

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 the related Notes.

OVERVIEW

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

The ACC regulates APS' retail electric rates. The key issue affecting Pinnacle West's and APS' financial outlook is the satisfactory resolution of APS' retail rate proceedings pending before the ACC. As discussed in greater detail in Note 3, APS has pending before the ACC:

- a general retail rate case pursuant to which APS is requesting a 21.3%, or \$453.9 million, increase in its annual retail electricity revenues effective no later than December 31, 2006;
- an application for an emergency interim rate increase of \$299 million, or approximately 14%, to be effective April 1, 2006 (the increase would accelerate recovery of the fuel and purchased power component of APS' general rate case and is not an additional increase and would be subject to refund); and
- an application for a temporary rate increase of approximately 2.6%, through two separate PSA surcharges, to recover \$59.9 million in retail fuel and purchased power costs deferred by APS in 2005 under the PSA.

APS has been operating Palo Verde Unit 1 at reduced power levels since December 25, 2005 due to a non-safety related acoustic impact in one of the unit's shutdown cooling lines. Unit 1 is currently operating at approximately 25% power. APS has concluded after comprehensive analysis that the preferred solution will require Unit 1 to undergo an outage of approximately five weeks in order for APS to effect the necessary modifications to the Unit. APS anticipates that Unit 1 will begin this outage in the June timeframe. In addition, an outage for preparatory work of approximately one week, beginning March 18, 2006, will take place prior to this outage. This preferred solution was initially planned for installation in the spring of 2007. APS estimates that, through February 28, 2006, Unit 1's reduced power level has resulted in incremental replacement power costs of approximately \$20 million after income taxes, approximately \$18 million of which has been incurred since January 1, 2006. Based on current forward market energy prices, APS estimates that (a) operating Unit 1 at reduced power levels until the assumed outage in the June timeframe will result in additional incremental replacement power costs of approximately \$25 million after income taxes and (b) the June Unit 1 outage will result in additional incremental replacement power costs of approximately \$15 million after income taxes. APS estimates that these reduced power levels and the June Unit 1 outage will result in additional PSA deferrals of \$50 million after tax (\$85 million pretax) in 2006. See "Deferred Fuel and Purchased Power Costs" below.

SunCor, our real estate development subsidiary, has been and is expected to be an important source of earnings and cash flow. Our subsidiary, APS Energy Services, provides competitive commodity-related energy services and energy-related products and services to commercial and industrial retail customers in the western United States. El Dorado, our investment subsidiary, owns minority interests in several energy-related investments and Arizona community-based ventures.

Pinnacle West Energy is our subsidiary that previously owned and operated unregulated generating plants. Pursuant to the ACC's April 7, 2005 order in APS' 2003 rate case, on July 29, 2005, Pinnacle West Energy transferred the PWEC Dedicated Assets to APS. See "APS 2003 Rate Case" in Note 3. Pinnacle West Energy sold its 75% interest

in Silverhawk to NPC on January 10, 2006. As a result Pinnacle West Energy no longer owns any generating plants and has ceased operations.

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

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

EARNINGS CONTRIBUTION BY BUSINESS SEGMENT

We have three principal business segments (determined by products, services and the regulatory environment):

- 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;
- our real estate segment, which consists of SunCor’s real estate development and investment activities; and
- our marketing and trading segment, which consists of our competitive energy business activities, including wholesale marketing and trading and APS Energy Services’ commodity-related energy services.

The following table summarizes net income for 2005, 2004 and 2003 (dollars in millions):

	2005	2004	2003
Regulated electricity	\$ 167	\$ 152	\$ 170
Real estate	35	40	45
Marketing and trading	16	29	8
Other (a)	5	26	2
Income from continuing operations	223	247	225
Discontinued operations – net of tax:			
Real estate (b)	17	4	10
Marketing and trading (c)	(67)	(12)	1
Other (d)	3	4	5
Net income	\$ 176	\$ 243	\$ 241

(a) Includes a \$21 million after-tax gain in 2004 related to the sale of a limited partnership interest in the Phoenix Suns.

(b) Primarily relates to sales of commercial properties.

(c) See “Sale of Silverhawk” below.

(d) Relates to the 2004 sale of NAC.

RESULTS OF OPERATIONS

General

Throughout the following explanations of our results of operations, we refer to “gross margin.” With respect to our regulated electricity segment and our marketing and trading segment, gross margin refers to electric operating revenues less fuel and purchased power costs. “Gross margin” is a “non-GAAP financial measure,” as defined in accordance with Securities and Exchange Commission rules. The charts on pages 82-83 reconcile this non-GAAP financial measure to operating income, which is the most directly comparable financial measure calculated and presented in accordance with GAAP. We view gross margin as an important performance measure of the core profitability of our operations. This measure is a key component of our internal financial reporting and is used by our management in analyzing our business segments. We believe that investors benefit from having access to the same financial measures that our management uses. In addition, we have reclassified certain prior year amounts to conform to our current-period presentation.

Sale of Silverhawk

In June 2005, we entered into an agreement to sell our 75% interest in Silverhawk to NPC. As a result of the sale, we recorded an after-tax loss from discontinued operations of approximately \$56 million in the second quarter of 2005.

The marketing and trading segment discontinued operations in the chart above include this loss as well as revenues and expenses related to the operations of Silverhawk. The sale was completed on January 10, 2006.

Deferred Fuel and Purchased Power Costs

The settlement of APS' 2003 general retail rate case became effective April 1, 2005. As part of the settlement, the ACC approved a 4.2% annual retail rate increase and the PSA, which provides mechanisms for adjusting rates to reflect variations in fuel and purchased power costs. In accordance with the PSA, APS defers for future rate recovery 90% of the difference between actual fuel and purchased power costs, net of Off-System Sales margins, and the amount for such costs currently included in base rates. The current base rate for fuel and purchased power costs is based on 2003 price levels and spot prices for natural gas and wholesale power have increased over 40% since then. Although APS defers actual fuel and purchased power costs on a current basis, APS' recovery of the deferrals from its ratepayers is subject to annual PSA adjustments and ACC approval of periodic surcharge applications.

Actual fuel and purchased power costs are higher than in prior periods primarily due to higher fuel prices and increased plant outage days.

APS' pretax PSA deferrals were approximately \$173 million at December 31, 2005. Based on recent forward market prices for natural gas and purchased power (which are subject to change), and assuming no interim rate relief, APS estimates that its pretax PSA deferrals in 2006 will be approximately \$240 million to \$250 million. In January 2006, the ACC approved the first annual adjustment under the PSA mechanism, which is expected to recover approximately \$110 million of the 2005 balance of \$173 million from retail customers over twelve months beginning February 1, 2006. In this same order, the ACC granted APS the authority to continue to defer fuel costs in excess of the \$776.2 million annual fuel cost cap established in the 2005 rate order and to seek recovery of those amounts in a future proceeding. On February 2, 2006, APS filed a request with the ACC to recover the remainder of the retail portion of the 2005 deferred fuel balance of \$173 million – approximately \$60 million – through two surcharges. The first surcharge is to recover \$15 million over a twelve-month period proposed to begin with the date of the ACC's decision in APS' pending emergency interim rate case. The second surcharge is to recover approximately \$45 million over a twelve-month period proposed to begin no later than the ACC's completion of its inquiry regarding unplanned 2005 outages at Palo Verde. The \$45 million of PSA deferrals represents additional replacement power costs associated with these outages. See Note 3. See "Overview" above for information about Palo Verde Unit 1 operating at reduced power levels and the related economic impact.

2005 Compared with 2004

Our consolidated net income for 2005 was \$176 million compared with \$243 million for the prior year. The current-year net income included an after-tax net loss from discontinued operations of \$47 million compared with a \$4 million after-tax loss in the prior year, which for both years is related primarily to the sale and operations of Silverhawk (see "Sale of Silverhawk" above), partially offset by sales of commercial properties at SunCor. Income from continuing operations decreased \$24 million in the period-to-period comparison, reflecting the following changes in earnings by segment:

- Regulated Electricity Segment – Income from continuing operations increased approximately \$15 million primarily due to deferred fuel and purchased power costs; a retail price increase effective April 1, 2005; higher retail sales volumes due to customer growth; lower depreciation due to lower depreciation rates; lower regulatory asset amortization; and effects of weather on retail sales. These positive factors were partially offset by the regulatory disallowance of plant costs in accordance with the APS retail rate case settlement; higher fuel and purchased power costs primarily due to higher prices and more plant outage days; higher operations and maintenance expense related to generation and customer service; and higher property taxes due to increased plant in service.
- Real Estate Segment – Income from continuing operations decreased approximately \$5 million primarily due to decreased parcel sales, partially offset by increased margins on home sales. Income from discontinued real estate operations increased \$13 million due to higher commercial property sales.

- Marketing and Trading Segment – Income from continuing operations decreased approximately \$13 million primarily due to lower unit margins on competitive retail sales in California; the absence of Off-System Sales that we began reporting in the regulated electricity segment in April 2005; and lower mark-to-market gains on contracts for future delivery.
- Other Segment – Income from continuing operations decreased approximately \$21 million primarily due to an after-tax gain related to the sale of a limited partnership interest in the Phoenix Suns recorded in the prior year.

Additional details on the major factors that increased (decreased) net income are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment gross margin:		
Deferred fuel and purchased power costs (see discussion above)	\$ 171	\$ 104
Retail price increase effective April 1, 2005	65	40
Higher retail sales volumes due to customer growth, excluding weather effects	58	35
Effects of weather on retail sales	14	9
Higher fuel and purchased power costs primarily due to higher prices and more plant outage days	(126)	(77)
Miscellaneous items, net	(8)	(5)
Net increase in regulated electricity segment gross margin	174	106
Marketing and trading segment gross margin:		
Lower unit margins on competitive retail sales in California	(13)	(8)
Lower realized margins on wholesale sales primarily due to the absence of sales that we began reporting in the regulated segment in April 2005	(4)	(3)
Lower mark-to-market gains on contracts for future delivery due to changes in forward prices	(4)	(2)
Net decrease in marketing and trading segment gross margin	(21)	(13)
Net increase in gross margin for regulated electricity and marketing and trading segments	153	93
Regulatory disallowance, in accordance with the APS retail rate case settlement	(139)	(84)
Lower real estate segment contribution primarily related to decreased parcel sales, partially offset by increased margins on home sales	(8)	(5)
Lower other income primarily due to sale of limited partnership interest in Phoenix Suns recorded in the prior year, partially offset by higher interest income	(30)	(18)
Operations and maintenance increases primarily due to:		
Generation costs, including maintenance and overhauls	(20)	(12)
Customer service costs, including regulatory demand-side management programs and planned maintenance	(20)	(12)
Miscellaneous items, net	(4)	(2)
Depreciation and amortization decreases primarily due to:		
Lower regulatory asset amortization	22	13
Lower depreciation rates, partially offset by increased depreciable assets	22	13
Higher property taxes primarily due to increased plant in service	(11)	(7)
Miscellaneous items, net	2	(3)
Net decrease in income from continuing operations	\$ (33)	(24)
Discontinued operations related to:		
Sale of Silverhawk (see discussion above)		(56)
Sales of real estate assets and other		13
Net decrease in net income		\$ (67)

Regulated Electricity Segment Revenues

Regulated electricity segment revenues were \$202 million higher for 2005 compared with the prior year primarily as a result of:

- an \$81 million increase in retail revenues related to customer growth, excluding weather effects;
- a \$65 million increase in retail revenues due to a price increase effective April 1, 2005;
- a \$40 million increase in Off-System Sales primarily resulting from sales previously reported in the marketing and trading segment that were classified beginning in April 2005 as sales in the regulated electricity segment in accordance with the APS retail rate case settlement;
- an \$11 million increase in retail revenues related to weather; and
- a \$5 million increase due to miscellaneous factors.

Marketing and Trading Segment Revenues

Marketing and trading segment revenues were \$49 million lower for 2005 compared with the prior year primarily as a result of:

- a \$40 million decrease in Off-System Sales due to the absence of sales previously reported in the marketing and trading segment that were classified beginning in April 2005 as sales in the regulated electricity segment in accordance with the APS retail rate case settlement;
- a \$4 million decrease in mark-to-market gains on contracts for future delivery due to changes in forward prices;
- a \$3 million decrease in marketing and trading revenues due to lower sales volumes; and
- a \$2 million decrease from lower volumes of competitive retail sales in California.

Real Estate Revenues

Real estate revenues were \$12 million lower for 2005 compared with the prior year primarily due to decreased parcel sales, partially offset by increased home sales at SunCor.

Other Revenues

Other revenues were \$18 million higher for 2005 compared with the prior year primarily due to increased sales of energy-related products and services by APS Energy Services.

2004 Compared with 2003

Our consolidated net income for 2004 was \$243 million compared with \$241 million for the prior year. 2004 net income included an after-tax net loss from discontinued operations of \$4 million primarily related to Silverhawk. The 2003 net income included a \$16 million after-tax gain from discontinued operations primarily related to sales of commercial properties at SunCor. Income from continuing operations increased \$22 million in the period-to-period comparison, reflecting the following changes in earnings by segment:

- Regulated Electricity Segment – Income from continuing operations decreased approximately \$18 million primarily due to higher costs (primarily interest expense, depreciation, operation and maintenance costs and property taxes, net of gross margin contributions) related to a new power plant placed in service in mid-2003; increased operations and maintenance costs primarily related to customer service and personnel costs; lower income tax credits; higher depreciation related to delivery and other assets; the effects of milder weather on retail sales; and a retail electricity rate decrease in mid-2003. These negative factors were partially offset by lower regulatory asset amortization, and higher retail sales volumes due to customer growth and usage.
- Real Estate Segment – Income from continuing operations decreased approximately \$5 million due to decreased asset sales, partially offset by increased land sales. Income from discontinued operations decreased \$6 million primarily due to the 2003 gain on the sale of SunCor's water utility company (see Note 22).
- Marketing and Trading Segment – Income from continuing operations increased approximately \$21 million primarily due to higher forward and realized prices for wholesale electricity, partially offset by lower margins

in California by APS Energy Services. Income from discontinued operations decreased \$13 million due to Silverhawk (see Note 22).

- Other Segment – Income from continuing operations increased approximately \$24 million primarily due to a \$21 million after-tax gain related to the sale of El Dorado’s limited partnership interest in the Phoenix Suns.

Additional details on the major factors that increased (decreased) income from continuing operations and net income are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment gross margin:		
Higher retail sales volumes due to customer growth, excluding weather effects	\$43	\$26
Lower replacement power costs due to fewer unplanned outages	6	4
Effects of weather on retail sales	(17)	(10)
Retail electricity price reduction effective July 1, 2003	(13)	(8)
Increased purchased power and fuel costs due to higher fuel and power prices	(4)	(2)
Miscellaneous factors, net	(8)	(6)
Net increase in regulated electricity segment gross margin	7	4
Marketing and trading segment gross margin:		
Higher mark-to-market gains on contracts for future delivery due to higher forward prices for wholesale electricity	28	17
Higher realized margins on energy trading primarily due to higher electricity prices	18	11
Increase in Off-System Sales due to higher sales volumes and higher unit margins	10	6
Lower unit margins and lower competitive retail sales volumes in California by APS Energy Services	(22)	(13)
Net increase in marketing and trading segment gross margin	34	21
Net increase in gross margin for regulated electricity and marketing and trading segments	41	25
Lower real estate segment contributions primarily due to decreased asset sales, a portion of which was recorded in other income in the prior period, partially offset by higher land sales (see Note 22)	(7)	(5)
Higher other income due to the sale of El Dorado's limited partnership interest in the Phoenix Suns	35	21
Higher operations and maintenance expense primarily related to customer service costs, new power plants in service and personnel costs	(44)	(26)
Interest expense net of capitalized financing costs, decreases (increases):		
New power plants in service	(16)	(10)
Lower other debt balances and rates partially offset by increased utility plant in service	9	5
Depreciation and amortization decreases (increases):		
Lower regulatory asset amortization	68	41
New power plants in service	(4)	(2)
Increased delivery and other assets	(20)	(12)
Higher property taxes due to increased plant in service	(10)	(6)
Lower income tax credits	–	(17)
Miscellaneous items, net	3	8
Net increase in income from continuing operations	\$55	22
Discontinued operations (see Note 22)		(20)
Net increase in net income		\$ 2

The increase in net costs (primarily interest expense, depreciation and operations and maintenance expense, net of gross margin contributions) related to new power plants placed in service in mid-2003 and mid-2004 by Pinnacle West Energy totaled approximately \$26 million after income taxes in 2004 compared with the prior year.

Regulated Electricity Segment Revenues

Regulated electricity segment revenues were \$57 million higher for 2004 compared with the prior year primarily as a result of:

- a \$101 million increase in retail revenues related to customer growth and higher average usage, excluding weather effects;
- a \$42 million decrease in retail revenues related to milder weather;
- a \$13 million decrease in retail revenues related to a reduction in retail electricity prices; and
- an \$11 million increase due to miscellaneous factors.

Marketing and Trading Segment Revenues

Marketing and trading segment revenues were \$9 million higher for 2004 compared with the prior year primarily as a result of:

- \$28 million in higher mark-to-market gains for future-period deliveries primarily as a result of higher forward prices for wholesale electricity;
- a \$25 million decrease from lower competitive retail sales volumes in California by APS Energy Services;
- \$20 million of higher energy trading revenues on realized sales of electricity primarily due to higher electricity prices; and
- a \$14 million decrease in Off-System Sales primarily due to lower wholesale unit margins and lower sales volumes.

Other Revenues

Other revenues were \$15 million higher for 2004 compared with the prior year primarily due to higher non-commodity revenues at APS Energy Services.

LIQUIDITY AND CAPITAL RESOURCES

Capital Needs and Resources

CAPITAL EXPENDITURE REQUIREMENTS

The following table summarizes the actual capital expenditures for the year ended 2005 and estimated capital expenditures for the next three years (dollars in millions):

	Actual	Estimated		
	2005	2006	2007	2008
APS				
Distribution	\$325	\$322	\$323	\$362
Transmission	92	120	169	203
Generation (a)	356	184	207	279
Other (b)	36	23	16	13
Subtotal	809	649	715	857
SunCor (c)	106	232	142	119
Other	13	6	2	6
Total	\$928	\$887	\$859	\$982

(a) Includes \$185 million in 2005 for the acquisition of the Sundance Plant.

(b) Primarily information systems and facilities projects.

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

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

Generation capital expenditures are comprised of various improvements to APS' existing fossil and nuclear plants, the acquisition of the Sundance Plant and the replacement of Palo Verde steam generators (see below). Examples of the types of projects included in this category are additions, upgrades and capital replacements of various power plant equipment such as turbines, boilers and environmental equipment. Generation also includes nuclear fuel expenditures of approximately \$35 million annually for 2006 through 2008.

Replacement of the steam generators at Palo Verde Unit 1 was completed during the fall 2005 outage at a cost to APS of approximately \$70 million. The Palo Verde owners have approved the manufacture of one additional set of steam generators. These generators will be installed in Unit 3 and are scheduled for completion in the fall of 2007 at an approximate cost of \$75 million (APS' share). Approximately \$20 million of the Unit 3 steam generator costs have been incurred through 2005 with the remaining \$55 million included in future years in the capital expenditure table above. Capital expenditures will be funded with internally generated cash or external financings.

CONTRACTUAL OBLIGATIONS

The following table summarizes Pinnacle West's consolidated contractual requirements as of December 31, 2005 (dollars in millions):

	2006	2007-2008	2009-2010	Thereafter	Total
Long-term debt payments, including interest (a):					
APS	\$ 219	\$ 259	\$ 480	\$ 3,350	\$4,308
Pinnacle West	312	–	–	–	312
SunCor	9	143	–	–	152
Total long-term debt payments, including interest	540	402	480	3,350	4,772
Short-term debt payments, including interest (b)	16	–	–	–	16
Capital lease payments	2	2	2	2	8
Operating lease payments	74	144	133	303	654
Minimum pension funding requirement (c)	37	–	–	–	37
Purchase power and fuel commitments (d)	316	419	256	908	1,899
Purchase obligations (e)	25	9	–	75	109
Nuclear decommissioning funding requirements	21	42	46	259	368
Total contractual commitments	\$ 1,031	\$ 1,018	\$ 917	\$ 4,897	\$ 7,863

(a) The long-term debt matures at various dates through 2035 and bears interest principally at fixed rates. Interest on variable-rate long-term debt is determined by using the rates at December 31, 2005 (see Note 6).

(b) The short-term debt matures within 12 months and is primarily related to short-term loans at SunCor. These loans are made up of multiple notes primarily with variable interest rates based on prime plus 1.75% or LIBOR plus 2.25% and 2.50% at December 31, 2005 (see Note 5).

(c) Future pension contributions are not determinable for time periods after 2006.

(d) Our fuel and purchased power commitments include purchases of coal, electricity, natural gas and nuclear fuel (see Note 11).

(e) These contractual obligations include commitments for capital expenditures and other obligations.

OFF-BALANCE SHEET ARRANGEMENTS

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

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of December 31, 2005, APS would have been required to assume approximately \$234 million of debt and pay the equity participants approximately \$185 million.

GUARANTEES AND LETTERS OF CREDIT

We and certain of our subsidiaries have issued guarantees and letters of credit in support of our unregulated businesses. We have also obtained surety bonds on behalf of APS Energy Services. We have not recorded any liability on our Consolidated Balance Sheets with respect to these obligations. 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.

CREDIT RATINGS

The ratings of securities of Pinnacle West and APS as of March 7, 2006 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 those companies' cost of and access to capital. It may also require additional collateral related to certain derivative instruments (see Note 18).

	Moody's	Standard & Poor's
PINNACLE WEST		
Senior unsecured	Baa2	BB+
Commercial paper	P-2	A-3
Outlook	Under Review for Possible Downgrade	Stable
APS		
Senior unsecured	Baa1	BBB-
Secured lease obligation bonds	Baa1	BBB-
Commercial paper	P-2	A-3
Outlook	Under Review for Possible Downgrade	Stable

DEBT PROVISIONS

Pinnacle West's and APS' debt covenants related to their respective bank financing arrangements include a debt to capitalization ratio. 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 each of Pinnacle West and APS, these covenants require that the ratio of consolidated debt to total consolidated capitalization cannot exceed 65%. At December 31, 2005, the ratio was approximately 49% for Pinnacle West and 47% for APS. The provisions regarding interest coverage require a minimum cash coverage of two times the interest requirements for APS. The interest coverage is approximately 4 times under APS' bank financing agreements as of December 31, 2005. 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.

Neither Pinnacle West's nor APS' financing agreements contain "rating triggers" that would result in an acceleration of the required interest and principal payments in the event of a rating downgrade. However, in the event of a further rating downgrade, Pinnacle West and/or APS may be subject to increased interest costs under certain financing agreements.

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

See Note 6 for further discussions.

Capital Needs and Resources

PINNACLE WEST (PARENT COMPANY)

Our primary cash needs are for dividends to our shareholders and principal and interest payments on our long-term debt. On October 19, 2005, our Board of Directors increased the common stock dividend to an indicated annual rate of \$2.00 per share from \$1.90 per share, effective with the December 1, 2005 dividend payment. The level of our common dividends and future dividend growth will be dependent on a number of factors including, but not limited to, payout ratio trends, free cash flow and financial market conditions.

Our primary sources of cash are dividends from APS, external financings and cash distributions from our other subsidiaries, primarily SunCor. For the years 2003 through 2005, total dividends from APS were \$510 million and total cash contributions from SunCor were \$243 million. For the year ended December 31, 2005 cash contributions from APS were approximately \$170 million and distributions from SunCor were approximately \$50 million. An ACC financing order requires APS to maintain a common equity ratio of at least 40% and prohibits APS from paying common stock dividends if the payment would reduce its common equity below that threshold. At December 31, 2005, APS' common equity ratio, as defined, was approximately 54%.

At December 31, 2005, Pinnacle West's outstanding long-term debt, including current maturities, was \$299 million. In December 2005, we replaced the existing revolving credit facility with a \$300 million revolving credit facility that terminates in December 2010. This line of credit is available to support the issuance of up to \$250 million in commercial paper or to be used as bank borrowings, including issuances of letters of credit. At December 31, 2005, we had no commercial paper or short-term borrowings outstanding. We ended 2005 in an invested position.

Pinnacle West sponsors a qualified pension plan for the employees of Pinnacle West and our subsidiaries. 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 the fund assets and our pension obligation. The assets in the plan are comprised of common stocks, bonds, common and collective trusts and short-term investments. Future year contribution amounts are dependent on fund performance and fund valuation assumptions. We contributed \$53 million in 2005. The contribution to our pension plan in 2006 is estimated to be approximately \$50 million. The expected contribution to our other postretirement benefit plans in 2006 is estimated to be approximately \$29 million. APS and other subsidiaries fund their share of the contributions. APS' share is approximately 96% of both plans.

On May 2, 2005, Pinnacle West redeemed at par all of its \$165 million Floating Rate Senior Notes due November 1, 2005. The Company used cash on hand to redeem the notes.

On May 2, 2005, Pinnacle West issued 6,095,000 shares of its common stock at an offering price of \$42 per share, resulting in net proceeds of approximately \$248 million. Pinnacle West used the net proceeds for general corporate purposes, including making capital contributions to APS, which, in turn, used a portion of such funds to acquire the Sundance Plant and fund other capital expenditures to meet the growing needs of APS' service territory.

On February 28, 2006, Pinnacle West entered into an Uncommitted Master Shelf Agreement with Prudential Investment Management, Inc. ("Prudential") and certain of its affiliates. The agreement provides the terms under which Pinnacle West may offer up to \$200 million of its senior notes for purchase by Prudential affiliates at any time prior to December 31, 2007. The maturity of notes issued under the agreement cannot exceed five years. Pursuant to the agreement, on February 28, 2006, Pinnacle West issued and sold to Prudential affiliates \$175 million aggregate principal amount of its 5.91% Senior Notes, Series A, due February 28, 2011 (the "Series A Notes"). Pinnacle West will use the proceeds of the Series A Notes to repay at maturity a portion of the \$300 million aggregate principal amount of its 6.40% Senior Notes due April 1, 2006 or for other general corporate purposes.

See "Equity Infusions" in Note 3 for information regarding the ACC approval of Pinnacle West's infusion of more than \$450 million of equity into APS, consisting of about \$250 million of the proceeds of Pinnacle West's common equity issuance and about \$210 million of the proceeds from the sale of Silverhawk in January 2006.

APS

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

On January 15, 2005, APS repaid its \$100 million 6.25% Notes due 2005. APS used cash on hand to redeem these notes.

On March 1, 2005, Maricopa County, Arizona Pollution Control Corporation issued \$164 million of variable interest rate pollution control bonds, 2005 Series A-E, due 2029. The bonds were issued to refinance \$164 million of outstanding pollution control bonds. The Series A-E bonds are payable solely from revenues obtained from APS pursuant to a loan agreement between APS and Maricopa County, Arizona Pollution Control Corporation. These bonds are classified as long-term debt on our Balance Sheets.

On May 12, 2003, APS issued \$500 million of debt and made a \$500 million loan to Pinnacle West Energy. Pinnacle West Energy distributed the net proceeds of that loan to Pinnacle West to fund the repayment of a portion of the debt incurred to finance the construction of the PWEC Dedicated Assets. On April 11, 2005, this loan was repaid with the proceeds of a new debt issuance by Pinnacle West Energy.

On August 1, 2005, APS repaid \$300 million of its 7.625% Notes due 2005. APS used cash on hand to repay these notes.

On August 22, 2005, APS issued \$250 million of 5.50% Senior Unsecured Notes due September 1, 2035. A portion of the net proceeds from the sale of the notes was used for general corporate purposes and, on October 3, 2005, APS used the balance of the proceeds, along with cash on hand, to fund the \$500 million that it was obligated to transfer to Pinnacle West Energy in connection with APS' acquisition of the PWEC Dedicated Assets. APS satisfied this obligation to Pinnacle West Energy on October 3, 2005.

APS' outstanding debt was approximately \$2.6 billion at December 31, 2005. In December 2005, APS replaced its \$325 million revolving credit facility that would have terminated in May 2007 with a \$400 million revolving credit facility that terminates in December 2010. This line of credit is 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. At December 31, 2005, APS had no outstanding commercial paper or bank borrowings. APS ended 2005 in an invested position.

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.

See "Deferred Fuel and Purchased Power Costs" above and "Power Supply Adjustor" in 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 PSA adjustments and ACC approval of periodic surcharge applications.

See "Cash Flow Hedges" in Note 18 for information related to increased collateral provided to us by counterparties.

PINNACLE WEST ENERGY

On April 11, 2005, Pinnacle West Energy issued \$500 million Floating Rate Senior Notes due April 1, 2007. Pinnacle West unconditionally guaranteed these notes. Pinnacle West Energy used the proceeds of this issuance to repay the \$500 million loan from APS to Pinnacle West Energy described under "Capital Needs and Resources – APS" above. On October 3, 2005, Pinnacle West Energy repaid the Floating Rate Senior Notes due April 1, 2007 with \$500 million received from APS in connection with the transfer of the PWEC Dedicated Assets.

See Note 22 of Notes to Consolidated Financial Statements above for a discussion of the sale of our 75% ownership interest in Silverhawk.

OTHER SUBSIDIARIES

During the past three years, SunCor funded its cash requirements with cash from operations and its own external financings. SunCor's capital needs consist primarily of capital expenditures for land development and retail and office building construction. See the capital expenditures table above for actual capital expenditures during 2005 and projected capital expenditures for the next three years. SunCor expects to fund its future capital requirements with cash from operations and external financings.

SunCor's total outstanding debt was approximately \$145 million as of December 31, 2005, including \$123 million of debt outstanding, which is classified as long-term debt, under a \$150 million line of credit. SunCor's total short-term debt was \$16 million at December 31, 2005. SunCor's long-term debt, including current maturities, totaled \$129 million at December 31, 2005. See Note 6.

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

APS Energy Services expects minimal capital expenditures over the next three years.

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. If future recovery of costs ceases to be probable, the assets would be written off as a charge in current period earnings. A major component of our regulatory assets is the retail fuel and power costs deferred under the PSA. APS defers for future rate recovery 90% of the difference between actual retail fuel and power costs and the amount of such costs currently included in base rates. We had \$324 million, including \$173 million related to the PSA, of regulatory assets on the Consolidated Balance Sheets at December 31, 2005. Included in the \$173 million is approximately \$45 million related to the 2005 unplanned Palo Verde outages, which currently are the subject of inquiry by the ACC. In addition, we had \$592 million of regulatory liabilities on the Consolidated Balance Sheets at December 31, 2005, which primarily are related to removal costs. See Notes 1 and 3 for more information about regulatory assets, APS' general rate case and power supply adjustor.

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, 2005 projected benefit obligation, our December 31, 2005 reported pension liability on the Consolidated Balance Sheets and our 2005 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 Projected Benefit Obligation	Impact on Pension Liability	Impact on Pension Expense
Discount rate:			
Increase 1%	\$(207)	\$(170)	\$(8)
Decrease 1%	237	195	8
Expected long-term rate of return on plan assets:			
Increase 1%	–	–	(4)
Decrease 1%	–	–	4

(a) Each fluctuation assumes that the other assumptions of the calculation are held constant.

The following chart reflects the sensitivities that a change in certain actuarial assumptions would have had on the December 31, 2005 accumulated other postretirement benefit obligation and our 2005 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 Accumulated Other Postretirement Benefit Obligation	Impact on Other Postretirement Benefit Expense
Discount rate:		
Increase 1%	\$(84)	\$(4)
Decrease 1%	106	5
Health care cost trend rate (b):		
Increase 1%	100	7
Decrease 1%	(79)	(6)
Expected long-term rate of return on plan assets – pretax:		
Increase 1%	–	(1)
Decrease 1%	–	1

(a) Each fluctuation assumes that the other assumptions of the calculation are held constant.

(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 fair value hedges, the gain or loss on the derivative as well as the offsetting loss or gain on the hedged item associated with the hedged risk are recognized in earnings. For cash flow hedges, the effective portion of changes in the fair value of the derivative are recognized in common stock equity (as a component of other comprehensive income (loss)).

The fair value of our derivative contracts is not always readily determinable. In some cases, we use models and other valuation techniques to determine fair value. The use of these models and valuation techniques sometimes requires subjective and complex judgment. Actual results could differ from the results estimated through application of these methods. Our marketing and trading portfolio consists of structured activities hedged with a portfolio of forward purchases that protects the economic value of the sales transactions. See “Market Risks – Commodity Price Risk” below for quantitative analysis. See Note 1 for discussion on accounting policies and Note 18 for a further discussion on derivative and energy trading accounting.

FACTORS AFFECTING OUR FINANCIAL OUTLOOK

Factors Affecting Operating Revenues, Fuel and Purchased Power Costs

GENERAL Electric operating revenues are derived from sales of electricity in regulated retail markets in Arizona and from competitive retail and wholesale power markets in the western United States. These revenues are affected by electricity sales volumes related to customer mix, customer growth and average usage per customer as well as electricity rates and tariffs and variations in weather from period to period. Competitive sales of energy and energy-related products and services are made by APS Energy Services in certain western states that have opened to competition.

RETAIL RATE PROCEEDINGS The key issue affecting Pinnacle West’s and APS’ financial outlook is the satisfactory resolution of APS’ retail rate proceedings pending before the ACC. As discussed in greater detail in Note 3, APS has pending before the ACC a general retail rate case, an application for an emergency interim rate increase, and an application for two separate surcharges under the PSA.

FUEL AND PURCHASED POWER COSTS Fuel and purchased power costs 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, variances in deferrals and amortization of fuel and purchased power beginning on April 1, 2005 and our hedging program for managing such costs. See “Power Supply Adjustor” in Note 3 for information regarding the PSA approved by the ACC. See “Natural Gas Supply” in Note 11 for more information on fuel costs. See “Overview” above for information about Palo Verde Unit 1 operating at reduced power levels and the related economic impact.

CUSTOMER AND SALES GROWTH The customer and sales growth referred to in this paragraph applies to Native Load customers and sales to them. Customer growth in APS’ service territory averaged about 3.8% a year for the three years 2003 through 2005; we currently expect customer growth to average about 3.8% per year from 2006 to 2008. We currently estimate that total retail electricity sales in kilowatt-hours will grow 3.7% on average, from 2006 through 2008, before the effects of weather variations. Customer growth for 2005 was 4.3%.

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

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

WHOLESALE POWER MARKET CONDITIONS The marketing and trading division focuses primarily on managing APS’ risks relating to fuel and purchased power costs in connection with its costs of serving Native Load customer demand. The marketing and trading division, subject to specified parameters, markets, hedges and trades in electricity, fuels and emission allowances and credits. Our future earnings will be affected by the strength or weakness of the wholesale power market.

Other Factors Affecting Financial Results

OPERATIONS AND MAINTENANCE EXPENSES Operations and maintenance expenses are impacted by growth, power plant additions and operations, inflation, outages, higher trending pension and other postretirement benefit costs and other factors.

DEPRECIATION AND AMORTIZATION EXPENSES Depreciation and amortization expenses are impacted by net additions to utility plant and other property, which include generation construction or acquisition, changes in depreciation and amortization rates (see Note 1), and changes in regulatory asset amortization. See Note 7 for information on APS' acquisition of the Sundance Plant in 2005.

PROPERTY TAXES Taxes other than income taxes consist primarily of property taxes, which are affected by tax rates and the value of property in-service and under construction. The average property tax rate for APS, which currently owns the majority of our property, was 9.2% of assessed value for 2005 and 2004. We expect property taxes to increase as new power plants, the acquisition of the Sundance Plant and our additions to transmission and distribution facilities are included in the property tax base.

INTEREST EXPENSE Interest expense is affected by the amount of debt outstanding and the interest rates on that debt. The primary factors affecting borrowing levels in the next several years are expected to be our capital requirements and our 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. Interest expense is also affected by interest rates on variable-rate debt.

RETAIL COMPETITION Although some very limited retail competition existed in Arizona in 1999 and 2000, there are currently no active retail competitors providing unbundled energy or other utility services to APS' customers. As a result, we cannot predict when, and the extent to which, additional competitors will re-enter APS' service territory.

SUBSIDIARIES SunCor's net income was \$56 million in 2003, \$45 million in 2004 and \$56 million in 2005. See Note 22 for further discussion. APS Energy Services' and El Dorado's historical results are not indicative of future performance.

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

Market Risks

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

INTEREST RATE AND EQUITY RISK

Our major financial market risk exposure is to changing interest rates. Changing interest rates will affect interest paid on variable-rate debt and interest earned by our nuclear decommissioning trust fund (see Note 12). Our policy is to manage interest rates through the use of a combination of fixed-rate and floating-rate debt. The nuclear decommissioning fund also has risk associated with the changing market value of equity 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, 2005 and 2004. The interest rates presented in the tables below represent the weighted-average interest rates as of December 31, 2005 and 2004 (dollars in thousands):

	2005					
	Short-Term Debt		Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount	Interest Rates	Amount
2006	7.11%	\$ 15,673	5.38%	\$ 350	6.47%	\$ 386,624
2007	–	–	5.38%	350	5.90%	1,271
2008	–	–	5.93%	128,178	5.85%	1,318
2009	–	–	–	–	5.73%	1,014
2010	–	–	–	–	5.69%	1,077
Years thereafter	–	–	3.25%	565,855	5.79%	1,918,026
Total		\$ 15,673		\$ 694,733		\$2,309,330
Fair value		\$ 15,673		\$ 694,733		\$2,326,235

	2004					
	Short-Term Debt		Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount	Interest Rates	Amount
2005	4.21%	\$ 71,030	1.99%	\$ 165,447	7.27%	\$ 402,198
2006	–	–	6.55%	2,918	6.45%	395,314
2007	–	–	4.81%	302	5.99%	1,154
2008	–	–	5.22%	5,294	5.51%	1,055
2009	–	–	–	–	5.51%	818
Years thereafter	–	–	1.89%	565,860	4.79%	1,669,901
Total		\$ 71,030		\$ 739,821		\$2,470,440
Fair value		\$ 71,030		\$ 740,271		\$2,574,608

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, 2005 and 2004. The interest rates presented in the tables below represent the weighted-average interest rates as of December 31, 2005 and 2004 (dollars in thousands):

2005				
	Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount
2006	-	\$ -	6.71%	\$ 86,165
2007	-	-	5.76%	1,075
2008	-	-	5.74%	1,271
2009	-	-	5.70%	1,005
2010	-	-	5.69%	1,077
Years thereafter	3.25%	565,855	5.79%	1,918,026
Total		\$ 565,855		\$ 2,008,619
Fair value		\$ 565,855		\$ 2,025,001

2004				
	Variable-Rate Long-Term Debt		Fixed-Rate Long-Term Debt	
	Interest Rates	Amount	Interest Rates	Amount
2005	-	\$ -	7.27%	\$ 401,727
2006	-	-	6.72%	86,082
2007	-	-	5.51%	867
2008	-	-	5.51%	1,054
2009	-	-	5.51%	818
Years thereafter	1.89%	565,860	4.79%	1,669,901
Total		\$ 565,860		\$ 2,160,449
Fair value		\$ 565,799		\$ 2,254,061

COMMODITY PRICE RISK

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas, coal and emissions allowances. 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. Our ERM, consisting of officers and key management personnel, oversees company-wide energy risk management activities and monitors the results of marketing and trading activities to ensure compliance with our stated energy risk management and trading policies. As part of our risk management program, we use such instruments to hedge purchases and sales of electricity, fuels and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities. In addition, subject to specified risk parameters monitored by the ERM, we engage in marketing and trading activities intended to profit from market price movements.

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

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

The following tables show the pretax changes in mark-to-market of our non-trading and trading derivative positions in 2005 and 2004 (dollars in millions):

	2005		2004	
	Regulated Electricity	Marketing and Trading	Regulated Electricity	Marketing and Trading
Mark-to-market of net positions at beginning of period	\$ 33	\$107	\$ –	\$ 69
Recognized in earnings:				
Change in mark-to-market gains (losses) for future period deliveries	14	20	9	20
Mark-to-market (gains) losses realized including ineffectiveness during the period	(8)	(14)	3	(15)
Deferred as a regulatory liability	31	–	–	–
Recognized in OCI:				
Changes in mark-to-market gains for future period deliveries (a)	359	102	42	37
Mark-to-market gains realized during the period	(94)	(34)	(21)	(6)
Change in valuation techniques	–	–	–	2
Mark-to-market of net positions at end of period	\$335	\$181	\$ 33	\$107

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

The tables below show the fair value of maturities of our non-trading and trading derivative contracts (dollars in millions) at December 31, 2005 by maturities and by the type of valuation that is performed to calculate the fair values. See Note 1, “Derivative Accounting,” for more discussion of our valuation methods.

Regulated Electricity

Source of Fair Value	2006	2007	2008	2009	2010	Years Thereafter	Total Fair Value
Prices actively quoted	\$162	\$ 58	\$ 39	\$ 7	\$ –	\$ –	\$266
Prices provided by other external sources	21	61	1	–	–	–	83
Prices based on models and other valuation methods	(3)	(2)	(1)	(2)	(1)	(5)	(14)
Total by maturity	\$180	\$117	\$ 39	\$ 5	\$ (1)	\$ (5)	\$335

Marketing and Trading

Source of Fair Value	2006	2007	2008	2009	2010	Years Thereafter	Total Fair Value
Prices actively quoted	\$ 22	\$ –	\$ –	\$ (1)	\$ (1)	\$ –	\$ 20
Prices provided by other external sources	76	87	20	–	–	–	183
Prices based on models and other valuation methods	(26)	(12)	16	(1)	(1)	2	(22)
Total by maturity	\$ 72	\$ 75	\$ 36	\$ (2)	\$ (2)	\$ 2	\$181

The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management and trading assets and liabilities included on Pinnacle West's Consolidated Balance Sheets at December 31, 2005 and 2004 (dollars in millions).

	December 31, 2005		December 31, 2004	
	Gain (Loss)		Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Mark-to-market changes reported in earnings (a):				
Electricity	\$ -	\$ -	\$ (4)	\$ 4
Natural gas	-	-	2	(2)
Other	-	-	1	(1)
Mark-to-market changes reported in OCI (b):				
Electricity	66	(66)	35	(35)
Natural gas	103	(103)	43	(43)
Total	\$ 169	\$(169)	\$ 77	\$(77)

(a) These contracts are primarily structured sales activities hedged with a portfolio of forward purchases that protects the economic value of the sales transactions.

(b) These contracts are hedges of our forecasted purchases of natural gas and electricity. The impact of these hypothetical price movements would substantially offset the impact that these same price movements would have on the physical exposures being hedged.

CREDIT RISK

We are exposed to losses in the event of non-performance or non-payment by counterparties. We have risk management and trading contracts with many counterparties. See Note 1, "Derivative Accounting" for a discussion of our credit valuation adjustment policy. See Note 18 for further discussion of credit risk.

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements based on current expectations, and Pinnacle West assumes no obligation to update these statements or make any further statements on any of these issues, except as required by applicable law. These forward-looking statements are often identified by words such as “estimate,” “predict,” “hope,” “may,” “believe,” “anticipate,” “plan,” “expect,” “require,” “intend,” “assume” and similar words. Because actual results may differ materially from expectations, we caution readers not to place undue reliance on these statements. A number of factors could cause future results to differ materially from historical results, or from results or outcomes currently expected or sought by Pinnacle West. These factors include, but are not limited to:

- state and federal regulatory and legislative decisions and actions, including the outcome and timing of APS’ retail rate proceedings pending before the ACC;
- the timely recovery of PSA deferrals;
- the ongoing restructuring of the electric industry, including the introduction of retail electric competition in Arizona and decisions impacting wholesale competition;
- the outcome of regulatory, legislative and judicial proceedings, both current and future, relating to the restructuring;
- market prices for electricity and natural gas;
- power plant performance and outages;
- transmission outages and constraints;
- weather variations affecting local and regional customer energy usage;
- customer growth and energy usage;
- regional economic and market conditions, including the results of litigation and other proceedings resulting from the California energy situation, volatile fuel and purchased power costs and the completion of generation and transmission construction in the region, which could affect customer growth and the cost of power supplies;
- the cost of debt and equity capital and access to capital markets;
- current credit ratings remaining in effect for any given period of time;
- our ability to compete successfully outside traditional regulated markets (including the wholesale market);
- the performance of our marketing and trading activities due to volatile market liquidity and any deteriorating counterparty credit and the use of derivative contracts in our business (including the interpretation of the subjective and complex accounting rules related to these contracts);
- changes in accounting principles generally accepted in the United States of America and the interpretation of those principles;
- the performance of the stock market and the changing interest rate environment, which affect the amount of required contributions to Pinnacle West’s pension plan and APS’ nuclear decommissioning trust funds, as well as the reported costs of providing pension and other postretirement benefits;
- technological developments in the electric industry;
- the strength of the real estate market in SunCor’s market areas, which include Arizona, Idaho, New Mexico and Utah; and
- other uncertainties, all of which are difficult to predict and many of which are beyond the control of Pinnacle West and APS.