

PINNACLE WEST CAPITAL CORP

FORM 10-Q (Quarterly Report)

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549

(Mark One)

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

For the quarterly period ended September 30, 2007

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	PINNACLE WEST CAPITAL CORPORATION (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0512431
1-4473	ARIZONA PUBLIC SERVICE COMPANY (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 checked="" type="checkbox"/>	No <input type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>

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 <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY		
Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input checked="" type="checkbox"/>

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

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 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 November 2, 2007: 100,385,036
ARIZONA PUBLIC SERVICE COMPANY	Number of shares of common stock, \$2.50 par value, outstanding as of November 2, 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.

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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

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

Base Fuel Rate – the portion of APS’ retail base rates attributable to fuel and purchased power costs

Cholla – Cholla Power Plant

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

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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

West Phoenix – West Phoenix Power Plant

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 September 30,	
	2007	2006
OPERATING REVENUES		
Regulated electricity segment	\$1,043,723	\$ 886,979
Real estate segment	47,411	97,871
Marketing and trading	99,203	84,425
Other revenues	15,597	7,167
Total	<u>1,205,934</u>	<u>1,076,442</u>
OPERATING EXPENSES		
Regulated electricity segment fuel and purchased power	407,242	314,150
Real estate segment operations	46,391	78,853
Marketing and trading fuel and purchased power	93,860	80,906
Operations and maintenance	178,419	164,396
Depreciation and amortization	95,059	90,390
Taxes other than income taxes	34,940	31,697
Other expenses	11,246	5,610
Total	<u>867,157</u>	<u>766,002</u>
OPERATING INCOME	<u>338,777</u>	<u>310,440</u>
OTHER		
Allowance for equity funds used during construction	5,235	3,178
Other income (Note 14)	4,276	18,055
Other expense (Note 14)	(6,744)	(3,693)
Total	<u>2,767</u>	<u>17,540</u>
INTEREST EXPENSE		
Interest charges	54,393	50,577
Capitalized interest	(5,435)	(5,612)
Total	<u>48,958</u>	<u>44,965</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	292,586	283,015
INCOME TAXES	91,588	98,836
INCOME FROM CONTINUING OPERATIONS	200,998	184,179
INCOME (LOSS) FROM DISCONTINUED OPERATIONS		
Net of income tax expense of \$5,038 and \$3 (Note 17)	7,710	(12)
NET INCOME	<u>\$ 208,708</u>	<u>\$ 184,167</u>
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING – BASIC	100,324	99,491
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING – DILUTED	100,829	99,973
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING		
Income from continuing operations – basic	\$ 2.00	\$ 1.85
Net income – basic	2.08	1.85
Income from continuing operations – diluted	1.99	1.84
Net income – diluted	2.07	1.84
DIVIDENDS DECLARED PER SHARE	<u>\$ 0.525</u>	<u>\$ 0.50</u>

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

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

	Nine Months Ended September 30,	
	2007	2006
OPERATING REVENUES		
Regulated electricity segment	\$2,291,067	\$2,065,823
Real estate segment	173,013	318,328
Marketing and trading	264,311	259,352
Other revenues	36,113	28,173
Total	<u>2,764,504</u>	<u>2,671,676</u>
OPERATING EXPENSES		
Regulated electricity segment fuel and purchased power	880,932	735,489
Real estate segment operations	154,008	248,595
Marketing and trading fuel and purchased power	226,337	227,797
Operations and maintenance	527,307	511,155
Depreciation and amortization	277,515	267,308
Taxes other than income taxes	104,416	99,970
Other expenses	28,537	22,562
Total	<u>2,199,052</u>	<u>2,112,876</u>
OPERATING INCOME	<u>565,452</u>	<u>558,800</u>
OTHER		
Allowance for equity funds used during construction	14,874	10,612
Other income (Note 14)	11,976	34,448
Other expense (Note 14)	(13,685)	(12,953)
Total	<u>13,165</u>	<u>32,107</u>
INTEREST EXPENSE		
Interest charges	158,352	143,985
Capitalized interest	(15,455)	(14,595)
Total	<u>142,897</u>	<u>129,390</u>
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	435,720	461,517
INCOME TAXES	140,428	154,900
INCOME FROM CONTINUING OPERATIONS	295,292	306,617
INCOME FROM DISCONTINUED OPERATIONS		
Net of income tax expense of \$5,827 and \$1,415 (Note 17)	8,940	2,159
NET INCOME	<u>\$ 304,232</u>	<u>\$ 308,776</u>
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING – BASIC	100,200	99,277
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING – DILUTED	100,767	99,723
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING		
Income from continuing operations – basic	\$ 2.95	\$ 3.09
Net income – basic	3.04	3.11
Income from continuing operations – diluted	2.93	3.07
Net income – diluted	3.02	3.10
DIVIDENDS DECLARED PER SHARE	\$ 1.575	\$ 1.50

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

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

	September 30, 2007	December 31, 2006
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 43,914	\$ 87,210
Investment in debt securities	—	32,700
Customer and other receivables	636,980	501,628
Allowance for doubtful accounts	(6,197)	(5,597)
Materials and supplies (at average cost)	146,755	125,802
Fossil fuel (at average cost)	30,806	21,973
Deferred income taxes	20,165	982
Assets from risk management and trading activities (Note 10)	141,182	641,040
Assets held for sale (Note 17)	5,781	—
Other current assets	49,586	68,924
Total current assets	<u>1,068,972</u>	<u>1,474,662</u>
INVESTMENTS AND OTHER ASSETS		
Real estate investments – net	617,050	526,008
Assets from long-term risk management and trading activities (Note 10)	67,161	167,211
Decommissioning trust accounts (Note 18)	375,898	343,771
Other assets	119,380	111,388
Total investments and other assets	<u>1,179,489</u>	<u>1,148,378</u>
PROPERTY, PLANT AND EQUIPMENT		
Plant in service and held for future use	11,527,758	11,154,919
Less accumulated depreciation and amortization	3,950,883	3,797,475
Net	<u>7,576,875</u>	<u>7,357,444</u>
Construction work in progress	543,964	368,284
Intangible assets, net of accumulated amortization	100,970	96,100
Nuclear fuel, net of accumulated amortization	74,500	60,100
Total property, plant and equipment	<u>8,296,309</u>	<u>7,881,928</u>
DEFERRED DEBITS		
Deferred fuel and purchased power regulatory asset (Note 5)	150,286	160,268
Other regulatory assets	583,331	686,016
Other deferred debits (Note 8)	117,618	104,691
Total deferred debits	<u>851,235</u>	<u>950,975</u>
TOTAL ASSETS	<u>\$11,396,005</u>	<u>\$11,455,943</u>

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

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

	<u>September 30,</u> 2007	<u>December 31,</u> 2006
LIABILITIES AND COMMON STOCK EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 305,420	\$ 346,047
Accrued taxes (Note 8)	315,697	263,935
Accrued interest	45,199	48,746
Short-term borrowings	273,608	35,750
Current maturities of long-term debt (Note 4)	67,231	1,596
Customer deposits	77,382	70,168
Liabilities from risk management and trading activities (Note 10)	89,265	558,195
Other current liabilities	132,543	134,123
Total current liabilities	<u>1,306,345</u>	<u>1,458,560</u>
LONG-TERM DEBT LESS CURRENT MATURITIES (NOTE 4)	<u>3,229,350</u>	<u>3,232,633</u>
DEFERRED CREDITS AND OTHER		
Deferred income taxes	1,273,826	1,225,798
Regulatory liabilities	672,679	635,431
Liability for asset retirements	277,378	268,389
Liabilities for pension and other postretirement benefits (Note 6)	552,591	588,852
Liabilities from long-term risk management and trading activities (Note 10)	54,348	171,170
Unamortized gain – sale of utility plant	37,750	41,182
Other	423,172	387,812
Total deferred credits and other	<u>3,291,744</u>	<u>3,318,634</u>
COMMITMENTS AND CONTINGENCIES (SEE NOTES)		
COMMON STOCK EQUITY		
Common stock, no par value	2,130,285	2,114,550
Treasury stock	(2,062)	(449)
Total common stock	<u>2,128,223</u>	<u>2,114,101</u>
Accumulated other comprehensive income (loss) (Note 11):		
Pension and other postretirement benefits	(44,902)	(19,263)
Derivative instruments	21,714	31,531
Total accumulated other comprehensive income (loss)	<u>(23,188)</u>	<u>12,268</u>
Retained earnings	1,463,531	1,319,747
Total common stock equity	<u>3,568,566</u>	<u>3,446,116</u>
TOTAL LIABILITIES AND COMMON STOCK EQUITY	<u>\$11,396,005</u>	<u>\$11,455,943</u>

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)

	Nine Months Ended September 30,	
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	\$ 304,232	\$ 308,776
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	302,314	288,065
Deferred fuel and purchased power	(203,065)	(231,388)
Deferred fuel and purchased power amortization	198,677	195,127
Deferred fuel and purchased power regulatory disallowance	14,370	—
Allowance for equity funds used during construction	(14,874)	(10,612)
Deferred income taxes	46,023	3,598
Change in mark-to-market valuations	18,907	16,974
Changes in current assets and liabilities:		
Customer and other receivables	(120,832)	(72,154)
Materials, supplies and fossil fuel	(29,786)	135
Other current assets	13,351	16,294
Accounts payable	(49,457)	(69,608)
Accrued taxes	14,207	130,137
Collateral	(48,103)	(176,110)
Other current liabilities	56,173	35,647
Proceeds from the sale of real estate assets	4,991	27,144
Real estate investments	(100,418)	(94,533)
Change in risk management and trading – liabilities	(13,959)	(132,540)
Change in other long-term assets	29,877	(6,609)
Change in other long-term liabilities	54,846	54,880
Net cash flow provided by operating activities	477,474	283,223
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(710,355)	(534,370)
Capitalized interest	(15,455)	(14,595)
Proceeds from the sale of Silverhawk	—	207,620
Proceeds from sale of investment securities	69,225	536,679
Purchases of investment securities	(36,525)	(739,996)
Proceeds from nuclear decommissioning trust sales	203,014	170,827
Investment in nuclear decommissioning trust	(218,570)	(186,383)
Proceeds from sale of real estate investments	33,615	2,134
Other	(3,010)	(2,246)
Net cash flow used for investing activities	(678,061)	(560,330)
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of long-term debt	181,321	703,283
Repayment of long-term debt	(119,700)	(384,800)
Short-term borrowings and payments – net	237,858	41,659
Dividends paid on common stock	(157,772)	(148,876)
Common stock equity issuance	18,626	24,574
Other	(3,042)	15,486
Net cash flow provided by financing activities	157,291	251,326
NET DECREASE IN CASH AND CASH EQUIVALENTS	(43,296)	(25,781)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	87,210	154,003
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 43,914	\$ 128,222
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Income taxes paid, net of refunds	\$ 87,974	\$ 71,901
Interest paid, net of amounts capitalized	\$ 142,741	\$ 113,408

**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, APSES, SunCor, El Dorado, Pinnacle West Marketing & Trading and Pinnacle West Energy (dissolved as of August 31, 2006). 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 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 \$35 million was outstanding at September 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.

On July 31, 2007, SunCor borrowed \$12 million under a new secured construction loan. The loan matures on July 31, 2009, and may be extended annually up to two years.

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

At September 30, 2007, APS had borrowings of \$150 million under its revolving line of credit. Pinnacle West had borrowings of \$105 million under its revolving line of credit. The amounts drawn under the Pinnacle West and APS lines of credit were used for general corporate purposes.

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 September 30, 2007, APS' common equity ratio, as defined, was 54%, its total common equity was approximately \$3.4 billion, and total capitalization was approximately \$6.3 billion. APS would be prohibited from paying dividends if the payment would reduce its common equity below approximately \$2.5 billion, assuming APS' total capitalization remains the same.

SunCor has a \$150 million loan facility secured primarily by an interest in land, commercial properties, land contracts and homes under construction. The loan facility requires compliance with certain loan covenants pertaining to debt to net worth, debt service, liquidity, cash flow coverage and restrictions on debt. As of September 30, 2007, the amount of SunCor's net assets that could not be transferred to Pinnacle West in the form of cash dividends as a result of these covenants was approximately \$213 million.

As a result of the restrictions in the preceding two paragraphs, as of September 30, 2007, the restricted net assets of our subsidiaries exceeded 25% of our consolidated net assets (at September 30, 2007, our consolidated net assets were approximately \$3.6 billion). These restrictions do not materially affect Pinnacle West's ability to meet its ongoing capital requirements.

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

Year	Consolidated Pinnacle West	APS
2007	\$ 1	\$ —
2008	194	1
2009	49	1
2010	224	224
2011	578	401
Thereafter	2,260	2,260
Total	<u>\$ 3,306</u>	<u>\$ 2,887</u>

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 Fuel Rate of \$0.0325 per kWh.

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 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 (February 1 through January 31) (see the following bullet point);

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

- the PSA rate includes (a) a “Forward Component,” under which APS recovers or refunds differences between expected fuel and purchased power costs for the upcoming calendar year and those embedded in the Base Fuel Rate; (b) an “Historical Component,” under which the differences between 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;
- 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 \$46 million of 2007 fuel and purchased power costs deferred as a result of the mid-year implementation of the new Base Fuel Rate.

2008 PSA Year

On September 28, 2007, APS submitted preliminary forecast calculations to the ACC for the Forward Component, Historical Component and Transition Component for the PSA Year beginning February 1, 2008. APS will update the calculations in a filing to the ACC prior to December 31, 2007. Based upon the preliminary calculations, the PSA rates would be limited to \$0.004 per kWh for the 2008 PSA Year. Any uncollected deferrals during the 2008 PSA Year resulting from this limit will flow into the 2009 Historical Component at the end of 2008.

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 2006 Palo Verde outage costs. Virtually all of the 2006 Deferrals were associated with a Unit 1 vibration issue. On October 4, 2007 the ACC staff filed a report with the ACC that concludes that APS’ response to the Unit 1 vibration issue was “reasonable and prudent.” APS continues to believe that these costs were prudently incurred and that the 2006 Deferrals are, therefore, recoverable.

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PSA Balance

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

	Nine Months Ended September 30,	
	2007	2006
Beginning balance	\$ 160	\$ 173
Deferred fuel and purchased power costs-current period	198	225
Regulatory disallowance	(14)	—
Interest on deferred fuel and purchased power	5	6
Amounts recovered through revenues	(199)	(195)
Ending balance	<u>\$ 150</u>	<u>\$ 209</u>

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. The parties are currently working together to develop the standard.

The ACC Order also required APS to file a revised line extension schedule for ACC approval that would eliminate certain footage and equipment allowances for new or expanded electric service and remove any requirement for economic feasibility analyses used to determine whether or how much of an allowance should be granted. This would permit APS to collect, on a current basis, costs related to line extensions. Such pretax costs are currently estimated to be approximately \$3,500-\$5,000 per new meter set. These are average figures and the actual costs of a service extension will vary by customer class and the particulars of the extension.

On October 24, 2007, APS filed a proposed amendment to its line extension schedule. On November 2, 2007, the ACC staff issued its recommended order, which accepts APS’ proposed amendment in all respects except for the accounting treatment for payments received for new or upgraded service. APS’ proposal would treat such payments as non-refundable other electric revenues, while the ACC Staff proposes these payments should be treated as contributions in aid of construction (“CIAC”). CIAC treatment would result in a positive cash flow that would offset capital expenditures, but without any revenue impact.

APS proposed to “grandfather” applicants that have executed line extension agreements prior to the effective date of its amended line extension schedule. The impact of the amended line extension schedule on APS’ financial condition cannot be accurately predicted at this time and depends on the accounting treatment authorized for the proceeds, the extent of any “grandfathering” required by the ACC, and the level and mix of new APS customers. APS intends to file exceptions to the ACC staff’s recommended order by mid-November, and the final outcome of this matter is pending until further ACC action, which is expected to occur in late November.

APS Financing Authorization

On December 15, 2006, APS filed a financing application with the ACC requesting an increase in APS’ (a) current short-term debt authorization (7% of APS’ capitalization) to (i) 7% of APS’ capitalization plus (ii) \$500 million in order to meet its growing cash requirements, including cash requirements for natural gas and power purchases and (b) current long-term debt authorization (approximately \$3.2 billion) to \$4.2 billion in light of the projected growth of APS and its customer base and the resulting projected financing needs. On October 30, 2007, the ACC issued a financing order in which it approved APS’ requests, subject to specified parameters and procedures.

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.

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FERC Order

On August 11, 2004, Pinnacle West, APS, Pinnacle West Energy, and APSES (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’ authority to make sales at market-based rates 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.

On August 13, 2007, the FERC issued an order on rehearing, reinstating the authority of the Pinnacle West Companies to make sales at market-based rates in all seasons for sales outside of the Phoenix Valley, and in all seasons except the summer for sales within the Phoenix Valley. The Pinnacle West Companies submitted a compliance filing implementing this order to the FERC on October 12, 2007.

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

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, 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. 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 the use of 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 transmission rate change.

On September 21, 2007, the FERC issued an order on these proposed revisions to APS’ transmission rates in which it accepted APS’ proposed formula rates and ordered settlement judge procedures, with an initial settlement conference held on October 11, 2007. The proposed rates

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become effective March 1, 2008, subject to refund based upon the outcome of the settlement procedures and a hearing, if necessary, that has been scheduled in abeyance to allow time for such settlement procedures.

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, amounts that were previously recorded as a regulatory asset, approximately \$45 million (\$27 million, net of income taxes), were charged to OCI 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 nine months ended September 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):

	Pension Benefits				Other Benefits			
	Three Months Ended September 30,		Nine Months Ended September 30,		Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006	2007	2006	2007	2006
Service cost-benefits earned during the period	\$ 13	\$ 12	\$ 38	\$ 36	\$ 3	\$ 5	\$ 14	\$ 16
Interest cost on benefit obligation	25	23	75	69	6	10	27	27
Expected return on plan assets	(27)	(24)	(80)	(72)	(8)	(10)	(32)	(29)
Amortization of:								
Transition (asset) obligation	—	(1)	—	(1)	1	1	2	2
Prior service cost	1	1	2	2	—	—	—	—
Net actuarial loss	4	6	12	18	1	2	3	7
Net periodic benefit cost	<u>\$ 16</u>	<u>\$ 17</u>	<u>\$ 47</u>	<u>\$ 52</u>	<u>\$ 3</u>	<u>\$ 8</u>	<u>\$ 14</u>	<u>\$ 23</u>
Portion of cost charged to expense	<u>\$ 7</u>	<u>\$ 7</u>	<u>\$ 21</u>	<u>\$ 22</u>	<u>\$ 2</u>	<u>\$ 3</u>	<u>\$ 6</u>	<u>\$ 10</u>
APS' share of costs charged to expense	<u>\$ 7</u>	<u>\$ 7</u>	<u>\$ 20</u>	<u>\$ 20</u>	<u>\$ 2</u>	<u>\$ 3</u>	<u>\$ 6</u>	<u>\$ 9</u>

Contributions

Our pension contribution of \$52 million has been made for the year. The contribution to our other postretirement benefit plans in 2007 is estimated to be approximately \$18 million, of which

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approximately \$15 million was contributed through September 30, 2007. APS and other subsidiaries fund their share of the contributions. APS' share is approximately 96% of both plans.

7. 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 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 nine months ended September 30, 2007 and 2006 and at September 30, 2007 and December 31, 2006 is provided as follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Operating Revenues:				
Regulated electricity segment	\$ 1,044	\$ 887	\$ 2,291	\$ 2,066
Real estate segment	47	98	173	319
All other (a)	115	91	301	287
Total	<u>\$ 1,206</u>	<u>\$ 1,076</u>	<u>\$ 2,765</u>	<u>\$ 2,672</u>
Net Income (Loss):				
Regulated electricity segment	\$ 205	\$ 170	\$ 278	\$ 252
Real estate segment	6	17	16	49
All other (a)	(2)	(3)	10	8
Total	<u>\$ 209</u>	<u>\$ 184</u>	<u>\$ 304</u>	<u>\$ 309</u>
Assets:				
Regulated electricity segment			As of September 30, 2007	As of December 31, 2006
			\$ 10,544	\$ 10,566
Real estate segment			673	591
All other (a)			179	299
Total			<u>\$ 11,396</u>	<u>\$ 11,456</u>

(a) All other activities relate to marketing and trading, APSES products and services and El Dorado. None of these segments is a reportable segment.

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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 our 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. Our 2001 federal consolidated income tax return is currently under examination by the IRS. As part of its ongoing examination, the IRS is reviewing this accounting method change and the resultant deduction. Within the next 12 months, we expect 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.

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 unrecognized tax benefits 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. APS’ share included in the total was approximately \$7 million. Partial resolution of previously unrecognized tax benefits during the quarter ended September 30, 2007 resulted in a \$10 million benefit.

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

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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 September 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 September 30, 2007, we hedged exposures to the price variability of the power and gas commodities for a maximum of 40 months. 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 ERM, we engage in marketing and trading activities intended to profit from market price movements.

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 nine months ended September 30, 2007 and 2006 are comprised of the following (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$ (239)	\$ (2,830)	\$ 1,094	\$ (5,984)
Gains (losses) from the change in options' time value excluded from measurement of effectiveness	—	4	—	(10)
Gains from the discontinuance of cash flow hedges	6	—	320	434

During the next twelve months ending September 30, 2008, we estimate that a net gain of \$34 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

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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 September 30, 2007 and December 31, 2006 (dollars in thousands):

September 30, 2007	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
Regulated electricity:					
Mark-to-market	\$ 35,843	\$ 50,147	\$(64,714)	\$(48,563)	\$(27,287)
Margin account and options	58,398	—	(557)	—	57,841
Marketing and trading:					
Mark-to-market	46,904	16,523	(23,529)	(5,785)	34,113
Options, emission allowances and other contracts – at cost	37	491	(465)	—	63
Total	<u>\$141,182</u>	<u>\$ 67,161</u>	<u>\$(89,265)</u>	<u>\$(54,348)</u>	<u>\$ 64,730</u>

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	<u>\$641,040</u>	<u>\$ 167,211</u>	<u>\$(558,195)</u>	<u>\$(171,170)</u>	<u>\$ 78,886</u>

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

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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 \$58 million at September 30, 2007 and \$73 million at December 31, 2006 and is included in the margin account in the table above. Cash is deposited with 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 \$4 million at September 30, 2007 and \$10 million at December 31, 2006, and is included in other current assets on the Condensed Consolidated Balance Sheets. No collateral was provided to us by counterparties at September 30, 2007 and \$54 million was provided to us 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. Our risk management process assesses and monitors the financial exposure of all counterparties. Despite the fact that the great majority of trading counterparties' securities are rated as investment grade by the credit rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. 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

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

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income	<u>\$208,708</u>	<u>\$184,167</u>	<u>\$304,232</u>	<u>\$ 308,776</u>
Other comprehensive income (loss):				
Net unrealized losses on derivative instruments (a)	(44,715)	(68,201)	(15,035)	(342,307)
Net reclassification of realized (gains) losses on derivative instruments to income (b)	17,989	2,519	(1,072)	(15,688)
Net unrealized gains (losses) related to pension and other postretirement benefits (c)	605	—	(43,968)	—
Reclassification of pension and other postretirement benefits to income	1,223	—	1,702	—
Net income tax benefit related to items of other comprehensive income	<u>9,764</u>	<u>25,649</u>	<u>22,917</u>	<u>139,798</u>
Total other comprehensive loss	<u>(15,134)</u>	<u>(40,033)</u>	<u>(35,456)</u>	<u>(218,197)</u>
Comprehensive income	<u>\$193,574</u>	<u>\$144,134</u>	<u>\$268,776</u>	<u>\$ 90,579</u>

- (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 OCI.

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 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.

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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 September 30, 2007, APS had a regulatory liability of approximately \$8 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 ("Column 4"), which has resulted in an enhanced NRC inspection regimen. Although only Palo Verde Unit 3 is in NRC's Column 4, in order to adequately assess the need for improvements, APS management has been conducting site-wide assessments of equipment and operations. Preliminary work in support of the NRC's enhanced inspection regimen took place throughout summer 2007. On June 21, 2007, the NRC issued an initial confirmatory action letter confirming APS' commitments regarding specific actions APS will take to improve Palo Verde's performance. From October 1, 2007, through November 2, 2007, a team of NRC inspectors performed on-site in-depth inspections of Palo Verde equipment and operations. APS expects to be informed of the NRC's inspection findings in late December 2007 or January 2008. APS continues to cooperate fully with the NRC throughout this process. Following receipt of the inspection findings and APS' revisions to improvement plans to address the inspection findings, the NRC will issue a revised confirmatory action letter in the first quarter of 2008.

On November 9, 2006, APS notified the NRC that a senior reactor operator at Palo Verde had attempted to conceal 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 was 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. The NRC also offered to resolve the potential escalated enforcement action through the agency's alternative dispute resolution program, which APS elected to do. As a result of the alternative dispute resolution proceeding between the NRC and APS, a settlement was reached under which APS agreed to take a number of corrective actions, including specified training for certain Palo Verde personnel and follow up reporting to the NRC. As a result of APS' commitments, the NRC agreed not to pursue any further enforcement action in connection with this matter. The agreement between APS and the NRC became effective upon the NRC's issuance of a confirmatory order, dated October 19, 2007, memorializing the agreement.

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

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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. The Ninth Circuit has extended the stay until November 16, 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 was appealed to the U.S. Court of Appeals

PINNACLE WEST CAPITAL CORPORATION
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for the Ninth Circuit. On August 24, 2007, the Ninth Circuit issued an opinion that remanded the proceeding to the FERC for further consideration. The Court stayed the date for petitions for rehearing of this opinion until November 16, 2007 to allow for any possible settlement negotiations. 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 sought appellate review to reallocate the cost responsibility associated with the changed contractual obligations in a way that would have increased APS’ annual capacity cost 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 was no basis for modifying the settlement rates during the remaining term of the settlement. By order of the D.C. Court of Appeals issued on October 10, 2007, this case was dismissed as a result of a motion for voluntary dismissal filed by the party that originally sought review in this case.

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

**PINNACLE WEST CAPITAL CORPORATION
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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 52nd 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.

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 financial position, results of operations or cash flows.

PINNACLE WEST CAPITAL CORPORATION
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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 \$21.1 million. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

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 nine months ended September 30, 2007 and 2006 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Other income:				
SO2 emission allowance sales and other (a)	\$ —	\$ 801	\$ —	\$ 9,972
Interest income	2,921	5,878	8,283	13,068
Investment gains – net	—	1,656	—	559
SunCor other income (b)	778	9,430	2,136	10,313
Miscellaneous	577	290	1,557	536
Total other income	<u>\$ 4,276</u>	<u>\$ 18,055</u>	<u>\$ 11,976</u>	<u>\$ 34,448</u>
Other expense:				
Non-operating costs (a)	\$ (3,552)	\$ (2,954)	\$ (9,207)	\$(10,501)
Investment losses – net	(2,070)	—	(1,128)	—
Miscellaneous	(1,122)	(739)	(3,350)	(2,452)
Total other expense	<u>\$ (6,744)</u>	<u>\$ (3,693)</u>	<u>\$ (13,685)</u>	<u>\$ (12,953)</u>

(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 APSES 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 September 30, 2007 are as follows (dollars in millions):

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	\$ 45	1	\$ —	—
APSES	18	1	22	1
Total	<u>\$ 63</u>		<u>\$ 22</u>	

At September 30, 2007, Pinnacle West had approximately \$5 million of letters of credit related to workers' compensation expiring in 2009. 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 September 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 \$83 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 September 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 nine months ended September 30, 2007 and 2006:

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Basic earnings per share:				
Income from continuing operations	\$ 2.00	\$ 1.85	\$ 2.95	\$ 3.09
Income from discontinued operations	0.08	—	0.09	0.02
Earnings per share – basic	<u>\$ 2.08</u>	<u>\$ 1.85</u>	<u>\$ 3.04</u>	<u>\$ 3.11</u>
Diluted earnings per share:				
Income from continuing operations	\$ 1.99	\$ 1.84	\$ 2.93	\$ 3.07
Income from discontinued operations	0.08	—	0.09	0.03
Earnings per share – diluted	<u>\$ 2.07</u>	<u>\$ 1.84</u>	<u>\$ 3.02</u>	<u>\$ 3.10</u>

Dilutive stock options and performance shares increased average common shares outstanding by approximately 505,000 shares and 482,000 shares for the three months ended September 30, 2007 and September 30, 2006, respectively, and by approximately 567,000 shares and 446,000 shares for the nine months ended September 30, 2007 and 2006, respectively.

Options to purchase 610,250 shares of common stock for the three-month period and 115,200 shares for the nine-month period ended September 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. Options to purchase shares of common stock that were excluded from the computation of diluted earnings per share for that same reason were 447,650 shares for the three-month period ended September 30, 2006 and 732,534 shares for the nine-month period ended September 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 \$8 million (\$13 million pretax). Assets held for sale at September 30, 2007 relate to commercial properties in the amount of \$6 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 nine months ended September 30, 2007 and 2006 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Revenue	\$ —	\$ 1	\$ 3	\$ 3
Income before income taxes	13	—	15	4
Income after income taxes	8	—	9	2

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 September 30, 2007 and December 31, 2006 (dollars in millions):

	Fair Value	Total Unrealized Gains
September 30, 2007		
Equity securities	\$ 181	\$ 75
Fixed income securities	195	3
Total	\$ 376	\$ 78
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 September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Realized gains	\$ —	\$ 1	\$ 2	\$ 2
Realized losses	(1)	(1)	(3)	(3)
Proceeds from the sale of securities	70	56	203	171

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

Fair Value	September 30, 2007
Less than one year	\$ 8
1 year - 5 years	44
5 years - 10 years	38
Greater than 10 years	105
Total	\$ 195

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 and preparing for the new disclosure requirements.

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.

In April 2007, the FASB issued FASB Staff Position No. FIN 39-1, "Amendment of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts" (FSP FIN 39-1). Under FSP FIN 39-1, a reporting entity is permitted to offset the fair value amounts recognized for cash collateral paid or cash collateral received against the fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement. This new guidance is effective for us on January 1, 2008, with early application permitted. We are currently evaluating the impacts of FSP FIN 39-1 on our balance sheet. We do not expect the guidance to have an impact on our results of operations or cash flows.

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

	Three Months Ended September 30,	
	<u>2007</u>	<u>2006</u>
ELECTRIC OPERATING REVENUES		
Regulated electricity	\$1,045,751	\$888,724
Marketing and trading	1,311	(2,038)
Total	<u>1,047,062</u>	<u>886,686</u>
OPERATING EXPENSES		
Regulated electricity fuel and purchased power	409,059	315,666
Marketing and trading fuel and purchased power	819	839
Operations and maintenance	171,963	156,170
Depreciation and amortization	92,834	88,999
Income taxes	99,469	93,061
Other taxes	34,774	31,371
Total	<u>808,918</u>	<u>686,106</u>
OPERATING INCOME	<u>238,144</u>	<u>200,580</u>
OTHER INCOME (DEDUCTIONS)		
Income taxes	1,262	684
Allowance for equity funds used during construction	5,235	3,178
Other income (Note S-3)	4,083	7,713
Other expense (Note S-3)	(3,303)	(2,770)
Total	<u>7,277</u>	<u>8,805</u>
INTEREST DEDUCTIONS		
Interest on long-term debt	40,232	39,175
Interest on short-term borrowings	2,715	2,438
Debt discount, premium and expense	1,162	1,066
Allowance for borrowed funds used during construction	(2,945)	(1,928)
Total	<u>41,164</u>	<u>40,751</u>
NET INCOME	<u>\$ 204,257</u>	<u>\$168,634</u>

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

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

	Nine Months Ended September 30,	
	2007	2006
ELECTRIC OPERATING REVENUES		
Regulated electricity	\$2,295,570	\$2,070,673
Marketing and trading	11,511	11,732
Total	<u>2,307,081</u>	<u>2,082,405</u>
OPERATING EXPENSES		
Regulated electricity fuel and purchased power	884,854	739,675
Marketing and trading fuel and purchased power	4,626	3,697
Operations and maintenance	508,528	493,896
Depreciation and amortization	271,519	263,279
Income taxes	145,294	136,682
Other taxes	103,884	99,585
Total	<u>1,918,705</u>	<u>1,736,814</u>
OPERATING INCOME	<u>388,376</u>	<u>345,591</u>
OTHER INCOME (DEDUCTIONS)		
Income taxes	1,617	1,873
Allowance for equity funds used during construction	14,874	10,612
Other income (Note S-3)	12,872	22,798
Other expense (Note S-3)	(10,976)	(10,298)
Total	<u>18,387</u>	<u>24,985</u>
INTEREST DEDUCTIONS		
Interest on long-term debt	120,707	108,315
Interest on short-term borrowings	6,748	7,449
Debt discount, premium and expense	3,477	3,264
Allowance for borrowed funds used during construction	(7,833)	(5,322)
Total	<u>123,099</u>	<u>113,706</u>
NET INCOME	<u>\$ 283,664</u>	<u>\$ 256,870</u>

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

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

	<u>September 30,</u> 2007	<u>December 31,</u> 2006
ASSETS		
UTILITY PLANT		
Electric plant in service and held for future use	\$11,464,755	\$11,094,868
Less accumulated depreciation and amortization	<u>3,941,211</u>	<u>3,789,534</u>
Net	7,523,544	7,305,334
Construction work in progress	541,530	365,704
Intangible assets, net of accumulated amortization	100,479	95,601
Nuclear fuel, net of accumulated amortization	<u>74,500</u>	<u>60,100</u>
Total utility plant	<u>8,240,053</u>	<u>7,826,739</u>
INVESTMENTS AND OTHER ASSETS		
Assets from long-term risk management and trading activities (Note S-1)	50,147	96,892
Decommissioning trust accounts (Note 18)	375,898	343,771
Other assets	<u>70,773</u>	<u>67,763</u>
Total investments and other assets	<u>496,818</u>	<u>508,426</u>
CURRENT ASSETS		
Cash and cash equivalents	37,410	81,870
Investment in debt securities	—	32,700
Customer and other receivables	578,328	410,436
Allowance for doubtful accounts	(4,754)	(4,223)
Materials and supplies (at average cost)	146,755	125,802
Fossil fuel (at average cost)	30,806	21,973
Assets from risk management and trading activities (Note S-1)	94,242	539,308
Deferred income taxes	33,713	19,220
Other current assets	<u>12,298</u>	<u>13,367</u>
Total current assets	<u>928,798</u>	<u>1,240,453</u>
DEFERRED DEBITS		
Deferred fuel and purchased power regulatory asset (Note 5)	150,286	160,268
Other regulatory assets	583,331	686,016
Unamortized debt issue costs	24,882	26,393
Other (Note 8)	<u>80,470</u>	<u>65,397</u>
Total deferred debits	<u>838,969</u>	<u>938,074</u>
TOTAL ASSETS	<u>\$10,504,638</u>	<u>\$10,513,692</u>

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

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

	September 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	1,118,782	960,405
Accumulated other comprehensive income (loss) (Note S-2):		
Pension benefits	(26,496)	—
Derivative instruments	7,385	2,988
Common stock equity	3,383,299	3,207,473
Long-term debt less current maturities (Note 4)	2,876,970	2,877,502
Total capitalization	<u>6,260,269</u>	<u>6,084,975</u>
CURRENT LIABILITIES		
Short-term debt	150,000	—
Current maturities of long-term debt (Note 4)	987	968
Accounts payable	205,560	223,417
Accrued taxes (Note 8)	448,514	381,444
Accrued interest	40,689	45,254
Customer deposits	68,987	61,900
Liabilities from risk management and trading activities (Note S-1)	65,352	490,855
Other current liabilities	114,533	74,728
Total current liabilities	<u>1,094,622</u>	<u>1,278,566</u>
DEFERRED CREDITS AND OTHER		
Deferred income taxes	1,262,589	1,215,862
Regulatory liabilities	672,679	635,431
Liability for asset retirements	277,378	268,389
Pension and other postretirement liabilities (Note 6)	516,579	551,531
Customer advances for construction	85,672	71,211
Unamortized gain – sale of utility plant	37,750	41,182
Liabilities from long-term risk management and trading activities (Note S-1)	48,563	135,056
Other	248,537	231,489
Total deferred credits and other	<u>3,149,747</u>	<u>3,150,151</u>
COMMITMENTS AND CONTINGENCIES (SEE NOTES)		
TOTAL LIABILITIES AND EQUITY	<u>\$10,504,638</u>	<u>\$10,513,692</u>

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

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

	Nine Months Ended September 30,	
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 283,664	\$ 256,870
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	296,318	284,036
Deferred fuel and purchased power	(203,065)	(231,388)
Deferred fuel and purchased power amortization	198,677	195,127
Deferred fuel and purchased power regulatory disallowance	14,370	—
Allowance for equity funds used during construction	(14,874)	(10,612)
Deferred income taxes	36,646	29,566
Changes in mark-to-market valuations	(3,785)	6,060
Changes in current assets and liabilities:		
Customer and other receivables	(152,467)	(85,190)
Materials, supplies and fossil fuel	(29,786)	(5,152)
Other current assets	12	4,311
Accounts payable	(26,687)	(13,468)
Accrued taxes	31,504	133,359
Collateral	(2,491)	(185,091)
Other current liabilities	42,923	41,306
Change in risk management and trading – liabilities	(1,952)	(120,769)
Change in other long-term assets	31,960	(70,411)
Change in other long-term liabilities	60,390	57,278
Net cash flow provided by operating activities	<u>561,357</u>	<u>285,832</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(675,870)	(466,095)
Capitalized interest	(7,833)	(5,322)
Proceeds from sale of investment securities	69,225	389,178
Purchases of investment securities	(36,525)	(592,495)
Proceeds from nuclear decommissioning trust sales	203,014	170,827
Investment in nuclear decommissioning trust	(218,570)	(186,383)
Other	(62)	(3,453)
Net cash flow used for investing activities	<u>(666,621)</u>	<u>(693,743)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Equity infusion	39,548	210,000
Short-term borrowings, net	150,000	—
Issuance of long-term debt	—	395,481
Dividends paid on common stock	(127,500)	(127,500)
Repayment and reacquisition of long-term debt	(1,244)	(2,310)
Net cash flow provided by financing activities	<u>60,804</u>	<u>475,671</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(44,460)	67,760
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	81,870	49,933
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 37,410</u>	<u>\$ 117,693</u>
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Income taxes, net of refunds	\$ 70,083	\$ 24,414
Interest, net of amounts capitalized	\$ 124,186	\$ 95,149

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

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Certain notes to APS' Condensed 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 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 Footnote Reference	APS' Supplemental Footnote Reference
Consolidation and Nature of Operations	Note 1	—
Condensed Consolidated Financial Statements	Note 2	—
Quarterly Fluctuations	Note 3	—
Changes in Liquidity	Note 4	—
Regulatory Matters	Note 5	—
Retirement Plans and Other Benefits	Note 6	—
Business Segments	Note 7	—
Income Taxes	Note 8	—
Variable-Interest Entities	Note 9	—
Derivative and Energy Trading Accounting	Note 10	Note S-1
Comprehensive Income (Loss)	Note 11	Note S-2
Commitments and Contingencies	Note 12	—
Nuclear Insurance	Note 13	—
Other Income and Other Expense	Note 14	Note S-3
Guarantees	Note 15	—
Earnings Per Share	Note 16	—
Discontinued Operations	Note 17	—
Nuclear Decommissioning Trust	Note 18	—
New Accounting Standards	Note 19	—

S-1. Derivative and Energy Trading Accounting

APS is exposed to the impact of market fluctuations in the commodity price of electricity, natural gas and emissions allowances. As part of its overall risk management program, APS uses various commodity instruments that qualify as derivatives to hedge purchases and sales of electricity, fuels, and emission allowances and credits. As of September 30, 2007, APS hedged exposures to these risks for a maximum of 40 months.

Cash Flow Hedges

The changes in the fair value of APS' hedged positions included in the APS Condensed Statements of Income, after consideration of amounts deferred under the PSA, for the three and nine months ended September 30, 2007 and 2006 were comprised of the following (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$ (239)	\$ (2,505)	\$ 1,094	\$ (5,765)
Gains (losses) from the change in options' time value excluded from measurement of effectiveness	—	4	—	(10)
Gains from the discontinuance of cash flow hedges	—	—	150	159

During the next twelve months ending September 30, 2008, APS estimates that a net gain of \$16 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).

APS' assets and liabilities from risk management and trading activities are presented in two categories.

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

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September 30, 2007	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
Regulated Electricity:					
Mark-to-market	\$35,843	\$ 50,147	\$(64,714)	\$(48,563)	\$(27,287)
Margin account and options	58,398	—	(557)	—	57,841
Marketing and Trading:					
Mark-to-market	1	—	(50)	—	(49)
Options and other contracts – at cost	—	—	(31)	—	(31)
Total	<u>\$94,242</u>	<u>\$ 50,147</u>	<u>\$(65,352)</u>	<u>\$(48,563)</u>	<u>\$ 30,474</u>
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	3,569	—	(6,654)	—	(3,085)
Options at cost	—	—	(312)	—	(312)
Total	<u>\$539,308</u>	<u>\$ 96,892</u>	<u>\$(490,855)</u>	<u>\$(135,056)</u>	<u>\$ 10,289</u>

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 income, 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 \$58 million at September 30, 2007 and \$73 million at December 31, 2006 and is included in the margin account in the table above. Cash is deposited with 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 APS' open positions on certain energy-related contracts. Collateral provided to counterparties was \$4 million at September 30, 2007 and \$2 million at December 31, 2006 and is included in other current assets on the

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Condensed Balance Sheets. No collateral was provided to us by counterparties at September 30, 2007 and \$1 million was provided to us at December 31, 2006, and is included in other current liabilities on the Condensed Balance Sheets.

S-2. Comprehensive Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income	<u>\$204,257</u>	<u>\$168,634</u>	<u>\$283,664</u>	<u>\$ 256,870</u>
Other comprehensive income (loss):				
Net unrealized losses on derivative instruments (a)	(35,322)	(51,359)	(10,558)	(276,555)
Net reclassification of realized losses on derivative instruments to income (b)	23,324	8,068	17,795	910
Net unrealized losses related to pension benefits (c)	—	—	(44,613)	—
Reclassification of pension and other postretirement benefits to income	1,005	—	1,005	—
Net income tax benefit related to items of other comprehensive income	<u>4,314</u>	<u>16,906</u>	<u>14,272</u>	<u>107,640</u>
Total other comprehensive loss	<u>(6,679)</u>	<u>(26,385)</u>	<u>(22,099)</u>	<u>(168,005)</u>
Comprehensive income	<u>\$197,578</u>	<u>\$142,249</u>	<u>\$261,565</u>	<u>\$ 88,865</u>

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

S-3. Other Income and Other Expense

The following table provides detail of APS' other income and other expense for the three and nine months ended September 30, 2007 and 2006 (dollars in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Other income:				
SO2 emission allowance sales and other (a)	\$ 420	\$ 801	\$ 854	\$ 9,972
Interest income	2,771	5,439	7,630	10,943
Investment gains – net	315	1,193	2,832	1,358
Miscellaneous	577	280	1,556	525
Total other income	<u>\$ 4,083</u>	<u>\$ 7,713</u>	<u>\$ 12,872</u>	<u>\$ 22,798</u>
Other expense:				
Non-operating costs (a)	\$ (2,690)	\$ (2,353)	\$ (7,924)	\$ (8,879)
Miscellaneous	(613)	(417)	(3,052)	(1,419)
Total other expense	<u>\$ (3,303)</u>	<u>\$ (2,770)</u>	<u>\$ (10,976)</u>	<u>\$ (10,298)</u>

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

**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 Financial Statements and the related Notes that appear in Item 1 of this report.

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 has historically accounted for a substantial part of our revenues and earnings, and is expected to continue to do so. Customer growth in APS' service territory is about three times the national average and remains a fundamental driver of our revenues and earnings.

The ACC regulates APS' retail electric rates. Our profitability is affected by the rates APS may charge and the timely recovery of costs through those rates. APS' capital expenditure requirements, which are discussed below under "Liquidity and Capital Resources," are substantial because of the significant customer growth in APS' service territory, highlighting APS' need for the timely recovery of these and other expenditures through rates. As discussed in greater detail in Note 5, on June 28, 2007, the ACC issued an order in a general rate case that APS filed in late 2005. Additionally, the ACC directed the ACC staff to conduct a "prudence audit" of 2006 Palo Verde outage costs. Virtually all of the 2006 Deferrals were associated with a Unit 1 vibration issue. On October 4, 2007 the ACC staff filed a report with the ACC that concludes that APS' response to the Unit 1 vibration issue was "reasonable and prudent." APS continues to believe that these costs were prudently incurred and that the 2006 Deferrals, totaling approximately \$79 million, are, therefore, recoverable.

SunCor, our real estate development subsidiary, has been and is expected to continue to be an important source of earnings. See discussion below in "Pinnacle West Consolidated – Factors Affecting our Financial Outlook – Subsidiaries." Our subsidiary, APSES, provides competitive commodity-related energy services and energy-related products and services to commercial and industrial retail customers in the western United States. El Dorado, our investment subsidiary, owns minority interests in several energy-related investments and Arizona community-based ventures. Pinnacle West Marketing & Trading is the Company's marketing and trading subsidiary, which began activity in February 2007. See Note 4.

We continue to focus on solid operational performance in our electricity generation and delivery activities. In the delivery area, we focus on superior reliability and customer satisfaction. We plan to expand long-term resources and our transmission and distribution systems to meet the electricity needs of our growing retail customers and sustain reliability.

See "Pinnacle West Consolidated – Factors Affecting Our Financial Outlook" below for a discussion of several factors that could affect our future financial results.

EARNINGS CONTRIBUTION BY BUSINESS SEGMENT

Pinnacle West's two reportable business segments are:

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

The following table summarizes income (loss) from continuing operations for the three months and nine months ended September 30, 2007 and 2006 and reconciles net income in total (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Regulated electricity segment	\$ 205	\$ 170	\$ 278	\$ 252
Real estate segment	(2)	17	7	47
All other (a)	(2)	(3)	10	8
Income from continuing operations	201	184	295	307
Discontinued operations – net of tax (b)	8	—	9	2
Net income	<u>\$ 209</u>	<u>\$ 184</u>	<u>\$ 304</u>	<u>\$ 309</u>

(a) All other includes activities related to marketing and trading, APSES products and services and El Dorado. None of these segments is a reportable segment.

(b) Primarily relates to sales of commercial properties.

PINNACLE WEST CONSOLIDATED – RESULTS OF OPERATIONS

Regulatory Matters

On June 28, 2007, the ACC issued an order in the general rate case of APS. In its order, effective July 1, 2007, among other things, the ACC (a) approved an increase in APS' retail base rates, the components of which included an increase in APS' Base Fuel Rate and a non-fuel rate increase; (b) modified the PSA; and (c) disallowed certain PSA deferrals as described below.

Under the PSA, APS defers for future rate recovery or refund 90% of the difference between actual retail fuel and purchased power costs and the Base Fuel Rate included in APS' retail rates, subject to specified parameters. APS absorbs the other 10% of variances between actual retail fuel and purchased power costs and the Base Fuel Rate. The increase in APS' Base Fuel Rate approved by the ACC reduced the amount of fuel and purchased power costs subject to the 90/10 PSA sharing arrangement. APS recovers PSA deferrals from its customers through PSA annual adjustors and surcharges. The recovery of PSA deferrals recorded as revenue is offset dollar-for-dollar by the amortization of those deferred expenses recorded as fuel and purchased power. The balance of APS' PSA accumulated unrecovered

deferrals at September 30, 2007 was approximately \$150 million. See Note 5 for additional information about the ACC order and the PSA.

APS recorded PSA deferrals of (a) \$45 million related to the 2005 Deferrals and (b) \$79 million related to the 2006 Deferrals. In its order, the ACC (a) disallowed approximately \$14 million, including accrued interest (\$8 million after income taxes), of the 2005 Deferrals 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 beginning July 1, 2007. The ACC directed the ACC staff to conduct a "prudence audit" of the 2006 Palo Verde outage costs. Virtually all of the 2006 Deferrals were associated with a Unit 1 vibration issue. On October 4, 2007, the ACC staff filed a report with the ACC that concludes that APS' response to the Unit 1 vibration issue was "reasonable and prudent." APS continues to believe that the 2006 Deferrals were prudently incurred and, therefore, are recoverable.

Operating Results – Three-month period ended September 30, 2007 compared with three-month period ended September 30, 2006

Our consolidated net income for the three months ended September 30, 2007 was \$209 million compared with \$184 million for the comparable prior-year period. The current period includes income from discontinued operations of \$8 million, which was related to income from the sale of commercial properties at SunCor. Income from continuing operations increased \$17 million in the period-to-period comparison, reflecting the following changes in earnings:

- Regulated Electricity Segment – Income from continuing operations increased approximately \$35 million primarily due to the effects of hotter weather on retail sales; higher retail sales primarily due to customer growth and usage patterns; impacts of the retail rate increase (see "Regulatory Matters" above); and income tax benefits related to prior years resolved in 2007. These positive factors were partially offset by higher operations and maintenance expense primarily for customer service and regulatory programs and increased costs for generation, including the Palo Verde performance improvement plan. In addition, higher fuel and purchased power costs related to commodity price increases were offset by the deferral of such costs in accordance with the PSA. See "Regulatory Matters" above.
- Real Estate Segment – Income from continuing operations decreased approximately \$19 million primarily due to lower sales of residential property and land parcels resulting from the continued slowdown in the western United States real estate markets and prior-year sales of certain joint venture assets. Income from discontinued operations increased \$8 million due to increased commercial property sales.

Additional details on the major factors that increased (decreased) net income for the three-month period ended September 30, 2007 compared with the same period in 2006 are contained in the following table (dollars in millions):

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	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment:		
Effects of hotter weather on retail sales	\$ 27	\$ 16
Higher retail sales primarily due to customer growth and usage patterns, excluding weather effects	17	10
Impacts of retail rate increase (see discussion above):		
Revenue increase related to higher Base Fuel Rate	114	70
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(103)	(63)
Non-fuel rate increase	5	3
Net changes in fuel and purchased power costs related to prices:		
Higher fuel and purchased power costs due to increased prices	(39)	(24)
Increased deferred fuel and purchased power costs related to increased prices	37	23
Operations and maintenance increases primarily due to:		
Customer service costs and regulatory programs	(8)	(5)
Increased generation costs, including Palo Verde performance improvement plan	(6)	(4)
Income tax benefits related to prior years resolved in 2007	—	10
Miscellaneous items, net	(4)	(1)
Increase in regulated electricity segment net income	40	35
Lower real estate segment contribution primarily due to decreased sales of residential property and land parcels and prior-year sales of certain joint venture assets	(31)	(19)
Other miscellaneous items, net	1	1
Increase in income from continuing operations	<u>\$ 10</u>	<u>17</u>
Discontinued operations primarily related to sales of commercial real estate assets		<u>8</u>
Increase in net income		<u>\$ 25</u>

Regulated Electricity Segment Revenues

Regulated electricity segment revenues were \$157 million higher for the three months ended September 30, 2007 compared with the prior-year period primarily because of:

- a \$119 million increase in retail revenues due to retail rate increase effective July 1, 2007;
- a \$36 million increase in retail revenues due to the effects of hotter weather;
- a \$22 million increase in retail revenues primarily related to customer growth and usage patterns, excluding weather effects;
- a \$16 million increase in Off-System Sales due to higher prices and volumes;
- a \$44 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount

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recorded as fuel and purchased power expense (see “Regulatory Matters” above); and

- an \$8 million net increase due to miscellaneous factors.

Real Estate Segment Revenues

Real estate segment revenues were \$50 million lower for the three months ended September 30, 2007 compared with the prior-year period primarily because of:

- a \$48 million decrease in residential property sales due to the continued slowdown in the western United States real estate markets;
- a \$4 million decrease in revenue primarily due to lower sales of land parcels; and
- a \$2 million net increase due to miscellaneous factors.

All Other Revenues

Marketing and trading revenues were \$15 million higher for the three months ended September 30, 2007 compared with the prior-year period primarily due to an increase in competitive retail sales volumes in California.

Other revenues were \$8 million higher for the three months ended September 30, 2007 compared to the prior-year period primarily as a result of increased sales by APSES of energy related products and services.

Operating Results — Nine-month period ended September 30, 2007 compared with nine-month period ended September 30, 2006

Our consolidated net income for the nine months ended September 30, 2007 was \$304 million compared with \$309 million for the comparable prior-year period. Our net income includes income from discontinued operations related primarily to sales of commercial properties by SunCor of \$9 million in the current period and \$2 million in the prior-year period. Income from continuing operations decreased \$12 million in the period-to-period comparison, reflecting the following changes in earnings:

- Regulated Electricity Segment — Income from continuing operations increased approximately \$26 million primarily due to higher retail sales primarily due to customer growth and usage patterns; the effects of weather on retail sales; impacts of the retail rate increase; and income tax benefits related to prior years resolved in 2007. These positive factors were partially offset by higher operations and maintenance expense primarily due to increased generation costs, including the Palo Verde performance improvement plan, customer service and regulatory programs; income tax credits related to prior years resolved in 2006; lower other income, net of expense, primarily due to miscellaneous asset sales in the prior-year period and lower interest income as a result of lower investment balances; and a

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regulatory disallowance. In addition, higher fuel and purchased power costs related to commodity price increases were partially offset by the deferral of such costs in accordance with the PSA. See “Regulatory Matters” above for further discussion.

- Real Estate Segment — Income from continuing operations decreased approximately \$40 million primarily due to lower sales of residential property and land parcels resulting from the continued slowdown in the western United States real estate markets and prior-year sales of certain joint venture assets. Income from discontinued operations increased \$7 million due to increased commercial property sales.

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Additional details on the major factors that increased (decreased) net income for the nine-month period ended September 30, 2007 compared with the same period in 2006 are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment:		
Higher retail sales primarily due to customer growth and usage patterns, excluding weather effects	\$ 37	\$ 23
Effects of weather on retail sales	33	20
Impacts of retail rate increase (see discussion above):		
Revenue increase related to higher Base Fuel Rate	114	70
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(103)	(63)
Non-fuel rate increase	5	3
Net changes in fuel and purchased power costs related to price:		
Higher fuel and purchased power costs due to increased prices	(80)	(49)
Increased deferred fuel and purchased power costs related to increased prices	75	46
Regulatory disallowance (see "Regulatory Matters" above)	(14)	(8)
Operations and maintenance increases primarily due to:		
Increased generation costs, including Palo Verde performance improvement plan	(8)	(5)
Customer service costs and regulatory programs	(8)	(5)
Higher depreciation and amortization primarily due to increased plant balances	(8)	(5)
Lower other income, net of expense, primarily due to lower interest income as a result of lower investment balances and miscellaneous asset sales in the prior-year period	(13)	(8)
Income tax benefits related to prior years resolved in 2007	—	13
Income tax credits related to prior years resolved in 2006	—	(10)
Miscellaneous items, net	7	4
Increase in regulated electricity segment net income	37	26
Lower real estate segment contribution primarily due to decreased sales of residential property and land parcels and prior year sales of certain joint venture assets	(66)	(40)
Higher marketing and trading contribution primarily due to higher competitive retail sales volumes in California and higher mark-to-market gains because of changes in forward prices	6	4
Other miscellaneous items, net	(3)	(2)
Decrease in income from continuing operations	<u>\$ (26)</u>	<u>(12)</u>
Discontinued operations primarily related to increased sales of commercial real estate assets		7
Decrease in net income		<u>\$ (5)</u>

Regulated Electricity Segment Revenues

Regulated electricity segment revenues were \$225 million higher for the nine months ended September 30, 2007 compared with the prior-year period primarily because of:

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- a \$119 million increase in retail revenues due to retail rate increase effective July 1, 2007;
- a \$49 million increase in retail revenues primarily related to customer growth and usage patterns, excluding weather effects;
- a \$45 million increase in retail revenues due to the effects of weather; and
- a \$12 million net increase due to miscellaneous factors.

Real Estate Segment Revenues

Real estate segment revenues were \$145 million lower for the nine months ended September 30, 2007 compared with the prior-year period primarily because of:

- a \$124 million decrease in residential property sales due to the continued slowdown in western United States real estate markets;
- a \$23 million decrease in revenue primarily due to lower sales of land parcels; and
- a \$2 million net increase due to miscellaneous factors.

All Other Revenues

Marketing and trading revenues were \$5 million higher for the nine months ended September 30, 2007 compared with the prior-year period primarily because of higher competitive retail sales volumes in California and higher mark-to-market gains because of changes in forward prices.

Other revenues were \$8 million higher for the nine months ended September 30, 2007 compared to the prior-year period primarily as a result of increased sales by APSES of energy-related products and services.

LIQUIDITY AND CAPITAL RESOURCES — Pinnacle West Consolidated

Operating Cash Flows

Net cash provided by operating activities was \$477 million for the nine months ended September 30, 2007, compared to \$283 million for the same period in 2006, an increase in cash provided of \$194 million. This change was primarily due to the 2006 return of cash collateral and margin cash held as a result of changes in commodity prices, partially offset by lower cash contributions from decreased sales of residential properties and land parcels due to the continued slowdown in western United States real estate markets.

Investing Cash Flows

Net cash used for investing activities was \$678 million for the nine months ended September 30, 2007, compared to \$560 million for the same period in 2006, an increase in cash used of \$118 million. This change was primarily due to:

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- Approximately \$208 million in proceeds received from the sale of Silverhawk in 2006;
- An approximate \$178 million increase in capital expenditures (see table and discussion below);
- An approximate \$236 million decrease in the invested position, primarily at APS. In 2006 we issued long-term debt and invested some of the proceeds in short-term investment securities until they were later redeemed and the cash used for general corporate purposes.

Capital Expenditure Requirements

The following table summarizes the actual capital expenditures for the nine months ended September 30, 2006 and 2007 and estimated capital expenditures for the next three years (dollars in millions):

	Nine Months Ended		Estimated for the Year Ended		
	September 30,		December 31,		
	2006	2007	2007	2008	2009
APS					
Distribution	\$ 275	\$ 306	\$ 360	\$ 410	\$ 460
Transmission	72	97	170	200	290
Generation	110	259	390	300	340
Other (a)	14	10	30	40	40
Subtotal	471	672	950	950	1,130
SunCor (b)	151	132	140	100	100
Other	6	2	10	20	10
Total	<u>\$ 628</u>	<u>\$ 806</u>	<u>\$ 1,100</u>	<u>\$ 1,070</u>	<u>\$ 1,240</u>

(a) Primarily information systems and facilities projects.

(b) Consists primarily of capital expenditures for residential land development and retail and office building construction reflected in "Real estate investments" on the Condensed Consolidated Statements of Cash Flows.

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

Generation capital expenditures are comprised of various improvements to APS' existing fossil and nuclear plants and the replacement of Palo Verde steam generators (see below). 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. Environmental expenditures are estimated at approximately \$80 million to \$100 million per year for 2007, 2008 and

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2009. Generation also includes nuclear fuel expenditures of approximately \$110 million for 2007, \$40 million for 2008, and \$100 million for 2009.

Installation of new steam generators in Palo Verde Unit 3 is in progress and is scheduled for completion in the fourth quarter of 2007 at an approximate cost of \$70 million (APS' share). Approximately \$52 million of the Unit 3 steam generator costs have been incurred through September 30, 2007, with the remaining \$18 million included in the capital expenditures table above. Capital expenditures will be funded with internally generated cash and/or external financings.

Financing Cash Flows and Liquidity

Net cash provided by financing activities was \$157 million for the nine months ended September 30, 2007, compared to \$251 million for the same period in 2006, a decrease in cash provided of \$94 million. This change was primarily due to:

- An approximate \$256 million decrease due to the 2006 issuance of approximately \$318 million of new long-term debt, net of redemptions, in order to fund our construction program and for other general corporate purposes. During the first nine months for 2007, we issued approximately \$62 million of new long-term debt, net of refinancing.
- An approximate \$196 million increase in short-term borrowings to fund day-to-day operations and liquidity needs.

Pinnacle West (Parent Company)

Our primary cash needs are for dividends to our shareholders and principal and interest payments on our 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.

Our primary sources of cash are dividends from APS, external financings and cash distributions from our other subsidiaries, primarily SunCor. An existing ACC order requires APS to maintain a common equity ratio of at least 40% and prohibits APS from paying common stock dividends if the payment would reduce its common equity below that threshold. 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 September 30, 2007, APS' common equity ratio, as defined, was approximately 54% (see Note 4).

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.

On October 17, 2007, the Pinnacle West Board of Directors declared a quarterly dividend of \$0.525 per share of common stock, payable on December 3, 2007, to shareholders of record on November 1, 2007.

At September 30, 2007, Pinnacle West had borrowings of \$105 million under its revolving line of credit. The amount drawn was used for general corporate purposes.

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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 fund performance and fund valuation assumptions. We contributed \$47 million in 2006. Our 2007 pension contribution of \$52 million has been made for the year. The contribution to our other postretirement benefit plans in 2007 is estimated to be approximately \$18 million, of which approximately \$15 million has been contributed through September 30, 2007. APS and other subsidiaries fund their share of the contributions. APS' share is approximately 96% of both plans.

APS

APS' capital requirements consist primarily of capital expenditures and optional and mandatory redemptions of long-term debt. APS pays for its capital requirements with cash from operations and, to the extent necessary, external financings. APS has historically paid its dividends to Pinnacle West with cash from operations. 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. As noted above, in May 2007, Pinnacle West infused approximately \$40 million of equity into APS.

Although provisions in APS' articles of incorporation and ACC financing orders establish maximum amounts of preferred stock and debt that APS may issue, APS does not expect any of these provisions to limit its ability to meet its capital requirements. APS requested the ACC to increase (a) APS' current short-term debt authorization (7% of APS' capitalization) to (i) 7% of APS' capitalization plus (ii) \$500 million and (b) APS' current long-term debt authorization (approximately \$3.2 billion) to \$4.2 billion in light of the projected growth of APS and its customer base and the resulting projected financing needs. On October 30, 2007, the ACC issued a financing order in which it approved APS' requests, subject to specified parameters and procedures. See "APS Financing Authorization" in Note 5.

See "Regulatory Matters" above and "PSA Modifications" in Note 5 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 PSA adjustments and, if necessary, periodic surcharge applications.

See "Cash Flow Hedges" in Note 10 for information related to collateral provided to us by counterparties.

At September 30, 2007, APS had borrowings of \$150 million under its revolving line of credit. The amount drawn was used for general corporate purposes.

Other Subsidiaries

During the past three years, SunCor funded its cash requirements with cash from operations and its own external financings. SunCor's capital needs consist primarily of capital expenditures for land development and retail and office building construction. See the capital expenditures table above for actual capital expenditures during the nine months ended September 30, 2007 and projected capital

expenditures for the next three years. SunCor expects to fund its future capital requirements with cash from operations and external financings.

SunCor entered into a secured construction loan on April 13, 2007, in the amount of \$60 million, of which \$35 million was outstanding at September 30, 2007. The loan matures on April 19, 2009, and may be extended one year if certain conditions are met.

On July 31, 2007, SunCor borrowed \$12 million under a new secured construction loan. The loan matures on July 31, 2009, and may be extended annually up to two years.

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 expects minimal capital expenditures over the next three years.

See "Overview" above and Note 4 for discussion of Pinnacle West Marketing & Trading, the Company's marketing and trading subsidiary, which began activity in February 2007.

Debt Provisions

Pinnacle West's and APS' debt covenants related to their respective bank financing arrangements include 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 September 30, 2007, the ratio was approximately 49% for Pinnacle West and 46% for APS. The provisions regarding interest coverage require a minimum cash coverage of two times the interest requirements for APS. The interest coverage was approximately 4.8 times under APS' bank financing agreements as of September 30, 2007. 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, in the event of a rating downgrade, Pinnacle West and/or APS may be subject to increased interest costs under certain financing agreements.

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 revolver borrowings.

See Note 4 for further discussions.

Credit Ratings

The ratings of securities of Pinnacle West and APS as of November 2, 2007 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 access to capital. It may also require additional collateral related to certain derivative instruments (see Note 10).

	<u>Moody's</u>	<u>Standard & Poor's</u>	<u>Fitch</u>
Pinnacle West			
Senior unsecured (a)	Baa3 (P)	BB+ (prelim)	N/A
Commercial paper	P-3	A-3	F-3
Outlook	Negative	Stable	Stable
APS			
Senior unsecured	Baa2	BBB-	BBB
Secured lease obligation bonds	Baa2	BBB-	BBB
Commercial paper	P-2	A-3	F-2
Outlook	Negative	Stable	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 assigns a provisional (P) rating and Standard & Poor's assigns a preliminary (prelim) rating to the senior unsecured securities that can be issued under such shelf registration.

Off-Balance Sheet Arrangements

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 September 30, 2007, APS would have been required to assume approximately \$208 million of debt and pay the equity participants approximately \$174 million.

Guarantees and Letters of Credit

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 APSES 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. 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 15 for additional information regarding guarantees and letters of credit.

Contractual Obligations

Our future contractual obligations have not changed materially from the amounts disclosed in Part II, Item 7 of the 2006 Form 10-K, with the exception of our aggregate fuel and purchased power commitments, which increased from approximately \$2.6 billion at December 31, 2006 to \$3.5 billion at September 30, 2007 as follows (dollars in billions):

2007	2008-2009	2010-2011	Thereafter	Total
\$0.5	\$0.7	\$0.5	\$1.8	\$3.5

See Note 4 for a list of payments due on total long-term debt and capitalized lease requirements.

Given our adoption of FIN 48, we are now required to include uncertain tax positions in our contractual obligations disclosure. As of September 30, 2007, we have uncertain tax positions of approximately \$210 million and we expect a majority of these positions to be settled within the next twelve months. See Note 8 for additional information.

CRITICAL ACCOUNTING POLICIES

In preparing the financial statements in accordance with GAAP, management must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex and actual results could differ from those estimates. Our most critical accounting policies include the impacts of regulatory accounting, the determination of the appropriate accounting for our pension and other postretirement benefits and derivatives accounting. There have been no changes to our critical accounting policies since our 2006 Form 10-K. See "Critical Accounting Policies" in Item 7 of the 2006 Form 10-K for further details about our critical accounting policies.

OTHER ACCOUNTING MATTERS

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 and preparing for the new disclosure requirements.

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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.

In April 2007, the FASB issued FASB Staff Position No. FIN 39-1, “Amendment of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts” (FSP FIN 39-1). Under FSP FIN 39-1, a reporting entity is permitted to offset the fair value amounts recognized for cash collateral paid or cash collateral received against the fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement. This new guidance is effective for us on January 1, 2008, with early application permitted. We are currently evaluating the impacts of FSP FIN 39-1 on our balance sheet. We do not expect the guidance to have an impact on our results of operations or cash flows.

PINNACLE WEST CONSOLIDATED — FACTORS AFFECTING OUR FINANCIAL OUTLOOK

Factors Affecting Operating Revenues, Fuel and Purchased Power Costs

General Electric operating revenues are derived from sales of electricity in regulated retail markets in Arizona and from competitive retail and wholesale power markets in the western United States. For the years 2004 through 2006, retail electric revenues comprised approximately 82% of our total electric operating revenues. Our electric operating revenues are affected by electricity sales volumes related to customer mix, customer growth, average usage per customer, electricity rates and tariffs, variations in weather from period to period, and amortization of PSA deferrals. Competitive retail sales of energy and energy-related products and services are made by APSES in certain western states that have opened to competition. 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 demand and prices. Competitive wholesale transactions are made by the marketing and trading group through structured trading opportunities involving matched sales and purchases of commodities.

Retail Rate Proceedings The ACC regulates APS’ retail electric rates. Our profitability is affected by the rates APS may charge and the timely recovery of costs through those rates. APS’ capital expenditure requirements, which are discussed above under “Liquidity and Capital Resources,” are substantial because of the significant customer growth in APS’ service territory, highlighting APS’ need for the timely recovery of these and other expenditures through rates. As discussed in greater detail in Note 5, on June 28, 2007, the ACC issued an order in a general rate case that APS filed in late 2005. Additionally, the ACC directed the ACC staff to conduct a “prudence audit” of 2006 Palo Verde outage costs. Virtually all of the deferrals related to these 2006 outage costs were associated with a Unit 1 vibration issue. On October 4, 2007, the ACC staff filed a report with the ACC that concludes that APS’ response to the Unit 1 vibration issue was “reasonable and prudent.” APS continues to believe that these

costs were prudently incurred and that the 2006 Deferrals, totaling approximately \$79 million, are, therefore, recoverable.

Fuel and Purchased Power Costs Fuel and purchased power costs included on our income statements 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, since April 1, 2005, PSA deferrals and the amortization thereof. See “PSA Modifications” and “PSA Deferrals Related to Palo Verde Outages” in Note 5 for information regarding the PSA, including the 2006 Deferrals. APS’ recovery of PSA deferrals from its ratepayers is subject to annual PSA adjustments and, if necessary, periodic surcharge applications.

Customer and Sales Growth The customer and sales growth referred to in this paragraph applies to Native Load customers and sales to them. Customer growth in APS’ service territory for the nine-month period ended September 30, 2007 was 3.5% compared with the prior-year period. Customer growth averaged 4.1% a year for the three years 2004 through 2006, and we currently expect customer growth to average about 3.0% per year from 2007 to 2009. For the three years 2004 through 2006, APS’ actual retail electricity sales in kilowatt-hours grew at an average rate of 4.2%; adjusted to exclude effects of weather variations, such retail sales growth averaged 4.6% a year. We currently estimate that total retail electricity sales in kilowatt-hours will grow 2.8% on average, during 2007 through 2009, before excluding the effects of weather variations. We currently expect our retail sales growth in 2007 to be below average because of potential effects on customer growth and usage from the slowdown in the residential housing market and retail rate increases (see Note 5).

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 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 can result in increases or decreases in annual net income of up to \$10 million.

Weather In forecasting retail sales growth, 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.

Wholesale Market Our marketing and trading activities focus primarily on managing APS’ risks relating to fuel and purchased power costs in connection with its costs of serving Native Load customer demand. Our marketing and trading activities include, subject to specified parameters, marketing, hedging and trading in electricity, fuels and emission allowances and credits. See “FERC Rate Case” in Note 5 for information regarding APS’ recent filing with the FERC requesting an increase in transmission rates.

Other Factors Affecting Financial Results

Operations and Maintenance Expenses Operations and maintenance expenses are impacted by growth, power plant additions and operations, inflation, outages, higher-trending pension and other postretirement benefit costs and other factors.

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Depreciation and Amortization Expenses Depreciation and amortization expenses are impacted by net additions to utility plant and other property, which include generation construction, changes in depreciation and amortization rates, and changes in regulatory asset amortization.

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, assessed valuation ratios, and tax rates. The average property tax rate for APS, which currently owns the majority of our property, was 8.9% of assessed value for 2006 and 9.2% for 2005. We expect property taxes to increase as new power plants and additions to our transmission and distribution facilities are included in the property tax base.

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

Retail Competition Although some very limited retail competition existed in Arizona in 1999 and 2000, there are currently no active retail electric service providers providing unbundled energy or other utility services to APS' customers. We cannot predict when, and the extent to which, additional electric service providers will re-enter APS' service territory.

Subsidiaries SunCor's net income was \$61 million in 2006, \$56 million in 2005, and \$45 million in 2004. See Note 17 for further discussion. We currently expect SunCor's net income in 2007 to be approximately \$20 million. This estimate reflects the continued slowdown in the western United States real estate markets, as well as deteriorating credit markets in the second half of 2007.

APSES' and El Dorado's historical results are not indicative of future performance.

General Our financial results may be affected by a number of broad factors. See "Forward-Looking Statements" below for further information on such factors, which may cause our actual future results to differ from those we currently seek or anticipate.

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. 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.

Commodity Price Risk

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas and emissions allowances. Our ERMC, consisting of officers and key management personnel, oversees company-wide energy risk management activities and monitors the

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results of marketing and trading activities to ensure compliance with our stated energy risk management and trading 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, fuels and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities. In addition, subject to specified risk parameters monitored by the ERMC, we engage in marketing and trading activities intended to profit from market price movements.

The mark-to-market value of derivative instruments related to our risk management and trading activities are presented in two categories:

- Regulated Electricity — non-trading derivative instruments that hedge our purchases and sales of electricity and fuel for APS' Native Load requirements of our regulated electricity business segment; and
- Marketing and Trading — non-trading and trading derivative instruments of our competitive business activities.

The following tables show the pretax changes in mark-to-market value of our non-trading and trading derivative positions for the nine months ended September 30, 2007 and 2006 (dollars in millions):

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	Nine Months Ended September 30, 2007		Nine Months Ended September 30, 2006	
	Regulated Electricity	Marketing and Trading	Regulated Electricity	Marketing and Trading
Mark-to-market of net positions at beginning of period	\$ (62)	\$ 77	\$ 335	\$ 181
Recognized in earnings:				
Change in mark-to-market gains (losses) for future period deliveries	1	(8)	(9)	(3)
Mark-to-market gains realized including ineffectiveness during the period	(1)	(12)	(3)	(2)
Decrease (increase) in regulatory asset	28	—	(76)	—
Recognized in OCI:				
Change in mark-to-market for future period deliveries — losses (a)	(11)	(4)	(277)	(66)
Mark-to-market (gains) losses realized during the period	18	(19)	1	(17)
Change in valuation techniques	—	—	—	—
Mark-to-market of net positions at end of period	<u>\$ (27)</u>	<u>\$ 34</u>	<u>\$ (29)</u>	<u>\$ 93</u>

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

The tables below show the fair value of maturities of our non-trading and trading derivative contracts (dollars in millions) at September 30, 2007 by maturities and by the type of valuation that is performed to calculate the fair values. See Note 1, “Derivative Accounting,” in Item 8 of our 2006 Form 10-K for more discussion of our valuation methods.

Regulated Electricity

Source of Fair Value	2007	2008	2009	2010	Years thereafter	Total fair value
Prices actively quoted	\$ (13)	\$ (12)	\$ 2	\$ 3	\$ —	\$ (20)
Prices provided by other external sources	—	(8)	(4)	(3)	—	(15)
Prices based on models and other valuation methods	—	(2)	(3)	(2)	15	8
Total by maturity	<u>\$ (13)</u>	<u>\$ (22)</u>	<u>\$ (5)</u>	<u>\$ (2)</u>	<u>\$ 15</u>	<u>\$ (27)</u>

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Marketing and Trading

Source of Fair Value	2007	2008	2009	2010	2011	Years thereafter	Total fair value
Prices actively quoted	\$ 9	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 9
Prices provided by other external sources	—	20	—	—	3	2	25
Prices based on models and other valuation methods	—	—	—	—	—	—	—
Total by maturity	<u>\$ 9</u>	<u>\$ 20</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 3</u>	<u>\$ 2</u>	<u>\$ 34</u>

The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management and trading assets and liabilities included on Pinnacle West's Condensed Consolidated Balance Sheets at September 30, 2007 and December 31, 2006 (dollars in millions):

Mark-to-market changes reported in:	September 30, 2007 Gain (Loss)		December 31, 2006 Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Earnings				
Electricity	\$ 4	\$ (4)	\$ —	\$ —
Natural gas	3	(3)	—	—
Regulatory asset (liability) or OCI (a)(b)				
Electricity	44	(44)	38	(38)
Natural gas	76	(76)	80	(80)
Total	<u>\$ 127</u>	<u>\$ (127)</u>	<u>\$ 118</u>	<u>\$ (118)</u>

- (a) To the extent the amounts are eligible for inclusion in the PSA, the amounts are recorded as either a regulatory asset or liability.
- (b) 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.

Credit Risk

We are exposed to losses in the event of non-performance or non-payment by counterparties. See Note 1, "Derivative Accounting" in Item 8 of our 2006 Form 10-K for a discussion of our credit valuation adjustment policy. See Note 10 for further discussion of credit risk.

ARIZONA PUBLIC SERVICE COMPANY – RESULTS OF OPERATIONS

Regulatory Matters

See “Pinnacle West Consolidated – Results of Operations — Regulatory Matters” above for information about the ACC’s order in APS’ general retail rate case and the PSA.

Operating Results – Three-month period ended September 30, 2007 compared with three-month period ended September 30, 2006

APS’ net income for the three months ended September 30, 2007 was \$204 million compared with \$168 million for the comparable prior-year period. The \$36 million increase was primarily due to the effects of hotter weather on retail sales; higher retail sales primarily due to customer growth and usage patterns; impacts of the retail rate increase (see Note 5); and income tax benefits related to prior years resolved in 2007. These positive factors were partially offset by higher operations and maintenance expense primarily for customer service and regulatory programs and increased costs for generation, including the Palo Verde performance improvement plan. In addition, higher fuel and purchased power costs related to commodity price increases were offset by the deferral of such costs in accordance with the PSA. See Note 5 for further discussion.

Additional details on the major factors that increased (decreased) net income for the three-month period ended September 30, 2007 compared with the same period in 2006 are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Effects of hotter weather on retail sales	\$ 27	\$ 16
Higher retail sales primarily due to customer growth and usage patterns, excluding weather effects	17	10
Impacts of retail rate increase (see Note 5):		
Revenue increase related to higher Base Fuel Rate	114	70
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(103)	(63)
Non-fuel rate increase	5	3
Net changes in fuel and purchased power costs related to prices:		
Higher fuel and purchased power costs due to increased prices	(39)	(24)
Increased deferred fuel and purchased power costs related to increased prices	37	23
Operations and maintenance increases primarily due to:		
Customer service costs and regulatory programs	(10)	(6)
Increased generation costs, including Palo Verde performance improvement plan	(6)	(4)
Income tax benefits related to prior years resolved in 2007	—	10
Other miscellaneous items, net	(1)	1
Increase in net income	<u>\$ 41</u>	<u>\$ 36</u>

Regulated Electricity Revenues

Regulated electricity revenues were \$157 million higher for the three months ended September 30, 2007 compared with the prior-year period primarily because of:

- a \$119 million increase in retail revenues due to retail rate increase effective July 1, 2007;
- a \$36 million increase in retail revenues due to the effects of hotter weather;
- a \$22 million increase in retail revenues primarily related to customer growth and usage patterns, excluding weather effects;
- a \$16 million increase in Off-System Sales due to higher prices and volumes;
- a \$44 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense (see Note 5); and
- an \$8 million net increase due to miscellaneous factors.

Operating Results – Nine-month period ended September 30, 2007 compared with nine-month period ended September 30, 2006

APS' net income for the nine months ended September 30, 2007 was \$284 million compared with \$257 million for the comparable prior-year period. The \$27 million increase was primarily due to higher retail sales primarily due to customer growth and usage patterns; the effects of weather on retail sales; impacts of the retail rate increase; and income tax benefits related to prior years resolved in 2007. These positive factors were partially offset by higher operations and maintenance expense primarily due to increased generation costs, including the Palo Verde performance improvement plan and customer service and regulatory programs; income tax credits related to prior years resolved in 2006; lower other income, net of expense, primarily due to miscellaneous asset sales in the prior-year period and lower interest income as a result of lower investment balances; and a regulatory disallowance. In addition, higher fuel and purchased power costs related to commodity price increases were partially offset by the deferral of such costs in accordance with the PSA. See Note 5 for further discussion.

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Additional details on the major factors that increased (decreased) net income for the nine-month period ended September 30, 2007 compared with the same period in 2006 are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Higher retail sales primarily due to customer growth and usage patterns, excluding weather effects	\$ 37	\$ 23
Effects of weather on retail sales	33	20
Impacts of retail rate increase (see Note 5):		
Revenue increase related to higher Base Fuel Rate	114	70
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(103)	(63)
Non-fuel rate increase	5	3
Net changes in fuel and purchased power costs related to price:		
Higher fuel and purchased power costs due to increased prices	(80)	(49)
Increased deferred fuel and purchased power costs related to increased prices	75	46
Regulatory disallowance (see "Regulatory Matters" above)	(14)	(8)
Operations and maintenance increases primarily due to:		
Increased generation costs, including the Palo Verde performance improvement plan	(8)	(5)
Customer service costs and regulatory programs	(7)	(4)
Higher depreciation and amortization primarily due to increased plant balances	(8)	(5)
Lower other income, net of expense, primarily due to lower interest income as a result of lower investment balances and miscellaneous asset sales in the prior-year period	(10)	(6)
Income tax benefits related to prior years resolved in 2007	—	11
Income tax credits related to prior years resolved in 2006	—	(7)
Other miscellaneous items, net	2	1
Increase in net income	<u>\$ 36</u>	<u>\$ 27</u>

Regulated Electricity Revenues

Regulated electricity revenues were \$225 million higher for the nine months ended September 30, 2007 compared with the prior-year period primarily because of:

- a \$119 million increase in retail revenues due to retail rate increase effective July 1, 2007;
- a \$49 million increase in retail revenues primarily related to customer growth and usage patterns, excluding weather effects;
- a \$45 million increase in retail revenues due to the effects of weather; and
- a \$12 million net increase due to miscellaneous factors.

LIQUIDITY AND CAPITAL RESOURCES – Arizona Public Service Company

Operating Cash Flows

Net cash provided by operating activities was \$561 million for the nine months ended September 30, 2007, compared to \$286 million for the same period in 2006, an increase in cash provided of \$276 million. This change was primarily due to the 2006 return of cash collateral and margin cash held as a result of changes in commodity prices.

Investing Cash Flows

Net cash used for investing activities was \$667 million for the nine months ended September 30, 2007, compared to \$694 million for the same period in 2006, a decrease in cash used of \$27 million. This change was primarily due to:

- An approximate \$236 million decrease in APS' invested position. In 2006, we issued long-term debt and invested some of the proceeds in short-term investment securities until they were later redeemed and the cash used for general corporate purposes; partially offset by
- An approximate \$201 million increase in capital expenditures. See "capital expenditures" chart, Liquidity and Capital Resources — Pinnacle West Consolidated.

Financing Cash Flows and Liquidity

Net cash provided by financing activities was \$61 million for the nine months ended September 30, 2007, compared to \$476 million for the same period in 2006, a decrease in cash provided of \$415 million. This change was primarily due to:

- An approximate \$394 million decrease due to the issuance of approximately \$393 million of new long-term debt, net of redemptions, in order to fund our construction program and for other general corporate purposes. During the first nine months of 2007, APS has not issued any new long-term debt.
- An approximate \$170 million decrease due to decreased equity infusions from Pinnacle West; and
- An approximate \$150 million increase in short-term borrowings to fund day-to-day operations and liquidity needs.

For additional discussion see "LIQUIDITY AND CAPITAL RESOURCES – Pinnacle West Consolidated."

Contractual Obligations

APS' future contractual obligations have not changed materially from the amounts disclosed in Part II, Item 7 of the 2006 Form 10-K, with the exception of our aggregate fuel and purchased power commitments, which increased from approximately \$2.5 billion at December 31, 2006 to \$3.4 billion at September 30, 2007 as follows (dollars in billions):

<u>2007</u>	<u>2008-2009</u>	<u>2010-2011</u>	<u>Thereafter</u>	<u>Total</u>
\$0.4	\$0.7	\$0.5	\$1.8	\$3.4

See Note 4 for a list of APS' payments due on total long-term debt and capitalized lease requirements.

Given our adoption of FIN 48, APS is now required to include uncertain tax positions in the contractual obligations disclosure. As of September 30, 2007, APS has uncertain tax positions of approximately \$204 million and expects a majority of these positions will be settled within the next twelve months. See Note 8 for additional information.

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 or make any further statements on any of these issues, except as required by applicable law. These forward-looking statements are often identified by words such as "estimate," "predict," "hope," "may," "believe," "anticipate," "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 results or outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Item 1A of the 2006 Form 10-K, these factors include, but are not limited to:

- state and federal regulatory and legislative decisions and actions, particularly those affecting our rates and our recovery of fuel and purchased power costs;
- the ongoing restructuring of the electric industry, including the introduction of retail electric competition in Arizona and decisions impacting wholesale competition;
- the outcome of regulatory, legislative and judicial proceedings, both current and future, relating to the restructuring and environmental matters (including those relating to climate change);
- market prices for electricity and natural gas;
- power plant performance and outages;
- transmission outages and constraints;
- weather variations affecting local and regional customer energy usage;
- customer growth and energy usage;
- regional economic and market conditions, including the results of litigation and other proceedings resulting from the California energy situation, volatile fuel and purchased power costs and the completion of generation and transmission construction in the region, which could affect customer growth and the cost of power supplies;
- the cost of debt and equity capital and access to capital markets;
- current credit ratings remaining in effect for any given period of time;

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- our ability to compete successfully outside traditional regulated markets (including the wholesale market);
- the performance of our marketing and trading activities due to volatile market liquidity and any deteriorating counterparty credit and the use of derivative contracts in our business (including the interpretation of the subjective and complex accounting rules related to these contracts);
- changes in accounting principles generally accepted in the United States of America and the interpretation of those principles;
- the performance of the stock market and the changing interest rate environment, which affect the value of our nuclear decommissioning trust, pension, and other postretirement benefit plan assets, the amount of required contributions to Pinnacle West's pension plan and contributions to APS' nuclear decommissioning trust funds, as well as the reported costs of providing pension and other postretirement benefits;
- technological developments in the electric industry;
- the strength of the real estate market in SunCor's market areas, which include Arizona, Idaho, New Mexico and Utah; and
- other uncertainties, all of which are difficult to predict and many of which are beyond the control of Pinnacle West and APS.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See “Pinnacle West Consolidated – Factors Affecting Our Financial Outlook” 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 September 30, 2007. 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 September 30, 2007. 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 September 30, 2007 that materially affected, or is reasonably likely to materially affect, Pinnacle West’s or APS’ internal control over financial reporting.

Part II — OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

See Note 12 in regard to pending or threatened litigation or other disputes. See also “Federal Implementation Plan – Four Corners FIP” under Item 5 below.

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 2006 Form 10-K, which could materially affect the business, financial condition, cash flows or future results of APS and Pinnacle West. The risks described in the 2006 Form 10-K are not the only risks facing APS and Pinnacle West. 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 APS and Pinnacle West.

Item 5. OTHER INFORMATION

Construction and Financing Programs

See “Liquidity and Capital Resources” in Part I, Item 2 of this report for a discussion of construction and financing programs of the Company and its subsidiaries.

Regulatory Matters

See Note 5 for a discussion of regulatory developments.

Environmental Matters

See “Environmental Matters – Superfund” in Note 12 for a discussion of a Superfund site.

Regional Haze Rules

On April 22, 1999, the EPA announced final regional haze rules. These regulations require states to submit state implementation plans (SIPs) by December 2007 to demonstrate “reasonable progress” towards achieving natural visibility conditions in certain “Class I Areas,” including several on the Colorado Plateau. The SIP is required to consider and potentially apply “best available retrofit technology” (BART) for certain older major stationary sources. The rules allow nine western states and Indian tribes to follow an alternate implementation plan and schedule for the Class I Areas. This alternate implementation plan is known as the Annex Rule.

On June 15, 2005, the EPA issued the Clean Air Visibility Rule, which amends the 1999 regional haze rules by providing guidelines, known as the BART guidelines, for states to use in determining which facilities must install controls and the type of controls the facilities must use. The EPA also issued a Revised Annex Rule on October 13, 2006 to address a previous challenge and court remand of that rule.

ADEQ is currently undertaking a rulemaking process to amend its SIP to reconcile it with the Revised Annex Rule and to implement the Clean Air Visibility Rule requirements. ADEQ’s Regional Haze SIPs are due to EPA Region 9 in December 2007. As part of the rulemaking process, ADEQ will

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require certain sources in the state to conduct BART analyses. Cholla and West Phoenix received letters from ADEQ asserting that the plants are potentially subject to BART and requesting that we either perform a BART analysis on each plant or provide information demonstrating that we are not subject to BART. We are currently performing a BART analysis for Cholla and expect to complete and submit it to ADEQ by the end of December 2007. Because we believe that ADEQ made several errors in its baseline modeling for West Phoenix, we re-performed the baseline modeling using correct input and have determined that West Phoenix is not subject to BART. We submitted these findings for West Phoenix to ADEQ and are awaiting its response. In addition, EPA Region 9 has requested us to perform a BART analysis for Four Corners. We are performing that analysis and expect to submit it to the EPA by the end of November 2007.

Once the analyses and BART recommendations for Cholla and Four Corners are submitted to ADEQ and the EPA respectively, the agencies will review the submissions and determine what, if anything, constitutes BART for the plants and will incorporate those determinations into implementation plans for the plants. We expect to receive the agencies' final determinations in 2008. Implementation of any such recommendations would likely occur over a five-year period. While we continue to monitor this matter, at the present time we cannot predict the outcome of our BART analyses, the nature of the BART controls, if any, the agencies may mandate, or the resulting financial or operational impact.

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 Generating Station. On September 12, 2006, the EPA proposed revised FIPs to establish air quality standards at both of these plants.

Four Corners FIP

On April 30, 2007, the EPA adopted a source specific FIP to set air quality standards at Four Corners. See "Environmental Regulation – Federal Implementation Plan" in Part 1, Item 1 of the 2006 Form 10-K for additional information regarding the procedural and litigation issues leading to the EPA's adoption of the FIP. The FIP essentially federalizes the requirements contained in the New Mexico State Implementation Plan, which Four Corners has historically followed. The FIP also includes a requirement to maintain and enhance dust suppression methods. On July 2, 2007, APS filed a petition for review in the United States District Court of Appeals for the Tenth Circuit seeking revisions to the FIP to clarify certain requirements and allow operational flexibility. The Sierra Club has intervened in this action. On July 6, 2007, the Sierra Club and other parties filed a petition for review with the same court challenging the FIP's compliance with the Clean Air Act and we have intervened in their action. Although we cannot predict the outcome of these matters, we do not believe that they will have a material adverse impact on our financial position, results of operations or cash flows.

Navajo Generating Station FIP

The proposed FIP for the Navajo Generating Station is still pending. APS cannot currently predict the effect of this proposed FIP on the Company's financial position, results of operations or cash flows, or whether the proposed FIP will be adopted in its current form.

Climate Change Initiative

On February 26, 2007, five western states (Arizona, California, New Mexico, Oregon and Washington) entered into an accord, called the Western Regional Climate Action Initiative, later

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renamed the Western Climate Initiative (the “Initiative”), to reduce greenhouse gas emissions from automobiles and certain industries, including utilities. Since then, Utah, British Columbia and Manitoba have joined the Initiative. In August 2007, the Initiative participants set a goal of reducing greenhouse gas emissions 15% below 2005 levels by 2020. By August 2008, the Initiative participants intend to develop a plan for implementation of this goal. Any such implementation would require independent action by each individual state’s (or province’s) legislature or Governor to adopt a version of the plan. The Company is currently developing a climate change management plan to address these and related issues. While we continue to monitor the impact of the Initiative, at the present time we cannot predict what form it will ultimately take, whether it will be implemented or, if it is implemented, what impact it will have on our operations.

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Item 6. EXHIBITS

(a) Exhibits

<i>Exhibit No.</i>	<i>Registrant(s)</i>	<i>Description</i>
10.1 ^a	Pinnacle West	Description of Annual Stock Grants to Non-Employee Directors
10.2 ^a	Pinnacle West	Description of Stock Grant to W. Douglas Parker
10.3 ^a	Pinnacle West APS	Form of Key Executive Employment and Severance Agreement between Pinnacle West and certain officers of Pinnacle West and its subsidiaries
10.4 ^{ab}	Pinnacle West APS	Form of Amended and Restated Key Executive Employment and Severance Agreement between Pinnacle West and certain officers of Pinnacle West and its subsidiaries
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 William J. Post, 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 Donald E. Brandt, Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended

^a Management contract or compensatory plan or arrangement to be filed as an exhibit pursuant to Item 6 of Form 10-Q.

^b The Company has entered into identical Amended and Restated Key Executive Employment and Severance Agreements (“KEESAs”) with each of its executive officers.

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<i>Exhibit No.</i>	<i>Registrant(s)</i>	<i>Description</i>
31.3	APS	Certificate of Jack E. Davis, 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 Donald E. Brandt, 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 1850, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	APS	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1850, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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In addition, the Company 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:

<u>Exhibit No.</u>	<u>Registrant(s)</u>	<u>Description</u>	<u>Previously Filed as Exhibit ¹</u>	<u>Date Filed</u>
3.1	Pinnacle West	Articles of Incorporation, restated as of May 23, 2007	4.1 to Pinnacle West/APS May 23, 2007 Form 8-K Report, File Nos. 1-8962 and 1-4473	5-25-07
3.2	Pinnacle West	Pinnacle West Capital Corporation Bylaws, amended as of May 23, 2007	4.2 to Pinnacle West/APS May 23, 2007 Form 8-K Report, File Nos. 1-8962 and 1-4473	5-25-07
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 June 23, 2004	3.1 to APS' June 30, 2004 Form 10-Q Report, File No. 1-4473	8-9-04

¹ 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.

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: November 5, 2007

By: /s/ Donald E. Brandt
Donald E. Brandt
Executive Vice President and Chief
Financial Officer
(Principal Financial Officer
and Officer Duly Authorized to sign this Report)

ARIZONA PUBLIC SERVICE COMPANY
(Registrant)

Dated: November 5, 2007

By: /s/ Donald E. Brandt
Donald E. Brandt
President and Chief Financial Officer
(Principal Financial Officer and
Officer Duly Authorized to sign this Report)

Description of Annual Stock Grants to Non-Employee Directors

From 2000 through 2006, Pinnacle West's non-employee directors of Pinnacle West Capital Corporation ("Pinnacle West") received annual grants of Pinnacle West common stock under the Pinnacle West Capital Corporation 2000 Director Equity Plan (the "2000 Plan"). As a result of Pinnacle West shareholder approval of the Pinnacle West Capital Corporation 2007 Long-Term Incentive Plan (the "2007 Plan") at the 2007 Annual Meeting of Shareholders, shares are no longer available for issuance under the 2000 Plan. Rather, as disclosed in Pinnacle West's 2007 proxy statement, annual common stock grants to non-employee directors will now be made under the 2007 Plan. The Human Resources Committee of Pinnacle West's Board of Directors approved annual grants of Pinnacle West common stock to non-employee directors under the 2007 Plan identical to the grants previously made under the 2000 Plan, as follows:

Each Pinnacle West non-employee director will annually receive 1,100 shares of Pinnacle West common stock under the 2007 Plan on the first business day of July, beginning July 2, 2007, subject to the following restrictions: In the first calendar year in which a non-employee director is eligible to participate in the 2007 Plan, he or she must own at least 900 shares of Pinnacle West's common stock as of December 31 of the same calendar year to receive a grant of 1,100 shares of Pinnacle West common stock. If the non-employee director owns 900 shares of common stock as of June 30, he or she will receive a grant of 1,100 shares of common stock on the first business day of July of the same calendar year. If the non-employee director does not own 900 shares of Pinnacle West's common stock as of June 30 in the first calendar year in which the non-employee director is eligible to participate in the 2007 Plan, but acquires the necessary shares on or before December 31 of the same year, he or she will receive a grant of 1,100 shares of common stock within a reasonable time after Pinnacle West verifies that the requisite number of shares has been acquired. In each subsequent year, the number of shares of Pinnacle West's common stock the non-employee director must own to receive a grant of 1,100 shares of common stock will increase by 900 shares, until reaching a maximum of 4,500 shares. In each of the subsequent years, the non-employee director must own the requisite number of shares of Pinnacle West's common stock as of June 30 of the relevant calendar year.

Description of Stock Grant to W. Douglas Parker

On October 17, 2007, W. Douglas Parker was appointed as a director of Pinnacle West Capital Corporation (“Pinnacle West”), effective November 1, 2007. Under the Pinnacle West Capital Corporation 2007 Long-Term Incentive Plan (the “2007 Plan”), the Human Resources Committee of Pinnacle West’s Board of Directors approved a grant of 1,100 shares of Pinnacle West common stock to Mr. Parker, effective November 1, 2007. Pinnacle West’s non-employee directors are also eligible to receive an annual common stock grant under the 2007 Plan. As a condition to Mr. Parker being eligible to receive the 2008 annual common stock grant to non-employee directors, Mr. Parker must own at least 900 shares of Pinnacle West common stock on June 30, 2008 (which may include shares of Pinnacle West common stock to be received by Mr. Parker on November 1, 2007). Mr. Parker’s annual stock ownership requirement in connection with the annual common stock grant will increase by 900 shares per year thereafter (e.g., Mr. Parker must own at least 1,800 shares of Pinnacle West common stock on June 30, 2009 to be eligible for the 2009 annual common stock grant).

KEY EXECUTIVE EMPLOYMENT AND SEVERANCE AGREEMENT

THIS AGREEMENT, made and entered into as of the ___day of _____, 2007, by and between Pinnacle West Capital Corporation, an Arizona corporation (hereinafter referred to as the "Company") and _____(hereinafter referred to as the "Executive"):

WITNESSETH

WHEREAS, the Executive is employed by the Company, in an executive capacity, possesses intimate knowledge of the business and affairs of the Company, and has acquired certain confidential information and data with respect to the Company;

WHEREAS, the Company desires to insure, insofar as possible, that the Company will continue to have the benefit of the Executive's services and to protect the confidential information and goodwill of the Company; and

WHEREAS, the Company recognizes that circumstances may arise in which a change in the control of the Company or Arizona Public Service Company, a subsidiary of the Company, through acquisition or otherwise occurs thereby causing uncertainty of employment without regard to the Executive's competence or past contributions which uncertainty may result in the loss of valuable services of the Executive to the detriment of the Company and its shareholders, and the Company and the Executive wish to provide reasonable security to the Executive against changes in the Executive's relationship with the Company in the event of any such change in control; and

WHEREAS, both the Company and the Executive are desirous that a proposal for any change of control or acquisition will be considered by the Executive objectively and with reference only to the business interests of the Company and its shareholders;

WHEREAS, the Executive will be in a better position to consider the best interests of the Company if the Executive is afforded reasonable security, as provided in this Agreement, against altered conditions of employment which could result from any such change in control or acquisition; and

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

1. Definitions.

- (a) "Accrued Benefits" shall mean the benefits payable to the Executive as described in Section 6(a).
 - (b) "Act" shall mean the Securities Exchange Act of 1934.
-

(c) “Affiliate” shall mean (i) a corporation other than the Company that is a member of a “controlled group of corporations” (within the meaning of Section 414(b) of the Code as modified by Section 415(h) of the Code) or (ii) a group of trades or businesses under common control (within the meaning of Section 414(c) of the Code as modified by Section 415(h) of the Code) that also includes the Company as a member. For purposes of determining whether a transaction or event constitutes a Change of Control within the meaning of Section 1(g), “Affiliate” status shall be determined on the day immediately preceding the date of the transaction or event.

(d) “APS” shall mean Arizona Public Service Company, a subsidiary of the Company.

(e) “Beneficial Owner” shall have the same meaning as given to that term in Rule 13d-3 of the General Rules and Regulations of the Act, provided that any pledgee of the voting securities of the Company or APS shall not be deemed to be the Beneficial Owner thereof prior to its disposition of, or acquisition of voting rights with respect to, such securities.

(f) “Cause” shall be limited to (i) the engaging by the Executive in conduct which has caused demonstrable and serious injury to the Employer, monetary or otherwise, as evidenced by a determination in a binding and final judgment, order or decree of a court or administrative agency of competent jurisdiction, in effect after exhaustion or lapse of all rights of appeal, in an action, suit or proceeding, whether civil, criminal, administrative or investigative, other than an action, suit or proceeding, brought by the Company or an Affiliate, the purpose of which is to establish “Cause” under this Agreement; (ii) conviction of a felony, as evidenced by a binding and final judgment, order or decree of a court of competent jurisdiction, in effect after exhaustion or lapse of all rights of appeal, which the Employer determines has a significant adverse impact on it in the conduct of its business; or (iii) unreasonable neglect or refusal by the Executive to perform the Executive’s duties or responsibilities (unless significantly changed without the Executive’s consent).

(g) “Change of Control” shall mean one (1) or more of the following events:

(i) Any Person, other than an Affiliate, through a transaction or series of transactions, is or becomes the Beneficial Owner, directly or indirectly, of securities of the Company or APS representing twenty percent (20%) or more of the combined voting power of the then outstanding securities of the Company or APS, as the case may be; *provided, however*, that, for purposes of this Section 1(g), any acquisition directly from the Company shall not constitute a Change of Control;

(ii) A merger or consolidation of (A) the Company with any other corporation which would result in the voting securities of the Company

outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or any parent thereof), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company or an Affiliate, less than sixty percent (60%) of the combined voting power of the securities of the Company or such surviving entity or any parent thereof outstanding immediately after such merger or consolidation, or (B) APS with any other corporation which would result in the voting securities of APS outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or any parent thereof), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company or an Affiliate, less than sixty percent (60%) of the combined voting power of the securities of APS or such surviving entity or any parent thereof outstanding immediately after such merger or consolidation; provided that, for purposes of this subparagraph (ii), a merger or consolidation effected to implement a recapitalization of the Company or of APS (or similar transaction) in which no Person is or becomes the Beneficial Owner, directly or indirectly, of securities of the Company or of APS representing twenty percent (20%) or more of the combined voting power of the then outstanding securities of the Company or of APS (excluding any securities acquired by that Person directly from the Company or an Affiliate) shall not result in a Change of Control; or

(iii) The sale, transfer or other disposition of all or substantially all of the assets of either the Company or APS to a Person other than the Company or an Affiliate

(iv) Individuals who, as of July 31, 2007, constitute the board of directors of the Company (the "Company Incumbent Board") or of APS (the "APS Incumbent Board") cease for any reason to constitute at least two-thirds (2/3) of the members of the Company or APS board of directors, as the case may be; provided, however, that for purposes of this subparagraph (iv), (A)(1) any person becoming a member of the Company board of directors after July 31, 2007 whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least two-thirds (2/3) of the members then comprising the Company Incumbent Board will be, considered as though such person were a member of the Company Incumbent Board and (2) the Company Incumbent Board shall not include a director whose initial assumption of office as a director was in connection with an actual or threatened election contest relating to the election of directors, and (B) (1) any person becoming a member of the APS board of directors after July 31, 2007 whose election, or nomination for election by APS' shareholder(s), was approved by a vote of at least two-thirds (2/3) of the members then comprising the APS Incumbent Board or by the Company, as a majority shareholder of APS, considered

as though such person were a member of the APS Incumbent Board and (2) the APS Incumbent Board shall not include a director whose initial assumption of office as a director was in connection with an actual or threatened election contest relating to the election of directors.

(h) "Code" shall mean the Internal Revenue Code of 1986, as amended from time to time.

(i) "Disability" shall have the same meaning as given to that term in the applicable long-term disability plan maintained by the company or the Employer for employees.

(j) "Employer" shall mean the Company, and upon the transfer of the Executive to an Affiliate, "Employer" shall mean such Affiliate.

(k) "Employment Period" shall mean the period commencing on the date of a Change of Control and ending on the second anniversary of such date.

(l) "Excise Tax" shall mean the excise tax imposed by Section 4999 of the Code, together with any interest or penalties imposed with respect to such excise tax.

(m) "Good Reason" shall mean:

(i) A material diminution in Executive's compensation;

(ii) A material diminution in Executive's authority, duties, or responsibilities;

(iii) A material diminution in the authority, duties, or responsibilities of the supervisor to whom Executive is required to report, including a requirement that Executive report to a corporate officer or employee instead of reporting directly to the Board;

(iv) A material diminution in the budget over which Executive retains authority;

(v) A material change in the geographic location at which Executive must perform the service;

(vi) Any other action or inaction that constitutes a material breach by the Company of the Agreement.

(n) A "Payment" shall mean any payment or distribution in the nature of compensation (within the meaning of Section 280G(b)(2) of the Code) to or for the benefit of the Executive, whether paid or payable pursuant to this Agreement or otherwise.

(o) "Person" shall mean any individual, partnership, joint venture, association, trust, corporation or other entity (including a "group" as defined in Section 13(d)(3) of the Act), other than an employee benefit plan of the Company or an Affiliate or an entity organized, appointed or established pursuant to the terms of any such benefit plan.

(p) "Termination Date" shall mean, except as otherwise provided in Section 12, (i) the Executive's date of death; (ii) the date of the Executive's voluntary early retirement as agreed upon in writing by the Employer and the Executive; (iii) sixty (60) days after the delivery of the Notice of Termination terminating the Executive's employment on account of Disability pursuant to Section 9, unless the Executive returns full-time to the performance of his or her duties prior to the expiration of such period; (iv) the date of the Notice of Termination if the Executive's employment is terminated by the Executive voluntarily other than for Good Reason; and (v) sixty (60) days after the delivery of the Notice of Termination if the Executive's employment is terminated by the Employer (other than by reason of Disability) or by the Executive for Good Reason.

(q) "Termination Payment" shall mean the amount described in Section 6(b).

2. Impact on Employment. The Employer and the Executive shall retain the right to terminate the employment of the Executive at any time and for any reason prior to a Change of Control. If a Change of Control occurs when the Executive is employed by the Employer, the Employer will continue thereafter to employ the Executive during the Employment Period.

3. Duties. During the Employment Period, the Executive shall, in the same capacities and positions held by the Executive at the time of such Change of Control or in such other capacities and positions as may be agreed to by the Employer and the Executive in writing, devote the Executive's reasonable best efforts, attention and skill to the business and affairs of the Company, as such business and affairs now exist and as they may hereafter be conducted. The services which are to be performed by the Executive hereunder are to be rendered at an employment location which is not more than seventy-five (75) miles from the Executive's employment location on the date of the Change of Control, or in such other place or places as shall be mutually agreed upon in writing by the Executive and the Employer from time to time. The Executive shall not be required to be absent from such employment location for more than forty-five (45) consecutive days in any fiscal year without the Executive's consent.

4. Compensation. During the Employment Period, the Executive shall be compensated as follows:

(a) The Executive shall receive, at such intervals and in accordance with such standard policies as may be in effect on the date of the Change of Control, an annual salary not less than the Executive's annual salary as in effect

as of the date of the Change of Control, subject to adjustment as provided in Section 5;

(b) The Executive shall be reimbursed, at such intervals and in accordance with such standard policies as may be in effect on the date of the Change of Control, for any and all monies advanced in connection with the Executive's employment for reasonable and necessary expenses incurred by the Executive on behalf of the Employer, including travel expenses;

(c) The Executive shall be included to the extent eligible thereunder in any and all plans providing general benefits for the Employer's employees, including but not limited to, group life insurance, disability, medical, dental, pension, profit sharing, savings and stock bonus plans and be provided any and all other benefits and perquisites made available to other employees of comparable status and position, on the same terms and conditions as generally provided to employees of comparable status and position;

(d) The Executive shall receive annually not less than the amount of paid vacation and not fewer than the number of paid holidays received annually immediately prior to the Change of Control or such greater amount of paid vacation and number of paid holidays as may be made available annually to other employees of comparable status and position with the Employer; and

(e) The Executive shall be included in all plans providing special benefits to corporate officers, including but not limited to bonus, deferred compensation, incentive compensation, supplemental pension, stock option, stock appreciation, stock bonus and similar or comparable plans extended by the Company or the Employer from time to time to corporate officers, key employees and other employees of comparable status.

5. Annual Compensation Adjustments. During the Employment Period, the Board of Directors of the Employer, an appropriate committee of the Board or the President of the Employer, whichever is appropriate, shall consider and appraise, at least annually, the Executive's compensation. In determining such compensation, the Board, the appropriate committee thereof or the President, whichever is appropriate, shall consider the commensurate increases given to other corporate officers and key employees generally, the scope and success of the Employer's operations, the expansion of Executive's duties and the Executive's performance of his duties.

6. Payments Upon Termination.

(a) Accrued Benefits. For purposes of this Agreement, the Executive's Accrued Benefits shall include the following amounts: (i) all salary earned or accrued through the Termination Date; (ii) reimbursement for any and all monies advanced in connection with the Executive's employment for reasonable and necessary expenses incurred by the Executive through the Termination Date; (iii) a lump sum payment of the bonus or incentive compensation otherwise payable

to the Executive under the terms of any bonus or incentive compensation plan or plans for the year in which termination occurs; and (iv) all other payments and benefits to which the Executive may be entitled under the terms of any benefit plan of the Company or the Employer. Payment of Accrued Benefits shall be made promptly in accordance with the Employer's prevailing practice and the terms of any applicable benefit plans, contracts or arrangements.

(b) Termination Payment. For purposes of this Agreement, the Executive's Termination Payment shall be an amount equal to (i) plus (ii), multiplied by (iii), where

(i) Equals the Executive's rate of annual salary, as in effect on the date of the Change of Control and as increased thereafter from time to time pursuant to Section 5;

(ii) Equals the amount of the average annual dollar award paid (or payable but deferred by the Executive) to the Executive pursuant to the Employer's regular annual bonus plan or arrangement with respect to the four (4) years (or for such lesser number of years prior for which the Executive was eligible to earn such a bonus, and annualized in the case of any bonus earned and payable for a partial fiscal year) preceding the Termination Date which shall be determined by dividing the total dollar amount paid (or payable but deferred by the Executive) to the Executive under such plan or arrangement with respect to such number of years by four (4) (or for such lesser number of years prior to which the Executive was eligible to earn such a bonus, and annualized in the case of any bonus earned and payable for a partial fiscal year); and

(iii) Equals 2.99.

The Termination Payment shall be payable in a lump sum on the Executive's Termination Date. Such lump sum payment shall not be reduced by any present value or similar factor. The Executive shall not be required to mitigate the amount of such payment by securing other employment or otherwise and such payment shall not be reduced by reason of the Executive securing other employment or for any other reason, except as provided in Section 16.

7. Death. If the Executive shall die during the Employment Period, but after delivery of a Notice of Termination by the Company for reasons other than Cause or Disability or by the Executive for Good Reason, the Executive's employment shall terminate on his or her date of death and the Executive's estate shall be entitled to receive the Executive's Accrued Benefits as of the Termination Date and, subject to the provisions of this Agreement, to such Termination Payment as the Executive would have been entitled to had the Executive survived. All benefits payable on account of the Executive's employment or death under the Company's or Employer's employee benefits plans, programs or arrangements shall be paid or distributed in accordance with the terms of such plans, programs or arrangements. The Executive's death following deliv-

ery of the Notice of Termination shall not affect his or her Termination Date which shall be determined without regard to the Executive's death, subject to the provisions of Section 12.

If the Executive shall die during the Employment Period, but prior to the delivery of a Notice of Termination, the Executive's employment shall terminate and the Executive's estate, heirs and beneficiaries shall receive all the Executive's Accrued Benefits through the Termination Date and all benefits available to them under the Company's benefit plans as in effect on the Termination Date on account of the Executive's death.

8. Retirement . If, during the Employment Period, the Executive and the Employer shall execute an agreement providing for the voluntary retirement of the Executive from the Employer, the Executive shall receive only his or her Accrued Benefits through the Termination Date. Without limiting the generality of the foregoing, the Executive's resignation under this Agreement with or without Good Reason, shall in no way affect the Executive's ability to terminate employment by reason of the Executive's "retirement" under any of the Company's retirement or pension plans or to be eligible to receive benefits under any retirement or pension plan of the Company and its affiliates or substitute plans adopted by the Company or its successors, and any termination which otherwise qualifies as Good Reason shall be treated as such even if it is also a "retirement" for purposes of any such plan.

9. Termination for Disability . If the Executive has been absent from his or her duties hereunder on a full-time basis for five (5) consecutive months during the Employment Period on account of a Disability, the Employer may provide a Notice of Termination, which satisfies the requirements of Section 12, and the Executive's employment shall, for purposes of this Agreement, terminate sixty (60) days thereafter, unless the Executive returns to the performance of his or her duties on a full-time basis prior to the end of the sixty (60) day period. During the term of the Executive's Disability prior to his or her Termination Date, the Executive shall continue to participate in all compensation and benefit plans, programs and arrangements in which the Executive was entitled to participate immediately prior to his or her Disability in accordance with the terms and provisions of such plans, programs and arrangements. If the Executive's employment is terminated on account of the Executive's Disability, the Executive shall receive his or her Accrued Benefits in accordance with Section 6(a) hereof, provided that the Executive's termination for purposes of this Agreement under this Section 9 shall not affect his or her entitlement to benefits on account of his or her Disability under any long-term disability programs of the Company or the Employer in effect at the time of such termination and in which the Executive participated immediately prior to his or her Disability.

10. Termination Not Giving Rise to a Termination Payment . If, during the Employment Period, the Executive's employment is terminated for Cause, or if the Executive voluntarily terminates his or her employment other than for Good Reason, subject to the procedures set forth in Section 12, the Executive shall be entitled to receive only his or her Accrued Benefits in accordance with Section 6(a).

11. Termination Giving Rise to a Termination Payment. If, during the Employment Period, the Executive's employment is terminated by the Executive for Good Reason within two years following the event giving rise to Good Reason or by the Employer other than by reason of death, Disability pursuant to Section 9 or Cause, subject to the procedures set forth in Section 12,

(a) the Executive shall be entitled to receive and the Company or the Employer, as applicable, shall pay the Executive's Accrued Benefits in accordance with Section 6(a) and, in lieu of further salary payments for periods following the Termination Date, as severance pay, a Termination Payment;

(b) the Executive and his eligible dependents shall continue to be covered until the end of the second calendar year following the year in which the Termination Date occurs, under the same terms and conditions, by the medical plan, dental plan and/or group life insurance plan maintained by the Company or the Employer which covered that Executive and his eligible dependents prior to the Executive's Termination Date. Notwithstanding the foregoing, if the Company's or Employer's medical plan, dental plan and/or group life insurance plan covering the Executive on his or her Termination Date was amended, replaced or terminated on or after the Change of Control and such action would constitute Good Reason within the meaning of Section 1(l), the Executive and his or her eligible dependents shall be entitled to continued coverage for purposes of this Section 11(b) under the terms of the medical plan, dental plan and/or group life insurance plan which they participated in immediately prior to the Change of Control. If the affected plan is no longer available, the Company shall make arrangements to provide equivalent coverage to the Executive and his or her eligible dependents. For this purpose, "equivalent coverage" shall mean medical, dental and/or life insurance coverage, which, when added to the coverage provided to the Executive and his or her eligible dependents under the Company's or Employer's medical plan, dental plan and/or group life insurance plan in effect on the Executive's Termination Date, equals or exceeds the level of benefits provided under the medical plan, dental plan and/or group life insurance plan to the Executive and his or her eligible dependents on the day immediately preceding the Change of Control. The Executive and the Employer shall share the cost of the continued coverage under this Section 11(b) in the same proportions as the Employer and similarly situated active employees shared the cost of such coverage on the day preceding the Executive's Termination Date. For purposes of satisfying the Company's or Employer's obligation under the Consolidated Omnibus Budget Reconciliation Act ("COBRA") to continue group health care coverage to the Executive and his eligible dependents as a result of the Executive's termination of employment, the period during which the Executive is permitted to continue to participate in the Company's or Employer's medical plans and/or dental plans under this Section 11(b) shall not be taken into account and treated as part of the period during which the Executive and his eligible dependents are entitled to continued coverage under the Company's or Employer's group health plans under COBRA. Following the end of the continuation period specified in this Section 11(b), the Executive and his eligible dependents shall be covered

under such plans and arrangements only as required under the provisions of COBRA;

(c) the Executive's termination shall be treated as a "Normal Termination" as defined in the Pinnacle West Capital Corporation Stock Option and Incentive Plan, as amended from time to time, the Pinnacle West Capital Corporation 2002 Long-Term Incentive Plan, the Pinnacle West Capital Corporation 2007 Long-Term Incentive Plan, or any successor plan thereto, which shall entitle the Executive to exercise any outstanding stock options during the three (3) month period beginning on the Executive's Termination Date, and any restrictions remaining on any "Restricted Stock" (as defined in such plan) awarded to the Executive shall lapse on his or her Termination Date; and

(d) "out-placement" services will be provided by the Company to the Executive for a period beginning on the Executive's Termination Date. Such services shall be provided for a period beginning on the Executive's Termination Date and ending on the earlier of the date on which the Executive becomes employed in a position commensurate with his or her current salary and responsibilities or the last day of the twelve (12) month period which began on the Executive's Termination Date. The "out-placement" services shall be provided by an out-placement company selected by the Company.

12. **Termination Notice and Procedure.** Any termination by the Employer or the Executive of the Executive's employment during the Employment Period shall be communicated by written Notice of Termination to the Executive if such Notice is delivered by the Company and to the Company if such Notice is delivered by the Executive, all in accordance with the following procedures:

(a) The Notice of Termination shall indicate the specific termination provision in this Agreement relied upon and shall set forth in reasonable detail the facts and circumstances alleged to provide a basis for termination.

(b) Any Notice of Termination by the Company shall be approved by a resolution duly adopted by a majority of the members of the Company's board of directors then in office.

(c) If the Company shall give a Notice of Termination for Cause or by reason of Disability and the Executive in good faith notifies the Company that a dispute exists concerning such termination within the fifteen (15) day period following the Executive's receipt of such notice, the Executive may elect to continue his or her employment during such dispute. If it is thereafter determined that (i) the reason given by the Company for termination did exist, the Executive's Termination Date shall be the earlier of (A) the date on which the dispute is finally determined, either by mutual written agreement of the parties or pursuant to Section 14, (B) the date of the Company's Notice of Termination for Cause, (C) the date of the Executive's death, or (D) one day prior to the end of the Employment Period, and the Executive shall not be entitled to a Termination Payment based

on events occurring after the Company delivered its Notice of Termination; or (ii) the reason given by the Company for termination did not exist, the employment of the Executive shall continue as if the Company had not delivered its Notice of Termination and there shall be no Termination Date arising out of such notice.

(d) Executive must provide the Company with written notice of Good Reason within a period not to exceed 90 days of the initial existence of the condition alleged to give rise to Good Reason, upon the notice of which the Company shall have a period of 30 days during which it may remedy the condition. If the Executive shall in good faith give a Notice of Termination for Good Reason and the Company notifies the Executive that a dispute exists concerning the termination within the fifteen (15) day period following the Company's receipt of such notice, the Executive may elect to continue his or her employment during such dispute. If it is thereafter determined that (i) Good Reason did exist, the Executive's Termination Date shall be the earlier of (A) the date on which the dispute is finally determined, either by mutual written agreement of the parties or pursuant to Section 14, (B) the date of the Executive's death, or (C) one day prior to the end of the Employment Period, and the Executive's Termination Payment shall reflect events occurring after the Executive delivered his or her Notice of Termination; or (ii) Good Reason did not exist, the employment of the Executive shall continue after such determination as if the Executive had not delivered the Notice of Termination asserting Good Reason.

(e) If the Executive does not elect to continue employment pending resolution of a dispute regarding a Notice of Termination under Sections 12(c) and (d), and it is finally determined that the reason for termination set forth in such Notice of Termination did not exist, if such notice was delivered by the Executive, the Executive will be deemed to have voluntarily terminated his or her employment and if delivered by the Company, the Company will be deemed to have terminated the Executive other than by reason of death, Disability or Cause.

13. Obligations of the Executive. The Executive covenants and agrees, during the Executive's employment with the Employer and following his or her Termination Date, to hold in strict confidence any and all information in the Executive's possession as a result of the Executive's employment with the Employer; provided that nothing in this Agreement shall be construed as prohibiting the Executive from reporting any suspected instance of illegal activity of any nature, any nuclear safety concern, any workplace safety concern or any public safety concern to the United States Nuclear Regulatory Commission, United States Department of Labor or any federal or state governmental agency or prohibiting the Executive from participating in any way in any state or federal administrative, judicial or legislative proceeding or investigation with respect to any such claims and matters.

14. Arbitration. All claims, disputes and other matters in question between the parties arising under this Agreement, other than Section 13, shall be decided by arbitration in accordance with the commercial arbitration rules of the American Arbitration Association, unless the parties mutually agree otherwise. Any arbitration re-

quired under this Agreement shall be held in Phoenix, Arizona, unless the parties mutually agree otherwise. The Company shall pay the costs of any such arbitration. The award by the arbitrator shall be final, and judgment may be entered upon it in accordance with applicable law in any state or Federal court having jurisdiction thereof.

The Company shall not be required to arbitrate claims arising under Section 13. The Company shall have the right to judicial enforcement of its rights under Section 13, including, but not limited to, injunctive relief.

15. Expenses and Interest . If, after a Change of Control a good faith dispute arises with respect to the enforcement of the Executive's rights under this Agreement or if any arbitration or legal proceeding shall be brought in good faith to enforce or interpret any provision contained herein, or to recover damages for breach hereof and the Executive is the prevailing party, the Executive shall recover from the Company any reasonable attorney's fees and necessary costs and disbursements incurred as a result of such dispute or legal proceeding, and prejudgment interest on any money judgment obtained by the Executive calculated at the rate of interest announced by JP Morgan Chase Bank N.A. (or any successor thereto) from time to time as its prime rate from the date that payments to the Executive should have been made under this Agreement. Any payment due under this section will be made on the fifth business day following the date the dispute is final.

16. Payment Obligations Absolute . The Company's obligation during and after the Employment Period to insure that the compensation and arrangements provided herein are provided to the Executive shall be absolute and unconditional and shall not be affected by any circumstances, provided that the Company may apply amounts payable under this Agreement to any loan or other debts then owed to the Company or an Affiliate by the Executive, the terms of which are reflected in a written document signed by the Executive. Nothing in this Agreement shall prevent or limit the Executive's continuing or future participation in any plan, program, policy or practice provided by the Company or its Affiliates and for which the Executive may qualify, nor shall anything herein limit or otherwise affect such rights as the Executive may have under any other contract or agreement with the Company or its Affiliates. Amounts that are vested benefits or that the Executive is otherwise entitled to receive under any plan, policy, practice or program of or any other contract or agreement with the Company or its Affiliates at or subsequent to the Termination Date shall be payable in accordance with such plan, policy, practice or program or contract or agreement, except as explicitly modified by this Agreement. Notwithstanding the foregoing, the amounts payable under this Agreement shall be in lieu of any amounts payable to the Executive under a separate severance plan, agreement or arrangement established by the Company. All amounts payable by the Company under this Agreement shall be paid without notice or demand. Each and every payment made under this Agreement by the Company shall be final. Notwithstanding the foregoing, in the event that the Company has paid an Executive more than the amount to which the Executive is entitled under this Agreement, the Company shall have the right to recover all or any part of such overpayment from the Executive or from whomsoever has received such amount.

17. Successors.

(a) If all or substantially all of the Company's business and assets are sold, assigned or transferred to any Person, or if the Company merges into or consolidates or otherwise combines with any Person which is a continuing or successor entity, then the Company shall assign all of its right, title and interest in this Agreement as of the date of such event to the Person which is either the acquiring or successor corporation, and such Person shall assume and perform from and after the date of such assignment the terms, conditions and, provisions imposed by this Agreement upon the Company. Failure of the Company to obtain such assignment shall be a breach of this Agreement. In case of such assignment by the Company and of assumption and agreement by such Person, all further rights as well as all other obligations of the Company under this Agreement thenceforth shall cease and terminate and thereafter the expression "the Company" wherever used herein shall be deemed to mean such Person(s).

(b) This Agreement and all rights of the Executive shall inure to the benefit of and be enforceable by the Executive's personal or legal representatives, estates, executors, administrators, heirs and beneficiaries. In the event of the Executive's death, all amounts payable to the Executive under this Agreement shall be paid to the Executive's estate. This Agreement shall inure to the benefit of, be binding upon and be enforceable by, any successor, surviving or resulting corporation or other entity to which all or substantially all of the Company's business and assets shall be transferred whether by merger, consolidation, transfer or sale. This Agreement shall not be terminated by the voluntary or involuntary dissolution of the Company.

18. Enforcement. The provisions of this Agreement shall be regarded as divisible, and if any of said provisions or any part hereof are declared invalid or unenforceable by a court of competent jurisdiction, the validity and enforceability of the remainder of such provisions or parts hereof and the applicability thereof shall not be affected thereby.

19. Amendment or Termination. The term of this Agreement shall run until December 31, 2008, and shall continue for additional one (1) year periods thereafter, unless the Company notifies the Executive in writing six (6) months prior to December 31, 2008 (or the anniversary of that date in the event the Agreement continues beyond that date pursuant to the provisions of this Section 19) that it does not intend to continue the Agreement. Notwithstanding the foregoing, (i) if a Change of Control has occurred on or before the date on which the Agreement would be terminated by the Company in accordance with this Section 19, the Agreement shall not terminate with respect to that Change of Control until the end of the Employment Period, and (ii) this Agreement shall terminate if, prior to a Change in Control, the Executive ceases to be employed by the Employer as a corporate officer.

This Agreement sets forth the entire agreement between the Executive and the Company with respect to the subject matter hereof, and supersedes all prior

oral or written negotiations, commitments, understandings and writings with respect thereto.

This Agreement may not be terminated, amended or modified during its term as specified above except by written instrument executed by the Company and the Executive.

20. Withholding. The Company and the Employer shall be entitled to withhold from amounts to be paid to the Executive under this Agreement any federal, state or local withholding or other taxes or charges which it is from time to time required to withhold. The Company and the Employer shall be entitled to rely on an opinion of counsel if any question as to the amount or requirement of any such withholding shall arise.

21. Venue; Governing Law. This Agreement and the Executive's and Company's respective rights and obligations hereunder shall be governed by and construed in accordance with the laws of the State of Arizona. Any action concerning this Agreement shall be brought in the Federal or state courts located in the County of Maricopa, Arizona, and each party consents to the venue and jurisdiction of such courts.

22. Notice. Notices given pursuant to this Agreement shall be in writing and (a) if hand delivered, shall be deemed given when delivered, and (b) if mailed, shall be deemed delivered when placed in the United States mail, postage prepaid, addressed,

if to the Company, to

Board of Directors
Pinnacle West Capital Corporation
400 North Fifth Street
Phoenix, Arizona 85004
Attention: Law Department

or if to the Executive, to

or to such other addresses as the parties may provide written notice of to each other, from time to time, in accordance with this Section 22.

23. Funding. Benefits payable under this Agreement shall constitute an unfunded general obligation of the Company payable from its general assets, and the Company shall not be required to establish any special fund or trust for purposes of paying benefits under this Agreement. The Executive shall not have any vested right to any particular assets of the Company as a result of execution of this Agreement and shall be a general creditor of the Company.

24. No Waiver. No waiver by either party at any time of any breach by the other party of, or compliance with, any condition or provision of this Agreement to be performed by the other party shall be deemed a waiver of similar or dissimilar provisions or conditions at the same time or any prior or subsequent time.

25. Headings. The headings contained are for reference only and shall not affect the meaning or interpretation of any provision of this Agreement.

26. Additional Payment.

(a) Anything in this Agreement to the contrary notwithstanding, in the event it shall be determined that any Payment would be subject to the Excise Tax, then the Executive shall be entitled to receive an additional payment (the "Gross-Up Payment") in an amount such that, after payment by the Executive of all taxes (and any interest or penalties imposed with respect to such taxes), including, without limitation, any income taxes (and any interest and penalties imposed with respect thereto) and Excise Tax imposed upon the Gross-Up Payment, the Executive retains an amount of the Gross-Up Payment equal to the Excise Tax imposed upon the Payments. The Company's obligation to make Gross-Up Payments under this Section 26 shall not be conditioned upon the Executive's termination of employment.

(b) Subject to the provisions of Section 26(c), all determinations required to be made under this Section 26, including whether and when a Gross-Up Payment is required, the amount of such Gross-Up Payment and the assumptions to be utilized in arriving at such determination, shall be made by a nationally-recognized accounting firm appointed by the Company prior to a Change of Control (the "Accounting Firm"). The Accounting Firm shall provide detailed supporting calculations both to the Company and the Executive within 15 business days of the receipt of notice from the Executive that there has been a Payment or such earlier time as is requested by the Company. In the event that the Accounting Firm is serving as accountant or auditor for the individual, entity or group effecting the Change of Control, the Executive may appoint another nationally recognized accounting firm to make the determinations required hereunder (which accounting firm shall then be referred to as the Accounting Firm hereunder). All fees and expenses of the Accounting Firm shall be borne solely by the Company. Any Gross-Up Payment, as determined pursuant to this Section 26, shall be paid by the Company to the Executive within 5 days of the receipt of the Accounting Firm's determination, but in all events by the last day of the calendar year following the calendar year in which the Executive remits the related taxes. Any determination by the Accounting Firm shall be binding upon the Company and the Executive. As a result of the uncertainty in the application of Section 4999 of the Code at the time of the initial determination by the Accounting Firm hereunder, it is possible that Gross-Up Payments that will not have been made by the Company should have been made (the "Underpayment"), consistent with the calculations required to be made hereunder. In the event the Company exhausts its remedies pursuant to Section 26(c) and the Executive thereafter is required to

make a payment of any Excise Tax, the Accounting Firm shall determine the amount of the Underpayment that has occurred and any such Underpayment shall be promptly paid by the Company to or for the benefit of the Executive; but in no event later than the last day of the calendar year following the calendar year in which the Executive remits the related taxes.

(c) The Executive shall notify the Company in writing of any claim by the Internal Revenue Service that, if successful, would require the payment by the Company of the Gross-Up Payment. Such notification shall be given as soon as practicable, but no later than 10 business days after the Executive is informed in writing of such claim. The Executive shall apprise the Company of the nature of such claim and the date on which such claim is requested to be paid. The Executive shall not pay such claim prior to the expiration of the 30-day period following the date on which the Executive gives such notice to the Company (or such shorter period ending on the date that any payment of taxes with respect to such claim is due). If the Company notifies the Executive in writing prior to the expiration of such period that the Company desires to contest such claim, the Executive shall:

(i) give the Company any information reasonably requested by the Company relating to such claim,

(ii) take such action in connection with contesting such claim as the Company shall reasonably request in writing from time to time, including, without limitation, accepting legal representation with respect to such claim by an attorney reasonably selected by the Company,

(iii) cooperate with the Company in good faith in order effectively to contest such claim, and

(iv) permit the Company to participate in any proceedings relating to such claim;

provided, however, that the Company shall bear and pay directly all costs and expenses (including additional interest and penalties) incurred in connection with such contest, and shall indemnify and hold the Executive harmless, on an after-tax basis, for any Excise Tax or income tax (including interest and penalties) imposed as a result of such representation and payment of costs and expenses. Without limitation on the foregoing provisions of this Section 26(c), the Company shall control all proceedings taken in connection with such contest, and, at its sole discretion, may pursue or forgo any and all administrative appeals, proceedings, hearings and conferences with the applicable taxing authority in respect of such claim and may, at its sole discretion, either pay the tax claimed to the appropriate taxing authority on behalf of the Executive and direct the Executive to sue for a refund or contest the claim in any permissible manner, and the Executive agrees to prosecute such contest to a determination before any administra-

tive tribunal, in a court of initial jurisdiction and in one or more appellate courts, as the Company shall determine; *provided, however*, that, if the Company pays such claim and directs the Executive to sue for a refund, the Company shall indemnify and hold the Executive harmless, on an after-tax basis, from any Excise Tax or income tax (including interest or penalties) imposed with respect to such payment or with respect to any imputed income in connection with such payment; and *provided, further*, that any extension of the statute of limitations relating to payment of taxes for the taxable year of the Executive with respect to which such contested amount is claimed to be due is limited solely to such contested amount. Furthermore, the Company's control of the contest shall be limited to issues with respect to which the Gross-Up Payment would be payable hereunder, and the Executive shall be entitled to settle or contest, as the case may be, any other issue raised by the Internal Revenue Service or any other taxing authority. In all events, any reimbursement of the Executive shall be made no later than the last day of the calendar year following the calendar year in which the taxes that are subject to audit or litigation are remitted to the taxing authority or, where as a result of such audit or litigation no taxes are remitted, the last day of the calendar year following the calendar year in which the audit is completed or there is a final and nonappealable settlement or other resolution of the litigation.

(d) If, after the receipt by the Executive of a Gross-Up Payment or payment by the Company of an amount on the Executive's behalf pursuant to Section 26(c), the Executive becomes entitled to receive any refund with respect to the Excise Tax to which such Gross-Up Payment relates or with respect to such claim, the Executive shall (subject to the Company's complying with the requirements of Section 26(c), if applicable) promptly pay to the Company the amount of such refund (together with any interest paid or credited thereon after taxes applicable thereto). If, after payment by the Company of an amount on the Executive's behalf pursuant to Section 26(c), a determination is made that the Executive shall not be entitled to any refund with respect to such claim and the Company does not notify the Executive in writing of its intent to contest such denial of refund prior to the expiration of 30 days after such determination, then the amount of such payment shall offset, to the extent thereof, the amount of Gross-Up Payment required to be paid.

(e) Notwithstanding any other provision of this Section 26, the Company may, in its sole discretion, withhold and pay over to the Internal Revenue Service or any other applicable taxing authority, for the benefit of the Executive, all or any portion of any Gross-Up Payment, and the Executive hereby consents to such withholding.

IN WITNESS WHEREOF, the Company has caused this Agreement to be executed by its duly authorized officer, and the Executive has executed this Agreement, on the date and year first above written.

PINNACLE WEST CAPITAL CORPORATION

By _____
Its _____

ATTEST:

By _____
Its _____

Executive

KEY EXECUTIVE EMPLOYMENT AND SEVERANCE AGREEMENT

THIS AGREEMENT, made and entered into as of the ___day of _____, 2007, by and between Pinnacle West Capital Corporation, an Arizona corporation (hereinafter referred to as the "Company") and _____(hereinafter referred to as the "Executive"):

WITNESSETH

WHEREAS, the Executive is employed by the Company, in an executive capacity, possesses intimate knowledge of the business and affairs of the Company, and has acquired certain confidential information and data with respect to the Company;

WHEREAS, the Company desires to insure, insofar as possible, that the Company will continue to have the benefit of the Executive's services and to protect the confidential information and goodwill of the Company; and

WHEREAS, the Company recognizes that circumstances may arise in which a change in the control of the Company or Arizona Public Service Company, a subsidiary of the Company, through acquisition or otherwise occurs thereby causing uncertainty of employment without regard to the Executive's competence or past contributions which uncertainty may result in the loss of valuable services of the Executive to the detriment of the Company and its shareholders, and the Company and the Executive wish to provide reasonable security to the Executive against changes in the Executive's relationship with the Company in the event of any such change in control; and

WHEREAS, both the Company and the Executive are desirous that a proposal for any change of control or acquisition will be considered by the Executive objectively and with reference only to the business interests of the Company and its shareholders;

WHEREAS, the Executive will be in a better position to consider the best interests of the Company if the Executive is afforded reasonable security, as provided in this Agreement, against altered conditions of employment which could result from any such change in control or acquisition;

WHEREAS, the Company and the Executive previously entered into a Key Executive Employment and Severance Agreement ("Prior Agreement"); and

WHEREAS, the Company and the Executive desire to enter into the Key Executive Employment and Severance Agreement as set forth herein ("Agreement") to amend, restate and completely supersede the Prior Agreement;

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

1. Definitions.

(a) "Accrued Benefits" shall mean the benefits payable to the Executive as described in Section 6(a).

(b) "Act" shall mean the Securities Exchange Act of 1934.

(c) "Affiliate" shall mean (i) a corporation other than the Company that is a member of a "controlled group of corporations" (within the meaning of Section 414(b) of the Code as modified by Section 415(h) of the Code) or (ii) a group of trades or businesses under common control (within the meaning of Section 414(c) of the Code as modified by Section 415(h) of the Code) that also includes the Company as a member. For purposes of determining whether a transaction or event constitutes a Change of Control within the meaning of Section 1(g), "Affiliate" status shall be determined on the day immediately preceding the date of the transaction or event.

(d) "APS" shall mean Arizona Public Service Company, a subsidiary of the Company.

(e) "Beneficial Owner" shall have the same meaning as given to that term in Rule 13d-3 of the General Rules and Regulations of the Act, provided that any pledgee of the voting securities of the Company or APS shall not be deemed to be the Beneficial Owner thereof prior to its disposition of, or acquisition of voting rights with respect to, such securities.

(f) "Cause" shall be limited to (i) the engaging by the Executive in conduct which has caused demonstrable and serious injury to the Employer, monetary or otherwise, as evidenced by a determination in a binding and final judgment, order or decree of a court or administrative agency of competent jurisdiction, in effect after exhaustion or lapse of all rights of appeal, in an action, suit or proceeding, whether civil, criminal, administrative or investigative, other than an action, suit or proceeding, brought by the Company or an Affiliate, the purpose of which is to establish "Cause" under this Agreement; (ii) conviction of a felony, as evidenced by a binding and final judgment, order or decree of a court of competent jurisdiction, in effect after exhaustion or lapse of all rights of appeal, which the Employer determines has a significant adverse impact on it in the conduct of its business; or (iii) unreasonable neglect or refusal by the Executive to perform the Executive's duties or responsibilities (unless significantly changed without the Executive's consent).

(g) "Change of Control" shall mean one (1) or more of the following events:

(i) Any Person, other than an Affiliate, through a transaction or series of transactions, is or becomes the Beneficial Owner, directly or indirectly, of securities of the Company or APS representing twenty percent (20%) or more of the combined voting power of the then outstanding secu-

rities of the Company or APS, as the case may be; *provided, however*, that, for purposes of this Section 1(g), any acquisition directly from the Company shall not constitute a Change of Control;

(ii) A merger or consolidation of (A) the Company with any other corporation which would result in the voting securities of the Company outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or any parent thereof), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company or an Affiliate, less than sixty percent (60%) of the combined voting power of the securities of the Company or such surviving entity or any parent thereof outstanding immediately after such merger or consolidation, or (B) APS with any other corporation which would result in the voting securities of APS outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or any parent thereof), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company or an Affiliate, less than sixty percent (60%) of the combined voting power of the securities of APS or such surviving entity or any parent thereof outstanding immediately after such merger or consolidation; provided that, for purposes of this subparagraph (ii), a merger or consolidation effected to implement a recapitalization of the Company or of APS (or similar transaction) in which no Person is or becomes the Beneficial Owner, directly or indirectly, of securities of the Company or of APS representing twenty percent (20%) or more of the combined voting power of the then outstanding securities of the Company or of APS (excluding any securities acquired by that Person directly from the Company or an Affiliate) shall not result in a Change of Control; or

(iii) The sale, transfer or other disposition of all or substantially all of the assets of either the Company or APS to a Person other than the Company or an Affiliate

(iv) Individuals who, as of July 31, 2007, constitute the board of directors of the Company (the "Company Incumbent Board") or of APS (the "APS Incumbent Board") cease for any reason to constitute at least two-thirds (2/3) of the members of the Company or APS board of directors, as the case may be; provided, however, that for purposes of this subparagraph (iv), (A)(1) any person becoming a member of the Company board of directors after July 31, 2007 whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least two-thirds (2/3) of the members then comprising the Company Incumbent Board will be, considered as though such person were a member of the Company Incumbent Board and (2) the Company Incumbent Board shall not include a director whose initial assumption of office as a director

was in connection with an actual or threatened election contest relating to the election of directors, and (B)(1) any person becoming a member of the APS board of directors after July 31, 2007 whose election, or nomination for election by APS' shareholder(s), was approved by a vote of at least two-thirds (2/3) of the members then comprising the APS Incumbent Board or by the Company, as a majority shareholder of APS, considered as though such person were a member of the APS Incumbent Board and (2) the APS Incumbent Board shall not include a director whose initial assumption of office as a director was in connection with an actual or threatened election contest relating to the election of directors.

(h) "Code" shall mean the Internal Revenue Code of 1986, as amended from time to time.

(i) "Disability" shall have the same meaning as given to that term in the applicable long-term disability plan maintained by the company or the Employer for employees.

(j) "Employer" shall mean the Company, and upon the transfer of the Executive to an Affiliate, "Employer" shall mean such Affiliate.

(k) "Employment Period" shall mean the period commencing on the date of a Change of Control and ending on the second anniversary of such date.

(l) "Excise Tax" shall mean the excise tax imposed by Section 4999 of the Code, together with any interest or penalties imposed with respect to such excise tax.

(m) "Good Reason" shall mean:

(i) A material diminution in Executive's compensation;

(ii) A material diminution in Executive's authority, duties, or responsibilities;

(iii) A material diminution in the authority, duties, or responsibilities of the supervisor to whom Executive is required to report, including a requirement that Executive report to a corporate officer or employee instead of reporting directly to the Board;

(iv) A material diminution in the budget over which Executive retains authority;

(v) A material change in the geographic location at which Executive must perform the service;

(vi) Any other action or inaction that constitutes a material breach by the Company of the Agreement.

(n) A "Payment" shall mean any payment or distribution in the nature of compensation (within the meaning of Section 280G(b)(2) of the Code) to or for the benefit of the Executive, whether paid or payable pursuant to this Agreement or otherwise.

(o) "Person" shall mean any individual, partnership, joint venture, association, trust, corporation or other entity (including a "group" as defined in Section 13(d)(3) of the Act), other than an employee benefit plan of the Company or an Affiliate or an entity organized, appointed or established pursuant to the terms of any such benefit plan.

(p) "Termination Date" shall mean, except as otherwise provided in Section 12, (i) the Executive's date of death; (ii) the date of the Executive's voluntary early retirement as agreed upon in writing by the Employer and the Executive; (iii) sixty (60) days after the delivery of the Notice of Termination terminating the Executive's employment on account of Disability pursuant to Section 9, unless the Executive returns full-time to the performance of his or her duties prior to the expiration of such period; (iv) the date of the Notice of Termination if the Executive's employment is terminated by the Executive voluntarily other than for Good Reason; and (v) sixty (60) days after the delivery of the Notice of Termination if the Executive's employment is terminated by the Employer (other than by reason of Disability) or by the Executive for Good Reason.

(q) "Termination Payment" shall mean the amount described in Section 6(b).

2. Impact on Employment. The Employer and the Executive shall retain the right to terminate the employment of the Executive at any time and for any reason prior to a Change of Control. If a Change of Control occurs when the Executive is employed by the Employer, the Employer will continue thereafter to employ the Executive during the Employment Period.

3. Duties. During the Employment Period, the Executive shall, in the same capacities and positions held by the Executive at the time of such Change of Control or in such other capacities and positions as may be agreed to by the Employer and the Executive in writing, devote the Executive's reasonable best efforts, attention and skill to the business and affairs of the Company, as such business and affairs now exist and as they may hereafter be conducted. The services which are to be performed by the Executive hereunder are to be rendered at an employment location which is not more than seventy-five (75) miles from the Executive's employment location on the date of the Change of Control, or in such other place or places as shall be mutually agreed upon in writing by the Executive and the Employer from time to time. The Executive shall not be required to be absent from such employment location for more than forty-five (45) consecutive days in any fiscal year without the Executive's consent.

4. Compensation. During the Employment Period, the Executive shall be compensated as follows:

(a) The Executive shall receive, at such intervals and in accordance with such standard policies as may be in effect on the date of the Change of Control, an annual salary not less than the Executive's annual salary as in effect as of the date of the Change of Control, subject to adjustment as provided in Section 5;

(b) The Executive shall be reimbursed, at such intervals and in accordance with such standard policies as may be in effect on the date of the Change of Control, for any and all monies advanced in connection with the Executive's employment for reasonable and necessary expenses incurred by the Executive on behalf of the Employer, including travel expenses;

(c) The Executive shall be included to the extent eligible thereunder in any and all plans providing general benefits for the Employer's employees, including but not limited to, group life insurance, disability, medical, dental, pension, profit sharing, savings and stock bonus plans and be provided any and all other benefits and perquisites made available to other employees of comparable status and position, on the same terms and conditions as generally provided to employees of comparable status and position;

(d) The Executive shall receive annually not less than the amount of paid vacation and not fewer than the number of paid holidays received annually immediately prior to the Change of Control or such greater amount of paid vacation and number of paid holidays as may be made available annually to other employees of comparable status and position with the Employer; and

(e) The Executive shall be included in all plans providing special benefits to corporate officers, including but not limited to bonus, deferred compensation, incentive compensation, supplemental pension, stock option, stock appreciation, stock bonus and similar or comparable plans extended by the Company or the Employer from time to time to corporate officers, key employees and other employees of comparable status.

5. Annual Compensation Adjustments . During the Employment Period, the Board of Directors of the Employer, an appropriate committee of the Board or the President of the Employer, whichever is appropriate, shall consider and appraise, at least annually, the Executive's compensation. In determining such compensation, the Board, the appropriate committee thereof or the President, whichever is appropriate, shall consider the commensurate increases given to other corporate officers and key employees generally, the scope and success of the Employer's operations, the expansion of Executive's duties and the Executive's performance of his duties.

6. Payments Upon Termination .

(a) Accrued Benefits . For purposes of this Agreement, the Executive's Accrued Benefits shall include the following amounts: (i) all salary earned or accrued through the Termination Date; (ii) reimbursement for any and all monies

advanced in connection with the Executive's employment for reasonable and necessary expenses incurred by the Executive through the Termination Date; (iii) a lump sum payment of the bonus or incentive compensation otherwise payable to the Executive under the terms of any bonus or incentive compensation plan or plans for the year in which termination occurs; and (iv) all other payments and benefits to which the Executive may be entitled under the terms of any benefit plan of the Company or the Employer. Payment of Accrued Benefits shall be made promptly in accordance with the Employer's prevailing practice and the terms of any applicable benefit plans, contracts or arrangements.

(b) Termination Payment. For purposes of this Agreement, the Executive's Termination Payment shall be an amount equal to (i) plus (ii), multiplied by (iii), where

(i) Equals the Executive's rate of annual salary, as in effect on the date of the Change of Control and as increased thereafter from time to time pursuant to Section 5;

(ii) Equals the amount of the average annual dollar award paid (or payable but deferred by the Executive) to the Executive pursuant to the Employer's regular annual bonus plan or arrangement with respect to the four (4) years (or for such lesser number of years prior for which the Executive was eligible to earn such a bonus, and annualized in the case of any bonus earned and payable for a partial fiscal year) preceding the Termination Date which shall be determined by dividing the total dollar amount paid (or payable but deferred by the Executive) to the Executive under such plan or arrangement with respect to such number of years by four (4) (or for such lesser number of years prior to which the Executive was eligible to earn such a bonus, and annualized in the case of any bonus earned and payable for a partial fiscal year); and

(iii) Equals 2.99.

The Termination Payment shall be payable in a lump sum on the Executive's Termination Date. Such lump sum payment shall not be reduced by any present value or similar factor. The Executive shall not be required to mitigate the amount of such payment by securing other employment or otherwise and such payment shall not be reduced by reason of the Executive securing other employment or for any other reason, except as provided in Section 16.

7. Death. If the Executive shall die during the Employment Period, but after delivery of a Notice of Termination by the Company for reasons other than Cause or Disability or by the Executive for Good Reason, the Executive's employment shall terminate on his or her date of death and the Executive's estate shall be entitled to receive the Executive's Accrued Benefits as of the Termination Date and, subject to the provisions of this Agreement, to such Termination Payment as the Executive would have been entitled to had the Executive survived. All benefits payable on account of the

Executive's employment or death under the Company's or Employer's employee benefits plans, programs or arrangements shall be paid or distributed in accordance with the terms of such plans, programs or arrangements. The Executive's death following delivery of the Notice of Termination shall not affect his or her Termination Date which shall be determined without regard to the Executive's death, subject to the provisions of Section 12.

If the Executive shall die during the Employment Period, but prior to the delivery of a Notice of Termination, the Executive's employment shall terminate and the Executive's estate, heirs and beneficiaries shall receive all the Executive's Accrued Benefits through the Termination Date and all benefits available to them under the Company's benefit plans as in effect on the Termination Date on account of the Executive's death.

8. Retirement. If, during the Employment Period, the Executive and the Employer shall execute an agreement providing for the voluntary retirement of the Executive from the Employer, the Executive shall receive only his or her Accrued Benefits through the Termination Date. Without limiting the generality of the foregoing, the Executive's resignation under this Agreement with or without Good Reason, shall in no way affect the Executive's ability to terminate employment by reason of the Executive's "retirement" under any of the Company's retirement or pension plans or to be eligible to receive benefits under any retirement or pension plan of the Company and its affiliates or substitute plans adopted by the Company or its successors, and any termination which otherwise qualifies as Good Reason shall be treated as such even if it is also a "retirement" for purposes of any such plan.

9. Termination for Disability. If the Executive has been absent from his or her duties hereunder on a full-time basis for five (5) consecutive months during the Employment Period on account of a Disability, the Employer may provide a Notice of Termination, which satisfies the requirements of Section 12, and the Executive's employment shall, for purposes of this Agreement, terminate sixty (60) days thereafter, unless the Executive returns to the performance of his or her duties on a full-time basis prior to the end of the sixty (60) day period. During the term of the Executive's Disability prior to his or her Termination Date, the Executive shall continue to participate in all compensation and benefit plans, programs and arrangements in which the Executive was entitled to participate immediately prior to his or her Disability in accordance with the terms and provisions of such plans, programs and arrangements. If the Executive's employment is terminated on account of the Executive's Disability, the Executive shall receive his or her Accrued Benefits in accordance with Section 6(a) hereof, provided that the Executive's termination for purposes of this Agreement under this Section 9 shall not affect his or her entitlement to benefits on account of his or her Disability under any long-term disability programs of the Company or the Employer in effect at the time of such termination and in which the Executive participated immediately prior to his or her Disability.

10. Termination Not Giving Rise to a Termination Payment. If, during the Employment Period, the Executive's employment is terminated for Cause, or if the

Executive voluntarily terminates his or her employment other than for Good Reason, subject to the procedures set forth in Section 12, the Executive shall be entitled to receive only his or her Accrued Benefits in accordance with Section 6(a).

11. Termination Giving Rise to a Termination Payment. If, during the Employment Period, the Executive's employment is terminated by the Executive for Good Reason within two years following the event giving rise to Good Reason or by the Employer other than by reason of death, Disability pursuant to Section 9 or Cause, subject to the procedures set forth in Section 12,

(a) the Executive shall be entitled to receive and the Company or the Employer, as applicable, shall pay the Executive's Accrued Benefits in accordance with Section 6(a) and, in lieu of further salary payments for periods following the Termination Date, as severance pay, a Termination Payment;

(b) the Executive and his eligible dependents shall continue to be covered until the end of the second calendar year following the year in which the Termination Date occurs, under the same terms and conditions, by the medical plan, dental plan and/or group life insurance plan maintained by the Company or the Employer which covered that Executive and his eligible dependents prior to the Executive's Termination Date. Notwithstanding the foregoing, if the Company's or Employer's medical plan, dental plan and/or group life insurance plan covering the Executive on his or her Termination Date was amended, replaced or terminated on or after the Change of Control and such action would constitute Good Reason within the meaning of Section 1(l), the Executive and his or her eligible dependents shall be entitled to continued coverage for purposes of this Section 11(b) under the terms of the medical plan, dental plan and/or group life insurance plan which they participated in immediately prior to the Change of Control. If the affected plan is no longer available, the Company shall make arrangements to provide equivalent coverage to the Executive and his or her eligible dependents. For this purpose, "equivalent coverage" shall mean medical, dental and/or life insurance coverage, which, when added to the coverage provided to the Executive and his or her eligible dependents under the Company's or Employer's medical plan, dental plan and/or group life insurance plan in effect on the Executive's Termination Date, equals or exceeds the level of benefits provided under the medical plan, dental plan and/or group life insurance plan to the Executive and his or her eligible dependents on the day immediately preceding the Change of Control. The Executive and the Employer shall share the cost of the continued coverage under this Section 11(b) in the same proportions as the Employer and similarly situated active employees shared the cost of such coverage on the day preceding the Executive's Termination Date. For purposes of satisfying the Company's or Employer's obligation under the Consolidated Omnibus Budget Reconciliation Act ("COBRA") to continue group health care coverage to the Executive and his eligible dependents as a result of the Executive's termination of employment, the period during which the Executive is permitted to continue to participate in the Company's or Employer's medical plans and/or dental plans under this Section 11(b) shall not be taken into account and treated as

part of the period during which the Executive and his eligible dependents are entitled to continued coverage under the Company's or Employer's group health plans under COBRA. Following the end of the continuation period specified in this Section 11(b), the Executive and his eligible dependents shall be covered under such plans and arrangements only as required under the provisions of COBRA;

(c) the Executive's termination shall be treated as a "Normal Termination" as defined in the Pinnacle West Capital Corporation Stock Option and Incentive Plan, as amended from time to time, the Pinnacle West Capital Corporation 2002 Long-Term Incentive Plan, the Pinnacle West Capital Corporation 2007 Long-Term Incentive Plan, or any successor plan thereto, which shall entitle the Executive to exercise any outstanding stock options during the three (3) month period beginning on the Executive's Termination Date, and any restrictions remaining on any "Restricted Stock" (as defined in such plan) awarded to the Executive shall lapse on his or her Termination Date; and

(d) "out-placement" services will be provided by the Company to the Executive for a period beginning on the Executive's Termination Date. Such services shall be provided for a period beginning on the Executive's Termination Date and ending on the earlier of the date on which the Executive becomes employed in a position commensurate with his or her current salary and responsibilities or the last day of the twelve (12) month period which began on the Executive's Termination Date. The "out-placement" services shall be provided by an out-placement company selected by the Company.

12. Termination Notice and Procedure. Any termination by the Employer or the Executive of the Executive's employment during the Employment Period shall be communicated by written Notice of Termination to the Executive if such Notice is delivered by the Company and to the Company if such Notice is delivered by the Executive, all in accordance with the following procedures:

(a) The Notice of Termination shall indicate the specific termination provision in this Agreement relied upon and shall set forth in reasonable detail the facts and circumstances alleged to provide a basis for termination.

(b) Any Notice of Termination by the Company shall be approved by a resolution duly adopted by a majority of the members of the Company's board of directors then in office.

(c) If the Company shall give a Notice of Termination for Cause or by reason of Disability and the Executive in good faith notifies the Company that a dispute exists concerning such termination within the fifteen (15) day period following the Executive's receipt of such notice, the Executive may elect to continue his or her employment during such dispute. If it is thereafter determined that (i) the reason given by the Company for termination did exist, the Executive's Termination Date shall be the earlier of (A) the date on which the dispute is finally

determined, either by mutual written agreement of the parties or pursuant to Section 14, (B) the date of the Company's Notice of Termination for Cause, (C) the date of the Executive's death, or (D) one day prior to the end of the Employment Period, and the Executive shall not be entitled to a Termination Payment based on events occurring after the Company delivered its Notice of Termination; or (ii) the reason given by the Company for termination did not exist, the employment of the Executive shall continue as if the Company had not delivered its Notice of Termination and there shall be no Termination Date arising out of such notice.

(d) Executive must provide the Company with written notice of Good Reason within a period not to exceed 90 days of the initial existence of the condition alleged to give rise to Good Reason, upon the notice of which the Company shall have a period of 30 days during which it may remedy the condition. If the Executive shall in good faith give a Notice of Termination for Good Reason and the Company notifies the Executive that a dispute exists concerning the termination within the fifteen (15) day period following the Company's receipt of such notice, the Executive may elect to continue his or her employment during such dispute. If it is thereafter determined that (i) Good Reason did exist, the Executive's Termination Date shall be the earlier of (A) the date on which the dispute is finally determined, either by mutual written agreement of the parties or pursuant to Section 14, (B) the date of the Executive's death, or (C) one day prior to the end of the Employment Period, and the Executive's Termination Payment shall reflect events occurring after the Executive delivered his or her Notice of Termination; or (ii) Good Reason did not exist, the employment of the Executive shall continue after such determination as if the Executive had not delivered the Notice of Termination asserting Good Reason.

(e) If the Executive does not elect to continue employment pending resolution of a dispute regarding a Notice of Termination under Sections 12(c) and (d), and it is finally determined that the reason for termination set forth in such Notice of Termination did not exist, if such notice was delivered by the Executive, the Executive will be deemed to have voluntarily terminated his or her employment and if delivered by the Company, the Company will be deemed to have terminated the Executive other than by reason of death, Disability or Cause.

13. Obligations of the Executive. The Executive covenants and agrees, during the Executive's employment with the Employer and following his or her Termination Date, to hold in strict confidence any and all information in the Executive's possession as a result of the Executive's employment with the Employer; provided that nothing in this Agreement shall be construed as prohibiting the Executive from reporting any suspected instance of illegal activity of any nature, any nuclear safety concern, any workplace safety concern or any public safety concern to the United States Nuclear Regulatory Commission, United States Department of Labor or any federal or state governmental agency or prohibiting the Executive from participating in any way in any state or federal administrative, judicial or legislative proceeding or investigation with respect to any such claims and matters.

14. Arbitration. All claims, disputes and other matters in question between the parties arising under this Agreement, other than Section 13, shall be decided by arbitration in accordance with the commercial arbitration rules of the American Arbitration Association, unless the parties mutually agree otherwise. Any arbitration required under this Agreement shall be held in Phoenix, Arizona, unless the parties mutually agree otherwise. The Company shall pay the costs of any such arbitration. The award by the arbitrator shall be final, and judgment may be entered upon it in accordance with applicable law in any state or Federal court having jurisdiction thereof.

The Company shall not be required to arbitrate claims arising under Section 13. The Company shall have the right to judicial enforcement of its rights under Section 13, including, but not limited to, injunctive relief.

15. Expenses and Interest. If, after a Change of Control a good faith dispute arises with respect to the enforcement of the Executive's rights under this Agreement or if any arbitration or legal proceeding shall be brought in good faith to enforce or interpret any provision contained herein, or to recover damages for breach hereof and the Executive is the prevailing party, the Executive shall recover from the Company any reasonable attorney's fees and necessary costs and disbursements incurred as a result of such dispute or legal proceeding, and prejudgment interest on any money judgment obtained by the Executive calculated at the rate of interest announced by JP Morgan Chase Bank N.A. (or any successor thereto) from time to time as its prime rate from the date that payments to the Executive should have been made under this Agreement. Any payment due under this section will be made on the fifth business day following the date the dispute is final.

16. Payment Obligations Absolute. The Company's obligation during and after the Employment Period to insure that the compensation and arrangements provided herein are provided to the Executive shall be absolute and unconditional and shall not be affected by any circumstances, provided that the Company may apply amounts payable under this Agreement to any loan or other debts then owed to the Company or an Affiliate by the Executive, the terms of which are reflected in a written document signed by the Executive. Nothing in this Agreement shall prevent or limit the Executive's continuing or future participation in any plan, program, policy or practice provided by the Company or its Affiliates and for which the Executive may qualify, nor shall anything herein limit or otherwise affect such rights as the Executive may have under any other contract or agreement with the Company or its Affiliates. Amounts that are vested benefits or that the Executive is otherwise entitled to receive under any plan, policy, practice or program of or any other contract or agreement with the Company or its Affiliates at or subsequent to the Termination Date shall be payable in accordance with such plan, policy, practice or program or contract or agreement, except as explicitly modified by this Agreement. Notwithstanding the foregoing, the amounts payable under this Agreement shall be in lieu of any amounts payable to the Executive under a separate severance plan, agreement or arrangement established by the Company. All amounts payable by the Company under this Agreement shall be paid without notice or demand. Each and every payment made under this Agreement by the Company shall be final. Notwithstanding the foregoing, in the event that the Company has paid an Ex-

ecutive more than the amount to which the Executive is entitled under this Agreement, the Company shall have the right to recover all or any part of such overpayment from the Executive or from whomsoever has received such amount.

17. Successors.

(a) If all or substantially all of the Company's business and assets are sold, assigned or transferred to any Person, or if the Company merges into or consolidates or otherwise combines with any Person which is a continuing or successor entity, then the Company shall assign all of its right, title and interest in this Agreement as of the date of such event to the Person which is either the acquiring or successor corporation, and such Person shall assume and perform from and after the date of such assignment the terms, conditions and, provisions imposed by this Agreement upon the Company. Failure of the Company to obtain such assignment shall be a breach of this Agreement. In case of such assignment by the Company and of assumption and agreement by such Person, all further rights as well as all other obligations of the Company under this Agreement thenceforth shall cease and terminate and thereafter the expression "the Company" wherever used herein shall be deemed to mean such Person(s).

(b) This Agreement and all rights of the Executive shall inure to the benefit of and be enforceable by the Executive's personal or legal representatives, estates, executors, administrators, heirs and beneficiaries. In the event of the Executive's death, all amounts payable to the Executive under this Agreement shall be paid to the Executive's estate. This Agreement shall inure to the benefit of, be binding upon and be enforceable by, any successor, surviving or resulting corporation or other entity to which all or substantially all of the Company's business and assets shall be transferred whether by merger, consolidation, transfer or sale. This Agreement shall not be terminated by the voluntary or involuntary dissolution of the Company.

18. Enforcement. The provisions of this Agreement shall be regarded as divisible, and if any of said provisions or any part hereof are declared invalid or unenforceable by a court of competent jurisdiction, the validity and enforceability of the remainder of such provisions or parts hereof and the applicability thereof shall not be affected thereby.

19. Amendment or Termination. The term of this Agreement shall run until December 31, 2008, and shall continue for additional one (1) year periods thereafter, unless the Company notifies the Executive in writing six (6) months prior to December 31, 2008 (or the anniversary of that date in the event the Agreement continues beyond that date pursuant to the provisions of this Section 19) that it does not intend to continue the Agreement. Notwithstanding the foregoing, (i) if a Change of Control has occurred on or before the date on which the Agreement would be terminated by the Company in accordance with this Section 19, the Agreement shall not terminate with respect to that Change of Control until the end of the Employment Period, and (ii) this

Agreement shall terminate if, prior to a Change in Control, the Executive ceases to be employed by the Employer as a corporate officer.

This Agreement sets forth the entire agreement between the Executive and the Company with respect to the subject matter hereof, and supersedes all prior oral or written negotiations, commitments, understandings and writings with respect thereto. Without limiting the foregoing, this Agreement shall amend, restate and completely supersede the Prior Agreement.

This Agreement may not be terminated, amended or modified during its term as specified above except by written instrument executed by the Company and the Executive.

20. Withholding. The Company and the Employer shall be entitled to withhold from amounts to be paid to the Executive under this Agreement any federal, state or local withholding or other taxes or charges which it is from time to time required to withhold. The Company and the Employer shall be entitled to rely on an opinion of counsel if any question as to the amount or requirement of any such withholding shall arise.

21. Venue; Governing Law. This Agreement and the Executive's and Company's respective rights and obligations hereunder shall be governed by and construed in accordance with the laws of the State of Arizona. Any action concerning this Agreement shall be brought in the Federal or state courts located in the County of Maricopa, Arizona, and each party consents to the venue and jurisdiction of such courts.

22. Notice. Notices given pursuant to this Agreement shall be in writing and (a) if hand delivered, shall be deemed given when delivered, and (b) if mailed, shall be deemed delivered when placed in the United States mail, postage prepaid, addressed,

if to the Company, to

Board of Directors
Pinnacle West Capital Corporation
400 North Fifth Street
Phoenix, Arizona 85004
Attention: Law Department

or if to the Executive, to

or to such other addresses as the parties may provide written notice of to each other, from time to time, in accordance with this Section 22.

23. Funding. Benefits payable under this Agreement shall constitute an unfunded general obligation of the Company payable from its general assets, and the Company shall not be required to establish any special fund or trust for purposes of paying benefits under this Agreement. The Executive shall not have any vested right to any particular assets of the Company as a result of execution of this Agreement and shall be a general creditor of the Company.

24. No Waiver. No waiver by either party at any time of any breach by the other party of, or compliance with, any condition or provision of this Agreement to be performed by the other party shall be deemed a waiver of similar or dissimilar provisions or conditions at the same time or any prior or subsequent time.

25. Headings. The headings contained are for reference only and shall not affect the meaning or interpretation of any provision of this Agreement.

26. Additional Payment.

(a) Anything in this Agreement to the contrary notwithstanding, in the event it shall be determined that any Payment would be subject to the Excise Tax, then the Executive shall be entitled to receive an additional payment (the "Gross-Up Payment") in an amount such that, after payment by the Executive of all taxes (and any interest or penalties imposed with respect to such taxes), including, without limitation, any income taxes (and any interest and penalties imposed with respect thereto) and Excise Tax imposed upon the Gross-Up Payment, the Executive retains an amount of the Gross-Up Payment equal to the Excise Tax imposed upon the Payments. The Company's obligation to make Gross-Up Payments under this Section 26 shall not be conditioned upon the Executive's termination of employment.

(b) Subject to the provisions of Section 26(c), all determinations required to be made under this Section 26, including whether and when a Gross-Up Payment is required, the amount of such Gross-Up Payment and the assumptions to be utilized in arriving at such determination, shall be made by a nationally-recognized accounting firm appointed by the Company prior to a Change of Control (the "Accounting Firm"). The Accounting Firm shall provide detailed supporting calculations both to the Company and the Executive within 15 business days of the receipt of notice from the Executive that there has been a Payment or such earlier time as is requested by the Company. In the event that the Accounting Firm is serving as accountant or auditor for the individual, entity or group effecting the Change of Control, the Executive may appoint another nationally recognized accounting firm to make the determinations required hereunder (which accounting firm shall then be referred to as the Accounting Firm hereunder). All fees and expenses of the Accounting Firm shall be borne solely by the Company. Any Gross-Up Payment, as determined pursuant to this Section 26, shall be paid by the Company to the Executive within 5 days of the receipt of the Accounting Firm's determination, but in all events by the last day of the calendar year following the calendar year in which the Executive remits the related taxes. Any de-

termination by the Accounting Firm shall be binding upon the Company and the Executive. As a result of the uncertainty in the application of Section 4999 of the Code at the time of the initial determination by the Accounting Firm hereunder, it is possible that Gross-Up Payments that will not have been made by the Company should have been made (the "Underpayment"), consistent with the calculations required to be made hereunder. In the event the Company exhausts its remedies pursuant to Section 26(c) and the Executive thereafter is required to make a payment of any Excise Tax, the Accounting Firm shall determine the amount of the Underpayment that has occurred and any such Underpayment shall be promptly paid by the Company to or for the benefit of the Executive; but in no event later than the last day of the calendar year following the calendar year in which the Executive remits the related taxes.

(c) The Executive shall notify the Company in writing of any claim by the Internal Revenue Service that, if successful, would require the payment by the Company of the Gross-Up Payment. Such notification shall be given as soon as practicable, but no later than 10 business days after the Executive is informed in writing of such claim. The Executive shall apprise the Company of the nature of such claim and the date on which such claim is requested to be paid. The Executive shall not pay such claim prior to the expiration of the 30-day period following the date on which the Executive gives such notice to the Company (or such shorter period ending on the date that any payment of taxes with respect to such claim is due). If the Company notifies the Executive in writing prior to the expiration of such period that the Company desires to contest such claim, the Executive shall:

(i) give the Company any information reasonably requested by the Company relating to such claim,

(ii) take such action in connection with contesting such claim as the Company shall reasonably request in writing from time to time, including, without limitation, accepting legal representation with respect to such claim by an attorney reasonably selected by the Company,

(iii) cooperate with the Company in good faith in order effectively to contest such claim, and

(iv) permit the Company to participate in any proceedings relating to such claim;

provided, however, that the Company shall bear and pay directly all costs and expenses (including additional interest and penalties) incurred in connection with such contest, and shall indemnify and hold the Executive harmless, on an after-tax basis, for any Excise Tax or income tax (including interest and penalties) imposed as a result of such representation and payment of costs and expenses. Without limitation on the foregoing provisions of this Section 26(c), the Company

shall control all proceedings taken in connection with such contest, and, at its sole discretion, may pursue or forgo any and all administrative appeals, proceedings, hearings and conferences with the applicable taxing authority in respect of such claim and may, at its sole discretion, either pay the tax claimed to the appropriate taxing authority on behalf of the Executive and direct the Executive to sue for a refund or contest the claim in any permissible manner, and the Executive agrees to prosecute such contest to a determination before any administrative tribunal, in a court of initial jurisdiction and in one or more appellate courts, as the Company shall determine; *provided, however*, that, if the Company pays such claim and directs the Executive to sue for a refund, the Company shall indemnify and hold the Executive harmless, on an after-tax basis, from any Excise Tax or income tax (including interest or penalties) imposed with respect to such payment or with respect to any imputed income in connection with such payment; and *provided, further*, that any extension of the statute of limitations relating to payment of taxes for the taxable year of the Executive with respect to which such contested amount is claimed to be due is limited solely to such contested amount. Furthermore, the Company's control of the contest shall be limited to issues with respect to which the Gross-Up Payment would be payable hereunder, and the Executive shall be entitled to settle or contest, as the case may be, any other issue raised by the Internal Revenue Service or any other taxing authority. In all events, any reimbursement of the Executive shall be made no later than the last day of the calendar year following the calendar year in which the taxes that are subject to audit or litigation are remitted to the taxing authority or, where as a result of such audit or litigation no taxes are remitted, the last day of the calendar year following the calendar year in which the audit is completed or there is a final and nonappealable settlement or other resolution of the litigation.

(d) If, after the receipt by the Executive of a Gross-Up Payment or payment by the Company of an amount on the Executive's behalf pursuant to Section 26(c), the Executive becomes entitled to receive any refund with respect to the Excise Tax to which such Gross-Up Payment relates or with respect to such claim, the Executive shall (subject to the Company's complying with the requirements of Section 26 (c), if applicable) promptly pay to the Company the amount of such refund (together with any interest paid or credited thereon after taxes applicable thereto). If, after payment by the Company of an amount on the Executive's behalf pursuant to Section 26(c), a determination is made that the Executive shall not be entitled to any refund with respect to such claim and the Company does not notify the Executive in writing of its intent to contest such denial of refund prior to the expiration of 30 days after such determination, then the amount of such payment shall offset, to the extent thereof, the amount of Gross-Up Payment required to be paid.

(e) Notwithstanding any other provision of this Section 26, the Company may, in its sole discretion, withhold and pay over to the Internal Revenue Service or any other applicable taxing authority, for the benefit of the Executive, all or any portion of any Gross-Up Payment, and the Executive hereby consents to such withholding.

IN WITNESS WHEREOF, the Company has caused this Agreement to be executed by its duly authorized officer, and the Executive has executed this Agreement, on the date and year first above written.

PINNACLE WEST CAPITAL CORPORATION

By _____
Its _____

ATTEST:

By _____
Its _____

Executive

Exhibit 12.1
PINNACLE WEST CAPITAL CORPORATION
COMPUTATION OF EARNINGS TO FIXED CHARGES
(dollars in thousands)

	Nine Months Ended September 30,	Twelve Months Ended December 31,				
	2007	2006	2005	2004	2003	2002
Earnings:						
Income from continuing operations	\$ 295,292	\$317,143	\$223,163	\$246,590	\$225,384	\$236,563
Income taxes	140,428	156,418	126,892	136,142	102,202	152,145
Fixed charges	178,785	225,119	214,430	214,803	225,041	219,178
Total Earnings	<u>\$ 614,505</u>	<u>\$698,680</u>	<u>\$564,485</u>	<u>\$597,535</u>	<u>\$552,627</u>	<u>\$607,886</u>
Fixed Charges:						
Interest charges	\$ 158,352	\$196,826	\$185,087	\$183,527	\$193,973	\$187,039
Estimated interest portion of annual rents	20,433	28,293	29,343	31,276	31,068	32,139
Total Fixed Charges	<u>\$ 178,785</u>	<u>\$225,119</u>	<u>\$214,430</u>	<u>\$214,803</u>	<u>\$225,041</u>	<u>\$219,178</u>
Ratio of Earnings to Fixed Charges (rounded down)	<u>3.43</u>	<u>3.10</u>	<u>2.63</u>	<u>2.78</u>	<u>2.45</u>	<u>2.77</u>

Exhibit 12.2
ARIZONA PUBLIC SERVICE COMPANY
COMPUTATION OF EARNINGS TO FIXED CHARGES
(dollars in thousands)

	Nine Months Ended September 30,	Twelve Months Ended December 31,				
	2007	2006	2005	2004	2003	2002
Earnings:						
Income from continuing operations	\$ 283,664	\$269,730	\$170,479	\$199,627	\$180,937	\$199,343
Income taxes	143,677	138,927	98,010	120,030	86,854	126,805
Fixed charges	151,085	191,174	178,437	181,372	181,793	168,985
Total Earnings	<u>\$ 578,426</u>	<u>\$599,831</u>	<u>\$446,926</u>	<u>\$501,029</u>	<u>\$449,584</u>	<u>\$495,133</u>
Fixed Charges:						
Interest charges	\$ 127,455	\$158,769	\$145,502	\$146,983	\$147,610	\$133,878
Amortization of debt discount	3,477	4,363	4,085	4,854	3,337	2,888
Estimated interest portion of annual rents	20,153	28,042	28,850	29,535	30,846	32,219
Total Fixed Charges	<u>\$ 151,085</u>	<u>\$191,174</u>	<u>\$178,437</u>	<u>\$181,372</u>	<u>\$181,793</u>	<u>\$168,985</u>
Ratio of Earnings to Fixed Charges (rounded down)	<u>3.82</u>	<u>3.13</u>	<u>2.50</u>	<u>2.76</u>	<u>2.47</u>	<u>2.93</u>

Exhibit 12.3
PINNACLE WEST CAPITAL CORPORATION
COMPUTATION OF EARNINGS TO FIXED CHARGES
AND PREFERRED STOCK DIVIDEND REQUIREMENTS
(dollars in thousands)

	Nine Months Ended September 30,	Twelve Months Ended December 31,				
	2007	2006	2005	2004	2003	2002
Earnings:						
Income from continuing operations	\$ 295,292	\$317,143	\$223,163	\$246,590	\$225,384	\$236,563
Income taxes	140,428	156,418	126,892	136,142	102,202	152,145
Fixed charges	178,785	225,119	214,430	214,803	225,041	219,178
Total Earnings	\$ 614,505	\$698,680	\$564,485	\$597,535	\$552,627	\$607,886
Fixed Charges:						
Interest charges	\$ 158,352	\$196,826	\$185,087	\$183,527	\$193,973	\$187,039
Estimated interest portion of annual rents	20,433	28,293	29,343	31,276	31,068	32,139
Total Fixed Charges	\$ 178,785	\$225,119	\$214,430	\$214,803	\$225,041	\$219,178
Preferred Stock Dividend Requirements:						
Income before income taxes	\$ 435,720	\$473,561	\$350,055	\$382,732	\$327,586	\$388,708
Net income from continuing operations	295,292	317,143	223,163	246,590	225,384	236,563
Ratio of income before income taxes to net income	1.476	1.493	1.569	1.552	1.453	1.643
Preferred stock dividends	—	—	—	—	—	—
Preferred Stock Dividend Requirements – Ratio (above) Times Preferred Stock Dividends						
	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Fixed Charges and Preferred Stock Dividend Requirements:						
Fixed charges	\$ 178,785	\$225,119	\$214,430	\$214,803	\$225,041	\$219,178
Preferred stock dividend requirements	—	—	—	—	—	—
Total Fixed Charges and Preferred Stock Dividend Requirements	\$ 178,785	\$225,119	\$214,430	\$214,803	\$225,041	\$219,178
Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements (rounded down)						
	3.43	3.10	2.63	2.78	2.45	2.77

CERTIFICATION

I, William J. Post, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Pinnacle West Capital Corporation;
 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
 4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
-

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2007.

/s/ William J. Post

William J. Post
Chairman and Chief Executive Officer

CERTIFICATION

I, Donald E. Brandt, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Pinnacle West Capital Corporation;
 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
 4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
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5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2007.

/s/ Donald E. Brandt

Donald E. Brandt
Executive Vice President &
Chief Financial Officer

CERTIFICATION

I, Jack E. Davis, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Arizona Public Service Company;
 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
 4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
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5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2007.

/s/ Jack E. Davis

Jack E. Davis
Chief Executive Officer

CERTIFICATION

I, Donald E. Brandt, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Arizona Public Service Company;
 2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
 4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
-

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2007.

/s/ Donald E. Brandt

Donald E. Brandt
President &
Chief Financial Officer

**CERTIFICATION
OF
CHIEF EXECUTIVE OFFICER
AND
CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, William J. Post, certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of Pinnacle West Capital Corporation for the fiscal quarter ended September 30, 2007, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Pinnacle West Capital Corporation.

Date: November 5, 2007.

/s/ William J. Post

William J. Post

Chairman and Chief Executive Officer

I, Donald E. Brandt, certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of Pinnacle West Capital Corporation for the fiscal quarter ended September 30, 2007 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Pinnacle West Capital Corporation.

Date: November 5, 2007.

/s/ Donald E. Brandt

Donald E. Brandt

Executive Vice President and
Chief Financial Officer

**CERTIFICATION
OF
CHIEF EXECUTIVE OFFICER
AND
CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Jack E. Davis, certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of Arizona Public Service Company for the fiscal quarter ended September 30, 2007 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Arizona Public Service Company.

Date: November 5, 2007.

/s/ Jack E. Davis

Jack E. Davis
Chief Executive Officer

I, Donald E. Brandt, certify, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of Arizona Public Service Company for the fiscal quarter ended September 30, 2007 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Arizona Public Service Company.

Date: November 5, 2007.

/s/ Donald E. Brandt

Donald E. Brandt
President and
Chief Financial Officer