

ARIZONA PUBLIC SERVICE CO  
Form 10-Q  
November 02, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2012

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**

86-0512431

(an Arizona corporation)

400 North Fifth Street, P.O. Box 53999

Phoenix, Arizona 85072-3999

(602) 250-1000

1-4473

**ARIZONA PUBLIC SERVICE COMPANY**

86-0011170

(an Arizona corporation)

400 North Fifth Street, P.O. Box 53999

Phoenix, Arizona 85072-3999

(602) 250-1000

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

PINNACLE WEST CAPITAL CORPORATION	Yes <input 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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

PINNACLE WEST CAPITAL CORPORATION

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input type="checkbox"/>

ARIZONA PUBLIC SERVICE COMPANY

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

PINNACLE WEST CAPITAL CORPORATION

Yes  No

ARIZONA PUBLIC SERVICE COMPANY

Yes  No

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  
October 29, 2012: 109,699,804

ARIZONA PUBLIC SERVICE COMPANY

Number of shares of common stock, \$2.50 par value, outstanding as of  
October 29, 2012: 71,264,947

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

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This combined Form 10-Q is separately provided by Pinnacle West Capital Corporation ( Pinnacle West ) and Arizona Public Service Company ( APS ). Any use of the words Company, we, and our refer to Pinnacle West. Each registrant is providing on its own behalf a portion of the information contained in this Form 10-Q that relates to such registrant and, where required, its subsidiaries. Except as stated in the preceding sentence, neither registrant is providing any information that does not relate to such registrant, and therefore makes no representation as to any such information. The information required with respect to each company is set forth within the applicable items. Item 1 of this report includes Condensed Consolidated Financial Statements of Pinnacle West and Condensed Consolidated Financial Statements of APS. Item 1 also includes Notes to Pinnacle West's Condensed Consolidated Financial Statements, the majority of which also relate to APS, and Supplemental Notes, which only relate to APS's Condensed Consolidated Financial Statements.

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**FORWARD-LOOKING STATEMENTS**

This document contains forward-looking statements based on current expectations. These forward-looking statements are often identified by words such as estimate, predict, may, believe, plan, expect, require, intend, assume and similar words. Because actual results may differ materially from expectations, we caution readers not to place undue reliance on these statements. A number of factors could cause future results to differ materially from historical results, or from outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Part I, Item 1A of the Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2011 ( 2011 Form 10-K ), Part II, Item 1A of this report and in Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations of this report, these factors include, but are not limited to:

- our ability to manage capital expenditures and operations and maintenance costs while maintaining reliability and customer service levels;
- variations in demand for electricity, including those due to weather, the general economy, customer and sales growth (or decline), and the effects of energy conservation measures and distributed generation;
- power plant and transmission system performance and outages;
- volatile fuel and purchased power costs;
- fuel and water supply availability;
- our ability to achieve timely and adequate rate recovery of our costs, including returns on debt and equity capital;
- regulatory and judicial decisions, developments and proceedings;
- new legislation or regulation, including those relating to environmental requirements and nuclear plant operations;
- our ability to meet renewable energy and energy efficiency mandates and recover related costs;
- risks inherent in the operation of nuclear facilities, including spent fuel disposal uncertainty;
- competition in retail and wholesale power markets;
- the duration and severity of the economic decline in Arizona and current real estate market conditions;
- the cost of debt and equity capital and the ability to access capital markets when required;
- changes to our credit ratings;
- the investment performance of the assets of our nuclear decommissioning trust, pension, and other postretirement benefit plans and the resulting impact on future funding requirements;
- the liquidity of wholesale power markets and the use of derivative contracts in our business;

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- potential shortfalls in insurance coverage;
- new accounting requirements or new interpretations of existing requirements;
- generation, transmission and distribution facility and system conditions and operating costs;
- the ability to meet the anticipated future need for additional baseload generation and associated transmission facilities in our region;
- the willingness or ability of our counterparties, power plant participants and power plant land owners to meet contractual or other obligations or extend the rights for continued power plant operations;
- technological developments affecting the electric industry; and
- restrictions on dividends or other provisions in our credit agreements and Arizona Corporation Commission ( ACC ) orders.

These and other factors are discussed in the Risk Factors described in Part I, Item 1A of our 2011 Form 10-K and in Part II, Item 1A of this report, which readers should review carefully before placing any reliance on our financial statements or disclosures. Neither Pinnacle West nor APS assumes any obligation to update these statements, even if our internal estimates change, except as required by law.

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

(unaudited)

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

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
OPERATING REVENUES	\$ 1,109,475	\$ 1,124,841
OPERATING EXPENSES		
Fuel and purchased power	302,894	337,896
Operations and maintenance	220,729	210,035
Depreciation and amortization	100,353	106,350
Taxes other than income taxes	36,507	34,223
Other expenses	1,022	1,320
Total	661,505	689,824
OPERATING INCOME	447,970	435,017
OTHER INCOME (DEDUCTIONS)		
Allowance for equity funds used during construction	5,708	7,378
Other income (Note 11)	420	441
Other expense (Note 11)	(5,696)	(3,052)
Total	432	4,767
INTEREST EXPENSE		
Interest charges	52,242	62,034
Allowance for borrowed funds used during construction	(3,830)	(6,939)
Total	48,412	55,095
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	399,990	384,689
INCOME TAXES	147,116	131,416
INCOME FROM CONTINUING OPERATIONS	252,874	253,273
INCOME (LOSS) FROM DISCONTINUED OPERATIONS		
Net of income tax expense (benefit) of \$(7) and \$6,216 (Note 13)	(11)	9,512
NET INCOME	252,863	262,785
Less: Net income attributable to noncontrolling interests (Note 7)	8,040	7,426
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$ 244,823	\$ 255,359
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC	109,555	109,128
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED	110,655	109,861
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING		
Income from continuing operations attributable to common shareholders basic	\$ 2.23	\$ 2.25
Net income attributable to common shareholders basic	2.23	2.34

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Income from continuing operations attributable to common shareholders	diluted	2.21	2.24
Net income attributable to common shareholders	diluted	2.21	2.32
DIVIDENDS DECLARED PER SHARE		\$	\$
AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:			
Income from continuing operations, net of tax		\$ 244,834	\$ 245,838
Discontinued operations, net of tax		(11)	9,521
Net income attributable to common shareholders		\$ 244,823	\$ 255,359

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



Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(unaudited)

(dollars in thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>NET INCOME</b>	<b>\$ 252,863</b>	<b>\$ 262,785</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX</b>		
Derivative instruments:		
Net unrealized loss, net of tax benefit of \$47 and \$10,055	(72)	(15,402)
Reclassification of net realized loss, net of tax benefit of \$19,543 and \$23,361	29,935	35,783
Pension and other postretirement benefits activity, net of tax expense of \$640 and \$489	980	750
Total other comprehensive income	30,843	21,131
<b>COMPREHENSIVE INCOME</b>	<b>283,706</b>	<b>283,916</b>
Less: Comprehensive income attributable to noncontrolling interests	8,040	7,426
<b>COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS</b>	<b>\$ 275,666</b>	<b>\$ 276,490</b>

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

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

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

	Nine Months Ended September 30,	
	2012	2011
<b>OPERATING REVENUES</b>	\$ 2,608,682	\$ 2,573,487
<b>OPERATING EXPENSES</b>		
Fuel and purchased power	783,926	793,952
Operations and maintenance	647,628	675,654
Depreciation and amortization	301,068	319,550
Taxes other than income taxes	120,271	112,002
Other expenses	5,323	4,536
Total	1,858,216	1,905,694
<b>OPERATING INCOME</b>	750,466	667,793
<b>OTHER INCOME (DEDUCTIONS)</b>		
Allowance for equity funds used during construction	15,639	18,697
Other income (Note 11)	1,357	2,630
Other expense (Note 11)	(12,433)	(7,921)
Total	4,563	13,406
<b>INTEREST EXPENSE</b>		
Interest charges	162,209	183,251
Allowance for borrowed funds used during construction	(10,428)	(14,371)
Total	151,781	168,880
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	603,248	512,319
<b>INCOME TAXES</b>	219,160	176,229
<b>INCOME FROM CONTINUING OPERATIONS</b>	384,088	336,090
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS</b>		
Net of income tax expense (benefit) of \$(1,047) and \$7,121 (Note 13)	(1,595)	10,860
<b>NET INCOME</b>	382,493	346,950
Less: Net income attributable to noncontrolling interests (Note 7)	23,582	20,041
<b>NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS</b>	\$ 358,911	\$ 326,909
<b>WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC</b>	109,449	109,003
<b>WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED</b>	110,420	109,683
<b>EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING</b>		
Income from continuing operations attributable to common shareholders basic	\$ 3.29	\$ 2.90
Net income attributable to common shareholders basic	3.28	3.00
Income from continuing operations attributable to common shareholders diluted	3.26	2.88
Net income attributable to common shareholders diluted	3.25	2.98
<b>DIVIDENDS DECLARED PER SHARE</b>	\$ 1.575	\$ 1.575
<b>AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:</b>		
Income from continuing operations, net of tax	\$ 360,515	\$ 316,001

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Discontinued operations, net of tax		(1,604)		10,908
Net income attributable to common shareholders	\$	358,911	\$	326,909

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

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(unaudited)

(dollars in thousands)

	Nine Months Ended September 30,	
	2012	2011
NET INCOME	\$ 382,493	\$ 346,950
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX		
Derivative instruments:		
Net unrealized loss, net of tax benefit of \$14,817 and \$16,113	(22,696)	(24,679)
Reclassification of net realized loss, net of tax benefit of \$34,361 and \$39,213	52,632	60,065
Pension and other postretirement benefits activity, net of tax expense of \$1,797 and \$1,853	2,752	2,838
Total other comprehensive income	32,688	38,224
COMPREHENSIVE INCOME	415,181	385,174
Less: Comprehensive income attributable to noncontrolling interests	23,582	20,041
COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$ 391,599	\$ 365,133

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

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

(unaudited)

(dollars in thousands)

	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 79,479	\$ 33,583
Customer and other receivables	365,309	284,183
Accrued unbilled revenues	136,425	125,239
Allowance for doubtful accounts	(4,297)	(3,748)
Materials and supplies (at average cost)	219,026	204,387
Fossil fuel (at average cost)	31,234	22,000
Deferred income taxes	95,487	130,571
Income tax receivable (Note 6)		6,466
Assets from risk management activities (Note 8)	26,257	30,264
Deferred fuel and purchased power regulatory asset (Note 3)	67,910	27,549
Other regulatory assets (Note 3)	53,960	69,072
Other current assets	28,062	26,904
Total current assets	1,098,852	956,470
<b>INVESTMENTS AND OTHER ASSETS</b>		
Assets from risk management activities (Note 8)	38,449	49,322
Nuclear decommissioning trust (Note 15)	566,960	513,733
Other assets	62,428	64,588
Total investments and other assets	667,837	627,643
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	14,116,015	13,753,971
Accumulated depreciation and amortization	(4,901,833)	(4,709,991)
Net	9,214,182	9,043,980
Construction work in progress	587,826	496,745
Palo Verde sale leaseback, net of accumulated depreciation (Note 7)	129,962	132,864
Intangible assets, net of accumulated amortization	152,665	170,571
Nuclear fuel, net of accumulated amortization	139,873	118,098
Total property, plant and equipment	10,224,508	9,962,258
<b>DEFERRED DEBITS</b>		
Regulatory assets (Note 3)	1,250,792	1,352,079
Income tax receivable (Note 6)	69,953	68,633
Other	148,344	143,935
Total deferred debits	1,469,089	1,564,647
<b>TOTAL ASSETS</b>	<b>\$ 13,460,286</b>	<b>\$ 13,111,018</b>

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



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

(unaudited)

(dollars in thousands)

	September 30, 2012	December 31, 2011
<b>LIABILITIES AND EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 231,151	\$ 326,987
Accrued taxes (Note 6)	190,188	120,289
Accrued interest	50,890	54,872
Current maturities of long-term debt	90,360	477,435
Customer deposits	76,853	72,176
Liabilities from risk management activities (Note 8)	56,263	53,968
Regulatory liabilities (Note 3)	96,362	88,362
Other current liabilities	157,281	148,616
Total current liabilities	949,348	1,342,705
<b>LONG-TERM DEBT LESS CURRENT MATURITIES</b>		
Long-term debt less current maturities	3,281,531	2,953,507
Palo Verde sale leaseback lessor notes less current maturities (Note 7)	57,420	65,547
Total long-term debt less current maturities	3,338,951	3,019,054
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	2,115,316	1,925,388
Regulatory liabilities (Note 3)	746,754	737,332
Liability for asset retirements	294,524	279,643
Liabilities for pension and other postretirement benefits (Note 4)	1,206,150	1,268,910
Liabilities from risk management activities (Note 8)	81,244	82,495
Customer advances	105,941	116,805
Coal mine reclamation	118,601	117,896
Unrecognized tax benefits (Note 6)	69,791	72,270
Other	248,082	217,934
Total deferred credits and other	4,986,403	4,818,673
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		
<b>EQUITY (Note 9)</b>		
Common stock, no par value	2,456,107	2,444,247
Treasury stock	(1,440)	(4,717)
Total common stock	2,454,667	2,439,530
Retained earnings	1,721,050	1,534,483
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(62,695)	(65,447)
Derivative instruments	(56,780)	(86,716)
Total accumulated other comprehensive loss	(119,475)	(152,163)
Total shareholders' equity	4,056,242	3,821,850
Noncontrolling interests (Note 7)	129,342	108,736

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Total equity		4,185,584		3,930,586
TOTAL LIABILITIES AND EQUITY	\$	13,460,286	\$	13,111,018

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



Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)

(dollars in thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 382,493	\$ 346,950
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of energy-related products and services business		(10,404)
Depreciation and amortization including nuclear fuel	360,570	370,107
Deferred fuel and purchased power	51,533	30,965
Deferred fuel and purchased power amortization	(91,894)	(121,018)
Allowance for equity funds used during construction	(15,639)	(18,697)
Deferred income taxes	206,501	131,582
Change in derivative instruments fair value	(943)	1,861
Changes in current assets and liabilities:		
Customer and other receivables	(76,697)	(47,410)
Accrued unbilled revenues	(11,186)	(80,877)
Materials, supplies and fossil fuel	(23,873)	(25,532)
Other current assets	(10,035)	(1,581)
Accounts payable	(69,776)	29,340
Accrued taxes and income tax receivable net	76,365	89,534
Other current liabilities	17,071	30,300
Change in margin and collateral accounts assets	1,980	33,591
Change in margin and collateral accounts liabilities	114,579	85,785
Change in unrecognized tax benefits	(3,554)	12,123
Change in other long-term assets	(15,205)	(10,678)
Change in other long-term liabilities	37,181	74,565
Net cash flow provided by operating activities	929,471	920,506
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(670,684)	(643,261)
Contributions in aid of construction	41,451	36,351
Allowance for borrowed funds used during construction	(10,428)	(14,371)
Proceeds from sale of energy-related products and services business		45,111
Proceeds from nuclear decommissioning trust sales	295,126	405,637
Investment in nuclear decommissioning trust	(308,063)	(417,957)
Proceeds from sale of life insurance policies		55,444
Other	(520)	(1,246)
Net cash flow used for investing activities	(653,118)	(534,292)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt	351,081	470,353
Repayment of long-term debt	(421,703)	(228,457)
Short-term borrowings and payments net		(16,600)
Dividends paid on common stock	(167,074)	(166,197)
Common stock equity issuance	9,684	14,953

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Distributions to noncontrolling interests	(2,630)	(2,610)
Other	185	(3,132)
Net cash flow provided by (used for) financing activities	(230,457)	68,310
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>45,896</b>	<b>454,524</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>33,583</b>	<b>110,188</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$ 79,479</b>	<b>\$ 564,712</b>
Supplemental disclosure of cash flow information Cash paid during the period for:		
Income taxes, net of (refunds)	\$ (651)	\$ 5,676
Interest, net of amounts capitalized	\$ 152,582	\$ 163,250

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

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**PINNACLE WEST CAPITAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Consolidation and Nature of Operations**

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our subsidiaries: APS and El Dorado Investment Company ( El Dorado ) and formerly SunCor Development Company ( SunCor ) and APS Energy Services Company, Inc. ( APSES ). See Note 13 for discussion of the bankruptcy filing of SunCor and the sale of APSES. Intercompany accounts and transactions between the consolidated companies have been eliminated. The unaudited condensed consolidated financial statements for APS include the accounts of APS and the Palo Verde Nuclear Generating Station ( Palo Verde ) sale leaseback variable interest entities ( VIEs ) (see Note 7 for further discussion). Our accounting records are maintained in accordance with accounting principles generally accepted in the United States of America ( GAAP ). The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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

Our condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments except as otherwise disclosed in the notes) that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. These condensed consolidated financial statements and notes have been prepared consistently with the 2011 Form 10-K with the exception of the reclassification of certain prior year amounts on our Condensed Consolidated Statements of Income and Condensed Consolidated Statements of Cash Flows to conform to the current year presentation.

See Note 16 for discussion of amended guidance on the presentation of comprehensive income.

The following tables show the impact of the reclassifications to prior year (previously reported) amounts (dollars in thousands):

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## PINNACLE WEST CAPITAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Statement of Income for the Three Months Ended September 30, 2011	As previously reported	Reclassifications to conform to current year presentation	Amount reported after reclassifications to conform to current year presentation
<b>Operating Revenues</b>			
Regulated electricity segment	\$ 1,124,049	\$ (1,124,049)	\$
Other revenues	792	(792)	
Operating revenues		1,124,841	1,124,841
<b>Statement of Income for the Nine Months Ended September 30, 2011</b>			
<b>Operating Revenues</b>			
Regulated electricity segment	\$ 2,570,692	\$ (2,570,692)	\$
Other revenues	2,795	(2,795)	
Operating revenues		2,573,487	2,573,487
<b>Statement of Cash Flows for the Nine Months Ended September 30, 2011</b>			
<b>Cash Flows from Investing Activities</b>			
Proceeds from sale of commercial real estate investments	\$ 1,100	\$ (1,100)	\$
Other	(2,346)	1,100	(1,246)

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

Pinnacle West and APS maintain committed revolving credit facilities in order to enhance liquidity and provide credit support for their commercial paper programs.

***Pinnacle West***

At September 30, 2012, Pinnacle West's \$200 million credit facility, which matures in November 2016, was available to refinance indebtedness of the Company and for other general corporate purposes, including credit support for its \$200 million commercial paper program. Pinnacle West has the option to increase the amount of the facility up to a maximum of \$300 million upon the satisfaction of certain conditions and with

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the consent of the lenders. At September 30, 2012, Pinnacle West had no outstanding borrowings under its credit facility, no letters of credit outstanding and no commercial paper borrowings.

*APS*

On January 13, 2012, APS issued \$325 million of 4.50% unsecured senior notes that mature on April 1, 2042. The net proceeds from the sale were used along with other funds to repay at maturity APS' s \$375 million aggregate principal amount of 6.50% senior notes on March 1, 2012.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

On May 1, 2012, pursuant to the mandatory tender provision, APS purchased all \$32 million of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project), 2009 Series B, due 2029. On June 1, 2012 we remarketed these bonds. Currently, the interest rate on these bonds is reset daily by a remarketing agent. The daily rate at September 30, 2012 was 0.20% per annum. Additionally, the bonds are supported by a letter of credit. These bonds are classified as long-term debt on our Condensed Consolidated Balance Sheets at September 30, 2012 and were classified as current maturities of long-term debt on our Condensed Consolidated Balance Sheets at December 31, 2011.

On June 1, 2012, pursuant to the mandatory tender provision, APS changed the interest rate mode for the approximately \$38 million of Navajo County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Cholla Project), 2009 Series A. The new term rate period for these bonds commenced on June 1, 2012, and ends, subject to a mandatory tender, on May 29, 2014. During this time, the bonds will bear interest at a rate of 1.25% per annum. These bonds are classified as long-term debt on our Condensed Consolidated Balance Sheets at September 30, 2012 and were classified as current maturities of long-term debt on our Condensed Consolidated Balance Sheets at December 31, 2011.

On November 1, 2012 APS redeemed at par all \$90 million of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds (Arizona Public Service Company Palo Verde Project) 2002 Series A, due 2029. The bonds were reflected as long-term debt on our Condensed Consolidated Balance Sheets as of September 30, 2012.

At September 30, 2012, APS had two credit facilities totaling \$1 billion, including a \$500 million credit facility that matures in February 2015, and a \$500 million facility that matures in November 2016. APS may increase the amount of each facility up to a maximum of \$700 million upon the satisfaction of certain conditions and with the consent of the lenders. APS will use these facilities to refinance indebtedness and for other general corporate purposes. Interest rates are based on APS' s senior unsecured debt credit ratings.

The facilities described above are available to support APS' s \$250 million commercial paper program, for bank borrowings or for issuances of letters of credit. At September 30, 2012, APS had no outstanding borrowings or outstanding letters of credit under these credit facilities, nor did it have any commercial paper borrowings.

See Financial Assurances in Note 10 for discussion of APS' s separate outstanding letters of credit.

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Our long-term debt fair value estimates are based on quoted market prices for the same or similar issues, and are classified within Level 2 of the fair value hierarchy. See Note 14 for discussion of the fair value hierarchy. The following table represents the estimated fair value of our long-term debt, including current maturities (dollars in millions):

	As of September 30, 2012		As of December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Pinnacle West	\$ 125	\$ 125	\$ 125	\$ 123
APS	3,304	3,817	3,371	3,803
Total	\$ 3,429	\$ 3,942	\$ 3,496	\$ 3,926

**Debt Provisions**

An 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 total shareholder equity divided by the sum of total shareholder equity and long-term debt, including current maturities of long-term debt. At September 30, 2012, APS was in compliance with this common equity ratio requirement. Its total shareholder equity was approximately \$4.2 billion, and total capitalization was approximately \$7.4 billion. APS would be prohibited from paying dividends if such payment would reduce its total shareholder equity below approximately \$3.0 billion, assuming APS's total capitalization remains the same. Since APS was in compliance with this common equity ratio requirement, this restriction does not materially affect Pinnacle West's ability to meet its ongoing cash needs or ability to pay dividends to shareholders.

**3. Regulatory Matters****Retail Rate Case Filing with the Arizona Corporation Commission**

On June 1, 2011, APS filed an application with the ACC for a net retail base rate increase of \$95.5 million. APS requested that the increase become effective July 1, 2012. The request would have increased the average retail customer bill approximately 6.6%. On January 6, 2012, APS and other parties to the general retail rate case entered into an agreement (the Settlement Agreement) detailing the terms upon which the parties agreed to settle the rate case. On May 15, 2012, the ACC approved the Settlement Agreement without material modifications.

*Settlement Agreement*

The Settlement Agreement provides for a zero net change in base rates, consisting of: (1) a non-fuel base rate increase of \$116.3 million; (2) a fuel-related base rate decrease of \$153.1 million (to be implemented by a change in the base fuel rate for purchased power costs ( Base Fuel Rate )) from \$0.03757 to \$0.03207 per kilowatt-hour ( kWh ); and (3) the transfer of cost recovery for certain renewable energy projects from the Arizona Renewable Energy Standard and Tariff ( RES ) surcharge to base rates in an estimated amount of \$36.8 million.



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APS also agreed not to file its next general rate case before May 31, 2015, and not to request that its next general retail rate increase be effective prior to July 1, 2016. The Settlement Agreement allows APS to request a change to its base rates during the stay-out period in the event of an extraordinary event that, in the ACC's judgment, requires base rate relief in order to protect the public interest. Nor is APS precluded from seeking rate relief, or any other party to the Settlement Agreement precluded from petitioning the ACC to examine the reasonableness of APS's rates, in the event of significant regulatory developments that materially impact the financial results expected under the terms of the Settlement Agreement.

Other key provisions of the Settlement Agreement include the following:

- An authorized return on common equity of 10.0%;
- A capital structure comprised of 46.1% debt and 53.9% common equity;
- A test year ended December 31, 2010, adjusted to include plant that is in service as of March 31, 2012;
- Deferral for future recovery or refund of property taxes above or below a specified 2010 test year level caused by changes to the Arizona property tax rate as follows:
  - Deferral of 25% in 2012, 50% in 2013 and 75% for 2014 and subsequent years if Arizona property tax rates increase; and
  - Deferral of 100% in all years if Arizona property tax rates decrease;
- A procedure to allow APS to request rate adjustments prior to its next general rate case related to APS's proposed acquisition (should it be consummated) of additional interests in Units 4 and 5 and the related closure of Units 1-3 of the Four Corners Power Plant ( Four Corners );

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- Implementation of a Lost Fixed Cost Recovery rate mechanism to support energy efficiency and distributed renewable generation;
- Modifications to the Environmental Improvement Surcharge ( EIS ) to allow for the recovery of carrying costs for capital expenditures associated with government-mandated environmental controls, subject to an existing cents per kWh cap on cost recovery that could produce up to approximately \$5 million in revenues annually;
- Modifications to the Power Supply Adjustor ( PSA ), including the elimination of the current 90/10 sharing provision;
- A limitation on the use of the RES surcharge and the Demand Side Management Adjustor Charge ( DSMAC ) to recoup capital expenditures not required under the terms of the 2008 rate case settlement agreement discussed below.
- Allowing a negative credit that currently exists in the PSA to continue until February 2013, rather than being reset on the anticipated July 1, 2012 rate effective date;

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- Modification of the transmission cost adjustor ( TCA ) to streamline the process for future transmission-related rate changes; and
- Implementation of various changes to rate schedules, including the adoption of an experimental buy-through rate that could allow certain large commercial and industrial customers to select alternative sources of generation to be supplied by APS.

The Settlement Agreement was approved by the ACC on May 15, 2012, with new rates effective on July 1, 2012. This accomplished a goal set by the parties to the 2008 rate case settlement to process subsequent rate cases within twelve months of sufficiency findings from the ACC staff, which generally occur within 30 days after the filing of a rate case.

**2008 General Retail Rate Case On-Going Impacts**

On December 30, 2009, the ACC issued an order approving a settlement agreement entered into by APS and twenty-one other parties in APS's prior general retail rate case, which was originally filed in March 2008. The settlement agreement contains certain on-going requirements, commitments and authorizations that will survive the 2012 Settlement Agreement, including the following:

- A commitment from APS to reduce average annual operational expenses by at least \$30 million from 2010 through 2014;
- Authorization and requirements of equity infusions into APS of at least \$700 million during the period beginning June 1, 2009 through December 31, 2014 (\$253 million of which was infused into APS from proceeds of a Pinnacle West equity issuance in the second quarter of 2010); and
- Various modifications to the existing energy efficiency, demand side management and renewable energy programs that require APS to, among other things, expand its conservation and demand side management programs through 2012 and its use of renewable energy through 2015, as well as allow for concurrent recovery of renewable energy expenses and provide for more concurrent recovery of demand side management costs and incentives.

**Cost Recovery Mechanisms**

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

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

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On July 1, 2011, APS filed its annual RES implementation plan, covering the 2012-2016 timeframe and requesting 2012 RES funding of \$129 million to \$152 million. On December 14, 2011, the ACC voted to approve APS's 2012 RES Plan and authorized a total 2012 RES budget of \$110 million. Within that budget, the ACC authorized APS to, among other items, (i) own an additional 100 megawatts ( MW ) under the AZ Sun Program, for a total of 200 MW; (ii) recover revenue requirements for the second 100 MW as APS did for the first 100 MW of the AZ Sun Program; (iii) expand APS's School and Government Program by another 6.25 MW of utility-owned distributed generation; and (iv) own another 25 MW of renewable generation to be described later and installed in 2014 and 2015. In addition, the ACC ordered an initial up front incentive of \$0.75 per watt for residential distributed energy and incentive level step downs throughout 2012 based upon the volume and timing of residential incentive applications. Under the ACC's order, residential incentives could fall to \$0.20 or \$0.10 per watt by the end of 2012 depending on demand.

On June 29, 2012, APS filed its annual RES implementation plan, covering the 2013-2017 timeframe and requesting 2013 RES funding of \$92.8 million to \$102.4 million. The budget range stems from options related to distributed energy. The first option involves no new incentives for distributed energy. The second option would offer incentives for residential photovoltaic distributed energy beginning where 2012 incentives end and stepping down gradually based upon market participation. APS's filing also proposed a system of establishing compliance with distributed energy requirements that depends upon tracking and recording distributed energy, rather than acquiring and retiring renewable energy credits. Further, APS described its Community Solar program, a utility-owned 25 MW program that will be split into 3 to 7 separate projects throughout communities in APS's service territory (this is the 25 MW program described in clause (iv) of the preceding paragraph). APS expects a decision from the ACC around year end.

***Demand Side Management Adjustor Charge.*** The ACC Electric Energy Efficiency Standards require APS to submit a Demand Side Management Implementation Plan for review by and approval of the ACC. In 2010, the DSMAC was modified to recover estimated amounts for use on certain demand side management programs over the current year. Previously, the DSMAC allowed for such recovery only on a historical or after-the-fact basis. The surcharge allows for the recovery of energy efficiency program expenses and any earned incentives.

The ACC previously approved recovery of all 2009 program costs plus incentives. The change from program cost recovery on a historical basis to recovery on a concurrent basis, as authorized in the 2008 retail rate case settlement agreement, resulted in this one-time need to address two years (2009 and 2010) of cost recovery. As requested by APS, 2009 program cost recovery is to be amortized over a three-year period, which ends in 2012.

On June 1, 2011, APS filed its 2012 Demand Side Management Implementation Plan consistent with the ACC's Electric Energy Efficiency Standards, which became effective January 1, 2011. The 2012 requirement under such standards is for cumulative energy efficiency savings of 3% of APS retail sales for the prior year. This energy savings requirement is slightly higher than the goal established by the 2008 retail rate case settlement agreement (2.75% of total energy resources for the same two-year period). The ACC issued an order on April 4, 2012 approving recovery of approximately \$72 million of APS's energy efficiency and demand side management program costs over a twelve-month period beginning March 1, 2012. This amount does not include \$10 million already being recovered in general retail base rates.



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On June 1, 2012, APS filed its 2013 Demand Side Management Implementation Plan. In 2013, the standards will require APS to achieve cumulative energy savings equal to 5% of its 2012 retail energy sales. Later this year, APS intends to file a supplement to its plan that will include a proposed budget for 2013.

**PSA Mechanism and Balance.** The PSA provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs.

The following table shows the changes in the deferred fuel and purchased power regulatory asset (liability) for 2012 and 2011 (dollars in millions):

	Nine Months Ended				
	2012		September 30,		2011
Beginning balance	\$	28	\$	(58)	
Deferred fuel and purchased power costs – current period		(52)		(31)	
Amounts credited to customers		92		121	
Ending balance	\$	68	\$	32	

The PSA rate for the PSA year beginning February 1, 2012 is negative \$0.0042 per kWh as compared to negative \$0.0057 per kWh for the prior year. Any uncollected (overcollected) deferrals during the 2012 PSA year will be included in the calculation of the PSA rate for the PSA year beginning February 1, 2013.

**Transmission Rates and Transmission Cost Adjustor.** In July 2008, the United States Federal Energy Regulatory Commission (FERC) approved an Open Access Transmission Tariff for APS to move from fixed rates to a formula rate-setting methodology in order to more accurately reflect and recover the costs that APS incurs in providing transmission services. A large portion of the rate represents charges for transmission services to serve APS's retail customers (Retail Transmission Charges). In order to recover the Retail Transmission Charges, APS was previously required to file an application with, and obtain approval from, the ACC to reflect changes in Retail Transmission Charges through the TCA. Under the terms of the Settlement Agreement (discussed above), however, an adjustment to rates to recover the Retail Transmission Charges will be made annually each June 1 beginning in 2013 and will go into effect automatically unless suspended by the ACC.

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

Effective June 1, 2011, APS's annual wholesale transmission rates for all users of its transmission system increased by approximately \$44 million for the twelve-month period beginning June 1, 2011 in accordance with the FERC-approved formula as a result of higher costs and lower revenues reflected in



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the formula. Approximately \$38 million of this revenue increase relates to Retail Transmission Charges. The ACC approved the related increase of APS' s TCA rate on June 21, 2011 and it became effective on July 1, 2011.

Effective June 1, 2012, APS' s annual wholesale transmission rates for all users of its transmission system increased by approximately \$16 million for the twelve-month period beginning June 1, 2012 in accordance with the FERC-approved formula. Because of higher relative system demand by APS' s retail customers, the approximately \$16 million increase reflects roughly a \$2 million decrease for wholesale customers and an \$18 million increase for APS retail customers.

On May 14, 2012, APS filed an application with the ACC to implement the FERC-approved transmission rates for retail customers. On July 18, 2012, the ACC approved the application authorizing the implementation of the FERC-approved transmission rates for retail customers, which became effective August 2012.

As part of APS' s proposed acquisition of Southern California Edison' s ( SCE ) interest in Units 4 and 5 of Four Corners, APS and SCE agreed that upon closing of the acquisition (or in 2016 if the closing does not occur), the companies will terminate an existing agreement that provides transmission capacity for SCE to transmit its portion of the output from Four Corners to California. On October 1, 2012, APS filed a request with FERC seeking authorization to cancel the existing agreement and defer a \$40 million payment to be made by APS associated with the termination and recover the payment through amortization over a 29-year period. APS expects a decision from FERC before the end of 2012. We believe these costs are recoverable, but cannot predict whether FERC will approve our request; however, if the recovery is disallowed by FERC, APS would record a charge to its results of operations at the time of the disallowance.

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## PINNACLE WEST CAPITAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**Regulatory Assets and Liabilities**

The detail of regulatory assets is as follows (dollars in millions):

	September 30, 2012		December 31, 2011	
	Current	Non-Current	Current	Non-Current
Pension and other postretirement benefits	\$	\$ 939	\$	\$ 1,023
Income taxes allowance for funds used during construction ( AFUDC ) equity	3	91	3	81
Deferred fuel and purchased power mark-to-market (Note 8)	11	16	43	34
Transmission vegetation management	9	25	9	32
Coal reclamation	8	26	2	35
Palo Verde VIEs (Note 7)		37		35
Deferred compensation		35		33
Deferred fuel and purchased power (a)	68		28	
Tax expense of Medicare subsidy	2	17	2	18
Loss on reacquired debt	1	18	1	19
Income taxes investment tax credit basis adjustment	1	17		15
Pension and other postretirement benefits deferral	8	15		12
Demand side management (a)			7	1
Other	11	15	2	14
Total regulatory assets (b)	\$ 122	\$ 1,251	\$ 97	\$ 1,352

(a) See Cost Recovery Mechanisms discussion above.

(b) There are no regulatory assets for which the ACC has allowed recovery of costs but not allowed a return by exclusion from rate base. FERC rates are set using a formula rate as described in Transmission Rates and Transmission Cost Adjustor.

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The detail of regulatory liabilities is as follows (dollars in millions):

	September 30, 2012		December 31, 2011	
	Current	Non-Current	Current	Non-Current
Removal costs (a)	\$ 28	\$ 328	\$ 22	\$ 349
Asset retirement obligations		258		225
Renewable energy standard (b)	47		54	
Income taxes - change in rates		59		59
Spent nuclear fuel	9	38	5	44
Deferred gains on utility property	2	13	2	14
Income taxes- deferred investment tax credit	1	35	1	30
Demand side management (b)	8			
Other	1	16	4	16
Total regulatory liabilities	\$ 96	\$ 747	\$ 88	\$ 737

(a) In accordance with regulatory accounting guidance, APS accrues for removal costs for its regulated assets, even if there is no legal obligation for removal.

(b) See Cost Recovery Mechanisms discussion above.

#### 4. Retirement Plans and Other Benefits

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a non-qualified supplemental excess benefit retirement plan, and other postretirement benefit plans for the employees of Pinnacle West and our subsidiaries. Pinnacle West uses a December 31 measurement date for its pension and other postretirement benefit plans. The market-related value of our plan assets is their fair value at the measurement date. See Note 14 for the fair value discussion of plan assets held in our retirement and other benefit plans.

Certain pension and other postretirement benefit costs in excess of amounts recovered in electric retail rates were deferred as a regulatory asset for future recovery, pursuant to an ACC regulatory order. We deferred pension and other postretirement benefit costs of approximately \$3 million for the three months ended September 30, 2011, and approximately \$14 million and \$9 million for the nine months ended September 30, 2012 and 2011, respectively. Pursuant to an ACC regulatory order, we began amortizing the regulatory asset in July 2012. We amortized approximately \$2 million for the three and nine months ended September 30, 2012. The following table provides details of the plans' net periodic benefit costs and the portion of these costs charged to expense (including administrative costs and excluding amounts capitalized as overhead construction, billed to electric plant participants or charged or amortized to the regulatory asset) (dollars in millions):



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	<b>Pension Benefits</b>				<b>Other Benefits</b>			
	<b>Three Months Ended September 30, 2012</b>		<b>Nine Months Ended September 30, 2012</b>		<b>Three Months Ended September 30, 2011</b>		<b>Nine Months Ended September 30, 2011</b>	
Service cost - benefits earned during the period	\$ 16	\$ 14	\$ 48	\$ 43	\$ 7	\$ 5	\$ 20	\$ 17
Interest cost on benefit obligation	30	31	90	94	12	12	35	35
Expected return on plan assets	(35)	(33)	(106)	(100)	(12)	(10)	(34)	(31)
Amortization of:								
Prior service cost			1	1				
Net actuarial loss	11	7	33	19	5	4	15	11
Net periodic benefit cost	\$ 22	\$ 19	\$ 66	\$ 57	\$ 12	\$ 11	\$ 36	\$ 32
Portion of cost charged to expense	\$ 12	\$ 7	\$ 25	\$ 22	\$ 7	\$ 4	\$ 13	\$ 12

**Contributions**

We have contributed \$65 million to our pension plan year to date in 2012. The minimum contributions for the pension plan due in 2013 and 2014 under the recently enacted Moving Ahead for Progress in the 21st Century Act (MAP-21) are estimated to be zero and \$89 million, respectively. However, we are currently evaluating future expected contributions considering the pension plan's current funded status, discount rates, interest rates, investment returns and actual contributions made in prior years, among other factors, to determine the level to which future contributions may exceed these new minimum funding levels. The contributions to our other postretirement benefit plans for 2012, 2013 and 2014 are expected to be approximately \$20 million each year.

**5. Business Segments**

Pinnacle West's only reportable business segment is our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily retail and wholesale sales supplied to traditional cost-based rate regulation (Native Load) customers) and related activities and includes electricity generation, transmission and distribution.

Financial data for the three and nine months ended September 30, 2012 and 2011 and at September 30, 2012 and December 31, 2011 is provided as follows (dollars in millions):



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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Operating revenues:</b>				
Regulated electricity segment	\$ 1,109	\$ 1,124	\$ 2,607	\$ 2,571
All other		1	2	2
<b>Total</b>	<b>\$ 1,109</b>	<b>\$ 1,125</b>	<b>\$ 2,609</b>	<b>\$ 2,573</b>
<b>Net income attributable to common shareholders:</b>				
Regulated electricity segment	\$ 246	\$ 246	\$ 364	\$ 318
All other (a)	(1)	9	(5)	9
<b>Total</b>	<b>\$ 245</b>	<b>\$ 255</b>	<b>\$ 359</b>	<b>\$ 327</b>
<b>Assets:</b>				
	<b>As of September 30, 2012</b>		<b>As of December 31, 2011</b>	
Regulated electricity segment	\$ 13,426	\$ 13,068		
All other (a)	34	43		
<b>Total</b>	<b>\$ 13,460</b>	<b>\$ 13,111</b>		

(a) All other activities relate to APSES, SunCor, Pinnacle West and El Dorado. See Note 13 for discussion of discontinued operations.

**6. Income Taxes**

The \$70 million long-term income tax receivable on the Condensed Consolidated Balance Sheets represents the anticipated refunds related to an APS tax accounting method change approved by the Internal Revenue Service ( IRS ) in the third quarter of 2009. This amount is classified as long-term, as there remains uncertainty regarding the timing of this cash receipt. Further clarification of the timing is expected from the IRS within the next twelve months.

Net Income associated with the Palo Verde sale leaseback variable interest entities is not subject to tax (see Note 7). As a result, there is no income tax expense associated with the VIEs recorded on the Condensed Consolidated Statements of Income.

It is reasonably possible that within the next twelve months the IRS will finalize the examination of tax returns for the years ended December 31, 2008 and 2009. At this time, a reasonable estimate of the range of 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.

On February 17, 2011, Arizona enacted legislation (H.B. 2001) that included a four year phase-in of corporate income tax rate reductions beginning in 2014. As a result of these tax rate reductions, Pinnacle West has revised the tax rate applicable to reversing temporary items in Arizona. In accordance with accounting for regulated companies, the benefit of this rate reduction is substantially offset by a regulatory liability.



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As of September 30, 2012, the tax year ended December 31, 2008 and all subsequent tax years remain subject to examination by the IRS. With few exceptions, we are no longer subject to state income tax examinations by tax authorities for years before 2007.

**7. Palo Verde Sale Leaseback Variable Interest Entities**

In 1986, APS entered into agreements with three separate VIE lessor trusts in order to sell and lease back interests in Palo Verde Unit 2 and related common facilities. APS will pay approximately \$49 million per year for the years 2012 to 2015 related to these leases. The lease agreements include fixed rate renewal periods, which gives APS the ability to utilize the asset for a significant portion of the asset's economic life, and therefore provide APS with the power to direct activities of the VIEs that most significantly impact the VIEs' economic performance. Predominately due to the fixed rate renewal periods, APS has been deemed the primary beneficiary of these VIEs and therefore consolidates the VIEs.

As a result of consolidation, we eliminate rent expense and recognize depreciation and interest expense, resulting in an increase in net income for the three and nine months ended September 30, 2012 of \$8 million and \$24 million, respectively, entirely attributable to the noncontrolling interests. Income attributable to Pinnacle West shareholders remains the same. Consolidation of these VIEs also results in changes to our Condensed Consolidated Statements of Cash Flows, but does not impact net cash flows.

Our Condensed Consolidated Balance Sheets at September 30, 2012 and December 31, 2011 include the following amounts relating to the VIEs (in millions):

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Palo Verde sale leaseback property plant and equipment, net of accumulated depreciation	\$ 130	\$ 133
Current maturities of long-term debt	26	31
Palo Verde sale leaseback lessor notes long-term debt excluding current maturities	57	66
Equity Noncontrolling interests	129	108

Assets of the VIEs are restricted and may only be used to settle the VIEs' debt obligations and for payment to the noncontrolling interest holders. Other than the VIEs' assets reported on our consolidated financial statements, the creditors of the VIEs have no other recourse to the assets of APS or Pinnacle West, except in certain circumstances such as a default by APS under the lease.

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APS is exposed to losses relating to these VIEs upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the United States Nuclear Regulatory Commission ( NRC ) issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to make specified payments to the VIEs noncontrolling equity participants, assume the VIEs debt, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of September 30, 2012, APS would have been required to pay the noncontrolling equity participants approximately \$142 million and assume \$83 million of debt. Since APS consolidates these VIEs, the debt APS would be required to assume is already reflected in our Condensed Consolidated Balance Sheets.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

For regulatory ratemaking purposes the leases continue to be treated as operating leases and, as a result, we have recorded a regulatory asset relating to the arrangements.

**8. Derivative Accounting**

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas, coal, emissions allowances and in interest rates. We manage risks associated with market volatility by utilizing various physical and financial derivative instruments, including futures, forwards, options and swaps. As part of our overall risk management program, we may use derivative instruments to hedge purchases and sales of electricity and fuels. Derivative instruments that meet certain hedge accounting criteria may be designated as cash flow hedges and are used to limit our exposure to cash flow variability on forecasted transactions. The changes in market value of such instruments have a high correlation to price changes in the hedged transactions. We also enter into derivative instruments for economic hedging purposes. While we believe the economic hedges mitigate exposure to fluctuations in commodity prices, these instruments have not been designated as accounting hedges. Contracts that have the same terms (quantities, delivery points and delivery periods) and for which power does not flow are netted, which reduces both revenues and fuel and purchased power costs in our Condensed Consolidated Statements of Income, but does not impact our financial condition, net income or cash flows.

On June 1, 2012, we elected to discontinue cash flow hedge accounting treatment for the significant majority of our contracts that had previously been designated as accounting hedges. This discontinuation is due to changes in PSA recovery (see Note 3), which now allows for 100% deferral of the unrealized gains and losses relating to these contracts. For those contracts that were de-designated, all changes in fair value after May 31, 2012 are no longer recorded through other comprehensive income ( OCI ), but are deferred through the PSA. The amounts previously recorded in accumulated OCI relating to these instruments will remain in accumulated OCI, and will transfer to earnings in the same period or periods during which the hedged transaction affects earnings or sooner if we determine it is probable that the forecasted transaction will not occur. Cash flow hedge accounting treatment will continue for a limited number of contracts that are not subject to PSA recovery.

Our derivative instruments, excluding those qualifying for a scope exception, are recorded on the balance sheet as an asset or liability and are measured at fair value; see Note 14 for a discussion of fair value measurements. Derivative instruments may qualify for the normal purchases and normal sales scope exception if they require physical delivery and the quantities represent those transacted in the normal course of business. Derivative instruments qualifying for the normal purchases and sales scope exception are accounted for under the accrual method of accounting and excluded from our derivative instrument discussion and disclosures below.

Hedge effectiveness is the degree to which the derivative instrument contract and the hedged item are correlated and is measured based on the relative changes in fair value of the derivative instrument contract and the hedged item over time. We assess hedge effectiveness both at inception and on a continuing basis. These assessments exclude the time value of certain options. For accounting hedges that are deemed an effective hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of OCI and reclassified into earnings in the same period during which the hedged transaction affects earnings. We recognize in current earnings, subject to the PSA, the gains and losses representing hedge ineffectiveness, and the gains and losses on any hedge components which are excluded from our effectiveness assessment. As cash flow hedge accounting has been discontinued for the



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significant majority of our contracts, after May 31, 2012, effectiveness testing is no longer being performed for these contracts.

Prior to the Settlement Agreement, for its regulated operations, APS deferred for future rate treatment approximately 90% of unrealized gains and losses on certain derivatives pursuant to the PSA mechanism that would otherwise be recognized in income. Due to the Settlement Agreement, for its regulated operations, APS now defers for future rate treatment 100% of the unrealized gains and losses for delivery periods after June 30, 2012 on derivatives pursuant to the PSA mechanism that would otherwise be recognized in income. Realized gains and losses on derivatives are deferred in accordance with the PSA to the extent the amounts are above or below the Base Fuel Rate (see Note 3). Gains and losses from derivatives in the following tables represent the amounts reflected in income before the effect of PSA deferrals.

As of September 30, 2012, we had the following outstanding gross notional volume of derivatives, which represent both purchases and sales (does not reflect net position):

Commodity	Quantity	
Power	8,517	gigawatt hours
Gas	155	Bcfs (a)

(a) Bcf is Billion Cubic Feet.

**Gains and Losses from Derivative Instruments**

The following table provides information about gains and losses from derivative instruments in designated cash flow accounting hedging relationships during the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

Commodity Contracts	Financial Statement Location	Three Months Ended September 30,		Nine Months Ended September 30,	
		2012	2011	2012	2011
Loss Recognized in OCI on Derivative Instruments (Effective Portion)	Other comprehensive loss - derivative instruments	\$ (119)	\$ (25,457)	\$ (37,513)	\$ (40,792)
Loss Reclassified from Accumulated Other Comprehensive Income into Income (Effective Portion Realized) (a)	Fuel and purchased power	(49,478)	(59,144)	(86,993)	(99,278)
			17	117	(147)

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Gain (Loss) Recognized in Income (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Fuel and purchased power
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(a) During the nine months ended September 30, 2012, we had \$1.8 million of losses reclassified from accumulated other comprehensive income to earnings related to discontinued cash flow hedges. There were no amounts reclassified in the third quarter of 2012 and in the 2011 periods related to discontinued cash flow hedges.

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During the next twelve months, we estimate that a net loss of \$51 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. In accordance with the PSA, substantially all of these amounts will be recorded as either a regulatory asset or liability and have no immediate effect on earnings.

The following table provides information about gains and losses from derivative instruments not designated as accounting hedging instruments during the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

Commodity Contracts	Financial Statement Location	Three Months Ended September 30,		Nine Months Ended September 30,	
		2012	2011	2012	2011
Net Gain Recognized in Income	Operating revenues	\$ 258	\$ 81	\$ 19	\$ 1,085
Net Gain (Loss) Recognized in Income	Fuel and purchased power	12,870	(13,219)	13,860	(25,138)
Total		\$ 13,128	\$ (13,138)	\$ 13,879	\$ (24,053)

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

The following table provides information about the fair value of our risk management activities reported on a gross basis. Transactions with counterparties that have master netting arrangements are reported net on the Condensed Consolidated Balance Sheets. These amounts are located in the assets and liabilities from risk management activities lines of our Condensed Consolidated Balance Sheets. Amounts are as of September 30, 2012 (dollars in thousands):

Commodity Contracts	Designated as Hedging Instruments	Not Designated as Hedging Instruments	Margin and Collateral Provided to Counterparties	Collateral Provided from Counterparties	Other (b)	Total
Current Assets	\$	\$ 57,165	\$ 320	\$	\$ (31,228)	\$ 26,257
Investments and Other Assets		47,868			(9,419)	38,449
Total Assets		105,033	320		(40,647)	64,706
Current Liabilities	(1,092)	(117,325)	43,480	(13,145)(a)	31,819	(56,263)
Deferred Credits and Other	(4,523)	(103,173)	17,033		9,419	(81,244)
Total Liabilities	(5,615)	(220,498)	60,513	(13,145)	41,238	(137,507)
Total	\$ (5,615)	\$ (115,465)	\$ 60,833	\$ (13,145)	\$ 591	\$ (72,801)

(a) Collateral relates to non-derivative instruments or derivative instruments that qualify for a scope exception.

(b) Other represents derivative instrument netting, option premiums, and other risk management contracts.



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The following table provides information about the fair value of our risk management activities reported on a gross basis at December 31, 2011 (dollars in thousands):

<b>Commodity Contracts</b>	<b>Designated as Hedging Instruments</b>	<b>Not Designated as Hedging Instruments</b>	<b>Margin and Collateral Provided to Counterparties</b>	<b>Collateral Provided from Counterparties</b>	<b>Other (b)</b>	<b>Total</b>
Current Assets	\$ 7,287	\$ 76,162	\$ 1,630	\$	\$ (54,815)	\$ 30,264
Investments and Other Assets	3,804	58,273			(12,755)	49,322
<b>Total Assets</b>	<b>11,091</b>	<b>134,435</b>	<b>1,630</b>		<b>(67,570)</b>	<b>79,586</b>
Current Liabilities	(82,195)	(124,028)	107,228	(11,145)(a)	56,172	(53,968)
Deferred Credits and Other	(68,137)	(92,880)	65,768		12,754	(82,495)
<b>Total Liabilities</b>	<b>(150,332)</b>	<b>(216,908)</b>	<b>172,996</b>	<b>(11,145)</b>	<b>68,926</b>	<b>(136,463)</b>
Total Derivative Instruments	\$ (139,241)	\$ (82,473)	\$ 174,626	\$ (11,145)	\$ 1,356	\$ (56,877)

(a) Collateral relates to non-derivative instruments or derivative instruments that qualify for a scope exception.

(b) Other represents derivative instrument netting, option premiums, and other risk management contracts.

**Credit Risk and Credit Related Contingent Features**

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management contracts with many counterparties, including two counterparties for which our exposure represents approximately 82% of Pinnacle West's \$65 million of risk management assets as of September 30, 2012. This exposure relates to long-term traditional wholesale contracts with counterparties that have high credit quality. Our risk management process assesses and monitors the financial exposure of all counterparties. Despite the fact that the great majority of trading counterparties' debt is rated as investment grade by the credit rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. Counterparties in the portfolio consist principally of financial institutions, major energy companies, municipalities and local distribution companies. We maintain credit policies that we believe minimize overall credit risk to within acceptable limits. Determination of the credit quality of our counterparties is based upon a number of factors, including credit ratings and our evaluation of their financial condition. To manage credit risk, we employ collateral requirements and standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. Valuation adjustments are established representing our estimated credit losses on our overall exposure to counterparties.

Certain of our derivative instrument contracts contain credit-risk-related contingent features including, among other things, investment grade credit rating provisions, credit-related cross default provisions, and adequate assurance provisions. Adequate assurance provisions allow a counterparty with reasonable grounds for uncertainty to demand additional collateral based on subjective events and/or conditions. For those derivative instruments in a net liability position, with investment grade credit contingencies, the counterparties could demand additional

collateral if our debt credit rating were to fall below investment grade (below BBB- for Standard & Poor's or Fitch or Baa3 for Moody's).

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The following table provides information about our derivative instruments that have credit-risk-related contingent features at September 30, 2012 (dollars in millions):

	<b>September 30, 2012</b>	
Aggregate Fair Value of Derivative Instruments in a Net Liability Position	\$	226
Cash Collateral Posted		60
Additional Cash Collateral in the Event Credit-Risk Related Contingent Features were Fully Triggered (a)		104

(a) This amount is after counterparty netting and includes those contracts which qualify for scope exceptions, which are excluded from the derivative details above.

We also have energy related non-derivative instrument contracts with investment grade credit-related contingent features which could also require us to post additional collateral of approximately \$183 million if our debt credit ratings were to fall below investment grade.

**9. Changes in Equity**

The following tables show Pinnacle West's changes in shareholders' equity and changes in equity of noncontrolling interests for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

	<b>Three Months Ended September 30, 2012</b>			<b>Three Months Ended September 30, 2011</b>		
	<b>Common Shareholders</b>	<b>Noncontrolling Interests</b>	<b>Total</b>	<b>Common Shareholders</b>	<b>Noncontrolling Interests</b>	<b>Total</b>
Beginning balance, July 1	\$ 3,778,035	\$ 121,302	\$ 3,899,337	\$ 3,613,705	\$ 101,905	\$ 3,715,610
Net income	244,823	8,040	252,863	255,359	7,426	262,785
Other comprehensive income	30,843		30,843	21,131		21,131
Total comprehensive income	275,666	8,040	283,706	276,490	7,426	283,916
Issuance of capital stock	2,365		2,365	3,789		3,789

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Reissuance (purchase) of treasury stock - net	(82)	(82)	537	537
Other (primarily stock compensation)	258	258	(436)	(436)
Net capital activities by noncontrolling interests			(421)	(421)
Ending balance, September 30	\$ 4,056,242	\$ 129,342	\$ 4,185,584	\$ 3,894,085
			\$ 108,910	\$ 4,002,995

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	Nine Months Ended September 30, 2012			Nine Months Ended September 30, 2011		
	Common Shareholders	Noncontrolling Interests	Total	Common Shareholders	Noncontrolling Interests	Total
Beginning balance, January 1	\$ 3,821,850	\$ 108,736	\$ 3,930,586	\$ 3,683,327	\$ 91,899	\$ 3,775,226
Net income	358,911	23,582	382,493	326,909	20,041	346,950
Other comprehensive income	32,688		32,688	38,224		38,224
Total comprehensive income	391,599	23,582	415,181	365,133	20,041	385,174
Issuance of capital stock	7,590		7,590	20,854		20,854
Reissuance (purchase) of treasury stock - net	3,277		3,277	(2,993)		(2,993)
Other (primarily stock compensation)	4,270		4,270	(606)		(606)
Dividends on common stock	(172,344)		(172,344)	(171,630)		(171,630)
Net capital activities by noncontrolling interests		(2,976)	(2,976)		(3,030)	(3,030)
Ending balance, September 30	\$ 4,056,242	\$ 129,342	\$ 4,185,584	\$ 3,894,085	\$ 108,910	\$ 4,002,995

**10. Commitments and Contingencies****Palo Verde Nuclear Generating Station****Spent Nuclear Fuel and Waste Disposal**

APS currently estimates it will incur \$122 million (in 2010 dollars) over the current life of Palo Verde for its share of the costs related to the on-site interim storage of spent nuclear fuel. At September 30, 2012, APS had a regulatory liability of \$47 million that represents amounts recovered in retail rates in excess of amounts spent for on-site interim spent fuel storage.

**Nuclear Insurance**

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

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secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen accidental outage of any of the three units. The property damage, decontamination, and replacement power coverages are provided by Nuclear Electric Insurance Limited ( NEIL ). APS is subject to retrospective assessments under all NEIL policies if NEIL 's losses in any policy year exceed accumulated funds. The maximum amount APS could incur under the current NEIL policies totals approximately \$18 million for each retrospective assessment declared by NEIL 's Board of Directors due to losses. In addition, NEIL policies contain rating triggers that would result in APS providing approximately \$48 million of collateral assurance within 20 business days of a rating downgrade to non-investment grade. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

**Contractual Obligations**

As of September 30, 2012, our contractual obligations for renewable energy credits increased approximately \$215 million from December 31, 2011 as discussed in the 2011 Form 10-K. As of September 30, 2012, the updated contractual obligations related to our renewable energy credits are as follows (dollars in millions):

<b>Year</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>Thereafter</b>	<b>Total</b>
Renewable Energy Credits	\$ 46	\$ 39	\$ 44	\$ 44	\$ 44	\$ 573	\$ 790

**FERC Market Issues**

On July 25, 2001, the FERC ordered an evidentiary proceeding to discuss and evaluate possible refunds for wholesale sales in the Pacific Northwest. The FERC affirmed the administrative law judge 's conclusion that the prices in the Pacific Northwest were not unreasonable or unjust and refunds should not be ordered in this proceeding. This decision was appealed to the U.S. Court of Appeals for the Ninth Circuit and ultimately remanded to the FERC for further consideration. On October 3, 2011, the FERC ordered an evidentiary, trial-type hearing before an administrative law judge to address possible activity that may have influenced prices in the Pacific Northwest spot market during the period from December 25, 2000 through June 20, 2001. FERC rejected a market-wide remedy approach and instead directed that buyers seeking refunds must demonstrate that a particular seller engaged in unlawful market activity in the spot market and that such unlawful activity directly affected the particular contract or contracts to which the seller was a party.

The first phase of the hearing is currently expected to commence in April 2013. Although the FERC has not yet determined whether any refunds will ultimately be required, we do not expect that the resolution of these issues will have a material adverse impact on our financial position, results of operations or cash flows.

**Superfund**

The Comprehensive Environmental Response, Compensation and Liability Act ( Superfund ) establishes liability for the cleanup of hazardous substances found contaminating the soil, water or air. Those who generated, transported or disposed of hazardous substances at a contaminated site are among those who are potentially responsible parties ( PRPs ). PRPs may be strictly, and often are jointly and severally, liable for clean-up. On September 3, 2003, the United States Environmental Protection Agency ( EPA ) advised APS that the EPA considers APS to be a PRP in the Motorola 52nd Street Superfund Site, Operable Unit 3 ( OU3 ) in Phoenix, Arizona. APS has facilities that are within this Superfund site.



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APS and Pinnacle West have agreed with the EPA to perform certain investigative activities of the APS facilities within OU3. In addition, on September 23, 2009, APS agreed with the EPA and one other PRP to voluntarily assist with the funding and management of the site-wide groundwater remedial investigation and feasibility study work plan. We estimate that our costs related to this investigation and study will be approximately \$2 million. We anticipate incurring additional expenditures in the future, but because the overall investigation is not complete and ultimate remediation requirements are not yet finalized, at the present time we cannot accurately estimate our total expenditures.

**Climate Change Lawsuit**

In February 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in federal court in the Northern District of California against nine oil companies, fourteen power companies (including Pinnacle West), and a coal company, alleging that the defendants emissions of carbon dioxide contribute to global warming and constitute a public and private nuisance under both federal and state law. The plaintiffs also allege that the effects of global warming will require the relocation of the village, and they are seeking an unspecified amount of monetary damages. In June 2008, the defendants filed motions to dismiss the action, which were granted. The plaintiffs filed an appeal with the Ninth Circuit Court of Appeals in November 2009. On January 24, 2011, the defendants filed a motion, which was later granted, to defer calendaring of oral argument until after the United States Supreme Court ruled in a similar nuisance lawsuit, *American Electric Power Co., Inc. v. Connecticut*.

On June 20, 2011, the Supreme Court issued its opinion in *Connecticut* holding, among other things, that the Clean Air Act and the EPA actions authorized by the act, which are aimed at controlling greenhouse gas emissions, displace any federal common law right to seek abatement of greenhouse gas emissions from fossil fuel-fired power plants. However, the Court left open the issue of whether such claims may be available under state law. On September 21, 2012, a three-judge panel of the Ninth Circuit affirmed the district court's dismissal of the *Kivalina* plaintiffs federal common law public nuisance action. The court declined to address any other issue raised by the parties, including the plaintiffs' state nuisance law claim. On October 4, 2012, the plaintiffs filed a petition for rehearing by the entire Ninth Circuit. APS continues to believe the action in *Kivalina* is without merit and will continue to defend against both the federal and state claims.

**Southwest Power Outage**

On September 8, 2011 at approximately 3:30PM, a 500 kilovolt ( kV ) transmission line running between the Hassayampa and North Gila substations in southwestern Arizona tripped out of service due to a fault that occurred at a switchyard operated by APS. At the time, an APS employee at the North Gila substation was performing a procedure to remove from service a capacitor bank that was believed not to be operating properly. Approximately ten minutes after the transmission line went off-line, generation and transmission resources for the Yuma area were lost, resulting in approximately 69,700 APS customers losing service.

Within the same time period that APS's Yuma customers lost service, a series of transmission and generation disruptions occurred across the systems of several utilities that resulted in outages affecting portions of southern Arizona, southern California and northern Mexico. A total of

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approximately 7,900 MW of firm load and 2.7 million customers were reported to have been affected. Service to all affected APS customers was restored by 9:15PM on September 8. Service to customers affected by the wider

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regional outages was restored by approximately 3:25AM on September 9. APS has an internal review of the September 8 events underway.

The FERC and the North American Electric Reliability Corporation ( NERC ) conducted a joint inquiry into the outages and, on May 1, 2012, they issued a report (the Joint Report ) with their analysis and conclusions as to the causes of the events. The report includes recommendations to help industry operators prevent similar outages in the future, including increased data sharing and coordination among the western utilities and entities responsible for bulk electric system reliability coordination. The Joint Report does not address potential reliability violations or an assessment of responsibility of the parties involved.

APS cannot predict the timing, results or potential impacts of any further inquiries into the September 8 events, or any claims that may be made as a result of the outages. If violations of NERC Reliability Standards are ultimately determined to have occurred, FERC has the legal authority to assert a possible fine of up to \$1 million per violation per day that a violation is found to have been in existence.

**Clean Air Act Lawsuit**

On October 4, 2011, Earthjustice, on behalf of several environmental organizations, filed a lawsuit in the United States District Court for the District of New Mexico against APS and the other Four Corners participants alleging violations of the Prevention of Significant Deterioration ( PSD ) provisions of the Clean Air Act. Subsequent to filing its original Complaint, on January 6, 2012, Earthjustice filed a First Amended Complaint adding claims for violations of the Clean Air Act 's New Source Performance Standards ( NSPS ) program. Among other things, the plaintiffs seek to have the court enjoin operations at Four Corners until APS applies for and obtains any required PSD permits and complies with the NSPS. The plaintiffs further request the court to order the payment of civil penalties, including a beneficial mitigation project. On April 2, 2012, APS and the other Four Corners participants filed motions to dismiss, which are pending. APS believes the claims in this matter are without merit and will vigorously defend against them. We are unable to determine a range of potential losses that are reasonably possible of occurring.

**Financial Assurances**

APS has entered into various agreements that require letters of credit for financial assurance purposes. At September 30, 2012, approximately \$76 million of letters of credit were outstanding to support existing variable interest rate pollution control bonds of a similar amount. The letters of credit are available to fund the payment of principal of and interest on such debt obligations. One of these letters of credit expires in 2015 and two expire in 2016. APS has also entered into letters of credit to support obligations to certain equity participants in the Palo Verde sale leaseback transactions (see Note 7 for further details on the Palo Verde sale leaseback transactions). These letters of credit will expire in 2015 and totaled approximately \$42 million at September 30, 2012. Additionally, APS has issued letters of credit to support collateral obligations under certain natural gas tolling contracts and hedge contracts entered into with third parties. At September 30, 2012, \$65 million of such letters

of credit were outstanding. Two of these letters of credit will expire in 2013 and one will expire in 2015.

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

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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.

**11. 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, 2012 and 2011 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Other income:</b>				
Interest income	\$ 307	\$ 429	\$ 1,018	\$ 1,364
Investment gains net				1,249
Miscellaneous	113	12	339	17
Total other income	\$ 420	\$ 441	\$ 1,357	\$ 2,630
<b>Other expense:</b>				
Non-operating costs	\$ (1,645)	\$ (1,807)	\$ (5,885)	\$ (4,925)
Investment losses net	(2,254)	(57)	(2,366)	
Miscellaneous	(1,797)	(1,188)	(4,182)	(2,996)
Total other expense	\$ (5,696)	\$ (3,052)	\$ (12,433)	\$ (7,921)

**12. Earnings Per Share**

The following table presents earnings per weighted average common share outstanding for the three and nine months ended September 30, 2012 and 2011:

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Basic earnings per share:</b>				
Income from continuing operations attributable to common shareholders	\$ 2.23	\$ 2.25	\$ 3.29	\$ 2.90
Income (loss) from discontinued operations		0.09	(0.01)	0.10
Earnings per share basic	\$ 2.23	\$ 2.34	\$ 3.28	\$ 3.00
<b>Diluted earnings per share:</b>				
Income from continuing operations attributable to common shareholders	\$ 2.21	\$ 2.24	\$ 3.26	\$ 2.88
Income (loss) from discontinued operations		0.08	(0.01)	0.10
Earnings per share diluted	\$ 2.21	\$ 2.32	\$ 3.25	\$ 2.98

Performance shares (which are contingently issuable) and restricted stock unit awards increased average diluted common shares outstanding by approximately 1,100,000 shares and 733,000 shares for the three months ended September 30, 2012 and 2011, respectively, and by approximately 971,000 shares and 680,000 shares for the nine months ended September 30, 2012 and 2011, respectively.

**13. Discontinued Operations**

**SunCor** In February 2012, SunCor filed for protection under the United States Bankruptcy Code to complete an orderly liquidation of its business. We do not expect SunCor's bankruptcy to have a material impact on Pinnacle West's financial position, results of operations, or cash flows. All activity for the income statement for the three and nine months ended September 30, 2012 and prior comparative period income statement amounts are included in discontinued operations.

**APSES** On August 19, 2011, Pinnacle West sold its investment in APSES. The sale resulted in an after-tax gain from discontinued operations of approximately \$10 million. Prior-period income statement amounts related to the sale of APSES and the associated revenues and costs are reflected in discontinued operations.

The following table provides revenue, income (loss) before income taxes and income (loss) after taxes classified as discontinued operations in Pinnacle West's Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

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	Three Months Ended September 30,		Nine Months Ended September 30,		
	2012	2011	2012	2011	
<b>Revenue:</b>					
SunCor	\$	\$	1	\$	4
APSES			11		36
Total revenue	\$	\$	12	\$	40
<b>Income (loss) before taxes:</b>					
SunCor	\$	\$	(2)	\$	(3)
APSES			18		20
Total income (loss) before taxes	\$	\$	16	\$	(3)
<b>Income (loss) after taxes:</b>					
SunCor	\$	\$	(1)	\$	(2)
APSES			10		12
Total income (loss) after taxes	\$	\$	9	\$	(2)

**14. Fair Value Measurements**

We classify our assets and liabilities that are carried at fair value within the fair value hierarchy. This hierarchy ranks the quality and reliability of the inputs used to determine fair values, which are then classified and disclosed in one of three categories. The three levels of the fair value hierarchy are:

**Level 1** Unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access at the measurement date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide information on an ongoing basis. This category includes exchange-traded equities, exchange-traded derivative instruments, cash equivalents, and investments in U.S. Treasury securities.

**Level 2** Utilizes quoted prices in active markets for similar assets or liabilities; quoted prices in markets that are not active; and model-derived valuations whose inputs are observable (such as yield curves). This category includes non-exchange traded contracts such as forwards, options, swaps and certain investments in fixed income securities. This category also includes investments in common and collective trusts and commingled funds that are redeemable and valued based on the funds' net asset values (NAV).

**Level 3** Valuation models with significant unobservable inputs that are supported by little or no market activity. Instruments in this category include long-dated derivative transactions where valuations are unobservable due to the length of the transaction, options, and transactions in locations where observable market data does not exist. The valuation models we employ utilize spot prices, forward prices, historical market data and other factors to forecast future prices.

Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Thus, a valuation may be classified in Level 3 even though the valuation may include significant inputs that are readily observable. We maximize the use of observable



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**PINNACLE WEST CAPITAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

inputs and minimize the use of unobservable inputs. We rely primarily on the market approach of using prices and other market information for identical and/or comparable assets and liabilities. If market data is not readily available, inputs may reflect our own assumptions about the inputs market participants would use. Our assessment of the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities as well as their placement within the fair value hierarchy levels. We assess whether a market is active by obtaining observable broker quotes, reviewing actual market activity, and assessing the volume of transactions. We consider broker quotes observable inputs when the quote is binding on the broker, we can validate the quote with market activity, or we can determine that the inputs the broker used to arrive at the quoted price are observable.

**Recurring Fair Value Measurements**

We apply recurring fair value measurements to certain cash equivalents, derivative instruments, investments held in our nuclear decommissioning trust and plan assets held in our retirement and other benefit plans. See Note 8 in the 2011 Form 10-K for the fair value discussion of plan assets held in our retirement and other benefit plans.

***Cash Equivalents***

Cash equivalents represent short-term investments with original maturities of three months or less in exchange traded money market funds that are valued using quoted prices in active markets.

***Risk Management Activities Derivative Instruments***

Exchange traded commodity contracts are valued using unadjusted quoted prices. For non-exchange traded commodity contracts, we calculate fair market value based on the average of the bid and offer price, discounted to reflect net present value. We maintain certain valuation adjustments for a number of risks associated with the valuation of future commitments. These include valuation adjustments for liquidity and credit risks. The liquidity valuation adjustment represents the cost that would be incurred if all unmatched positions were closed out or hedged. The credit valuation adjustment represents estimated credit losses on our net exposure to counterparties, taking into account netting agreements, expected default experience for the credit rating of the counterparties and the overall diversification of the portfolio. We maintain credit policies that management believes minimize overall credit risk.

Certain non-exchange traded commodity contracts are valued based on unobservable inputs due to the long-term nature of contracts or the unique location of the transactions. Our long-dated energy transactions consist of observable valuations for the near term portion and unobservable valuations for the long-term portions of the transaction. We rely primarily on broker quotes to value these instruments. When broker quotes are not available, the primary valuation technique used to calculate fair value is the extrapolation of forward pricing curves using

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observable market data for more liquid delivery points in the same region and actual transactions at more illiquid delivery points.

Option contracts are primarily valued using a Black-Scholes option valuation model which utilizes both observable and unobservable inputs such as broker quotes, interest rates and price volatilities.

When the unobservable portion is significant to the overall valuation of the transaction, the entire transaction is classified as Level 3. Our classification of instruments as Level 3 is primarily reflective of

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**PINNACLE WEST CAPITAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

the long-term nature of our energy transactions and the use of option valuation models with significant unobservable inputs.

Our energy risk management committee, consisting of officers and key management personnel, oversees our energy risk management activities to ensure compliance with our stated energy risk management policies. We have a risk control function that is responsible for valuing our derivative commodity instruments in accordance with established policies and procedures. The risk control function reports to the chief financial officer's organization.

***Investments Held in our Nuclear Decommissioning Trust***

The nuclear decommissioning trust invests in fixed income securities and equity securities. Equity securities are held indirectly through commingled funds. The commingled funds are valued based on NAV, which is primarily derived from the quoted active market prices of the underlying equity securities. We may transact in these commingled funds on a semi-monthly basis at the NAV, and accordingly classify these investments as Level 2. The commingled funds, which are similar to mutual funds, are maintained by a bank and hold investments in accordance with the stated objective of tracking the performance of the S&P 500 index. Because the commingled fund shares are offered to a limited group of investors, they are not considered to be traded in an active market.

Cash equivalents reported within Level 2 represent investments held in a short-term investment commingled fund, valued using NAV, which invests in U.S. government fixed income securities. We may transact in this commingled fund on a daily basis at the NAV.

Fixed income securities issued by the U.S. Treasury held directly by the nuclear decommissioning trust are valued using quoted active market prices and are classified as Level 1. Fixed income securities issued by corporations, municipalities, and other agencies including mortgage-backed instruments are valued using quoted inactive market prices, quoted active market prices for similar securities, or by utilizing calculations which incorporate observable inputs such as yield curves and spreads relative to such yield curves. These instruments are classified as Level 2. Whenever possible, multiple market quotes are obtained which enables a cross-check validation. A primary price source is identified based on asset type, class, or issue of securities.

Our trustee provides valuation of our nuclear decommissioning trust assets by using pricing services that utilize the valuation methodologies described to determine fair market value. We assess these valuations and verify that pricing can be supported by actual recent market transactions. Additionally, we obtain and review independent audit reports on the trustee's operating controls and valuation processes. See Note 15 for additional discussion about our nuclear decommissioning trust.



Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS***Fair Value Tables*

The following table presents the fair value at September 30, 2012 of our assets and liabilities that are measured at fair value on a recurring basis (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (a) (Level 3)	Other	Balance at September 30, 2012
<b>Assets</b>					
Nuclear decommissioning trust:					
U.S. commingled equity funds	\$	\$ 204	\$	\$	\$ 204
Fixed income securities:					
U.S. Treasury	93				93
Cash and cash equivalent funds		13		(3)(b)	10
Corporate debt		79			79
Mortgage-backed securities		83			83
Municipality bonds		86			86
Other		12			12
Subtotal nuclear decommissioning trust	93	477		(3)	567
Cash equivalents	46				46
Risk management activities derivative instruments:					
Commodity contracts		45	60	(40)(c)	65
Total	\$ 139	\$ 522	\$ 60	\$ (43)	\$ 678
<b>Liabilities</b>					
Risk management activities derivative instruments:					
Commodity contracts	\$	\$ (116)	\$ (110)	\$ 88(c)	\$ (138)

(a) Primarily consists of heat rate options and long-dated electricity contracts.

(b) Represents nuclear decommissioning trust net pending securities sales and purchases.

(c) Primarily represents counterparty netting, margin and collateral (see Note 8).



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## PINNACLE WEST CAPITAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the fair value at December 31, 2011 of our assets and liabilities that are measured at fair value on a recurring basis (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (a) (Level 3)	Other	Balance at December 31, 2011
<b>Assets</b>					
Nuclear decommissioning trust:					
U.S. commingled equity funds	\$	\$ 175	\$	\$	\$ 175
Fixed income securities:					
U.S. Treasury	69				69
Cash and cash equivalent funds		9		(1)(b)	8
Corporate debt		73			73
Mortgage-backed securities		78			78
Municipality bonds		90			90
Other		21			21
Subtotal nuclear decommissioning trust	69	446		(1)	514
Risk management activities derivative instruments:					
Commodity contracts		70	74	(64)(c)	80
Total	\$ 69	\$ 516	\$ 74	\$ (65)	\$ 594
<b>Liabilities</b>					
Risk management activities derivative instruments:					
Commodity contracts	\$	\$ (241)	\$ (125)	\$ 229(c)	\$ (137)

- (a) Primarily consists of heat rate options and long-dated electricity contracts.
- (b) Represents nuclear decommissioning trust net pending securities sales and purchases.
- (c) Represents counterparty netting, margin and collateral (see Note 8).

**Fair Value Measurements Classified as Level 3**

The significant unobservable inputs used in the fair value measurement of our energy derivative contracts include broker quotes that cannot be validated as an observable input primarily due to the long term nature of the quote and option model inputs. Significant changes in these inputs in isolation would result in significantly higher or lower fair value measurements. Changes in our derivative contract fair values, including

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changes relating to unobservable inputs, typically will not impact net income due to regulatory accounting treatment (see Note 3).

Because our forward commodity contracts classified as Level 3 are currently in a net purchase position generally if the price of the underlying commodity increases we would expect the net fair value



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of contracts related to that commodity to increase, and if the price of the underlying commodity decreases the net fair value of the related contracts would likely decrease.

Our option contracts classified as Level 3 primarily relate to purchase heat rate options. The significant unobservable inputs for these instruments include electricity prices, gas prices and implied volatilities. If electricity prices and electricity price implied volatilities increase we would expect the fair value of these options to increase, and if these valuation inputs decrease we would expect the fair value of these options to decrease. If natural gas prices and natural gas price implied volatilities increase we would expect the fair value of these options to decrease, and if these inputs decrease we would expect the fair value of the options to increase. The commodity prices and implied volatilities do not always move in corresponding directions. The options' fair values are impacted by the net changes of these various inputs.

Other unobservable valuation inputs include credit and liquidity reserves which do not have a material impact on our valuations; however, significant changes in these inputs could also result in higher or lower fair value measurements.

The following table provides information regarding our significant unobservable inputs used to value our Level 3 instruments.

## Risk Management Activities Derivative Instruments: Commodity Contracts

Commodity Contracts	September 30, 2012 Fair Value (millions)		Valuation Technique	Significant Unobservable Input	Range
	Assets	Liabilities			
Electricity:					
Forward Contracts (a)	\$ 57	\$ 81	Discounted cash flows	Electricity forward price (per MWh)(b)	\$22.00 - \$63.71
Option Contracts		27	Option model	Electricity forward price (per MWh)(b)	\$30.50 - \$92.37
				Natural gas forward price (per mmbtu)(c)	\$2.98 - \$4.38
				Implied electricity price volatilities	16% - 57%
				Implied natural gas price volatilities	17% - 42%
Natural Gas:					
Forward Contracts (a)	3	2	Discounted cash flows	Natural gas forward price (per mmbtu)(c)	\$2.98 - \$4.61
Total	\$ 60	\$ 110			

- 
- (a) Includes swaps and physical and financial contracts.
  - (b) MWh means megawatt-hour, one million watts per hour.
  - (c) mmbtu means one million British Thermal Units.

The following table shows the changes in fair value for our risk management activities assets and liabilities that are measured at fair value on a recurring basis using Level 3 inputs for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

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Commodity Contracts	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net derivative balance at beginning of period	\$ (45)	\$ (47)	\$ (51)	\$ (38)
Total net gains (losses) realized/unrealized:				
Included in earnings		1	2	2
Included in OCI		2	(2)	1
Deferred as a regulatory asset or liability	(3)	2	4	(4)
Settlements	(1)	6	(1)	10
Transfers into Level 3 from Level 2	(4)		(2)	(4)
Transfers from Level 3 into Level 2	3	(2)		(5)
Net derivative balance at end of period	\$ (50)	\$ (38)	\$ (50)	\$ (38)
Net unrealized gains included in earnings related to instruments still held at end of period	\$	\$	\$	\$ 1

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

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

**Nonrecurring Fair Value Measurements**

For the periods ended September 30, 2012 and 2011, we had no assets or liabilities measured at fair value on a nonrecurring basis.

**Financial Instruments Not Carried at Fair Value**

The carrying value of our net accounts receivable, accounts payable and any short-term borrowings approximate fair value. Our short term borrowings are classified within Level 2 of the fair value hierarchy. For our long-term debt fair values, see Note 2.

**15. Nuclear Decommissioning Trust**

To fund the costs APS expects to incur to decommission Palo Verde, APS established external decommissioning trusts in accordance with NRC regulations. Third-party investment managers are authorized to buy and sell securities per their stated investment guidelines. The trust funds are invested in fixed income securities and domestic equity securities. APS classifies investments in decommissioning trust funds as available for sale. As a result, we record the decommissioning trust funds at their fair value on our Condensed Consolidated Balance Sheets. See Note 14 for a discussion of how fair value is determined and the classification of the nuclear decommissioning trust investments within the fair value hierarchy. Because of the ability of APS to recover decommissioning costs in rates and in accordance

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with the regulatory treatment for decommissioning trust funds, we have recorded deferred realized and unrealized gains and losses on investment securities in other regulatory liabilities or assets. The following table includes the unrealized gains and losses based on the original cost of the investment and summarizes the fair value of APS's nuclear decommissioning trust fund assets at September 30, 2012 and December 31, 2011 (dollars in millions):

	Fair Value		Total Unrealized Gains		Total Unrealized Losses
September 30, 2012					
Equity securities	\$	204	\$	68	\$
Fixed income securities		366		27	
Net payables (a)		(3)			
Total	\$	567	\$	95	\$

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

	Fair Value		Total Unrealized Gains		Total Unrealized Losses
December 31, 2011					
Equity securities	\$	175	\$	44	\$ (1)
Fixed income securities		340		23	(1)
Net payables (a)		(1)			
Total	\$	514	\$	67	\$ (2)

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

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
Realized gains	\$	1	\$	3	\$	5	\$	6
Realized losses		(1)		(1)		(3)		(4)
Proceeds from the sale of securities (a)		84		106		295		406

- (a) Proceeds are reinvested in the trust.

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The fair value of fixed income securities, summarized by contractual maturities, at September 30, 2012 is as follows (dollars in millions):

	<b>Fair Value</b>	
Less than one year	\$	22
1 year - 5 years		94
5 years - 10 years		103
Greater than 10 years		147
Total	\$	366

**16. New Accounting Standards**

During the first quarter of 2012, we adopted amended guidance intended to converge fair value measurement and disclosure requirements for GAAP and international financial reporting standards ( IFRS ). The amended guidance clarifies how certain fair value measurement principles should be applied and requires enhanced fair value disclosures. The adoption of this new guidance resulted in additional fair value disclosures (see Note 14), but did not impact our financial statement results.

During the first quarter of 2012, we also adopted amended guidance on the presentation of comprehensive income. As a result of the amended guidance, we have changed our format for presenting comprehensive income. Previously, components of comprehensive income were presented within changes of equity. Due to the amended guidance, we now present comprehensive income in a new financial statement titled Condensed Consolidated Statements of Comprehensive Income . The adoption of this guidance changed our format for presenting comprehensive income, but did not impact our financial statement results.

Table of Contents**ARIZONA PUBLIC SERVICE COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

(dollars in thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>ELECTRIC OPERATING REVENUES</b>	\$ 1,108,623	\$ 1,124,057
<b>OPERATING EXPENSES</b>		
Fuel and purchased power	302,894	337,897
Operations and maintenance	218,403	207,967
Depreciation and amortization	100,329	106,326
Income taxes	153,797	145,230
Taxes other than income taxes	36,255	33,854
Total	811,678	831,274
<b>OPERATING INCOME</b>	<b>296,945</b>	<b>292,783</b>
<b>OTHER INCOME (DEDUCTIONS)</b>		
Income taxes	3,170	9,422
Allowance for equity funds used during construction	5,708	7,377
Other income (Note S-2)	815	617
Other expense (Note S-2)	(3,352)	(3,045)
Total	6,341	14,371
<b>INTEREST EXPENSE</b>		
Interest on long-term debt	48,841	56,314
Interest on short-term borrowings	1,334	2,846
Debt discount, premium and expense	1,070	1,164
Allowance for borrowed funds used during construction	(3,830)	(6,938)
Total	47,415	53,386
<b>NET INCOME</b>	<b>255,871</b>	<b>253,768</b>
Less: Net income attributable to noncontrolling interests (Note 7)	8,040	7,435
<b>NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER</b>	<b>\$ 247,831</b>	<b>\$ 246,333</b>

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



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

(unaudited)

(dollars in thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>NET INCOME</b>	\$ 255,871	\$ 253,768
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX</b>		
Derivative instruments:		
Net unrealized loss, net of tax benefit of \$47 and \$10,057	(72)	(15,400)
Reclassification of net realized loss, net of tax benefit of \$19,547 and \$23,366	29,931	35,778
Pension and other postretirement benefits activity, net of tax expense of \$568 and \$431	869	660
Total other comprehensive income	30,728	21,038
<b>COMPREHENSIVE INCOME</b>	286,599	274,806
Less: Comprehensive income attributable to noncontrolling interests	8,040	7,435
<b>COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER</b>	\$ 278,559	\$ 267,371

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

Table of Contents**ARIZONA PUBLIC SERVICE COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

(dollars in thousands)

	Nine Months Ended September 30,	
	2012	2011
<b>ELECTRIC OPERATING REVENUES</b>	\$ 2,606,458	\$ 2,570,737
<b>OPERATING EXPENSES</b>		
Fuel and purchased power	783,926	793,952
Operations and maintenance	640,596	669,170
Depreciation and amortization	300,997	319,477
Income taxes	233,679	193,485
Taxes other than income taxes	119,499	110,892
Total	2,078,697	2,086,976
<b>OPERATING INCOME</b>	527,761	483,761
<b>OTHER INCOME (DEDUCTIONS)</b>		
Income taxes	6,906	9,647
Allowance for equity funds used during construction	15,639	18,697
Other income (Note S-2)	2,343	3,828
Other expense (Note S-2)	(11,969)	(11,288)
Total	12,919	20,884
<b>INTEREST EXPENSE</b>		
Interest on long-term debt	150,416	165,805
Interest on short-term borrowings	5,283	7,675
Debt discount, premium and expense	3,182	3,485
Allowance for borrowed funds used during construction	(10,428)	(14,371)
Total	148,453	162,594
<b>NET INCOME</b>	392,227	342,051
Less: Net income attributable to noncontrolling interests (Note 7)	23,573	20,089
<b>NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER</b>	\$ 368,654	\$ 321,962

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

Table of Contents**ARIZONA PUBLIC SERVICE COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(unaudited)

(dollars in thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>NET INCOME</b>	<b>\$ 392,227</b>	<b>\$ 342,051</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX</b>		
Derivative instruments:		
Net unrealized loss, net of tax benefit of \$14,820 and \$16,116	(22,693)	(24,676)
Reclassification of net realized loss, net of tax benefit of \$34,367 and \$39,221	52,625	60,056
Pension and other postretirement benefits activity, net of tax expense of \$1,409 and \$1,794	2,158	2,746
Total other comprehensive income	32,090	38,126
<b>COMPREHENSIVE INCOME</b>	<b>424,317</b>	<b>380,177</b>
Less: Comprehensive income attributable to noncontrolling interests	23,573	20,089
<b>COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER</b>	<b>\$ 400,744</b>	<b>\$ 360,088</b>

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

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## ARIZONA PUBLIC SERVICE COMPANY

## CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)

	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	\$ 14,112,149	\$ 13,750,105
Accumulated depreciation and amortization	(4,898,234)	(4,706,462)
Net	9,213,915	9,043,643
Construction work in progress	587,826	496,745
Palo Verde sale leaseback, net of accumulated depreciation (Note 7)	129,962	132,864
Intangible assets, net of accumulated amortization	152,510	170,416
Nuclear fuel, net of accumulated amortization	139,873	118,098
Total property, plant and equipment	10,224,086	9,961,766
<b>INVESTMENTS AND OTHER ASSETS</b>		
Nuclear decommissioning trust (Note 15)	566,960	513,733
Assets from risk management activities (Note 8)	38,449	49,322
Other assets	31,071	30,551
Total investments and other assets	636,480	593,606
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	53,774	19,873
Customer and other receivables	363,681	280,100
Accrued unbilled revenues	136,425	125,239
Allowance for doubtful accounts	(4,297)	(3,748)
Materials and supplies (at average cost)	219,026	204,387
Fossil fuel (at average cost)	31,234	22,000
Deferred fuel and purchased power regulatory asset (Note 3)	67,910	27,549
Other regulatory assets (Note 3)	53,960	69,072
Deferred income taxes	44,115	111,503
Income tax receivable	3,644	2,869
Assets from risk management activities (Note 8)	26,257	30,264
Other current assets	28,055	26,486
Total current assets	1,023,784	915,594
<b>DEFERRED DEBITS</b>		
Regulatory assets (Note 3)	1,250,792	1,352,079
Income tax receivable (Note 6)	70,348	69,028
Unamortized debt issue costs	23,410	21,181
Other	121,785	118,983
Total deferred debits	1,466,335	1,561,271
<b>TOTAL ASSETS</b>	<b>\$ 13,350,685</b>	<b>\$ 13,032,237</b>

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

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

(unaudited)

(dollars in thousands)

	September 30, 2012	December 31, 2011
<b>LIABILITIES AND EQUITY</b>		
<b>CAPITALIZATION</b>		
Common stock	\$ 178,162	\$ 178,162
Additional paid-in capital	2,379,696	2,379,696
Retained earnings	1,716,994	1,510,740
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(36,728)	(38,886)
Derivative instruments	(56,773)	(86,705)
Total shareholder equity	4,181,351	3,943,007
Noncontrolling interests (Note 7)	129,342	108,399
Total equity (Note S-1)	4,310,693	4,051,406
Long-term debt less current maturities	3,156,531	2,828,507
Palo Verde sale leaseback lessor notes less current maturities (Note 7)	57,420	65,547
Total capitalization	7,524,644	6,945,460
<b>CURRENT LIABILITIES</b>		
Current maturities of long-term debt	90,360	477,435
Accounts payable	223,185	322,047
Accrued taxes (Note 6)	176,764	113,930
Accrued interest	50,545	54,611
Customer deposits	76,853	72,176
Liabilities from risk management activities (Note 8)	56,263	53,968
Regulatory liabilities (Note 3)	96,362	88,362
Other current liabilities	131,974	140,185
Total current liabilities	902,306	1,322,714
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	2,134,571	1,952,608
Regulatory liabilities (Note 3)	746,754	737,332
Liability for asset retirements	294,524	279,643
Liabilities for pension and other postretirement benefits (Note 4)	1,162,964	1,222,542
Liabilities for risk management activities (Note 8)	81,244	82,495
Customer advances	105,941	116,805
Coal mine reclamation	118,601	117,896
Unrecognized tax benefits (Note 6)	69,589	72,073
Other	209,547	182,669
Total deferred credits and other	4,923,735	4,764,063