

# PINNACLE WEST CAPITAL CORP

## FORM 10-K (Annual Report)

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**UNITED STATES  
 SECURITIES AND EXCHANGE COMMISSION  
 WASHINGTON, D.C. 20549**

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2009

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	Registrants; State of Incorporation; Addresses; 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

**Securities registered pursuant to Section 12(b) of the Act:**

	Title Of Each Class	Name Of Each Exchange On Which Registered
PINNACLE WEST CAPITAL CORPORATION	Common Stock, No Par Value	New York Stock Exchange
ARIZONA PUBLIC SERVICE COMPANY	None	None

**Securities registered pursuant to Section 12(g) of the Act:**

ARIZONA PUBLIC SERVICE COMPANY Common Stock, Par Value \$2.50 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

PINNACLE WEST CAPITAL CORPORATION	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

PINNACLE WEST CAPITAL CORPORATION	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input type="checkbox"/>	No <input checked="" type="checkbox"/>

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

PINNACLE WEST CAPITAL CORPORATION	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>
ARIZONA PUBLIC SERVICE COMPANY	Yes <input checked="" type="checkbox"/>	No <input type="checkbox"/>

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

PINNACLE WEST CAPITAL CORPORATION	Yes <input type="checkbox"/>	No <input type="checkbox"/>
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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or in any amendment to this Form 10-K.

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 Rule 12b-2 of the Act). Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of each registrant's most recently completed second fiscal quarter:

PINNACLE WEST CAPITAL CORPORATION

\$3,035,693,863 as of June 30, 2009

ARIZONA PUBLIC SERVICE COMPANY

\$0 as of June 30, 2009

The number of shares outstanding of each registrant's common stock as of February 15, 2010

PINNACLE WEST CAPITAL CORPORATION

101,445,202 shares

ARIZONA PUBLIC SERVICE COMPANY

Common Stock, \$2.50 par value, 71,264,947 shares.

Pinnacle West Capital Corporation is the sole holder of Arizona Public Service Company's Common Stock.

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#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of Pinnacle West Capital Corporation's definitive Proxy Statement relating to its Annual Meeting of Shareholders to be held on May 19, 2010 are incorporated by reference into Part III hereof.

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

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**This combined Form 10-K is separately filed by Pinnacle West and APS. Each registrant is filing on its own behalf all of the information contained in this Form 10-K 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. The information required with respect to each company is set forth within the applicable items. Item 7 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. Item 8 of this report includes Consolidated Financial Statements of Pinnacle West and Financial Statements of APS. Item 8 also includes Notes to Pinnacle West’s Consolidated Financial Statements, the majority of which also relates to APS, and Supplemental Notes, which only relate to APS’ Financial Statements.**

## GLOSSARY OF NAMES AND TECHNICAL TERMS

ACC	Arizona Corporation Commission
ADEQ	Arizona Department of Environmental Quality
AFUDC	Allowance for Funds Used During Construction
ANPP	Arizona Nuclear Power Project, also known as Palo Verde
APS	Arizona Public Service Company, a subsidiary of the Company
APSES	APS Energy Services Company, Inc., a subsidiary of the Company
Base Fuel Rate	The portion of APS' retail base rates attributable to fuel and purchased power costs
Cholla	Cholla Power Plant
DOE	United States Department of Energy
El Dorado	El Dorado Investment Company, a subsidiary of the Company
EPA	United States Environmental Protection Agency
FASB	Financial Accounting Standards Board
FERC	United States Federal Energy Regulatory Commission
Four Corners	Four Corners Power Plant
kV	Kilovolt, one thousand volts
kWh	Kilowatt-hour, one thousand watts per hour
MW	Megawatt, one million watts
Native Load	Retail and wholesale sales supplied under traditional cost-based rate regulation
Navajo Plant	Navajo Generating Station
NRC	United States Nuclear Regulatory Commission
OCI	Other comprehensive income
Palo Verde	Palo Verde Nuclear Generating Station
Pinnacle West	Pinnacle West Capital Corporation (any use of the words "Company," "we," and "our" refer to Pinnacle West)
Pinnacle West Marketing & Trading	Pinnacle West Marketing & Trading Co., LLC, a subsidiary of the Company
PRP	Potentially responsible party under Superfund
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
SunCor	SunCor Development Company, a subsidiary of the Company
TCA	Transmission cost adjustor
VIE	Variable-interest entity
West Phoenix	West Phoenix Power Plant

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**FORWARD-LOOKING STATEMENTS**

This document contains forward-looking statements based on current expectations. These forward-looking statements are often identified by words such as “estimate,” “predict,” “may,” “believe,” “plan,” “expect,” “require,” “intend,” “assume” and similar words. Because actual results may differ materially from expectations, we caution you 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. These factors include:

- 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 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’s market areas.

These and other factors are discussed in Risk Factors described in Item 1A of this report, which you should review carefully before placing any reliance on our financial statements or disclosures. Neither Pinnacle West nor APS assumes any obligation to update any forward-looking statements, even if our internal estimates change, except as may be required by applicable law.



**PART I**  
**ITEM 1. BUSINESS**

**Pinnacle West**

Pinnacle West is a holding company that conducts business through its subsidiaries. We derive the majority of our revenues and earnings from our wholly-owned subsidiary, APS. APS is a vertically-integrated electric utility that provides either retail or 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.

Operating Revenues (in thousands) :

	Year Ended December 31,		
	2009	2008	2007
APS	\$ 3,149,500	\$ 3,133,496	\$ 2,936,277
Percentage of Pinnacle West Consolidated	96%	95%	89%

Pinnacle West's other first-tier subsidiaries are SunCor, APSES and El Dorado. Additional information related to these businesses is provided later in this report.

Our reportable business segments are the 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 the real estate segment, which consists of real estate development and investment activities in the western United States.

Due to the continuing distressed conditions in the real estate markets, in 2009 our real-estate subsidiary, SunCor, undertook a program to dispose of its homebuilding operations, master-planned communities, land parcels, commercial assets and golf courses in order to eliminate its outstanding debt. As a part of this plan to sell substantially all of SunCor's assets, the real estate segment may no longer be a reporting segment in the future. See Note 17 for financial information of our business segments.

**BUSINESS OF ARIZONA PUBLIC SERVICE COMPANY**

APS currently provides electric service to approximately 1.1 million customers. We own or lease more than 6,280 MW of regulated generation capacity and we hold a mix of both long-term and short-term power purchase agreements for additional capacity, including a variety of agreements for the purchase of renewable energy. During 2009, no single purchaser or user of energy accounted for more than 1.1% of our electric revenues.

The following map shows APS’ retail service territory, including the locations of its generating facilities and principal transmission lines.



**Energy Sources and Resource Planning**

To serve its customers, APS obtains power through its various generation stations and through power purchase agreements. Resource planning is an important function necessary to meet Arizona’s future energy needs. APS’ sources of energy by fuel type during 2009 were: coal — 36.3%; nuclear — 25.9%; purchased power — 20.6%; and gas, oil and other — 17.2%.

**Generation Facilities**

APS has ownership interests in or leases the coal, nuclear, gas, oil and solar generating facilities described below. For additional information regarding these facilities, see Item 2.

**Coal Fueled Generating Facilities**

*Four Corners* — Four Corners is a 5-unit coal-fired power plant located in the northwestern corner of New Mexico. APS operates the plant and owns 100% of Four Corners Units 1, 2 and 3 and 15% of Units 4 and 5. APS has a total entitlement from Four Corners of 785 MW. The Four Corners plant site is leased from the Navajo Nation and is also subject to an easement from the federal government. See “Plant and Transmission Line Leases and Easements on Indian Lands” in Item 2 for additional information. APS purchases all of Four Corners’ coal requirements from a supplier with a long-term lease of coal reserves with the Navajo Nation. The Four Corners coal contract runs through 2016.

*Cholla* — Cholla is a 4-unit coal-fired power plant located in northeastern Arizona. APS operates the plant and owns 100% of Cholla Units 1, 2 and 3. PacifiCorp owns Cholla Unit 4 and APS operates that unit for PacifiCorp. APS has a total entitlement from Cholla of 647 MW. APS purchases all of Cholla's coal requirements from a coal supplier that mines all of the coal under long-term leases of coal reserves with the federal government and private landholders. The Cholla coal contract runs through 2024. APS has the ability under the contract to reduce its annual coal commitment and purchase a portion of Cholla's coal requirements on the spot market to take advantage of competitive pricing options and to purchase coal required for increased operating capacity. APS believes that the current fuel contracts and competitive fuel supply options ensure the continued operation of Cholla for its useful life. In addition, APS has a long-term coal transportation contract.

*Navajo Generating Station* — The Navajo Plant is a 3-unit coal-fired power plant located in northern Arizona. Salt River Project operates the plant and APS owns a 14% interest in Navajo Units 1, 2 and 3. APS has a total entitlement from the Navajo Plant of 315 MW. The Navajo Plant's coal requirements are purchased from a supplier with long-term leases from the Navajo Nation and the Hopi Tribe. The Navajo Plant is under contract with its coal supplier through 2011, with options to extend through 2019. The Navajo Plant site is leased from the Navajo Nation and is also subject to an easement from the federal government. See "Plant and Transmission Line Leases and Easements on Indian Lands" in Item 2 for additional information.

These coal plants face uncertainties related to existing and potential legislation and regulation that could significantly impact their economics and operations. See "Environmental Matters" below and "Management's Discussion and Analysis of Financial Condition and Results of Operations — Capital Expenditures" in Item 7 for environmental and climate change developments impacting these coal facilities. See Note 11 for information regarding APS' coal mine reclamation obligations.

## **Nuclear**

*Palo Verde Nuclear Generating Station* — Palo Verde is a nuclear power plant located about 50 miles west of Phoenix, Arizona. APS operates the plant and owns 29.1% of Palo Verde Units 1 and 3 and about 17% of Unit 2. In addition, APS leases about 12.1% of Unit 2, resulting in a 29.1% combined interest in that Unit. APS has a total entitlement from Palo Verde of 1,146 MW.

*Palo Verde Leases* — In 1986, APS sold about 42% of its share of Palo Verde Unit 2 and certain common facilities in three separate sale leaseback transactions. APS accounts for these leases as operating leases. The leases, which have terms of 29.5 years, contain options to renew the leases or to purchase the property for fair market value at the end of the lease terms. APS must give notice to the respective lessors between December 31, 2010 and December 31, 2012 if it wishes to exercise, or not exercise, either of these options. We are analyzing these options. See Notes 9 and 20 for additional information regarding the Palo Verde Unit 2 sale leaseback transactions.

*Palo Verde Operating Licenses* — Operation of each of the three Palo Verde units requires an operating license from the NRC. The NRC issued full power operating licenses for Unit 1 in June 1985, Unit 2 in April 1986 and Unit 3 in November 1987. The full power operating licenses, each valid for a period of 40 years, authorize APS, as operating agent for Palo Verde, to operate the three Palo Verde units at full power. On December 15, 2008, APS applied for renewed operating licenses for the Palo Verde units for a period of 20 years beyond the expirations of the current licenses. The current NRC schedule for the applications estimates a final decision in the fall of 2011. APS is making preparations to secure resources necessary to operate the plant for the period of extended operation.

*Palo Verde Fuel Cycle* — The fuel cycle for Palo Verde is comprised of the following stages:

- mining and milling of uranium ore to produce uranium concentrates;
- conversion of uranium concentrates to uranium hexafluoride;
- enrichment of uranium hexafluoride;
- fabrication of fuel assemblies;
- utilization of fuel assemblies in reactors; and
- storage and disposal of spent nuclear fuel.

The Palo Verde participants are continually identifying their future nuclear fuel resource needs and negotiating arrangements to fill those needs. The Palo Verde participants have contracted for all of Palo Verde's requirements for uranium concentrates through 2011. New contracts are currently being negotiated that would meet the plant's conversion services needs through 2011, taking into account available inventory. The participants have also contracted for all of Palo Verde's enrichment services through 2013 and all of Palo Verde's fuel assembly fabrication services until at least 2015.

*Spent Nuclear Fuel and Waste Disposal* — Palo Verde has sufficient capacity at its on-site independent spent fuel storage installation ("ISFSI") to store all of the nuclear fuel that will be irradiated during the initial operating license period, through 2027. Additionally, Palo Verde has sufficient capacity at its on-site ISFSI to store a portion of the fuel that will be irradiated during the period of extended operation. If uncertainties regarding the United States government's obligation to accept and store used fuel are not favorably resolved, APS will evaluate alternative storage solutions that may obviate the need to expand the ISFSI to accommodate all of the fuel that will be irradiated during the period of extended operation. See "Palo Verde Nuclear Generating Station" in Note 11 for a discussion of spent nuclear fuel and waste disposal.

*NRC Inspection* — On February 22, 2007, the NRC issued a "white" finding (low to moderate safety significance) due to electrical output issues with the Unit 3 emergency diesel generator that occurred in 2006. Under the NRC's Action Matrix, this finding, coupled with a previous NRC "yellow" finding relating to a 2004 matter involving Palo Verde's safety injection systems, resulted in Palo Verde Unit 3 being placed in the "multiple/repetitive degraded cornerstone" column of the NRC's Action Matrix ("Column 4"), subjecting it to an enhanced NRC inspection regime. Although only Palo Verde Unit 3 was in NRC's Column 4, in order to adequately assess the need for improvements, APS' management conducted site-wide assessments of equipment and operations.

On March 24, 2009, the NRC informed APS that it was removing Palo Verde Unit 3 from Column 4, removing Units 1 and 2 from the "one degraded cornerstone" column ("Column 3") of the NRC's Action Matrix, and returning all three units of the plant to "Column 1" routine inspection and oversight by the NRC. This notification followed the NRC's completion of its inspections of the corrective actions taken by Palo Verde to address the performance deficiencies that caused the NRC to place Unit 3 into Column 4 and Units 1 and 2 into Column 3.

*Nuclear Decommissioning Costs* — APS currently relies on an external sinking fund mechanism to meet the NRC financial assurance requirements for its interests in Palo Verde Units 1, 2 and 3. The decommissioning costs of Palo Verde Units 1, 2 and 3 are currently included in APS' ACC jurisdictional rates. Decommissioning costs are recoverable through a non-bypassable system benefits charge, which allows APS to maintain its external sinking fund mechanism. See Note 12 for additional information about APS' nuclear decommissioning costs.

*Palo Verde Liability and Insurance Matters* — See “Palo Verde Nuclear Generating Station — Nuclear Insurance” in Note 11 for a discussion of the insurance maintained by the Palo Verde participants, including APS, for Palo Verde.

### **Natural Gas and Oil Fueled Generating Facilities**

APS has six natural gas power plants located throughout Arizona, consisting of Redhawk, located near the Palo Verde Nuclear Generating Station; Ocotillo, located in Tempe; Sundance, located in Coolidge; West Phoenix, located in southwest Phoenix; Saguaro, located north of Tucson; and Yucca, located near Yuma. Several of the units at Saguaro and Yucca run on either gas or oil. APS has one oil power plant, Douglas, located in the town of Douglas, Arizona. APS owns and operates each of these plants with the exception of one combustion turbine unit and one steam unit at Yucca that are operated by APS and owned by the Imperial Irrigation District. APS has a total entitlement from these plants of 3,389 MW. Gas for these plants is acquired through APS' hedging program. APS has long-term gas transportation agreements with three different companies, which provide APS with fuel delivery through 2024. Fuel oil is acquired under short-term purchases delivered primarily to West Phoenix, where it is distributed to APS' other oil power plants by truck.

### **Solar Facilities**

APS owns and operates more than thirty on-grid and off-grid small solar systems around the state. Together they have the capacity to produce about 6 MW of renewable energy. This fleet of solar systems is anchored by a 3 MW facility located at the Prescott Airport and a 1 MW facility located at APS' Saguaro power plant.

### **Purchased Power Contracts**

In addition to its own available generating capacity, APS purchases electricity under various arrangements, including long-term contracts and purchases through short-term markets to supplement its owned or leased generation and hedge its energy requirements. A substantial portion of APS' purchased power expense is netted against wholesale sales on the Consolidated Statements of Income. (See Note 18.) APS continually assesses its need for additional capacity resources to assure system reliability. APS does not expect to require new conventional generation sources sooner than 2017, due to planned additions of renewable resources and energy efficiency initiatives.

*Purchased Power Capacity* — APS' purchased power capacity under long-term contracts, including its renewable energy portfolio, is summarized in the tables below. All capacity values are based on net capacity unless otherwise noted.

**CONVENTIONAL AGREEMENTS:**

<b>Type</b>	<b>Dates Available</b>	<b>Capacity (MW)</b>
Purchase Agreement (a)	Year-round through December 2014	Up to 90
Purchase Agreement (b)	Year-round through June 15, 2010	238
Exchange Agreement (c)	May 15 to September 15 annually through 2020	480
Tolling Agreement	June 2007 through May 2017	500
Tolling Agreement	June 2010 through October 2019	560
Day-Ahead Call Option Agreement	June 2007 through September 2015 (summer seasons)	500
Day-Ahead Call Option Agreement	June 2007 through summer 2016	150
Demand Response Agreement (d)	2010 through 2024 (summer seasons)	100

- (a) The capacity under this agreement varies by month, with a maximum capacity of 90 MW.
- (b) The amount of electricity available to APS under this agreement is based in large part on customer demand and is adjusted annually. This contract is being replaced with a purchase agreement for approximately 36MW starting June 15, 2010 and ending June 14, 2020.
- (c) This is a seasonal capacity exchange agreement under which APS receives electricity during the summer peak season (from May 15 to September 15) and APS returns a like amount of electricity during the winter season (from October 15 to February 15).
- (d) The capacity under this agreement increases in a phased manner over the first three years to reach the 100 MW level by the summer of 2012.

**RENEWABLE AGREEMENTS:**

<b>Type and Name</b>	<b>Location</b>	<b>Contract End Date</b>	<b>Capacity (MW)</b>
<b>Operating Facilities:</b>			
<i>Wind</i>			
Aragonne Mesa	Santa Rosa, NM	2026	90
High Lonesome	Mountainair, NM	2039	100
<i>Geothermal</i>			
Salton Sea	Imperial County, CA	2029	10
<i>Biomass</i>			
White Mountain Power	Snowflake, AZ	2023	10
<i>Biogas</i>			
Glendale Landfill	Glendale, AZ	2030	3
<b>Signed Agreements for Other Facilities:</b>			
<i>Solar</i>			
Solana (a)	Gila Bend, AZ	2043	250
Solar 1 (b)	Ajo, AZ	2036	5
Solar 2 (b)	Buckeye, AZ	2035	6
Solar 3 (b)	Prescott, AZ	2041	10

- (a) Represents contracted capacity.
- (b) Details of these agreements have not yet been publicly announced.

## **Current and Future Resources**

### **Current Demand and Reserve Margin**

Electric power demand is generally seasonal. In Arizona, demand for power peaks during the hot summer months. APS' 2009 peak one-hour demand on its electric system was recorded on July 27, 2009 at 7,218 MW, compared to the 2008 peak of 7,026 MW recorded on August 1, 2008. APS' operable generating capacity, together with firm purchases totaling 2,657 MW, including short-term seasonal purchases and unit contingent purchases, resulted in an actual reserve margin, at the time of the 2009 peak demand, of 15.6%. The power actually available to APS from its resources fluctuates from time to time due in part to planned and unplanned plant and transmission outages and technical problems.

### **Future Resources and Resource Plan**

On January 29, 2009, APS submitted a Resource Plan Report to the ACC proposing a diverse portfolio of generation resources to address the projected 60% increase in customer peak demand by 2025, which equates to approximately 6,500 MW of new capacity resources and accounts for both new resources needed to meet growing customer loads as well as resources that will be needed to replace expiring long-term purchases.

On December 15, 2009, the ACC approved a modified resource planning rule that requires APS to file by April 1<sup>st</sup> of each even year its resource plans for the next fifteen-year period. The ACC's modified rule also requires APS to file its first resource plan within 120 days after the rule becomes effective. APS believes the modified rule will likely become effective by mid-2010, requiring APS to file a revised resource plan by the Fall of 2010, which will supercede the January 2009 filing. The modified rule also requires the ACC to issue an order with its acknowledgment of APS' resource plan within approximately nine months following its submittal.

## Renewable Energy Standard

In connection with its ongoing resource planning efforts, APS continues to focus on increasing the percentage of its energy that is produced by renewable resources. In 2006, the ACC adopted the Arizona Renewable Energy Standard and Tariff (the “Renewable Energy Standard” or “RES”). Under the Renewable Energy Standard, 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. The renewable energy requirement is 2.5% of retail electric sales in 2010 and increases annually until it reaches 15% in 2025. In APS’ recent retail rate case settlement agreement, APS committed to, among other things, an interim renewable energy target of 10% by year-end 2015, which is double the existing RES target of 5% for that year. (See Note 3.) A component of the original RES is focused on stimulating development of distributed energy systems (generally speaking, small-scale renewable technologies that are located on customers’ properties). Accordingly, under the original RES, an increasing percentage of that requirement must be supplied from distributed energy resources. This distributed energy requirement is 20% of the overall RES requirement of 2.5% in 2010 and increases to 30% of the applicable RES requirement in 2012 and subsequent years. The following table summarizes these requirement standards and their timing:

	2010	2015	2020	2025
RES as a % of retail electric sales	2.5%	5.0%	10.0%	15.0%
Percent of RES to be supplied from distributed energy resources	20.0%	30.0%	30.0%	30.0%
APS’ RES commitment as a % of retail electric sales per the retail rate case settlement agreement		10.0%		

APS has a diverse portfolio of renewable resources including wind, geothermal, solar and biomass, which currently collectively generates over 210 MW of renewable energy for its customers via owned or contracted renewable generation facilities and an additional installed capacity of 21 MW equivalent of customer-sited distribution energy systems in operation. These current renewable generation projects are either APS-owned solar facilities, as described under “Generation Facilities — Solar Facilities” above, are acquired through long-term purchased power agreements, as described under “Purchased Power Contracts” above, or are partially funded by renewable incentives we offer to our customers. APS continues to actively consider opportunities to enhance its renewable energy portfolio, both to ensure its compliance with the Renewable Energy Standard and to meet the needs of its customer base.

## Demand Side Management and Energy Efficiency

Arizona regulators are placing an increased focus on energy efficiency and demand side management programs to encourage customers to conserve energy, while incentivizing utilities to aid in these efforts that ultimately reduce the demand for energy. In December 2009, the ACC initiated Energy Efficiency rulemaking, with a proposed Energy Efficiency Standard of 22% annual energy savings by 2020. An ambitious standard, such as that proposed, will likely increase participation by APS customers in these conservation and energy efficiency programs, which in turn will likely impact Arizona’s future energy resource needs. Energy Efficiency Rules are expected to be formally adopted in 2010. (See Note 3 for demand side management and energy efficiency obligations resulting from APS’ recent retail rate case settlement.)

## Economic Stimulus Projects

Through the American Recovery and Reinvestment Act of 2009 (“ARRA”), the Federal government is making a number of programs available for utilities to develop renewable resources, improve reliability and create jobs from the availability of economic stimulus funding. Certain programs are also available through the State of Arizona.

In 2009, the DOE announced an ARRA commitment to fund the majority of a carbon dioxide emission reduction research and development project in the amount of \$70.5 million, which will be located at our Cholla power plant. It also announced a commitment to fund, subject to final negotiations, a \$3.3 million high penetration photovoltaic generation study related to a proposed APS community power project in Flagstaff, Arizona. These funding amounts are contingent upon meeting certain project milestones, including DOE-established budget parameters, over the next four years.

APS has also been selected by the State of Arizona's Department of Commerce as a sub-recipient under the State's ARRA award for the implementation of various distributed energy and energy efficiency programs in Arizona. The State is in final negotiations to provide APS with approximately \$3.7 million from the State's ARRA grant so that APS can implement certain solar water heater, photovoltaic and/or wind energy related community projects.

APS intends to continue to evaluate additional funding opportunities under the ARRA programs that may be of benefit to APS' business, operations or community activities.

## **Competitive Environment and Regulatory Oversight**

### **Retail**

The ACC regulates APS' retail electric rates and its issuance of securities. The ACC must also approve any transfer or encumbrance of APS' property used to provide retail electric service and approve or receive prior notification of certain transactions between Pinnacle West, APS and their respective affiliates.

APS is subject to varying degrees of competition from other investor-owned electric and gas utilities in Arizona (such as Southwest Gas Corporation), as well as cooperatives, municipalities, electrical districts and similar types of governmental or non-profit organizations. In addition, some customers, particularly industrial and large commercial customers, may own and operate generation facilities to meet some or all of their own energy requirements. This practice is becoming more popular with customers installing or having installed products such as roof top solar panels to meet or supplement their energy needs.

In 1999, the ACC approved rules for the introduction of retail electric competition in Arizona. As a result, as of January 1, 2001, all of APS' retail customers were eligible to choose alternate energy suppliers. However, there are currently no active retail competitors offering unbundled energy or other utility services to APS' customers. In 2000, an Arizona Superior Court found that the rules were in part unconstitutional and in other respects unlawful, the latter finding being primarily on procedural grounds, and invalidated all ACC orders authorizing competitive electric services providers to operate in Arizona. In 2004, the Arizona Court of Appeals invalidated some, but not all of the rules and upheld the invalidation of the orders authorizing competitive electric service providers. In 2005, the Arizona Supreme Court declined to review the Court of Appeals decision.

To date, the ACC has taken no further or substantive action on either the rules or the prior orders authorizing competitive electric service providers in response to the final Court of Appeals decision. However, as a result of a new request for authorization to provide competitive retail electric service by Sempra Energy Solutions, LLC, the ACC directed the ACC staff to investigate whether such retail competition was in the public interest and what legal impediments remain to competition in light of the Court of Appeals decision referenced above. The ACC staff's report on the results of its investigation is due to be filed with the ACC on April 1, 2010. At present, only limited electric retail competition exists in Arizona and only with certain entities not regulated by the ACC.

Currently, there are two matters pending with the ACC that involve a business model where customers pay solar vendors for the installation and operation of solar facilities based on the amount of energy produced. The ACC must make a determination whether these entities would be considered "public service corporations" under the Arizona Constitution, causing them to be regulated by the ACC. Use of such products by customers within our territory would result in some level of competition; however, at this time we do not feel this would materially impact our financial results. APS cannot predict when, and the extent to which, additional electric service providers will enter or re-enter APS' service territory.

## Wholesale

The FERC regulates rates for wholesale power sales and transmission services. (See Note 3 for information regarding APS' transmission rates.) During 2009, approximately 4.8% of APS' electric operating revenues resulted from such sales and services. APS' wholesale activity primarily consists of managing fuel and purchased power risks in connection with the costs of serving retail customer energy requirements. APS also sells, in the wholesale market, its generation output that is not needed for APS' Native Load and, in doing so, competes with other utilities, power marketers and independent power producers. Additionally, subject to specified parameters, APS markets, hedges and trades in electricity and fuels.

## Environmental Matters

### 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. On June 26, 2009, the House of Representatives approved the American Clean Energy and Security Act of 2009, H.R. 2454. In addition to establishing clean energy programs, H.R. 2454 would establish a greenhouse gas emission cap-and-trade system starting in 2012 applicable to about 85% of all emission sources in the nation. A similar bill (Kerry-Boxer Bill, S. 1733) is pending before the Senate. Both of these bills would allocate a certain number of allowances to local distribution companies (such as APS) through 2030.

To the extent APS' emissions exceed the allowances allocated to it under these proposed bills, APS would have an "allowance gap." APS would have to purchase enough allowances from the market to fill these gaps. The table below illustrates the estimated cost impacts to APS in 2012 to acquire allowances to fill its allowance gap, and the associated retail rate impacts to customers under H.R. 2454 and S. 1733. For purposes of this illustration, the table provides three assumed allowance prices of \$20, \$50 and \$75 per metric ton.

Allowance Cost (\$ per metric ton)	H.R. 2454		S. 1733	
	Annual Cost (\$ in millions)	Rate Impact	Annual Cost (\$ in millions)	Rate Impact
\$ 20	\$ 68	2%	\$ 101	3%
\$ 50	\$ 170	5%	\$ 252	8%
\$ 75	\$ 255	8%	\$ 379	12%

The actual economic and operational impact of this or any similar legislation on the Company depends on a variety of factors, none of which can be fully known until such legislation passes and the specifics of the resulting program are established. These factors include the terms of the legislation with regard to allowed emissions; whether the permitted emissions allowances will be allocated to source operators free of cost or auctioned; the cost to reduce emissions or buy allowances in the marketplace; and the availability of offsets and mitigating factors to moderate the costs of compliance. At the present time, we cannot predict what form of legislation, if any, will ultimately pass.

The EPA recently determined that greenhouse gas emissions endanger public health and welfare. This determination was made in response to a 2007 United States Supreme Court ruling 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 recent endangerment finding could result in the EPA issuing new regulatory requirements under the Clean Air Act for new and modified major greenhouse gas emitting sources, including power plants. On September 30, 2009, the EPA announced a proposed rule under the Clean Air Act requiring certain new and modified stationary sources, including power plants, to use the best available control technology to minimize greenhouse gas emissions. Several groups have filed lawsuits challenging the EPA's endangerment finding. At the present time we cannot predict whether the proposed stationary source rule will be adopted in its current or a revised form, what other rules or regulations may ultimately result from the EPA's finding, whether the parties challenging the endangerment finding will be successful, and what impact the proposed rule and potential other rules or regulations will have on APS' operations.

In anticipation of potential future regulation of greenhouse gases under the Clean Air Act as described above, on September 22, 2009, the EPA issued a mandatory greenhouse gas reporting rule. The rule applies to direct greenhouse gas emissions from facilities such as APS' power plants. We expect that our incremental costs to comply with this rule will be immaterial since APS already routinely reports CO<sub>2</sub> and other greenhouse gas emissions from its plants.

In addition to federal legislative initiatives, state specific initiatives may also impact our business. While Arizona has not yet enacted any state specific legislation regarding greenhouse gas emissions, the California legislature enacted AB 32 and SB 1368 in 2006 to address greenhouse gas emissions and New Mexico is currently considering proposed legislation to address these issues. We are monitoring these and other state legislative developments to understand the extent to which they may affect our business, including our sales into the impacted states or the ability of our out-of-state power plant participants to continue their participation in certain coal-fired power plants.

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, retirement or suspension of operations at certain coal-fired facilities, 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 ("WCI"), to reduce greenhouse gas emissions from automobiles and certain industries, including utilities. Montana, Quebec and Ontario have also joined WCI. WCI participants set a goal of reducing greenhouse gas emissions 15% below 2005 levels by 2020. After soliciting public comment, in September 2008 WCI issued the design of a cap-and-trade program for greenhouse gas emissions. Due in part to the recent activity at the federal level discussed above, the initiative's momentum and the movement toward detailed proposed rules has slowed. On February 2, 2010, Arizona's Governor issued an executive order stating that Arizona will continue to be a member of WCI to monitor its advancements in this area, but it will not implement the WCI regional cap-and-trade program. As a result, while we continue to monitor the progress of WCI, at the present time we do not believe it will have a material impact on our operations.

***Company Response to Climate Change Initiatives*** . We have undertaken a number of initiatives to address emission concerns, including renewable energy procurement and development, promotion of programs and rates that promote energy conservation, renewable energy use and energy efficiency, and implementation of an active technology innovation effort to evaluate potential emerging new technologies. APS 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.

On May 18, 2009, we submitted a comprehensive Climate Change Management Plan to the ACC 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. The Climate Change Management Plan details scientific, legislative and policy issues, potential physical and financial risks to APS, greenhouse gas emission inventory, APS technology innovation and greenhouse gas reduction efforts, and our companies' strategic approach to climate change management.

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. APS will not participate in the Climate Registry after 2009 because we will be reporting substantially the same information under the new EPA reporting rule. 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, as well as a copy of our Climate Change Management Plan discussed above. The information on Pinnacle West's website, including the Corporate Responsibility Report, is not incorporated by reference into this report.

***Climate Change Lawsuits***. In February 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in federal court in the Northern District of California against nine oil companies, fourteen power companies (including Pinnacle West), and a coal company, alleging that the defendants' emissions of carbon dioxide contribute to global warming and constitute a public and private nuisance. The plaintiffs also allege that the effects of global warming will require the relocation of the village and they are seeking an unspecified amount of monetary damages. In June 2008, the defendants filed motions to dismiss the action, which were granted. The plaintiffs filed an appeal with the court in November 2009. We believe the action is without merit and intend to continue to defend against the claims.

Similar nuisance lawsuits are currently pending in the 2nd and 5th Circuits. In the fall of 2009, the U.S. Courts of Appeals for each of these Circuits reversed lower court decisions and ruled that the plaintiffs in both cases could bring common law nuisance lawsuits against coal-burning utilities allegedly contributing to global warming. Both cases, as well as the Kivalina case, raise political and legal considerations, including whether the courts can or should be making climate change policy decisions. We are not a party to either of these two lawsuits, but will monitor these developments and their potential industry impacts.

## EPA Environmental Regulation

**Regional Haze Rules.** Over a decade ago, the EPA announced regional haze rules to reduce visibility impairment in national parks and wilderness areas. The rules require states (or, for sources located on tribal land, the EPA) to determine what pollution control technologies constitute the “best available retrofit technology” (“BART”) for certain older major stationary sources. The EPA subsequently issued the Clean Air Visibility Rule, which provides guidelines on how to perform a BART analysis.

ADEQ is currently undertaking a rulemaking process to address the Clean Air Visibility Rule requirements. ADEQ’s rules were due to EPA Region 9 in December 2007, but are expected to be submitted in 2010. As part of the rulemaking process, ADEQ required APS to perform a BART analysis for Cholla. APS completed a BART analysis for Cholla and submitted its BART recommendations to ADEQ on February 4, 2008. The recommendations include the installation of certain pollution control equipment that APS believes constitutes BART. Once APS receives ADEQ’s final determination as to what constitutes BART for Cholla, we will have five years to complete the installation of the equipment and to achieve the emission limits established by ADEQ. However, in order to coordinate with the plant’s other scheduled activities, APS is currently implementing portions of its recommended plan for Cholla on a voluntary basis. Costs related to the implementation of these portions of our recommended plan are included in our environmental expenditure estimates (see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Capital Expenditures” in Item 7).

EPA Region 9 requested that APS, as the operating agent for Four Corners, and SRP, as the operating agent for the Navajo Plant, perform a BART analysis for Four Corners and the Navajo Plant, respectively. APS and SRP each submitted an analysis to the EPA concluding that certain combustion control equipment constitutes BART for these plants. Based on the analyses and comments received through EPA’s rulemaking process, the EPA will determine what it believes constitutes BART for each plant.

The EPA recently issued an Advanced Notice of Proposed Rulemaking (ANPR) seeking public comments on what constitutes BART for each plant. The public comment period expired in October, 2009, but the EPA has extended the comment period until March 20, 2010 for the Navajo and Hopi Tribes. We expect that the EPA will issue proposed and final BART determinations for Four Corners and the Navajo Plant in 2010. The participant owners of Four Corners and the Navajo Plant will have five years after the EPA issues its final determination to achieve compliance with their respective BART requirements. In addition, on February 16, 2010, a group of environmental organizations filed a petition with the Departments of Interior and Agriculture requesting those agencies to certify to the EPA that visibility impairment in sixteen national park and wilderness areas is reasonably attributable to emissions from Four Corners. If the agencies certify impairment, the EPA is required to evaluate and, if necessary, determine BART for Four Corners.

APS’ recommended plan for Four Corners includes the installation of combustion control equipment, with an estimated cost to APS, based on preliminary engineering estimates and APS’ Four Corners ownership interest, of approximately \$50 million. If the EPA determines that post-combustion controls are required, APS’ total costs could be up to approximately \$422 million for Four Corners. SRP’s recommended plan for the Navajo Plant includes the installation of combustion control equipment, with an estimated cost to APS of approximately \$6 million based on APS’ Navajo ownership interest. If the EPA determines that post-combustion controls are required, APS’ total costs could be up to approximately \$93 million for Navajo. The Four Corners and Navajo Plant participants’ obligations to comply with the EPA’s final BART determinations, coupled with the financial impact of future climate change legislation, other environmental regulations and other business considerations, could jeopardize the economic viability of these plants or the ability of individual participants to continue their participation in these plants.

In order to coordinate with each plant's other scheduled activities, the plants are currently implementing portions of their recommended plans described above on a voluntary basis. APS' share of the costs related to the implementation of these portions of the recommended plans are included in our environmental expenditure estimates (see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Capital Expenditures" in Item 7).

**Mercury and other Hazardous Air Pollutants.** In early 2008, the U.S. Court of Appeals for the D.C. Circuit vacated the Clean Air Mercury Rule ("CAMR"), which was adopted by the EPA to regulate mercury emissions from coal fired power plants. As a result, the law in effect prior to the adoption of the CAMR became the applicable law, and the EPA is now required to adopt final maximum achievable control technology emissions ("MACT") standards. Under a proposed consent decree, the EPA has agreed to issue final MACT standards for mercury and other hazardous air pollutants by November 2011. If the consent decree is finalized in its current form, APS will have three years after the EPA issues its final rule to achieve compliance, which would likely require APS to install additional pollution control equipment.

APS has installed, and continues to install, certain of the equipment necessary to meet the anticipated standards. 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 Item 7).

**Federal Implementation Plan ("FIP").** In September 1999, the EPA proposed FIPs to set air quality standards at certain power plants, including Four Corners and the Navajo Plant, which it later revised in 2006. The FIP for Four Corners was finalized in 2009, and we do not believe compliance with its required limits will have a material adverse impact on our financial position, results of operations or cash flows. The proposed FIP for the Navajo Plant is still pending. APS cannot currently predict the effect of this proposed FIP on its financial position, results of operations or cash flows, or whether the proposed FIP will be adopted in its current form.

**Coal Combustion Waste.** The EPA is expected to issue proposed regulations governing the handling and disposal of coal combustion byproducts ("CCBs"), such as fly ash and bottom ash. APS currently disposes of CCBs in ash ponds and dry storage areas at Cholla and Four Corners, and also sells a portion of its fly ash for beneficial reuse as a constituent in concrete production. The EPA is evaluating options that include regulation of CCBs under non-hazardous waste standards, hazardous waste standards, or a combination of both, and a potential phase out of the disposal of CCBs through the use of ash ponds. A proposed rule is expected during the first quarter of 2010. We do not know when the EPA will issue a final rule, including required compliance dates. While APS continues to advocate for the regulation of CCBs as non-hazardous waste, we cannot currently predict the outcome of the EPA's actions and whether such actions will have a material adverse impact on our financial position, results of operations or cash flows.

**Section 114 Request .** On April 6, 2009, APS received a request from the EPA under Section 114 of the Clean Air Act seeking detailed information regarding projects at and operations of Four Corners. This request is part of an enforcement initiative that the EPA has undertaken under the Clean Air Act. The EPA has taken the position that many utilities have made certain physical or operational changes at their plants that should have triggered additional regulatory requirements under the New Source Review provisions of the Clean Air Act ("NSR"). Other electric utilities have received and responded to similar Section 114 requests, and several of them have been the subject of notices of violation and lawsuits by the EPA. APS has responded to the EPA's request and is currently unable to predict the timing or content of EPA's response, if any, or any resulting actions.

**Superfund** . The Comprehensive Environmental Response, Compensation and Liability Act (“Superfund”) establishes liability for the cleanup of hazardous substances found contaminating the soil, water or air. Those who generated, transported or disposed of hazardous substances at a contaminated site are among those who are PRPs. PRPs may be strictly, and often are jointly and severally, liable for clean-up. On September 3, 2003, the EPA advised APS that the EPA considers APS to be a PRP in the Motorola 52<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. In addition, on September 23, 2009, APS agreed with the EPA and one other PRP to voluntarily assist with the funding and management of the site-wide groundwater remedial investigation and feasibility study work plan. APS estimates that its costs related to this investigation and study will be approximately \$1.2 million, which is reserved as a liability on its financial statements. We anticipate incurring additional expenditures in the future, but because the overall investigation is not complete and ultimate remediation requirements are not yet finalized, at the present time we cannot accurately estimate our total expenditures.

By letter dated April 25, 2008, the EPA informed APS that it may be a PRP in the Gila River Indian Reservation Superfund Site in Maricopa County, Arizona. APS, along with three other electric utility companies, owns a parcel of property on which a transmission pole and a portion of a transmission line are located. The property abuts the Gila River Indian Community boundary and, at one time, may have been part of an airfield where crop dusting took place. Currently, the EPA is only seeking payment from APS and four other PRPs for past cleanup-related costs involving contamination from the crop dusting. Based upon the total amount of cleanup costs reported by the EPA in its letter to APS, we do not expect that the resolution of this matter will have a material adverse impact on APS’ financial position, results of operations, or cash flows.

**Manufactured Gas Plant Sites**. Certain properties which APS now owns or which were previously owned by it or its corporate predecessors were at one time sites of, or sites associated with, manufactured gas plants. APS is taking action to voluntarily remediate these sites. APS does not expect these matters to have a material adverse effect on its financial position, results of operations, cash flows or liquidity.

#### **Navajo Nation Environmental Issues**

Four Corners and the Navajo Plant are located on the Navajo Reservation and are held under easements granted by the federal government as well as leases from the Navajo Nation. See “Energy Sources and Planning — Generation — Coal Fueled Generating Facilities” above for additional information regarding these plants.

In July 1995, the Navajo Nation enacted the Navajo Nation Air Pollution Prevention and Control Act, the Navajo Nation Safe Drinking Water Act and the Navajo Nation Pesticide Act (collectively, the “Navajo Acts”). The Navajo Acts purport to give the Navajo Nation Environmental Protection Agency authority to promulgate regulations covering air quality, drinking water and pesticide activities, including those activities that occur at Four Corners and the Navajo Plant. On October 17, 1995, the Four Corners participants and the Navajo Plant participants each filed a lawsuit in the District Court of the Navajo Nation, Window Rock District, challenging the applicability of the Navajo Acts as to Four Corners and the Navajo Plant. The Court has stayed these proceedings pursuant to a request by the parties, and the parties are seeking to negotiate a settlement.

In April 2000, the Navajo Tribal Council approved operating permit regulations under the Navajo Nation Air Pollution Prevention and Control Act. APS believes the Navajo Nation exceeded its authority when it adopted the operating permit regulations. On July 12, 2000, the Four Corners participants and the Navajo Plant participants each filed a petition with the Navajo Supreme Court for review of these regulations. Those proceedings have been stayed, pending the settlement negotiations mentioned above. APS cannot currently predict the outcome of this matter.

On May 18, 2005, APS, Salt River Project, as the operating agent for the Navajo Plant, and the Navajo Nation executed a Voluntary Compliance Agreement to resolve their disputes regarding the Navajo Nation Air Pollution Prevention and Control Act. As a result of this agreement, APS sought, and the Courts granted, dismissal of the pending litigation in the Navajo Nation Supreme Court and the Navajo Nation District Court, to the extent the claims relate to the Clean Air Act. The agreement does not address or resolve any dispute relating to other Navajo Acts. APS cannot currently predict the outcome of this matter.

### **Water Supply**

Assured supplies of water are important for APS' generating plants. At the present time, APS has adequate water to meet its needs. However, conflicting claims to limited amounts of water in the southwestern United States have resulted in numerous court actions.

Both groundwater and surface water in areas important to APS' operations have been the subject of inquiries, claims and legal proceedings, which will require a number of years to resolve. APS is one of a number of parties in a proceeding, filed March 13, 1975, before the Eleventh Judicial District Court in New Mexico to adjudicate rights to a stream system from which water for Four Corners is derived. An agreement reached with the Navajo Nation in 1985, however, provides that if Four Corners loses a portion of its rights in the adjudication, the Navajo Nation will provide, for an agreed upon cost, sufficient water from its allocation to offset the loss.

A summons served on APS in early 1986 required all water claimants in the Lower Gila River Watershed in Arizona to assert any claims to water on or before January 20, 1987, in an action pending in Maricopa County, Arizona, Superior Court. Palo Verde is located within the geographic area subject to the summons. APS' rights and the rights of the other Palo Verde participants to the use of groundwater and effluent at Palo Verde are potentially at issue in this action. As operating agent of Palo Verde, APS filed claims that dispute the court's jurisdiction over the Palo Verde participants' groundwater rights and their contractual rights to effluent relating to Palo Verde. Alternatively, APS seeks confirmation of such rights. Five of APS' other power plants are also located within the geographic area subject to the summons. APS' claims dispute the court's jurisdiction over its groundwater rights with respect to these plants. Alternatively, APS seeks confirmation of such rights. In November 1999, the Arizona Supreme Court issued a decision confirming that certain groundwater rights may be available to the federal government and Indian tribes. In addition, in September 2000, the Arizona Supreme Court issued a decision affirming the lower court's criteria for resolving groundwater claims. Litigation on both of these issues has continued in the trial court. In December 2005, APS and other parties filed a petition with the Arizona Supreme Court requesting interlocutory review of a September 2005 trial court order regarding procedures for determining whether groundwater pumping is affecting surface water rights. The Court denied the petition in May 2007, and the trial court is now proceeding with implementation of its 2005 order. No trial date concerning APS' water rights claims has been set in this matter.

APS has also filed claims to water in the Little Colorado River Watershed in Arizona in an action pending in the Apache County, Arizona, Superior Court, which was originally filed on September 5, 1985. APS' groundwater resource utilized at Cholla is within the geographic area subject to the adjudication and, therefore, is potentially at issue in the case. APS' claims dispute the court's jurisdiction over its groundwater rights. Alternatively, APS seeks confirmation of such rights. A number of parties are in the process of settlement negotiations with respect to certain claims in this matter. Other claims have been identified as ready for litigation in motions filed with the court. No trial date concerning APS' water rights claims has been set in this matter.

Although the above matters remain subject to further evaluation, APS does not expect that the described litigation will have a material adverse impact on its financial position, results of operations, cash flows or liquidity.

The Four Corners region, in which Four Corners is located, has been experiencing drought conditions that may affect the water supply for the plants if adequate moisture is not received in the watershed that supplies the area. APS is continuing to work with area stakeholders to implement agreements to minimize the effect, if any, on future operations of the plant. The effect of the drought cannot be fully assessed at this time, and APS cannot predict the ultimate outcome, if any, of the drought or whether the drought will adversely affect the amount of power available, or the price thereof, from Four Corners.

## **BUSINESS OF OTHER SUBSIDIARIES**

### **SunCor**

SunCor has been a developer of residential, commercial and industrial real estate projects in Arizona, Idaho, New Mexico and Utah. Due to the continuing distressed conditions in the real estate markets, in 2009 SunCor undertook a program to dispose of its homebuilding operations, master-planned communities, land parcels, commercial assets and golf courses in order to eliminate its outstanding debt.

At December 31, 2009, SunCor had total assets of about \$166 million. At December 31, 2008, SunCor had total assets of about \$547 million. The reduction in SunCor's assets is primarily due to 2009 real estate impairment charges of \$266 million and 2009 asset sales. SunCor's remaining assets consist primarily of land with improvements, commercial buildings, golf courses and other real estate investments. SunCor's remaining projects include master-planned communities and commercial and residential projects. Four of the master-planned communities and the commercial and residential projects are in Arizona. Other master-planned communities are located in Idaho, New Mexico and Utah.

SunCor's operating revenues were approximately \$103 million in 2009, \$75 million in 2008, and \$190 million in 2007. SunCor's net loss attributable to common shareholders was approximately \$279 million in 2009, which includes \$266 million (pre-tax) in real estate impairment charges. In 2009, income tax benefits related to SunCor operations were recorded by Pinnacle West in accordance with an intercompany tax sharing agreement. SunCor's net loss attributable to common shareholders in 2008 was \$26 million, which included a \$53 million (pre-tax) real estate impairment charge. SunCor's net income was approximately \$24 million in 2007. Certain components of SunCor's real estate sales activities, which are included in the real estate segment, are required to be reported as discontinued operations on Pinnacle West's Consolidated Statements of Income. (See Notes 22 and 23.)

See "Liquidity — Other Subsidiaries — SunCor" in Item 7 for a discussion of SunCor's long-term debt, liquidity and capital requirements, and the SunCor-related risk factor in Item 1A for a discussion of risks facing SunCor.

## **APSES**

APSES provides energy-related products and services (such as energy master planning, energy use consultation and facility audits, cogeneration analysis and installation, and project management) with a focus on energy efficiency and renewable energy to commercial and industrial retail customers in the western United States. APSES also owns and operates district cooling systems.

APSES had a net loss of \$2 million in 2009, a net loss of \$1 million in 2008 and a net loss of \$4 million in 2007. At December 31, 2009, APSES had total assets of \$74 million.

## **El Dorado**

El Dorado owns minority interests in several energy-related investments and Arizona community-based ventures. El Dorado's short-term goal is to prudently realize the value of its existing investments. On a long-term basis, Pinnacle West may use El Dorado, when appropriate, for investments that are strategic to the business of generating, distributing and marketing electricity.

El Dorado had a net loss of \$7 million in 2009, a net loss of \$10 million in 2008 and a net loss of \$6 million in 2007. Income taxes related to El Dorado are recorded by Pinnacle West. At December 31, 2009, El Dorado had total assets of \$19 million.

**OTHER INFORMATION**

Pinnacle West, APS and Pinnacle West's other first-tier subsidiaries are all incorporated in the State of Arizona. Additional information for each of these companies is provided below:

	Principal Executive Office Address	Year of Incorporation	Approximate Number of Employees at December 31, 2009
Pinnacle West	400 North Fifth Street Phoenix, AZ 85004	1985	7,200(a)
APS	400 North Fifth Street P.O. Box 53999 Phoenix, AZ 85072-3999	1920	6,800(b)
SunCor	80 East Rio Salado Parkway Suite 410 Tempe, AZ 85281	1965	260
APSES	60 E. Rio Salado Parkway Suite 1001 Tempe, AZ 85281	1998	70
El Dorado	400 North Fifth Street Phoenix, AZ 85004	1983	—

- (a) Includes 6,800 APS employees and 400 people employed by Pinnacle West and its other subsidiaries.
- (b) Includes employees at jointly-owned generating facilities (approximately 3,300 employees) for which APS serves as the generating facility manager. Approximately 2,000 APS employees are union employees. The collective bargaining agreement with union employees in the fossil generation and energy delivery business areas expires in April 2011, and the parties will likely begin negotiating a successor agreement in early 2011. The agreement with union employees serving as Palo Verde security officers expires in 2013.

**WHERE TO FIND MORE INFORMATION**

We use our website [www.pinnaclewest.com](http://www.pinnaclewest.com) as a channel of distribution for material Company information. The following filings are available free of charge on our website as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC: Annual Reports on Form 10-K, definitive proxy statements for our annual shareholder meetings, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all amendments to those reports. Our board and committee charters, Code of Ethics and other corporate governance information is also available on the Pinnacle West website. Pinnacle West will post any amendments to the Code of Ethics and Ethics Policy and Standards of Business Practices, and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, on its website. The information on Pinnacle West's website is not incorporated by reference into this report.

You can request a copy of these documents, excluding exhibits, by contacting Pinnacle West at the following address: Pinnacle West Capital Corporation, Office of the Secretary, Station 9068, P.O. Box 53999, Phoenix, Arizona 85072-3999 (telephone 602-250-3252).

**ITEM 1A. RISK FACTORS**

In addition to the factors affecting specific business operations identified in connection with the description of these operations contained elsewhere in this report, set forth below are risks and uncertainties that could affect our financial results. Unless otherwise indicated or the context otherwise requires, the following risks and uncertainties apply to Pinnacle West and its subsidiaries, including APS.

**REGULATORY RISKS**

*Our financial condition depends upon APS' ability to recover costs in a timely manner from customers through regulated rates and otherwise execute its business strategy.*

APS is subject to comprehensive regulation by several federal, state and local regulatory agencies that significantly influence its business, liquidity, results of operations and its ability to fully recover costs from utility customers in a timely manner. The ACC regulates APS' retail electric rates and the FERC regulates rates for wholesale power sales and transmission services. While approved electric rates are intended to permit APS to recover its costs of service and earn a reasonable rate of return, the profitability of APS is affected by the rates it may charge. Consequently, our financial condition and results of operations are dependent upon the satisfactory resolution of any APS retail rate proceedings and ancillary matters which may come before the ACC and the FERC. In connection with its recent rate case settlement agreement, APS agreed not to request its next general retail rate increase to be effective prior to July 1, 2012. The ACC must also approve APS' issuance of securities and any transfer of APS property used to provide retail electric service, and must approve or receive prior notification of certain transactions between us, APS and our respective affiliates. Decisions made by the ACC and the FERC could have a material adverse impact on our financial condition, results of operations or cash flows.

*APS' ability to conduct its business operations and avoid fines and penalties depends upon compliance with federal, state or local statutes and regulations, and obtaining and maintaining certain regulatory permits, approvals and certificates.*

APS must comply in good faith with all applicable statutes, regulations, rules, tariffs, and orders of agencies that regulate APS' business, including the FERC, the NRC, the EPA and state and local governmental agencies. These agencies regulate many aspects of APS' utility operations, including safety and performance, emissions, siting and construction of facilities, customer service and the rates that APS can charge retail and wholesale customers. Failure to comply can subject APS to, among other things, fines and penalties. For example, under the Energy Policy Act of 2005, the FERC can impose penalties (up to one million dollars per day per violation) for failure to comply with mandatory electric reliability standards. APS underwent its first mandatory regularly-scheduled triennial audit for compliance with these standards in early 2010 and expects to receive its results by mid-2010. In addition, APS is required to have numerous permits, approvals and certificates from these agencies. APS believes the necessary permits, approvals and certificates have been obtained for its existing operations and that APS' business is conducted in accordance with applicable laws in all material respects. However, changes in regulations or the imposition of new or revised laws or regulations could have an adverse impact on our results of operations. We are also unable to predict the impact on our business and operating results from pending or future regulatory activities of any of these agencies .

***The operation of APS' nuclear power plant exposes it to substantial regulatory oversight and potentially significant liabilities and capital expenditures.***

The NRC has broad authority under federal law to impose licensing and safety-related requirements for the operation of nuclear generation facilities. In the event of noncompliance, the NRC has the authority to impose monetary civil penalties or a progressively increased inspection regime that could ultimately result in the shut down of a unit, or both, depending upon the NRC's assessment of the severity of the situation, until compliance is achieved. APS was subject to this heightened scrutiny until March 2009, when it exited the NRC's enhanced inspection regime. The increased costs resulting from penalties, a heightened level of scrutiny and implementation of plans to achieve compliance with NRC requirements, may adversely affect APS' financial condition, results of operations and cash flows.

***APS is subject to numerous environmental laws and regulations, and changes in, or liabilities under, existing or new laws or regulations may increase APS' cost of operations or impact its business plans.***

APS is subject to numerous environmental laws and regulations affecting many aspects of its present and future operations, including air emissions, water quality, wastewater discharges, solid waste, hazardous waste, and coal combustion products, which consist of bottom ash, fly ash and air pollution control wastes. These laws and regulations can result in increased capital, operating, and other costs, particularly with regard to enforcement efforts focused on power plant emissions obligations. These laws and regulations generally require APS to obtain and comply with a wide variety of environmental licenses, permits, and other approvals. If there is a delay or failure to obtain any required environmental regulatory approval, or if APS fails to obtain, maintain or comply with any such approval, operations at affected facilities could be suspended or subject to additional expenses. In addition, failure to comply with applicable environmental laws and regulations could result in civil liability or criminal penalties. Both public officials and private individuals may seek to enforce applicable environmental laws and regulations. APS cannot predict the outcome (financial or operational) of any related litigation that may arise.

*Environmental Clean Up.* APS has been named as a PRP for a Superfund site in Phoenix, Arizona and it could be named a PRP in the future for other environmental clean up at sites identified by a regulatory body. APS cannot predict with certainty the amount and timing of all future expenditures related to environmental matters because of the difficulty of estimating clean up costs. There is also uncertainty in quantifying liabilities under environmental laws that impose joint and several liability on all potentially responsible parties.

*Regional Haze.* APS is currently awaiting final rulemaking from the EPA that could impose new requirements on Four Corners and the Navajo Plant. APS is also awaiting final rulemaking from ADEQ that could impose new requirements on Cholla. The EPA and ADEQ will require these plants to install pollution control equipment that constitutes the best available retrofit technology to lessen the impacts of emissions on visibility surrounding the plants. Depending upon the agencies' final determinations of what constitutes BART for these plants, the financial impact of installing the required pollution control equipment could jeopardize the economic viability of the plants or the ability of individual participants to continue their participation in these plants.

*Coal Ash.* Recently Congress directed the EPA to propose new federal regulations governing the disposal of CCBs, which are generated as a result of burning coal and consist of, among other things, fly ash and bottom ash. APS currently disposes of CCBs in ash ponds and dry storage areas at Four Corners and Cholla, and also sells a portion of its fly ash for beneficial reuse as a constituent in concrete products. If the EPA regulates CCBs as a hazardous solid waste or phases out APS' ability to dispose of CCBs through the use of ash ponds, APS could incur significant costs for CCB disposal and may be unable to continue its sale of fly ash for beneficial reuse.

*New Source Review.* The EPA has taken the position that many projects electric utilities have performed are major modifications that trigger NSR requirements under the Clean Air Act. The utilities generally have taken the position that these projects are routine maintenance and did not result in emissions increases, and thus are not subject to NSR. APS received and responded to a request from the EPA regarding projects and operations of Four Corners. If the EPA seeks to impose NSR requirements at Four Corners or any other APS plant, either through a lawsuit or a Notice of Violation, significant capital investments could be required to install new pollution control technologies. The EPA could also seek civil penalties.

*Mercury and other Hazardous Air Pollutants.* The EPA is required to adopt maximum achievable control technology emissions standards for mercury and other hazardous air pollutants by November 2011. Depending on the compliance requirements contained in the final rule, APS may need to make significant capital investments to install additional pollution control equipment to meet these new standards.

APS cannot be sure that existing environmental regulations will not be revised or that new regulations seeking to protect the environment will not be adopted or become applicable to it. Revised or additional regulations that result in increased compliance costs or additional operating restrictions, particularly if those costs incurred by APS are not fully recoverable from APS' customers, could have a material adverse effect on its financial condition, results of operations or cash flows.

***APS faces physical and operational risks related to climate change, and potential financial risks resulting from climate change litigation and legislative and regulatory efforts to limit greenhouse gas emissions.***

Concern over climate change, deemed by many to be induced by rising levels of greenhouse gases in the atmosphere, has led to significant legislative and regulatory efforts to limit CO<sub>2</sub>, which is a major byproduct of the combustion of fossil fuel, and other greenhouse gas emissions. In addition, lawsuits have been filed against companies that emit greenhouse gases, including a lawsuit filed by the Native Village of Kivalina and the City of Kivalina, Alaska against us and several other utilities seeking damages related to climate change, which was dismissed but has been appealed.

*Physical and Operational Risks.* Projections for the Southwest United States from climate change models include an increase in the number of extreme hot days in the summer, less precipitation in the form of snow and the earlier runoff of snowmelt, increased wildfire potential, and the potential for water shortages. Assuming that the primary physical and operational risks to APS from climate change are increased potential for drought or water shortage, and a mild to moderate increase in ambient temperatures, APS believes it is taking the appropriate steps at this time to respond to these risks. Weather extremes such as drought and high temperature variations are common occurrences in the Southwest's desert area, and these are risk factors that APS considers in the normal course of business in the engineering and construction of its electric system. Large increases in ambient temperature due to climate change could require evaluation of certain materials used within its system and represents a greater challenge.

*Financial Risks — Potential Legislation and Regulation* . In the past several years, the United States Congress has considered bills that would regulate domestic greenhouse gas emissions. The House of Representatives approved a bill that would establish a greenhouse gas emission cap-and-trade system, and the Senate is currently considering proposed legislation. 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.

If the United States Congress, or individual states or groups of states in which APS operates, ultimately pass legislation regulating the emissions of greenhouse gases, any resulting limitations on generation facility CO<sub>2</sub> and other greenhouse gas emissions could result in the creation of substantial additional capital expenditures and operating costs in the form of taxes, emissions allowances or required equipment upgrades and could have a material adverse impact on all fossil fuel fired generation facilities (particularly coal-fired facilities, which constitute approximately 28% of APS' generation capacity). A cap-and-trade program may also result in counterparty credit risk and financial liquidity risk since collateral is typically exchanged between counterparties as a means of mitigating risk in the event of a counterparty default.

At the state level, the California legislature enacted legislation to address greenhouse gas emissions. This legislation and other state-specific initiatives may affect APS' business, including sales into the impacted states or the ability of its out-of-state power plant participants to continue their participation in certain coal-fired power plants, including Four Corners following expiration of the current lease term in 2016.

In addition, the EPA recently determined that greenhouse gas emissions endanger public health and welfare. This determination was made in response to a 2007 United States Supreme Court ruling 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 recent endangerment finding could result in the EPA issuing new regulatory requirements under the Clean Air Act, beyond those related to motor vehicle emissions, which could impact APS' power plants and result in substantial additional costs. Excessive costs to comply with future legislation or regulations could force APS and other similarly-situated electric power generators to retire or suspend operations at certain coal-fired facilities.

***If APS cannot meet or maintain the level of renewable energy required under Arizona's increasing Renewable Energy Standards or the higher commitment levels established in the settlement agreement, APS may be subject to penalties or fines for non-compliance.***

The Renewable Energy Standard and Tariff ("RES") requires APS to supply an increasing percentage of renewable energy each year, so that the amount of retail electricity sales from eligible renewable resources is at least 2.5% of total retail sales by 2010. This amount increases annually to 15% by 2025. In its recent retail rate case settlement agreement, APS agreed to exceed these standards and committed to an interim renewable energy target of 10% by year end 2015. A portion of this total renewable energy requirement must be met with an increasing percentage of distributed energy resources (generally, small scale renewable technologies located on customers' properties). The distributed energy requirement is 20% of the overall RES requirement of 2.5% in 2010 and increases to 30% of the applicable RES requirement in 2012 and subsequent years. If APS fails to implement any of its annual ACC-approved renewable resource plans, it may be subject to penalties imposed by the ACC, including APS' inability to recover certain costs. Compliance with the distributed resource requirement is contingent upon customer participation. The development of any renewable generation facilities resulting from the RES is subject to many other risks, including risks relating to financing, permitting, technology, fuel supply, and the construction of sufficient transmission capacity to support these facilities.

***Deregulation or restructuring of the electric industry may result in increased competition, which could have a significant adverse impact on APS' business and its results of operations.***

In 1999, the ACC approved rules for the introduction of retail electric competition in Arizona. Retail competition could have a significant adverse financial impact on APS due to an impairment of assets, a loss of retail customers, lower profit margins or increased costs of capital. Although some very limited retail competition existed in APS' service area in 1999 and 2000, there are currently no active retail competitors offering unbundled energy or other utility services to APS' customers. As a result, APS cannot predict if, when, and the extent to which, additional competitors may re-enter APS' service territory.

Currently, there are two matters pending with the ACC that involve a business model where customers pay solar vendors for the installation and operation of solar facilities based on the amount of energy produced. The ACC must make a determination whether these entities would be considered "public service corporations" under the Arizona Constitution, causing them to be regulated by the ACC. Use of such products by customers within APS' territory would result in some level of competition.

As a result of changes in federal law and regulatory policy, competition in the wholesale electricity market has greatly increased due to a greater participation by traditional electricity suppliers, non-utility generators, independent power producers, and wholesale power marketers and brokers. This increased competition could affect APS' load forecasts, plans for power supply and wholesale energy sales and related revenues. As a result of the changing regulatory environment and the relatively low barriers to entry, we expect wholesale competition to increase, which could adversely affect our business.

**OPERATIONAL RISKS**

***APS' results of operations can be adversely affected by various factors impacting demand for electricity.***

*Weather Conditions.* Weather conditions directly influence the demand for electricity and affect the price of energy commodities. Electric power demand is generally a seasonal business. In Arizona, demand for power peaks during the hot summer months, with market prices also peaking at that time. As a result, APS' overall operating results fluctuate substantially on a seasonal basis. In addition, APS has historically sold less power, and consequently earned less income, when weather conditions are milder. As a result, unusually mild weather could diminish APS' results of operations and harm its financial condition.

Higher temperatures may decrease the snowpack, which might result in lowered soil moisture and an increased threat of forest fires. Forest fires could threaten APS' communities and electric transmission lines. Any damage caused as a result of forest fires could negatively impact APS' results of operations.

*Effects of Energy Conservation Measures and Distributed Energy.* The ACC has initiated a rulemaking regarding energy efficiency, which includes a proposed 22% annual energy savings requirement by 2020. If adopted, this will likely increase participation by APS customers in energy efficiency and conservation programs and demand-side management efforts, which in turn would impact the demand for electricity. The proposed rules also include a requirement for the ACC to review and address financial disincentives, recovery of fixed costs and the recovery of net lost income/revenue that would result from lower sales due to increased energy efficiency requirements. The retail rate case settlement agreement establishes energy efficiency goals for APS that begin in 2010, subjecting APS to energy efficiency requirements in advance of the proposed rules described above.

APS must also meet certain distributed energy requirements. A portion of APS' total renewable energy requirement must be met with an increasing percentage of distributed energy resources (generally, small scale renewable technologies located on customers' properties). The distributed energy requirement is 20% of the overall RES requirement of 2.5% in 2010 and increases to 30% of the applicable RES requirement in 2012 and subsequent years. Customer participation in distributed energy programs would result in lower demand, since customers would be meeting some or all of their own energy needs. Reduced demand due to these energy efficiency and distributed energy requirements, unless offset through regulatory mechanisms, could have a material adverse impact on APS' financial condition, results of operations or cash flows.

***The operation of power generation facilities involves risks that could result in unscheduled power outages or reduced output, which could materially affect APS' results of operations .***

The operation of power generation facilities involves certain risks, including the risk of breakdown or failure of equipment, fuel interruption, and performance below expected levels of output or efficiency. Unscheduled outages, including extensions of scheduled outages due to mechanical failures or other complications, occur from time to time and are an inherent risk of APS' business. If APS' facilities operate below expectations, especially during its peak seasons, it may lose revenue or incur additional expenses, including increased purchased power expenses.

***The lack of access to sufficient supplies of water could have a material adverse impact on APS' business and results of operations.***

Assured supplies of water are important for APS' generating plants. Water in the southwestern United States is limited and various parties have made conflicting claims regarding the right to access and use such limited supply of water. Both groundwater and surface water in areas important to APS' generating plants have been the subject of inquiries, claims and legal proceedings. In addition, the Four Corners region, in which Four Corners is located, has been experiencing drought conditions that may affect the water supply for the plants if adequate moisture is not received in the watershed that supplies the area. APS' inability to access sufficient supplies of water could have a material adverse impact on our business and results of operations.

***The ownership and operation of power generation and transmission facilities on Indian lands could result in uncertainty related to continued easements and rights-of-way, which could have a significant impact on our business.***

Certain APS power plants, including Four Corners, and portions of the transmission lines that carry power from these plants are located on Indian lands pursuant to easements or other rights-of-way that are effective for specified periods. APS is currently unable to predict the outcome of discussions with the appropriate Indian tribes with respect to future renewal of these easements and rights-of-way.

***There are inherent risks in the ownership and operation of nuclear facilities, such as environmental, health, fuel supply, spent fuel disposal, regulatory and financial risks and the risk of terrorist attack.***

APS has an ownership interest in and operates, on behalf of a group of owners, Palo Verde, which is the largest nuclear electric generating facility in the United States. Palo Verde is subject to environmental, health and financial risks such as the ability to obtain adequate supplies of nuclear fuel; the ability to dispose of spent nuclear fuel; the ability to maintain adequate reserves for decommissioning; potential liabilities arising out of the operation of these facilities; the costs of securing the facilities against possible terrorist attacks; and unscheduled outages due to equipment and other problems. APS maintains nuclear decommissioning trust funds and external insurance coverage to minimize its financial exposure to some of these risks; however, it is possible that damages could exceed the amount of insurance coverage. In addition, APS may be required under federal law to pay up to \$103 million (but not more than \$15 million per year) of liabilities arising out of a nuclear incident occurring not only at Palo Verde, but at any other nuclear power plant in the United States. Although we have no reason to anticipate a serious nuclear incident at Palo Verde, if an incident did occur, it could materially and adversely affect our results of operations and financial condition. A major incident at a nuclear facility anywhere in the world could cause the NRC to limit or prohibit the operation or licensing of any domestic nuclear unit.

The operation of Palo Verde requires licenses that need to be periodically renewed and/or extended. In December 2008, APS applied for renewed operating licenses for all three Palo Verde units for 20 years beyond the expirations of the current licenses. APS does not anticipate any problems renewing these licenses. However, as a result of potential terrorist threats and increased public scrutiny of utilities, the licensing process could result in increased licensing or compliance costs that are difficult or impossible to predict.

***The use of derivative contracts in the normal course of our business could result in financial losses that negatively impact our results of operations.***

APS' operations include managing market risks related to commodity prices. APS is exposed to the impact of market fluctuations in the price and transportation costs of electricity, natural gas and coal to the extent that unhedged positions exist. We have established procedures to manage risks associated with these market fluctuations by utilizing various commodity derivatives, including exchange-traded futures and options and over-the-counter forwards, options, and swaps. As part of our overall risk management program, we enter into derivative transactions to hedge purchases and sales of electricity and fuels. The changes in market value of such contracts have a high correlation to price changes in the hedged commodity. To the extent that commodity markets are illiquid, we may not be able to execute our risk management strategies, which could result in greater unhedged positions than we would prefer at a given time and financial losses that negatively impact our results of operations.

Congress is considering legislation to impose restrictions on the use of over-the-counter derivatives, including energy derivatives, which could subject APS to governmental regulation relating to these hedging transactions. If such legislation becomes law, APS could potentially face higher costs to hedge its risks, fewer potential counterparties still active in the newly-regulated marketplace and increased liquidity requirements.

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We use a risk management process to assess and monitor the financial exposure of all counterparties. Despite the fact that the majority of trading counterparties are rated as investment grade by the rating agencies, there is still a possibility that one or more of these companies could default, which could result in a material adverse impact on our earnings for a given period.

***Changes in technology may adversely affect APS' business.***

Research and development activities are ongoing to improve alternative technologies to produce power, including fuel cells, micro turbines, clean coal and coal gasification, photovoltaic (solar) cells and improvements in traditional technologies and equipment, such as more efficient gas turbines. Advances in these, or other technologies could reduce the cost of power production, making APS' generating facilities less competitive. In addition, advances in technology could reduce the demand for power supply, which could adversely affect APS' business.

APS is pursuing and implementing advanced technologies, including smart grid transmission and distribution systems and advanced meters for use in customers' homes and businesses. Many of the products and processes resulting from these and other alternative technologies have not yet been widely used or tested, and their use on large-scale systems is not as advanced and established as APS' existing technologies and equipment. Uncertainties and unknowns related to these and other advancements in technology and equipment could adversely affect APS' business if national standards develop that do not embrace the current technologies or if the technologies and equipment fail to perform as expected.

**FINANCIAL RISKS**

***Financial market disruptions may increase our financing costs or limit our access to the credit markets, which may adversely affect our liquidity and our ability to implement our financial strategy.***

We rely on access to short-term money markets, longer-term capital markets and the bank markets as a significant source of liquidity and for capital requirements not satisfied by the cash flow from our operations. We believe that we will maintain sufficient access to these financial markets. However, certain market disruptions may increase our cost of borrowing or adversely affect our ability to access one or more financial markets. Such disruptions could include:

- continuation of the current economic downturn;
- terrorist attacks or threatened attacks on our facilities or those of unrelated energy companies;
- mergers among financial institutions and the overall health of the banking industry; or
- the overall health of the utility industry.

In addition, the credit commitments of our lenders under our bank facilities may not be satisfied for a variety of reasons, including unexpected periods of financial distress affecting our lenders, which could materially adversely affect the adequacy of our liquidity sources.

Changes in economic conditions could result in higher interest rates, which would increase our interest expense on our debt and reduce funds available to us for our current plans. Additionally, an increase in our leverage could adversely affect us by:

- increasing the cost of future debt financing;
- reducing our credit ratings;
- increasing our vulnerability to adverse economic and industry conditions; and
- requiring us to dedicate a substantial portion of our cash flow from operations to payments on our debt, which would reduce funds available to us for operations, future business opportunities or other purposes.

***A reduction in our credit ratings could materially and adversely affect our business, financial condition and results of operations.***

Our current ratings are set forth in “Pinnacle West Consolidated — Liquidity and Capital Resources — Credit Ratings” in Item 7. We cannot be sure that any of our current ratings will remain in effect for any given period of time or that a rating will not be lowered or withdrawn entirely by a rating agency if, in its judgment, circumstances in the future so warrant. Any downgrade or withdrawal could adversely affect the market price of Pinnacle West’s and APS’ securities, limit our access to capital and increase our borrowing costs, which would diminish our financial results. We would be required to pay a higher interest rate in future financings, and our potential pool of investors and funding sources could decrease. In addition, borrowing costs under certain of our existing credit facilities depend on our credit ratings. A downgrade would also require us to provide substantial additional support in the form of letters of credit or cash or other collateral to various counterparties. If our short-term ratings were to be lowered, it could completely eliminate any possible future access to the commercial paper market. We note that the ratings from rating agencies are not recommendations to buy, sell or hold our securities and that each rating should be evaluated independently of any other rating.

***Market performance, changing interest rates and other economic factors could decrease the value of our benefit plan assets and nuclear decommissioning trust funds and increase our related obligations, resulting in significant additional funding that could negatively impact our business.***

Disruptions in the capital markets may adversely affect the values of fixed income and equity investments held in our employee benefit plan trusts and nuclear decommissioning trusts. We have significant obligations in these areas and hold substantial assets in these trusts. A decline in the market value of these trusts may increase our funding requirements. Additionally, the pension plan and other postretirement benefit liabilities are impacted by the discount rate, which is the interest rate used to discount future pension and other postretirement benefit obligations. Declining interest rates impact the discount rate, and may result in increases in pension and other postretirement benefit costs, cash contributions, regulatory assets, and charges to other comprehensive income. Changes in demographics, including increased numbers of retirements or changes in life expectancy assumptions, may also increase the funding requirements of the obligations related to the pension and other postretirement benefit plans. A significant portion of the pension costs and other postretirement benefit costs and all of the nuclear decommissioning costs are recovered in regulated electricity prices. Our inability to fully recover these costs in a timely manner or any increased funding obligations could negatively impact our financial condition, results of operations or cash flows.

***We may be required to adopt International Financial Reporting Standards (“IFRS”). The ultimate adoption of such standards could negatively impact our business, financial condition or results of operations.***

IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board that is being considered by the SEC to replace accounting principles generally accepted in the United States of America (“GAAP”) for use in preparation of financial statements. If the SEC requires mandatory adoption of IFRS, we may lose our ability to use regulatory accounting treatment, and would follow IFRS rather than GAAP for the preparation of our financial statements beginning in 2014. The implementation and adoption of these new standards and the inability to use regulatory accounting could negatively impact our business, financial condition or results of operations.

***Our cash flow largely depends on the performance of our subsidiaries.***

We conduct our operations primarily through subsidiaries. Substantially all of our consolidated assets are held by such subsidiaries. Accordingly, our cash flow is dependent upon the earnings and cash flows of these subsidiaries and their distributions to us. The subsidiaries are separate and distinct legal entities and have no obligation to make distributions to us.

The debt agreements of some of our subsidiaries may restrict their ability to pay dividends, make distributions or otherwise transfer funds to us. An ACC financing order requires APS to maintain a common equity ratio of at least 40% and does not allow APS to pay common dividends if the payment would reduce its common equity below that threshold. The common equity ratio, as defined in the ACC order, is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt.

***Our ability to meet our debt service obligations could be adversely affected because our debt securities are structurally subordinated to the debt securities and other obligations of our subsidiaries.***

Because we are structured as a holding company, all existing and future debt and other liabilities of our subsidiaries will be effectively senior in right of payment to our debt securities. None of the indentures under which we or our subsidiaries may issue debt securities limits our ability or the ability of our subsidiaries to incur additional debt in the future. The assets and cash flows of our subsidiaries will be available, in the first instance, to service their own debt and other obligations. Our ability to have the benefit of their assets and cash flows, particularly in the case of any insolvency or financial distress affecting our subsidiaries, would arise only through our equity ownership interests in our subsidiaries and only after their creditors have been satisfied.

***The market price of our common stock may be volatile.***

The market price of our common stock could be subject to significant fluctuations in response to factors such as the following, some of which are beyond our control:

- variations in our quarterly operating results;
- operating results that vary from the expectations of management, securities analysts and investors;

- changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- developments generally affecting industries in which we operate, particularly the energy distribution and energy generation industries;
- announcements by us or our competitors of significant contracts, acquisitions, joint marketing relationships, joint ventures or capital commitments;
- announcements by third parties of significant claims or proceedings against us;
- favorable or adverse regulatory or legislative developments;
- our dividend policy;
- future sales by the Company of equity or equity-linked securities; and
- general domestic and international economic conditions.

In addition, the stock market in general has experienced volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the market price of our common stock.

***Certain provisions of our articles of incorporation and bylaws and of Arizona law make it difficult for shareholders to change the composition of our board and may discourage takeover attempts.***

These provisions, which could preclude our shareholders from receiving a change of control premium, include the following:

- restrictions on our ability to engage in a wide range of “business combination” transactions with an “interested shareholder” (generally, any person who owns 10% or more of our outstanding voting power or any of our affiliates or associates) or any affiliate or associate of an interested shareholder, unless specific conditions are met;
- anti-greenmail provisions of Arizona law and our bylaws that prohibit us from purchasing shares of our voting stock from beneficial owners of more than 5% of our outstanding shares unless specified conditions are satisfied;
- the ability of the Board of Directors to increase the size of the Board and fill vacancies on the Board, whether resulting from such increase, or from death, resignation, disqualification or otherwise; and
- the ability of our Board of Directors to issue additional shares of common stock and shares of preferred stock and to determine the price and, with respect to preferred stock, the other terms, including preferences and voting rights, of those shares without shareholder approval.

While these provisions have the effect of encouraging persons seeking to acquire control of us to negotiate with our Board of Directors, they could enable the Board to hinder or frustrate a transaction that some, or a majority, of our shareholders might believe to be in their best interests and, in that case, may prevent or discourage attempts to remove and replace incumbent directors.

***SunCor's business and financial results would be adversely affected if it is unable to extend, modify or renew its credit facilities or repay its debt through sales of its remaining assets.***

At December 31, 2009, SunCor had borrowings of approximately \$57 million under its principal loan facility (the "Secured Revolver"). The Secured Revolver matured on January 30, 2010 and SunCor and the agent bank for the Secured Revolver are discussing an extension of the maturity date to allow time for SunCor to continue discussions concerning the potential sale of additional properties. In addition to the Secured Revolver, at December 31, 2009, SunCor had approximately \$43 million of outstanding debt under other credit facilities (\$9 million of which has matured since December 31, 2009 and remains outstanding).

If SunCor is unable to obtain an extension or renewal of the 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 intends to apply the proceeds of its planned asset sales to the repayment of its outstanding debt. If it is unable to locate suitable buyers and close certain asset sales or obtain sufficient proceeds from these sales to maintain or pay off its existing debt, it may be unable to satisfy obligations under its credit facilities, resulting in the immediate repayment obligations described above.

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

The Company has not guaranteed any SunCor indebtedness. As a result, we do not believe that SunCor's inability to meet its financial covenants under the Secured Revolver or its other outstanding credit facilities would have a material adverse impact on Pinnacle West's cash flows or liquidity. Any resulting SunCor losses would be reflected in Pinnacle West's consolidated financial statements. If SunCor were required to seek protection under federal bankruptcy laws, Pinnacle West could be exposed to the uncertainties and complexities inherent for parent companies in such proceedings.

During 2008 and 2009 the real estate market weakened significantly resulting in lower land and home sales and depressed real estate prices. As a result, in 2008 and 2009 SunCor recognized certain impairment charges. SunCor may be required to record additional impairments.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

Neither Pinnacle West nor APS has received written comments regarding its periodic or current reports from the SEC staff that were issued 180 days or more preceding the end of its 2009 fiscal year and that remain unresolved .

## ITEM 2. PROPERTIES

## Generation Facilities

APS' portfolio of owned and leased generating facilities is provided in the table below:

Name	No. of Units	% Owned (a)	Principal Fuels Used	Primary Dispatch Type	Owned Capacity (MW)
<b>Nuclear:</b>					
Palo Verde (b)	3	29.1%	Uranium	Base Load	1,146
<b>Total Nuclear</b>					<u>1,146</u>
<b>Steam:</b>					
Four Corners 1, 2, 3	3		Coal	Base Load	560
Four Corners 4, 5 (c)	2	15%	Coal	Base Load	225
Cholla	3		Coal	Base Load	647
Navajo (d)	3	14%	Coal	Base Load	315
Ocotillo	2		Gas	Peaking	220
Saguaro	2		Gas/Oil	Peaking	210
<b>Total Steam</b>					<u>2,177</u>
<b>Combined Cycle:</b>					
Redhawk	2		Gas	Load Following	984
West Phoenix	5		Gas	Load Following	887
<b>Total Combined Cycle</b>					<u>1,871</u>
<b>Combustion Turbine:</b>					
Ocotillo	2		Gas	Peaking	110
Saguaro 1, 2	2		Gas/Oil	Peaking	110
Saguaro 3	1		Gas	Peaking	79
Douglas	1		Oil	Peaking	16
Sundance	10		Gas	Peaking	420
West Phoenix	2		Gas	Peaking	110
Yucca 1, 2, 3	3		Gas/Oil	Peaking	93
Yucca 4	1		Oil	Peaking	54
Yucca 5, 6	2		Gas	Peaking	96
<b>Total Combustion Turbine</b>					<u>1,088</u>
<b>Solar:</b>					
Multiple state-wide solar facilities			Solar	Peaking	6
<b>Total Solar</b>					<u>6</u>
<b>Total Capacity</b>					<u><u>6,288</u></u>

(a) 100% unless otherwise noted.

(b) See "Business of Arizona Public Service Company — Generation — Nuclear" in Item 1 for details regarding leased interests in Palo Verde. The other owners are Salt River Project (17.5%), Southern California Edison (15.8%), El Paso Electric (15.8%), Public Service Company of New Mexico (10.2%), Southern California Public Power Authority (5.9%), and Los Angeles Department of Water & Power (5.7%).

- (c) The other owners are Salt River Project (10%), Public Service Company of New Mexico (13%), Southern California Edison (48%), Tucson Electric Power Company (1%) and El Paso Electric (1%).
- (d) The other owners are Salt River Project (21.7%), Nevada Power Company (11.3%), the United States Government (24.3%), Tucson Electric Power Company (7.5%) and Los Angeles Department of Water & Power (21.2%).

See “Business of Arizona Public Service Company — Environmental Matters” in Item 1 with respect to matters having a possible impact on the operation of certain of APS’ generating facilities.

See “Business of Arizona Public Service Company” in Item 1 for a map detailing the location of APS’ major power plants and principal transmission lines.

### Transmission and Distribution Facilities

**Current Facilities** . APS’ transmission facilities consist of approximately 5,946 pole miles of overhead lines and approximately 49 miles of underground lines, 5,723 miles of which are located in Arizona. APS’ distribution facilities consist of approximately 11,362 miles of overhead lines and approximately 17,308 miles of underground primary cable, all of which are located in Arizona. APS shares ownership of some of its transmission facilities with other companies. The following table shows APS’ jointly-owned interests in those transmission facilities recorded on the Consolidated Balance Sheets at December 31, 2009:

	<b>Percent Owned (Weighted Average)</b>
North Valley System	65.9%
Palo Verde — Estrella 500KV System	55.5%
Round Valley System	50.0%
ANPP 500KV System	35.8%
Navajo Southern System	31.4%
Four Corners Switchyards	27.5%
Palo Verde — Yuma 500KV System	23.9%
Phoenix — Mead System	17.1%

**Expansion.** Each year APS prepares and files with the ACC a ten-year transmission plan. In APS’ 2010 plan, APS projects it will invest approximately \$520 million in new transmission over the next ten years, which includes 270 miles of new lines. This investment will increase the import capability into metropolitan Phoenix by approximately 26% and will increase the import capability into the Yuma area by approximately 38%. One significant project presently under construction is the Morgan - Pinnacle Peak project, which consists of 26 miles of 500kV and 230kV lines. APS completed two major substation projects in 2009. The Dugas substation (500/69kV) will provide system voltage support and capacity for the Verde Valley area and the Sugarloaf substation (500/69kV) will provide system voltage support and capacity for the Show Low and Snowflake areas, and will also support renewable energy development in that area.

APS continues to work with regulators to identify transmission projects necessary to support renewable energy facilities. Two such projects, which are included in APS’ 2010 transmission plan, are the Delany to Palo Verde line and the North Gila to Palo Verde line, both of which are intended to support the transmission of renewable energy to Phoenix and California.

**Plant and Transmission Line Leases and Easements on Indian Lands**

The Navajo Plant and Four Corners are located on land held under leases from the Navajo Nation and also under easements from the federal government. The easement and lease for the Navajo Plant expire in 2019 and the easement and lease for Four Corners expire in 2016. Each of the leases contains an option to extend for an additional 25-year period from the end of the existing lease term, for a rental amount tied to the original rent payment adjusted based on an index. The easements do not contain an express renewal option and it is unclear what conditions to renewal or extension of the easements may be imposed. The ultimate cost of renewal of the Navajo Plant and Four Corners leases and easements is uncertain. The coal contracted for use in these plants is also located on Indian reservations.

Certain portions of the transmission lines that carry power from several of our power plants are located on Indian lands pursuant to easements or other rights-of-way that are effective for specified periods. Some of these rights-of-way have expired and our renewal applications have not yet been acted upon by the appropriate Indian tribes. Other rights expire at various times in the future and renewal action by the applicable tribe will be required at that time. The majority of our transmission lines residing on Indian lands are on the Navajo Nation. The Four Corners and Navajo Plant leases provide Navajo Nation consent to certain of the rights-of-way for transmission lines related to those plants at a specified rental rate for the original term of the rights-of-way and for a like payment in any renewal period. In addition, a 1985 amendment to the leases provides a formula for calculating payments for certain new and renewal rights-of-way. However, some of our rights-of-way are not covered by the leases, or are granted by other Indian tribes. In recent negotiations with other utilities or companies for renewal of similar rights-of-way, certain of the affected Indian tribes have required payments substantially in excess of amounts that we have paid in the past for such rights-of-way or that are typical for similar permits across non-Indian lands; however, we are unaware of the underlying agreements and/or specific circumstances surrounding these renewals. The ultimate cost of renewal of the rights-of-way for our transmission lines is uncertain. We are monitoring these rights-of-way and easement issues and have initiated discussions with the Navajo Nation regarding them. We are currently unable to predict the outcome of this matter.

**Real Estate Segment Properties**

See “Business of Other Subsidiaries — SunCor ” in Item 1 for information regarding SunCor’s remaining properties. Substantially all of SunCor’s debt is collateralized by interests in its real property.

**ITEM 3. LEGAL PROCEEDINGS**

See “Business of Arizona Public Service Company — Environmental Matters” in Item 1 with regard to pending or threatened litigation and other disputes.

See Note 3 for the resolution of APS’ general retail rate case and other matters before the ACC.

See Note 11 with regard to a lawsuit brought by APS on behalf of itself and the other Palo Verde owners against the DOE, for information relating to the FERC proceedings on California and Pacific Northwest energy market issues and for information regarding the bankruptcy proceeding involving the landlord for our corporate headquarters building.

**ITEM 4. SUBMISSION OF MATTERS TO A  
VOTE OF SECURITY HOLDERS**

Not applicable.

**EXECUTIVE OFFICERS OF PINNACLE WEST**

Pinnacle West's executive officers are elected no less often than annually and may be removed by the Board of Directors at any time. The executive officers, their ages at February 19, 2010, current positions and principal occupations for the past five years are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>	<u>Period</u>
Donald E. Brandt	55	Chairman of the Board and Chief Executive Officer of Pinnacle West;	2009-Present
		Chairman of the Board of APS	
		Chief Executive Officer of APS	2008-Present
		President and Chief Operating Officer of Pinnacle West	2008-2009
		President of APS	2006-2009
		Executive Vice President of Pinnacle West; Chief Financial Officer of APS	2003-2008
		Chief Financial Officer of Pinnacle West	2002-2008
Executive Vice President of APS	2003-2006		
Donald G. Robinson	56	President and Chief Operating Officer of APS	2009-Present
		Senior Vice President, Planning and Administration of APS	2007-2009
		Vice President, Planning of APS	2003-2007
James R. Hatfield	52	Treasurer of Pinnacle West and APS	2009-Present
		Senior Vice President and Chief Financial Officer of Pinnacle West and APS	2008-Present
		Senior Vice President and Chief Financial Officer of OGE Energy Corp.	1999-2008
Denise R. Danner	54	Vice President, Controller and Chief Accounting Officer of Pinnacle West;	2010-Present
		Chief Accounting Officer of APS	
		Vice President and Controller of APS	2009-Present
		Senior Vice President, Controller and Chief Accounting Officer of Allied Waste Industries, Inc.	2007-2008
		Vice President, Controller and Chief Accounting Officer of Phelps Dodge Corporation	2004-2007
Randall K. Edington	56	Executive Vice President and Chief Nuclear Officer of APS	2007-Present
		Senior Vice President and Chief Nuclear Officer of APS	2007
		Site Vice President and Chief Nuclear Officer of Cooper Generating Station with Entergy Corporation	2003-2007

<u>Name</u>	<u>Age</u>	<u>Position</u>	<u>Period</u>
David P. Falck	56	Executive Vice President, General Counsel and Secretary of Pinnacle West and APS	2009-Present
		Senior Vice President — Law of Public Service Enterprise Group Inc.	2007-2009
		Partner — Pillsbury Winthrop Shaw Pittman LLP	1987-2007
Mark A. Schiavoni	54	Senior Vice President, Fossil Operations of APS	2009-Present
		Senior Vice President of Exelon Generation and President of Exelon Power	2004-2009
Lori S. Sundberg	46	Vice President, Human Resources of APS	2007-Present
		Vice President, Employee Relations, Safety, Compliance & Embrace of American Express Company	2007
		Vice President, HR Relationship Leader, Global Corporate Travel Division of American Express Company	2003-2007
Steven M. Wheeler	61	Executive Vice President, Customer Service and Regulation of APS	2003-Present

## PART II

**ITEM 5. MARKET FOR REGISTRANTS' COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Pinnacle West's common stock is publicly held and is traded on the New York Stock Exchange. At the close of business on February 15, 2010, Pinnacle West's common stock was held of record by approximately 28,216 shareholders.

## QUARTERLY STOCK PRICES AND DIVIDENDS PAID PER SHARE STOCK SYMBOL: PNW

2009	High	Low	Close	Dividends Per Share
1st Quarter	\$ 35.13	\$ 22.32	\$ 26.56	\$ 0.525
2nd Quarter	30.30	25.28	30.15	0.525
3rd Quarter	33.71	28.87	32.82	0.525
4th Quarter	37.96	31.08	36.58	0.525
2008	High	Low	Close	Dividends Per Share
1st Quarter	\$ 42.92	\$ 34.08	\$ 35.08	\$ 0.525
2nd Quarter	37.39	30.26	30.77	0.525
3rd Quarter	37.88	30.34	34.41	0.525
4th Quarter	35.83	26.27	32.13	0.525

APS' common stock is wholly-owned by Pinnacle West and is not listed for trading on any stock exchange. As a result, there is no established public trading market for APS' common stock.

The chart below sets forth the dividends paid on APS' common stock for each of the four quarters for 2009 and 2008.

**Common Stock Dividends  
(Dollars in Thousands)**

Quarter	2009	2008
1 <sup>st</sup> Quarter	\$42,500	\$42,500
2 <sup>nd</sup> Quarter	42,500	42,500
3 <sup>rd</sup> Quarter	42,500	42,500
4 <sup>th</sup> Quarter	42,500	42,500

The sole holder of APS' common stock, Pinnacle West, is entitled to dividends when and as declared out of legally available funds. As of December 31, 2009, APS did not have any outstanding preferred stock.

**Issuer Purchases of Equity Securities**

The following table contains information about our purchases of our common stock during the fourth quarter of 2009.

<b>Period</b>	<b>Total Number of Shares Purchased (1)</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
October 1 - October 31, 2009	—	—	—	—
November 1 - November 30, 2009	35	\$ 33.46	—	—
December 1 - December 31, 2009	—	—	—	—
<b>Total</b>	<b>35</b>	<b>\$ 33.46</b>	<b>—</b>	<b>—</b>

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

**ITEM 6. SELECTED FINANCIAL DATA**  
**PINNACLE WEST CAPITAL CORPORATION — CONSOLIDATED**

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(dollars in thousands, except per share amounts)				
<b>OPERATING RESULTS</b>					
Operating revenues:					
Regulated electricity segment	\$ 3,149,187	\$ 3,127,383	\$ 2,918,163	\$ 2,635,036	\$ 2,237,145
Real estate segment	103,152	74,549	189,726	306,938	280,204
Marketing and trading	—	66,897	138,247	136,748	179,895
Other revenues	<u>44,762</u>	<u>41,729</u>	<u>48,018</u>	<u>36,172</u>	<u>61,221</u>
Total operating revenues	<u>\$ 3,297,101</u>	<u>\$ 3,310,558</u>	<u>\$ 3,294,154</u>	<u>\$ 3,114,894</u>	<u>\$ 2,758,465</u>
Income from continuing operations					
(a)	\$ 67,231	\$ 231,304	\$ 300,436	\$ 308,972	\$ 223,933
Discontinued operations — net of income taxes (b)	<u>(13,676)</u>	<u>10,821</u>	<u>6,707</u>	<u>18,283</u>	<u>(47,666)</u>
Net Income	53,555	242,125	307,143	327,255	176,267
Less: Net loss attributable to noncontrolling interests	<u>(14,775)</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net income attributable to common shareholders	<u>\$ 68,330</u>	<u>\$ 242,125</u>	<u>\$ 307,143</u>	<u>\$ 327,255</u>	<u>\$ 176,267</u>
<b>COMMON STOCK DATA</b>					
Book value per share — year-end	\$ 32.69	\$ 34.16	\$ 35.15	\$ 34.48	\$ 34.58
Earnings per weighted-average common share outstanding:					
Continuing operations attributable to common shareholders — basic					
	\$ 0.81	\$ 2.30	\$ 3.00	\$ 3.11	\$ 2.32
Net income attributable to common shareholders — basic	\$ 0.68	\$ 2.40	\$ 3.06	\$ 3.29	\$ 1.83
Continuing operations attributable to common shareholders — diluted					
	\$ 0.81	\$ 2.29	\$ 2.98	\$ 3.09	\$ 2.32
Net income attributable to common shareholders — diluted	\$ 0.67	\$ 2.40	\$ 3.05	\$ 3.27	\$ 1.82
Dividends declared per share	\$ 2.10	\$ 2.10	\$ 2.10	\$ 2.025	\$ 1.925
Weighted-average common shares outstanding — basic	101,160,659	100,690,838	100,255,807	99,417,008	96,483,781
Weighted-average common shares outstanding — diluted	101,263,795	100,964,920	100,834,871	100,010,108	96,589,949
<b>BALANCE SHEET DATA</b>					
Total assets	<u>\$ 11,808,155</u>	<u>\$ 11,620,093</u>	<u>\$ 11,162,209</u>	<u>\$ 10,817,900</u>	<u>\$10,588,485</u>
Liabilities and equity:					
Current liabilities	\$ 1,083,160	\$ 1,505,928	\$ 1,344,449	\$ 923,338	\$ 1,608,863
Long-term debt less current maturities	3,370,524	3,031,603	3,127,125	3,232,633	2,608,455
Deferred credits and other	<u>4,008,791</u>	<u>3,589,194</u>	<u>3,159,024</u>	<u>3,215,813</u>	<u>2,946,203</u>
Total liabilities	8,462,475	8,126,725	7,630,598	7,371,784	7,163,521
Total equity	<u>3,345,680</u>	<u>3,493,368</u>	<u>3,531,611</u>	<u>3,446,116</u>	<u>3,424,964</u>
Total liabilities and equity	<u>\$ 11,808,155</u>	<u>\$ 11,620,093</u>	<u>\$ 11,162,209</u>	<u>\$ 10,817,900</u>	<u>\$10,588,485</u>

- (a) Includes a \$157 million after tax real estate impairment charge in 2009 (see Note 23). Also includes regulatory disallowance of \$8 million after tax in 2007 and \$84 million after tax in 2005.
- (b) Amounts primarily related to SunCor's real estate impairment charges (see Note 23), Silverhawk Power Station ("Silverhawk") and APSES discontinued operations (see Note 22).



**SELECTED FINANCIAL DATA**  
**ARIZONA PUBLIC SERVICE COMPANY**

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
	(dollars in thousands)				
<b>OPERATING RESULTS</b>					
Electric operating revenues	\$ 3,149,500	\$ 3,133,496	\$ 2,936,277	\$ 2,658,513	\$ 2,270,793
Fuel and purchased power costs	1,178,620	1,289,883	1,151,392	969,767	688,982
Other operating expenses	<u>1,533,037</u>	<u>1,408,213</u>	<u>1,358,890</u>	<u>1,290,804</u>	<u>1,200,198</u>
Operating income	437,843	435,400	425,995	397,942	381,613
Other income (deductions)	13,893	836	20,870	27,584	(69,171)
Interest deductions — net of AFUDC	<u>200,511</u>	<u>173,892</u>	<u>162,925</u>	<u>155,796</u>	<u>141,963</u>
Net income	<u>\$ 251,225</u>	<u>\$ 262,344</u>	<u>\$ 283,940</u>	<u>\$ 269,730</u>	<u>\$ 170,479</u>
<b>BALANCE SHEET DATA</b>					
Total assets	<u>\$ 11,503,402</u>	<u>\$ 10,963,577</u>	<u>\$ 10,321,402</u>	<u>\$ 9,948,766</u>	<u>\$ 9,143,643</u>
<b>Liabilities and equity:</b>					
Common stock equity	\$ 3,445,355	\$ 3,339,150	\$ 3,351,441	\$ 3,207,473	\$ 2,985,225
Long-term debt less current maturities	<u>3,180,406</u>	<u>2,850,242</u>	<u>2,876,881</u>	<u>2,877,502</u>	<u>2,479,703</u>
Total capitalization	6,625,761	6,189,392	6,228,322	6,084,975	5,464,928
Current liabilities	874,842	1,267,768	1,055,706	806,556	1,021,084
Deferred credits and other	4,002,799	3,506,417	3,037,374	3,057,235	2,657,631
Total liabilities and equity	<u>\$ 11,503,402</u>	<u>\$ 10,963,577</u>	<u>\$ 10,321,402</u>	<u>\$ 9,948,766</u>	<u>\$ 9,143,643</u>

## ITEM 7. 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 Consolidated Financial Statements and APS' Financial Statements and the related Notes that appear in Item 8 of this report. For information on the broad factors that may cause our actual future results to differ from those we currently seek or anticipate, see "Forward-Looking Statements" at the front of this report and "Risk Factors" in Item 1A.

### 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 accounts for substantially all of our revenues and earnings, and is expected to continue to do so.

#### Areas of Business Focus

##### *Operational Performance and Reliability.*

**Nuclear.** Palo Verde experienced strong performance during 2009, with its three units achieving a combined year-end capacity factor of 89%. With a focus on safely and efficiently generating electricity for the long-term, APS applied for twenty-year renewals of its operating licenses for each of the three Palo Verde units, and is making preparations to secure necessary resources to operate the plant during this extended period of time. Palo Verde's 2009 accomplishments also included the installation of a new reactor vessel head, upgraded equipment and processes designed to substantially reduce the time required to defuel and refuel the reactor during refueling outages, and the successful implementation of a comprehensive improvement plan, which allowed Palo Verde Unit 3 to exit the NRC's enhanced inspection regime ("Column 4") earlier than anticipated, in March of 2009.

**Coal and Related Environmental Matters.** APS' coal plants, Four Corners and Cholla, achieved net capacity factors of 88% and 77%, respectively, in 2009. APS is focused on developing legislation and increased regulation concerning greenhouse gas emissions, and the potential impacts on our coal fleet. Recent concern over climate change and other emission-related issues could have a significant impact on our capital expenditures and operating costs in the form of taxes, emissions allowances or required equipment upgrades for these plants. APS is closely monitoring our long range capital management plans, understanding that the resulting legislation and regulation could impact the economic viability of certain plants, as well as the willingness or ability of power plant participants to fund any such equipment upgrades. See "Business of Arizona Public Service Company — Environmental Matters — Climate Change" in Item 1 and climate change-related risks described in Item 1A for additional climate change developments and risks facing APS.

**Transmission and Delivery.** In the area of transmission and delivery to its customers, APS also ranked favorably during 2009, with top quartile performance for average customer outage time. During 2009, APS undertook several significant transmission projects, including the Morgan to Pinnacle Peak transmission line scheduled for completion at the end of 2010, and the completion of two switchyards, one of which will support capacity for renewable energy projects. APS is working closely with regulators to identify and plan for transmission needs resulting from the current focus on renewable energy. APS is also working to establish and expand smart grid technology throughout its service territory designed to provide a variety of benefits both to APS and its customers. This technology should allow customers to better monitor their energy use and needs, minimize system outage durations and the number of customers that experience outages, and facilitate cost savings to APS through improved reliability and the automation of certain distribution functions, including remote meter reading and remote connects and disconnects.

**Renewable Energy.** APS is committed to increasing the amount of energy produced by renewable energy resources, which was a significant focus in APS' recent rate case settlement described below. APS and the other parties to the rate case worked with the ACC Commissioners to address a wide range of customer needs and to secure a clean, sustainable energy future for Arizona. The ACC adopted a renewable energy standard several years ago, recognizing the importance of renewable energy to our state. In the rate case settlement agreement, APS agreed to exceed these standards, committing that 10% of APS' resources will come from renewable energy by the year 2015. A variety of other provisions in the settlement agreement reinforce APS' dedication to renewable energy through initiatives to build a photovoltaic solar plant, install solar rooftop panels on schools and seek an Arizona wind generation project.

During 2009, APS filed its annual RES implementation plan that included a request for ACC approval of the "AZ Sun Program." As proposed in its plan, APS would invest an estimated \$500 million to develop at least 100 MW of photovoltaic solar plants. It currently anticipates that this solar capacity would be placed into service in the 2011 to 2014 timeframe. The ultimate timing depends on the outcome of current and future procurement processes. See Note 3 for additional details regarding this program, including the estimated timing of the ACC's determination on the matter and the related cost recovery. APS also issued two requests for proposal ("RFP") for renewable resources in early 2010. These RFP's are part of the process for procuring the additional renewable resources required under the rate case settlement. The first RFP is for utility-scale solar photovoltaic projects between 15 and 50 MW. Assuming ACC approval of the AZ Sun Program as proposed, this RFP will serve as the first procurement step for implementing that program. The second RFP is for wind projects between 15 and 100 MW to be located within Arizona.

**Rate Matters.** APS needs timely recovery through rates of its capital and operating expenditures to maintain adequate financial health. APS' retail rates are regulated by the ACC and its wholesale electric rates (primarily for transmission) are regulated by the FERC. At the end of 2009, the ACC approved a settlement agreement entered into by APS and twenty-one of the twenty-three other parties to APS' general retail rate case, with modifications that did not materially affect the overall economic terms of the agreement. The rate case settlement should strengthen APS' financial condition by allowing for rate stability and a greater level of cost recovery and return on investment. It also authorizes and requires equity infusions into APS of at least \$700 million prior to the end of 2014. The settlement demonstrates cooperation among APS, the ACC staff, the Residential Utility Consumer Office (RUCO) and other intervenors to the rate case, and establishes a future rate case filing plan that allows APS the opportunity to help shape Arizona's energy future outside of continual rate cases. See Note 3 for a detailed discussion of the settlement agreement terms and information on APS' FERC rates.

APS has several recovery mechanisms in place that provide more timely recovery to APS of its fuel and transmission costs, and costs associated with the promotion and implementation of its energy efficiency, demand-side management and renewable energy efforts and customer programs. These mechanisms are described more fully in Note 3.

**Financial Strength and Flexibility.** Despite the volatility and disruption of the credit markets, Pinnacle West and APS currently have ample borrowing capacity under their respective credit facilities and have been able to access these facilities, ensuring adequate liquidity for each company. In early February 2010, APS entered into a \$500 million revolving credit facility, replacing its \$377 million revolving credit facility that would have otherwise terminated in December 2010. At that same time, Pinnacle West entered into a \$200 million revolving credit facility that replaces its \$283 million facility that also would have otherwise terminated in December 2010.

**SunCor Real Estate Operations.** As a result of the continuing distressed conditions in the real estate markets, during 2009 SunCor undertook a program to dispose of its homebuilding operations, master-planned communities, land parcels, commercial assets and golf courses in order to eliminate its outstanding debt. This resulted in impairment charges of approximately \$266 million, or \$161 million after income taxes, for 2009. See “Pinnacle West Consolidated — Liquidity and Capital Resources — Other Subsidiaries — SunCor” below for a discussion of SunCor’s outstanding debt and related matters, Note 23 for a further discussion of impairment charges and the SunCor-related risk factor in Item 1A.

**Subsidiaries.** Our other first tier subsidiaries, El Dorado and APSES, are not expected to have any material impact on our financial results, or to require any material amounts of capital, over the next three years.

### Key Financial Drivers

In addition to the continuing impact of the matters described above, many factors influence our financial results and our future financial outlook, including those listed below. We closely monitor these factors to plan for the Company’s current needs, and to adjust our expectations, financial budgets and forecasts appropriately.

**Electric Operating Revenues.** For the years 2007 through 2009, retail electric revenues comprised approximately 94% of our total electric operating revenues. Our electric operating revenues are affected by customer growth, variations in weather from period to period, customer mix, average usage per customer and the impacts of energy efficiency programs, electricity rates and tariffs, the recovery of PSA deferrals and the operation of other recovery mechanisms. Off-system sales of excess generation output, purchased power and natural gas are included in regulated electricity segment revenues and related fuel and purchased power because they are credited to APS’ retail customers through the PSA. These revenue transactions are affected by the availability of excess economic generation or other energy resources and wholesale market conditions, including competition, demand and prices.

**Customer and Sales Growth.** Customer growth in APS’ service territory for the year ended December 31, 2009 was 0.6% compared with the prior year. For the three years 2007 through 2009, APS’ customer growth averaged 1.8% per year. We currently expect customer growth to average about 1% per year for 2010 through 2012 due to economic conditions both nationally and in Arizona. Retail sales in kilowatt-hours, adjusted to exclude the effects of weather variations, for 2009 declined 2.4% compared to the prior year, reflecting the poor economic conditions in 2009 and the effects of our energy efficiency programs. For the three years 2007 through 2009, APS’ actual retail electricity sales in kilowatt-hours, adjusted to exclude the effects of weather variations, grew at an average annual rate of 0.3%. We currently estimate that total retail electricity sales in kilowatt-hours will remain flat on average per year during 2010 through 2012, including the effects of APS’ energy efficiency programs, but excluding the effects of weather variations. A continuation of the economic downturn, or the failure of the Arizona economy to rebound in the near future, could further impact these estimates. The customer and sales growth referred to in this paragraph apply to Native Load customers.

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, impacts of energy efficiency programs 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 under normal business conditions can result in increases or decreases in annual net income of up to \$10 million.

**Weather.** In forecasting the retail sales growth numbers provided above, 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.

**Fuel and Purchased Power Costs.** Fuel and purchased power costs included on our 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 PSA deferrals and the amortization thereof.

**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, renewable energy and demand side management related expenses (which are offset by the same amount of regulated electricity segment operating revenues) and other factors. In its recent retail rate case settlement, APS committed to operational expense reductions from 2010 through 2014 and received approval to defer certain pension and other postretirement benefit cost increases to be incurred in 2011 and 2012.

**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. The “Capital Expenditures” section below provides information regarding the planned additions to our facilities. We have also applied to the NRC for renewed operating licenses for each of the Palo Verde units. If the NRC grants the extension, we estimate that our annual pretax depreciation expense will decrease by approximately \$34 million at the later of the license extension date or January 1, 2012.

**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 7.5% of the assessed value for 2009, 7.8% of the assessed value for 2008 and 8.3% of the assessed value for 2007. We expect property taxes to increase as we add new utility plant (including new generation, transmission and distribution facilities described below under “Capital Additions”) and as we improve our existing facilities.

**Income Taxes .** Income taxes are affected by the amount of pre-tax book income, income tax rates, and certain non-taxable items, such as the allowance for equity funds used during construction. In addition, income taxes may also be affected by the settlement of issues with taxing authorities.

**Interest Expense.** Interest expense is affected by the amount of debt outstanding and the interest rates on that debt (see Note 6.) 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.

### **PINNACLE WEST CONSOLIDATED — RESULTS OF OPERATIONS**

Our results of operations, provided below, are based upon our two reportable business segments:

- 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.

#### **Operating Results — 2009 Compared with 2008**

Our consolidated net income attributable to common shareholders for 2009 was \$68 million, compared with net income of \$242 million for the prior year. The decrease in net income was primarily due to 2009 real estate impairment charges recorded by SunCor, the Company's real estate subsidiary.

In addition, regulated electricity segment net income decreased approximately \$13 million from the prior year primarily due to lower retail sales resulting from lower usage per customer; higher interest charges, net of capitalized financing costs; higher depreciation and amortization expenses; and the absence of income tax benefits related to prior years recorded in 2008. These negative factors were partially offset by increased revenues due to the interim rate increase effective January 1, 2009 and transmission rate increases.

The following table presents net income attributable to common shareholders by business segment compared with the prior year:

	Year Ended December 31,		Increase (Decrease) in Net Income Attributable to Common Shareholders
	<u>2009</u>	<u>2008</u>	
(dollars in millions)			
<b>Regulated Electricity Segment:</b>			
Operating revenues less fuel and purchased power expenses	\$ 1,970	\$ 1,843	\$ 127
Operations and maintenance	(862)	(796)	(66)
Depreciation and amortization	(400)	(383)	(17)
Taxes other than income taxes	(123)	(125)	2
Other income (expenses), net	(1)	(20)	19
Interest charges, net of capitalized financing costs	(199)	(171)	(28)
Income taxes	(142)	(92)	(50)
Regulated electricity segment net income	<u>243</u>	<u>256</u>	<u>(13)</u>
<b>Real Estate Segment:</b>			
Real estate impairment charges (a)	(266)	(53)	(213)
Other real estate operations	(10)	10	(20)
Income taxes	109	17	92
Real estate segment net loss	<u>(167)</u>	<u>(26)</u>	<u>(141)</u>
<b>All Other (b)</b>	<u>(8)</u>	<u>12</u>	<u>(20)</u>
<b>Net Income Attributable to Common Shareholders</b>	<u>\$ 68</u>	<u>\$ 242</u>	<u>\$ (174)</u>

(a) See Note 23 for additional information on real estate impairment charges.

(b) Includes activities related to marketing and trading, APSES and El Dorado. Income for 2008 includes income from discontinued operations of \$8 million related to the resolution of certain tax issues associated with the sale of Silverhawk in 2005. None of these segments is a reportable segment.

#### Regulated electricity segment

This section includes a discussion of major variances in income and expense amounts for the regulated electricity segment.

**Operating revenues less fuel and purchased power expenses**

Regulated electricity segment operating revenues less fuel and purchased power expenses were \$127 million higher for the year ended 2009 compared with the prior year. The following table describes the major components of this change:

	Increase (Decrease)		Net change
	Operating revenues	Purchased power and fuel expenses	
	(dollars in millions)		
Higher renewable energy and demand-side management surcharges (substantially offset in operations and maintenance expense)	\$ 63	\$	\$ 63
Interim retail rate increases effective January 1, 2009	61		61
Transmission rate increases	21		21
Increased mark-to-market valuations of fuel and purchased power contracts related to favorable changes in market prices, net of related PSA deferrals		(18)	18
Effects of weather on retail sales, primarily due to hotter weather in the third quarter of 2009	12	3	9
Lower retail sales primarily due to lower usage per customer, including the effects of the Company's energy efficiency programs, but excluding the effects of weather	(58)	(26)	(32)
Higher fuel and purchased power costs including the effects of lower off-system sales, net of related PSA deferrals	(30)	(19)	(11)
Lower retail revenues related to recovery of PSA deferrals, offset by lower amortization of the same amount recorded as fuel and purchased power expense (see Note 3)	(36)	(36)	—
Miscellaneous items, net	(11)	(9)	(2)
Total	<u>\$ 22</u>	<u>\$ (105)</u>	<u>\$ 127</u>

**Operations and maintenance** Operations and maintenance expenses increased \$66 million for the year ended 2009 compared with the prior year primarily because of:

- An increase of \$62 million related to renewable energy and demand-side management programs, which are offset in operating revenues;
- An increase of \$29 million in generation costs, including more planned maintenance, partially offset by lower costs at Palo Verde due to cost efficiency measures; and
- A decrease of \$25 million associated with cost saving measures and other factors, including the absence of employee severance costs in 2009.

**Depreciation and amortization** Depreciation and amortization expenses increased \$17 million for the year ended 2009 compared with the prior year primarily because of increases in utility plant in service. The increases in utility plant in service are the result of various improvements to APS' existing fossil and nuclear generating plants and distribution and transmission infrastructure additions and upgrades.

**Interest charges, net of capitalized financing costs** Interest charges, net of capitalized financing costs increased \$28 million for the year ended 2009 compared with the prior year primarily because of higher debt balances, partially offset by the effects of lower interest rates (see discussion related to APS' debt issuances in "Pinnacle West Consolidated — Liquidity and Capital Resources" below). Interest charges, net of capitalized financing costs are comprised of the regulated electricity segment portions of the line items interest expense, capitalized interest and allowance for equity funds used during construction from the Consolidated Statements of Income.

**Other income (expenses), net** Other income (expenses), net improved \$19 million for the year ended 2009 compared with the prior year primarily because of improved investment gains. Other income (expenses), net is comprised of the regulated electricity segment portions of the line items other income and other expense from the Consolidated Statements of Income.

**Income taxes** Income taxes were \$50 million higher for the year ended 2009 compared with the prior year primarily because of \$30 million of income tax benefits related to prior years recorded in 2008 and higher pretax income. See Note 4.

#### **Real estate segment**

During the first quarter of 2009, we decided to restructure SunCor through the sale of substantially all of its assets. The real estate segment net loss attributable to common shareholders was \$141 million higher for the year ended 2009 compared with the prior year primarily because of:

- An increase in real estate impairment charges of \$213 million (see Note 23 for details of the impairment charges);
- A decrease of \$20 million in income from other real estate operations primarily due to 2008 income from a commercial property sale; and
- An increase in income tax benefits of \$92 million primarily because of a higher net loss.

#### **All Other**

All other earnings were \$20 million lower for the year ended 2009 compared with the prior year primarily because of planned reductions of marketing and trading activities and the absence of the 2008 resolution of certain tax issues associated with the sale of Silverhawk in 2005.

#### **Operating Results — 2008 Compared with 2007**

Our consolidated net income attributable to common shareholders for 2008 was \$242 million, compared with net income of \$307 million for the prior year. The decrease in net income was primarily due to lower results recorded by SunCor, the Company's real estate subsidiary.

In addition, regulated electricity segment net income decreased approximately \$18 million from the prior year primarily due to higher operations and maintenance expenses; lower retail sales due to the effects of weather; higher depreciation and amortization expenses; and higher interest charges, net of capitalized financing costs. These negative factors were partially offset by increased revenues due to the rate increase effective July 1, 2007; transmission rate increases; and income tax benefits related to prior years recorded in 2008.

The following table presents net income attributable to common shareholders by business segment compared with the prior year:

	Year Ended December 31,		Increase (Decrease) in Net Income Attributable to Common Shareholders
	2008	2007	
(dollars in millions)			
<b>Regulated Electricity Segment:</b>			
Operating revenues less fuel and purchased power expenses	\$ 1,843	\$ 1,777	\$ 66
Operations and maintenance	(796)	(709)	(87)
Depreciation and amortization	(383)	(365)	(18)
Taxes other than income taxes	(125)	(128)	3
Other income (expenses), net	(20)	(6)	(14)
Interest charges, net of capitalized financing costs	(171)	(156)	(15)
Income taxes	(92)	(139)	47
Regulated electricity segment net income	<u>256</u>	<u>274</u>	<u>(18)</u>
<b>Real Estate Segment:</b>			
Real estate impairment charges (a)	(53)	—	(53)
Other real estate operations	10	37	(27)
Income taxes	17	(14)	31
Real estate segment net income (loss)	<u>(26)</u>	<u>23</u>	<u>(49)</u>
<b>All Other (b)</b>	<u>12</u>	<u>10</u>	<u>2</u>
<b>Net Income Attributable to Common Shareholders</b>	<u>\$ 242</u>	<u>\$ 307</u>	<u>\$ (65)</u>

(a) See Note 23 for additional information on real estate impairment charges.

(b) Includes activities related to marketing and trading, APSES and El Dorado. Income for 2008 includes income from discontinued operations of \$8 million related to the resolution of certain tax issues associated with the sale of Silverhawk in 2005. None of these segments is a reportable segment.

**Regulated electricity segment**

This section includes a discussion of major variances in income and expense amounts for the regulated electricity segment.

**Operating revenues less fuel and purchased power expenses**

Regulated electricity segment operating revenues less fuel and purchased power expenses were \$66 million higher for the year ended 2008 compared with the prior year. The following table describes the major components of this change:

	Increase (Decrease)		
	Operating revenues	Purchased power and fuel expenses	Net change
	(dollars in millions)		
Retail rate increases effective July 1, 2007	\$ 156	\$	\$ 156
Deferred fuel and purchased power costs related to higher base fuel rate		141	(141)
Transmission rate increases	31		31
Higher retail sales primarily due to customer growth partially offset by lower usage per customer, but excluding the effects of weather	29	8	21
Higher renewable energy surcharges (substantially offset in operations and maintenance expense)	14		14
Regulatory disallowance in 2007		(14)	14
Revenues related to long-term traditional wholesale contracts	26	14	12
Higher fuel and purchased power costs including the effects of lower off-system sales, net of related PSA deferrals	38	41	(3)
Lower mark-to-market valuations of fuel and purchased power contracts related to changes in market prices, net of related PSA deferrals		14	(14)
Effects of weather on retail sales	(63)	(20)	(43)
Lower retail revenues related to recovery of PSA deferrals, offset by lower amortization of the same amount recorded as fuel and purchased power expense (see Note 3)	(47)	(47)	—
Miscellaneous items, net	25	6	19
<b>Total</b>	<b>\$ 209</b>	<b>\$ 143</b>	<b>\$ 66</b>

**Operations and maintenance** Operations and maintenance expenses increased \$87 million for the year ended 2008 compared with the prior year primarily because of:

- An increase of \$30 million related to customer service and other costs including distribution system reliability;
- An increase of \$18 million in generation costs, including more planned maintenance;
- An increase of \$14 million related to renewable energy programs, which are offset in operating revenues;
- An increase of \$9 million associated with employee severance costs in 2008; and
- An increase of \$16 million due to other miscellaneous factors.

**Depreciation and amortization** Depreciation and amortization expenses increased \$18 million for the year ended 2008 compared with the prior year primarily because of increases in utility plant in service. The increases in utility plant in service are the result of various improvements to APS' existing fossil and nuclear generating plants and distribution and transmission infrastructure additions and upgrades.

**Interest charges, net of capitalized financing costs** Interest charges, net of capitalized financing costs increased \$15 million for the year ended 2008 compared with the prior year primarily because of higher rates on certain APS pollution control bonds and higher short-term debt balances. Interest charges, net of capitalized financing costs, are comprised of the regulated electricity segment portions of the line items interest expense, capitalized interest and allowance for equity funds used during construction from the Consolidated Statements of Income.

**Other income (expenses), net** Other income (expenses), net reduced earnings by an additional \$14 million for the year ended 2008 compared with the prior year primarily because of losses on investments and lower interest income. Other income (expenses), net is comprised of the regulated electricity segment portions of the line items other income and other expense from the Consolidated Statements of Income.

**Income taxes** Income taxes were \$47 million lower for the year ended 2008 compared with the prior year primarily because of \$17 million of increased income tax benefits related to prior years resolved in 2008 and 2007 and lower pre-tax income. See Note 4.

#### **Real estate segment**

The real estate segment net income attributable to common shareholders was \$49 million lower for the year ended 2008 compared with the prior year primarily because of:

- Real estate impairment charges of \$53 million (see Note 23) without comparable charges in the prior year;
- A decrease of \$27 million from other real estate operations primarily due to decreased land parcel sales in the 2008 period as a result of the weak real estate market; and
- An increase in income tax benefits of \$31 million primarily because of the net loss recorded in 2008.

**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 years ended December 31, 2009, 2008 and 2007 (dollars in millions):

	2009	2008	2007
Net cash flow provided by operating activities	\$ 1,031	\$ 814	\$ 658
Net cash flow used for investing activities	(705)	(815)	(873)
Net cash flow provided by (used for) financing activities	(286)	51	185
Net increase (decrease) in cash and cash equivalents	<u>\$ 40</u>	<u>\$ 50</u>	<u>\$ (30)</u>

**2009 Compared with 2008**

The increase of approximately \$217 million in net cash provided by operating activities is primarily due to a reduction of collateral and margin cash required as a result of changes in commodity prices and a 2009 income tax refund (see Note 4).

The decrease of approximately \$110 million in net cash used for investing activities is primarily due to lower levels of capital expenditures net of contributions (see table and discussion below), partially offset by lower real estate sales primarily due to a commercial property sale in 2008.

The increase of approximately \$337 million in net cash used for financing activities is primarily due to repayments of short-term borrowings, partially offset by APS' issuance of \$500 million of unsecured senior notes (see Note 6).

**2008 Compared with 2007**

The increase of approximately \$156 million in net cash provided by operating activities is primarily due to lower current income taxes; lower real estate investments resulting from the weak real estate market; and increased retail revenue related to higher Base Fuel Rates, partially offset by increased collateral and margin cash provided as a result of changes in commodity prices.

The decrease of approximately \$58 million in net cash used for investing activities is primarily due to a real estate commercial property sale in 2008; lower levels of capital expenditures (see table and discussion below); and increased contributions in aid of construction related to changes in 2008 in APS' line extension policy (see Note 3), partially offset by lower cash proceeds from the net sales and purchases of investment securities.

The decrease of approximately \$134 million in net cash provided by financing activities is primarily due to the use of the proceeds from the sale of a real estate commercial property to pay down long-term debt in 2008, partially offset by higher levels of short-term debt borrowings.

## Liquidity

### Capital Expenditure Requirements

The following table summarizes the actual capital expenditures for 2007, 2008 and 2009 and estimated capital expenditures for the next three years:

#### CAPITAL EXPENDITURES (dollars in millions)

	Actual			Estimated		
	2007	2008	2009	2010	2011	2012
<b>APS</b>						
Generation (a)	\$ 353	\$ 310	\$ 241	\$ 408	\$ 425	\$ 545
Distribution	372	340	246	304	344	368
Transmission	138	163	193	158	169	206
Other (b)	37	43	52	84	71	48
Subtotal	900	856	732	954	1,009	1,167
Other (c)	164	48	13	—	—	—
Total	<u>\$ 1,064</u>	<u>\$ 904</u>	<u>\$ 745</u>	<u>\$ 954</u>	<u>\$ 1,009</u>	<u>\$ 1,167</u>

- (a) Generation includes nuclear fuel expenditures of approximately \$60 million to \$80 million per year for 2010, 2011 and 2012.
- (b) Primarily information systems and facilities projects.
- (c) Consists primarily of capital expenditures for residential, land development and retail and office building construction reflected in “Real estate investments” and “Capital expenditures” on the Consolidated Statements of Cash Flows.

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 for the years 2010, 2011 and 2012 are approximately \$20 million, \$80 million and \$220 million, respectively. 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 — EPA Environmental Regulation — Regional Haze Rules and Mercury and other Hazardous Air Pollutants” in Item 1.)

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.

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, payout ratio trends, free cash flow and financial market conditions.

On January 20, 2010, the Pinnacle West Board of Directors declared a quarterly dividend of \$0.525 per share of common stock, payable on March 1, 2010, to shareholders of record on February 1, 2010.

Our primary sources of cash are dividends from APS, external debt and equity financings. For the years 2007 through 2009, total distributions from APS were \$510 million and total distributions received from SunCor were \$5 million. For 2009, cash distributions from APS were \$170 million and there were no distributions from SunCor.

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 December 31, 2009, APS' common equity ratio, as defined, was 50%. Its total common equity was approximately \$3.4 billion, and total capitalization was approximately \$6.8 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.

The credit and liquidity markets experienced significant stress beginning the third quarter of 2008. Since the fourth quarter of 2008, Pinnacle West and APS have not accessed the commercial paper market due to negative market conditions. They have both been able to access existing credit facilities, ensuring adequate liquidity.

At December 31, 2009, Pinnacle West had a \$283 million revolving credit facility that was scheduled to terminate in December 2010. The revolver was 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 of up to \$94 million. The parent company had \$149 million of borrowings outstanding under its revolving credit facility and no letters of credit at December 31, 2009.

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 revolving credit facility terminates in February 2013. Pinnacle West may 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, and for the issuance of letters of credit. Interest rates are based on Pinnacle West's senior unsecured debt credit ratings. In addition, because of the downsized revolving credit facility, the Company is in the process of reducing the size of its commercial paper program to \$200 million from \$250 million.

Pinnacle West expects to recognize approximately \$125 million of cash tax benefits related to SunCor's strategic asset sales (see Note 23), which will not be realized until the asset sale transactions are completed. Approximately \$105 million of these benefits were recorded in 2009 as reductions to income tax expense related to the current impairment charges. The additional \$20 million of tax benefits were recorded as reductions to income tax expense related to the SunCor impairment charge recorded in the fourth quarter of 2008.

The \$91 million income tax receivable (current and long-term) on the Consolidated Balance Sheets represents the anticipated cash refunds related to an APS tax accounting method change approved by the United States Internal Revenue Service ("IRS") in the third quarter of 2009 and the expected tax benefits related to the SunCor strategic asset sales that closed in 2009.

Pinnacle West sponsors a qualified defined benefit and account balance pension plan and a non-qualified supplemental excess benefit retirement plan for the employees of Pinnacle West and our subsidiaries. IRS regulations require us to contribute a minimum amount to the qualified plan. We contribute at least the minimum amount required under IRS regulations, but no more than the maximum tax-deductible amount. The minimum required funding takes into consideration the value of plan assets and our pension obligation. The assets in the plan are comprised of fixed-income, equity and short-term investments. Future year contribution amounts are dependent on plan asset performance and plan actuarial assumptions. We made no contribution to our pension plan in 2009. We currently estimate that our pension contributions could average around \$100 million for several years, assuming the discount rate remains at approximately current levels. In January 2010, we made a voluntary contribution of approximately \$50 million to our pension plan and we expect to make an additional voluntary contribution of \$50 million later in 2010. 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.

See Note 3 for information regarding the recent retail rate case settlement, which includes ACC authorization and requires equity infusions into APS of at least \$700 million by December 31, 2014. Pinnacle West intends to issue equity to provide most of the funds for the equity infusions into APS. Such equity issuances may occur at any time in the period through 2014, in Pinnacle West's discretion.

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

### **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 and, to the extent necessary, equity infusions from Pinnacle West and external financings. 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.

On February 26, 2009, APS issued \$500 million of 8.75% unsecured senior notes that mature on March 1, 2019. Net proceeds from the sale of the notes were used to repay short-term borrowings under two committed revolving lines of credit incurred to fund capital expenditures and for general corporate purposes.

During 2009, APS refinanced approximately \$343 million of its \$656 million pollution control bonds. As a result of these refinancings, the terms of which are described in detail in Note 6, APS no longer has any outstanding debt securities in auction rate mode.

On September 11, 2008, APS purchased all of the approximately \$27 million of the Coconino Pollution Control Revenue Bonds, Series 1996A and Series 1999 due December 2031 and April 2034 and held them as treasury bonds. On September 22, 2009, Coconino issued approximately \$27 million of Coconino Pollution Control Revenue Refunding Bonds, 2009 Series B due April 2038 to redeem the existing bonds. APS used the funds received from the issuance to repay certain existing indebtedness under a revolving line of credit drawn upon by APS to fund its purchase of the 1996A and 1999 Series Bonds in 2008. The 2009 Series B Bonds are payable solely from revenues obtained from APS pursuant to a loan agreement between APS and Coconino. According to the indenture of the bonds, the interest rate of the 2009 Series B Bonds could be reset daily, weekly, monthly, or at other time intervals. The initial rate period selected for the 2009 Series B Bonds is a daily rate period. At December 31, 2009, the daily interest rate was 0.26%. The daily rates are variable rates set by a remarketing agent. Concurrently with the issuance of the 2009 Series B Bonds, the Company entered into a two year letter of credit and reimbursement agreement to provide credit support for the 2009 Series B Bonds.

At December 31, 2009, APS had two committed revolving credit facilities totaling \$866 million, of which \$377 million was scheduled to terminate in December 2010 and \$489 million terminates in September 2011. The revolvers were 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 \$583 million. At December 31, 2009, APS had no borrowings and no letters of credit under its revolving lines of credit.

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 may 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 and for the issuance of letters of credit. Interest rates are based on APS' senior unsecured debt credit ratings.

*Other Financing Matters* — See Note 3 for information regarding the PSA approved by the ACC. Although APS defers actual retail fuel and purchased power costs on a current basis, APS' recovery of the deferrals from its ratepayers is subject to annual and, if necessary, periodic PSA adjustments.

See Note 3 for information regarding the recent retail rate case settlement, which includes ACC authorization and requires equity infusions into APS of at least \$700 million by December 31, 2014.

See Note 18 for information related to the change in our margin accounts.

### *Other Subsidiaries*

*SunCor* — SunCor's principal loan facility, the SunCor Secured Revolver, is secured primarily by an interest in land, commercial properties, land contracts and homes under construction. At December 31, 2009, SunCor had borrowings of approximately \$57 million under the Secured Revolver (see Note 6). The revolver matured on January 30, 2010. SunCor and the agent bank for the Secured Revolver are discussing an extension of the maturity date to allow time for SunCor to continue discussions concerning the potential sale of additional properties. In addition to the Secured Revolver, at December 31, 2009, SunCor had approximately \$43 million of outstanding debt under other credit facilities (\$9 million of which has matured since December 31, 2009 and remains outstanding) (see Notes 5 and 6). SunCor intends to apply the proceeds of planned asset sales (see Note 23) to the repayment of its outstanding debt.

Real estate impairment charges recorded throughout 2009 (see Note 23) resulted in violations of certain covenants contained in the SunCor Secured Revolver and SunCor's other credit facilities. The lenders have taken no enforcement action related to the covenant defaults.

If SunCor is unable to obtain an extension or renewal of the 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. 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 waivers or similar relief from SunCor's lenders would have a material adverse impact on Pinnacle West's cash flows or liquidity.

As of December 31, 2009, SunCor could not transfer any cash dividends to Pinnacle West as a result of the covenants mentioned above. The restriction does not materially affect Pinnacle West's ability to meet its ongoing capital requirements.

*El Dorado* — 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* — 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 December 31, 2009, the ratio was approximately 52% for Pinnacle West and 48% for APS. The provisions regarding interest coverage require minimum cash coverage of two times the interest requirements for APS. The interest coverage was approximately 4.6 times under APS' bank financing agreements as of December 31, 2009. 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 Notes 5 and 6 for further discussions of liquidity matters.

### **Credit Ratings**

The ratings of securities of Pinnacle West and APS as of February 17, 2010 are shown below. The ratings reflect the respective views of the rating agencies, from which an explanation of the significance of their ratings may be obtained. There is no assurance that these ratings will continue for any given period of time. The ratings may be revised or withdrawn entirely by the rating agencies if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely affect the market price of Pinnacle West's or APS' securities and serve to increase the cost of and limit access to capital. It may also require substantial additional cash or other collateral requirements related to certain derivative instruments, insurance policies, natural gas transportation, fuel supply, and other energy-related contracts. At this time, we believe we have sufficient liquidity to cover a downward revision to our credit ratings.

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

- (a) Pinnacle West has a shelf registration under SEC Rule 415. Pinnacle West currently has no outstanding, rated senior unsecured securities. However, Moody's 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. 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 December 31, 2009, APS would have been required to assume approximately \$152 million of debt and pay the equity participants approximately \$153 million.

SunCor is the primary beneficiary of certain land development arrangements and, accordingly, consolidates the variable interest entities. The assets and non-controlling interests reflected in our Consolidated Balance Sheets related to these arrangements were approximately \$29 million at December 31, 2009 and at December 31, 2008.

See Note 2 for a discussion of amended accounting guidance relating to VIEs adopted on January 1, 2010.

### *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 APS relate to commodity energy products. In addition, Pinnacle West has obtained approximately \$8 million of surety bonds related to APS' operations, which primarily relate to self-insured workers' compensation. Our credit support instruments enable APSES to offer energy-related products. Non-performance or non-payment under the original contract by our subsidiaries would require us to perform under the guarantee or surety bond. No liability is currently recorded on the Consolidated Balance Sheets related to Pinnacle West's current outstanding guarantees on behalf of our subsidiaries. At December 31, 2009, we had no guarantees that were in default. Our guarantees have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees. We generally agree to indemnification provisions related to liabilities arising from or related to certain of our agreements, with limited exceptions depending on the particular agreement. See Note 21 for additional information regarding guarantees and letters of credit.

**Contractual Obligations**

The following table summarizes Pinnacle West's consolidated contractual requirements as of December 31, 2009 (dollars in millions):

	2010	2011- 2012	2013- 2014	Thereafter	Total
Long-term debt payments, including interest: (a)					
APS	\$ 397	\$ 1,233	\$ 785	\$ 2,835	\$ 5,250
SunCor	81	14	2	—	97
Pinnacle West	10	177	—	—	187
Total long-term debt payments, including interest and capital lease obligations	<u>488</u>	<u>1,424</u>	<u>787</u>	<u>2,835</u>	<u>5,534</u>
Short-term debt payments, including interest (b)	154	—	—	—	154
Purchased power and fuel commitments (c)	444	687	947	6,397	8,475
Operating lease payments (d)	77	141	126	73	417
Nuclear decommissioning funding requirements	24	49	49	161	283
Renewable energy credits (e)	48	30	30	142	250
Purchase obligations (f)	44	62	14	165	285
Total contractual commitments	<u>\$ 1,279</u>	<u>\$ 2,393</u>	<u>\$ 1,953</u>	<u>\$ 9,773</u>	<u>\$ 15,398</u>

- (a) The long-term debt matures at various dates through 2038 and bears interest principally at fixed rates. Interest on variable-rate long-term debt is determined by using average rates at December 31, 2009 (see Note 6).
- (b) The short-term debt is primarily related to bank borrowings at Pinnacle West under its revolving line of credit (see Note 5).
- (c) Our purchased power and fuel commitments include purchases of coal, electricity, natural gas, renewable energy and nuclear fuel (see Notes 3 and 11).
- (d) Relates to the Palo Verde sale leaseback and other items (see Note 9).
- (e) Contracts to purchase renewable energy credits in compliance with the Renewable Energy Standard.
- (f) These contractual obligations include commitments for capital expenditures and other obligations.

This table excludes \$209 million in unrecognized tax benefits because the timing of the future cash outflows is uncertain.

## 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. We consider the following accounting policies to be our most critical because of the uncertainties, judgments and complexities of the underlying accounting standards and operations involved.

### Regulatory Accounting

Regulatory accounting allows for the actions of regulators, such as the ACC and the FERC, to be reflected in our financial statements. Their actions may cause us to capitalize costs that would otherwise be included as an expense in the current period by unregulated companies. Regulatory assets represent incurred costs that have been deferred because they are probable of future recovery in customer rates. Regulatory liabilities generally represent expected future costs that have already been collected from customers. Management continually assesses whether our regulatory assets are probable of future recovery by considering factors such as applicable regulatory environment changes and recent rate orders to other regulated entities in the same jurisdiction. This determination reflects the current political and regulatory climate in the state and is subject to change in the future. If future recovery of costs ceases to be probable, the assets would be written off as a charge in current period earnings. We had \$782 million of regulatory assets and \$766 million of regulatory liabilities on the Consolidated Balance Sheets at December 31, 2009.

Included in the balance of regulatory assets at December 31, 2009 is a regulatory asset of \$532 million for pension and other postretirement benefits. This regulatory asset represents the future recovery of these costs through retail rates as these amounts are charged to earnings. If these costs are disallowed by the ACC, this regulatory asset would be charged to OCI and result in lower future earnings.

See Notes 1 and 3 for more information.

### Pensions and Other Postretirement Benefit Accounting

Changes in our actuarial assumptions used in calculating our pension and other postretirement benefit liability and expense can have a significant impact on our earnings and financial position. The most relevant actuarial assumptions are the discount rate used to measure our liability and net periodic cost, the expected long-term rate of return on plan assets used to estimate earnings on invested funds over the long-term, and the assumed healthcare cost trend rates. We review these assumptions on an annual basis and adjust them as necessary.

The following chart reflects the sensitivities that a change in certain actuarial assumptions would have had on the December 31, 2009 reported pension liability on the Consolidated Balance Sheets and our 2009 reported pension expense, after consideration of amounts capitalized or billed to electric plant participants, on Pinnacle West's Consolidated Statements of Income (dollars in millions):

Actuarial Assumption (a)	Increase (Decrease)	
	Impact on Pension Liability	Impact on Pension Expense
<b>Discount rate:</b>		
Increase 1%	\$ (231)	\$ (7)
Decrease 1%	260	10
<b>Expected long-term rate of return on plan assets:</b>		
Increase 1%	—	(7)
Decrease 1%	—	7

(a) Each fluctuation assumes that the other assumptions of the calculation are held constant while the rates are changed by one percentage point.

The following chart reflects the sensitivities that a change in certain actuarial assumptions would have had on the December 31, 2009 reported other postretirement benefit obligation on the Consolidated Balance Sheets and our 2009 reported other postretirement benefit expense, after consideration of amounts capitalized or billed to electric plant participants, on Pinnacle West's Consolidated Statements of Income (dollars in millions):

Actuarial Assumption (a)	Increase (Decrease)	
	Impact on Other Postretirement Benefit Obligation	Impact on Other Postretirement Benefit Expense
<b>Discount rate:</b>		
Increase 1%	\$ (96)	\$ (5)
Decrease 1%	111	5
<b>Health care cost trend rate (b):</b>		
Increase 1%	110	8
Decrease 1%	(89)	(7)
<b>Expected long-term rate of return on plan assets — pretax:</b>		
Increase 1%	—	(2)
Decrease 1%	—	2

(a) Each fluctuation assumes that the other assumptions of the calculation are held constant while the rates are changed by one percentage point.

(b) This assumes a 1% change in the initial and ultimate health care cost trend rate.

See Note 8 for further details about our pension and other postretirement benefit plans.

**Derivative Accounting**

Derivative accounting requires evaluation of rules that are complex and subject to varying interpretations. Our evaluation of these rules, as they apply to our contracts, determines whether we use accrual accounting (for contracts designated as normal) or fair value (mark-to-market) accounting. Mark-to-market accounting requires that changes in the fair value are recognized periodically in income unless certain hedge criteria are met. For cash flow hedges, the effective portion of changes in the fair value of the derivative is recognized in common stock equity (as a component of other comprehensive income (loss)) and the ineffective portion is recognized in current earnings.

See “Market Risks — Commodity Price Risk” below for quantitative analysis. See “Fair Value Measurements” below for additional information on valuation. See Note 1 for discussion on accounting policies and Note 18 for a further discussion on derivative accounting.

**Fair Value Measurements**

We apply recurring fair value measurements to derivative instruments, nuclear decommissioning trusts, certain cash equivalents and plan assets held in our retirement and other benefit plans. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We use inputs, or assumptions that market participants would use, to determine fair market value, and the significance of a particular input determines how the instrument is classified in the fair value hierarchy. We utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The determination of fair value sometimes requires subjective and complex judgment. Our assessment of the inputs and the significance of a particular input to fair value measurement may affect the valuation of the instruments and their placement within the fair value hierarchy. Actual results could differ from our estimates of fair value. See Note 14 for further fair value measurement discussion, Note 1 for discussion on accounting policies and Note 18 for a further discussion on derivative accounting.

Our nuclear decommissioning trusts invest in fixed income securities and equity securities. The fair values of these securities are based on observable inputs for identical or similar assets. See Note 12 for further discussion of our nuclear decommissioning trusts.

**Real Estate Investment Impairments**

We had real estate investments of \$120 million and \$3 million of home inventory on our Consolidated Balance Sheets at December 31, 2009. For purposes of evaluating impairment, in accordance with guidance on the impairment and disposal of long-lived assets, we classify our real estate assets, such as land under development, land held for future development, and commercial property, as “held and used.” When events or changes in circumstances indicate that the carrying value of real estate assets considered held and used may not be recoverable, we compare the undiscounted cash flows that we estimate will be generated by each asset to its carrying amount. If the carrying amount exceeds the undiscounted cash flows, we adjust the asset to fair value and recognize an impairment charge. The adjusted value becomes the new book value (carrying amount) for held and used assets. We may have real estate assets classified as held and used with fair values that are lower than their carrying amounts, but are not deemed to be impaired because the undiscounted cash flows exceed the carrying amounts.

Real estate home inventory is considered to be held for sale for the purposes of evaluating impairment. Home inventories are reported at the lower of carrying amount or fair value less cost to sell. Fair value less cost to sell is evaluated each period to determine if it has changed. Losses (and gains not to exceed any cumulative loss previously recognized) are reported as adjustments to the carrying amount.

We determine fair value for our real estate assets primarily based on the future cash flows that we estimate will be generated by each asset discounted for market risk. Our impairment assessments and fair value determinations require significant judgment regarding key assumptions such as future sales prices, future construction and land development costs, future sales timing, and discount rates. The assumptions are specific to each project and may vary among projects. The discount rates we used to determine fair values at December 31, 2009 ranged from 11% to 29%. Due to the judgment and assumptions applied in the estimation process, with regard to impairments, it is possible that actual results could differ from those estimates. If conditions in the broader economy or the real estate markets worsen, or as a result of a change in SunCor's strategy, we may be required to record additional impairments.

## **OTHER ACCOUNTING MATTERS**

See Note 2 for a discussion of recently adopted accounting standards and new standards to be adopted in the future.

In June 2009, the FASB issued amended guidance on the consolidation of variable interest entities. The model for determining which enterprise has a controlling financial interest and is the primary beneficiary of a VIE has changed significantly under the new guidance. Previously, variable interest holders had to determine whether they had a controlling financial interest in a VIE based on a quantitative analysis of the expected gains and/or losses of the entity. The new guidance requires an enterprise with a variable interest in a VIE to perform a qualitative assessment in determining whether it has a controlling financial interest in the entity, and if so, whether it is the primary beneficiary. Furthermore, the amended guidance requires companies to continually evaluate VIEs for consolidation. This guidance was effective for us on January 1, 2010. We are continuing to evaluate the impact this new guidance may have on our financial statements.

## **MARKET AND CREDIT RISKS**

### **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 (see Note 12). 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.

The tables below present contractual balances of our consolidated long-term and short-term debt at the expected maturity dates as well as the fair value of those instruments on December 31, 2009 and 2008. The interest rates presented in the tables below represent the weighted-average interest rates as of December 31, 2009 and 2008 (dollars in thousands):

Pinnacle West — Consolidated

2009	Short-Term Debt		Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount	Interest Rates	Amount
2010	1.09%	\$ 153,715	1.66%	\$ 276,636	5.56%	\$ 1,057
2011	—	—	2.00%	39,967	6.23%	576,228
2012	—	—	5.25%	38	6.30%	446,418
2013	—	—	5.25%	1,774	5.75%	32,234
2014	—	—	—	—	5.79%	477,050
Years thereafter	—	—	—	—	6.48%	1,804,000
<b>Total</b>		<b><u>\$ 153,715</u></b>		<b><u>\$ 318,415</u></b>		<b><u>\$3,336,987</u></b>
Fair value		<b><u>\$ 153,715</u></b>		<b><u>\$ 318,415</u></b>		<b><u>\$3,463,960</u></b>

2008	Short-Term Debt		Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount	Interest Rates	Amount
2009	2.24%	\$ 670,469	3.88%	\$ 173,619	4.62%	\$ 4,027
2010	—	—	3.99%	2,042	5.66%	1,137
2011	—	—	6.22%	2,259	6.23%	576,250
2012	—	—	6.00%	16	6.50%	376,338
2013	—	—	6.00%	1,864	6.00%	231
Years thereafter	—	—	8.30%	539,145	5.64%	1,540,229
<b>Total</b>		<b><u>\$ 670,469</u></b>		<b><u>\$ 718,945</u></b>		<b><u>\$2,498,212</u></b>
Fair value		<b><u>\$ 670,469</u></b>		<b><u>\$ 718,945</u></b>		<b><u>\$2,107,635</u></b>

The tables below present contractual balances of APS' long-term debt at the expected maturity dates as well as the fair value of those instruments on December 31, 2009 and 2008. The interest rates presented in the tables below represent the weighted-average interest rates as of December 31, 2009 and 2008 (dollars in thousands):

APS

	Short-Term Debt		Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount	Interest Rates	Amount
2009						
2010	—	\$ —	0.25%	\$ 196,170	5.60%	\$ 1,006
2011	—	—	0.26%	26,710	6.37%	401,201
2012	—	—	—	—	6.30%	446,398
2013	—	—	—	—	5.75%	32,232
2014	—	—	—	—	5.79%	477,050
Years thereafter	—	—	—	—	6.48%	1,804,000
Total		<u>\$ —</u>		<u>\$ 222,880</u>		<u>\$3,161,887</u>
Fair value		<u>\$ —</u>		<u>\$ 222,880</u>		<u>\$3,283,631</u>

	Short-Term Debt		Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount	Interest Rates	Amount
2008						
2009	2.09%	\$ 521,684	—	\$ —	5.62%	\$ 874
2010	—	—	—	—	5.60%	1,012
2011	—	—	—	—	6.37%	401,208
2012	—	—	—	—	6.50%	376,325
2013	—	—	—	—	6.00%	231
Years thereafter	—	—	8.30%	539,145	5.64%	1,540,229
Total		<u>\$ 521,684</u>		<u>\$ 539,145</u>		<u>\$2,319,879</u>
Fair value		<u>\$ 521,684</u>		<u>\$ 539,145</u>		<u>\$1,935,160</u>

### Commodity Price Risk

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity and natural gas. Our risk management committee, consisting of officers and key management personnel, oversees company-wide energy risk management activities to ensure compliance with our stated energy risk management 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 and fuels. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities.

The following table shows the net pretax changes in mark-to-market of our derivative positions in 2009 and 2008 (dollars in millions):

	2009	2008
Mark-to-market of net positions at beginning of year	\$ (282)	\$ 40
Recognized in earnings:		
Change in mark-to-market losses for future period deliveries	(4)	(4)
Mark-to-market (gains) losses realized including ineffectiveness during the period	11	(5)
Decrease (increase) in regulatory asset	76	(111)
Recognized in OCI:		
Change in mark-to-market losses for future period deliveries (a)	(155)	(138)
Mark-to-market (gains) losses realized during the period	185	(64)
Change in valuation techniques	—	—
Mark-to-market of net positions at end of year	<u>\$ (169)</u>	<u>\$ (282)</u>

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

The table below shows the fair value of maturities of our derivative contracts (dollars in millions) at December 31, 2009 by maturities and by the type of valuation that is performed to calculate the fair values. See Note 1, "Derivative Accounting" and "Fair Value Measurements," for more discussion of our valuation methods.

Source of Fair Value	2010	2011	2012	2013	2014	Years thereafter	Total fair value
Prices actively quoted	\$ (13)	\$ —	\$ —	\$ —	\$ —	\$ —	\$ (13)
Prices provided by other external sources	(76)	(59)	(11)	—	—	—	(146)
Prices based on models and other valuation methods	(4)	(1)	3	(2)	(2)	(4)	(10)
Total by maturity	<u>\$ (93)</u>	<u>\$ (60)</u>	<u>\$ (8)</u>	<u>\$ (2)</u>	<u>\$ (2)</u>	<u>\$ (4)</u>	<u>\$ (169)</u>

The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management assets and liabilities included on Pinnacle West's Consolidated Balance Sheets at December 31, 2009 and 2008 (dollars in millions):

	December 31, 2009		December 31, 2008	
	Gain (Loss)		Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Mark-to-market changes reported in:				
Earnings				
Electricity	\$ 1	\$ (1)	\$ 2	\$ (2)
Natural gas	1	(1)	3	(3)
Regulatory asset (liability) or OCI (a)				
Electricity	21	(21)	20	(20)
Natural gas	59	(59)	64	(64)
Total	<u>\$ 82</u>	<u>\$ (82)</u>	<u>\$ 89</u>	<u>\$ (89)</u>

- (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 18 for a discussion of our credit valuation adjustment policy.

## ARIZONA PUBLIC SERVICE COMPANY — RESULTS OF OPERATIONS

### Regulatory Matters

See Note 3 for information about rate matters affecting APS.

### Operating Results — 2009 Compared with 2008

APS' net income for 2009 was \$251 million, compared with net income of \$262 million for the comparable prior-year period.

APS' net income decreased approximately \$11 million from the prior-year period primarily due to lower retail sales resulting from lower usage per customer; higher interest charges, net of capitalized financing costs; higher depreciation and amortization expenses; and the absence of income tax benefits related to prior years recorded in 2008. These negative factors were partially offset by increased revenues due to the interim rate increase effective January 1, 2009 and transmission rate increases.

The following table presents net income compared with the prior-year period:

	Year Ended December 31,		Increase (Decrease) in Net Income
	<u>2009</u>	<u>2008</u>	
	(dollars in millions)		
Operating revenues less fuel and purchased power expenses	\$ 1,971	\$ 1,844	\$ 127
Operations and maintenance	(853)	(787)	(66)
Depreciation and amortization	(399)	(383)	(16)
Taxes other than income taxes	(122)	(124)	2
Other income (expenses), net	(8)	(25)	17
Interest charges, net of capitalized financing costs	(185)	(155)	(30)
Income taxes	<u>(153)</u>	<u>(108)</u>	<u>(45)</u>
<b>Net Income</b>	<u>\$ 251</u>	<u>\$ 262</u>	<u>\$ (11)</u>

**Operating revenues less fuel and purchased power expenses**

Electric operating revenues less fuel and purchased power expenses were \$127 million higher for 2009 compared with the prior-year period. The following table describes the major components of this change:

	Increase (Decrease)		
	Operating revenues	Purchased power and fuel expenses	Net change
	(dollars in millions)		
Higher renewable energy and demand-side management surcharges (substantially offset in operations and maintenance expense)	\$ 63	\$	\$ 63
Interim retail rate increases effective January 1, 2009	61		61
Transmission rate increases	21		21
Increased mark-to-market valuations of fuel and purchased power contracts related to favorable changes in market prices, net of related PSA deferrals		(18)	18
Effects of weather on retail sales, primarily due to hotter weather in the third quarter of 2009	12	3	9
Lower retail sales primarily due to lower usage per customer, including the effects of the Company's energy efficiency programs, but excluding the effects of weather	(58)	(26)	(32)
Higher fuel and purchased power costs including the effects of lower off-system sales, net of related PSA deferrals	(30)	(19)	(11)
Lower retail revenues related to recovery of PSA deferrals, offset by lower amortization of the same amount recorded as fuel and purchased power expense (see Note 3)	(36)	(36)	—
Miscellaneous items, net	(17)	(15)	(2)
Total	<u>\$ 16</u>	<u>\$ (111)</u>	<u>\$ 127</u>

**Operations and maintenance** Operations and maintenance expenses increased \$66 million for 2009 compared with the prior-year period primarily because of:

- An increase of \$62 million related to renewable energy and demand-side management programs, which are offset in operating revenues;
- An increase of \$29 million in generation costs, including more planned maintenance, partially offset by lower costs at Palo Verde due to cost efficiency measures; and
- A decrease of \$25 million associated with cost saving measures and other factors, including the absence of employee severance costs in 2009.

**Depreciation and amortization** Depreciation and amortization expenses increased \$16 million for 2009 compared with the prior-year period primarily because of increases in utility plant in service. The increases in utility plant in service are the result of various improvements to APS' existing fossil and nuclear generating plants and distribution and transmission infrastructure additions and upgrades.

**Interest charges, net of capitalized financing costs** Interest charges, net of capitalized financing costs increased \$30 million for 2009 compared with the prior-year period primarily because of higher debt balances, partially offset by the effects of lower interest rates (see discussion related to APS' debt issuances in "Pinnacle West Consolidated — Liquidity and Capital Resources" above). Interest charges, net of capitalized financing costs are comprised of the line items interest expense, capitalized interest and allowance for equity funds used during construction from the APS' Statements of Income.

**Other income (expenses), net** Other income (expenses), net improved \$17 million for 2009 compared with the prior-year period primarily because of improved investment gains. Other income (expenses), net is comprised of the line items other income and other expense from the APS' Statements of Income.

**Income taxes** Income taxes were \$45 million higher for 2009 compared with the prior-year period primarily because of \$29 million of income tax benefits related to prior years recorded in 2008 and higher pretax income. See Note S-1.

#### **Operating Results — 2008 Compared with 2007**

APS' net income for the year ended 2008 was \$262 million, compared with net income of \$284 million for the comparable prior-year period. The decrease in net income was primarily due to higher operations and maintenance expenses; lower retail sales due to the effects of weather; higher depreciation and amortization expenses; and higher interest charges, net of capitalized financing costs. These negative factors were partially offset by increased revenues due to the rate increase effective July 1, 2007; transmission rate increases; and income tax benefits related to prior years recorded in 2008.

The following table presents net income compared with the prior-year period:

	Year Ended December 31,		Increase (Decrease) in Net Income
	2008	2007	
	(dollars in millions)		
Operating revenues less fuel and purchased power expenses	\$ 1,844	\$ 1,785	\$ 59
Operations and maintenance	(787)	(710)	(77)
Depreciation and amortization	(383)	(365)	(18)
Taxes other than income taxes	(124)	(128)	4
Other income (expenses), net	(25)	(5)	(20)
Interest charges, net of capitalized financing costs	(155)	(142)	(13)
Income taxes	(108)	(151)	43
Net income	<u>\$ 262</u>	<u>\$ 284</u>	<u>\$ (22)</u>

**Operating revenues less fuel and purchased power expenses**

Electric operating revenues less fuel and purchased power expenses were \$59 million higher for the year ended 2008 compared with the prior year. The following table describes the major components of this change:

	Increase (Decrease)		
	Operating revenues	Purchased power and fuel expenses	Net change
		(dollars in millions)	
Retail rate increases effective July 1, 2007	\$ 156	\$	\$ 156
Deferred fuel and purchased power costs related to higher base fuel rate		141	(141)
Transmission rate increases	31		31
Higher retail sales primarily due to customer growth partially offset by lower usage per customer, but excluding the effects of weather	29	8	21
Higher renewable energy surcharge (substantially offset in operations and maintenance expense)	14		14
Regulatory disallowance in 2007		(14)	14
Revenues related to long-term traditional wholesale contracts	26	14	12
Higher fuel and purchased power costs including the effects of lower off-system sales, net of related PSA deferrals	38	41	(3)
Lower mark-to-market valuations of fuel and purchased power contracts related to changes in market prices, net of related PSA deferrals		14	(14)
Effects of weather on retail sales	(63)	(20)	(43)
Lower retail revenues related to recovery of PSA deferrals, offset by lower amortization of the same amount recorded as fuel and purchased power expense (see Note 3)	(47)	(47)	—
Miscellaneous items, net	13	1	12
<b>Total</b>	<b>\$ 197</b>	<b>\$ 138</b>	<b>\$ 59</b>

**Operations and maintenance** Operations and maintenance expenses increased \$77 million for the year ended 2008 compared with the prior year primarily because of:

- An increase of \$30 million related to customer service and other costs including distribution system reliability;
- An increase of \$18 million in generation costs, including more planned maintenance;
- An increase of \$14 million related to renewable energy programs, which are offset in operating revenues;
- An increase of \$9 million associated with employee severance costs in 2008; and
- An increase of \$6 million due to other miscellaneous factors.

**Depreciation and amortization** Depreciation and amortization expenses increased \$18 million for the year ended 2008 compared with the prior year primarily because of increases in utility plant in service. The increases in utility plant in service are the result of various improvements to APS' existing fossil and nuclear generating plants and distribution and transmission infrastructure additions and upgrades.

**Interest charges, net of capitalized financing costs** Interest charges, net of capitalized financing costs increased \$13 million for the year ended 2008 compared with the prior year primarily because of higher rates on certain APS pollution control bonds and higher short-term debt balances. Interest charges, net of capitalized financing costs, are comprised of the line items interest expense, capitalized interest and allowance for equity funds used during construction from the APS Statements of Income.

**Other income (expenses), net** Other income (expenses), net reduced earnings by an additional \$20 million for the year ended 2008 compared with the prior year primarily because of lower interest income. Other income (expenses), net is comprised of the line items other income and other expense from the APS Statements of Income.

**Income taxes** Income taxes were \$43 million lower for the year ended 2008 compared with the prior year primarily because of \$18 million of increased income tax benefits related to prior years resolved in 2008 and 2007. See Note S-1.

## ARIZONA PUBLIC SERVICE COMPANY — LIQUIDITY AND CAPITAL RESOURCES

### Cash Flows

The following table presents APS' net cash provided by (used for) operating, investing and financing activities for the years ended December 31, 2009, 2008 and 2007 (dollars in millions):

	2009	2008	2007
Net cash flow provided by operating activities	\$ 959	\$ 785	\$ 766
Net cash flow used for investing activities	(738)	(879)	(881)
Net cash flow provided by (used for) financing activities	(172)	114	86
Net increase (decrease) in cash and cash equivalents	<u>\$ 49</u>	<u>\$ 20</u>	<u>\$ (29)</u>

### 2009 Compared with 2008

The increase of approximately \$174 million in net cash provided by operating activities is primarily due to a reduction of collateral and margin cash required as a result of changes in commodity prices.

The decrease of approximately \$141 million in net cash used for investing activities is primarily due to lower levels of capital expenditures net of contributions.

The increase of approximately \$286 million in net cash used for financing activities is primarily due to repayments of short-term borrowings partially offset by APS' issuance of \$500 million of unsecured senior notes (see Note 6).

**2008 Compared with 2007**

The increase of approximately \$19 million in net cash provided by operating activities is primarily due to lower current income taxes and increased retail revenue related to higher Base Fuel Rates, partially offset by increased collateral and margin cash provided as a result of changes in commodity prices.

The decrease of approximately \$2 million in net cash used for investing activities is primarily due to lower levels of capital expenditures (see table and discussion above) and increased contributions in aid of construction related to changes in 2008 in our line extension policy (see Note 3), substantially offset by lower cash proceeds from the net sales and purchases of investment securities.

The increase of approximately \$28 million in net cash provided by financing activities is primarily due to higher levels of short-term borrowings, partially offset by decreased equity infusions from Pinnacle West and the repurchase of pollution control bonds (see Note 6).

**Liquidity**

For a discussion of APS' capital requirements and liquidity, see "APS" under "Pinnacle West Consolidated — Liquidity and Capital Resources."

**Contractual Obligations**

The following table summarizes contractual requirements for APS as of December 31, 2009 (dollars in millions):

	2010	2011- 2012	2013- 2014	There- after	Total
Long-term debt payments, including interest (a)	\$ 397	\$ 1,233	\$ 785	\$ 2,835	\$ 5,250
Purchased power and fuel commitments (b)	444	687	947	6,397	8,475
Operating lease payments (c)	70	131	120	63	384
Nuclear decommissioning funding requirements	24	49	49	161	283
Renewable energy credits (d)	48	30	30	142	250
Purchase obligations (e)	44	62	14	165	285
<b>Total contractual commitments</b>	<u>\$ 1,027</u>	<u>\$ 2,192</u>	<u>\$ 1,945</u>	<u>\$ 9,763</u>	<u>\$ 14,927</u>

- (a) The long-term debt matures at various dates through 2038 and bears interest principally at fixed rates. Interest on variable-rate long-term debt is determined by using average rates at December 31, 2009 (see Note 6).
- (b) APS' purchased power and fuel commitments include purchases of coal, electricity, natural gas, renewable energy and nuclear fuel (see Notes 3 and 11).
- (c) Relates to the Palo Verde sale leaseback and other items (see Note 9).
- (d) Contracts to purchase renewable energy credits in compliance with the Renewable Energy Standard.
- (e) These contractual obligations include commitments for capital expenditures and other obligations.

This table excludes \$208 million in unrecognized tax benefits because the timing of the future cash outflows is uncertain.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE  
DISCLOSURES ABOUT MARKET RISK**

See “Market and Credit Risks” in Item 7 above for a discussion of quantitative and qualitative disclosures about market risk.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**INDEX TO FINANCIAL STATEMENTS AND  
FINANCIAL STATEMENT SCHEDULES

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See Note 13 and S-2 for the selected quarterly financial data (unaudited) required to be presented in this Item.	

**MANAGEMENT'S REPORT ON INTERNAL CONTROL  
OVER FINANCIAL REPORTING  
(PINNACLE WEST CAPITAL CORPORATION)**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f), for Pinnacle West Capital Corporation. Management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control — Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2009. The effectiveness of our internal control over financial reporting as of December 31, 2009 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein and also relates to the Company's consolidated financial statements.

February 19, 2010

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
Pinnacle West Capital Corporation  
Phoenix, Arizona

We have audited the accompanying consolidated balance sheets of Pinnacle West Capital Corporation and subsidiaries (the "Company") as of December 31, 2009 and 2008 and the related consolidated statements of income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2009. Our audits also included the financial statement schedules listed in the Index at Item 15. We also have audited the Company's internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and financial statement schedules and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ DELOITTE & TOUCHE LLP

Phoenix, Arizona  
February 19, 2010

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

	Year Ended December 31,		
	2009	2008	2007
<b>OPERATING REVENUES</b>			
Regulated electricity segment	\$ 3,149,187	\$ 3,127,383	\$ 2,918,163
Real estate segment	103,152	74,549	189,726
Marketing and trading	—	66,897	138,247
Other revenues	44,762	41,729	48,018
Total	<u>3,297,101</u>	<u>3,310,558</u>	<u>3,294,154</u>
<b>OPERATING EXPENSES</b>			
Regulated electricity segment fuel and purchased power	1,178,620	1,284,116	1,140,923
Real estate segment operations	102,381	100,102	168,911
Real estate impairment charge (Note 23)	258,453	18,108	—
Marketing and trading fuel and purchased power	—	45,572	100,462
Operations and maintenance	875,357	807,852	728,340
Depreciation and amortization	404,331	390,093	371,877
Taxes other than income taxes	123,663	125,336	128,210
Other expenses	32,523	34,171	38,925
Total	<u>2,975,328</u>	<u>2,805,350</u>	<u>2,677,648</u>
<b>OPERATING INCOME</b>	<u>321,773</u>	<u>505,208</u>	<u>616,506</u>
<b>OTHER</b>			
Allowance for equity funds used during construction	14,999	18,636	21,195
Other income (Note 19)	5,669	12,797	25,362
Other expense (Note 19)	(14,269)	(31,576)	(25,857)
Total	<u>6,399</u>	<u>(143)</u>	<u>20,700</u>
<b>INTEREST EXPENSE</b>			
Interest charges	233,859	215,684	207,827
Capitalized interest	(10,745)	(18,820)	(23,063)
Total	<u>223,114</u>	<u>196,864</u>	<u>184,764</u>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES</b>			
	105,058	308,201	452,442
<b>INCOME TAXES (Note 4)</b>	<u>37,827</u>	<u>76,897</u>	<u>152,006</u>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<u>67,231</u>	<u>231,304</u>	<u>300,436</u>
<b>INCOME (LOSS) FROM DISCONTINUED OPERATIONS</b>			
Net of income tax expense (benefit) of \$(8,917), \$6,999 and \$4,486 (Note 22)	(13,676)	10,821	6,707
<b>NET INCOME</b>	<u>53,555</u>	<u>242,125</u>	<u>307,143</u>
Less: Net loss attributable to noncontrolling interests	(14,775)	—	—
<b>NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS</b>	<u>\$ 68,330</u>	<u>\$ 242,125</u>	<u>\$ 307,143</u>
<b>WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING — BASIC</b>			
	101,161	100,691	100,256
<b>WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING — DILUTED</b>			
	101,264	100,965	100,835
<b>EARNINGS PER WEIGHTED — AVERAGE COMMON SHARE OUTSTANDING</b>			
Income from continuing operations attributable to common shareholders — basic	\$ 0.81	\$ 2.30	\$ 3.00
Net income attributable to common shareholders — basic	0.68	2.40	3.06
Income from continuing operations attributable to common shareholders — diluted	0.81	2.29	2.98
Net income attributable to common shareholders — diluted	0.67	2.40	3.05
<b>DIVIDENDS DECLARED PER SHARE</b>	<u>\$ 2.10</u>	<u>\$ 2.10</u>	<u>\$ 2.10</u>
<b>AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:</b>			
Income from continuing operations, net of tax	\$ 82,006	\$ 231,304	\$ 300,436
Discontinued operations, net of tax	(13,676)	10,821	6,707
Net income attributable to common shareholders	<u>\$ 68,330</u>	<u>\$ 242,125</u>	<u>\$ 307,143</u>



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

	December 31,	
	2009	2008
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 145,378	\$ 105,245
Customer and other receivables	301,915	292,682
Accrued utility revenues	110,971	100,089
Allowance for doubtful accounts	(6,153)	(3,383)
Materials and supplies (at average cost)	176,020	173,252
Fossil fuel (at average cost)	39,245	29,752
Deferred income taxes (Note 4)	53,990	79,729
Income tax receivable	26,005	—
Home inventory (Notes 1 and 23)	3,282	50,688
Assets from risk management activities (Note 18)	50,619	32,581
Other current assets	27,465	21,847
Total current assets	<u>928,737</u>	<u>882,482</u>
<b>INVESTMENTS AND OTHER ASSETS</b>		
Real estate investments — net (Notes 1, 6 and 23)	119,989	415,296
Assets from risk management activities (Note 18)	28,855	33,675
Nuclear decommissioning trust (Note 12)	414,576	343,052
Other assets	110,091	117,935
Total investments and other assets	<u>673,511</u>	<u>909,958</u>
<b>PROPERTY, PLANT AND EQUIPMENT (Notes 1, 6, 9 and 10)</b>		
Plant in service and held for future use	12,848,138	12,264,805
Less accumulated depreciation and amortization	<u>(4,340,645)</u>	<u>(4,141,546)</u>
Net	8,507,493	8,123,259
Construction work in progress	467,700	572,354
Intangible assets, net of accumulated amortization of \$294,724 and \$282,196	164,380	131,722
Nuclear fuel, net of accumulated amortization of \$64,544 and \$55,343	118,243	89,323
Total property, plant and equipment	<u>9,257,816</u>	<u>8,916,658</u>
<b>DEFERRED DEBITS</b>		
Deferred fuel and purchased power regulatory asset (Notes 1 and 3)	—	7,984
Other regulatory assets (Notes 1, 3 and 4)	781,714	787,506
Income tax receivable	65,103	—
Other deferred debits	101,274	115,505
Total deferred debits	<u>948,091</u>	<u>910,995</u>
<b>TOTAL ASSETS</b>	<u>\$ 11,808,155</u>	<u>\$ 11,620,093</u>

See Notes to Pinnacle West's Consolidated Financial Statements.

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

	December 31,	
	2009	2008
<b>LIABILITIES AND EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 240,637	\$ 261,029
Accrued taxes	104,011	109,798
Accrued interest	54,596	40,741
Short-term borrowings (Note 5)	153,715	670,469
Current maturities of long-term debt (Note 6)	277,693	177,646
Customer deposits	71,026	78,745
Liabilities from risk management activities (Note 18)	55,908	69,585
Other current liabilities	125,574	97,915
Total current liabilities	<u>1,083,160</u>	<u>1,505,928</u>
LONG-TERM DEBT LESS CURRENT MATURITIES (Note 6)	<u>3,370,524</u>	<u>3,031,603</u>
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes (Note 4)	1,496,095	1,403,318
Deferred fuel and purchased power regulatory liability (Note 3)	87,291	—
Other regulatory liabilities (Notes 1 and 3)	679,072	587,586
Liability for asset retirements (Note 12)	301,783	275,970
Liabilities for pension and other postretirement benefits (Note 8)	811,338	675,788
Liabilities from risk management activities (Note 18)	62,443	126,532
Customer advances	136,595	132,023
Coal mine reclamation	92,060	91,201
Unrecognized tax benefits	142,099	68,904
Other	200,015	227,872
Total deferred credits and other	<u>4,008,791</u>	<u>3,589,194</u>
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		
<b>EQUITY (Note 7)</b>		
Common stock, no par value; authorized 150,000,000 shares; issued 101,527,937 at end of 2009 and 100,948,436 at end of 2008	2,153,295	2,151,323
Treasury stock at cost; 93,239 shares at end of 2009 and 59,827 at end of 2008	(3,812)	(2,854)
Total common stock	<u>2,149,483</u>	<u>2,148,469</u>
Retained earnings	1,298,213	1,444,208
Accumulated other comprehensive loss:		
Pension and other postretirement benefits (Note 8)	(50,892)	(47,547)
Derivative instruments	(80,695)	(99,151)
Total accumulated other comprehensive loss	<u>(131,587)</u>	<u>(146,698)</u>
Total Pinnacle West shareholders' equity	3,316,109	3,445,979
Noncontrolling real estate interests	29,571	47,389
Total equity	<u>3,345,680</u>	<u>3,493,368</u>
<b>TOTAL LIABILITIES AND EQUITY</b>	<u>\$ 11,808,155</u>	<u>\$ 11,620,093</u>

See Notes to Pinnacle West's Consolidated Financial Statements.

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

	Year Ended December 31,		
	2009	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net Income	\$ 53,555	\$ 242,125	\$ 307,143
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization including nuclear fuel	443,160	423,969	403,896
Deferred fuel and purchased power	(51,742)	(80,183)	(196,136)
Deferred fuel and purchased power amortization	147,018	183,126	231,106
Deferred fuel and purchased power regulatory disallowance	—	—	14,370
Allowance for equity funds used during construction	(14,999)	(18,636)	(21,195)
Real estate impairment charge	280,188	53,250	—
Deferred income taxes	105,492	158,024	(58,027)
Change in mark-to-market valuations	(6,939)	9,074	17,579
Changes in current assets and liabilities:			
Customer and other receivables	12,292	73,446	58,793
Accrued utility revenues	(10,882)	7,388	4,057
Materials, supplies and fossil fuel	(12,261)	(25,453)	(29,776)
Other current assets	(9,186)	8,734	(10,040)
Accounts payable	(27,328)	(69,439)	(42,004)
Accrued taxes and income tax receivable — net	(31,792)	(13,149)	20,764
Home inventory	33,833	48,041	(56,883)
Other current liabilities	29,274	(5,130)	22,657
Expenditures for real estate investments	(2,957)	(21,168)	(121,316)
Other changes in real estate assets	(4,216)	18,211	82,521
Change in margin and collateral accounts — assets	(12,806)	17,450	(37,371)
Change in margin and collateral accounts — liabilities	35,654	(132,416)	19,284
Change in long term income tax receivable	(131,984)	—	—
Change in unrecognized tax benefits	137,898	(94,551)	25,178
Change in other regulatory liabilities	110,642	(12,129)	7,133
Change in other long-term assets	(47,899)	6,104	(23,826)
Change in other long-term liabilities	7,050	36,880	40,029
Net cash flow provided by operating activities	<u>1,031,065</u>	<u>813,568</u>	<u>657,936</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Capital expenditures	(764,609)	(935,577)	(960,390)
Contributions in aid of construction	53,525	60,292	41,809
Capitalized interest	(10,745)	(18,820)	(23,063)
Proceeds from sale of investment securities	—	—	69,225
Purchases of investment securities	—	—	(36,525)
Proceeds from nuclear decommissioning trust sales	441,242	317,619	259,026
Investment in nuclear decommissioning trust	(463,033)	(338,361)	(279,768)
Proceeds from sale of commercial real estate investments	43,370	94,171	58,139
Other	(4,667)	5,517	(1,807)
Net cash flow used for investing activities	<u>(704,917)</u>	<u>(815,159)</u>	<u>(873,354)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Issuance of long-term debt	867,469	96,934	230,571
Repayment and reacquisition of long-term debt	(435,127)	(181,491)	(162,060)
Short-term borrowings — net	(516,754)	331,741	304,911
Dividends paid on common stock	(205,076)	(204,247)	(210,473)
Common stock equity issuance	3,302	3,687	24,089
Other	171	3,891	(2,509)
Net cash flow provided by (used for) financing activities	<u>(286,015)</u>	<u>50,515</u>	<u>184,529</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>40,133</b>	<b>48,924</b>	<b>(30,889)</b>

CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>105,245</u>	<u>56,321</u>	<u>87,210</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u>\$ 145,378</u>	<u>\$ 105,245</u>	<u>\$ 56,321</u>
Supplemental disclosure of cash flow information			
Cash paid during the period for:			
Income taxes, net of (refunds)	\$ (52,776)	\$ 24,233	\$ 204,643
Interest, net of amounts capitalized	\$ 203,860	\$ 191,085	\$ 193,533

See Notes to Pinnacle West's Consolidated Financial Statements.

**PINNACLE WEST CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
(dollars in thousands)

	Year Ended December 31,		
	2009	2008	2007
<b>COMMON STOCK (Note 7)</b>			
Balance at beginning of year	\$ 2,151,323	\$ 2,135,787	\$ 2,114,550
Issuance of common stock	10,620	10,845	24,089
Other	(8,648)	4,691	(2,852)
Balance at end of year	<u>2,153,295</u>	<u>2,151,323</u>	<u>2,135,787</u>
<b>TREASURY STOCK (Note 7)</b>			
Balance at beginning of year	(2,854)	(2,054)	(449)
Purchase of treasury stock	(2,156)	(1,387)	(1,964)
Reissuance of treasury stock used for stock compensation	1,198	587	359
Balance at end of year	<u>(3,812)</u>	<u>(2,854)</u>	<u>(2,054)</u>
<b>RETAINED EARNINGS</b>			
Balance at beginning of year	1,444,208	1,413,741	1,319,747
Net income attributable to common shareholders	68,330	242,125	307,143
Common stock dividends	(212,386)	(211,405)	(210,473)
Cumulative effect of change in accounting for income taxes (Note 4)	—	—	(2,676)
Other	(1,939)	(253)	—
Balance at end of year	<u>1,298,213</u>	<u>1,444,208</u>	<u>1,413,741</u>
<b>ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)</b>			
Balance at beginning of year	(146,698)	(15,863)	12,268
Pension and other postretirement benefits (Note 8):			
Unrealized actuarial loss, net of tax benefit of \$(4,223), \$(7,801) and \$(13,573)	(6,350)	(11,053)	(21,976)
Prior service cost, net of tax benefit of \$(495)	—	—	(769)
Amortization to income:			
Actuarial loss, net of tax benefit of \$1,705, \$1,578 and \$1,670	2,615	2,437	2,214
Prior service cost, net of tax benefit of \$215, \$222 and \$252	329	343	391
Transition obligation, net of tax benefit of \$39, \$40 and \$43	61	62	67
Derivative instruments:			
Net unrealized loss, net of tax benefit of \$(61,328), \$(54,490) and \$(414)	(93,996)	(83,093)	(785)
Reclassification of net realized (gain) loss to income, net of tax (expense) benefit of \$72,876, \$(24,786) and \$(4,679)	112,452	(39,531)	(7,273)
Balance at end of year	<u>(131,587)</u>	<u>(146,698)</u>	<u>(15,863)</u>
<b>NONCONTROLLING INTERESTS</b>			
Balance at beginning of year	47,389	54,569	49,682
Net loss	(14,775)	—	—
Net capital activities by noncontrolling interests	(2,632)	(8,006)	4,320
Other	(411)	826	567
Balance at end of year	<u>29,571</u>	<u>47,389</u>	<u>54,569</u>
<b>TOTAL EQUITY</b>	<u>\$ 3,345,680</u>	<u>\$ 3,493,368</u>	<u>\$ 3,586,180</u>
<b>COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS</b>			
Net income attributable to common shareholders	\$ 68,330	\$ 242,125	\$ 307,143
Other comprehensive income (loss)	15,111	(130,835)	(28,131)
Comprehensive income attributable to common shareholders	<u>\$ 83,441</u>	<u>\$ 111,290</u>	<u>\$ 279,012</u>

See Notes to Pinnacle West's Consolidated Financial Statements.



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

## **1. Summary of Significant Accounting Policies**

### **Consolidation and Nature of Operations**

Pinnacle West's 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.

APS is a vertically-integrated electric utility that provides either retail or wholesale electric service to substantially all 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. SunCor is a developer of residential, commercial and industrial real estate projects in Arizona, New Mexico, Idaho and Utah. APSES provides energy-related projects to commercial and industrial retail customers in competitive markets in the western United States. In 2008, APSES discontinued its commodity-related energy services (see Note 22). El Dorado is an investment firm. Pinnacle West Marketing & Trading began operations in early 2007. These operations were previously conducted by a division of Pinnacle West through the end of 2006. By the end of 2008, substantially all the contracts were transferred to APS or expired.

In preparing the consolidated financial statements, we have evaluated the events that have occurred after December 31, 2009 through the date the financial statements were issued on February 19, 2010.

Our 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 consolidated financial statements and notes have been prepared consistently with the exception of the reclassification of certain prior year amounts on our Consolidated Statements of Income and Consolidated Balance Sheets in accordance with accounting requirements for reporting discontinued operations (see Note 22), and amended accounting guidance on reporting noncontrolling interests in consolidated financial statements (see Note 2). We have also presented certain line items in more detail in the Consolidated Balance Sheets than was presented at December 31, 2008. The prior year amounts were reclassified to conform to the current year presentation. Customer advances, coal mine reclamation and unrecognized tax benefits are presented as separate line items instead of the previously reported single line item of other deferred credits.

Certain line items are presented in more detail on the Consolidated Statements of Cash Flows than was presented in the prior years. Other line items are more condensed than the previous presentation. The prior year amounts were reclassified to conform to the current year presentation. Customer and other receivables and accrued utility revenues are presented as separate line items instead of the previously reported single line item of customer and other receivables. Accrued taxes and income tax receivable-net and other current liabilities are presented as separate line items instead of the previously reported single line item of other current liabilities. Change in other regulatory liabilities is reported separately from change in other long-term liabilities. These reclassifications had no impact on total net cash flow provided by operating activities.

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

**Accounting Records and Use of Estimates**

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.

**Derivative Accounting**

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity and natural gas. We manage risks associated with these market fluctuations by utilizing various instruments that qualify as derivatives, including exchange-traded futures and options and over-the-counter forwards, options and swaps. As part of our overall risk management program, we use such instruments to hedge purchases and sales of electricity and fuels. The changes in market value of such contracts have a high correlation to price changes in the hedged transactions.

We account for our derivative contracts in accordance with derivatives and hedging guidance, which requires that entities recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. See Note 18 for additional information about our derivative accounting policies.

**Fair Value Measurements**

We determine and disclose the fair value of certain assets and liabilities in accordance with fair value guidance. Fair value is the price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between willing market participants on the measurement date. Inputs to fair value include observable and unobservable data. We maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

We determine fair market value using actively-quoted prices for identical instruments when available. When actively quoted prices are not available for the identical instruments we use prices for similar instruments or other corroborative market information or prices provided by other external sources. For options, long-term contracts and other contracts for which price quotes are not available, we use unobservable inputs, such as models and other valuation methods, to determine fair market value.

The use of models and other valuation methods to determine fair market value often requires subjective and complex judgment. Actual results could differ from the results estimated through application of these methods. Our structured activities are hedged with a portfolio of forward purchases that protects the economic value of the sales transactions. Our practice is to hedge within timeframes established by the ERM.

See Note 14 for additional information about fair value measurements.

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

**Regulatory Accounting**

APS is regulated by the ACC and the FERC. The accompanying financial statements reflect the rate-making policies of these commissions. As a result, we capitalize certain costs that would be included as expense in the current period by unregulated companies. Regulatory assets represent incurred costs that have been deferred because they are probable of future recovery in customer rates. Regulatory liabilities generally represent expected future costs that have already been collected from customers.

Management continually assesses whether our regulatory assets are probable of future recovery by considering factors such as applicable regulatory environment changes and recent rate orders to other regulated entities in the same jurisdiction. This determination reflects the current political and regulatory climate in the state and is subject to change in the future. If future recovery of costs ceases to be probable, the assets would be written off as a charge in current period earnings.

A component of our regulatory assets and liabilities is the retail fuel and power costs deferred under the PSA. APS defers for future rate recovery or refund approximately 90% of the difference between actual retail fuel and purchased power costs and the amount of such costs currently included in base rates, subject to specified parameters. See Note 3.

Also included in the balance of regulatory assets at December 31, 2009 is a regulatory asset for pension and other postretirement benefits. This regulatory asset represents the future recovery of these costs through retail rates as these amounts are charged to earnings. If these costs are disallowed by the ACC, this regulatory asset would be charged to OCI and result in lower future earnings.

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

	December 31,	
	2009	2008
Pension and other postretirement benefits	\$ 532	\$ 473
Regulatory asset for deferred income taxes	59	51
Deferred fuel and purchased power — mark-to-market	41	118
Transmission vegetation management	34	20
Deferred compensation	31	30
Loss on reacquired debt	23	16
Demand side management	18	17
Coal reclamation	16	17
Competition rules compliance charge (a)	7	16
Deferred fuel and purchased power (a)	—	8
Other	21	29
Total regulatory assets (b)	<u>\$ 782</u>	<u>\$ 795</u>

(a) Subject to a carrying charge.

(b) There are no regulatory assets for which regulators have allowed recovery of costs but not allowed a return by exclusion from rate base.

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

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

	December 31,	
	2009	2008
Removal costs (a)	\$ 385	\$ 388
Regulatory liability related to asset retirement obligations	156	103
Deferred fuel and purchased power (b)	87	—
Renewable energy standard	51	22
Spent nuclear fuel	34	22
Deferred gains on utility property	20	20
Tax benefit of Medicare subsidy	17	16
Deferred interest income (b)	3	8
Other	13	9
Total regulatory liabilities	<u>\$ 766</u>	<u>\$ 588</u>

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

#### Utility Plant and Depreciation

Utility plant is the term we use to describe the business property and equipment that supports electric service, consisting primarily of generation, transmission and distribution facilities. We report utility plant at its original cost, which includes:

- material and labor;
- contractor costs;
- capitalized leases;
- construction overhead costs (where applicable); and
- capitalized interest or an allowance for funds used during construction.

We expense the costs of plant outages, major maintenance and routine maintenance as incurred. We charge retired utility plant to accumulated depreciation. Liabilities associated with the retirement of tangible long-lived assets are recognized at fair value as incurred and capitalized as part of the related tangible long-lived assets. Accretion of the liability due to the passage of time is an operating expense and the capitalized cost is depreciated over the useful life of the long-lived asset. See Note 12.

APS records a regulatory liability for the asset retirement obligations related to its regulated assets. This regulatory liability represents the difference between the amount that has been recovered in regulated rates and the amount calculated in accordance with guidance on accounting for asset retirement obligations. APS believes it can recover in regulated rates the costs capitalized in accordance with this accounting guidance.

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

We record depreciation on utility plant on a straight-line basis over the remaining useful life of the related assets. The approximate remaining average useful lives of our utility property at December 31, 2009 were as follows:

- Fossil plant — 18 years;
- Nuclear plant — 17 years;
- Other generation — 29 years;
- Transmission — 44 years;
- Distribution — 32 years; and
- Other — 8 years.

For the years 2007 through 2009, the depreciation rates ranged from a low of 1.11% to a high of 12.46%. The weighted-average rate was 3.06% for 2009, 3.08% for 2008 and 3.11% for 2007. We depreciate non-utility property and equipment over the estimated useful lives of the related assets, ranging from 3 to 34 years.

### **Investments**

El Dorado accounts for its investments using either the equity method (if significant influence) or the cost method (if less than 20% ownership).

Our investments in the nuclear decommissioning trust fund are accounted for in accordance with guidance on accounting for certain investments in debt and equity securities. See Note 12 for more information on these investments.

### **Capitalized Interest**

Capitalized interest represents the cost of debt funds used to finance non-regulated construction projects. Plant construction costs, including capitalized interest, are expensed through depreciation when completed projects are placed into commercial operation. The rate used to calculate capitalized interest was a composite rate of 4.4% for 2009, 5.2% for 2008 and 5.8% for 2007. Capitalized interest ceases when construction is complete.

### **Allowance for Funds Used During Construction**

AFUDC represents the approximate net composite interest cost of borrowed funds and an allowed return on the equity funds used for construction of regulated utility plant. APS' allowance for borrowed funds is included in capitalized interest on the Consolidated Financial Statements. Plant construction costs, including AFUDC, are recovered in authorized rates through depreciation when completed projects are placed into commercial operation.

AFUDC was calculated by using a composite rate of 5.9% for 2009, 7.0% for 2008 and 8.2% for 2007. APS compounds AFUDC monthly and ceases to accrue AFUDC when construction work is completed and the property is placed in service.

### **Electric Revenues**

We derive electric revenues primarily from sales of electricity to our regulated Native Load customers. Revenues related to the sale of electricity are generally recorded when service is rendered or electricity is delivered to customers. The billing of electricity sales to individual Native Load customers is based on the reading of their meters, which occurs on a systematic basis throughout the month. Unbilled revenues are estimated by applying an average revenue/kWh to the number of estimated kWhs delivered but not billed. Differences historically between the actual and estimated unbilled revenues are immaterial. We exclude sales taxes and franchise fees on electric revenues from both revenue and taxes other than income taxes.

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

Revenues from our Native Load customers and non-derivative instruments are reported on a gross basis on Pinnacle West's Consolidated Statements of Income. In the electricity business, some contracts to purchase energy are netted against other contracts to sell energy. This is called a "book-out" and usually occurs for contracts that have the same terms (quantities and delivery points) and for which power does not flow. We net these book-outs, which reduces both revenues and purchased power and fuel costs.

Effective January 1, 2010, electric revenues will also include proceeds for line extension payments for new or upgraded service in accordance with the ACC Settlement Agreement (see Note 3). This revenue treatment will continue through 2012 or until new rates are established in APS' next general retail rate case, if that is before year end 2012. Certain proceeds received under previous versions of the line extension policy, or for activities not involving an extension or upgrade of service (e.g., service relocations at the request of governmental entities or undergrounding of overhead facilities) will continue to be treated as contributions in aid of construction and will not impact electric revenues.

**Allowance for Doubtful Accounts**

The allowance for doubtful accounts represents our best estimate of existing accounts receivable that will ultimately be uncollectible. The allowance is calculated by applying estimated write-off factors to various classes of outstanding receivables, including accrued utility revenues. The write-off factors used to estimate uncollectible accounts are based upon consideration of both historical collections experience and management's best estimate of future collections success given the existing collections environment.

**Real Estate Revenues**

SunCor recognizes revenue from land, home and qualifying commercial operating assets sales in full, provided (a) the income is determinable, that is, the collectability of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, SunCor is not obligated to perform significant activities after the sale to earn the income. Unless both conditions exist, recognition of all or part of the income is postponed under the percentage of completion method in accordance with accounting guidance relating to sales of real estate. SunCor recognizes income only after the asset title has passed. Commercial property and management revenues are recorded over the term of the lease or period in which services are provided. In addition, see Note 22.

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

**Real Estate Investments**

Real estate investments primarily include SunCor's land, home inventory, commercial property and investments in joint ventures. Land includes acquisition costs, infrastructure costs, capitalized interest and property taxes directly associated with the acquisition and development of each project. Home inventory consists of construction costs, improved lot costs, capitalized interest and property taxes on homes and condos under construction. Homes under construction are classified as "real estate investments" on the Consolidated Balance Sheets; upon completion of construction they are transferred to "home inventory" with the expectation that they will be sold in a timely manner.

For the purposes of evaluating impairment, in accordance with the provisions on accounting for the impairment or disposal of long-lived assets, we classify our real estate assets, including land under development, land held for future development, and commercial property as "held and used." When events or changes in circumstances indicate that the carrying values of real estate assets considered held and used may not be recoverable, we compare the undiscounted cash flows that we estimate will be generated by each asset to its carrying amount. If the carrying amount exceeds the undiscounted cash flows, we adjust the asset to fair value and recognize an impairment charge. The adjusted value becomes the new book value (carrying amount) for held and used assets. Our internal models use inputs that we believe are consistent with those that would be used by market participants.

Real estate home inventory is considered to be held for sale for purposes of evaluating impairment in accordance with the provisions of accounting for impairment or disposal of long-lived assets. Home inventories are reported at the lower of carrying amount or fair value less costs to sell. Fair value less costs to sell is evaluated each period to determine if it has changed. Losses (and gains not to exceed any cumulative loss previously recognized) are reported as adjustments to the carrying amount.

Investments in joint ventures for which SunCor does not have a controlling financial interest are not consolidated, but are accounted for using the equity method of accounting. In addition, see Note 22 and Note 23.

**Cash and Cash Equivalents**

We consider all highly liquid investments with a maturity of three months or less at acquisition to be cash equivalents.

**Nuclear Fuel**

APS amortizes nuclear fuel by using the unit-of-production method. The unit-of-production method is based on actual physical usage. APS divides the cost of the fuel by the estimated number of thermal units it expects to produce with that fuel. APS then multiplies that rate by the number of thermal units produced within the current period. This calculation determines the current period nuclear fuel expense.

APS also charges nuclear fuel expense for the interim storage and permanent disposal of spent nuclear fuel. The DOE is responsible for the permanent disposal of spent nuclear fuel and charges APS \$0.001 per kWh of nuclear generation. See Note 11 for information on spent nuclear fuel disposal and Note 12 for information on nuclear decommissioning costs.

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

**Income Taxes**

Income taxes are provided using the asset and liability approach prescribed by guidance relating to accounting for income taxes. We file our federal income tax return on a consolidated basis and we file our state income tax returns on a consolidated or unitary basis. In accordance with our intercompany tax sharing agreement, federal and state income taxes are allocated to each first-tier subsidiary as though each first-tier subsidiary filed a separate income tax return. Any difference between that method and the consolidated (and unitary) income tax liability is attributed to the parent company. The income tax liability accounts reflect the tax and interest associated with management's estimate of the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement for all known and measurable tax exposures. See Note 4.

**Intangible Assets**

We have no goodwill recorded and have separately disclosed other intangible assets, primarily APS' software, on Pinnacle West's Consolidated Balance Sheets. The intangible assets are amortized over their finite useful lives. Amortization expense was \$35 million in 2009, \$33 million in 2008 and \$37 million in 2007. Estimated amortization expense on existing intangible assets over the next five years is \$33 million in 2010, \$27 million in 2011, \$23 million in 2012, \$18 million in 2013 and \$13 million in 2014. At December 31, 2009, the weighted average remaining amortization period for intangible assets was 7 years.

**2. New Accounting Standards****Variable Interest Entities**

In June 2009, the FASB issued amended guidance on the consolidation of variable interest entities. The model for determining which enterprise has a controlling financial interest and is the primary beneficiary of a VIE has changed significantly under the new guidance. Previously, variable interest holders had to determine whether they had a controlling financial interest in a VIE based on a quantitative analysis of the expected gains and/or losses of the entity. The new guidance requires an enterprise with a variable interest in a VIE to perform a qualitative assessment in determining whether it has a controlling financial interest in the entity, and if so, whether it is the primary beneficiary. Furthermore, the amended guidance requires companies to continually evaluate VIEs for consolidation. This guidance was effective for us on January 1, 2010. We are continuing to evaluate the impact this new guidance may have on our financial statements. See Note 20.

**Fair Value Measurements and Disclosures**

We adopted guidance relating to fair value measurements and disclosures for our non-financial assets on January 1, 2009. This guidance was adopted for our financial assets on January 1, 2008.

On April 1, 2009, we adopted new fair value accounting provisions on the following topics:

- Determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly.
- The recognition and presentation of other-than-temporary impairments.
- Interim disclosures about fair value of financial instruments.

On October 1, 2009, we adopted new fair value accounting provisions on the following topics:

- Measuring fair value of liabilities, which provides additional guidance on how fair value measurements of liabilities should be determined.
- Measuring fair value of certain alternative investments. This guidance provides clarification on the measurement and disclosure of investments in entities that calculate net asset value.

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

The adoption of fair value measurement and disclosure guidance has not had a significant impact on our financial statement results. See Note 14 for fair value discussions and related disclosures.

In January 2010 guidance was issued that amends the fair value disclosure requirements. This guidance adds new fair value disclosures and clarifies existing disclosure requirements. This amended guidance is effective for us during the first quarter of 2010. The adoption of this new guidance will not have an impact on our financial statement results.

**Derivative Instruments**

We adopted amended guidance on disclosures about derivative instruments and hedging activities on January 1, 2009. See Note 18 for additional information and related disclosures. Since this guidance provides only disclosure requirements, the adoption of this standard did not impact our financial statement results.

**Noncontrolling Interests**

We adopted amended guidance on reporting noncontrolling interests in consolidated financial statements on January 1, 2009. This guidance provides accounting and reporting standards for noncontrolling interests in a consolidated subsidiary and clarifies that noncontrolling interests should be reported as equity on the consolidated financial statements. As a result of adopting this guidance, we have disclosed on the face of our financial statements the portion of equity and net income attributable to the noncontrolling interests in consolidated subsidiaries. Additionally, we reclassified \$47 million of noncontrolling interests from other deferred credits to equity on the December 31, 2008 Consolidated Balance Sheets. Prior year's net income attributable to noncontrolling interests was not material to our Consolidated Statements of Income and was not reclassified. The adoption of this guidance modified our financial statement presentation, but did not have an impact on our financial statement results.

**Employers' Disclosure about Postretirement Benefit Plan Assets**

In December 2008, the FASB issued guidance on employers' disclosures about postretirement benefit plan assets. This guidance requires enhanced disclosures about employers' plan assets of a defined benefit pension or other postretirement plan including fair value related disclosures. We adopted this guidance during the fourth quarter of 2009. See Note 8 for the related disclosures. The adoption of this guidance expanded certain disclosures but did not have an impact on our financial statement results.

**Subsequent Events**

In May 2009, the FASB issued guidance which established general standards of accounting for and disclosure of subsequent events. Subsequent events are events that occur after the balance sheet date but before financial statements are issued or are available to be issued. We adopted this guidance during the second quarter of 2009. The adoption of this guidance expanded certain disclosures but did not have an impact on our financial statement results.

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

### **3. Regulatory Matters**

#### **2008 General Retail Rate Case Decision**

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 ACC approved the Settlement Agreement with modifications and obligations for APS that did not materially affect the overall economic terms of the settlement.

The Settlement Agreement includes a net retail rate increase of \$207.5 million, which represents a base rate increase of \$344.7 million less a reclassification of \$137.2 million of fuel and purchased power revenues from the existing PSA to base rates. The new rates were effective January 1, 2010.

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. 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.

Other key provisions of the Settlement Agreement, effective January 1, 2010, include the following:

- A non-fuel base rate increase in annual pretax revenues of \$196.3 million;
- A net increase in annual pretax revenues of \$11.2 million for fuel and purchased power costs reflected in base rates that would not otherwise have been recoverable under the PSA;
- A Base Fuel Rate of \$0.0376 per kWh (compared to the prior Base Fuel Rate of \$0.0325 per kWh);
- 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;

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

- 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; 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.

**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 an 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 seeks various other determinations in its plan, including approval of the AZ Sun program, which provides for 100 MW of utility-owned solar resources through 2014 and recovery of associated costs through the RES adjustor until such costs can be recovered through APS’ base rates or alternative mechanisms. At its December open meeting, the ACC approved APS’ 2010 RES funding request, and deferred action on other portions of APS’ plan including the AZ Sun matter. On February 10, 2010, the ACC staff issued a recommendation that the ACC approve APS’ request on the AZ Sun matter. It is expected that the ACC will make a determination on this matter in March 2010.

**Demand-Side Management Adjustor Charge.** 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 but one of its proposed programs and expects to receive a determination from the ACC on the remaining program in the near future.

**PINNACLE WEST CAPITAL CORPORATION**  
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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 PSA, which the ACC initially approved in 2005 as a part of APS' 2003 rate case, and which was modified by the ACC in 2007, provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs. The PSA is subject to specified parameters and procedures, including the following:

- APS records deferrals for recovery or refund to the extent actual retail fuel and purchased power costs vary from the Base Fuel Rate;
- under a 90/10 sharing arrangement, APS defers 90% of the difference between retail fuel and purchased power costs (excluding certain costs, such as renewable energy resources and the capacity components of long-term purchase power agreements acquired through competitive procurement) and the Base Fuel Rate; APS absorbs 10% of the retail fuel and purchased power costs above the Base Fuel Rate and retains 10% of the benefit from the retail fuel and purchased power costs that are below the Base Fuel Rate;
- an adjustment to the PSA rate is made annually each February 1<sup>st</sup> (unless otherwise approved by the ACC) and goes into effect automatically unless suspended by the ACC;
- the PSA uses a forward-looking estimate of fuel and purchased power costs to set the annual PSA rate, which will be reconciled to actual costs experienced for each PSA Year (February 1 through January 31) (see the following bullet point); and
- the PSA rate includes (a) a "Forward Component," under which APS recovers or refunds differences between expected fuel and purchased power costs for the upcoming calendar year and those embedded in the Base Fuel Rate; (b) a "Historical Component," under which differences between actual fuel and purchased power costs and those recovered through the combination of the Base Fuel Rate and the Forward Component are recovered during the next PSA Year; and (c) a "Transition Component," under which APS may seek mid-year PSA changes due to large variances between actual fuel and purchased power costs and the combination of the Base Fuel Rate and the Forward Component.

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The following table shows the changes in the deferred fuel and purchased power regulatory asset (liability) for 2009 and 2008 (dollars in millions):

	Year Ended December 31,	
	2009	2008
Beginning balance	\$ 8	\$ 111
Deferred fuel and purchased power costs-current period	52	78
Interest on deferred fuel and purchased power	—	2
Amounts recovered through revenues	(147)	(183)
Ending balance	<u>\$ (87)</u>	<u>\$ 8</u>

The PSA rate for the PSA Year that began February 1, 2010 was set at (\$0.0045) per kWh. The \$87 million regulatory liability at December 31, 2009 reflected lower average prices and the seasonal nature of fuel and purchased power costs. These overcollected fuel cost deferrals during the 2009 PSA Year were refunded through the historical component of the PSA rate for the PSA Year beginning February 1, 2010. Since this 2010 PSA adjustment was a reduction of the PSA rate, the ACC accelerated the 2010 adjustment from February 1<sup>st</sup> to January 1<sup>st</sup> 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 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 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. The formula rate is 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. 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 TCA mechanism, by which changes in Retail Transmission Charges can be reflected in APS' retail rates.

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.

#### 4. Income Taxes

Certain assets and liabilities are reported differently for income tax purposes than they are for financial statements purposes. The tax effect of these differences is recorded as deferred taxes. We calculate deferred taxes using the current income tax rates.

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APS has recorded a regulatory asset and a regulatory liability related to income taxes on its Balance Sheets in accordance with accounting guidance for regulated operations. The regulatory asset is for certain temporary differences, primarily the allowance for equity funds used during construction. The regulatory liability relates to deferred taxes resulting primarily from pension and other postretirement benefits. APS amortizes these amounts as the differences reverse.

Pinnacle West expects to recognize approximately \$125 million of cash tax benefits related to SunCor's strategic asset sales (see Note 23) which will not be realized until the asset sale transactions are completed. Approximately \$105 million of these benefits were recorded in 2009 as reductions to income tax expense related to the current impairment charges. The additional \$20 million of tax benefits were recorded as reductions to income tax expense related to the SunCor impairment charge recorded in the fourth quarter of 2008.

The \$91 million income tax receivables on the Consolidated Balance Sheets represent the anticipated refunds related to an APS tax accounting method change approved by the IRS in the third quarter of 2009 and the current year tax benefits related to the SunCor strategic asset sales that closed in 2009.

The following is a tabular reconciliation of the total amounts of unrecognized tax benefits, excluding interest and penalties, at the beginning and end of the period that are included in accrued taxes and unrecognized tax benefits on the Consolidated Balance Sheets (dollars in thousands):

	2009	2008
Total unrecognized tax benefits, January 1	\$ 63,318	\$ 157,869
Additions for tax positions of the current year	44,094	12,923
Additions for tax positions of prior years	98,942	32,510
Reductions for tax positions of prior years for:		
Changes in judgment	—	(4,454)
Settlements with taxing authorities	(4,089)	(35,812)
Lapses of applicable statute of limitations	(1,049)	(99,718)
Total unrecognized tax benefits, December 31	<u>\$ 201,216</u>	<u>\$ 63,318</u>

Included in both balances of unrecognized tax benefits at December 31, 2009 and 2008 were approximately \$16 million of tax positions that, if recognized, would decrease our effective tax rate.

As of the balance sheet date, 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.

Within the next 12 months, it is reasonably possible that the Company will reach a settlement with the IRS with regard to the examination of tax returns for years ended December 31, 2005 through 2007. As a result of these anticipated settlements, and the expiration of certain statutes of limitations, the Company believes that it is reasonably possible that unrecognized tax benefits could be reduced by an amount up to \$70 million.

We reflect interest and penalties, if any, on unrecognized tax benefits in the Consolidated Statements of Income as income tax expense. The amount of interest recognized in the consolidated statement of income related to unrecognized tax benefits was a pre-tax expense of \$2 million for 2009 and pre-tax benefit of \$51 million for 2008.

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The total amount of accrued liabilities for interest recognized in the consolidated balance sheets related to unrecognized tax benefits was \$8 million as of December 31, 2009 and \$6 million as of December 31, 2008. To the extent that matters are settled favorably, this amount could reverse and decrease our effective tax rate. Additionally, as of December 31, 2009, we have recognized \$1 million of interest expense to be paid on the underpayment of income taxes for certain adjustments that we have filed, or will file, with the IRS.

The components of income tax expense are as follows (dollars in thousands):

	Year Ended December 31,		
	2009	2008	2007
<b>Current:</b>			
Federal	\$ (38,502)	\$ (85,866)	\$ 182,181
State	(38,080)	11,738	30,801
Total current	<u>(76,582)</u>	<u>(74,128)</u>	<u>212,982</u>
<b>Deferred:</b>			
Income from continuing operations	105,492	158,024	(56,147)
Discontinued operations	—	—	(343)
Total deferred	<u>105,492</u>	<u>158,024</u>	<u>(56,490)</u>
Total income tax expense	28,910	83,896	156,492
Less: income tax expense (benefit) on discontinued operations	(8,917)	6,999	4,486
Income tax expense — continuing operations	<u>\$ 37,827</u>	<u>\$ 76,897</u>	<u>\$ 152,006</u>

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The following chart compares pretax income from continuing operations at the 35% federal income tax rate to income tax expense — continuing operations (dollars in thousands):

	Year Ended December 31,		
	2009	2008	2007
Federal income tax expense at 35% statutory rate	\$ 36,770	\$ 107,870	\$ 158,355
Increases (reductions) in tax expense resulting from:			
State income tax net of federal income tax benefit	3,662	10,857	17,078
Credits and favorable adjustments related to prior years resolved in current year	—	(28,873)	(13,205)
Medicare Subsidy Part-D	(2,095)	(1,993)	(3,236)
Allowance for equity funds used during construction (see Note 1)	(4,264)	(5,755)	(6,899)
Other	3,754	(5,209)	(87)
Income tax expense — continuing operations	<u>\$ 37,827</u>	<u>\$ 76,897</u>	<u>\$ 152,006</u>

The following table shows the net deferred income tax liability recognized on the Consolidated Balance Sheets (dollars in thousands):

	December 31,	
	2009	2008
Current asset	\$ 53,990	\$ 79,729
Long-term liability	(1,496,095)	(1,403,318)
Accumulated deferred income taxes — net	<u>\$ (1,442,105)</u>	<u>\$ (1,323,589)</u>

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The components of the net deferred income tax liability were as follows (dollars in thousands):

	December 31,	
	2009	2008
<b>DEFERRED TAX ASSETS</b>		
Risk management activities	\$ 87,404	\$ 132,383
Regulatory liabilities:		
Asset retirement obligation	213,814	194,326
Deferred fuel and purchased power	34,463	—
Other	21,613	13,986
Pension and other postretirement liabilities	306,515	281,053
Deferred gain on Palo Verde Unit 2 sale leaseback	11,836	12,665
Real estate investments and assets held for sale	113,082	23,469
Other	48,602	78,210
Total deferred tax assets	<u>837,329</u>	<u>736,092</u>
<b>DEFERRED TAX LIABILITIES</b>		
Plant-related	(1,951,262)	(1,709,872)
Risk management activities	(20,863)	(20,732)
Regulatory assets:		
Allowance for equity funds used during construction	(23,285)	(20,174)
Deferred fuel and purchased power — mark-to-market	(16,167)	(46,593)
Pension and other postretirement benefits	(210,080)	(186,916)
Other	(57,210)	(58,519)
Other	(567)	(16,875)
Total deferred tax liabilities	<u>(2,279,434)</u>	<u>(2,059,681)</u>
Accumulated deferred income taxes — net	<u>\$ (1,442,105)</u>	<u>\$ (1,323,589)</u>

**PINNACLE WEST CAPITAL CORPORATION**  
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**5. Lines of Credit and Short-Term Borrowing**

Pinnacle West and APS maintain credit facilities in order to enhance liquidity and provide credit support. The credit and liquidity markets experienced significant stress beginning in the third quarter of 2008. Since the fourth quarter of 2008, Pinnacle West and APS have not accessed the commercial paper market due to negative market conditions. They have both been able to access existing credit facilities, ensuring adequate liquidity. The table below presents the consolidated lines of credit available and outstanding as of December 31, 2009 (dollars in millions):

Credit Facility	Expiration	Amount Committed	Borrowed	Unused Amount	Weighted Average Interest Rate	Commitment Fees
PNW Revolving Credit Line	December 2010	\$ 283	\$ 149	\$ 134	0.982%	0.15%
APS Revolving Credit Line	December 2010	377	—	377	—	0.11%
APS Revolving Credit Line	September 2011	489	—	489	—	0.10%
Other SunCor Short-term Borrowings	January 2010	—	5	—	LIBOR plus 2.50%	—
<b>Total</b>		<b>\$ 1,149</b>	<b>\$ 154</b>	<b>\$ 1,000</b>		

The PNW revolver is available to support the issuance of up to \$250 million in commercial paper or bank borrowings, including issuances of letters of credit up to \$94 million.

The APS 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 \$583 million. See Note 21 for discussion of APS' letters of credit. At December 31, 2009, APS had no borrowings and no letters of credit under its revolving lines of credit.

The table below presents the consolidated lines of credit available and outstanding as of December 31, 2008 (dollars in millions):

Credit Facility	Expiration	Amount Committed	Borrowed	Unused Amount	Weighted Average Interest Rate	Commitment Fees
PNW Revolving Credit Line	December 2010	\$ 300	\$ 144	\$ 156	2.713%	0.15%
APS Revolving Credit Line	December 2010	400	38	362	1.00%	0.11%
APS Revolving Credit Line	September 2011	500	484	16	2.18%	0.10%
Other SunCor Short-term Borrowings	January 2010	—	4	—	LIBOR plus 2.50%	—
<b>Total</b>		<b>\$ 1,200</b>	<b>\$ 670</b>	<b>\$ 534</b>		

Pinnacle West had a committed line of credit with various banks totaling \$300 million at December 31, 2008. Credit commitments totaling approximately \$17 million from Lehman Brothers were no longer available. The remaining \$283 million was available to support the issuance of up to \$250 million in commercial paper or bank borrowings, including issuances of letters of credit up to \$94 million of which \$7 million was outstanding.

APS had committed lines of credit totaling \$900 million at December 31, 2008. Credit commitments totaling approximately \$34 million from Lehman Brothers were no longer available. The remaining capacity of \$866 million under the APS revolvers was 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 \$583 million.



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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 revolving credit facility terminates in February 2013. Pinnacle West may 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, and for the issuance of letters of credit. Interest rates are based on Pinnacle West's senior unsecured debt credit ratings. In addition, because of the downsized revolving credit facility, the Company is in the process of reducing the size of its commercial paper program to \$200 million from \$250 million.

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 may 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 and for the issuance of letters of credit. Interest rates are based on APS' senior unsecured debt credit ratings.

Although provisions in APS' articles of incorporation and ACC financing orders establish maximum amounts of preferred stock and debt that APS may issue, APS does not expect any of these provisions to limit its ability to meet its capital requirements. On October 30, 2007, the ACC issued a financing order in which it approved APS' request, subject to specified parameters and procedures, to increase (a) APS' short-term debt authorization from 7% of APS' capitalization to (i) 7% of APS' capitalization plus (ii) \$500 million (which is required to be used for purchases of natural gas and power) and (b) APS' long-term debt authorization from approximately \$3.2 billion to \$4.2 billion in light of the projected growth of APS and its customer base and the resulting projected financing needs. This financing order expires December 31, 2012; however, all debt previously authorized and outstanding on December 31, 2012 will remain authorized and valid obligations of APS.

See discussion about SunCor's Secured Revolver in Note 6.

*Other Short-term Borrowings*

Neither Pinnacle West nor APS had commercial paper borrowings or other short-term debt at December 31, 2009 or December 31, 2008. SunCor had other short-term notes of approximately \$5 million at December 31, 2009 and December 31, 2008 with variable interest rates based on LIBOR plus 2.5%.

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

Substantially all of APS' debt is unsecured. SunCor's short and long-term debt is collateralized by interests in certain real property and Pinnacle West's debt is unsecured. The following table presents the components of long-term debt on the Consolidated Balance Sheets outstanding at December 31, 2009 and 2008 (dollars in thousands):

	Maturity Dates (a)	Interest Rates	December 31,	
			2009	2008
<b>APS</b>				
Pollution control bonds — Variable	2024-2038	(b)	\$ 222,880	\$ 539,145
Pollution control bonds — Fixed	2029-2034	(c)	342,975	—
Pollution control bonds with senior notes	2029	5.05%	90,000	90,000
Unsecured notes	2011	6.375%	400,000	400,000
Unsecured notes	2012	6.50%	375,000	375,000
Unsecured notes	2014	5.80%	300,000	300,000
Unsecured notes	2015	4.650%	300,000	300,000
Unsecured notes	2016	6.25%	250,000	250,000
Unsecured notes (d)	2019	8.75%	500,000	—
Unsecured notes	2033	5.625%	200,000	200,000
Unsecured notes	2035	5.50%	250,000	250,000
Unsecured notes	2036	6.875%	150,000	150,000
Secured note	2014	6.00%	1,075	1,258
Unamortized discount and premium			(7,185)	(7,908)
Capitalized lease obligations	2010-2012	(e)	2,837	3,621
Subtotal (f)			<u>3,377,582</u>	<u>2,851,116</u>
<b>SUNCOR</b>				
Notes payable	2010-2013	(g)	95,535	182,804
Capitalized lease obligations	2010-2012	(h)	100	329
Subtotal			<u>95,635</u>	<u>183,133</u>
<b>PINNACLE WEST</b>				
Senior notes	2011	5.91%	175,000	175,000
Total long-term debt			3,648,217	3,209,249
Less current maturities:				
APS			197,176	874
SunCor			80,517	176,772
Pinnacle West			—	—
Total			<u>277,693</u>	<u>177,646</u>
<b>TOTAL LONG-TERM DEBT LESS CURRENT MATURITIES</b>			<u>\$ 3,370,524</u>	<u>\$ 3,031,603</u>

- (a) This schedule does not reflect the timing of redemptions that may occur prior to maturities.
- (b) The weighted-average rate for the variable rate pollution control bonds was 0.25% at December 31, 2009 and 8.30% at December 31, 2008. The 2008 weighted average rate included rates associated with debt securities in auction rate mode. See discussion of the refinancing of pollution control bonds below.
- (c) The bonds' fixed rate of interest range from 5.00% to 6.00% and are subject to mandatory tender dates. Refer to the discussion below on Pollution Control Bonds.
- (d) On February 26, 2009, APS issued \$500 million of 8.75% unsecured senior notes that mature on March 1, 2019.
- (e) The weighted-average interest rate was 5.50% at December 31, 2009 and 5.51% at December 31, 2008.

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- (f) APS' long-term debt less current maturities was \$3.180 billion at December 31, 2009 and \$2.850 billion at December 31, 2008. APS' current maturities of long-term debt was \$197 million at December 31, 2009 and \$1 million at December 31, 2008.
- (g) SunCor had \$57 million outstanding at December 31, 2009 and \$120 million at December 31, 2008 under its secured revolver that matured on January 30, 2010. The weighted-average interest rates were 5.00% at December 31, 2009 and 4.19% at December 31, 2008. At December 31, 2009 and December 31, 2008 approximately \$39 million and \$63 million of other debt remained outstanding under other long-term credit facilities. The remaining debt which is primarily classified as current maturities of long-term debt consisted of multiple notes with variable interest rates of prime plus 2.0% and LIBOR plus 1.70%, 2.0%, 2.25% and 2.50% at December 31, 2009. At December 31, 2008, the remaining debt consisted of multiple notes with variable interest rates of prime plus 1.75% and 2.00% and LIBOR plus 1.70%, 2.00%, 2.25%, 2.50% and a fixed rate note of 4.25%. See below for further discussion of SunCor debt.
- (h) The weighted-average interest rate was 4.9% at December 31, 2009 and 6.2% at December 31, 2008.

**Debt Issuances****Unsecured Senior Notes**

On February 26, 2009, APS issued \$500 million of 8.75% unsecured senior notes that mature on March 1, 2019. Net proceeds from the sale of the notes were used to repay short-term borrowings under two committed revolving lines of credit incurred to fund capital expenditures and for general corporate purposes.

**Pollution Control Bonds**

During 2009, APS refinanced approximately \$343 million of its \$656 million pollution control bonds. As a result of these refinancings, which are described in the following table, APS no longer has any outstanding debt securities in auction rate mode. Each series of bonds, described below, is payable solely from revenues obtained from APS pursuant to a loan agreement between APS and the respective pollution control corporation. The interest rates on these bonds are fixed through the applicable interest reset dates as presented in the table below. At the interest reset dates, we will be required to purchase the bonds and will have the opportunity to remarket the bonds in daily, weekly, monthly or other interest rate modes at that time. These bonds are classified as long-term debt on our Consolidated Balance Sheets at December 31, 2009.

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Issuer	Navajo County, AZ Pollution Control Corporation (1)	Coconino County, AZ Pollution Control Corporation (2)	Maricopa County, AZ Pollution Control Corporation (3)
Issuance Date	May 28, 2009	May 28, 2009	June 26, 2009
Due Date	June 1, 2034	June 1, 2034	May 1, 2029
Bond series details (series, fixed interest rate, amount, reset date)	Series A – 5.00% \$38 million June 1, 2012	Series A – 5.50% \$13 million June 1, 2014	Series A – 6.00% \$36 million May 1, 2014
	Series B – 5.50% \$32 million June 1, 2014		Series B – 5.50% \$32 million May 1, 2012
	Series C – 5.50% \$32 million June 1, 2014		Series C – 5.75% \$32 million May 1, 2013
	Series D – 5.75% \$32 million June 1, 2016		Series D – 6.00% \$32 million May 1, 2014
	Series E – 5.75%, \$32 million June 1, 2016		Series E – 6.00% \$32 million May 1, 2014
Total	\$166 million	\$13 million	\$164 million
(1)	Issued to redeem all of approximately \$166 million of the Navajo County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds 2004 Series A-E, due 2034.		
(2)	Issued to redeem all of approximately \$13 million of the Coconino County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds 2004 Series A, due 2034.		
(3)	Issued to redeem all of approximately \$164 million of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds 2005 Series A-E, due 2029.		

On September 11, 2008, APS purchased all of the approximately \$27 million of the Coconino County, Arizona Pollution Control Corporation (“Coconino”) Pollution Control Revenue Bonds, Series 1996A and Series 1999 due December 2031 and April 2034 and held them as treasury bonds. On September 22, 2009, Coconino issued approximately \$27 million of Coconino Pollution Control Revenue Refunding Bonds, 2009 Series B due April 2038 to redeem the existing bonds. APS used the funds received from the issuance to repay certain existing indebtedness under a revolving line of credit drawn upon by APS to fund its purchase of the 1996A and 1999 Series Bonds in 2008. The 2009 Series B Bonds are payable solely from revenues obtained from APS pursuant to a loan agreement between APS and Coconino. According to the indenture of the bonds, the interest rate of the 2009 Series B Bonds could be reset daily, weekly, monthly, or at other time intervals. The initial rate period selected for the 2009 Series B Bonds is a daily rate period. At December 31, 2009, the daily interest rate was 0.26%. The daily rates are variable rates set by a remarketing agent. Concurrently with the issuance of the 2009 Series B Bonds, the Company entered into a two year letter of credit and reimbursement agreement to provide credit support for the 2009 Series B Bonds. These bonds are classified as long-term debt on our Consolidated Balance Sheets at December 31, 2009.

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Approximately \$196 million of pollution control bonds were classified as current maturities of long-term debt at December 31, 2009. Currently, interest rates on these bonds are set daily by a remarketing agent. Additionally, the bonds are backed by letters of credit that expire in 2010, at which time the letters of credit will have to be replaced, renewed or extended, or the bonds will have to be remarketed in a different interest rate mode. The bond holders will have to surrender the bonds back to APS if APS decides to remarket them in a different interest rate mode.

The interest rate on the remaining \$90 million of pollution control bonds with senior notes is fixed for life, and the bonds are also backed by insurance. The bonds are classified as long-term debt on our Consolidated Balance Sheets at December 31, 2009.

**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 December 31, 2009, the ratio was approximately 52% for Pinnacle West and 48% for APS. The provisions regarding interest coverage require minimum cash coverage of two times the interest requirements for APS. The interest coverage was approximately 4.6 times under APS' bank financing agreements as of December 31, 2009. 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 financing 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.

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 December 31, 2009, APS common equity ratio, as defined, was 50%. Its total common equity was approximately \$3.4 billion, and total capitalization was approximately \$6.8 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.

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*SunCor* — SunCor's principal loan facility, the SunCor Secured Revolver, is secured primarily by an interest in land, commercial properties, land contracts and homes under construction. At December 31, 2009, SunCor had borrowings of approximately \$57 million under the Secured Revolver. The revolver matured on January 30, 2010. SunCor and the agent bank for the Secured Revolver are discussing an extension of the maturity date to allow time for SunCor to continue discussions concerning the potential sale of additional properties. In addition to the Secured Revolver, at December 31, 2009, SunCor had approximately \$43 million of outstanding debt under other credit facilities (\$9 million of which has matured since December 31, 2009 and remains outstanding). SunCor intends to apply the proceeds of planned asset sales (see Note 23) to the repayment of its outstanding debt.

Real estate impairment charges recorded throughout 2009 (see Note 23) resulted in violations of certain covenants contained in the SunCor Secured Revolver and SunCor's other credit facilities. The lenders have taken no enforcement action related to the covenant defaults.

If SunCor is unable to obtain an extension or renewal of the 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. 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 waivers or similar relief from SunCor's lenders would have a material adverse impact on Pinnacle West's cash flows or liquidity.

As of December 31, 2009, SunCor could not transfer any cash dividends to Pinnacle West as a result of the covenants mentioned above. The restriction does not materially affect Pinnacle West's ability to meet its ongoing capital requirements.

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

Year	Pinnacle West- Consolidated	APS
2010	\$ 278	\$ 197
2011	616	428
2012	446	446
2013	33	32
2014	477	477
Thereafter	1,805	1,805
<b>Total</b>	<b>\$ 3,655</b>	<b>\$ 3,385</b>