

Pinnacle West Capital Corporation
Earnings Variance Explanations
For Three-Month and Six-Month Periods Ended June 30, 2010 and 2009

The following earnings variance explanations were excerpted from the Pinnacle West Capital Corporation (“Pinnacle West”)/Arizona Public Service Company (“APS”) Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2010 (the “June 2010 Form 10-Q”). We suggest that this discussion be read in connection with the Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2009 and the June 2010 Form 10-Q. Additional operating and financial statistics and a glossary of terms are available on our website (www.pinnaclewest.com).

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 retail and wholesale sales supplied to traditional cost-based rate regulation (“Native Load”) customers) and related activities and includes electricity generation, transmission and distribution; and
- our real estate segment, which consists of SunCor’s real estate development and investment activities. As of June 30, 2010, all of SunCor’s operations have been reclassified to discontinued operations (see Notes 5 and 14). The real estate segment activities are presented separately in the period-over-period discussions that follow.

Operating Results – Three-month period ended June 30, 2010 compared with three-month period ended June 30, 2009

Our consolidated net income attributable to common shareholders for the three months ended June 30, 2010 was \$115 million, compared with net income of \$68 million for the comparable prior-year period. The improved results reflect an increase of approximately \$10 million in regulated electricity segment net income primarily due to increased revenues related to APS’ retail rate increases and other factors, partially offset by milder weather in 2010.

In addition, our consolidated results for 2010 include a gain of \$25 million after income taxes related to the sale of APSES’ district cooling business.

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

| | Three Months Ended June 30, | | Increase (Decrease) in Net Income Attributable to Common Shareholders |
|---|--------------------------------|---------------------|--|
| | 2010 | 2009 | |
| (dollars in millions) | | | |
| Regulated Electricity Segment: | | | |
| Operating revenues less fuel and purchased power expenses | \$ 548 | \$ 521 | \$ 27 |
| Operations and maintenance | (213) | (213) | -- |
| Depreciation and amortization | (103) | (101) | (2) |
| Taxes other than income taxes | (32) | (33) | 1 |
| Other income (expenses), net | (3) | 3 | (6) |
| Interest charges, net of capitalized financing costs | (53) | (52) | (1) |
| Income taxes | (51) | (42) | (9) |
| Noncontrolling interests (Note 7) | (5) | (5) | -- |
| Regulated electricity segment net income | <u>88</u> | <u>78</u> | <u>10</u> |
| All Other (a) | <u>2</u> | <u>(2)</u> | <u>4</u> |
| Income from Continuing Operations Attributable to Common Shareholders | <u>90</u> | <u>76</u> | <u>14</u> |
| Real Estate Segment: | | | |
| Real estate impairment charges (Note 16) | (2) | (6) | 4 |
| Other real estate operations | -- | (9) | 9 |
| Income taxes | 1 | 6 | (5) |
| Real estate segment net loss | <u>(1)</u> | <u>(9)</u> | <u>8</u> |
| All other (a) | <u>26</u> | <u>1</u> | <u>25</u> |
| Income (Loss) from Discontinued Operations Attributable to Common Shareholders | <u>25</u> | <u>(8)</u> | <u>33</u> |
| Net Income Attributable to Common Shareholders | <u>\$ 115</u> | <u>\$ 68</u> | <u>\$ 47</u> |

- (a) Includes activities related to APSES and El Dorado. None of the activities of either of these companies constitutes a reportable segment. Income from discontinued operations for the period ended June 30, 2010 includes a gain of \$25 million after income taxes related to the sale of APSES' district cooling business.

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 \$27 million higher for the three months ended June 30, 2010 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) | | |
| Retail regulatory settlement effective January 1, 2010: | | | |
| Retail base rate increases, net of deferrals | \$ 68 | \$ 31 | \$ 37 |
| Line extension revenues (Note 3) | 4 | | 4 |
| Transmission rate increases | 5 | | 5 |
| Higher demand-side management and renewable energy surcharges (substantially offset in operations and maintenance expense) | 8 | | 8 |
| Lower retail revenues related to recovery of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense | (67) | (68) | 1 |
| Effects of weather on retail sales, primarily due to milder weather in 2010 | (39) | (12) | (27) |
| Miscellaneous items, net | 8 | 9 | (1) |
| Total | <u>\$ (13)</u> | <u>\$ (40)</u> | <u>\$ 27</u> |

Operations and maintenance Operations and maintenance expense variances for the three months ended June 30, 2010 compared with the prior-year period include:

- An increase of \$7 million related to demand-side management and renewable energy programs, which are primarily offset in operating revenues; and
- A decrease of \$7 million due to miscellaneous adjustments related primarily to employee benefits.

Other income (expenses), net Other income (expenses), net, decreased earnings by \$7 million for the three months ended June 30, 2010 compared with the prior-year period primarily due to net investment losses related to certain nonqualified employee benefit plans. Other income (expenses), net, is comprised of the regulated electricity segment portions of the line items other income and other expense from the Condensed Consolidated Statements of Income.

Income taxes Income taxes were \$9 million higher for the three months ended June 30, 2010 compared with the prior-year period primarily because of higher pretax income in the current-year period.

Real estate segment

As of June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations. The real estate segment net loss attributable to common shareholders was \$8 million lower for the three months ended June 30, 2010 compared with the prior-year period primarily because of:

- A decrease in real estate impairment charges of \$4 million;
- A decrease in the loss from other real estate operations of \$9 million; and
- A decrease in income tax benefits of \$5 million primarily because of a lower net loss for the 2010 period.

All Other

All other earnings from discontinued operations were \$25 million higher for the three months ended June 30, 2010 compared to the prior-year period primarily because of a gain of \$25 million after income taxes related to the sale of APSES' district cooling business in 2010.

Operating Results – Six-month period ended June 30, 2010 compared with six-month period ended June 30, 2009

Our consolidated net income attributable to common shareholders for the six months ended June 30, 2010 was \$109 million, compared with a net loss of \$88 million for the comparable prior-year period. The improved results were primarily due to lower real estate impairment charges recorded in 2010 compared with the prior-year period by SunCor, the Company's real estate subsidiary.

In addition, regulated electricity segment net income increased approximately \$37 million from the prior-year period primarily due to increased revenues related to APS' retail rate increases and other factors, partially offset by milder weather in 2010. Our consolidated results for 2010 also include a gain of \$25 million after income taxes related to the sale of APSES' district cooling business.

The following table presents net income (loss) attributable to common shareholders by business segment compared with the prior-year period:

| | Six Months Ended June 30, | | Increase (Decrease) in Net Income Attributable to Common Shareholders |
|--|------------------------------|-----------------------|--|
| | 2010 | 2009 | |
| (dollars in millions) | | | |
| Regulated Electricity Segment: | | | |
| Operating revenues less fuel and purchased power expenses | \$ 944 | \$ 876 | \$ 68 |
| Operations and maintenance | (420) | (408) | (12) |
| Depreciation and amortization | (204) | (201) | (3) |
| Taxes other than income taxes | (63) | (67) | 4 |
| Other income (expenses), net | (5) | (1) | (4) |
| Interest charges, net of capitalized financing costs | (104) | (100) | (4) |
| Income taxes | (43) | (32) | (11) |
| Noncontrolling interests (Note 7) | (10) | (9) | (1) |
| Regulated electricity segment net income | <u>95</u> | <u>58</u> | <u>37</u> |
| All Other (a) | <u>2</u> | <u>(7)</u> | <u>9</u> |
| Income from Continuing Operations Attributable to Common Shareholders | <u>97</u> | <u>51</u> | <u>46</u> |
| Real Estate Segment: | | | |
| Real estate impairment charges (Note 16) | (17) | (208) | 191 |
| Other real estate operations | (7) | (23) | 16 |
| Income taxes | 9 | 91 | (82) |
| Real estate segment net loss | <u>(15)</u> | <u>(140)</u> | <u>125</u> |
| All other (a) | <u>27</u> | <u>1</u> | <u>26</u> |
| Income from Discontinued Operations Attributable to Common Shareholders | <u>12</u> | <u>(139)</u> | <u>151</u> |
| Net Income (Loss) Attributable to Common Shareholders | <u>\$ 109</u> | <u>\$ (88)</u> | <u>\$ 197</u> |

- (a) Includes activities related to APSES and El Dorado. None of the activities of either of these companies constitutes a reportable segment. Income from discontinued operations for the period ended June 30, 2010 includes a gain of \$25 million after income taxes related to the sale of APSES' district cooling business.

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 \$68 million higher for the six months ended June 30, 2010 compared with the prior-year period. The following table describes the major components of this change:

| | Increase (Decrease) | | |
|--|-----------------------|----------------|--------------|
| | Operating | Purchased | Net change |
| | revenues | power and fuel | |
| | | expenses | |
| | (dollars in millions) | | |
| Retail regulatory settlement effective January 1, 2010: | | | |
| Retail base rate increases, net of deferrals | \$ 119 | \$ 57 | \$ 62 |
| Line extension revenues (Note 3) | 8 | | 8 |
| Transmission rate increases | 9 | | 9 |
| Higher demand-side management and renewable energy surcharges (substantially offset in operations and maintenance expense) | 15 | | 15 |
| Lower retail revenues related to recovery of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense | (122) | (125) | 3 |
| Effects of weather on retail sales, primarily due to milder weather in the second quarter 2010 | (33) | (10) | (23) |
| Miscellaneous items, net | -- | 6 | (6) |
| Total | <u>\$ (4)</u> | <u>\$ (72)</u> | <u>\$ 68</u> |

Operations and maintenance Operations and maintenance expenses increased \$12 million for the six months ended June 30, 2010 compared with the prior-year period primarily because of:

- An increase of \$13 million related to demand-side management and renewable energy programs, which are primarily offset in operating revenues;
- An increase of \$7 million related to customer service and other costs; and
- A decrease of \$8 million in generation costs, including timing of fossil-plant planned maintenance.

Income taxes Income taxes were \$11 million higher for the six months ended June 30, 2010 compared with the prior-year period primarily because of higher pretax income in

the current-year period, partially offset by \$9 million related to a reduction in the Company's 2010 effective income tax rate. See Note 6.

All Other

All other earnings from continuing operations were \$9 million higher for the six months ended June 30, 2010 compared to the prior-year period primarily because of improved margins from APSES' products and services business and investment losses at El Dorado in 2009.

Real estate segment

During the first quarter of 2009, SunCor's Board of Directors authorized a series of strategic transactions to dispose of SunCor's assets. This decision resulted in impairment charges of approximately \$208 million pretax in the first six months of 2009. As of June 30, 2010, all of SunCor's operations have been reclassified to discontinued operations (see Note 2). The real estate segment net loss attributable to common shareholders was \$125 million lower for the six months ended June 30, 2010 compared with the prior-year period primarily because of:

- A decrease in real estate impairment charges of \$191 million;
- A decrease in the loss from other real estate operations of \$16 million; and
- A decrease in income tax benefits of \$82 million primarily because of a lower net loss for the 2010 period.

All Other

All other earnings from discontinued operations were \$26 million higher for the six months ended June 30, 2010 compared to the prior-year period primarily because of a gain of \$25 million after income taxes related to the sale of APSES' district cooling business in 2010.