

Pinnacle West Capital Corporation
Earnings Variance Explanations
For Three-Month and Nine-Month Periods Ended September 30, 2011 and 2010

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, 2011 (the “September 2011 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, 2010 and the September 2011 Form 10-Q. Additional operating and financial statistics and a glossary of terms are available on our website (www.pinnaclewest.com).

RESULTS OF OPERATIONS

Pinnacle West’s reportable business segment is our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electricity service to Native Load customers) and related activities and includes electricity generation, transmission and distribution.

APSES’s and SunCor’s operations have been classified as discontinued operations. Pinnacle West sold its investment in APSES in August 2011.

Operating Results – Three-month period ended September 30, 2011 compared with three-month period ended September 30, 2010

Our consolidated net income attributable to common shareholders for the three months ended September 30, 2011 was \$255 million, compared with net income of \$234 million for the comparable prior-year period. The increase in results from continuing operations reflects an increase of approximately \$21 million for the regulated electricity segment primarily due to increased revenues related to warmer weather and decreased operations and maintenance expenses.

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

	Three Months Ended September 30,		Net Change
	2011	2010	
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$ 786	\$ 762	\$ 24
Operations and maintenance	(210)	(220)	10
Depreciation and amortization	(106)	(104)	(2)
Taxes other than income taxes	(34)	(38)	4
Other income (expenses), net	(3)	-	(3)
Interest charges, net of allowances for funds used during construction	(48)	(48)	--
Income taxes	(132)	(122)	(10)
Less income related to noncontrolling interests (Note 7)	(7)	(5)	(2)
Regulated electricity segment income from continuing operations	246	225	21
Income from Discontinued Operations			
Attributable to Common Shareholders (a)	9	9	-
Net Income Attributable to Common Shareholders	<u>\$ 255</u>	<u>\$ 234</u>	<u>\$ 21</u>

(a) Includes activities related to APSES and SunCor.

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 \$24 million higher for the three months ended September 30, 2011 compared with the prior-year period. The following table describes the major components of this change:

	Increase (Decrease)		
	Operating revenues	Fuel and purchased power expenses	Net change
	(dollars in millions)		
Effects of weather on retail sales	\$ 27	\$ 9	\$ 18
Higher retail transmission charges	7		7
Higher demand-side management, renewable energy and similar regulatory surcharges (substantially offset in operations and maintenance expense)	6	-	6
Lower retail revenues related to refund of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense	(12)	(14)	2
Higher fuel and purchased power costs and lower off-system sales, net of related PSA deferrals	(17)	(13)	(4)
Miscellaneous items, net	(3)	2	(5)
Total	<u>\$ 8</u>	<u>\$ (16)</u>	<u>\$ 24</u>

Operations and maintenance Operations and maintenance expenses decreased \$10 million for the three months ended September 30, 2011 compared with the prior-year period primarily because of:

- A decrease of \$11 million related to employee benefit costs;
- A decrease of \$9 million in generation costs, primarily due to timing of planned fossil plant maintenance and other costs;
- An increase of \$8 million related to costs for demand-side management, renewable energy, and similar regulatory programs, which are offset in operating revenues; and
- An increase of \$2 million due to other miscellaneous factors.

Income taxes Income taxes were \$10 million higher for the three months ended September 30, 2011 compared with the prior-year period primarily due to higher pretax income in the current-year period.

Discontinued Operations

Income from discontinued operations for the three months ended September 30, 2011 included a gain of approximately \$10 million after income taxes related to the sale of our investment in APSES. Income from discontinued operations for the period ended September 30, 2010 of \$9 million related primarily to real estate activities.

Operating Results – Nine-month period ended September 30, 2011 compared with nine-month period ended September 30, 2010

Our consolidated net income attributable to common shareholders for the nine months ended September 30, 2011 was \$327 million, compared with net income of \$343 million for the comparable prior-year period. The \$16 million variance consists of a \$4 million decrease in income from continuing operations and a \$12 million decrease in income from discontinued operations. The reduction in income from continuing operations reflects a decrease of approximately \$3 million for the regulated electricity segment. Increased revenues related to warmer weather and higher retail customer usage were offset by higher depreciation and amortization due to increased plant in service, higher property taxes due to increased property tax rates and higher income taxes resulting from income tax benefits recognized in the prior-year period.

In addition, income from discontinued operations for the nine months ended September 30, 2011 included a gain of approximately \$10 million after income taxes related to the sale of our investment in APSES. Income from discontinued operations in the prior-year period is primarily due to a gain of \$25 million related to the sale of APSES's district cooling business.

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

	Nine Months Ended September 30,		Net Change
	2011	2010	
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses (a)	\$ 1,777	\$ 1,706	\$ 71
Operations and maintenance (a)	(676)	(639)	(37)
Depreciation and amortization	(320)	(308)	(12)
Taxes other than income taxes	(112)	(101)	(11)
Other income (expenses), net	(5)	(5)	--
Interest charges, net of allowances for funds used during construction	(150)	(152)	2
Income taxes	(177)	(166)	(11)
Less income related to noncontrolling interests (Note 7)	(20)	(15)	(5)
Regulated electricity segment income from continuing operations	317	320	(3)
All other	(1)	--	(1)
Income from Continuing Operations Attributable to Common Shareholders	316	320	(4)
Income from Discontinued Operations Attributable to Common Shareholders (b)	11	23	(12)
Net Income Attributable to Common Shareholders	<u>\$ 327</u>	<u>\$ 343</u>	<u>\$ (16)</u>

(a) Includes effects of settlement of certain prior-period transmission rights-of-way related to Four Corners, which did not affect net income, but increased both electric operating revenues and operations and maintenance expenses by \$28 million. Costs related to the settlement were offset by related revenues from SCE, which leases the related transmission line from APS.

(b) Includes activities related to APSES and SunCor.

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 \$71 million higher for the nine months

ended September 30, 2011 compared with the prior-year period. The following table describes the major components of this change:

	Increase (Decrease)		
	Operating revenues	Fuel and purchased power expenses	Net change
	(dollars in millions)		
Settlement of certain prior-period transmission rights-of-way (offset in operations and maintenance expense)	\$ 28	\$ -	\$ 28
Effects of weather on retail sales	33	12	21
Higher demand-side management, renewable energy and similar regulatory surcharges (substantially offset in operations and maintenance expense)	16	2	14
Higher retail revenues primarily due to higher usage per customer, excluding the effects of weather, but including the effects of APS's energy efficiency programs	7	4	3
Lower retail revenues related to refund of PSA deferrals, substantially offset by lower amortization of fuel and purchased power expense	(25)	(30)	5
Higher fuel and purchased power costs and lower off-system sales, net of related PSA deferrals	(19)	(19)	--
Miscellaneous items, net	4	4	--
Total	<u>\$ 44</u>	<u>\$ (27)</u>	<u>\$ 71</u>

Operations and maintenance Operations and maintenance expenses increased \$37 million for the nine months ended September 30, 2011 compared with the prior-year period primarily because of:

- An increase of \$28 million for settlement of certain transmission rights-of-way, which is offset in operating revenues;
- An increase of \$15 million related to costs for demand-side management, renewable energy, and similar regulatory programs, which are offset in operating revenues;
- A decrease of \$11 million related to employee benefit costs; and
- An increase of \$5 million due to other miscellaneous factors.

Depreciation and amortization Depreciation and amortization expenses were \$12 million higher for the nine months ended September 30, 2011 compared with the prior-year period primarily because of increased plant in service.

Taxes other than income taxes Taxes other than income taxes increased \$11 million for the nine months ended September 30, 2011 compared with the prior-year period primarily because of higher property tax rates in the current period.

Income taxes Income taxes were \$11 million higher for the nine months ended September 30, 2011 compared with the prior-year period. This is primarily due to \$8 million of income tax benefits recognized in the prior-year period related to a reduction in the Company's 2010 effective income tax rate and the effects of higher pretax income in the current period.

Discontinued Operations

Income from discontinued operations for the nine months ended September 30, 2011 included a gain of \$10 million related to the sale of our investment in APSES. Income from discontinued operations for the nine months ended September 30, 2010 included a gain of \$25 million related to the sale of APSES's district cooling business.