

Pinnacle West Capital Corporation
Earnings Variance Explanations
For Three-Month and Nine-Month Periods Ended September 30, 2009 and 2008

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 September 30, 2009 (the “September 2009 Form10-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, 2008 and the September 30, 2009 Form 10-Q. Additional operating and financial statistics and a glossary of terms are available on our website (www.pinnaclewest.com).

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 – Three-month period ended September 30, 2009 compared with three-month period ended September 30, 2008

Our consolidated net income attributable to common shareholders for the three months ended September 30, 2009 was \$187 million, compared with net income of \$152 million for the comparable prior-year period. The increase in net income was primarily due to improved results from the Company’s regulated electricity segment relating to increased mark-to-market valuations of fuel and purchased power contracts and increased revenues due to the interim rate increase effective January 1, 2009. These positive factors were partially offset by higher interest charges, net of capitalized financing costs.

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

	Three Months Ended September 30,		Increase (Decrease) in Net Income Attributable to Common Shareholders
	2009	2008	
(dollars in millions)			
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$ 702	\$ 620	\$ 82
Operations and maintenance	(205)	(209)	4
Depreciation and amortization	(101)	(97)	(4)
Taxes other than income taxes	(34)	(28)	(6)
Other income (expenses), net	2	(6)	8
Interest charges, net of capitalized financing costs	(53)	(41)	(12)
Income taxes	(111)	(81)	(30)
Regulated electricity segment net income	200	158	42
Real Estate Segment:			
Other real estate activities	18	(11)	29
Real estate impairment charges	(37)	--	(37)
Income taxes	7	5	2
Real estate segment net loss	(12)	(6)	(6)
All other (a)	(1)	--	(1)
Net Income Attributable to Common Shareholders	\$ 187	\$ 152	\$ 35

- (a) Includes activities related to marketing and trading, APSES and El Dorado. 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 \$82 million higher for the three months ended September 30, 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)		
Increased mark-to-market valuations of fuel and purchased power contracts related to favorable changes in market prices, net of related PSA deferrals	\$	\$ (37)	\$ 37
Interim retail rate increases effective January 1, 2009	21		21
Higher renewable energy and demand-side management surcharges (substantially offset in operations and maintenance expense)	17		17
Effects of hotter weather on retail sales	12	4	8
Transmission rate increases	7		7
Lower retail sales primarily due to lower usage per customer, including the effects of the energy efficiency programs, but excluding the effects of weather	(11)	(4)	(7)
Higher retail revenues related to recovery of PSA deferrals, offset by amortization of the same amount recorded as fuel and purchased power expense (see Note 5)	5	5	--
Miscellaneous items, net	(8)	(7)	(1)
Total	\$ 43	\$ (39)	\$ 82

Operations and maintenance Operations and maintenance expenses decreased \$4 million for the three months ended September 30, 2009 compared with the prior-year period primarily because of:

- A decrease of \$21 million associated with cost saving measures and other factors, including the absence of employee severance costs in 2009; and
- An increase of \$17 million related to renewable energy and demand-side management programs, which are offset in operating revenues.

Depreciation and amortization Depreciation and amortization expenses increased \$4 million for the three months ended September 30, 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.

Taxes other than income taxes Taxes other than income taxes increased \$6 million for the three months ended September 30, 2009 compared with the prior-year period

primarily because of higher property tax assessments as a result of increased utility plant in service described above.

Interest charges, net of capitalized financing costs Interest charges, net of capitalized financing costs increased \$12 million for the three months ended September 30, 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" below). 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 Condensed Consolidated Statements of Income.

Other income (expenses), net Other income (expenses), net improved \$8 million for the three months ended September 30, 2009 compared with the prior-year period primarily because of improved investment gains (losses). Other income (expenses), net is comprised of the line items other income and other expense from the Condensed Consolidated Statements of Income.

Income taxes Income taxes were \$30 million higher for the three months ended September 30, 2009 compared with the prior-year period primarily because of higher pretax income.

Real estate segment

During the first quarter of 2009, we decided to restructure SunCor through the sale of the substantial majority of its assets. The real estate segment net income attributable to common shareholders was \$6 million lower for the three months ended September 30, 2009 compared with the prior-year period primarily because of:

- Real estate impairment charges of \$37 million recorded in the 2009 period (see Note 21 for details of the impairment charge), without comparable charges in the prior-year period;
- A \$29 million increase in other real estate activities primarily due to increased parcel sales in the 2009 period; and
- A \$2 million decrease in income taxes related to lower pretax income.

Operating Results – Nine-month period ended September 30, 2009 compared with nine-month period ended September 30, 2008

Our consolidated net income attributable to common shareholders for the nine months ended September 30, 2009 was \$98 million, compared with net income of \$281 million for the comparable prior-year period. 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 \$16 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 attributable to common shareholders by business segment compared with the prior-year period:

	Nine Months Ended September 30,		Increase (Decrease) in Net Income Attributable to Common Shareholders
	2009	2008	
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$ 1,578	\$ 1,476	\$ 102
Operations and maintenance	(633)	(589)	(44)
Depreciation and amortization	(298)	(287)	(11)
Taxes other than income taxes	(101)	(94)	(7)
Other income (expenses), net	1	(12)	13
Interest charges, net of capitalized financing costs	(147)	(121)	(26)
Income taxes	(143)	(100)	(43)
Regulated electricity segment net income	<u>257</u>	<u>273</u>	<u>(16)</u>
Real Estate Segment:			
Real estate impairment charges	(247)	--	(247)
Other real estate operations	(6)	(28)	22
Income taxes	93	11	82
Income (loss) from discontinued operations	(8)	25	(33)
Noncontrolling interests	15	--	15
Real estate segment net income (loss)	<u>(153)</u>	<u>8</u>	<u>(161)</u>
All Other (a)	<u>(6)</u>	<u>--</u>	<u>(6)</u>
Net Income Attributable to Common Shareholders	<u>\$ 98</u>	<u>\$ 281</u>	<u>\$ (183)</u>

(a) Includes activities related to marketing and trading, APSES and El Dorado. 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 \$102 million higher for the nine months ended September 30, 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)		
Interim retail rate increases effective January 1, 2009	\$ 50	\$	\$ 50
Higher renewable energy and demand-side management surcharges (substantially offset in operations and maintenance expense)	49		49
Transmission rate increases	16		16
Increased mark-to-market valuations of fuel and purchased power contracts related to favorable changes in market prices, net of related PSA deferrals		(9)	9
Effects of weather on retail sales, primarily due to hotter weather in the third quarter of 2009	9	2	7
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	(41)	(18)	(23)
Higher fuel and purchased power costs including the effects of lower off-system sales, net of related PSA deferrals	(26)	(21)	(5)
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 5)	(43)	(43)	--
Miscellaneous items, net	(8)	(7)	(1)
Total	\$ 6	\$ (96)	\$ 102

Operations and maintenance Operations and maintenance expenses increased \$44 million for the nine months ended September 30, 2009 compared with the prior-year period primarily because of:

- An increase of \$48 million related to renewable energy and demand-side management programs, which are offset in operating revenues;
- An increase of \$14 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 \$18 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 \$11 million for the nine months ended September 30, 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.

Taxes other than income taxes Taxes other than income taxes increased \$7 million for the nine months ended September 30, 2009 compared with the prior-year period primarily because of higher property tax assessments as a result of increased utility plant in service described above.

Interest charges, net of capitalized financing costs Interest charges, net of capitalized financing costs increased \$26 million for the nine months ended September 30, 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" below). 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 Condensed Consolidated Statements of Income.

Other income (expenses), net Other income (expenses), net improved \$13 million for the nine months ended September 30, 2009 compared with the prior-year period primarily because of improved investment gains (losses). Other income (expenses), net is comprised of the line items other income and other expense from the Condensed Consolidated Statements of Income.

Income taxes Income taxes were \$43 million higher for the nine months ended September 30, 2009 compared with the prior-year period primarily because of \$30 million of income tax benefits related to prior years recorded in 2008 and higher pretax income.

Real estate segment

During the first quarter of 2009, we decided to restructure SunCor through the sale of the substantial majority of its assets. The real estate segment net loss attributable to common shareholders was \$161 million higher for the nine months ended September 30, 2009 compared with the prior-year period primarily because of:

- Real estate impairment charges of \$247 million recorded in the 2009 period (see Note 21 for details of the impairment charge), without comparable charges in the prior-year period;
- An increase of \$22 million from other real estate operations primarily due to increased parcel sales in the 2009 period;
- A decrease of \$33 million in income from discontinued operations related to gains on certain real estate commercial property sales in 2008 and real estate impairment charges in 2009 (see Note 21);
- An increase of \$15 million related to noncontrolling interests' portion of real estate impairment charges and other results (see Note 21); and
- An increase in income tax benefits of \$82 million primarily because of higher net loss.

All other

All other earnings were \$6 million lower for the nine months ended September 30, 2009 compared to the prior-year period primarily because of planned reductions of marketing and trading activities.