligation | 23 | 17 | 50 | 46 | 5 | 4 | 18 | 17 |
| Expected return on plan assets | (25) | (18) | (53) | (48) | (6) | (4) | (21) | (18) |
| Amortization of: | | | | | | | | |
| Transition (asset) obligation | | | | (1) | | | 2 | 2 |
| Prior service cost | 1 | 1 | 2 | 1 | | | | |
| Net actuarial loss | 4 | 4 | 8 | 12 | 1 | 1 | 2 | 4 |
| Net periodic benefit cost | $ 15 | $ 13 | $ 32 | $ 34 | $ 3 | $ 3 | $ 10 | $ 15 |
| Portion of cost charged to expense | $ 7 | $ 5 | $ 14 | $ 14 | $ 1 | $ 1 | $ 5 | $ 6 |
| APS share of costs charged to expense | $ 6 | $ 5 | $ 13 | $ 13 | $ 1 | $ 1 | $ 4 | $ 6 |

**Contributions**

The contribution to our pension plan in 2007 is estimated to be approximately $52 million, of which approximately $0.3 million was contributed through August 2007. The contribution to our other postretirement benefit plans in 2007 is estimated to be approximately $21 million. APS share is approximately 96% of both plans.

**7. Business Segments**

Pinnacle West s two principal business segments are:

our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electricity service to 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.

Financial data for the three and six months ended June 30, 2007 and 2006 and at June 30, 2007 and December 31, 2006 by business segment is provided as follows (dollars in millions):

Table of Contents

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

| | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Operating Revenues: | | | | |
| Regulated electricity | $ 712 | $ 713 | $ 1,248 | $ 1,179 |
| Real estate | 48 | 113 | 126 | 220 |
| Other | 103 | 99 | 185 | 196 |
| Total | $ 863 | $ 925 | $ 1,559 | $ 1,595 |
| Net Income: | | | | |
| Regulated electricity | $ 71 | $ 95 | $ 74 | $ 82 |
| Real estate | | 9 | 10 | 32 |
| Other | 8 | 8 | 12 | 11 |
| Total | $ 79 | $ 112 | $ 96 | $ 125 |

| | As of June 30, 2007 | As of December 31, 2006 |
|---|---|---|
| Assets: | | |
| Regulated electricity | $ 10,239 | $ 10,566 |
| Real estate | 665 | 591 |
| Other | 278 | 299 |
| Total | $ 11,182 | $ 11,456 |

**8. Income Taxes**

As a result of a change in IRS guidance, we claimed a tax deduction related to an APS tax accounting method change on the 2001 federal consolidated income tax return. The accelerated deduction resulted in a $200 million reduction in the current income tax liability and a corresponding increase in the plant-related deferred tax liability. The 2001 federal consolidated income tax return is currently under examination by the IRS. As part of this ongoing examination, the IRS is reviewing this accounting method change and the resultant deduction. During 2007, it is expected that the IRS will finalize its examination and will issue a settlement on the tax accounting method change. At this time, an estimate of the range of reasonably possible change in the uncertain tax position cannot be made. However, we do not expect the ultimate outcome of this examination to have a material adverse impact on our financial position or results of operations. We expect that it will have a negative impact on cash flows.

We adopted FIN 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 on January 1, 2007. The effect of applying the new guidance was not significantly different in terms of tax impacts from the application of our previous policy. Accordingly, the impact to retained earnings upon adoption was immaterial. In addition, the guidance required us to reclassify certain tax benefits, which had the effect of increasing accrued taxes and deferred debits by approximately $50 million to better reflect the expected timing of the payment of taxes and interest.

Table of Contents

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

The total amount of unrecognized tax benefits recorded in accrued taxes as of January 1, 2007 was $186 million, of which $179 million related to APS. The majority of the unrecognized tax benefits relate to the 2001 tax return position described above. Included in the balance of unrecognized tax benefits at January 1, 2007 are approximately $5 million of tax positions for consolidated Pinnacle West that, if recognized, would decrease our effective tax rate. For APS, approximately $3 million would have the same effect.

We continue to recognize potential accrued interest related to unrecognized tax benefits in the financial statements as income tax expense. As of January 1, 2007, the total amount of accrued interest expense related to uncertain tax positions was $54 million for consolidated Pinnacle West, which is included as a component of the $186 million unrecognized tax benefit noted above. APS share included in the total was approximately $53 million. Additionally, Pinnacle West has accrued $9 million of interest income to be received on the overpayment of income taxes for certain adjustments that we have filed, or will file, with the IRS. The application of FIN 48 did not have a material impact for the six months ended June 30, 2007.

As of January 1, 2007, the tax year ended December 31, 1999 and all subsequent tax years remain subject to examination by federal and state taxing authorities. In addition, tax years ended prior to December 31, 1999 may remain subject to examination by state taxing authorities.

**9. Variable-Interest Entities**

In 1986, APS entered into agreements with three separate VIE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. We are not the primary beneficiary of the Palo Verde VIEs and, accordingly, do not consolidate them.

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of June 30, 2007, APS would have been required to assume approximately $208 million of debt and pay the equity participants approximately $174 million.

**10. Derivative and Energy Trading Accounting**

We use derivative instruments (primarily forward purchases and sales, swaps, options and futures) to manage our exposure to the commodity price risk inherent in the purchase and sale of fuel, electricity and emission allowances and credits. As of June 30, 2007, we hedged exposures to the price variability of the power and gas commodities for a maximum of 3.25 years. The changes in market value of such contracts have a high correlation to price changes in the hedged transactions. In addition, subject to specified risk parameters monitored by the ERMC, we engage in marketing and trading activities intended to profit from market price movements.

**Table of Contents**

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

**Cash Flow Hedges**

The changes in the fair value of our hedged positions included in the Condensed Consolidated Statements of Income, after consideration of amounts deferred under the PSA, for the three and six months ended June 30, 2007 and 2006 are comprised of the following (dollars in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting | $422 | $(2,975) | $1,333 | $(3,154) |
| Gains (losses) from the change in options time value excluded from measurement of effectiveness | | 3 | | (14) |
| Gains from the discontinuance of cash flow hedges | | | 314 | 434 |

During the next twelve months ending June 30, 2008, we estimate that a net gain of $37 million before income taxes will be reclassified from accumulated other comprehensive income as an offset to the effect of market price changes for the related hedged transactions. To the extent the amounts are eligible for inclusion in the PSA, the amounts will be recorded as either a regulatory asset or liability and have no effect on earnings (see Note 5).

Our assets and liabilities from risk management and trading activities are presented in two categories, regulated electricity and marketing and trading.

The following tables summarize our assets and liabilities from risk management and trading activities at June 30, 2007 and December 31, 2006 (dollars in thousands):

**Table of Contents**

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

| June 30, 2007 | Current Assets | Investments and Other Assets | Current Liabilities | Deferred Credits and Other | Net Asset (Liability) |
|---|---|---|---|---|---|
| Regulated electricity: | | | | | |
| Mark-to-market | $ 47,698 | $ 61,239 | $ (70,823) | $ (44,571) | $ (6,457) |
| Margin account and options | 52,453 | | | | 52,453 |
| Marketing and trading: | | | | | |
| Mark-to-market | 94,653 | 39,790 | (54,883) | (15,025) | 64,535 |
| Options, emission allowances and other contracts at cost | 2,471 | 12,590 | (30,864) | | (15,803) |
| Total | $ 197,275 | $ 113,619 | $ (156,570) | $ (59,596) | $ 94,728 |

| December 31, 2006 | Current Assets | Investments and Other Assets | Current Liabilities | Deferred Credits and Other | Net Asset (Liability) |
|---|---|---|---|---|---|
| Regulated electricity: | | | | | |
| Mark-to-market | $ 458,034 | $ 96,892 | $ (481,661) | $ (135,056) | $ (61,791) |
| Margin account and options | 77,705 | | (2,228) | | 75,477 |
| Marketing and trading: | | | | | |
| Mark-to-market | 105,301 | 69,480 | (61,553) | (36,114) | 77,114 |
| Options and emission allowances at cost | | 839 | (12,753) | | (11,914) |
| Total | $ 641,040 | $ 167,211 | $ (558,195) | $ (171,170) | $ 78,886 |

During the first quarter of 2007, we changed the presentation of mark-to-market positions related to natural gas basis swaps in the regulated electricity segment. We historically presented the buy side and the sell side of such swaps at fair value gross on our consolidated balance sheets, which resulted in mark-to-market assets and separate mark-to-market liabilities. We now offset these matching assets and liabilities, thus presenting the net mark-to-market position by contract, which correctly reflects the true nature of these contracts. The net asset/liability position as historically disclosed in the table above is unchanged. Further, this change has no impact on results of operations, common stock equity or cash flows. Had we previously presented such amounts net, the effect on the December 31, 2006 balance sheet would have been to decrease Current Assets and Current Liabilities by $376 million and decrease Investments and Other Assets and Deferred Credits and Other by $59 million. We believe that the effect of presenting these contracts gross in prior periods is immaterial to previously issued financial statements.

We maintain a margin account with a broker to support our risk management and trading activities. The margin account was an asset of $52 million at June 30, 2007 and $73 million at December 31, 2006 and is included in the margin account in the table above. Cash is deposited with

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

the broker in this account at the time futures or options contracts are initiated. The change in market value of these contracts (reflected in mark-to-market) requires adjustment of the margin account balance.

Cash or other assets may be required to serve as collateral against our open positions on certain energy-related contracts. Collateral provided to counterparties was $5 million at June 30, 2007 and $10 million at December 31, 2006, and is included in other current assets on the Condensed Consolidated Balance Sheets. Collateral provided to us by counterparties was $3 million at June 30, 2007 and $54 million at December 31, 2006, and is included in other current liabilities on the Condensed Consolidated Balance Sheets.

**Credit Risk**

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management and trading contracts with many counterparties, including one counterparty for which a worst case exposure represents approximately 14% of Pinnacle West s $311 million of risk management and trading assets as of June 30, 2007. Our risk management process assesses and monitors the financial exposure of this and all other counterparties. Despite the fact that the great majority of trading counterparties securities are rated as investment grade by the credit rating agencies, including the counterparty discussed above, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. Counterparties in the portfolio consist principally of 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, standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty and credit default swaps. Valuation adjustments are established representing our estimated credit losses on our overall exposure to counterparties.

**11. Comprehensive Income (Loss)**

Components of comprehensive income (loss) for the three and six months ended June 30, 2007 and 2006 are as follows (dollars in thousands):

**Table of Contents**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Net income | $ 78,994 | $ 112,154 | $ 95,524 | $ 124,609 |
| Other comprehensive income (loss): | | | | |
| Net unrealized gains (losses) on derivative instruments (a) | (32,880) | (69,124) | 29,680 | (274,107) |
| Net reclassification of realized gains to income (b) | (14,049) | (676) | (19,061) | (18,206) |
| Net unrealized losses related to pension and other postretirement benefits (c) | (44,573) | | (44,573) | |
| Reclassification of pension and other postretirement benefits to income | 228 | | 479 | |
| Income tax benefit related to items of other comprehensive income | 35,724 | 27,257 | 13,154 | 114,149 |
| Total other comprehensive loss | (55,550) | (42,543) | (20,321) | (178,164) |
| Comprehensive income (loss) | $ 23,444 | $ 69,611 | $ 75,203 | $ (53,555) |

(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 for contracted commodities delivered during the period.

(c) In accordance with the ACC s June 28, 2007 order in APS general rate case, these amounts primarily include costs that were previously recorded as a regulatory asset and have now been charged to other comprehensive income.

Table of Contents

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

**12. 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 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 has announced that the repository cannot be completed before at least 2017. 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 is currently pursuing that damages claim.

APS currently estimates it will incur $147 million (in 2006 dollars) over the life of Palo Verde for its share of the costs related to the on-site interim storage of spent nuclear fuel. At June 30, 2007, APS had a regulatory liability of approximately $5 million that represents amounts recovered in retail rates in excess of amounts spent for on-site interim spent fuel storage.

**NRC Matters**

In October 2006, the NRC conducted an inspection of the Palo Verde emergency diesel generators after a Palo Verde Unit 3 generator started but did not provide electrical output during routine inspections on July 25 and September 22, 2006. On February 22, 2007, the NRC issued a white finding (low to moderate safety significance) for this matter. Under the NRC s Action Matrix, this finding, coupled with a previous NRC yellow finding relating to a 2004 matter involving Palo Verde s safety injection systems, resulted in Palo Verde Unit 3 being placed in the multiple/repetitive degraded cornerstone column of the NRC s Action Matrix, which has resulted in an enhanced NRC inspection regimen. On June 21, 2007, the NRC issued a confirmatory action letter confirming APS commitments regarding specific actions APS will take to improve Palo Verde s performance. APS continues to implement its plan to improve Palo Verde s performance. APS does not currently believe that this matter will have a material adverse impact on APS financial position, results of operations, or cash flows.

On November 9, 2006, APS notified the NRC that a senior reactor operator at Palo Verde had attempted to cover up a mistaken entry the operator had made in a Palo Verde operations verification log. The senior reactor operator resigned shortly thereafter. By letter dated July 12, 2007, the NRC notified APS that, based upon the results of its investigation of the matter, the NRC is considering an escalated enforcement action against Palo Verde due to the willfulness of the senior reactor operator s actions. The NRC noted in its letter that the safety significance of the matter was very low. In accordance with NRC procedures, APS has requested alternative dispute resolution with the NRC in an attempt to resolve this issue. APS cannot predict the outcome of this matter.

Table of Contents

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

**California Energy Market Issues and Refunds in the Pacific Northwest**

**FERC**

In July 2001, the FERC ordered an expedited fact-finding hearing to calculate refunds for spot market transactions in California during a specified time frame. APS was a seller and a purchaser in the California markets at issue and, to the extent that refunds are ordered, APS should be a recipient as well as a payor of such amounts. The FERC is still considering the evidence and refund amounts have not yet been finalized. However, on September 6, 2005, the Ninth Circuit issued a decision, concluding that the FERC may not order refunds from entities that are not within the FERC s jurisdiction. Because a number of the entities owing refunds under the FERC s calculations are not within the FERC s jurisdiction, this order may affect the level of recovery of refunds due in this proceeding. In addition, on August 8, 2005, the FERC issued an order allowing sellers in the California markets to demonstrate that its refund methodology results in an overall revenue shortfall for their transactions in the relevant markets over a specified time frame. More than twenty sellers made such cost recovery filings on September 14, 2005. On January 26, 2006, the FERC conditionally accepted thirteen of these filings, reducing the refund liability for these sellers. Correspondingly, this will reduce the recovery of total refunds in the California markets. On August 2, 2006, the Ninth Circuit issued a decision on the appropriate temporal scope and the type of transactions that are properly subject to the refund orders. In the decision, the Court preserved the scope of the FERC s existing refund proceedings, but also expanded it potentially to include additional transactions, remanding the orders to the FERC for further proceedings. Various parties filed petitions for rehearing on this order. In addition, on December 19, 2006, the Ninth Circuit issued a decision on the appropriate standard of review at the FERC on wholesale power contracts in the refund proceedings, specifically addressing the application of the so-called just and reasonable standard as opposed to the public interest standard. In so doing, the Ninth Circuit remanded the matter back to the FERC with the requirement that the FERC review the refund matter using the appropriate standard of review. Like the August 2, 2006 Ninth Circuit decision, the December 19, 2006 decision has the potential to expand the existing FERC refund proceedings. We currently believe the refund claims at FERC will have no material adverse impact on our financial position, results of operations, or cash flows.

On March 19, 2002, the State of California filed a complaint with the FERC alleging that wholesale sellers of power and energy, including the Company, failed to properly file rate information at the FERC in connection with sales to California from 2000 to the present under market-based rates. The complaint requests the FERC to require the wholesale sellers to refund any rates that are found to exceed just and reasonable levels. This complaint was dismissed by the FERC and the State of California appealed the matter to the Ninth Circuit Court of Appeals. In an order issued September 9, 2004, the Ninth Circuit upheld the FERC s authority to permit market-based rates, but rejected the FERC s claim that it was without authority to consider retroactive refunds when a utility has not strictly adhered to the quarterly reporting requirements of the market-based rate system. On September 9, 2004, the Ninth Circuit remanded the case to the FERC for further proceedings. Several of the intervenors in this appeal filed a petition for rehearing of this decision on October 25, 2004. The petition for rehearing was denied on July 31, 2006. On December 28, 2006, certain parties petitioned the Supreme Court for a writ of certiorari. This petition was denied on June 18, 2007. On October 10, 2006, the State of California filed a motion to stay the issuance of the mandate (scheduled to be issued on November 2, 2006) until June 13, 2007.

Table of Contents

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

On June 12, 2007, the Ninth Circuit extended the stay until August 13, 2007. The outcome of the further proceedings cannot be predicted at this time.

On July 25, 2001, the FERC also ordered an evidentiary proceeding to discuss and evaluate possible refunds for wholesale sales in the Pacific Northwest. The FERC affirmed the ALJ 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 has now been appealed to the Ninth Circuit Court of Appeals and oral argument was held on January 8, 2007. Although the FERC ruling in this matter is being appealed and the FERC has not yet calculated the specific refund amounts due in California, we do not expect that the resolution of these issues, as to the amounts alleged in the proceedings, will have a material adverse impact on our financial position, results of operations or cash flows.

On March 26, 2003, the FERC made public a Final Report on Price Manipulation in Western Markets, prepared by its staff and covering spot markets in the West in 2000 and 2001. The report stated that a significant number of entities who participated in the California markets during the 2000-2001 time period, including APS, may potentially have been involved in arbitrage transactions that allegedly violated certain provisions of the Independent System Operator tariff. After reviewing the matter, along with the data supplied by APS, the FERC staff moved to dismiss the claims against APS and to dismiss the proceeding. The motion to dismiss was granted by the FERC on January 22, 2004. Certain parties have sought rehearing of this order, and that request is pending.

**FERC Order**

See FERC Order in Note 5 for a discussion of an order issued by the FERC on April 17, 2006.

**Natural Gas Supply**

Pursuant to the terms of a comprehensive settlement entered into in 1996 with El Paso Natural Gas Company, the rates charged for natural gas transportation were subject to a rate moratorium through December 31, 2005.

On July 9, 2003, the FERC issued an order that altered the capacity rights of parties to the 1996 settlement but maintained the cost responsibility provisions agreed to by parties to that settlement. On December 28, 2004, the D.C. Court of Appeals upheld the FERC s authority to alter the capacity rights of parties to the settlement. With respect to the FERC s authority to maintain the cost responsibility provisions of the settlement, a party has sought appellate review and is seeking to reallocate the cost responsibility associated with the changed contractual obligations in a way that would be less favorable to APS than under the FERC s July 9, 2003 order. Should this party prevail on this point, APS annual capacity cost could be increased by approximately $3 million per year after income taxes for the period September 2003 through December 2005. This appeal had been stayed pending further consideration by the FERC. On May 26, 2006, the FERC issued an Order on Remand affirming its earlier decision that there is no basis for modifying the settlement rates during the remaining term of the settlement. The party seeking appellate review is continuing to pursue an appeal of this issue and has therefore sought rehearing of the May 26, 2006 order. A final FERC order is pending.

Table of Contents

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

**Navajo Nation Litigation**

In June 1999, the Navajo Nation served Salt River Project with a lawsuit filed in the United States District Court for the District of Columbia (the D.C. Lawsuit ) naming Salt River Project, several Peabody Coal Company entities (collectively, Peabody ), Southern California Edison Company and other defendants, and citing various claims in connection with the renegotiations of the coal royalty and lease agreements under which Peabody mines coal for the Navajo Generating Station and the Mohave Generating Station. APS is a 14% owner of the Navajo Generating Station, which Salt River Project operates. The D.C. Lawsuit alleges, among other things, that the defendants obtained a favorable coal royalty rate by improperly influencing the outcome of a federal administrative process under which the royalty rate was to be adjusted. The suit seeks $600 million in damages, treble damages, punitive damages of not less than $1 billion, and the ejection of defendants from all possessory interests and Navajo Tribal lands arising out of the [primary coal lease]. In July 2001, the court dismissed all claims against Salt River Project.

In January 2005, Peabody served APS with a lawsuit filed in the Circuit Court for the City of St. Louis naming APS and the other Navajo Generating Station participants and seeking, among other things, a declaration that the participants are obligated to reimburse Peabody for any royalty, tax, or other obligation arising out of the D.C. Lawsuit. Based on APS ownership interest in the Navajo Generating Station, APS could be liable for up to 14% of any such obligation. APS cannot currently predict the outcome of this matter.

**Superfund**

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 PRPs. PRPs may be strictly, and often jointly and severally, liable for clean-up. On September 3, 2003, the EPA advised APS that the EPA considers APS to be a PRP in the Motorola 52$^{nd}$ 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. Because the investigation has not yet been completed and ultimate remediation requirements are not yet finalized, neither APS nor Pinnacle West can currently estimate the expenditures that may be required.

**Salt River Project**

Salt River Project has notified APS that Salt River Project allegedly failed to bill APS for (a) energy losses under certain service schedules of a power contract between the parties, and (b) certain other charges under the contract. Salt River Project asserts that certain of these failures to bill APS for such losses and charges may extend back to 1996 and, as a result, claims that APS owes it approximately $29 million. APS disputes that it is required to pay these amounts. No lawsuit or litigation has been initiated in the matter at this time. We do not expect that resolution of this matter will have a material adverse impact on our financial position, results of operations, or cash flows.

Table of Contents

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

**Litigation**

We are party to various other claims, legal actions and complaints arising in the ordinary course of business, including but not limited to environmental matters related to the Clean Air Act, Navajo Nation issues and EPA and ADEQ issues. In our opinion, the ultimate resolution of these matters will not have a material adverse effect on our results of operations, cash flows or liquidity.

## 13. Nuclear Insurance

The Palo Verde participants have insurance for public liability resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of $300 million and the balance by an industry-wide retrospective assessment program. If losses at any nuclear power plant covered by the 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 $101 million, subject to an annual limit of $15 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 $88 million, with an annual payment limitation of approximately $13 million.

The Palo Verde participants maintain all risk (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. APS has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen 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 of retrospective assessments APS could incur under the current NEIL policies totals $18.1 million. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

Table of Contents

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

**14. 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, 2007 and 2006 (dollars in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Other income: | | | | |
| SO2 emission allowance sales and other (a) | $ | $ 8,810 | $ | $ 9,171 |
| Interest income | 1,950 | 2,285 | 5,362 | 7,190 |
| Investment gains net | 2,681 | | 942 | |
| SunCor other income (b) | 778 | 717 | 1,358 | 883 |
| Miscellaneous | 460 | 210 | 980 | 245 |
| Total other income | $ 5,869 | $ 12,022 | $ 8,642 | $ 17,489 |
| Other expense: | | | | |
| Non-operating costs (a) | $ (2,344) | $ (3,828) | $ (5,655) | $ (7,547) |
| Investment losses net | | (1,066) | | (1,097) |
| Miscellaneous | (925) | (921) | (2,228) | (1,712) |
| Total other expense | $ (3,269) | $ (5,815) | $ (7,883) | $ (10,356) |

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

(b) Includes equity earnings from a real estate joint venture that is a pass-through entity for tax purposes.

**15. Guarantees**

We have issued parental guarantees and letters of credit and obtained surety bonds on behalf of our subsidiaries. Our parental guarantees for Pinnacle West Marketing & Trading relate to commodity energy products. Our credit support instruments enable APS Energy Services to offer commodity energy and energy-related products.

Non-performance or non-payment under the original contract by our subsidiaries would require us to perform under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West s current outstanding guarantees on behalf of our subsidiaries. Our guarantees have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees. The amounts and approximate terms of our guarantees and surety bonds for each subsidiary at June 30, 2007 are as follows (dollars in millions):

**Table of Contents**

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

| | Guarantees | | Surety Bonds | |
|---|---|---|---|---|
| | Amount | Term (in years) | Amount | Term (in years) |
| Parental: | | | | |
| Pinnacle West Marketing & Trading | $ 51 | 1 | $ | |
| APS Energy Services | 18 | 1 | 24 | 1 |
| Total | $ 69 | | $ 24 | |

At June 30, 2007, Pinnacle West had approximately $5 million of letters of credit related to workers compensation expiring in late 2007. We intend to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

APS has entered into various agreements that require letters of credit for financial assurance purposes. At June 30, 2007, approximately $200 million of letters of credit were outstanding to support existing pollution control bonds of approximately $200 million. The letters of credit are available to fund the payment of principal and interest of such debt obligations and expire in 2010. APS has also entered into approximately $86 million of letters of credit to support certain equity lessors in the Palo Verde sale leaseback transactions (see Note 9 for further details on the Palo Verde sale leaseback transactions). These letters of credit expire in 2010. Additionally, at June 30, 2007, APS had approximately $4 million of letters of credit related to counterparty collateral requirements expiring in 2007. APS intends to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

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.

**16. Earnings Per Share**

The following table presents earnings per weighted average common share outstanding for the three and six months ended June 30, 2007 and 2006:

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Basic earnings per share: | | | | |
| Income from continuing operations | $ 0.78 | $ 1.12 | $ 0.94 | $ 1.23 |
| Income from discontinued operations | 0.01 | 0.01 | 0.01 | 0.03 |
| Earnings per share basic | $ 0.79 | $ 1.13 | $ 0.95 | $ 1.26 |
| Diluted earnings per share: | | | | |
| Income from continuing operations | $ 0.78 | $ 1.11 | $ 0.94 | $ 1.23 |
| Income from discontinued operations | | 0.02 | 0.01 | 0.02 |
| Earnings per share diluted | $ 0.78 | $ 1.13 | $ 0.95 | $ 1.25 |

Dilutive stock options and performance shares increased average common shares outstanding by approximately 550,000 shares and 419,000 shares for the three months ended June 30, 2007 and June 30, 2006, respectively, and by approximately 580,000 shares and 394,000 shares for the six months ended June 30, 2007 and 2006, respectively.

Options to purchase 113,250 shares of common stock for the three-month period ended June 30, 2007 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. There were no such options outstanding for the six-month period ended June 30, 2007. Options to purchase shares of common stock that were excluded from the computation of diluted earnings per share for that same reason were 881,628 shares for the three-month period ended June 30, 2006 and 808,876 shares for the six-month period ended June 30, 2006.

**17. Discontinued Operations**

**SunCor** (real estate segment) In 2006 and 2007, SunCor sold commercial properties that were required to be reported as discontinued operations on Pinnacle West s Condensed Consolidated Statements of Income in accordance with SFAS No. 144. As a result of those sales, we recorded in 2007 a gain from discontinued operations of approximately $1 million ($1 million pretax). The assets held for sale at June 30, 2007 relate to property in the amount of $21 million. The following table contains SunCor s revenue, income before income taxes and income after income taxes classified as discontinued operations on Pinnacle West s Condensed Consolidated Statements of Income for the three and six months ended June 30, 2007 and 2006 (dollars in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue | $1 | $2 | $3 | $3 |
| Income before income taxes | 1 | 2 | 2 | 3 |
| Income after income taxes | | 1 | 2 | 2 |

**Table of Contents**

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

**18. 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. APS invests the trust funds in fixed income and equity securities. APS applies the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, in accounting for investments in decommissioning trust funds, and classifies these investments as available for sale. As a result, 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, APS has recorded the offsetting amount of unrealized gains (losses) on investment securities in other regulatory liabilities/assets. The following table summarizes the fair value of APS nuclear decommissioning trust fund assets at June 30, 2007 and December 31, 2006 (dollars in millions):

| | Fair Value | Total Unrealized Gains |
|---|---|---|
| June 30, 2007 | | |
| Equity securities | $ 178 | $ 72 |
| Fixed income securities | 184 | 1 |
| Total | $ 362 | $ 73 |
| December 31, 2006 | | |
| Equity securities | $ 164 | $ 63 |
| Fixed income securities | 180 | 3 |
| Total | $ 344 | $ 66 |

The costs of securities sold are determined on the basis of specific identification. The following table sets forth approximate 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, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Realized gains | $ 1 | $ 1 | $ 2 | $ 1 |
| Realized losses | (1) | (1) | (3) | (2) |
| Proceeds from the sale of securities | 70 | 49 | 133 | 115 |

Table of Contents

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

The fair value of fixed income securities, summarized by contractual maturities, at June 30, 2007 is as follows (dollars in millions):

| Fair Value | June 30, 2007 |
|---|---|
| Less than one year | $ 17 |
| 1 year 5 years | 37 |
| 5 years 10 years | 38 |
| Greater than 10 years | 92 |
| Total | $ 184 |

**19. New Accounting Standards**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This guidance establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Statement is effective for us on January 1, 2008. We are currently evaluating this new guidance.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 provides companies with an option to report selected financial assets and liabilities at fair value. SFAS No. 159 is effective for us on January 1, 2008. We are currently evaluating this new guidance.

See Note 8 for a discussion of FIN 48 on accounting for uncertainty in income taxes, which we adopted January 1, 2007. The effect of applying the new guidance was not significantly different in terms of tax impacts from the application of our previous policy. Accordingly, the impact to retained earnings upon adoption was immaterial.

**Table of Contents**

**ARIZONA PUBLIC SERVICE COMPANY**
**CONDENSED STATEMENTS OF INCOME**
(unaudited)
(dollars in thousands)

| | Three Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| ELECTRIC OPERATING REVENUES | | |
| Regulated electricity | $ 712,443 | $ 714,727 |
| Marketing and trading | 9,316 | 4,123 |
| Total | 721,759 | 718,850 |
| OPERATING EXPENSES | | |
| Regulated electricity fuel and purchased power | 271,301 | 265,735 |
| Marketing and trading fuel and purchased power | 2,105 | 1,490 |
| Operations and maintenance | 170,631 | 164,373 |
| Depreciation and amortization | 90,809 | 87,969 |
| Income taxes | 42,682 | 46,650 |
| Other taxes | 34,588 | 32,666 |
| Total | 612,116 | 598,883 |
| OPERATING INCOME | 109,643 | 119,967 |
| OTHER INCOME (DEDUCTIONS) | | |
| Income taxes | (399) | 953 |
| Allowance for equity funds used during construction | 5,195 | 3,633 |
| Other income (Note S-3) | 4,356 | 10,989 |
| Other expense (Note S-3) | (2,769) | (4,558) |
| Total | 6,383 | 11,017 |
| INTEREST DEDUCTIONS | | |
| Interest on long-term debt | 40,400 | 34,890 |
| Interest on short-term borrowings | 2,052 | 2,985 |
| Debt discount, premium and expense | 1,159 | 1,025 |
| Allowance for borrowed funds used during construction | (2,675) | (1,673) |
| Total | 40,936 | 37,227 |
| NET INCOME | $ 75,090 | $ 93,757 |

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

**Table of Contents**

**ARIZONA PUBLIC SERVICE COMPANY**
**CONDENSED STATEMENTS OF INCOME**
(unaudited)
(dollars in thousands)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| ELECTRIC OPERATING REVENUES | | |
| Regulated electricity | $ 1,249,819 | $ 1,181,949 |
| Marketing and trading | 10,200 | 13,770 |
| Total | 1,260,019 | 1,195,719 |
| OPERATING EXPENSES | | |
| Regulated electricity fuel and purchased power | 475,795 | 424,009 |
| Marketing and trading fuel and purchased power | 3,807 | 2,858 |
| Operations and maintenance | 336,565 | 337,726 |
| Depreciation and amortization | 178,685 | 174,280 |
| Income taxes | 45,825 | 43,621 |
| Other taxes | 69,110 | 68,214 |
| Total | 1,109,787 | 1,050,708 |
| OPERATING INCOME | 150,232 | 145,011 |
| OTHER INCOME (DEDUCTIONS) | | |
| Income taxes | 355 | 1,189 |
| Allowance for equity funds used during construction | 9,639 | 7,434 |
| Other income (Note S-3) | 8,789 | 15,085 |
| Other expense (Note S-3) | (7,673) | (7,528) |
| Total | 11,110 | 16,180 |
| INTEREST DEDUCTIONS | | |
| Interest on long-term debt | 80,475 | 69,140 |
| Interest on short-term borrowings | 4,033 | 5,011 |
| Debt discount, premium and expense | 2,315 | 2,198 |
| Allowance for borrowed funds used during construction | (4,888) | (3,394) |
| Total | 81,935 | 72,955 |
| NET INCOME | $ 79,407 | $ 88,236 |

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

Table of Contents

**ARIZONA PUBLIC SERVICE COMPANY**
**CONDENSED BALANCE SHEETS**
(unaudited)
(dollars in thousands)

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| ASSETS | | |
| UTILITY PLANT | | |
| Electric plant in service and held for future use | $ 11,329,496 | $ 11,094,868 |
| Less accumulated depreciation and amortization | 3,873,132 | 3,789,534 |
| Net | 7,456,364 | 7,305,334 |
| Construction work in progress | 445,780 | 365,704 |
| Intangible assets, net of accumulated amortization | 88,488 | 95,601 |
| Nuclear fuel, net of accumulated amortization | 71,420 | 60,100 |
| Total utility plant | 8,062,052 | 7,826,739 |
| INVESTMENTS AND OTHER ASSETS | | |
| Decommissioning trust accounts (Note 18) | 362,484 | 343,771 |
| Assets from long-term risk management and trading activities (Note S-1) | 61,239 | 96,892 |
| Other assets | 70,744 | 67,763 |
| Total investments and other assets | 494,467 | 508,426 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | 1,799 | 81,870 |
| Investment in debt securities | | 32,700 |
| Customer and other receivables | 430,672 | 410,436 |
| Allowance for doubtful accounts | (3,989) | (4,223) |
| Materials and supplies (at average cost) | 139,743 | 125,802 |
| Fossil fuel (at average cost) | 31,527 | 21,973 |
| Assets from risk management and trading activities (Note S-1) | 105,258 | 539,308 |
| Deferred income taxes | 37,764 | 19,220 |
| Other current assets | 16,908 | 13,367 |
| Total current assets | 759,682 | 1,240,453 |
| DEFERRED DEBITS | | |
| Deferred fuel and purchased power regulatory asset (Note 5) | 136,989 | 160,268 |
| Other regulatory assets | 592,564 | 686,016 |
| Unamortized debt issue costs | 25,352 | 26,393 |
| Other (Note 8) | 133,121 | 65,397 |

| | | |
|---|---|---|
| Total deferred debits | 888,026 | 938,074 |
| TOTAL ASSETS | $ 10,204,227 | $ 10,513,692 |

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

**Table of Contents**

**ARIZONA PUBLIC SERVICE COMPANY**
**CONDENSED BALANCE SHEETS**
(unaudited)
(dollars in thousands)

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| LIABILITIES AND EQUITY | | |
| CAPITALIZATION | | |
| Common stock | $ 178,162 | $ 178,162 |
| Additional paid-in capital | 2,105,466 | 2,065,918 |
| Retained earnings | 957,025 | 960,405 |
| Accumulated other comprehensive income (loss) (Note S-2): | | |
| Pension benefits | (27,107) | |
| Derivative instruments | 14,675 | 2,988 |
| Common stock equity | 3,228,221 | 3,207,473 |
| Long-term debt less current maturities (Note 4) | 2,877,346 | 2,877,502 |
| Total capitalization | 6,105,567 | 6,084,975 |
| CURRENT LIABILITIES | | |
| Commercial paper | 28,000 | |
| Current maturities of long-term debt (Note 4) | 1,045 | 968 |
| Accounts payable | 240,231 | 223,417 |
| Accrued taxes (Note 8) | 434,205 | 381,444 |
| Accrued interest | 46,455 | 45,254 |
| Customer deposits | 66,644 | 61,900 |
| Liabilities from risk management and trading activities (Note S-1) | 75,493 | 490,855 |
| Other current liabilities | 92,466 | 74,728 |
| Total current liabilities | 984,539 | 1,278,566 |
| DEFERRED CREDITS AND OTHER | | |
| Deferred income taxes | 1,232,781 | 1,215,862 |
| Regulatory liabilities | 658,102 | 635,431 |
| Liability for asset retirements | 272,977 | 268,389 |
| Pension and other postretirement liabilities (Note 6) | 567,208 | 551,531 |
| Customer advances for construction | 77,861 | 71,211 |
| Unamortized gain sale of utility plant | 38,894 | 41,182 |
| Liabilities from long-term risk management and trading activities (Note S-1) | 44,571 | 135,056 |
| Other | 221,727 | 231,489 |
| Total deferred credits and other | 3,114,121 | 3,150,151 |

COMMITMENTS AND CONTINGENCIES ( NOTES 5, 8, 12, 13 and 15)

| | | |
|---|---|---|
| TOTAL LIABILITIES AND EQUITY | $ 10,204,227 | $ 10,513,692 |

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

**Table of Contents**

**ARIZONA PUBLIC SERVICE COMPANY**
**CONDENSED STATEMENTS OF CASH FLOWS**
(unaudited)
(dollars in thousands)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | $ 79,407 | $ 88,236 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization including nuclear fuel | 195,122 | 186,225 |
| Deferred fuel and purchased power | (132,016) | (94,565) |
| Deferred fuel and purchased power amortization | 140,925 | 92,655 |
| Deferred fuel and purchased power regulatory disallowance | 14,370 | |
| Allowance for equity funds used during construction | (9,639) | (7,434) |
| Deferred income taxes | (2,862) | 16,481 |
| Changes in mark-to-market valuations | (3,000) | 2,464 |
| Changes in current assets and liabilities: | | |
| Customer and other receivables | 5,583 | (13,257) |
| Materials, supplies and fossil fuel | (23,495) | (4,707) |
| Other current assets | (5,060) | 1,677 |
| Accounts payable | 10,492 | (26,765) |
| Collateral | 1,259 | (162,310) |
| Other current liabilities | 40,944 | 63,366 |
| Change in risk management and trading liabilities | (2,306) | (120,505) |
| Change in other long-term assets | (1,750) | (5,045) |
| Change in other long-term liabilities | 26,316 | 21,553 |
| Net cash flow provided by operating activities | 334,290 | 38,069 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Capital expenditures | (410,463) | (313,479) |
| Allowance for borrowed funds used during construction | | |