ARIZONA PUBLIC SERVICE CO
Form 10-Q
May 06, 2010

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

(Mark One)

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

For the quarterly period ended March 31, 2010

OR

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

For the transition period from __________ to __________

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

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

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

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

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

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

PINNACLE WEST CAPITAL CORPORATION
Large accelerated filer þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
ARIZONA PUBLIC SERVICE COMPANY

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ	Smaller reporting company o

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

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

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

PINNACLE WEST CAPITAL CORPORATION	Number of shares of common stock, no par value, outstanding as of May 3, 2010: 108,447,282
ARIZONA PUBLIC SERVICE COMPANY	Number of shares of common stock, $2.50 par value, outstanding as of May 3, 2010: 71,264,947

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

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This combined Form 10-Q is separately provided by Pinnacle West Capital Corporation (Pinnacle West) and Arizona Public Service Company (APS). Any use of the words Company, we, and our refer to Pinnacle West Each registrant is providing on its own behalf all of the information contained in this Form 10-Q that relates to such registrant and, where required, its subsidiaries. Except as stated in the preceding sentence, neither registrant is providing any information that does not relate to such registrant, and therefore makes no representation as to any such information. The information required with respect to each company is set forth

within the applicable items. Item 1 of this report includes Condensed Consolidated Financial Statements of Pinnacle West and Condensed Consolidated Financial Statements of APS. Item 1 also includes Notes to Pinnacle West s Condensed Consolidated Financial Statements, the majority of which also relates to APS, and Supplemental Notes, which only relate to APS Condensed Consolidated Financial Statements. Item 2 of this report is divided into two sections Pinnacle West Consolidated and APS. The Pinnacle West Consolidated section describes Pinnacle West and its subsidiaries on a consolidated basis, including discussions of Pinnacle West s regulated utility and non-utility operations.

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FORWARD-LOOKING STATEMENTS

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

- regulatory and judicial decisions, developments and proceedings;
- our ability to achieve timely and adequate rate recovery of our costs;
- our ability to reduce capital expenditures and other costs while maintaining reliability and customer service levels;
- variations in demand for electricity, including those due to weather, the general economy, customer and sales growth (or decline), and the effects of energy conservation measures;
- power plant performance and outages;
- volatile fuel and purchased power costs;
- fuel and water supply availability;
- new legislation or regulation relating to greenhouse gas emissions, renewable energy mandates and energy efficiency standards;
- our ability to meet renewable energy requirements and recover related costs;
- risks inherent in the operation of nuclear facilities, including spent fuel disposal uncertainty;
- competition in retail and wholesale power markets;
- the duration and severity of the economic decline in Arizona and current credit, financial and real estate market conditions;
- the cost of debt and equity capital and the ability to access capital markets when required;
- restrictions on dividends or other burdensome provisions in our credit agreements and Arizona Corporation Commission (ACC) orders;
- our ability, or the ability of our subsidiaries, to meet debt service obligations;
- changes to our credit ratings;
- the investment performance of the assets of our nuclear decommissioning trust, pension, and other postretirement benefit plans and the resulting impact on future funding requirements;

liquidity of wholesale power markets and the use of derivative contracts in our business;

potential shortfalls in insurance coverage;

new accounting requirements or new interpretations of existing requirements;

transmission and distribution system conditions and operating costs;

the ability to meet the anticipated future need for additional baseload generation and associated transmission facilities in our region;

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

technological developments in the electric industry; and

economic and other conditions affecting the real estate market in SunCor Development Company s (SunCor) market areas.

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

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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 March 31, 2010	Three Months Ended March 31, 2009
OPERATING REVENUES		
Regulated electricity segment	$ 611,425	$ 602,578
Real estate segment	9,416	14,840
Other revenues	12,750	8,449
Total	633,591	625,867
OPERATING EXPENSES		
Regulated electricity segment fuel and purchased power	215,540	247,388
Real estate segment operations	13,890	26,910
Real estate impairment charge (Note 20)	15,112	208,480
Operations and maintenance	209,991	197,616
Depreciation and amortization	101,536	101,812
Taxes other than income taxes	31,827	34,128
Other expenses	8,061	6,467
Total	595,957	822,801
OPERATING INCOME (LOSS)	37,634	(196,934)
OTHER		
Allowance for equity funds used during construction	5,389	4,992
Other income (Note 14)	2,395	537
Other expense (Note 14)	(2,696)	(9,741)
Total	5,088	(4,212)
INTEREST EXPENSE		
Interest charges	62,054	59,035
Capitalized interest	(3,080)	(3,834)
Total	58,974	55,201
LOSS FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	(16,252)	(256,347)
INCOME TAXES	(15,480)	(95,004)
LOSS FROM CONTINUING OPERATIONS	(772)	(161,343)
LOSS FROM DISCONTINUED OPERATIONS		
Net of income tax benefit of $81 and $3,063 (Note 17)	(125)	(4,727)

NET LOSS		(897)		(166,070)
Less: Net income (loss) attributable to noncontrolling interests (Notes 9 and 20)		5,117		(9,560)
NET LOSS ATTRIBUTABLE TO COMMON SHAREHOLDERS	$	(6,014)	$	(156,510)
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC		101,474		100,986
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED		101,474		100,986
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING				
Loss from continuing operations attributable to common shareholders basic	$	(0.06)	$	(1.50)
Net loss attributable to common shareholders basic	$	(0.06)	$	(1.55)
Loss from continuing operations attributable to common shareholders diluted	$	(0.06)	$	(1.50)
Net loss attributable to common shareholders diluted	$	(0.06)	$	(1.55)
DIVIDENDS DECLARED PER SHARE	$	0.525	$	0.525
AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:				
Loss from continuing operations, net of tax	$	(5,889)	$	(151,783)
Discontinued operations, net of tax		(125)		(4,727)
Net loss attributable to common shareholders	$	(6,014)	$	(156,510)

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)

	March 31, 2010	December 31, 2009
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 3,528	$ 145,378
Customer and other receivables	215,062	301,915
Accrued unbilled revenues	86,466	110,971
Allowance for doubtful accounts	(5,892)	(6,153)
Materials and supplies (at average cost)	171,118	176,020
Fossil fuel (at average cost)	37,907	39,245
Deferred income taxes	77,915	53,990
Income tax receivable (Note 8)	19,503	26,005
Assets from risk management activities (Note 10)	75,421	50,619
Other current assets	39,583	30,747
Total current assets	720,611	928,737
INVESTMENTS AND OTHER ASSETS		
Real estate investments net (Note 20)	104,177	119,989
Assets from risk management activities (Note 10)	40,763	28,855
Nuclear decommissioning trust (Note 18)	433,399	414,576
Other assets	112,571	110,091
Total investments and other assets	690,910	673,511
PROPERTY, PLANT AND EQUIPMENT		
Plant in service and held for future use	12,849,716	12,848,138
Less accumulated depreciation and amortization	(4,349,437)	(4,340,645)
Net	8,500,279	8,507,493
Construction work in progress	528,940	467,700
Palo Verde sale leaseback, net of accumulated depreciation (Note 9)	144,528	146,722
Intangible assets, net of accumulated amortization	169,912	164,380
Nuclear fuel, net of accumulated amortization	142,254	118,243
Total property, plant and equipment	9,485,913	9,404,538
DEFERRED DEBITS		
Regulatory assets	863,233	813,161
Income tax receivable (Note 8)	65,103	65,103

Other	109,149	101,274
Total deferred debits	1,037,485	979,538
TOTAL ASSETS	$ 11,934,919	$ 11,986,324

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

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

	March 31, 2010	December 31, 2009
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 219,888	$ 240,637
Accrued taxes	127,513	104,011
Accrued interest	53,336	54,596
Short-term borrowings	289,616	153,715
Current maturities of long-term debt (Note 4)	489,626	303,476
Customer deposits	70,484	71,026
Liabilities from risk management activities (Note 10)	52,469	55,908
Other current liabilities	90,794	125,574
Total current liabilities	1,393,726	1,108,943
LONG-TERM DEBT LESS CURRENT MATURITIES		
Long-term debt (Note 4)	3,180,476	3,370,524
Palo Verde sale leaseback lessor notes (Notes 4 and 9)	126,000	126,000
Total long-term debt less current maturities	3,306,476	3,496,524
DEFERRED CREDITS AND OTHER		
Deferred income taxes	1,582,660	1,496,095
Deferred fuel and purchased power regulatory liability (Note 5)	105,378	87,291
Other regulatory liabilities	670,023	679,072
Liability for asset retirements	306,868	301,783
Liabilities for pension and other postretirement benefits (Note 6)	723,959	811,338
Liabilities from risk management activities (Note 10)	79,194	62,443
Customer advances	134,030	136,595
Coal mine reclamation	92,303	92,060
Unrecognized tax benefits (Note 8)	76,632	142,099
Other	133,670	144,077
Total deferred credits and other	3,904,717	3,952,853
COMMITMENTS AND CONTINGENCIES (SEE NOTES)		
EQUITY (Note 11)		
Common stock, no par value	2,155,977	2,153,295
Treasury stock	(2,734)	(3,812)

Total common stock	2,153,243	2,149,483
Retained earnings	1,238,940	1,298,213
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(50,048)	(50,892)
Derivative instruments	(128,202)	(80,695)
Total accumulated other comprehensive loss	(178,250)	(131,587)
Total Pinnacle West shareholders equity	3,213,933	3,316,109
Noncontrolling interests (Note 9)	116,067	111,895
Total equity	3,330,000	3,428,004
TOTAL LIABILITIES AND EQUITY	$ 11,934,919	$ 11,986,324

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (897)	$ (166,070)
Adjustments to reconcile net loss to net cash used for operating activities:		
Depreciation and amortization including nuclear fuel	114,122	112,000
Deferred fuel and purchased power	44,040	28,238
Deferred fuel and purchased power amortization	(25,953)	28,961
Allowance for equity funds used during construction	(5,389)	(4,992)
Real estate impairment charge	15,112	215,869
Deferred income taxes	50,845	(3,901)
Change in mark-to-market valuations	1,842	3,822
Changes in current assets and liabilities:		
Customer and other receivables	60,244	76,390
Accrued unbilled revenues	24,505	15,365
Materials, supplies and fossil fuel	6,240	(11,796)
Other current assets	(8,836)	(711)
Accounts payable	(23,334)	(78,090)
Accrued taxes and income tax receivable-net	30,004	(81,846)
Other current liabilities	(36,582)	(29,658)
Expenditures for real estate investments	(443)	(1,459)
Gains and other changes in real estate assets	4,095	(264)
Change in margin and collateral accounts assets	(11,280)	(23,476)
Change in margin and collateral accounts liabilities	(124,495)	(162,013)
Change in unrecognized tax benefits	(62,062)	(1,050)
Change in other long-term assets	(25,903)	8,897
Change in other long-term liabilities	(39,550)	19,618
Net cash flow used for operating activities	(13,675)	(56,166)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(202,554)	(193,014)
Contributions in aid of construction	2,949	18,762
Capitalized interest	(3,080)	(3,834)
Proceeds from nuclear decommissioning trust sales	158,448	129,816
Investment in nuclear decommissioning trust	(164,552)	(135,264)
Other	(1,639)	1,501
Net cash flow used for investing activities	(210,428)	(182,033)
CASH FLOWS FROM FINANCING ACTIVITIES		

Issuance of long-term debt		499,683
Repayment and reacquisition of long-term debt	(4,150)	(16,386)
Short-term borrowings and payments net	135,901	(263,464)
Dividends paid on common stock	(51,421)	(51,196)
Common stock equity issuance	844	815
Other	1,079	(3,694)
Net cash flow provided by financing activities	82,253	165,758
NET DECREASE IN CASH AND CASH EQUIVALENTS	(141,850)	(72,441)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	145,378	105,245
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 3,528	$ 32,804
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Income taxes, net of (refunds)	$ (5,547)	$ 17,602
Interest, net of amounts capitalized	$ 58,679	$ 46,040

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Consolidation and Nature of Operations

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our subsidiaries: APS, SunCor, APS Energy Services Company, Inc. (APSES), and El Dorado Investment Company (El Dorado). Intercompany accounts and transactions between the consolidated companies have been eliminated. The unaudited condensed consolidated financial statements for APS include the accounts of APS and the Palo Verde sale leaseback variable interest entities (see Note 9 for further discussion). Our accounting records are maintained in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Condensed Consolidated Financial Statements

Our condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments except as otherwise disclosed in the notes) that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. These condensed consolidated financial statements and notes have been prepared consistently with the exception of the reclassification of certain prior year amounts on our Condensed Consolidated Statements of Income, Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Cash Flows in accordance with accounting requirements for reporting discontinued operations (see Note 17) and amended accounting guidance on consolidation of variable interest entities (see Note 9).

3. Quarterly Fluctuations

Weather conditions cause significant seasonal fluctuations in our revenues. In addition, real estate activities, such as the real estate impairment charges recorded in 2009 and 2010 (see Note 20), 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. Long-term Debt and Liquidity Matters

The following table shows principal payments due on Pinnacle West s and APS total long-term debt and capitalized lease requirements as of March 31, 2010 (dollars in millions):

Year	Consolidated Pinnacle West	APS
2010	$ 315	$ 223
2011	632	457
2012	478	478
2013	59	59
2014	503	503
Thereafter	1,816	1,816
Total	$ 3,803	$ 3,536

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PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Credit Facilities and Debt Issuances

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

Pinnacle West

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

At March 31, 2010, the $200 million revolver was available to support the issuance of up to $200 million in commercial paper or to be used as bank borrowings, including issuances of letters of credit up to $100 million. At March 31, 2010 the Company had outstanding $10 million of borrowings under its revolving credit facility and no letters of credit. In addition, Pinnacle West had commercial paper borrowings of $80 million at March 31, 2010.

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

APS

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

At March 31, 2010 APS had two committed revolving credit facilities totaling $989 million, including the $500 million credit facility described above and a $489 million facility that terminates in September 2011. The revolvers 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 up to $739 million. At March 31, 2010, APS had borrowings of $70 million under its $489 million credit facility and no letters of credit under its revolving credit facilities. APS had commercial paper borrowings of $125 million at March 31, 2010.

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PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

On January 1, 2010, due to the adoption of amended accounting guidance relating to variable interest entities (VIEs), APS began consolidating the Palo Verde Lessor Trusts (see Note 9) and, as a result of consolidation of these VIEs, we have reported the Lessor Trusts long-term debt on our Condensed Consolidated Balance Sheets. Interest rates on these debt instruments are 8% and are fixed for the remaining life. As of March 31, 2010, approximately $26 million was classified as current maturities of long-term debt and $126 million was classified as long-term debt relating to these VIEs. These debt instruments mature on December 30, 2015 and have sinking fund features that are serviced by the lease payments. See Note 9 for additional discussion of the VIEs.

SunCor

SunCor s principal loan facility (the SunCor Secured Revolver) is secured primarily by an interest in land, commercial properties and land contracts. At March 31, 2010, SunCor had outstanding borrowings of approximately $54 million under the SunCor Secured Revolver, which matured on January 30, 2010. SunCor and the lenders under the SunCor Secured Revolver have signed a forbearance agreement under which the lenders have agreed not to exercise any remedies prior to June 30, 2010 to allow time for SunCor to continue discussions concerning the potential sale of additional properties. In addition to the SunCor Secured Revolver, at March 31, 2010, SunCor had approximately $42 million of outstanding debt under other credit facilities ($26 million of which has matured and remains outstanding). To date, the lenders under these credit facilities have taken no enforcement action. At March 31, 2010, $92 million was classified as current maturities of long-term debt and $4 million was classified as short-term borrowings on our Condensed Consolidated Balance Sheets.

If SunCor is unable to obtain extensions or renewals of the SunCor Secured Revolver or its other matured debt, or if it is unable to comply with the mandatory repayment and other provisions of any new or modified credit agreements, SunCor could be required to immediately repay its outstanding indebtedness under all of its credit facilities as a result of cross-default provisions. Such an immediate repayment obligation would have a material adverse impact on SunCor s business and financial position and impair its ongoing viability.

SunCor cannot predict the outcome of negotiations with its lenders or its ability to sell assets for sufficient proceeds to repay its outstanding debt (see Note 20). SunCor s ability to generate sufficient cash from operations while it pursues lender negotiations and further asset sales is uncertain.

Neither Pinnacle West nor any of its other subsidiaries has guaranteed any SunCor indebtedness. A SunCor debt default would not result in a cross-default of any of the debt of Pinnacle West or any of its other subsidiaries. While there can be no assurances as to the ultimate outcome of this matter, Pinnacle West does not believe that SunCor s inability to obtain extensions or renewals from SunCor s lenders would have a material adverse impact on Pinnacle West s cash flows or liquidity.

As of March 31, 2010, SunCor could not transfer any cash dividends to Pinnacle West as a result of the covenants mentioned above. The restriction does not affect Pinnacle West s ability to meet its ongoing capital requirements.

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PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Debt Provisions

An existing ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At March 31, 2010, APS common equity ratio, as defined, was 50%. Its total common equity was approximately $3.4 billion, and total capitalization was approximately $6.7 billion. APS would be prohibited from paying dividends if the payment would reduce its common equity below approximately $2.7 billion, assuming APS total capitalization remains the same. This restriction does not materially affect Pinnacle West s ability to meet its ongoing capital requirements.

5. Regulatory Matters

2008 General Retail Rate Case Impacts

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

- Revenue accounting treatment for line extension payments received for new or upgraded service from January 1, 2010 through year end 2012 (or until new rates are established in APS next general rate case, if that is before the end of 2012), resulting in present estimates of increased revenues of $23 million, $25 million and $49 million, respectively;
- An authorized return on common equity of 11.0%;
- A capital structure comprised of 46.2% debt and 53.8% common equity;
- A commitment from APS to reduce average annual operational expenses by at least $30 million from 2010 through 2014;
- Authorization and requirements of equity infusions into APS of at least $700 million during the period beginning June 1, 2009 through December 31, 2014 ($253 million of which was infused into APS as of May 6, 2010 from proceeds of a Pinnacle West equity issuance (see Note 4)); and
- Various modifications to the existing energy efficiency, demand-side management and renewable energy programs that require APS to, among other things, expand its conservation and demand-side management programs and its use of renewable energy, as well as allow for concurrent recovery of renewable energy expenses and provide for more concurrent recovery of demand-side management costs and incentives.

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

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PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Cost Recovery Mechanisms

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

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

During 2009, APS filed its annual RES implementation plan, covering the 2010-2014 timeframe and requesting 2010 RES funding approval. The plan provides for the acquisition of renewable generation in compliance with requirements through 2014, and requests RES funding of $86.7 million for 2010. APS also sought various other determinations in its plan, including approval of the AZ Sun program and the Community Power Project in Flagstaff, Arizona. At its December 2009 open meeting, the ACC approved APS 2010 RES funding request.

On March 3, 2010, the ACC approved the AZ Sun program, which contemplates the addition of 100 megawatts (MW) of utility-owned solar resources through 2014. Through the expected life of the program, APS plans to invest up to $500 million for turn-key photovoltaic power plants across Arizona. Developers will be selected through competitive procurement processes to build the plants, which APS will own. The costs associated with the first 50 MW under this program will be recovered initially through the RES until such time as the costs are recovered in base rates. The costs of the second 50 MW will be recovered through a mechanism to be determined in APS s next retail rate case.

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

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

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The ACC approved recovery of the 2010 Energy Efficiency budget less some $1.0 million, which reflected a recalculation of the incentive payment due to APS under the Energy Efficiency Implementation Plan and not a reduction in allowed program costs. The ACC also approved recovery of all 2009 program costs plus incentives. The change from program cost recovery on a historical basis to recovery on a concurrent basis, as authorized in the Settlement Agreement, resulted in this one-time need to address two years (2009 and 2010) of cost recovery. As requested by APS, 2009 program cost recovery is to be spread over a three-year period.

PSA Mechanism and Balance. The power supply adjustor (PSA) provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs. The following table shows the changes in the deferred fuel and purchased power regulatory asset (liability) for the three-month periods ended March 31, 2010 and 2009 (dollars in millions):

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Beginning balance	$ (87)	$ 8
Deferred fuel and purchased power costs-current period	(44)	(28)
Amounts refunded (recovered)	26	(29)
Ending balance	$ (105)	$ (49)

The PSA rate for the current PSA Year is ($0.0045) per kilowatt hour (kWh). Since the 2010 PSA adjustment was a reduction of the PSA rate, the ACC accelerated the 2010 adjustment from the standard PSA year start date of February 1st to January 1st to coincide with the increase in retail rates resulting from the ACC s decision in the general retail rate case, causing a minimal net impact on residential bills. This accelerated 2010 adjustment will remain in effect until February 1, 2011. The $105 million regulatory liability at March 31, 2010 reflects lower average prices and the seasonal nature of fuel and purchased power costs. Any uncollected (overcollected) deferrals during the 2010 PSA Year will be included in the historical component of the PSA rate for the PSA Year beginning February 1, 2011.

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

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

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

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In 2009, APS was authorized to implement an increase in its annual transmission revenues based on calculations filed with the FERC using data for its 2008 fiscal year. Increases in APS annual transmission revenues of $22.8 million became effective June 1, 2009. Of this amount, $21 million represents an increase in Retail Transmission Charges, which was approved by the ACC on July 29, 2009 and allows APS to reflect the related increased Retail Transmission Charges in its retail rates through the TCA effective August 1, 2009. The 2010 TCA will be filed with the ACC in mid-May.

6. Retirement Plans and Other Benefits

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

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

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

	Pension Benefits Three Months Ended March 31,		Other Benefits Three Months Ended March 31,	
	2010	2009	2010	2009
Service cost benefits earned during the period	$ 15	$ 14	$ 5	$ 5
Interest cost on benefit obligation	31	29	11	10
Expected return on plan assets	(31)	(29)	(10)	(9)
Amortization of:				
Transition obligation			1	1
Prior service cost	1	1		
Net actuarial loss	6	3	3	3
Net periodic benefit cost	$ 22	$ 18	$ 10	$ 10
Portion of cost charged to expense	$ 11	$ 8	$ 5	$ 5
APS share of cost charged to expense	$ 10	$ 8	$ 5	$ 5

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Contributions

The required minimum contribution to our pension plan is zero in 2010. During the first quarter of 2010 we made a voluntary contribution of $100 million to our pension plan. The contribution to our other postretirement benefit plans in 2010 is estimated to be approximately $15 million. APS and other subsidiaries fund their share of the contributions. APS share is approximately 97% of both plans.

7. Business Segments

Pinnacle West s two reportable business segments are:

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

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

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Operating revenues:		
Regulated electricity segment	$ 611	$ 603
Real estate segment (a)	10	15
All other (b)	13	8
Total	$ 634	$ 626
Net income (loss) attributable to common shareholders:		
Regulated electricity segment	$ 7	$ (20)
Real estate segment (a)	(13)	(132)
All other (b)		(5)
Total	$ (6)	$ (157)

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	As of March 31, 2010	As of December 31, 2009
Assets:		
Regulated electricity segment	$ 11,686	$ 11,691
Real estate segment (a)	133	161
All other (b)	116	134
Total	$ 11,935	$ 11,986

(a) In 2009 our real estate subsidiary, SunCor, began disposing of substantially all of its assets (see Note 20). As a result, the real estate segment may no longer be a reporting segment in the future.

(b) Includes activities related to APSES and El Dorado. None of the activities of either of these companies constitutes a reportable segment.

8. Income Taxes

Pinnacle West expects to recognize approximately $131 million of cash tax benefits related to SunCor s strategic asset sales (see Note 20), which will not be fully realized until all the asset sale transactions are completed. Approximately $6 million of these benefits were recorded in the three months ended March 31, 2010 as reductions to income tax expense related to the current impairment charges. The additional $125 million of tax benefits were recorded as reductions to income tax expense related to SunCor impairment charges recorded on or before December 31, 2009.

The $85 million income tax receivable on the Condensed Consolidated Balance Sheets represents the anticipated refunds related to an APS tax accounting method change approved by the Internal Revenue Service (IRS) in the third quarter of 2009 and the current year tax benefits related to the SunCor strategic asset sales that closed prior to

March 31, 2010.

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

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

9. Variable Interest Entities

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