

PINNACLE WEST CAPITAL CORP

Form 10-Q

November 04, 2008

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

**(Mark One)**

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

**For the quarterly period ended September 30, 2008**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

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

Indicate by check mark whether each registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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

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. (Check one):

PINNACLE WEST CAPITAL CORPORATION

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
 (Do not check if a smaller reporting company)

ARIZONA PUBLIC SERVICE COMPANY

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
 (Do not check if a 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 o No

ARIZONA PUBLIC SERVICE COMPANY Yes o 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 30, 2008: 100,814,563

ARIZONA PUBLIC SERVICE COMPANY      Number of shares of common stock, \$2.50 par value, outstanding as of October 30, 2008: 71,264,947

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

This combined Form 10-Q is separately filed by Pinnacle West Capital Corporation and Arizona Public Service Company. Each registrant is filing on its own behalf all of the information contained in this Form 10-Q that relates to such registrant and, where required, its subsidiaries. Except as stated in the preceding sentence, neither registrant is filing any information that does not relate to such registrant, and therefore makes no representation as to any such information.

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GLOSSARY

ACC	Arizona Corporation Commission
ADEQ	Arizona Department of Environmental Quality
ALJ	Administrative Law Judge
APS	Arizona Public Service Company, a subsidiary of the Company
APSES	APS Energy Services Company, Inc., a subsidiary of the Company
Base Fuel Rate	the portion of APS retail base rates attributable to fuel and purchased power costs
Clean Air Act	Clean Air Act, as amended
Company	Pinnacle West Capital Corporation
DOE	United States Department of Energy
El Dorado	El Dorado Investment Company, a subsidiary of the Company
EPA	United States Environmental Protection Agency
ERMC	Energy Risk Management Committee
FASB	Financial Accounting Standards Board
FERC	United States Federal Energy Regulatory Commission
FIN	FASB Interpretation Number
Fitch	Fitch, Inc.
GAAP	accounting principles generally accepted in the United States of America
IRS	United States Internal Revenue Service
kWh	kilowatt-hour, one thousand watts per hour
Moody's	Moody's Investors Service, Inc.
Native Load	retail and wholesale sales supplied under traditional cost-based rate regulation
Note	a Note to Pinnacle West's Condensed Consolidated Financial Statements in Item 1 of this report
NRC	United States Nuclear Regulatory Commission
OCI	other comprehensive income
Off-System Sales	sales of electricity from generation owned or contracted by the Company that is over and above the amount required to serve APS retail customers and traditional wholesale contracts
Palo Verde	Palo Verde Nuclear Generating Station
Pinnacle West	Pinnacle West Capital Corporation, the Company
Pinnacle West Energy	Pinnacle West Energy Corporation, a subsidiary of the Company, dissolved as of August 31, 2006
Pinnacle West Marketing & Trading	Pinnacle West Marketing & Trading Co., LLC, a subsidiary of the Company
PRP	potentially responsible parties under Superfund

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PSA power supply adjustor approved by the ACC to provide for recovery or refund of variations in actual fuel and purchased power costs compared with the Base Fuel Rate  
Salt River Project Salt River Project Agricultural Improvement and Power District  
SEC United States Securities and Exchange Commission  
SFAS Statement of Financial Accounting Standards  
Standard & Poor's Standard & Poor's Ratings Services  
SunCor SunCor Development Company, a subsidiary of the Company  
Superfund Comprehensive Environmental Response, Compensation and Liability Act  
2005 Deferrals PSA deferrals related to 2005 replacement power costs associated with Palo Verde outages  
2007 Form 10-K Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2007  
VIE variable-interest entity

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

(unaudited)

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

	Three Months Ended September 30,	
	2008	2007
<b>OPERATING REVENUES</b>		
Regulated electricity segment	\$ 1,040,348	\$ 1,043,723
Real estate segment	18,965	46,711
Marketing and trading	11,737	99,203
Other revenues	8,925	15,597
<b>Total</b>	<b>1,079,975</b>	<b>1,205,234</b>
<b>OPERATING EXPENSES</b>		
Regulated electricity segment fuel and purchased power	419,979	407,242
Real estate segment operations	28,941	46,075
Marketing and trading fuel and purchased power	9,503	93,860
Operations and maintenance	212,327	178,419
Depreciation and amortization	98,568	94,730
Taxes other than income taxes	28,423	34,940
Other expenses	8,321	11,246
<b>Total</b>	<b>806,062</b>	<b>866,512</b>
<b>OPERATING INCOME</b>	<b>273,913</b>	<b>338,722</b>
<b>OTHER</b>		
Allowance for equity funds used during construction	4,673	5,235
Other income (Note 14)	2,274	4,276
Other expense (Note 14)	(7,132)	(6,744)
<b>Total</b>	<b>(185)</b>	<b>2,767</b>
<b>INTEREST EXPENSE</b>		
Interest charges	51,231	53,151
Capitalized interest	(3,976)	(5,435)
<b>Total</b>	<b>47,255</b>	<b>47,716</b>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<b>226,473</b>	<b>293,773</b>
<b>INCOME TAXES</b>	<b>75,970</b>	<b>92,055</b>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<b>150,503</b>	<b>201,718</b>
<b>INCOME FROM DISCONTINUED OPERATIONS</b>		

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Net of income tax expense of \$703 and \$4,571 (Note 17)		1,083	6,990
NET INCOME		\$ 151,586	\$ 208,708
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING	BASIC	100,750	100,324
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING	DILUTED	101,018	100,829
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE			
OUTSTANDING			
Income from continuing operations	basic	\$ 1.49	\$ 2.01
Net income	basic	1.50	2.08
Income from continuing operations	diluted	1.49	2.00
Net income	diluted	1.50	2.07
DIVIDENDS DECLARED PER SHARE		\$ 0.525	\$ 0.525

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



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

(unaudited)

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

	Nine Months Ended September 30,	
	2008	2007
<b>OPERATING REVENUES</b>		
Regulated electricity segment	\$ 2,492,627	\$ 2,291,067
Real estate segment	103,587	171,662
Marketing and trading	119,868	264,311
Other revenues	26,824	36,113
Total	2,742,906	2,763,153
<b>OPERATING EXPENSES</b>		
Regulated electricity segment fuel and purchased power	1,016,918	880,932
Real estate segment operations	118,906	153,328
Marketing and trading fuel and purchased power	106,270	226,337
Operations and maintenance	601,360	527,307
Depreciation and amortization	291,959	276,584
Taxes other than income taxes	94,826	104,416
Other expenses	21,081	28,537
Total	2,251,320	2,197,441
<b>OPERATING INCOME</b>	<b>491,586</b>	<b>565,712</b>
<b>OTHER</b>		
Allowance for equity funds used during construction	16,211	14,874
Other income (Note 14)	10,050	11,976
Other expense (Note 14)	(22,103)	(13,685)
Total	4,158	13,165
<b>INTEREST EXPENSE</b>		
Interest charges	157,580	155,104
Capitalized interest	(14,593)	(15,455)
Total	142,987	139,649
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>	<b>352,757</b>	<b>439,228</b>
<b>INCOME TAXES</b>	<b>92,489</b>	<b>141,809</b>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<b>260,268</b>	<b>297,419</b>
<b>INCOME FROM DISCONTINUED OPERATIONS</b>		
Net of income tax expense of \$13,431 and \$4,446 (Note 17)	20,707	6,813

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NET INCOME		\$ 280,975	\$ 304,232
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING	BASIC	100,642	100,200
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING	DILUTED	100,911	100,767
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE			
OUTSTANDING			
Income from continuing operations	basic	\$ 2.59	\$ 2.97
Net income	basic	2.79	3.04
Income from continuing operations	diluted	2.58	2.95
Net income	diluted	2.78	3.02
DIVIDENDS DECLARED PER SHARE		\$ 1.575	\$ 1.575

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, 2008	December 31, 2007
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 104,528	\$ 56,321
Customer and other receivables	552,629	456,007
Allowance for doubtful accounts	(3,960)	(4,782)
Materials and supplies (at average cost)	162,969	149,759
Fossil fuel (at average cost)	28,109	27,792
Deferred income taxes	22,847	31,510
Home inventory	82,086	98,729
Assets from risk management and trading activities (Note 10)	26,534	57,605
Other current assets	23,961	33,988
<b>Total current assets</b>	<b>999,703</b>	<b>906,929</b>
<b>INVESTMENTS AND OTHER ASSETS</b>		
Real estate investments net	440,723	532,600
Assets from long-term risk management and trading activities (Note 10)	20,507	48,928
Nuclear decommissioning trust (Note 18)	359,697	379,347
Other assets	123,542	117,941
<b>Total investments and other assets</b>	<b>944,469</b>	<b>1,078,816</b>
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	12,090,518	11,640,739
Less accumulated depreciation and amortization	4,110,345	4,004,944
<b>Net</b>	<b>7,980,173</b>	<b>7,635,795</b>
Construction work in progress	572,575	625,577
Intangible assets, net of accumulated amortization	134,190	105,746
Nuclear fuel, net of accumulated amortization	97,756	69,271
<b>Total property, plant and equipment</b>	<b>8,784,694</b>	<b>8,436,389</b>
<b>DEFERRED DEBITS</b>		
Deferred fuel and purchased power regulatory asset (Note 5)	57,703	110,928
Other regulatory assets	559,837	514,353
Other deferred debits	106,472	114,794

Total deferred debits	724,012	740,075
<b>TOTAL ASSETS</b>	<b>\$ 11,452,878</b>	<b>\$ 11,162,209</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, 2008	December 31, 2007
<b>LIABILITIES AND COMMON STOCK EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 307,410	\$ 323,346
Accrued taxes (Note 8)	145,083	269,628
Accrued interest	41,783	39,836
Short-term borrowings	441,547	340,661
Current maturities of long-term debt (Note 4)	155,817	163,773
Customer deposits	79,093	80,010
Liabilities from risk management and trading activities (Note 10)	44,795	24,510
Other current liabilities	145,808	102,685
<b>Total current liabilities</b>	<b>1,361,336</b>	<b>1,344,449</b>
<b>LONG-TERM DEBT LESS CURRENT MATURITIES (NOTE 4)</b>	<b>3,047,404</b>	<b>3,127,125</b>
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	1,429,385	1,243,743
Regulatory liabilities	630,825	642,564
Liability for asset retirements	271,814	281,903
Liabilities for pension and other postretirement benefits (Note 6)	503,724	504,603
Liabilities from long-term risk management and trading activities (Note 10)	46,948	4,701
Other	548,457	481,510
<b>Total deferred credits and other</b>	<b>3,431,153</b>	<b>3,159,024</b>
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		
<b>COMMON STOCK EQUITY</b>		
Common stock, no par value	2,142,475	2,135,787
Treasury stock	(2,854)	(2,054)
<b>Total common stock</b>	<b>2,139,621</b>	<b>2,133,733</b>
<b>Accumulated other comprehensive income (loss) (Note 11):</b>		
Pension and other postretirement benefits	(43,566)	(39,336)
Derivative instruments	(19,056)	23,473
<b>Total accumulated other comprehensive loss</b>	<b>(62,622)</b>	<b>(15,863)</b>

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Retained earnings	1,535,986	1,413,741
Total common stock equity	3,612,985	3,531,611
<b>TOTAL LIABILITIES AND COMMON STOCK EQUITY</b>	<b>\$ 11,452,878</b>	<b>\$ 11,162,209</b>

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

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

(unaudited)  
(dollars in thousands)

	Nine Months Ended September 30,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 280,975	\$ 304,232
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	317,366	301,383
Deferred fuel and purchased power	(104,774)	(203,065)
Deferred fuel and purchased power amortization	157,999	198,677
Deferred fuel and purchased power regulatory disallowance		14,370
Allowance for equity funds used during construction	(16,211)	(14,874)
Deferred income taxes	228,567	46,023
Change in mark-to-market valuations	1,411	18,907
Changes in current assets and liabilities:		
Customer and other receivables	(91,038)	(120,832)
Materials, supplies and fossil fuel	(13,527)	(29,786)
Other current assets	25,906	13,351
Accounts payable	(10,571)	(49,457)
Other current liabilities	66,289	106,609
Expenditures for real estate investments	(17,397)	(99,487)
Other changes in real estate assets	34,875	4,991
Change in unrecognized tax benefits	(107,069)	25,285
Change in margin and collateral accounts-assets	19,510	(50,367)
Change in other long-term assets	11,152	10,260
Change in other long-term liabilities	478	1,254
 Net cash flow provided by operating activities	 783,941	 477,474
 <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(707,685)	(734,802)
Contributions in aid of construction	40,950	24,447
Capitalized interest	(14,593)	(15,455)
Proceeds from sale of investment securities		69,225
Purchases of investment securities		(36,525)
Proceeds from nuclear decommissioning trust sales	255,706	203,014
Investment in nuclear decommissioning trust	(271,263)	(218,570)
Proceeds from sale of commercial real estate investments	94,171	33,615
Other	5,628	(3,010)
 Net cash flow used for investing activities	 (597,086)	 (678,061)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		

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Issuance of long-term debt	88,550	181,321
Repayment of long-term debt	(179,796)	(119,700)
Short-term borrowings and payments net	100,886	237,858
Dividends paid on common stock	(158,477)	(157,772)
Common stock equity issuance	8,165	18,626
Other	2,024	(3,042)
Net cash flow (used for) provided by financing activities	(138,648)	157,291
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	48,207	(43,296)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	56,321	87,210
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 104,528	\$ 43,914
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Income taxes, net of refunds	\$ 202	\$ 87,974
Interest, net of amounts capitalized	\$ 136,996	\$ 142,741
See Notes to Pinnacle West's Condensed Consolidated Financial Statements.		



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

**1. Consolidation and Nature of Operations**

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our subsidiaries: APS, SunCor, APSES, El Dorado and Pinnacle West Marketing & Trading. Intercompany accounts and transactions between the consolidated companies have been eliminated. Our accounting records are maintained in accordance with GAAP. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**2. Condensed Consolidated Financial Statements**

Our unaudited condensed consolidated financial statements reflect all adjustments that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. These condensed consolidated statements and notes should be read in conjunction with the consolidated financial statements and related notes included in our 2007 Form 10-K. These condensed consolidated financial statements and notes have been prepared consistently with the 2007 Form 10-K with the exception of the following items: (1) we have reclassified certain prior-year real estate segment revenues and expenses to discontinued operations on our Condensed Consolidated Statements of Income in accordance with SFAS No. 144; (2) we have netted certain prior-year amounts on our Condensed Consolidated Balance Sheets and Statements of Cash Flows to reflect the adoption of FASB Staff Position No. FIN 39-1 (see Note 10); (3) contributions in aid of construction was previously reported as part of capital expenditures on the Condensed Consolidated Statements of Cash Flows; and (4) change in unrecognized tax benefits was previously reported as change in other long-term liabilities and other current liabilities on the Condensed Consolidated Statements of Cash Flows. Items (3) and (4) above have been disclosed separately to provide more detail.

**3. Quarterly Fluctuations**

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

**4. Liquidity Matters**

The following table shows principal payments due on Pinnacle West's and APS' total long-term debt and capitalized lease requirements as of September 30, 2008 (dollars in millions):

Year	Consolidated Pinnacle West	APS
2008	\$ 126	\$ 1
2009	46	197
2010	199	401
2011	578	376
2012	376	1,884
Thereafter	1,886	1,884
Total	\$ 3,211	\$ 2,859

The credit and liquidity markets experienced significant stress beginning the week of September 15, 2008. Pinnacle West and APS have been able to access existing credit facilities, ensuring adequate

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

liquidity. Cash on hand is being invested in money market funds consisting of U.S. Treasury and government agency securities and repurchase agreements collateralized fully by U.S. Treasury and government agency securities.

The interest rates on eleven issues of APS pollution control bonds, in the aggregate amount of approximately \$343 million, are reset every seven days through auction processes. These bonds are supported by bond insurance policies provided by Ambac Assurance Corporation, and the interest rates on the bonds can be directly affected by the rating of the bond insurer. Certain bond insurers have had downgrades of their credit ratings due to their insuring certain mortgage-backed securities and collateralized debt obligations. Downgrades of bond insurers also increase the possibility of a failed auction, which results in higher interest rates during the failed auction periods. When auctions of APS bonds fail, the APS bondholders receive the maximum 14% annual interest rate for the week of the failed auction. For the nine months ended September 30, 2008, we had nine failed auctions, which represented about 2% of all of our auctions. The average interest rate at the end of the third quarter on the auction rate securities was 9.8%. Subsequent to September 30, 2008, a significant number of our auctions have failed. We continue to closely monitor this market. We do not expect, however, that our auction rate interest exposure will have a material adverse impact on our financial position, results of operations, cash flows or liquidity.

On September 11, 2008, APS repurchased at par two series of pollution control bonds that had no credit enhancements. These bonds were \$7 million of its 1996 Series A Coconino County Pollution Control Bonds and \$20 million of its 1999 Series A Coconino County Pollution Control Bonds ( Repurchased Bonds ). APS borrowed funds under its revolving lines of credit to re-purchase the bonds as permitted under the bond indenture. APS intends to keep the \$27 million outstanding under its line of credit until the Repurchased Bonds are sold to third parties in the near future.

Pinnacle West has a \$300 million revolving credit facility that terminates in December 2010. Credit commitments totaling approximately \$17 million from Lehman Brothers are no longer available due to its September 2008 bankruptcy filing. The remaining \$283 million revolver is available to support the issuance of up to \$250 million in commercial paper or to be used as bank borrowings, including issuances of letters of credit. At September 30, 2008, Pinnacle West had \$127 million of borrowings under its revolving credit facility, approximately \$7 million of letters of credit and \$40 million of commercial paper. Pinnacle West had remaining capacity available under its revolver of approximately \$109 million and had cash and investments of approximately \$19 million.

APS has two committed revolving credit facilities totaling \$900 million that are available either to support the issuance of up to \$250 million in commercial paper or to be used for bank borrowings, including issuances of letters of credit. The \$400 million revolver terminates in December 2010 and the \$500 million revolver terminates in September 2011. Credit commitments totaling about \$34 million from Lehman Brothers are no longer available due to its September 2008 bankruptcy filing. At September 30, 2008, APS had borrowings of approximately \$270 million and no letters of credit under its revolving lines of credit. APS had no commercial paper outstanding at September 30, 2008. At September 30, 2008, APS had remaining capacity available under its revolvers of \$596 million and had cash and investments of approximately \$76 million.

An existing ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At September 30, 2008, APS common equity ratio, as defined, was 55%, its total common equity was approximately \$3.5 billion, and its total capitalization was approximately \$6.3 billion. APS would be prohibited from paying dividends if its

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

common equity falls below approximately \$2.5 billion, assuming APS' total capitalization remains the same.

SunCor has a \$150 million loan facility secured primarily by an interest in land, commercial properties, land contracts and homes under construction (the Secured Revolver). The Secured Revolver matures December 22, 2008, which SunCor expects to renew in the near future and which requires compliance with certain loan covenants pertaining to debt to net worth, debt service, liquidity, cash flow coverage and restrictions on debt. If SunCor were unable to renew the Secured Revolver, this would have a material impact on SunCor's financial position. At September 30, 2008, SunCor had borrowings of approximately \$112 million under this facility. In addition to the Secured Revolver, at September 30, 2008, SunCor had borrowings of approximately \$70 million under other credit facilities which mature at various dates and also contain certain loan covenants.

As of September 30, 2008, the amount of SunCor's net assets that could not be transferred to Pinnacle West in the form of cash dividends as a result of the covenants mentioned above was approximately \$221 million out of a total of approximately \$297 million. As a result of the restrictions under the ACC order referenced above and contained in the SunCor loan facilities, as of September 30, 2008, the restricted net assets of our subsidiaries exceeded 25% of our consolidated net assets (at September 30, 2008, our consolidated net assets were approximately \$3.6 billion). These restrictions do not materially affect Pinnacle West's ability to meet its ongoing capital requirements.

**5. Regulatory Matters****2008 General Rate Case**

On June 2, 2008, APS filed with the ACC updated financial statements, testimony and other data in the general rate case originally filed on March 24, 2008. As requested by the ACC staff, the updated information reflects a test year ended December 31, 2007, rather than the September 30, 2007 test year used in APS' original filing. As a result of the updated filing, APS is requesting a net rate increase of \$278.2 million for retail customers effective no later than October 1, 2009. As proposed by APS, the updated request would result in an average rate increase of 8.5% for existing customers plus the establishment of a new growth-related impact fee charged to new connections. A hearing on this case is scheduled to begin on April 2, 2009.

The key financial provisions of the updated request include:

an increase of \$264.3 million in non-fuel base rates and a net increase of \$13.9 million for fuel and purchased power costs reflected in base rates, and recovery of up to \$53 million of such increases through the impact fee;

a rate base of \$5.4 billion, which approximates the ACC-jurisdictional portion of the book value of utility assets, net of accumulated depreciation and other credits, as of December 31, 2007, which includes certain adjustments, such as the inclusion of Units 5 and 6 of the Yucca Power Plant (near Yuma in southwestern Arizona), the steam generator replacement at Palo Verde Unit 3, environmental upgrades to APS coal plants, and other plant additions under construction at the end of the test year that are currently in service or expected to go into service before the proposed rates are requested to become effective;

the following proposed capital structure and costs of capital:

	Capital Structure	Cost of Capital
Long-term debt	46.2%	5.77%
Common stock equity	53.8%	11.50%
Weighted-average cost of capital		8.86%

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a Base Fuel Rate of \$0.0388 per kWh based on estimated 2010 prices (an increase from the current Base Fuel Rate of \$0.0325 per kWh, including the reclassification of \$170 million of fuel and purchased power revenues from the PSA to base rates);

an attrition adjustment of \$79.3 million to address erosion in APS earnings and return on equity through 2010; and

a new super-peak residential time-of-use rate and a commercial and industrial critical peak pricing proposal to allow eligible customers additional options to manage their electric bills, as well as other conservation-related rate design proposals.

The update also requests that the ACC adopt certain goals for APS to improve its financial strength, which include: allowing APS internal cash flow generation to cover its operating and capital costs of providing service; stabilizing and improving APS credit ratings; and providing a meaningful and ongoing opportunity for APS to achieve a reasonable return on the fair value of its property.

In addition, APS requested various modifications to the Environmental Improvement Surcharge and the Demand Side Management Adjustment Clause that would allow APS to expand its conservation and demand-side management programs and support environmental upgrades to APS facilities in response to and in anticipation of future environmental requirements.

**Motion for Approval of Interim Rate**

On June 6, 2008, APS filed with the ACC a motion in its currently pending retail rate case, requesting an interim base rate surcharge that would be subject to refund pending the final outcome of the rate case. The motion requested that the interim base rate surcharge of \$0.003987 per kWh become effective upon the expiration of the \$0.003987 per kWh 2007 PSA charge (the 2007 PSA Adjustor), the latter of which remained in effect through the last billing cycle in July 2008. On June 30, 2008, APS submitted a proposed schedule to the ACC ALJ, with a goal to resolve the motion by November 2008, without otherwise changing the nature or amount of the request. In addition, rather than becoming effective upon the expiration of the 2007 PSA Adjustor, APS proposed that the interim rates, if approved, would be reflected in customer bills during the month of November when APS switches from summer to winter rates, which are generally lower than summer rates by an amount that is more than the requested interim relief. A hearing on this matter was held in mid-September and we expect to receive a recommended order from the ALJ in the near future.

The purpose of the interim surcharge is to minimize the risk of credit rating downgrades by improving APS credit metrics until the ACC is able to grant permanent rate relief, allow APS to partially recover already incurred costs related to necessary capital expenditure programs to serve its customers, provide a better opportunity for APS to achieve a return on equity closer to the level deemed reasonable and approved by the ACC in APS last rate case, and better position APS to fund customer-centered programs and needed infrastructure and access necessary capital on reasonable terms. The interim base rate surcharge would produce approximately \$115 million in annual pretax retail revenues. APS cannot predict the outcome of this matter.

**2007 Retail Rate Order**

As previously disclosed, in June 2007 the ACC issued an order (the Retail Rate Order) in a general retail rate case that APS filed in late 2005. The Retail Rate Order approved a \$322 million increase in APS annual retail base revenues, effective July 1, 2007, which included a \$315 million fuel-related

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increase and a \$7 million non-fuel related increase. The Retail Rate Order also authorized APS' recovery of approximately \$34 million of 2005 Deferrals through a temporary PSA surcharge over a twelve-month period beginning July 1, 2007, modified the PSA in various respects and increased the Base Fuel Rate. In addition, the Retail Rate Order provided that the 2007 PSA Adjustor, which took effect on February 1, 2007 and that was scheduled to expire on January 31, 2008, remain in effect as long as necessary to allow APS to collect \$46 million of 2007 fuel and purchased power costs deferred as a result of the mid-2007 implementation of the new Base Fuel Rate. The 2007 PSA Adjustor expired as of the last billing cycle in July 2008.

**PSA Balance**

The following table shows the changes in the deferred fuel and purchased power regulatory asset for the nine months ended September 30, 2008 and 2007 (dollars in millions):

	Nine Months Ended September 30,	
	2008	2007
Beginning balance	\$ 111	\$ 160
Deferred fuel and purchased power costs-current period	103	198
Regulatory disallowance		(14)
Interest on deferred fuel and purchased power	2	5
Amounts recovered through revenues	(158)	(199)
Ending balance	\$ 58	\$ 150

The PSA rate for the PSA Year (February 1 through January 31) beginning February 1, 2008 was set at the maximum \$0.004 per kWh. Any uncollected deferrals during the 2008 PSA Year resulting from this limit will be included in the historical component of the PSA rate for the PSA Year beginning February 1, 2009.

**Rate Request for a Formula Transmission Tariff**

On July 10, 2007, APS submitted a revised Open Access Transmission Tariff filing with the FERC to move from fixed rates to a formula rate-setting methodology in order to more accurately reflect the costs that APS incurs in providing transmission services. The originally requested formula rate, based on fiscal year 2006 data, proposed an estimated \$37 million increase in annual transmission revenues, effective October 1, 2007. The proposed formula rate would be updated each year effective June 1 on the basis of APS' actual cost of service, as disclosed in APS' FERC Form 1 report for the previous fiscal year, and projected capital expenditures. Approximately \$30 million of the originally requested increase represented charges for transmission services to serve APS' retail customers (Retail Transmission Charges).

On September 21, 2007, the FERC issued an order on the proposed revisions to APS' transmission rates in which it accepted APS' proposed formula rates and ordered settlement judge procedures. The proposed rates became effective March 1, 2008, subject to refund based upon the ultimate outcome of proceedings at the FERC on this matter.

In order to recover the Retail Transmission Charges authorized by the FERC described above, on December 31, 2007, APS filed with the ACC an application to increase annual pretax retail revenues by approximately \$30 million, effective March 1, 2008. This retail rate increase implemented an ACC-approved mechanism, the transmission cost adjustor (TCA), by which changes in Retail Transmission

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Charges can be reflected in APS retail rates. On February 13, 2008, the ACC voted to approve APS request, subject to refund pending final outcome of FERC proceedings on this matter.

APS and intervening parties reached and filed a proposed settlement with the FERC on May 29, 2008 that contained some minor variations from the originally proposed formula method used for calculation of the rates. Through the proposed settlement, APS agreed to an initial increase of \$28 million in annual transmission revenues, of which \$27 million represents Retail Transmission Charges. Pursuant to the proposed settlement agreement, refund of the difference between the originally requested amount and the amount agreed to in the settlement will be netted against the next annual rate change. The refund amount is not expected to have a material impact on our financial position, results of operations or cash flows. On July 25, 2008, the FERC approved the rates and substance of the settlement through a conditional approval of the settlement, subject to the parties' revision of a procedural provision. The parties submitted their revision, which was accepted by the FERC on October 2, 2008.

In addition, during the period of settlement discussions described above, APS filed calculations with the FERC, based on fiscal year 2007 data, which resulted in the automatic adjustment on June 1, 2008 of our transmission rates under the formula mechanism (as modified in accordance with the proposed settlement at that time). As a result, APS filed a new request with the ACC to allow APS to reflect the resulting increased Retail Transmission Charges in its retail rates through the TCA. On July 3, 2008, the ACC issued an order approving this request. These calculations produced an increase in annual transmission revenues of \$15 million, of which \$13 million represents Retail Transmission Charges. Also on July 3, 2008, the ACC agreed to follow the refund method contained in the settlement agreement by allowing for the refund of any difference between the originally requested amounts and the amounts resulting from the settlement to be netted against the next annual change in Retail Transmission Charges under the TCA.

**Equity Infusion Approval**

On May 2, 2008, Pinnacle West filed a notice with the ACC that would allow Pinnacle West to infuse up to \$400 million of equity into APS in the event Pinnacle West deems it appropriate to do so to strengthen or maintain APS financial integrity. Under Arizona law and implementing regulatory decisions, Pinnacle West is required to give such notice at least 120 days prior to an equity infusion into APS that exceeds \$150 million in a single calendar year. On August 6, 2008, the ACC issued an order permitting the infusion to occur on or before December 31, 2009.

**Federal**

**FERC Order**

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

On April 17, 2006, the FERC issued an order revoking the Pinnacle West Companies' authority to make sales at market-based rates in the APS control area (the April 17 Order). The FERC found that the Pinnacle West Companies failed to provide the necessary information about the calculation of transmission

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imports into the APS control area to allow the FERC to make a determination regarding FERC's generation market power screens in the APS control area. The FERC found that the Pinnacle West Companies may charge market-based rates in the PNM and TEP control areas.

On August 13, 2007, the FERC issued an order on rehearing, reinstating the authority of the Pinnacle West Companies to make sales at market-based rates in all seasons for sales outside of the Phoenix Valley, and in all seasons except the summer for sales within the Phoenix Valley. The Pinnacle West Companies submitted a compliance filing implementing this order to the FERC on October 12, 2007. This compliance filing was accepted conditionally by the FERC in an order issued January 17, 2008. In compliance with the January 17, 2008 order, the Pinnacle West Companies filed a revised mitigation plan to implement cost-based rates for sales in the Phoenix Valley during the summer months. On May 30, 2008, the FERC issued a letter order accepting our mitigation plan. The first summer period under this cost-based mitigation began on June 1, 2008. This proceeding is now concluded.

**6. Retirement Plans and Other Benefits**

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

The following table provides details of the plans' benefit costs for the three and nine months ended September 30, 2008 and 2007. Also included is the portion of these costs charged to expense, including administrative costs and excluding amounts billed to electric plant participants or capitalized as overhead construction (dollars in millions):

	Pension Benefits				Other Benefits			
	Three Months Ended September 30, 2008		Nine Months Ended September 30, 2008		Three Months Ended September 30, 2007		Nine Months Ended September 30, 2007	
Service cost-benefits earned during the period	\$ 13	\$ 13	\$ 39	\$ 38	\$ 4	\$ 3	\$ 13	\$ 14
Interest cost on benefit obligation	27	25	83	75	8	6	28	27
Expected return on plan assets	(30)	(27)	(89)	(80)	(10)	(8)	(32)	(32)
Amortization of:								
Transition obligation					1	1	2	2
Prior service cost	1	1	2	2				
Net actuarial loss	3	4	8	12	1	1	2	3
Net periodic benefit cost	\$ 14	\$ 16	\$ 43	\$ 47	\$ 4	\$ 3	\$ 13	\$ 14
Portion of cost charged to expense	\$ 6	\$ 7	\$ 19	\$ 21	\$ 2	\$ 2	\$ 6	\$ 6
APS' share of costs charged to expense	\$ 6	\$ 7	\$ 18	\$ 20	\$ 2	\$ 2	\$ 5	\$ 6

**Contributions**

We made a \$35 million contribution to our pension plan in September 2008. Adjusted for this contribution, our plan was 94% funded on a cash-funded basis at plan year-end 2007, which is 2% over the minimum cash-funded status required by federal law under the Pension Protection Act of 2006. The contribution to our other postretirement benefit plans in 2008 is estimated to be approximately \$11 million, of which \$10



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million has been contributed through October 2008. APS and other subsidiaries fund their share of the contributions. APS share is approximately 96% of the plans.

**7. Business Segments**

Pinnacle West's two reportable business segments are:

our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electric service to Native Load customers) and related activities and includes electricity generation, transmission and distribution; and

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

Financial data for the three and nine months ended September 30, 2008 and 2007 and at September 30, 2008 and December 31, 2007 is provided as follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Operating Revenues:				
Regulated electricity segment	\$ 1,040	\$ 1,044	\$ 2,493	\$ 2,291
Real estate segment	19	46	103	171
All other (a)	21	115	147	301
Total	\$ 1,080	\$ 1,205	\$ 2,743	\$ 2,763
Net Income (Loss):				
Regulated electricity segment	\$ 158	\$ 205	\$ 273	\$ 278
Real estate segment	(6)	6	8	16
All other (a)		(2)		10
Total	\$ 152	\$ 209	\$ 281	\$ 304
		As of		As of
		September 30,		December 31,
		2008		2007
Assets:				
Regulated electricity segment		\$ 10,724		\$ 10,356
Real estate segment		568		661
All other (a)		161		145
Total		\$ 11,453		\$ 11,162

(a) Includes activities related to marketing and trading, APSES and EI

Dorado. None of these segments is a reportable segment.

**8. Income Taxes**

As a result of a change in IRS guidance, we previously claimed a tax deduction related to an APS tax accounting method change on our 2001 federal consolidated income tax return. The accelerated deduction resulted in a \$200 million reduction in the current income tax liability and a corresponding

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increase in the plant-related deferred tax liability on our 2002 financial statements. Our 2001 return was the subject of an IRS review and the IRS finalized its examination in the second quarter of 2008, which included a settlement on the tax accounting method change. As a result of this settlement, we were required to reverse a portion of accelerated deductions previously claimed. Also as a result of this settlement, the favorable resolution of other various tax matters, and the lapse of federal statutes prior to 2004, we recognized income tax benefits of approximately \$30 million in the second quarter of 2008, including approximately \$23 million related to interest. Additionally, the settlement and lapse of federal statutes have resulted in a net decrease in uncertain tax positions of \$107 million through September 30, 2008.

As of September 30, 2008, the tax year ended December 31, 2005 and all subsequent tax years remain subject to examination by the IRS. With few exceptions, we are no longer subject to state income tax examinations by tax authorities for years before 1999.

**9. Variable-Interest Entities**

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

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of September 30, 2008, APS would have been required to assume approximately \$188 million of debt and pay the equity participants approximately \$169 million.

**10. Derivative and Energy Trading Accounting**

We use derivative instruments (primarily forward purchases and sales, swaps, options and futures) to manage our exposure to the commodity price risk inherent in the purchase and sale of power, gas and emission allowances and credits. As of September 30, 2008, we hedged exposures to the price variability of the power and gas commodities for a maximum of 39 months. The changes in market value of such contracts have a high correlation to price changes in the hedged transactions.

We consider the probability of counterparty default in evaluating the effectiveness of our cash flow hedges and the expected performance of counterparties where we have elected the normal purchases and sales exception under FAS 133. Neither our cash flow hedges or our normal exception was significantly affected by changes in counterparty credit in the periods presented.

**Cash Flow Hedges**

The changes in the fair value of our hedged positions included in the Condensed Consolidated Statements of Income, after consideration of amounts deferred under the PSA, for the three and nine months ended September 30, 2008 and 2007 are comprised of the following (dollars in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$(2,483)	\$(239)	\$(78)	\$1,094
Gains from the discontinuance of cash flow hedges		6		320

During the twelve months ending September 30, 2009, we estimate that a net loss of \$21 million before income taxes will be reclassified from accumulated other comprehensive income as an offset to the effect of market price changes for the related hedged transactions. To the extent the amounts are eligible for inclusion in the PSA, the amounts will be recorded as either a regulatory asset or liability and have no effect on earnings.

**FIN 39-1**

We adopted FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39-1), on January 1, 2008. In accordance with this guidance, we elected to offset the fair value amounts for derivative instruments, including collateral, executed with the same counterparty under a master netting arrangement. Collateral was previously reported in other current assets or other current liabilities on our Condensed Consolidated Balance Sheets. This guidance required retrospective application for all prior periods presented. As a result, our Condensed Consolidated Balance Sheet and Statement of Cash Flows line items changed by the following amounts (dollars in thousands):

	As originally reported in the	Reclassifications as a result of the	After adoption of
	2007 Form 10-K	adoption of FIN 39-1	FIN 39-1
Balance Sheet - December 31, 2007			
Current Assets    Assets from risk management and trading activities	\$ 97,373	\$ (39,768)	\$ 57,605
Current Assets    Other current assets	34,738	(750)	33,988
Investments and Other Assets    Assets from long-term risk management and trading activities	89,913	(40,985)	48,928
Current Liabilities    Liabilities from risk management and trading activities	65,028	(40,518)	24,510
Deferred Credits and Other    Liabilities from long-term risk management and trading activities	45,686	(40,985)	4,701

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	As originally reported in the	Reclassifications as a result of the	After adoption
Statement of Cash Flows	September 30, 2007 Form	adoption of	of FIN 39-1
Nine months ended September 30, 2007	10-Q	FIN 39-1	of FIN 39-1
Change in other long-term assets	\$ 29,877	\$ (19,617)	\$ 10,260
Change in margin and collateral accounts assets		(50,367)	(50,367)
Change in risk management and trading liabilities	(13,959)	13,959	
Change in other long-term liabilities	54,846	7,922	62,768(a)
Collateral	(48,103)	48,103	

(a) The amount on the Condensed Consolidated Statement of Cash Flows at September 30, 2007 is \$1.3 million. The difference is due to additional reclassification of uncertain tax positions. See Note 2.

The following tables summarize our assets and liabilities from risk management and trading activities presented net in accordance with FIN 39-1 (dollars in thousands):

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
September 30, 2008					
Mark-to-market	\$ 14,773	\$ 20,507	\$ (69,886)	\$ (50,554)	\$ (85,160)
Margin account	13,019		20,841	3,606	37,466
Collateral provided to counterparties	543		4,250		4,793
Collateral provided from counterparties	(1,801)				(1,801)
Total	\$ 26,534	\$ 20,507	\$ (44,795)	\$ (46,948)	\$ (44,702)

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other
December 31, 2007				

					Net Asset
Mark-to-market	\$ 26,333	\$ 48,928	\$ (30,786)	\$ (4,701)	\$ 39,774
Margin account	30,650		6,148		36,798
Collateral provided to counterparties	622		128		750
Collateral provided from counterparties					
Total	\$ 57,605	\$ 48,928	\$ (24,510)	\$ (4,701)	\$ 77,322

We maintain a margin account with a broker to support our risk management and trading activities. Cash is deposited with the broker in this account at the time futures or options contracts are initiated. The change in market value of these contracts (reflected in mark-to-market) requires adjustment of the margin account balance.

See Note 20 for a discussion of SFAS No. 157, Fair Value Measurements, which we adopted January 1, 2008.

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**Credit Risk**

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management and trading contracts with many counterparties, including one counterparty for which a worst case exposure represents approximately 56% of Pinnacle West's \$47 million of risk management and trading assets as of September 30, 2008. This exposure relates to a long-term traditional wholesale contract with a counterparty that has very high credit quality. Our risk management process assesses and monitors the financial exposure of this and all other counterparties. Despite the fact that the great majority of trading counterparties' securities are rated as investment grade by the credit rating agencies, 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.

**11. Comprehensive Income**

Components of comprehensive income for the three and nine months ended September 30, 2008 and 2007 are as follows (dollars in thousands):

	Three Months		Nine Months	
	Ended September 30, 2008	2007	Ended September 30, 2008	2007
Net income	\$ 151,586	\$ 208,708	\$ 280,975	\$ 304,232
Other comprehensive loss:				
Net unrealized gains (losses) on derivative instruments (a)	(348,207)	(44,715)	12,584	(15,035)
Net reclassification of realized (gains) losses to income (b)	(43,718)	17,989	(82,488)	(1,072)
Net unrealized gains (losses) related to pension and other postretirement benefits (c)		605	(10,595)	(43,968)
Reclassification of pension and other postretirement benefits to income	1,175	1,223	3,522	1,702
Income tax benefit related to items of other comprehensive income	153,043	9,764	30,218	22,917
Total other comprehensive loss	(237,707)	(15,134)	(46,759)	(35,456)
Comprehensive income (loss)	\$ (86,121)	\$ 193,574	\$ 234,216	\$ 268,776

(a) These amounts primarily include unrealized gains and losses on contracts used

to hedge our  
forecasted  
electricity and  
natural gas  
requirements to  
serve Native  
Load. These  
changes are  
primarily due to  
changes in  
forward natural  
gas prices and  
wholesale  
electricity  
prices.



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

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

**12. Commitments and Contingencies**

**Palo Verde Nuclear Generating Station**

**Spent Nuclear Fuel and Waste Disposal**

Nuclear power plant operators are required to enter into spent fuel disposal contracts with the DOE, and the DOE is required to accept and dispose of all spent nuclear fuel and other high-level radioactive wastes generated by domestic power reactors. Although the Nuclear Waste Policy Act required the DOE to develop a permanent repository for the storage and disposal of spent nuclear fuel by 1998, the DOE has announced that the repository cannot be completed before at least 2017. In November 1997, the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit) issued a decision preventing the DOE from excusing its own delay, but refused to order the DOE to begin accepting spent nuclear fuel. Based on this decision and the DOE s delay, a number of utilities, including APS (on behalf of itself and the other Palo Verde owners), filed damages actions against the DOE in the Court of Federal Claims. APS is currently pursuing that damages claim. In August 2008, the United States Court of Appeals for the Federal Circuit issued decisions in three damages actions brought by other nuclear utilities that could result in a decrease in the amount of our recoverable damages; however, additional appeals in those actions are possible and APS continues to monitor the status of those actions. A trial in the APS matter is expected to occur in 2009.

APS currently estimates it will incur \$132 million (in 2008 dollars) over the life of Palo Verde for its share of the costs related to the on-site interim storage of spent nuclear fuel. At September 30, 2008, APS had a regulatory liability of \$20 million that represents amounts recovered in retail rates in excess of amounts spent for on-site interim spent fuel storage.

#### **Fuel and Purchased Power Commitments**

Pinnacle West and APS are parties to various fuel and purchased power contracts that include required purchase provisions. Pinnacle West estimates the contract requirements to be approximately \$468 million in 2008; \$426 million in 2009; \$357 million in 2010; \$307 million in 2011; \$400 million in 2012; and \$6.2 billion thereafter. APS estimates the contract requirements to be approximately \$425 million in 2008; \$426 million in 2009; \$357 million in 2010; \$307 million in 2011; \$400 million in 2012; and \$6.2 billion thereafter. However, these amounts may vary significantly pursuant to certain provisions in such contracts that permit us to decrease required purchases under certain circumstances. These amounts have increased since the 2007 Form 10-K primarily due to contingent obligations related to renewable energy contracts, primarily the 280MW solar project described in Portfolio Resources Alternative Generation Sources in Part I, Item 1 of the 2007 Form 10-K.

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

##### **FERC**

In July 2001, the FERC ordered an expedited fact-finding hearing to calculate refunds for spot market transactions in California during a specified time frame. APS was a seller and a purchaser in the California markets at issue and, to the extent that refunds are ordered, APS should be a recipient as well as a payor of such amounts. In addition, on March 19, 2002, the State of California filed a complaint with the FERC alleging that wholesale sellers of power and energy, including APS, failed to properly file rate information at the FERC in connection with sales to California from 2000 to March 2002 under market-based rates. Since 2004, the Ninth Circuit and the FERC have issued various decisions and orders involving the aforementioned issues, including decisions related to: entities subject to FERC jurisdiction and, therefore, potentially owing refunds; applicable refund methodologies; the temporal scope and types of transactions that are properly subject to the refund orders; and the appropriate standard of review at the FERC on wholesale power contracts in the refund proceedings. A settlement, resolving APS issues with certain California parties for the current refund period, was approved by the FERC in an order issued on June 30, 2008. The resolution of the claims related to the parties involved in this settlement had no material

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**PINNACLE WEST CAPITAL CORPORATION  
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adverse impact on our financial position, results of operations or cash flows. We currently believe the refund claims at the FERC related to the parties not involved in this settlement will have no material adverse impact on our financial position, results of operations or cash flows.

On March 26, 2003, the FERC made public a Final Report on Price Manipulation in Western Markets, prepared by its staff and covering spot markets in the West in 2000 and 2001. The report stated that a significant number of entities who participated in the California markets during the 2000-2001 time period, including APS, may potentially have been involved in arbitrage transactions that allegedly violated certain provisions of the Independent System Operator tariff. After reviewing the matter, along with the data supplied by APS, the FERC staff moved to dismiss the claims against APS and to dismiss the proceeding. The motion to dismiss was granted by the FERC on January 22, 2004. Certain parties sought rehearing of this order; however, under the settlement agreement mentioned above, these parties withdrew their request for rehearing on July 22, 2008.

On July 25, 2001, the FERC also ordered an evidentiary proceeding to discuss and evaluate possible refunds for wholesale sales in the Pacific Northwest. The FERC affirmed the ALJ's conclusion that the prices in the Pacific Northwest were not unreasonable or unjust and refunds should not be ordered in this proceeding. This decision was appealed to the U.S. Court of Appeals for the Ninth Circuit. On August 24, 2007, the Ninth Circuit issued an opinion that remanded the proceeding to the FERC for further consideration. Petitions for rehearing of this opinion were filed. 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.

**Navajo Nation Litigation**

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

In January 2005, Peabody served APS with a lawsuit filed in the Circuit Court for the City of St. Louis naming APS and the other Navajo Generating Station participants and seeking, among other things, a declaration that the participants are obligated to reimburse Peabody for any royalty, tax, or other obligation arising out of the D.C. Lawsuit. Based on APS' ownership interest in the Navajo Generating Station, APS could be liable for up to 14% of any such obligation. On July 10, 2008, Peabody agreed to dismiss this litigation without prejudice. APS cannot currently predict whether the lawsuit will be refiled based upon the final outcome of the D.C. Lawsuit.

**Superfund**

Superfund establishes liability for the cleanup of hazardous substances found contaminating the soil, water or air. Those who generated, transported or disposed of hazardous substances at a contaminated site are among those who are PRPs. PRPs may be strictly, and often are jointly and severally, liable for

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clean-up. On September 3, 2003, the EPA advised APS that the EPA considers APS to be a PRP in the Motorola 52<sup>nd</sup> Street Superfund Site, Operable Unit 3 (OU3) in Phoenix, Arizona. APS has facilities that are within this Superfund site. APS and Pinnacle West have agreed with the EPA to perform certain investigative activities of the APS facilities within OU3. Because the investigation has not yet been completed and ultimate remediation requirements are not yet finalized, at the present time neither APS nor Pinnacle West can accurately estimate the expenditures that may be required.

**Salt River Project**

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

**Litigation**

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

**13. Nuclear Insurance**

The Palo Verde participants have insurance for public liability resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of \$300 million and the balance by an industry-wide retrospective assessment program. If losses at any nuclear power plant covered by the program exceed the accumulated funds, APS could be assessed retrospective premium adjustments. The maximum assessment per reactor under the program for each nuclear incident is approximately \$118 million, subject to an annual limit of \$18 million per incident, to be periodically adjusted for inflation. Based on APS' interest in the three Palo Verde units, APS' maximum potential assessment per incident for all three units is approximately \$103 million, with an annual payment limitation of approximately \$15 million.

The Palo Verde participants maintain all risk (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of \$2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. APS has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen accidental outage of any of the three units. The property damage, decontamination, and replacement power coverages are provided by Nuclear Electric Insurance Limited (NEIL). APS is subject to retrospective assessments under all NEIL policies if NEIL's losses in any policy year exceed accumulated funds. The maximum amount of retrospective assessments APS could incur under the current NEIL policies totals approximately \$21 million. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

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

**14. Other Income and Other Expense**

The following table provides detail of other income and other expense for the three and nine months ended September 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Other income:				
Interest income	\$ 1,082	\$ 2,921	\$ 6,559	\$ 8,283
SunCor other income (a)	710	778	2,347	2,136
Miscellaneous	482	577	1,144	1,557
<b>Total other income</b>	<b>\$ 2,274</b>	<b>\$ 4,276</b>	<b>\$ 10,050</b>	<b>\$ 11,976</b>
Other expense:				
Non-operating costs	\$ (2,226)	\$ (3,552)	\$ (8,581)	\$ (9,207)
Investment losses net	(4,698)	(2,070)	(12,906)	(1,128)
Miscellaneous	(208)	(1,122)	(616)	(3,350)
<b>Total other expense</b>	<b>\$ (7,132)</b>	<b>\$ (6,744)</b>	<b>\$ (22,103)</b>	<b>\$ (13,685)</b>

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

**15. Guarantees**

We have issued parental guarantees and letters of credit and obtained surety bonds on behalf of our subsidiaries. Our parental guarantees for Pinnacle West Marketing & Trading and APSES relate to commodity energy products. Our credit support instruments enable APSES to offer energy-related products and commodity energy. Non-performance or non-payment under the original contract by our subsidiaries would require performance under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West's current outstanding guarantees on behalf of our subsidiaries. Our guarantees have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees. The amounts and approximate terms of our guarantees and surety bonds for each subsidiary at September 30, 2008 are as follows (dollars in millions):

	Guarantees		Surety Bonds	
	Amount	Term (in years)	Amount	Term (in years)
Parental:				
Pinnacle West Marketing & Trading	\$ 2	1	\$	
APSES	14	1	9	1

APS	4	1
Total	\$ 20	\$ 9

At September 30, 2008, Pinnacle West had approximately \$7 million of letters of credit related to workers compensation expiring in 2009. We intend to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

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

APS has entered into various agreements that require letters of credit for financial assurance purposes. At September 30, 2008, approximately \$200 million of letters of credit were outstanding to support existing pollution control bonds of approximately \$200 million. The letters of credit are available to fund the payment of principal and interest on such debt obligations and expire in 2010. APS has also entered into approximately \$78 million of letters of credit to support certain equity lessors in the Palo Verde sale leaseback transactions (see Note 9 for further details on the Palo Verde sale leaseback transactions). These letters of credit expire in 2010. APS intends to provide from either existing or new facilities for the extension, renewal or substitution of the letters of credit to the extent required.

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

**16. Earnings Per Share**

The following table presents earnings per weighted average common share outstanding for the three and nine months ended September 30, 2008 and 2007:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Basic earnings per share:				
Income from continuing operations	\$ 1.49	\$ 2.01	\$ 2.59	\$ 2.97
Income from discontinued operations	0.01	0.07	0.20	0.07
Earnings per share basic	\$ 1.50	\$ 2.08	\$ 2.79	\$ 3.04
Diluted earnings per share:				
Income from continuing operations	\$ 1.49	\$ 2.00	\$ 2.58	\$ 2.95
Income from discontinued operations	0.01	0.07	0.20	0.07
Earnings per share diluted	\$ 1.50	\$ 2.07	\$ 2.78	\$ 3.02

Dilutive stock options and performance shares (which are contingently issuable) increased average common shares outstanding by approximately 268,000 shares and 505,000 shares for the three months ended September 30, 2008 and September 30, 2007, respectively, and by approximately 269,000 shares and 567,000 shares for the nine months ended September 30, 2008 and 2007, respectively.

Options to purchase 679,000 shares of common stock for the three-month period and 600,778 shares for the nine-month period ended September 30, 2008 were outstanding but were excluded from the computation of diluted earnings per share because the options' exercise prices were higher than the average market price of the common shares. Options to purchase 610,250 shares of common stock for the three-month period and 115,200 shares for the nine-month period ended September 30, 2007 were outstanding but were excluded from the computation of diluted earnings per share because the options' exercise prices were higher than the average market price of the common shares.

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

**17. Discontinued Operations**

SunCor (real estate segment) In 2008 and 2007, SunCor sold or expects to sell commercial properties that are required to be reported as discontinued operations on Pinnacle West's Condensed Consolidated Statements of Income in accordance with SFAS No. 144. The following table contains SunCor's revenue, income before income taxes and income after income taxes classified as discontinued operations on Pinnacle West's Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2008 and 2007 (dollars in millions):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Revenue	\$ 1	\$ 1	\$ 1	\$ 4
Income before income taxes	2	12	34	11
Income after income taxes	1	7	21	7

**18. Nuclear Decommissioning Trust**

To fund the costs APS expects to incur to decommission Palo Verde, APS established external decommissioning trusts in accordance with NRC regulations. APS invests the trust funds in fixed income securities and domestic equity securities. APS applies the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, in accounting for investments in decommissioning trust funds, and classifies these investments as available for sale. As a result, we record the decommissioning trust funds at their fair value on our Condensed Consolidated Balance Sheets. Because of the ability of APS to recover decommissioning costs in rates and in accordance with the regulatory treatment for decommissioning trust funds, we have recorded the offsetting amount of gains (losses) on investment securities in other regulatory liabilities or assets. The following table summarizes the fair value of APS' nuclear decommissioning trust fund assets at September 30, 2008 and December 31, 2007 (dollars in millions):

	Trust	Total	Total
	Fund	Unrealized	Unrealized
	Assets	Gains	Losses
September 30, 2008			
Equity securities - fair value	\$ 143	\$ 37	\$ (3)
Fixed income securities - fair value	215	3	(6)
Net receivables (a)	2		
Total	\$ 360	\$ 40	\$ (9)

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

December 31, 2007

Equity securities - fair value	\$ 175	\$ 68	\$
Fixed income securities - fair value	204	5	(1)



Total	\$ 379	\$ 73	\$ (1)
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**PINNACLE WEST CAPITAL CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Realized gains	\$	\$	\$ 2	\$ 2
Realized losses	(2)	(1)	(4)	(3)
Proceeds from the sale of securities	67	70	256	203

The fair value of fixed income securities, summarized by contractual maturities, at September 30, 2008 is as follows (dollars in millions):

	September 30, 2008
Fair Value	
Less than one year	\$ 7
1 year - 5 years	45
5 years - 10 years	41
Greater than 10 years	122
Total	\$ 215

See Note 20 for a discussion of SFAS No. 157, Fair Value Measurements, which we adopted January 1, 2008.

#### **19. New Accounting Standards**

See Note 20 for a discussion of SFAS No. 157, Fair Value Measurements, which we adopted January 1, 2008.

See Notes 10 and S-1 for discussions of FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39-1), which we adopted January 1, 2008.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, was effective for us on January 1, 2008. This guidance provides companies with an option to report selected financial assets and liabilities at fair value. We did not elect the fair value option for any of our financial assets or liabilities. Therefore, SFAS No. 159 did not have an impact on our financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. This guidance requires enhanced disclosures about derivative instruments and hedging activities. The Statement is effective for us on January 1, 2009. We do not expect it to have a material impact on our financial statements.

In October 2008, the FASB issued FASB Staff Position No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. This guidance clarifies the application of SFAS No 157, Fair Value Measurements, in a market that is not active and provides guidance on key considerations in determining the fair value of a financial asset when the market for the asset is not active. We adopted this guidance in the third quarter of 2008. It did not have a material impact on our financial statements. See Note 20 for a discussion of fair value measurements.

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**PINNACLE WEST CAPITAL CORPORATION**  
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**20. Fair Value Measurements**

We adopted SFAS No. 157, Fair Value Measurements, on January 1, 2008. This new standard defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. We apply fair value measurements to derivative instruments and nuclear decommissioning trust assets. The adoption of SFAS No. 157 did not have a material impact on our financial statements.

SFAS No. 157 requires companies to disclose the fair value of certain assets and liabilities according to a fair value hierarchy. This hierarchy ranks the quality and reliability of the inputs used to determine fair values, which are then classified and disclosed in one of three categories. The three levels of the fair value hierarchy are:

Level 1 quoted prices in active markets for identical assets or liabilities.

Level 2 quoted prices in active markets for similar assets or liabilities; quoted prices in markets that are not active; and model-derived valuations whose inputs are observable.

Level 3 model-derived valuations with unobservable inputs that are supported by little or no market activity.

As required by SFAS No. 157, assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of fair value assets and liabilities and their placement within the fair value hierarchy levels. The following table presents the fair value at September 30, 2008 of our assets and liabilities that are measured at fair value on a recurring basis for Pinnacle West Consolidated (substantially all of this fair value is recorded at APS) (dollars in millions):

	Quoted Prices in Active Markets for Identical	Significant Other Observable	Significant Unobservable	Counterparty Netting	Balance at September 30, 2008
Pinnacle West:	Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)		
<b>Assets</b>					
Risk management and trading activities (a)	\$ 29	\$ 65	\$ 32	\$ (91)	\$ 35
Nuclear decommissioning trust (b)	33	325			358
<b>Total</b>	<b>\$ 62</b>	<b>\$ 390</b>	<b>\$ 32</b>	<b>\$ (91)</b>	<b>\$ 393</b>
<b>Liabilities</b>					
Risk management and trading activities (a)	\$ (45)	\$ (114)	\$ (52)	\$ 91	\$ (120)

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

- (a) Excludes \$37 million of margin account asset and net collateral of \$3 million. See Notes 10 and S-1.
- (b) The nuclear decommissioning trust invests in fixed income securities directly, and equity securities indirectly through commingled funds. Commingled funds are valued based on the fund share price and are classified within Level 2. The commingled funds underlying investments would be Level 1 if the investments were held directly by the trust. The trust fund investments have been established to satisfy APS nuclear decommissioning obligations, (see Note 18).

The following table shows the changes in fair value for assets and liabilities that are measured at fair value on a recurring basis using Level 3 inputs for the three and nine months ended September 30, 2008 for Pinnacle West Consolidated (substantially all of this fair value is recorded at APS) (dollars in millions):

Three Months Ended	Nine Months Ended
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	September 30, 2008	September 30, 2008
Net derivative asset balance at beginning of period	\$ 7	\$ 8
Total net gains (losses) realized/ unrealized:		
Included in earnings	31	(8)
Included in OCI	(11)	(3)
Deferred as a regulatory asset or liability	(37)	(23)
Purchases, issuances, and settlements		
Level 3 transfers (a)	(10)	6
Net derivative liability balance at end of period	\$ (20)	\$ (20)
Net unrealized losses included in earnings related to instruments still held as of September 30, 2008	\$ 23	\$ 3

(a) Transfers reflect fair market value as of the beginning of the quarter.

We did not have any non-recurring fair value measurements during the quarter that required disclosure.

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

(unaudited)

(dollars in thousands)

	Three Months Ended September 30,	
	2008	2007
ELECTRIC OPERATING REVENUES	\$ 1,042,084	\$ 1,047,062
<b>OPERATING EXPENSES</b>		
Fuel and purchased power	421,632	409,878
Operations and maintenance	206,526	171,963
Depreciation and amortization	96,769	92,834
Income taxes	86,484	99,469
Other taxes	28,018	34,774
Total	839,429	808,918
<b>OPERATING INCOME</b>	<b>202,655</b>	<b>238,144</b>
<b>OTHER INCOME (DEDUCTIONS)</b>		
Income taxes	1,909	1,262
Allowance for equity funds used during construction	4,673	5,235
Other income (Note S-3)	1,462	4,083
Other expense (Note S-3)	(9,458)	(3,303)
Total	(1,414)	7,277
<b>INTEREST DEDUCTIONS</b>		
Interest on long-term debt	40,841	40,232
Interest on short-term borrowings	2,563	2,715
Debt discount, premium and expense	1,162	1,162
Allowance for borrowed funds used during construction	(3,079)	(2,945)
Total	41,487	41,164
<b>NET INCOME</b>	<b>\$ 159,754</b>	<b>\$ 204,257</b>

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

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

(unaudited)

(dollars in thousands)

	Nine Months Ended September 30,	
	2008	2007
ELECTRIC OPERATING REVENUES	\$ 2,498,743	\$ 2,307,081
OPERATING EXPENSES		
Fuel and purchased power	1,022,762	889,480
Operations and maintenance	582,480	508,528
Depreciation and amortization	286,615	271,519
Income taxes	113,194	145,294
Other taxes	93,549	103,884
Total	2,098,600	1,918,705
OPERATING INCOME	400,143	388,376
OTHER INCOME (DEDUCTIONS)		
Income taxes	4,863	1,617
Allowance for equity funds used during construction	16,211	14,874
Other income (Note S-3)	4,560	12,872
Other expense (Note S-3)	(21,546)	(10,976)
Total	4,088	18,387
INTEREST DEDUCTIONS		
Interest on long-term debt	123,733	120,707
Interest on short-term borrowings	8,931	6,748
Debt discount, premium and expense	3,482	3,477
Allowance for borrowed funds used during construction	(10,687)	(7,833)
Total	125,459	123,099
NET INCOME	\$ 278,772	\$ 283,664

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

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

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
<b>UTILITY PLANT</b>		
Electric plant in service and held for future use	\$ 12,023,814	\$ 11,582,862
Less accumulated depreciation and amortization	4,099,358	3,994,777
Net	7,924,456	7,588,085
Construction work in progress	572,283	622,693
Intangible assets, net of accumulated amortization	133,681	105,225
Nuclear fuel, net of accumulated amortization	97,756	69,271
Total utility plant	8,728,176	8,385,274
<b>INVESTMENTS AND OTHER ASSETS</b>		
Nuclear decommissioning trust (Note 18)	359,697	379,347
Assets from long-term risk management and trading activities (Note S-1)	20,496	41,603
Other assets	63,942	69,570
Total investments and other assets	444,135	490,520
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	75,838	52,151
Customer and other receivables	511,314	402,244
Allowance for doubtful accounts	(3,587)	(4,265)
Materials and supplies (at average cost)	162,969	149,759
Fossil fuel (at average cost)	28,109	27,792
Assets from risk management and trading activities (Note S-1)	23,205	34,087
Deferred income taxes	31,571	38,707
Other current assets	15,132	16,545
Total current assets	844,551	717,020
<b>DEFERRED DEBITS</b>		
Deferred fuel and purchased power regulatory asset (Note 5)	57,703	110,928
Other regulatory assets	559,837	514,353
Unamortized debt issue costs	22,519	24,373
Other deferred debits	72,953	78,934



Total deferred debits	713,012	728,588
<b>TOTAL ASSETS</b>	<b>\$ 10,729,874</b>	<b>\$ 10,321,402</b>

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

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

	September 30, 2008	December 31, 2007
<b>LIABILITIES AND EQUITY</b>		
<b>CAPITALIZATION</b>		
Common stock	\$ 178,162	\$ 178,162
Additional paid-in capital	2,117,789	2,105,466
Retained earnings	1,227,830	1,076,557
Accumulated other comprehensive income (loss) (Note S-2):		
Pension and other postretirement benefits	(26,195)	(21,782)
Derivative instruments	(20,593)	13,038
Common stock equity	3,476,993	3,351,441
Long-term debt less current maturities (Note 4)	2,850,175	2,876,881
Total capitalization	6,327,168	6,228,322
<b>CURRENT LIABILITIES</b>		
Short-term borrowings	269,580	218,000
Current maturities of long-term debt (Note 4)	930	978
Accounts payable	267,295	239,923
Accrued taxes (Note 8)	238,774	374,444
Accrued interest	40,936	38,262
Customer deposits	77,528	71,376
Liabilities from risk management and trading activities (Note S-1)	44,003	19,921
Other current liabilities	142,862	92,802
Total current liabilities	1,081,908	1,055,706
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	1,437,537	1,250,028
Regulatory liabilities	630,825	642,564
Liability for asset retirements	271,814	281,903
Pension and other postretirement liabilities (Note 6)	469,802	469,945
Customer advances for construction	129,941	94,801
Liabilities from long-term risk management and trading activities (Note S-1)	46,937	4,573
Other	333,942	293,560
Total deferred credits and other	3,320,798	3,037,374
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		

TOTAL LIABILITIES AND EQUITY	\$ 10,729,874	\$ 10,321,402
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See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Financial Statements.

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

(unaudited)  
(dollars in thousands)

	Nine Months Ended September 30,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 278,772	\$ 283,664
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	312,022	296,318
Deferred fuel and purchased power	(104,774)	(203,065)
Deferred fuel and purchased power amortization	157,999	198,677
Deferred fuel and purchased power regulatory disallowance		14,370
Allowance for equity funds used during construction	(16,211)	(14,874)
Deferred income taxes	220,180	36,646
Changes in mark-to-market valuations	190	(3,785)
Changes in current assets and liabilities:		
Customer and other receivables	(110,450)	(152,467)
Materials, supplies and fossil fuel	(13,527)	(29,786)
Other current assets	2,774	13
Accounts payable	40,339	(26,687)
Other current liabilities	66,155	114,399
Change in unrecognized tax benefits	(104,523)	26,538
Change in other long-term assets	41,379	11,688
Change in other long-term liabilities	11,968	9,708
Net cash flow provided by operating activities	782,293	561,357
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(681,775)	(700,317)
Contributions in aid of construction	40,950	24,447
Allowance for borrowed funds used during construction	(10,687)	(7,833)
Purchases of investment securities		(36,525)
Proceeds from sale of investment securities		69,225
Proceeds from nuclear decommissioning trust sales	255,706	203,014
Investment in nuclear decommissioning trust	(271,263)	(218,570)
Other	4,267	(62)
Net cash flow used for investing activities	(662,802)	(666,621)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Equity infusion	7,601	39,548
Short-term borrowings and payments-net	51,580	150,000
Dividends paid on common stock	(127,500)	(127,500)
Repayment and reacquisition of long-term debt	(27,485)	(1,244)

Net cash flow provided by (used for) financing activities	(95,804)	60,804
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	23,687	(44,460)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	52,151	81,870
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 75,838	\$ 37,410

Supplemental disclosure of cash flow information Cash paid during the year for:

Income taxes, net of refunds	\$ 25,710	\$ 70,083
Interest, net of amounts capitalized	\$ 119,302	\$ 124,186

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

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

	Condensed Consolidated Footnote Reference	APS Supplemental Footnote Reference
Consolidation and Nature of Operations	Note 1	
Condensed Consolidated Financial Statements	Note 2	
Quarterly Fluctuations	Note 3	
Liquidity Matters	Note 4	
Regulatory Matters	Note 5	
Retirement Plans and Other Benefits	Note 6	
Business Segments	Note 7	
Income Taxes	Note 8	
Variable-Interest Entities	Note 9	
Derivative and Energy Trading Accounting	Note 10	Note S-1
Comprehensive Income	Note 11	Note S-2
Commitments and Contingencies	Note 12	
Nuclear Insurance	Note 13	
Other Income and Other Expense	Note 14	Note S-3
Guarantees	Note 15	
Earnings Per Share	Note 16	
Discontinued Operations	Note 17	
Nuclear Decommissioning Trust	Note 18	
New Accounting Standards	Note 19	
Fair Value Measurements	Note 20	

**Table of Contents****S-1. Derivative and Energy Trading Accounting**

APS uses derivative instruments (primarily forward purchases and sales, swaps, options and futures) to manage its exposure to the commodity price risk inherent in the purchase and sale of power, gas and emission allowances and credits. As of September 30, 2008, APS hedged exposures to the price variability of the power and gas commodities for a maximum of 39 months. The changes in the market value of such contracts have a high correlation to price changes in the hedged transactions.

**Cash Flow Hedges**

The changes in the fair value of APS hedged positions included in the APS Condensed Statements of Income, after consideration of amounts deferred under the PSA, for the three and nine months ended September 30, 2008 and 2007 were comprised of the following (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	\$(2,483)	\$(239)	\$(78)	\$1,094
Gains from the discontinuance of cash flow hedges				150

During the twelve months ending September 30, 2009, APS estimates that a net loss of \$23 million before income taxes will be reclassified from accumulated other comprehensive income as an offset to the effect of market price changes for the related hedged transactions. To the extent the amounts are eligible for inclusion in the PSA, the amounts will be recorded as either a regulatory asset or liability and have no effect on earnings.

**FIN 39-1**

We adopted FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39-1), on January 1, 2008. In accordance with this guidance, we elected to offset the fair value amounts for derivative instruments, including collateral, executed with the same counterparty under a master netting arrangement. Collateral was previously reported in other current assets or other current liabilities on our Condensed Balance Sheets. This guidance required retrospective application for all prior periods presented. As a result, APS Condensed Balance Sheet and Statement of Cash Flows line items changed by the following amounts (dollars in thousands):

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	As originally reported in the 2007 Form 10-K	Reclassifications as a result of the adoption of FIN 39-1	After adoption of FIN 39-1
Balance Sheet - December 31, 2007			
Current Assets - Assets from risk management and trading activities	\$ 73,854	\$ (39,767)	\$ 34,087
Current Assets - Other current assets	17,296	(751)	16,545
Investments and Other Assets - Assets from long-term risk management and trading activities	82,588	(40,985)	41,603
Current Liabilities - Liabilities from risk management and trading activities	60,439	(40,518)	19,921
Deferred Credits and Other - Liabilities from long-term risk management and trading activities	45,558	(40,985)	4,573
	As originally reported in the September 30, 2007 Form 10-Q	Reclassifications as a result of the adoption of FIN 39-1	After adoption of FIN 39-1
Statement of Cash Flows			
Nine months ended September 30, 2007			
Change in other long-term assets	\$ 31,960	\$ (20,272)	\$ 11,688
Change in risk management and trading- liabilities	(1,952)	1,952	
Change in other long-term liabilities	60,390	15,829	76,219(a)
Collateral	(2,491)	2,491	

(a) The amount on the Condensed Statement of Cash Flows at September 30, 2007 is \$9.7 million. The difference is due to additional reclassifications of uncertain tax positions. See note 2.

The following tables summarize APS assets and liabilities from risk management and trading activities presented net in accordance with FIN 39-1 (dollars in thousands):

	Current Assets	Investments and Other Assets	Current Liabilities	Deferred Credits and Other	Net Asset (Liability)
September 30, 2008	\$ 11,444	\$ 20,496	\$ (69,094)	\$ (50,543)	\$ (87,697)



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Margin account	13,019		20,841	3,606	37,466
Collateral provided to counterparties	543		4,250		4,793
Collateral provided from counterparties	(1,801)				(1,801)
Total	\$ 23,205	\$ 20,496	\$ (44,003)	\$ (46,937)	\$ (47,239)

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	Current	Investments and Other	Current	Deferred Credits and Other	Net Asset
December 31, 2007	Assets	Assets	Liabilities		
Mark-to-market	\$ 2,815	\$ 41,603	\$ (26,197)	\$ (4,573)	\$ 13,648
Margin account	30,650		6,148		36,798
Collateral provided to counterparties	622		128		750
Collateral provided from counterparties					
Total	\$ 34,087	\$ 41,603	\$ (19,921)	\$ (4,573)	\$ 51,196

We maintain a margin account with a broker to support our risk management and trading activities. Cash is deposited with the broker in this account at the time futures or options contracts are initiated. The change in market value of these contracts (reflected in mark-to-market) requires adjustment of the margin account balance.

See Note 20 for a discussion of SFAS No. 157, Fair Value Measurements, which we adopted January 1, 2008.

**S-2. Comprehensive Income**

Components of APS comprehensive income for the three and nine months ended September 30, 2008 and 2007 are as follows (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	\$ 159,754	\$ 204,257	\$ 278,772	\$ 283,664
Other comprehensive income (loss):				
Net unrealized gains (losses) on derivative instruments (a)	(334,384)	(35,322)	6,984	(10,558)
Net reclassification of realized (gains) losses to income (b)	(39,115)	23,324	(62,444)	17,795
Net unrealized losses related to pension benefits (c)			(10,279)	(44,613)
Reclassification of pension and other postretirement benefits to income	1,000	1,005	3,001	1,005
Income tax benefit related to items of other comprehensive income	146,616	4,314	24,694	14,272
Total other comprehensive loss	(225,883)	(6,679)	(38,044)	(22,099)
Comprehensive income (loss)	\$ (66,129)	\$ 197,578	\$ 240,728	\$ 261,565

(a) These amounts primarily include unrealized gains and losses on contracts used to hedge our

forecasted electricity and natural gas requirements to serve Native Load. These changes are primarily due to changes in forward natural gas prices and wholesale electricity prices.

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

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

**S-3. Other Income and Other Expense**

The following table provides detail of APS other income and other expense for the three and nine months ended September 30, 2008 and 2007 (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Other income:				
Interest income	\$ 739	\$ 2,771	\$ 3,064	\$ 7,630
Investment gains net		315		2,832
Miscellaneous	723	997	1,496	2,410
Total other income	\$ 1,462	\$ 4,083	\$ 4,560	\$ 12,872
Other expense:				
Non-operating costs (a)	\$ (2,779)	\$ (2,690)	\$ (8,966)	\$ (7,924)
Asset dispositions	(2,168)	(156)	(2,999)	(1,524)
Investment losses net	(3,066)		(5,929)	
Miscellaneous	(1,445)	(457)	(3,652)	(1,528)
Total other expense	\$ (9,458)	\$ (3,303)	\$ (21,546)	\$ (10,976)

(a) As defined by the FERC, includes below-the-line non-operating utility income and expense

(items excluded from utility rate recovery).

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

The following discussion should be read in conjunction with Pinnacle West's Condensed Consolidated Financial Statements and Arizona Public Service Company's Condensed Financial Statements and the related Notes that appear in Item 1 of this report.

**OVERVIEW**

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

Customer growth in APS's service territory is an important driver of our revenues and earnings. Customer growth averaged 4.0% a year for the three years 2005 through 2007. We currently expect customer growth and retail electricity sales growth (excluding the effects of weather variations) to average about 1% per year during 2008 through 2010 due to factors reflecting economic conditions both nationally and in

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Arizona. These economic conditions are reflected in the recent volatility and disruption in credit markets (see Note 4). As discussed in detail under Pinnacle West Consolidated Liquidity and Capital Resources below, Pinnacle West and APS have ample borrowing capacity under their respective credit facilities and have been able to access these facilities, ensuring adequate liquidity for each company.

Our cash flows and profitability are affected by the rates APS may charge and the timely recovery of costs through those rates. APS retail rates are regulated by the ACC and its wholesale electric rates (primarily for transmission) are regulated by the FERC. APS capital expenditure requirements, which are discussed below under Liquidity and Capital Resources, are substantial because of customer growth in APS service territory, inflationary impacts on the capital budget and increased generation, environmental and reliability costs, highlighting APS need for the timely recovery through rates of these and other expenditures. See Pinnacle West Consolidated Factors Affecting Our Financial Outlook below. On March 24, 2008, APS filed a rate case with the ACC, which it updated on June 2, 2008, requesting, among other things, an increase in rates to help defray rising infrastructure costs, approval of an impact fee and approval of new conservation rates. Details of the current ACC rate case, a request for an interim increase related to this rate case, and other retail and wholesale rate matters are discussed in Note 5.

SunCor, our real estate development subsidiary, has been an important source of earnings in recent years, although SunCor's earnings in 2007 and expected earnings in 2008 reflect the weak real estate market and current economic conditions. See discussion below in Pinnacle West Consolidated Factors Affecting our Financial Outlook Subsidiaries. Our subsidiary, APSES, provides energy-related products and services to commercial and industrial retail customers in the western United States. El Dorado, our investment subsidiary, owns minority interests in several energy-related investments and Arizona community-based ventures.

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

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

**EARNINGS CONTRIBUTION BY BUSINESS SEGMENT**

Pinnacle West's two reportable business segments are:

our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electric service to Native Load customers) and related activities and includes electricity generation, transmission and distribution; and

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

The following table presents income from continuing operations for our regulated electricity and real estate segments and reconciles those amounts to net income in total for the three months and nine months ended September 30, 2008 and 2007 (dollars in millions):

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	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Regulated electricity segment	\$ 158	\$ 205	\$ 273	\$ 278
Real estate segment	(7)	(1)	(13)	9
All other (a)		(2)		10
Income from continuing operations	151	202	260	297
Income from discontinued operations, real estate segment net of tax (b)	1	7	21	7
Net income	\$ 152	\$ 209	\$ 281	\$ 304

(a) Includes activities related to marketing and trading, APSES and El Dorado. None of these segments is a reportable segment.

(b) Primarily relates to commercial property sales.

### PINNACLE WEST CONSOLIDATED RESULTS OF OPERATIONS

#### Operating Results Three-month period ended September 30, 2008 compared with three-month period ended September 30, 2007

Our consolidated net income decreased approximately \$57 million, from \$209 million for the three months ended September 30, 2007 to \$152 million for the comparable current-year period. Various factors contributed to this decrease, including lower mark-to-market valuations of fuel and purchased power contracts related to changes in market prices, higher operations and maintenance expenses, the effects of more average temperatures on retail sales, and lower sales by our real estate subsidiary resulting from the weak real estate market.

Additional details of these and other factors that increased (decreased) net income for the three-month period ended September 30, 2008 compared with the prior-year period are contained in the following table (dollars in millions):

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	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment:		
Lower mark-to-market valuations of fuel and purchased power contracts related to changes in market prices, net of related PSA deferrals	\$ (28)	\$ (17)
Effects of more normal weather on retail sales	(23)	(14)
Transmission rate increases (including related retail rates)	12	7
Higher retail sales primarily due to customer growth, excluding weather effects	10	6
Operations and maintenance expense increases primarily due to:		
Increased customer service and other costs, including distribution system reliability	(21)	(13)
Increased generation costs, including more planned maintenance	(12)	(7)
Income tax benefits related to prior years resolved in 2007		(10)
Miscellaneous items, net	2	1
Decrease in regulated electricity segment net income	(60)	(47)
Lower real estate segment income from continuing operations primarily due to lower land parcel and home sales resulting from the weak real estate market	(10)	(6)
Other miscellaneous items, net	3	2
Decrease in income from continuing operations	\$ (67)	(51)
Decrease in real estate segment income from discontinued operations primarily due to decreased commercial property sales		(6)
Decrease in net income		\$ (57)

**Regulated Electricity Segment Revenues**

Regulated electricity segment revenues were \$3 million lower for the three months ended September 30, 2008 compared with the prior-year period primarily because of:

a \$36 million decrease in retail revenue due to the effects of more normal weather;

a \$14 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of lower amortization of the same amount recorded as fuel and purchased power expense;

a \$16 million increase in retail revenues primarily related to customer growth, excluding weather effects;

a \$12 million increase due to transmission rate increases (including related retail rates);

a \$7 million increase in revenues related to long-term traditional wholesale contracts;

a \$5 million increase in renewable energy surcharges offset in operations and maintenance expense; and

a \$7 million net increase due to miscellaneous factors.



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**Real Estate Segment Revenues**

Real estate segment revenues were \$28 million lower for the three months ended September 30, 2008 compared with the prior-year period primarily due to lower land parcel and home sales as a result of the weak real estate market.

**All Other Revenues**

All other revenues were \$94 million lower for the three months ended September 30, 2008 compared with the prior-year period primarily due to planned reductions of APSES retail commodity-related energy services and other marketing and trading activities.

**Operating Results Nine-month period ended September 30, 2008 compared with nine-month period ended September 30, 2007**

Our consolidated net income decreased approximately \$23 million, from \$304 million for the nine months ended September 30, 2007 to \$281 million for the comparable current-year period. Various factors contributed to this decrease, including higher operations and maintenance expenses, the effects of weather on retail sales, and lower sales by our real estate subsidiary resulting from the weak real estate market.

Additional details of these and other factors that increased (decreased) net income for the nine-month period ended September 30, 2008 compared with the prior-year period are contained in the following table (dollars in millions):

**Table of Contents**

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment:		
Impacts of retail rate increase effective July 1, 2007 and transmission rate increases:		
Retail revenue increase primarily related to higher Base Fuel Rate	\$ 156	\$ 95
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(141)	(86)
Transmission rate increases (including related retail rates)	22	13
Regulatory disallowance in 2007	14	8
Higher retail sales primarily due to customer growth, excluding weather effects	22	13
Increased revenues, net of fuel and purchased power costs, related to long-term traditional wholesale contracts	8	5
Effects of weather on retail sales	(42)	(26)
Operations and maintenance expense increases primarily due to:		
Increased customer service and other costs, including distribution system reliability	(41)	(25)
Increased generation costs, including more planned maintenance and overhauls	(27)	(16)
Higher depreciation and amortization primarily due to higher plant balances	(15)	(9)
Lower taxes other than income taxes primarily due to decreased property tax assessments	10	6
Higher other expense net of income, primarily due to losses on investments	(9)	(5)
Income tax benefits related to prior years resolved in 2008		30
Income tax benefits related to prior years resolved in 2007		(13)
Miscellaneous items, net	7	5
Decrease in regulated electricity segment net income	(36)	(5)
Lower real estate segment income from continuing operations primarily due to lower land parcel and home sales resulting from the weak real estate market	(36)	(22)
Lower marketing and trading contribution primarily due to lower sales volumes	(24)	(15)
Other miscellaneous items, net	10	5
Decrease in income from continuing operations	\$ (86)	(37)
Increase in real estate segment income from discontinued operations primarily related to a commercial property sale		14
Decrease in net income		\$ (23)

**Regulated Electricity Segment Revenues**

Regulated electricity segment revenues were \$202 million higher for the nine months ended September 30, 2008 compared with the prior-year period primarily because of:

a \$156 million increase in retail revenues due to a rate increase effective July 1, 2007;

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- a \$35 million increase in revenues from Off-System Sales due to higher prices and volumes;
- a \$33 million increase in retail revenues primarily related to customer growth, excluding weather effects;
- a \$22 million increase due to transmission rate increases (including related retail rates);
- a \$19 million increase in revenues related to long-term traditional wholesale contracts;
- a \$10 million increase in renewable energy surcharges offset in operations and maintenance expense;
- a \$60 million decrease in retail revenue due to the effects of weather;
- a \$40 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of lower amortization of the same amount recorded as fuel and purchased power expense; and
- a \$27 million net increase due to miscellaneous factors.

**Real Estate Segment Revenues**

Real estate segment revenues were \$68 million lower for the nine months ended September 30, 2008 compared with the prior-year period primarily due to lower land parcel and home sales as a result of the weak real estate market.

**All Other Revenues**

All other revenues were \$154 million lower for the nine months ended September 30, 2008 compared with the prior-year period primarily due to planned reductions of APSES retail commodity-related energy services and other marketing and trading activities.

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

The following table presents net cash provided by (used for) operating, investing and financing activities for the nine months ended September 30, 2008 and 2007 (dollars in millions):

	Nine Months Ended September 30,	
	2008	2007
Net cash flow provided by operating activities	\$ 784	\$ 477
Net cash flow used for investing activities	(597)	(678)
Net cash flow provided by (used for) financing activities	(139)	157

The increase of approximately \$307 million in net cash provided by operating activities is primarily due to lower real estate investments resulting from the weak real estate market; increased collateral

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and margin cash collected as a result of changes in commodity prices; lower current income taxes; increased retail revenue related to higher Base Fuel Rates; and changes in working capital.

The decrease of approximately \$81 million in net cash used for investing activities is primarily due to a real estate commercial property sale in 2008 and lower levels of capital expenditures (see table and discussion below), partially offset by lower cash proceeds from the net sales and purchases of investments.

The increase of approximately \$296 million in net cash used for financing activities is primarily due to lower levels of short-term debt as a result of higher cash from operations and lower levels of long-term debt as a result of the proceeds from the sale of a real estate commercial property in 2008.

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

The following table summarizes the actual capital expenditures for the nine months ended September 30, 2007 and 2008 and estimated capital expenditures, net of contributions in aid of construction, for the next three years:

**CAPITAL EXPENDITURES**

(dollars in millions)

	Nine Months Ended September 30,		Estimated for the Year Ended December 31,		
	2007	2008	2008	2009	2010
APS					
Distribution	\$ 306	\$ 258	\$ 370	\$ 270	\$ 260
Generation (a)	259	244	370	330	310
Transmission	97	109	180	260	100
Other (b)	10	22	40	40	40
Subtotal	672	633	960	900	710
SunCor (c)	132	36	40	20	70
Other	2	7	10	5	30
Total	\$ 806	\$ 676	\$ 1,010	\$ 925	\$ 810

(a) Generation includes nuclear fuel expenditures of approximately \$90 million to \$120 million per year for 2008, 2009 and 2010.

(b) Primarily information systems and facilities projects.

(c) Primarily capital expenditures for

residential, land  
development  
and retail and  
office building  
construction  
reflected in  
Expenditures for  
real estate  
investments and  
Capital  
expenditures on  
the Condensed  
Consolidated  
Statements of  
Cash Flows.

Distribution and transmission capital expenditures are comprised of infrastructure additions and upgrades, capital replacements, new customer construction and related information systems and facility costs. Examples of the types of projects included in the forecast include power lines, substations, line extensions to new residential and commercial developments and upgrades to customer information systems, partially offset by contributions in aid of construction in accordance with APS line extension policy. See Line Extension

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Schedule in Note 3 of the 2007 Form 10-K for details regarding changes in early 2008 to the line extension policy.

Generation capital expenditures are comprised of various improvements to APS existing fossil and nuclear plants. Examples of the types of projects included in this category are additions, upgrades and capital replacements of various power plant equipment such as turbines, boilers and environmental equipment. Environmental expenditures differ for each of the years 2008, 2009 and 2010, with the lowest year estimated at approximately \$30 million, and the highest year estimated at approximately \$100 million. We are also monitoring the status of certain environmental matters, which, depending on their final outcome, could require modification to our environmental expenditures. (See Business of Arizona Public Service Company Environmental Matters Regional Haze Rules in Item 1 of the 2007 Form 10-K and Environmental Matters Mercury in Part II, Item 5 below.)

In early 2008, we announced and began implementing a cost reduction effort that included the elimination of approximately \$200 million of capital expenditures for the years 2008-2012. These capital expenditure reductions, as they relate to the years 2008-2010, are reflected in the estimates provided above. In addition, we recently announced and completed a capital expenditure reduction analysis due primarily to our reduced customer growth outlook as well as the deferral of upgrades and other capital projects. Anticipated capital expenditure reductions in distribution (net of amounts for projected line extensions), transmission and general plant under this program exceed \$500 million over the years 2009-2011. These capital expenditure reductions, as they relate to the years 2008-2010, are reflected in the estimates provided above. (See Pinnacle West Consolidated Factors Affecting Our Financial Outlook Customer and Sales Growth below for additional information on our growth outlook.)

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

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

Our primary cash needs are for dividends to our shareholders and principal and interest payments on our long-term debt. The level of our common stock dividends and future dividend growth will be dependent on a number of factors including, but not limited to, our outlook for future business prospects, payout ratio trends, free cash flow and financial market conditions.

Our primary sources of cash are dividends from APS, external debt and equity financings and cash distributions from our other subsidiaries, primarily SunCor. An existing ACC order requires APS to maintain a common equity ratio of at least 40% and prohibits APS from paying common stock dividends if the payment would reduce its common equity below that threshold. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At September 30, 2008, APS common equity ratio, as defined, was approximately 55%.

The credit and liquidity markets experienced significant stress beginning the week of September 15, 2008. Pinnacle West and APS have been able to access existing credit facilities, ensuring adequate liquidity. Cash on hand is being invested in money market funds consisting of U.S. Treasury and government agency securities and repurchase agreements collateralized fully by U.S. Treasury and government agency securities.

Pinnacle West sponsors a qualified defined benefit and account balance pension plan and a non-qualified supplemental excess benefit retirement plan for the employees of Pinnacle West and our subsidiaries. IRS regulations require us to contribute a minimum amount to the qualified plan. We contribute at least the minimum amount required under IRS regulations, but no more than the maximum tax-deductible

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amount. The minimum required funding takes into consideration the value of plan assets and our pension obligation. The assets in the plan are comprised of fixed-income, equity and short-term investments. Future year contribution amounts are dependent on plan asset performance and plan actuarial assumptions. We contributed approximately \$52 million in 2007. We made a \$35 million contribution to our pension plan in September 2008. Adjusted for this contribution, our plan was 94% funded on a cash-funded basis at plan year-end 2007, which is 2% over the minimum cash-funded status required by federal law under the Pension Protection Act of 2006. The expected contribution to our other postretirement benefit plans in 2008 is estimated to be approximately \$11 million, of which \$10 million has been contributed through October 2008. APS and other subsidiaries fund their share of the contributions. APS share is approximately 96% of both plans.

On October 22, 2008, the Pinnacle West Board of Directors declared a quarterly dividend of \$0.525 per share of common stock, payable on December 1, 2008, to shareholders of record on November 3, 2008.

Pinnacle West has a \$300 million revolving credit facility that terminates in December 2010. Credit commitments totaling approximately \$17 million from Lehman Brothers are no longer available due to its September 2008 bankruptcy filing. The remaining \$283 million revolver is available to support the issuance of up to \$250 million in commercial paper or to be used as bank borrowings, including issuances of letters of credit. At September 30, 2008, Pinnacle West had outstanding \$127 million of borrowings under its revolving credit facility, approximately \$7 million of letters of credit and \$40 million of commercial paper. Pinnacle West had remaining capacity available under its revolver of approximately \$109 million and had cash and investments of approximately \$19 million.

See Equity Infusion Approval in Note 5 for information regarding Pinnacle West's approval from the ACC regarding a potential equity infusion into APS of up to \$400 million.

**APS**

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

Although APS defers actual retail fuel and purchased power costs on a current basis, APS recovery of the deferrals from its ratepayers is subject to annual and, if necessary, periodic PSA adjustments. See PSA Modifications in Note 3, Item 8 of the 2007 Form 10-K for information regarding the PSA approved by the ACC.

On September 11, 2008, APS repurchased at par two series of pollution control bonds that had no credit enhancements. These bonds were \$7 million of its 1996 Series A Coconino County Pollution Control Bonds and \$20 million of its 1999 Series A Coconino County Pollution Control Bonds (Repurchased Bonds). APS borrowed funds under its revolving lines of credit to re-purchase the bonds as permitted under the bond indenture. APS intends to keep the \$27 million outstanding under its line of credit until the Repurchased Bonds are sold to third parties in the near future.

APS has two committed revolving credit facilities totaling \$900 million that are available either to support the issuance of up to \$250 million in commercial paper or to be used for bank borrowings, including issuances of letters of credit. The \$400 million revolver terminates in December 2010 and the \$500 million revolver terminates in September 2011. Credit commitments totaling about \$34 million from Lehman Brothers are no longer available due to its September 2008 bankruptcy filing. At September 30, 2008, APS had borrowings of approximately \$270 million and no letters of credit under its revolving lines of credit. APS had no commercial paper outstanding at September 30, 2008. At September 30, 2008, APS had remaining

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capacity available under its revolvers of \$596 million and had cash and investments of approximately \$76 million.

See Cash Flow Hedges in Note 10 for information related to the change in our margin account.

***Other Subsidiaries***

During the past three years, SunCor funded its cash requirements with cash from operations and its own external financings. SunCor's capital needs consist primarily of capital expenditures for residential, land development and retail and office building construction. See the capital expenditures table above for actual capital expenditures during the nine months ended September 30, 2007 and 2008 and projected capital expenditures for the next three years. SunCor expects to fund its future capital requirements with cash from operations and external financings. See Note 4 for a discussion of SunCor's outstanding debt obligations.

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

APSES expects minimal capital expenditures over the next three years.

***Debt Provisions***

Pinnacle West's and APS' debt covenants related to their respective bank financing arrangements include debt to capitalization ratios. Certain of APS' bank financing arrangements also include an interest coverage test. Pinnacle West and APS comply with these covenants and each anticipates it will continue to meet these and other significant covenant requirements. For both Pinnacle West and APS, these covenants require that the ratio of consolidated debt to total consolidated capitalization not exceed 65%. At September 30, 2008, the ratio was approximately 49% for Pinnacle West and 46% for APS. The provisions regarding interest coverage require minimum cash coverage of two times the interest requirements for APS. The interest coverage was approximately 4.7 times under APS' bank financing agreements as of September 30, 2008. Failure to comply with such covenant levels would result in an event of default which, generally speaking, would require the immediate repayment of the debt subject to the covenants and could cross-default other debt. See further discussion of cross-default provisions below.

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

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

See Note 4 for further discussions.

***Credit Ratings***

The ratings of securities of Pinnacle West and APS as of October 30, 2008 are shown below. The ratings reflect the respective views of the rating agencies, from which an explanation of the significance of



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their ratings may be obtained. There is no assurance that these ratings will continue for any given period of time. The ratings may be revised or withdrawn entirely by the rating agencies if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely affect the market price of Pinnacle West's or APS securities and serve to increase the cost of and access to capital. It may also require additional collateral related to certain derivative instruments, natural gas transportation, fuel supply, and other energy-related contracts.

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

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

**Off-Balance Sheet Arrangements**

In 1986, APS entered into agreements with three separate VIE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. We are not the primary beneficiary of the Palo Verde VIEs and, accordingly, do not consolidate them (see Note 9).

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of September 30, 2008, APS would have been required to assume approximately \$188 million of debt and pay the equity participants approximately \$169 million.

***Guarantees and Letters of Credit***

We have issued parental guarantees and letters of credit and obtained surety bonds on behalf of our subsidiaries. Our parental guarantees for Pinnacle West Marketing & Trading and APS relate to commodity energy products. Our credit support instruments enable APSES to offer energy-related products and commodity energy. Non-performance or non-payment under the original contract by our subsidiaries would require performance under the guarantee or surety bond. No liability is currently recorded on the Condensed Consolidated Balance Sheets related to Pinnacle West's current outstanding guarantees on behalf of our subsidiaries. Our guarantees have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees. We generally agree to indemnification provisions related to liabilities arising from or related to certain of our

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agreements, with limited exceptions depending on the particular agreement. See Note 15 for additional information regarding guarantees and letters of credit.

**Contractual Obligations**

Our future contractual obligations related to fuel and purchased power contracts have increased from approximately \$3.1 billion at December 31, 2007 to \$8.2 billion at September 30, 2008 as follows (dollars in billions):

2008	2009-2010	2011-2012	Thereafter	Total
\$0.5	\$0.8	\$0.7	\$6.2	\$8.2

This increase is primarily due to contingent obligations related to renewable energy contracts, primarily the 280MW solar project described in Portfolio Resources Alternative Generation Sources in Part I, Item 1 of the 2007 Form 10-K.

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

**CRITICAL ACCOUNTING POLICIES**

In preparing the financial statements in accordance with GAAP, management must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex and actual results could differ from those estimates. Our most critical accounting policies include the impacts of regulatory accounting, the determination of the appropriate accounting for our pension and other postretirement benefits and derivatives accounting. There have been no changes to our critical accounting policies since our 2007 Form 10-K. See Critical Accounting Policies in Item 7 of the 2007 Form 10-K for further details about our critical accounting policies.

**OTHER ACCOUNTING MATTERS**

See Note 20 for a discussion of SFAS No. 157, Fair Value Measurements, which we adopted January 1, 2008.

See Notes 10 and S-1 for discussions of FASB Staff Position No. FIN 39-1, Amendment of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39-1), which we adopted January 1, 2008.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, was effective for us on January 1, 2008. This guidance provides companies with an option to report selected financial assets and liabilities at fair value. We did not elect the fair value option for any of our financial assets or liabilities. Therefore, SFAS No. 159 did not have an impact on our financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. This guidance requires enhanced disclosures about derivative instruments and hedging activities. The Statement is effective for us on January 1, 2009. We do not expect it to have a material impact on our financial statements.

In October 2008, the FASB issued FASB Staff Position No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. This guidance clarifies the application of SFAS No 157, Fair Value Measurements, in a market that is not active and provides guidance on

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key considerations in determining the fair value of a financial asset when the market for the asset is not active. We adopted this guidance in the third quarter of 2008. It did not have a material impact on our financial statements. See Note 20 for a discussion of fair value measurements.

**PINNACLE WEST CONSOLIDATED FACTORS AFFECTING  
OUR FINANCIAL OUTLOOK**

**Factors Affecting Operating Revenues, Fuel and Purchased Power Costs**

**General** Electric operating revenues are derived from sales of electricity in regulated retail markets in Arizona and, to a lesser extent, from competitive retail and wholesale power markets in the western United States. For the years 2005 through 2007, retail electric revenues comprised approximately 84% of our total electric operating revenues. Our electric operating revenues are affected by electricity sales volumes related to customer growth, variations in weather from period to period, customer mix, average usage per customer, electricity rates and tariffs and the recovery of PSA deferrals. Off-System Sales are included in regulated electricity segment revenues and related fuel and purchased power because they are credited to APS retail customers through the PSA. These revenue transactions are affected by the availability of excess economic generation or other energy resources and wholesale market conditions, including demand and prices.

**Rate Proceedings** Our cash flows and profitability are affected by the rates APS may charge and the timely recovery of costs through those rates. APS retail rates are regulated by the ACC and its wholesale electric rates (primarily for transmission) are regulated by the FERC. APS capital expenditure requirements, which are discussed above under Liquidity and Capital Resources Capital Expenditure Requirements, are substantial because of customer growth in APS service territory, inflationary impacts on the capital budget and increased generation, environmental and reliability costs, highlighting APS need for the timely recovery through rates of these and other expenditures. On March 24, 2008, and later updated on June 2, 2008, APS filed a rate case with the ACC requesting, among other things, an increase in rates to help defray rising infrastructure costs, approval of an impact fee and approval of new conservation rates. Details of the current ACC rate case, a request for an interim increase related to this rate case, and other retail and wholesale rate matters are discussed in Note 5.

**Fuel and Purchased Power Costs** Fuel and purchased power costs included on our Condensed Consolidated Statements of Income are impacted by our electricity sales volumes, existing contracts for purchased power and generation fuel, our power plant performance, transmission availability or constraints, prevailing market prices, new generating plants being placed in service in our market areas, our hedging program for managing such costs and, since April 1, 2005, PSA deferrals and the amortization thereof. See PSA Modifications in Note 3, Item 8 of the 2007 Form 10-K for information regarding the PSA. APS recovery of PSA deferrals from its ratepayers is subject to annual and, if necessary, periodic PSA adjustments.

**Customer and Sales Growth** The customer and sales growth referred to in this paragraph apply to Native Load customers and sales to them. Customer growth in APS service territory for the nine-month period ended September 30, 2008 was 1.6% compared with the prior-year period. Customer growth averaged 4.0% a year for the three years 2005 through 2007. We currently expect customer growth to decline, averaging about 1% per year for 2008 through 2010 due to factors reflecting the economic conditions both nationally and in Arizona; however, uncertainty surrounding current and future financial and economic conditions has decreased the visibility into our expected customer growth path in the near-term. For the three years 2005 through 2007, APS actual retail electricity sales in kilowatt-hours grew at an average annual rate of 4.9%; adjusted to exclude the effects of weather variations, such retail sales growth averaged 4.0% a year. We currently estimate that total retail electricity sales in kilowatt-hours will grow about 1% on average per year during 2008 through 2010, excluding the effects of weather variations. We

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currently expect our retail sales growth in 2008 to be below average because of potential effects on customer usage from economic conditions and retail rate increases (see Note 5).

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

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

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

**Other Factors Affecting Financial Results**

**Operations and Maintenance Expenses** Operations and maintenance expenses are impacted by growth, power plant operations, maintenance of utility plant (including generation, transmission, and distribution facilities), inflation, outages, higher-trending pension and other postretirement benefit costs and other factors.

**Depreciation and Amortization Expenses** Depreciation and amortization expenses are impacted by net additions to utility plant and other property (such as new generation, transmission, and distribution facilities), and changes in depreciation and amortization rates. See Capital Expenditure Requirements above for information regarding planned additions to our facilities.

**Property Taxes** Taxes other than income taxes consist primarily of property taxes, which are affected by the value of property in-service and under construction, assessment ratios, and tax rates. The average property tax rate for APS, which currently owns the majority of our property, was 8.3% of the assessed value for 2007 and 8.9% of the assessed value for 2006. We expect property taxes to increase as we add new utility plant (including new generation, transmission and distribution facilities) and as we improve our existing facilities. See Capital Expenditure Requirements above for information regarding planned additions to our facilities.

**Interest Expense** Interest expense is affected by the amount of debt outstanding and the interest rates on that debt. The primary factors affecting borrowing levels are expected to be our capital expenditures, long-term debt maturities, and internally generated cash flow. Capitalized interest offsets a portion of interest expense while capital projects are under construction. We stop accruing capitalized interest on a project when it is placed in commercial operation. The recent volatility and disruption in credit markets (see Note 4) could adversely affect our future interest expense to the extent these conditions continue. Pinnacle West and APS have ample borrowing capacity under their respective credit facilities and have been able to access these facilities, ensuring adequate liquidity for each company.

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

**Subsidiaries** SunCor's net income was \$24 million in 2007, \$61 million in 2006 and \$56 million in 2005. See Note 17 for further discussion. We currently expect minimal contributions from SunCor in 2008. This estimate reflects the weak real estate market.

The historical results of APSES, Pinnacle West Marketing & Trading and El Dorado are not indicative of future performance.

**General** Our financial results may be affected by a number of broad factors. See Forward-Looking Statements below for further information on such factors, which may cause our actual future results to differ from those we currently seek or anticipate. Also, for a discussion of climate change issues affecting our Company, see Environmental Matters - Climate Change in Part II, Item 5 below.

**Market Risks**

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

**Interest Rate and Equity Risk**

We have exposure to changing interest rates. Changing interest rates will affect interest paid on variable-rate debt and the market value of fixed income securities held by our nuclear decommissioning trust fund. The nuclear decommissioning trust fund also has risks associated with the changing market value of its investments. Nuclear decommissioning costs are recovered in regulated electricity prices. For additional information, see Note 4.

**Commodity Price Risk**

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

The following tables show the net pretax changes in mark-to-market value of our derivative positions for the nine months ended September 30, 2008 and 2007 (dollars in millions):

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	Nine Months Ended September 30,	
	2008	2007
Mark-to-market of net positions at beginning of period	\$ 40	\$ 15
Recognized in earnings:		
Change in mark-to-market gains (losses) for future period deliveries	5	(7)
Mark-to-market gains realized including ineffectiveness during the period	(7)	(13)
Decrease (increase) in regulatory asset	(53)	28
Recognized in OCI:		
Change in mark-to-market gains (losses) for future period deliveries (a)	13	(15)
Mark-to-market gains realized during the period	(83)	(1)
Change in valuation techniques		
Mark-to-market of net positions at end of period	\$ (85)	\$ 7

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

The table below shows the net fair value of maturities of our derivative contracts (dollars in millions) at September 30, 2008 by yearly maturities and by the type of valuation that is performed to calculate the fair values. See Note 1, Derivative Accounting, in Item 8 of our 2007 Form 10-K and Note 20 for more discussion of our valuation methods.

Source of Fair Value	2008	2009	2010	2011	2012	Years thereafter	Total fair value
Level 1 Quoted prices in active markets	\$ (4)	\$ (12)	\$	\$	\$	\$	\$ (16)
Level 2 Significant other observable inputs	(27)	(23)	13	(11)	(1)		(49)
Level 3 Significant unobservable inputs	1	(2)	(15)	1	3	(8)	(20)
Total by maturity	\$ (30)	\$ (37)	\$ (2)	\$ (10)	\$ 2	\$ (8)	\$ (85)

The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management and trading assets and liabilities included on Pinnacle West's Condensed Consolidated Balance Sheets at September 30, 2008 and December 31, 2007 (dollars in millions):

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	September 30, 2008		December 31, 2007	
	Gain (Loss)		Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Mark-to-market changes reported in:				
Earnings				
Electricity	\$ 3	\$ (3)	\$ 3	\$ (3)
Natural gas	5	(5)	4	(4)
Regulatory asset (liability) or OCI (a)				
Electricity	24	(24)	45	(45)
Natural gas	77	(77)	85	(85)
Total	\$ 109	\$ (109)	\$ 137	\$ (137)

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

**Credit Risk**



We are exposed to losses in the event of non-performance or non-payment by counterparties. See Note 1, Derivative Accounting, in Item 8 of our 2007 Form 10-K for a discussion of our credit valuation adjustment policy. See Note 10 for further discussion of credit risk.

**ARIZONA PUBLIC SERVICE COMPANY RESULTS OF OPERATIONS**

**Operating Results Three-month period ended September 30, 2008 compared with three-month period ended September 30, 2007**

Our net income decreased approximately \$44 million, from \$204 million for the three months ended September 30, 2007 to \$160 million for the comparable current-year period. Various factors contributed to this decrease, including lower mark-to-market valuations of fuel and purchased power contracts related to changes in market prices, higher operations and maintenance expenses and the effects of more average temperatures on retail sales.

Additional details of these and other factors that increased (decreased) net income for the three-month period ended September 30, 2008 compared with the prior-year period are contained in the following table (dollars in millions):

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	Increase (Decrease)	
	Pretax	After Tax
Lower mark-to-market valuations of fuel and purchased power contracts related to changes in market prices, net of related PSA deferrals	\$ (28)	\$ (17)
Effects of more normal weather on retail sales	(23)	(14)
Transmission rate increases (including related retail rates)	12	7
Higher retail sales primarily due to customer growth, excluding weather effects	10	6
Operations and maintenance expense increases primarily due to:		
Increased customer service and other costs, including distribution system reliability	(18)	(11)
Increased generation costs, including more planned maintenance	(12)	(7)
Higher other expense, net of income, primarily due to losses on investments	(9)	(5)
Income tax benefits related to prior years resolved in 2007		(10)
Miscellaneous items, net	10	7
Decrease in net income	\$ (58)	\$ (44)

Electric operating revenues were \$5 million lower for the three months ended September 30, 2008 compared with the prior-year period primarily because of:

- a \$36 million decrease in retail revenue due to the effects of more normal weather;
- a \$14 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of lower amortization of the same amount recorded as fuel and purchased power expense;
- a \$16 million increase in retail revenues primarily related to customer growth, excluding weather effects;
- a \$12 million increase due to transmission rate increases (including related retail rates);
- a \$7 million increase in revenues related to long-term traditional wholesale contracts;
- a \$5 million increase in renewable energy surcharges offset in operations and maintenance expense; and
- a \$5 million net increase due to miscellaneous factors.

**Operating Results Nine-month period ended September 30, 2008 compared with nine-month period ended September 30, 2007**

Our net income decreased approximately \$5 million, from \$284 million for the nine months ended September 30, 2007 to \$279 million for the comparable current-year period. Various factors contributed to this decrease, including higher operations and maintenance expenses and the effects of weather on retail sales.

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Additional details of these and other factors that increased (decreased) net income for the nine-month period ended September 30, 2008 compared with the prior-year period are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Impacts of retail rate increase effective July 1, 2007 and transmission rate increases:		
Retail revenue increase primarily related to higher Base Fuel Rate	\$ 156	\$ 95
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(141)	(86)
Transmission rate increases (including related retail rates)	22	13
Regulatory disallowance in 2007	14	8
Higher retail sales primarily due to customer growth, excluding weather effects	22	13
Increased revenues, net of fuel and purchased power costs, related to long-term traditional wholesale contracts	8	5
Effects of weather on retail sales	(42)	(26)
Operations and maintenance expense increases primarily due to:		
Increased customer service and other costs, including distribution system reliability	(33)	(20)
Increased generation costs, including more planned maintenance and overhauls	(27)	(16)
Higher depreciation and amortization primarily due to higher plant balances	(15)	(9)
Lower taxes other than income taxes primarily due to decreased property tax assessments	10	6
Higher other expense, net of income, primarily due to losses on investments and lower interest income	(19)	(12)
Income tax benefits related to prior years resolved in 2008		29
Income tax benefits related to prior years resolved in 2007		(11)
Miscellaneous items, net	5	6
Decrease in net income	\$ (40)	\$ (5)

Electric operating revenues were \$192 million higher for the nine months ended September 30, 2008 compared with the prior-year period primarily because of:

- a \$156 million increase in retail revenues due to a rate increase effective July 1, 2007;
- a \$35 million increase in revenues from Off-System Sales due to higher prices and volumes;
- a \$33 million increase in retail revenues primarily related to customer growth, excluding weather effects;
- a \$22 million increase due to transmission rate increases (including related retail rates);
- a \$19 million increase in revenues related to long-term traditional wholesale contracts;

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a \$10 million increase in renewable energy surcharges offset in operations and maintenance expense;

a \$60 million decrease in retail revenue due to the effects of weather;

a \$40 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of lower amortization of the same amount recorded as fuel and purchased power expense; and

a \$17 million net increase due to miscellaneous factors.

**ARIZONA PUBLIC SERVICE COMPANY LIQUIDITY AND CAPITAL RESOURCES****Cash Flows**

The following table presents net cash provided by (used for) operating, investing and financing activities for the nine months ended September 30, 2008 and 2007 (dollars in millions):

	Nine Months Ended September 30,	
	2008	2007
Net cash flow provided by operating activities	\$ 782	\$ 561
Net cash flow used for investing activities	(663)	(667)
Net cash flow provided by (used for) financing activities	(96)	61

The increase of approximately \$221 million in net cash provided by operating activities is primarily due to increased collateral and margin cash collected as a result of changes in commodity prices; lower current income taxes; increased retail revenue related to higher Base Fuel Rates; and changes in working capital.

The decrease of approximately \$4 million in net cash used for investing activities is primarily due to lower levels of capital expenditures (see table and discussion above) offset by lower cash proceeds from the net sales and purchases of investments at APS.

The increase of approximately \$157 million in net cash used for financing activities is primarily due to lower levels of short-term debt as a result of higher cash from operations partially offset by decreased equity infusions from Pinnacle West.

**Contractual Obligations**

APS future contractual obligations related to fuel and purchased power contracts have increased from approximately \$3.0 billion at December 31, 2007 to \$8.1 billion at September 30, 2008 as follows (dollars in billions):

2008	2009-2010	2011-2012	Thereafter	Total
\$0.4	\$0.8	\$0.7	\$6.2	\$8.1

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This increase is primarily due to contingent obligations related to renewable energy contracts, primarily the 280MW solar project described in Portfolio Resources Alternative Generation Sources in Part I, Item 1 of the 2007 Form 10-K.

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

**FORWARD-LOOKING STATEMENTS**

This document contains forward-looking statements based on current expectations, and neither Pinnacle West nor APS assumes any obligation to update these statements or make any further statements on any of these issues, except as required by applicable law. These forward-looking statements are often identified by words such as estimate, predict, hope, may, believe, anticipate, plan, expect, require, intend, assume and similar words. Because our expectations may differ materially from expectations, we caution readers not to place undue reliance on these statements. A number of factors could cause future results to differ materially from historical results, or from results or outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Item 1A of the 2007 Form 10-K, these factors include, but are not limited to:

state and federal regulatory and legislative decisions and actions, including the outcome or timing of any pending APS rate cases;

increases in our capital expenditures and operating costs and our ability to achieve timely and adequate rate recovery of these increased costs;

our ability to reduce capital expenditures and other costs while maintaining reliability and customer service levels, and unexpected developments that would limit us from achieving all or some of our planned capital expenditure reductions;

volatile fuel and purchased power costs, including fluctuations in market prices for natural gas, coal, uranium and other fuels used in our generating facilities, and availability of supplies of such commodities;

the outcome of regulatory, legislative and judicial proceedings, both current and future, including those related to environmental matters and climate change;

the potential for additional restructuring of the electric industry, including decisions impacting wholesale competition and the introduction of retail electric competition in Arizona;

regional, national and international economic and market conditions, including the strength of the housing, credit and financial markets;

the potential adverse impact of current economic conditions on our results of operations;

the cost of debt and equity capital and access to capital markets;

changes in the market price of our common stock;

entering into credit agreements that restrict dividends or contain other burdensome provisions;

our ability to meet debt service obligations;

current credit ratings remaining in effect for any given period of time;

the performance of the stock market and the changing interest rate environment, which affect the value of our nuclear decommissioning trusts, pension and other postretirement benefit plan assets, the amount of

required contributions to Pinnacle West's pension plan and contributions to APS' nuclear decommissioning trust funds, as well as the reported costs of providing pension and other postretirement benefits;

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volatile market liquidity, any deteriorating counterparty credit and the use of derivative contracts in our business (including the interpretation of the subjective and complex accounting rules related to these contracts);

changes in accounting principles generally accepted in the United States of America and the interpretation of those principles;

customer growth and energy usage;

weather variations affecting local and regional customer energy usage;

power plant performance and outages;

transmission outages and constraints;

the completion of generation and transmission construction in the region, which could affect customer growth and the cost of power supplies;

the ability of our power plant participants to meet contractual or other obligations;

technological developments in the electric industry;

the results of litigation and other proceedings resulting from the California and Pacific Northwest energy situations;

the performance of our subsidiaries and any resulting effects on our cash flows;

the strength of the real estate market and economic and other conditions affecting the real estate market in SunCor's market areas, which include Arizona, Idaho, New Mexico and Utah; and

other uncertainties, all of which are difficult to predict and many of which are beyond the control of Pinnacle West and APS.

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

See Pinnacle West Consolidated Factors Affecting Our Financial Outlook in Item 2 above for a discussion of quantitative and qualitative disclosures about market risks.

**Item 4. CONTROLS AND PROCEDURES**

(a) Disclosure Controls and Procedures

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

Pinnacle West's management, with the participation of Pinnacle West's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of Pinnacle West's disclosure controls and procedures as of September 30, 2008. Based on that evaluation, Pinnacle West's Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, Pinnacle West's disclosure controls and procedures were effective.

APS management, with the participation of APS Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of APS disclosure controls and procedures as of September 30,

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2008. Based on that evaluation, APS Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, APS disclosure controls and procedures were effective.

(b) Changes in Internal Control Over Financial Reporting

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

No change in Pinnacle West's or APS' internal control over financial reporting occurred during the fiscal quarter ended September 30, 2008 that materially affected, or is reasonably likely to materially affect, Pinnacle West's or APS' internal control over financial reporting.

**Table of Contents****Part II OTHER INFORMATION****Item 1. LEGAL PROCEEDINGS**

See Note 12 in regard to pending or threatened litigation or other disputes.

**Item 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in the 2007 Form 10-K, which could materially affect the business, financial condition, cash flows or future results of APS and Pinnacle West. The risks described in the 2007 Form 10-K are not the only risks facing APS and Pinnacle West. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect the business, financial condition, cash flows and/or operating results of APS and Pinnacle West.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities**

The following table contains information about our purchases of our common stock during the third quarter of 2008.

Period		Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1	July 31, 2008	17,600	\$ 30.95		
August 1	August 31, 2008				
September 1	September 30, 2008				
Total		17,600	\$ 30.95		

(1) Represents shares of common stock withheld by Pinnacle West to satisfy tax withholding obligations upon the vesting of restricted stock.

**Item 5. OTHER INFORMATION****Construction and Financing Programs**

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

**Regulatory Matters**

See Note 5 for a discussion of regulatory developments.

**Environmental Matters**

**Superfund**

See Superfund in Note 12 for a discussion of a Superfund site.

**Table of Contents****Climate Change**

*Legislative and Regulatory Initiatives.* In the past several years, the United States Congress has considered bills that would regulate domestic greenhouse gas emissions, but such bills have not yet received sufficient Congressional approval to become law; however, there is growing consensus that some form of regulation or legislation is likely to occur in the near future at the federal level with respect to greenhouse gas emissions. In 2007, the United States Supreme Court ruled that greenhouse gases fit within the Clean Air Act's broad definition of "air pollutant" and, as a result, the EPA has the authority to regulate greenhouse gas emissions of new motor vehicles under the Clean Air Act. The court held that the only way the EPA can avoid regulating greenhouse gases is if it determines that the emissions do not contribute to climate change, or if the EPA provides a reasonable explanation for why it cannot or will not exercise its discretion to regulate these emissions. While this decision applies only to emissions from new motor vehicles, if the EPA determines that greenhouse gas emissions can reasonably be anticipated to endanger public health or welfare, this determination will likely impact other Clean Air Act programs as well, and could potentially result in new regulatory requirements for our power plants.

In addition to federal legislative initiatives, state specific initiatives may also impact us. While Arizona has not yet enacted any state specific legislation regarding greenhouse gas emissions, AB 32 is a California statute mandating the reduction of greenhouse gas emissions to 1990 levels by 2020. On January 1, 2009, a scoping plan is due, which is intended to form the basis of rules required under AB 32. On January 1, 2012, the regulations based on the 2009 scoping plan will become effective. We are monitoring this and other state legislative developments to evaluate whether, and the extent to which, any resulting statutes or rules in California or other states may affect our business, including our sales into the impacted states or the ability of our out-of-state power plant participants to meet their obligations.

If any emission reduction legislation or regulations are enacted, we will assess our compliance alternatives, which may include replacement of existing equipment, installation of additional pollution control equipment, purchase of allowances, curtailing certain operations, or other actions. Although associated capital expenditures or operating costs resulting from greenhouse gas emission regulations or legislation could be material, we believe that we would be able to recover the costs of these environmental compliance initiatives through our rates.

*Regional Initiative.* In 2007, six western states (Arizona, California, New Mexico, Oregon, Utah and Washington) and two Canadian provinces (British Columbia and Manitoba) entered into an accord, the Western Climate Initiative (the "Initiative"), to reduce greenhouse gas emissions from automobiles and certain industries, including utilities. Montana, Quebec and Ontario have also joined the Initiative. In August 2007, the Initiative participants set a goal of reducing greenhouse gas emissions 15% below 2005 levels by 2020. In September 2008, the Initiative issued Design Recommendations for the cap-and-trade portion of the program and Essential Requirements for Reporting. We are reviewing these recommendations and requirements, which currently provide only a general framework for the proposed program. Over the next year, the Initiative intends to develop detailed rules to more fully establish and define the program. Since details are not yet available, such as the number of allowances each source may receive, we are unable to quantify the potential financial and operational impacts on our business. In addition, we believe that the implementation of any such program in Arizona would require legislative action so, while we continue to monitor the progress and impact of the Initiative, at the present time we cannot predict what detailed form it will ultimately take, whether it will be implemented or, if it is implemented, what impact it will have on our operations.

*Company Response to Climate Change Initiatives.* We have undertaken a number of initiatives to address emission concerns, including renewable energy development and the procurement and promotion of programs and rates related to energy conservation, renewable energy use and energy efficiency. APS

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currently has a diverse portfolio of renewable resources including wind, geothermal, solar and biomass and we are focused on increasing the percentage of our energy that is produced by renewable resources. (See Business of Arizona Public Service Company Alternative Generation Sources in Item 1 of the 2007 Form 10-K.) In addition, we are currently developing a Climate Management Report to comply with an ACC order that directed APS to undertake a climate management plan, carbon emission reduction study and commitment and action plan with public input and ACC review. We expect to complete the report in 2008.

In January 2008, APS joined the Climate Registry as a Founding Reporter. Founding Reporters are companies that voluntarily joined the non-profit organization before May 2008 to measure and report greenhouse gas emissions in a common, accurate and transparent manner consistent across industry sectors and borders. Pinnacle West has also reported, and will continue to report, greenhouse gas emissions in its annual Corporate Responsibility Report, which is available on our website ([www.pinnaclewest.com](http://www.pinnaclewest.com)). In addition to emissions data, the report provides information related to the Company, its approach to sustainability and its workplace and environmental performance. The information on Pinnacle West's website, including the Corporate Responsibility Report, is not incorporated by reference into this report.

**Mercury**

On March 15, 2005, the EPA issued the Clean Air Mercury Rule (CAMR) to control mercury emissions from coal-fired power plants. This rule established performance standards limiting mercury emissions from coal-fired power plants and established a two phased market-based emissions trading program. Under the trading program, the EPA assigned each state a mercury emissions budget and each state was required to submit to the EPA a plan detailing how it will meet its budget.

In November 2006, ADEQ submitted a State Implementation Plan (SIP) to the EPA to implement the CAMR. ADEQ's SIP generally incorporated the EPA's model cap-and-trade program, but it included additional requirements, including the requirement to meet a 90% mercury removal control level or 0.0087 lbs/GWh, whichever is greater, the requirement to obtain mercury allowances at a 2:1 ratio for any emissions that fall below the specified control level, and the requirement, beginning in 2013, to consider clean coal technologies as part of permitting any new generation.

On February 8, 2008, the U.S. Court of Appeals for the D.C. Circuit vacated the CAMR and the EPA rule that allowed for the creation of the CAMR and, on March 14, 2008, the court issued the mandate to vacate these rules. On May 20, 2008, the D.C. Circuit denied EPA's request to reconsider its decision. On October 17, 2008, the U.S. Solicitor General, on behalf of the EPA, petitioned the Supreme Court for a writ of certiorari to review the judgment of the D.C. Circuit Court of Appeals' vacatur of the CAMR. In filing the petition, the U.S. contended, among other things, that the Court of Appeals' decision effectively divests EPA of the discretion that Congress conferred on the agency to consider alternative regulatory approaches to combating air pollution from power plants. Unless and until this decision is overturned, the law in effect prior to the adoption of the CAMR becomes the applicable law, and requires the EPA to develop an emission limit for mercury that represents the maximum achievable control technology (MACT). It is expected to take the EPA several years to establish such a standard, followed by a period of several years during which existing plants would implement any controls needed to comply with the standard.

The court's ruling also invalidates CAMR-based portions of ADEQ's mercury rule (the trading provisions of the rule), although the state-only emission limits remain in effect. On July 25, 2008, the Arizona Utilities Group (comprised of APS, Arizona Electric Power Cooperative, Salt River Project, Tucson Electric Power Company, and Tri-State Generation and Transmission Association) filed with ADEQ a Petition for Reconsideration and Repeal of the state mercury rule. The petition asserts that ADEQ does not have statutory authority to administer and enforce the state mercury rule, in light of the vacatur of the CAMR and the requirement that EPA promulgate a MACT standard. ADEQ granted the petition in part and agreed to

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begin rulemaking efforts to repeal those portions of ADEQ's mercury rule that are no longer valid in light of the vacatur of the federal CAMR. However, ADEQ denied the petition with respect to certain compliance deadlines and, unless the Arizona Utilities Group reaches an agreement with ADEQ on revisions to the state mercury rule, APS and others will have to comply with the 90% mercury removal or 0.0087 lbs/GWh levels discussed above by 2013.

While we continue to monitor this matter, we cannot predict the final outcome of the petition to the Supreme Court, additional actions by ADEQ resulting from the federal court's decision or the Arizona Utilities Group petition, or the scope, timing or impact of any alternate rules that may be enacted to address mercury emissions.

We have installed, and continue to install, certain of the equipment necessary to meet the current mercury standards. However, due to the U.S. Court of Appeals decision described above, we will monitor the type and timing of any necessary equipment installation. The estimated costs expected to be incurred over the next three years for such equipment are included in our environmental expenditure estimates (see Management's Discussion and Analysis of Financial Condition and Results of Operations - Capital Expenditures in Part I, Item 2).

**Table of Contents****Item 6. EXHIBITS**

## (a) Exhibits

<i>Exhibit No.</i>	<i>Registrant(s)</i>	<i>Description</i>
12.1	Pinnacle West	Ratio of Earnings to Fixed Charges
12.2	APS	Ratio of Earnings to Fixed Charges
12.3	Pinnacle West	Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements
31.1	Pinnacle West	Certificate of William J. Post, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Pinnacle West	Certificate of James R. Hatfield, Senior Vice President and Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.3	APS	Certificate of Donald E. Brandt, President and Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.4	APS	Certificate of James R. Hatfield, Senior Vice President and Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32.1	Pinnacle West	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1850, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	APS	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1850, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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

<i>Exhibit No.</i>	<i>Registrant(s)</i>	<i>Description</i>	<i>Previously Filed as Exhibit<sup>1</sup></i>	<i>Date Filed</i>
3.1	Pinnacle West	Articles of Incorporation, restated as of May 21, 2008	3.1 to Pinnacle West/APS June 30, 2008 Form 10-Q Report, File Nos. 1-8962 and 1-4473	8-7-08
3.2	Pinnacle West	Pinnacle West Capital Corporation Bylaws, amended as of May 23, 2007	4.2 to Pinnacle West/APS May 23, 2007 Form 8-K Report, File Nos. 1-8962 and 1-4473	5-25-07
3.3	APS	Articles of Incorporation, restated as of May 25, 1988	4.2 to APS Form S-3 Registration Nos. 33-33910 and 33-55248 by means of September 24, 1993 Form 8-K Report, File No. 1-4473	9-29-93
3.4	APS	Arizona Public Service Company Bylaws, amended as of June 23, 2004	3.1 to APS June 30, 2004 Form 10-Q Report, File No. 1-4473	8-9-04

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



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SIGNATURES

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

PINNACLE WEST CAPITAL  
CORPORATION  
(Registrant)

Dated: November 4, 2008

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

ARIZONA PUBLIC SERVICE COMPANY  
(Registrant)

Dated: November 4, 2008

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