

ARIZONA PUBLIC SERVICE CO
Form 10-Q
May 03, 2013
Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

OR

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

For the transition period from _____ to _____

Commission File
Number
1-8962

Exact Name of Each Registrant as specified in its
charter; State of Incorporation; Address; and
Telephone Number

IRS Employer
Identification No.
86-0512431

PINNACLE WEST CAPITAL CORPORATION

(an Arizona corporation)

400 North Fifth Street, P.O. Box 53999

Phoenix, Arizona 85072-3999

(602) 250-1000

1-4473

ARIZONA PUBLIC SERVICE COMPANY

86-0011170

(an Arizona corporation)

400 North Fifth Street, P.O. Box 53999

Phoenix, Arizona 85072-3999

(602) 250-1000

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

PINNACLE WEST CAPITAL CORPORATION Yes x No o
ARIZONA PUBLIC SERVICE COMPANY Yes x No o

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

PINNACLE WEST CAPITAL CORPORATION Yes x No o
ARIZONA PUBLIC SERVICE COMPANY Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

PINNACLE WEST CAPITAL CORPORATION
Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o
ARIZONA PUBLIC SERVICE COMPANY
Large accelerated filer o Accelerated filer o Non-accelerated filer x Smaller reporting company o

Indicate by check mark whether each registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

PINNACLE WEST CAPITAL CORPORATION Yes o No x
ARIZONA PUBLIC SERVICE COMPANY Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

PINNACLE WEST CAPITAL CORPORATION Number of shares of common stock, no par value, outstanding as of
ARIZONA PUBLIC SERVICE COMPANY April 26, 2013: 109,947,418

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Number of shares of common stock, \$2.50 par value, outstanding as of
April 26, 2013: 71,264,947

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

Table of Contents

TABLE OF CONTENTS

	Page
<u>Forward-Looking Statements</u>	2
<u>Part I</u>	3
<u>Item 1.</u>	3
	<u>Financial Statements</u>
	<u>Pinnacle West Capital Corporation</u>
	<u>Arizona Public Service Company</u>
	42
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	50
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	67
<u>Item 4.</u>	<u>Controls and Procedures</u>
	67
<u>Part II</u>	69
<u>Item 1.</u>	<u>Legal Proceedings</u>
	69
<u>Item 1A.</u>	<u>Risk Factors</u>
	69
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	69
<u>Item 5.</u>	<u>Other Information</u>
	70
<u>Item 6.</u>	<u>Exhibits</u>
	71
<u>Signatures</u>	74

This combined Form 10-Q is separately provided by Pinnacle West Capital Corporation (Pinnacle West) and Arizona Public Service Company (APS). Any use of the words Company, we, and our refer to Pinnacle West. Each registrant is providing on its own behalf a portion of the information contained in this Form 10-Q that relates to such registrant and, where required, its subsidiaries. Except as stated in the preceding sentence, neither registrant is providing any information that does not relate to such registrant, and therefore makes no representation as to any such information. The information required with respect to each company is set forth within the applicable items. Item 1 of this report includes Condensed Consolidated Financial Statements of Pinnacle West and Condensed Consolidated Financial Statements of APS. Item 1 also includes Notes to Pinnacle West's Condensed Consolidated Financial Statements, the majority of which also relate to APS, and Supplemental Notes, which only relate to APS's Condensed Consolidated Financial Statements.

Table of Contents

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements based on current expectations. These forward-looking statements are often identified by words such as estimate, predict, may, believe, plan, expect, require, intend, assume and similar words. Because actual results may differ materially from expectations, we caution 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 outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Part I, Item 1A of the Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2012 (2012 Form 10-K), Part II, Item 1A of this report and in Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations of this report, these factors include, but are not limited to:

- our ability to manage capital expenditures and operations and maintenance costs while maintaining reliability and customer service levels;
- variations in demand for electricity, including those due to weather, the general economy, customer and sales growth (or decline), and the effects of energy conservation measures and distributed generation;
- power plant and transmission system performance and outages;
- volatile fuel and purchased power costs;
- fuel and water supply availability;
- our ability to achieve timely and adequate rate recovery of our costs, including returns on debt and equity capital;
- regulatory and judicial decisions, developments and proceedings;
- new legislation or regulation, including those relating to environmental requirements and nuclear plant operations;
- our ability to meet renewable energy and energy efficiency mandates and recover related costs;
- risks inherent in the operation of nuclear facilities, including spent fuel disposal uncertainty;
- competition in retail and wholesale power markets;
- the duration and severity of the economic decline in Arizona and current real estate market conditions;
- the cost of debt and equity capital and the ability to access capital markets when required;
- changes to our credit ratings;
- the investment performance of the assets of our nuclear decommissioning trust, pension, and other postretirement benefit plans and the resulting impact on future funding requirements;
- the liquidity of wholesale power markets and the use of derivative contracts in our business;

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- potential shortfalls in insurance coverage;
- new accounting requirements or new interpretations of existing requirements;
- generation, transmission and distribution facility and system conditions and operating costs;
- the ability to meet the anticipated future need for additional baseload generation and associated transmission facilities in our region;
- the willingness or ability of our counterparties, power plant participants and power plant land owners to meet contractual or other obligations or extend the rights for continued power plant operations;
- technological developments affecting the electric industry; and
- restrictions on dividends or other provisions in our credit agreements and Arizona Corporation Commission (ACC) orders.

These and other factors are discussed in the Risk Factors described in Part I, Item 1A of our 2012 Form 10-K and in Part II, Item 1A of this report, which readers should review carefully before placing any reliance on our financial statements or disclosures. Neither Pinnacle West nor APS assumes any obligation to update these statements, even if our internal estimates change, except as required by law.

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

(dollars and shares in thousands, except per share amounts)

	Three Months Ended March 31,	
	2013	2012
OPERATING REVENUES	\$ 686,652	\$ 620,631
OPERATING EXPENSES		
Fuel and purchased power	230,679	216,309
Operations and maintenance	223,250	210,663
Depreciation and amortization	103,730	100,109
Taxes other than income taxes	40,021	42,475
Other expenses	2,049	3,068
Total	599,729	572,624
OPERATING INCOME	86,923	48,007
OTHER INCOME (DEDUCTIONS)		
Allowance for equity funds used during construction	6,864	4,756
Other income (Note 10)	758	760
Other expense (Note 10)	(3,752)	(4,068)
Total	3,870	1,448
INTEREST EXPENSE		
Interest charges	49,478	56,967
Allowance for borrowed funds used during construction	(3,990)	(3,151)
Total	45,488	53,816
INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	45,305	(4,361)
INCOME TAXES	12,469	(4,645)
INCOME FROM CONTINUING OPERATIONS	32,836	284
LOSS FROM DISCONTINUED OPERATIONS		
Net of income tax benefit of \$(505)		(765)
NET INCOME (LOSS)	32,836	(481)
Less: Net income attributable to noncontrolling interests (Note 6)	8,392	7,776
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$ 24,444	\$ (8,257)
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC	109,832	109,299
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED	110,835	109,299
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING		
Income (loss) from continuing operations attributable to common shareholders basic	\$ 0.22	\$ (0.07)

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Net income (loss) attributable to common shareholders	basic	0.22	(0.08)
Income (loss) from continuing operations attributable to common shareholders	diluted	0.22	(0.07)
Net income (loss) attributable to common shareholders	diluted	0.22	(0.08)
DIVIDENDS DECLARED PER SHARE			
		\$	\$
			0.525
AMOUNTS ATTRIBUTABLE TO COMMON SHAREHOLDERS:			
Income (loss) from continuing operations, net of tax		\$	24,444
Discontinued operations, net of tax			(774)
Net income (loss) attributable to common shareholders		\$	24,444
		\$	(8,257)

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(unaudited)

(dollars in thousands)

	Three Months Ended March 31,	
	2013	2012
NET INCOME (LOSS)	\$ 32,836	\$ (481)
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX		
Derivative instruments:		
Net unrealized gain (loss), net of tax benefit (expense) of (\$38) and \$16,551	58	(25,352)
Reclassification of net realized loss, net of tax benefit of \$3,300 and \$5,728	5,053	8,772
Pension and other postretirement benefits activity, net of tax expense of \$631 and \$631	966	966
Total other comprehensive income (loss)	6,077	(15,614)
COMPREHENSIVE INCOME (LOSS)	38,913	(16,095)
Less: Comprehensive income attributable to noncontrolling interests	8,392	7,776
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$ 30,521	\$ (23,871)

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)

	March 31, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 25,109	\$ 26,202
Customer and other receivables	267,937	277,225
Accrued unbilled revenues	90,147	94,845
Allowance for doubtful accounts	(2,537)	(3,340)
Materials and supplies (at average cost)	223,605	218,096
Fossil fuel (at average cost)	35,211	31,334
Deferred income taxes	75,866	152,191
Income tax receivable (Note 5)	2,856	2,423
Assets from risk management activities (Note 7)	20,346	25,699
Deferred fuel and purchased power regulatory asset (Note 3)	41,315	72,692
Other regulatory assets (Note 3)	52,872	71,257
Other current assets	39,050	37,102
Total current assets	871,777	1,005,726
INVESTMENTS AND OTHER ASSETS		
Assets from risk management activities (Note 7)	34,047	35,891
Nuclear decommissioning trust (Note 13)	596,168	570,625
Other assets	64,325	62,694
Total investments and other assets	694,540	669,210
PROPERTY, PLANT AND EQUIPMENT		
Plant in service and held for future use	14,494,326	14,346,367
Accumulated depreciation and amortization	(4,997,126)	(4,929,613)
Net	9,497,200	9,416,754
Construction work in progress	498,124	565,716
Palo Verde sale leaseback, net of accumulated depreciation (Note 6)	128,027	128,995
Intangible assets, net of accumulated amortization	162,978	162,150
Nuclear fuel, net of accumulated amortization	140,909	122,778
Total property, plant and equipment	10,427,238	10,396,393
DEFERRED DEBITS		
Regulatory assets (Note 3)	1,097,389	1,099,900
Income tax receivable (Note 5)	70,828	70,389
Other	139,155	137,997
Total deferred debits	1,307,372	1,308,286
TOTAL ASSETS	\$ 13,300,927	\$ 13,379,615

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)

	March 31, 2013	December 31, 2012
LIABILITIES AND EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 212,078	\$ 221,312
Accrued taxes (Note 5)	164,554	124,939
Accrued interest	44,818	49,380
Common dividends payable		59,789
Short-term borrowings		92,175
Current maturities of long-term debt	122,828	122,828
Customer deposits	80,783	79,689
Liabilities from risk management activities (Note 7)	65,354	73,741
Regulatory liabilities (Note 3)	76,640	88,116
Other current liabilities	124,456	171,573
Total current liabilities	891,511	1,083,542
LONG-TERM DEBT LESS CURRENT MATURITIES		
Long-term debt less current maturities	3,265,589	3,160,219
Palo Verde sale leaseback lessor notes less current maturities (Note 6)	38,869	38,869
Total long-term debt less current maturities	3,304,458	3,199,088
DEFERRED CREDITS AND OTHER		
Deferred income taxes	2,064,476	2,151,371
Regulatory liabilities (Note 3)	805,230	759,201
Liability for asset retirements	358,184	357,097
Liabilities for pension and other postretirement benefits (Note 4)	1,034,327	1,058,755
Liabilities from risk management activities (Note 7)	82,876	85,264
Customer advances	108,986	109,359
Coal mine reclamation	119,044	118,860
Unrecognized tax benefits (Note 5)	72,252	71,135
Other	307,253	283,654
Total deferred credits and other	4,952,628	4,994,696
COMMITMENTS AND CONTINGENCIES (SEE NOTES)		
EQUITY (Note 8)		
Common stock, no par value	2,484,347	2,466,923
Treasury stock	(10,482)	(4,211)
Total common stock	2,473,865	2,462,712
Retained earnings	1,648,521	1,624,102
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(63,450)	(64,416)
Derivative instruments	(44,481)	(49,592)
Total accumulated other comprehensive loss	(107,931)	(114,008)

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Total shareholders' equity	4,014,455	3,972,806
Noncontrolling interests (Note 6)	137,875	129,483
Total equity	4,152,330	4,102,289
TOTAL LIABILITIES AND EQUITY	\$ 13,300,927	\$ 13,379,615

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)

(dollars in thousands)

	Three Months Ended March 31,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ 32,836	\$ (481)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	124,344	118,487
Deferred fuel and purchased power	31,194	46,754
Deferred fuel and purchased power amortization	1,122	(24,514)
Allowance for equity funds used during construction	(6,864)	(4,756)
Deferred income taxes	12,163	(1,989)
Change in derivative instruments fair value	333	1,985
Changes in current assets and liabilities:		
Customer and other receivables	3,931	52,264
Accrued unbilled revenues	4,698	20,511
Materials, supplies and fossil fuel	(9,386)	(13,753)
Other current assets	(2,525)	(3,502)
Accounts payable	11,925	(39,355)
Accrued taxes and income tax receivable net	39,182	37,398
Other current liabilities	(62,636)	(39,804)
Change in margin and collateral accounts assets	933	(1,853)
Change in margin and collateral accounts liabilities	24,205	(32,950)
Change in other long-term assets	(31,202)	(21,469)
Change in other long-term liabilities	37,904	22,362
Net cash flow provided by operating activities	212,157	115,335
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(182,859)	(240,973)
Contributions in aid of construction	14,912	13,871
Allowance for borrowed funds used during construction	(3,990)	(3,151)
Proceeds from nuclear decommissioning trust sales	135,240	92,047
Investment in nuclear decommissioning trust	(139,553)	(96,360)
Other	(470)	(533)
Net cash flow used for investing activities	(176,720)	(235,099)
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of long-term debt	104,307	319,081
Repayment of long-term debt		(375,727)
Short-term borrowings and payments net	(92,175)	216,600
Dividends paid on common stock	(58,067)	(55,595)
Common stock equity issuance	9,441	4,289
Other	(36)	(1,757)
Net cash flow provided by (used for) financing activities	(36,530)	106,891
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,093)	(12,873)

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CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		26,202		33,583
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$	25,109	\$	20,710

See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. Consolidation and Nature of Operations**

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our subsidiaries: APS and El Dorado Investment Company (El Dorado) and formerly SunCor Development Company (SunCor). Intercompany accounts and transactions between the consolidated companies have been eliminated. The unaudited condensed consolidated financial statements for APS include the accounts of APS and the Palo Verde Nuclear Generating Station (Palo Verde) sale leaseback variable interest entities (VIEs) (see Note 6 for further discussion). Our accounting records are maintained in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Weather conditions cause significant seasonal fluctuations in our revenues; therefore, results for interim periods do not necessarily represent results expected for the year.

Our condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments except as otherwise disclosed in the notes) that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. These condensed consolidated financial statements and notes have been prepared consistently with the 2012 Form 10-K.

Supplemental Cash Flow Information

The following table summarizes supplemental Pinnacle West cash flow information (dollars in thousands):

	Three Months Ended	
	March 31,	
	2013	2012
Cash paid during the period for:		
Income taxes, net of (refunds)	\$ 425	\$ (650)
Interest, net of amounts capitalized	49,038	62,892
Significant non-cash investing and financing activities:		
Accrued capital expenditures	\$ 6,575	\$ 13,622

2. Long-Term Debt and Liquidity Matters

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Pinnacle West and APS maintain committed revolving credit facilities in order to enhance liquidity and provide credit support for their commercial paper programs.

Pinnacle West

At March 31, 2013, Pinnacle West's \$200 million credit facility, which matures in November 2016, was available to refinance indebtedness of the Company and for other general corporate purposes, including credit support for its \$200 million commercial paper program. Pinnacle West has the option to increase the amount of the facility up to a maximum of \$300 million upon the satisfaction of certain

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

conditions and with the consent of the lenders. At March 31, 2013, Pinnacle West had no outstanding borrowings under its credit facility, no letters of credit outstanding, and no commercial paper borrowings.

APS

On March 22, 2013, APS issued an additional \$100 million par amount of its outstanding 4.50% unsecured senior notes that mature on April 1, 2042. The net proceeds from the sale were used to repay short-term commercial paper borrowings and replenish cash used to redeem certain tax-exempt indebtedness in November 2012.

At March 31, 2013, APS had two credit facilities totaling \$1 billion, including a \$500 million credit facility that was refinanced in April 2013 (see below) and a \$500 million facility that matures in November 2016. APS may increase the amount of each facility up to a maximum of \$700 million upon the satisfaction of certain conditions and with the consent of the lenders. APS will use these facilities to refinance indebtedness and for other general corporate purposes. Interest rates are based on APS' s senior unsecured debt credit ratings.

On April 9, 2013, APS refinanced its \$500 million revolving credit facility that would have matured in February 2015, with a new \$500 million facility. The new revolving credit facility terminates in April 2018.

The facilities described above are available to support APS' s \$250 million commercial paper program, for bank borrowings or for issuances of letters of credit. At March 31, 2013, APS had no outstanding borrowings or outstanding letters of credit under these credit facilities, nor did it have any commercial paper borrowings.

On May 1, 2013, APS purchased all \$32 million of the Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds, 2009 Series C, due 2029. We expect to remarket these bonds within the next twelve months. These bonds are classified as current maturities of long-term debt on our Condensed Consolidated Balance Sheets at March 31, 2013 and December 31, 2012.

See Financial Assurances in Note 9 for a discussion of APS' s separate outstanding letters of credit.

Debt Fair Value

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Our long-term debt fair value estimates are based on quoted market prices for the same or similar issues, and are classified within Level 2 of the fair value hierarchy. See Note 12 for discussion of the fair value hierarchy. The following table represents the estimated fair value of our long-term debt, including current maturities (dollars in millions):

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	As of March 31, 2013		As of December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Pinnacle West	\$ 125	\$ 125	\$ 125	\$ 125
APS	3,302	3,772	3,197	3,750
Total	\$ 3,427	\$ 3,897	\$ 3,322	\$ 3,875

Debt Provisions

An existing ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the ACC order, the common equity ratio is total shareholder equity divided by the sum of total shareholder equity and long-term debt, including current maturities of long-term debt. At March 31, 2013, APS was in compliance with this common equity ratio requirement. Its total shareholder equity was approximately \$4.1 billion, and total capitalization was approximately \$7.4 billion. APS would be prohibited from paying dividends if payment would reduce its total shareholder equity below approximately \$2.9 billion, assuming APS's total capitalization remains the same. Since APS was in compliance with this common equity ratio requirement, this restriction does not materially affect Pinnacle West's ability to meet its ongoing cash needs.

3. Regulatory Matters**Retail Rate Case Filing with the Arizona Corporation Commission**

On June 1, 2011, APS filed an application with the ACC for a net retail base rate increase of \$95.5 million. APS requested that the increase become effective July 1, 2012. The request would have increased the average retail customer bill approximately 6.6%. On January 6, 2012, APS and other parties to the general retail rate case entered into an agreement (the Settlement Agreement) detailing the terms upon which the parties agreed to settle the rate case. On May 15, 2012, the ACC approved the Settlement Agreement without material modifications.

Settlement Agreement

The Settlement Agreement provides for a zero net change in base rates, consisting of: (1) a non-fuel base rate increase of \$116.3 million; (2) a fuel-related base rate decrease of \$153.1 million (to be implemented by a change in the base fuel rate for fuel and purchased power costs (Base Fuel Rate) from \$0.03757 to \$0.03207 per kilowatt hour (kWh)); and (3) the transfer of cost recovery for certain renewable energy projects from the Arizona Renewable Energy Standard and Tariff (RES) surcharge to base rates in an estimated amount of \$36.8 million.

APS also agreed not to file its next general rate case before May 31, 2015, and not to request that its next general retail rate increase be effective prior to July 1, 2016. The Settlement Agreement allows APS to request a change to its base rates during the stay-out period in the event of an extraordinary event that, in the ACC's judgment, requires base rate relief in order to protect the public interest. Nor is APS precluded from seeking rate relief, or any other party to the Settlement Agreement precluded from petitioning the ACC to examine the reasonableness of APS's rates, in the event of significant regulatory

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

developments that materially impact the financial results expected under the terms of the Settlement Agreement.

Other key provisions of the Settlement Agreement include the following:

- An authorized return on common equity of 10.0%;
- A capital structure comprised of 46.1% debt and 53.9% common equity;
- A test year ended December 31, 2010, adjusted to include plant that is in service as of March 31, 2012;
- Deferral for future recovery or refund of property taxes above or below a specified 2010 test year level caused by changes to the Arizona property tax rate as follows:
 - Deferral of 25% in 2012, 50% in 2013 and 75% for 2014 and subsequent years if Arizona property tax rates increase;
and
 - Deferral of 100% in all years if Arizona property tax rates decrease;
- A procedure to allow APS to request rate adjustments prior to its next general rate case related to APS's proposed acquisition (should it be consummated) of additional interests in Units 4 and 5 and the related closure of Units 1-3 of the Four Corners Power Plant (Four Corners);
- Implementation of a Lost Fixed Cost Recovery rate mechanism to support energy efficiency and distributed renewable generation;

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- Modifications to the Environmental Improvement Surcharge (EIS) to allow for the recovery of carrying costs for capital expenditures associated with government-mandated environmental controls, subject to an existing cents per kWh cap on cost recovery that could produce up to approximately \$5 million in revenues annually;
- Modifications to the Power Supply Adjustor (PSA), including the elimination of the 90/10 sharing provision;
- A limitation on the use of the RES surcharge and the Demand Side Management Adjustor Charge (DSMAC) to recoup capital expenditures not required under the terms of the 2008 rate case settlement agreement discussed below;
- Allowing a negative credit that existed in the PSA rate to continue until February 2013, rather than being reset on the anticipated July 1, 2012 rate effective date;
- Modification of the transmission cost adjustor (TCA) to streamline the process for future transmission-related rate changes; and

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

- Implementation of various changes to rate schedules, including the adoption of an experimental buy-through rate that could allow certain large commercial and industrial customers to select alternative sources of generation to be supplied by APS.

The Settlement Agreement was approved by the ACC on May 15, 2012, with new rates effective on July 1, 2012. This accomplished a goal set by the parties to the 2008 rate case settlement to process subsequent rate cases within twelve months of sufficiency findings from the ACC staff, which generally occur within 30 days after the filing of a rate case.

2008 General Retail Rate Case On-Going Impacts

On December 30, 2009, the ACC issued an order approving a settlement agreement entered into by APS and twenty-one other parties in APS's prior general retail rate case, which was originally filed in March 2008. The settlement agreement contains certain on-going requirements, commitments and authorizations that will survive the 2012 Settlement Agreement, including the following:

- A commitment from APS to reduce average annual operational expenses by at least \$30 million from 2010 through 2014;
- Authorization and requirements of equity infusions into APS of at least \$700 million during the period beginning June 1, 2009 through December 31, 2014 (\$253 million of which was infused into APS from proceeds of a Pinnacle West equity issuance in the second quarter of 2010); and
- Various modifications to the existing energy efficiency, demand side management and renewable energy programs that require APS to, among other things, expand its conservation and demand side management programs through 2012 and its use of renewable energy through 2015, as well as allow for concurrent recovery of renewable energy expenses and provide for more concurrent recovery of demand side management costs and incentives.

Cost Recovery Mechanisms

APS has received regulatory decisions that allow for more timely recovery of certain costs through the following recovery mechanisms.

Renewable Energy Standard. In 2006, the ACC approved the RES. Under the RES, electric utilities that are regulated by the ACC must supply an increasing percentage of their retail electric energy sales from eligible renewable resources, including solar, wind, biomass, biogas and geothermal technologies. In order to achieve these requirements, the ACC allows APS to include a RES surcharge as part of customer bills to recover the approved amounts for use on renewable energy projects. Each year APS is required to file a five-year implementation plan with the ACC and seek approval for funding the upcoming year's RES budget.

On December 14, 2011, the ACC voted to approve APS's 2012 RES plan covering the 2012-2016 timeframe and authorized a total 2012 RES budget of \$110 million. On June 29, 2012, APS filed its annual RES implementation plan, covering the 2013-2017 timeframe and requested 2013 RES funding of \$97 million to \$107 million. In a final order dated January 31, 2013, the ACC approved a budget of \$103 million for APS's 2013 RES plan. That budget includes \$4 million for residential distributed energy

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

incentives and \$0.1 million for commercial distributed energy up-front incentives, but did not include any funds for new commercial distributed energy production-based incentives beyond those for previously approved programs. The ACC further ordered that a hearing take place to consider APS's proposal to establish compliance with distributed energy requirements by tracking and recording distributed energy, rather than acquiring and retiring renewable energy credits. The track and record approach would require monitoring the distributed energy systems that are connected to APS's system, recording the amount of energy they produce, and reporting the energy production amounts to the ACC for informational purposes only. Finally, the ACC authorized an APS-led multi-session technical conference designed to consider APS's net metering policy and the cost and benefits of distributed energy.

Demand Side Management Adjustor Charge. The ACC Electric Energy Efficiency Standards require APS to submit a Demand Side Management Implementation Plan for review by and approval of the ACC. In 2010, the DSMAC was modified to recover estimated amounts for use on certain demand side management programs over the current year. Previously, the DSMAC allowed for such recovery only on a historical or after-the-fact basis. The surcharge allows for the recovery of energy efficiency program expenses and any earned incentives.

The ACC previously approved recovery of all 2009 program costs plus incentives. The change from program cost recovery on a historical basis to recovery on a concurrent basis, as authorized in the 2008 retail rate case settlement agreement, resulted in this one-time need to address two years (2009 and 2010) of cost recovery. As requested by APS, 2009 program cost recovery was amortized over a three-year period, which ended in 2012.

On June 1, 2011, APS filed its 2012 Demand Side Management Implementation Plan consistent with the ACC's Electric Energy Efficiency Standards, which became effective January 1, 2011. The 2012 requirement under such standards is for cumulative energy efficiency savings of 3% of APS retail sales for the prior year. This energy savings requirement is slightly higher than the goal established by the 2008 retail rate case settlement agreement (2.75% of total energy resources for the same two-year period). The ACC issued an order on April 4, 2012 approving recovery of approximately \$72 million of APS's energy efficiency and demand side management program costs. This amount will be recovered by the then existing DSMAC over a twelve-month period beginning March 1, 2012. This amount does not include \$10 million already being recovered in general retail base rates.

On June 1, 2012, APS filed its 2013 Demand Side Management Implementation Plan. In 2013, the standards will require APS to achieve cumulative energy savings equal to 5% of its 2012 retail energy sales. Later in 2012, APS filed a supplement to its plan that included a proposed budget for 2013 of \$87.6 million. Although this proposed budget is approximately \$5.6 million more than the approved 2012 budget, the expiration of the three-year amortization of 2009 costs and prior year credits would result in a small decrease in the DSMAC for the balance of 2013. APS expects to receive a decision from the ACC in the second quarter of 2013.

PSA Mechanism and Balance. The PSA provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs.

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The following table shows the changes in the deferred fuel and purchased power regulatory asset (liability) for 2013 and 2012 (dollars in millions):

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Three Months Ended			
	March 31,			
	2013		2012	
Beginning balance	\$	73	\$	28
Deferred fuel and purchased power costs – current period		(31)		(47)
Amounts (collected from) credited to customers		(1)		24
Ending balance	\$	41	\$	5

The PSA rate for the PSA year beginning February 1, 2013 is \$0.0013 per kWh as compared to (\$0.0042) per kWh for the prior year. This represents a \$0.0055 per kWh increase over the 2012 PSA charge. This new rate is comprised of a forward component of (\$0.0010) per kWh and a historical component of \$0.0023 per kWh. The Settlement Agreement allowed APS to exceed the \$0.004 per kWh cap to PSA rate changes in this instance. Any uncollected (overcollected) deferrals during the 2013 PSA year will be included in the calculation of the PSA rate for the PSA year beginning February 1, 2014.

Transmission Rates and Transmission Cost Adjustor. In July 2008, the United States Federal Energy Regulatory Commission (FERC) approved an Open Access Transmission Tariff for APS to move from fixed rates to a formula rate-setting methodology in order to more accurately reflect and recover the costs that APS incurs in providing transmission services. A large portion of the rate represents charges for transmission services to serve APS's retail customers (Retail Transmission Charges). In order to recover the Retail Transmission Charges, APS was previously required to file an application with, and obtain approval from, the ACC to reflect changes in Retail Transmission Charges through the TCA. Under the terms of the Settlement Agreement (discussed above), however, an adjustment to rates to recover the Retail Transmission Charges will be made annually each June 1 beginning in 2013 and will go into effect automatically unless suspended by the ACC.

The formula rate is updated each year effective June 1 on the basis of APS's actual cost of service, as disclosed in APS's FERC Form 1 report for the previous fiscal year. Items to be updated include actual capital expenditures made as compared with previous projections, transmission revenue credits and other items. The resolution of proposed adjustments can result in significant volatility in the revenues to be collected. APS reviews the proposed formula rate filing amounts with the ACC staff. Any items or adjustments which are not agreed to by APS and the ACC staff can remain in dispute until settled or litigated at FERC. Settlement or litigated resolution of disputed issues could require an extended period of time and could have a significant effect on the Retail Transmission Charge because any adjustment, though applied prospectively, may be calculated to account for previously over- or under-collected amounts.

Effective June 1, 2012, APS's annual wholesale transmission rates for all users of its transmission system increased by approximately \$16 million for the twelve-month period beginning June 1, 2012 in accordance with the FERC-approved formula. Because of higher relative system demand by APS's retail customers, the approximately \$16 million increase reflects roughly a \$2 million decrease for wholesale customers and an \$18 million increase for APS retail customers.

On July 18, 2012, the ACC authorized the implementation of the FERC-approved transmission rates for retail customers discussed above, which became effective August 2012.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As part of APS's proposed acquisition of Southern California Edison's (SCE) interest in Units 4 and 5 of Four Corners, APS and SCE agreed that upon closing of the acquisition (or in 2016 if the closing does not occur), the companies will terminate an existing agreement that provides transmission capacity for SCE to transmit its portion of the output from Four Corners to California. On May 1, 2013, APS filed a request with FERC seeking authorization to cancel the existing agreement and defer a \$40 million payment to be made by APS associated with the termination and recover the payment through amortization over a 10-year period. APS believes the costs associated with the termination of the existing agreement are recoverable, but cannot predict whether FERC will approve our request; however, if the recovery is disallowed by FERC, APS would record a charge to its results of operations at the time of the disallowance.

Lost Fixed Cost Recovery (LFCR) Mechanism. The LFCR mechanism permits APS to recover on an after-the-fact basis a portion of its fixed costs that would otherwise have been collected by APS in the kWh sales lost due to APS energy efficiency programs and to distributed generation such as roof-top solar arrays. The fixed costs recoverable by the LFCR mechanism were established in the recent rate case and amount to approximately 3.1 cents per residential kWh lost and 2.3 cents per non-residential kWh lost. The kWh's lost from energy efficiency are based on a third-party evaluation of APS's energy efficiency programs. Distributed generation sales losses are determined from the metered output from the distributed generation units or if metering is unavailable, through accepted estimating techniques.

APS filed its first LFCR adjustment on January 15, 2013 and will file for its LFCR adjustment every January thereafter. On February 12, 2013, the ACC approved an LFCR adjustment of \$5.1 million, representing a pro-rated amount for 2012 since the Settlement Agreement went into effect on July 1, 2012.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Regulatory Assets and Liabilities**

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

Pension and other postretirement benefits	(a)	\$		\$	769	\$		\$	780
Income taxes allowance for funds used during construction (AFUDC) equity	2043		4		93		4		92
Deferred fuel and purchased power mark-to-market (Note 7)	2016				20		19		21
Transmission vegetation management	2016		9		20		9		23
Coal reclamation	2038		8		22		8		24
Palo Verde VIEs (Note 6)	2046				39				38
Deferred compensation	2036				35				34
Deferred fuel and purchased power (b) (c)	2013		41				73		
Tax expense of Medicare subsidy	2024		2		17		2		17
Loss on reacquired debt	2034		1		18		2		18
Income taxes investment tax credit basis adjustment	2042		1		31		1		26
Pension and other postretirement benefits deferral	2015		8		11		8		13
Other	Various		20		22		18		14
Total regulatory assets (d)		\$	94	\$	1,097	\$	144	\$	1,100

(a) This asset represents the future recovery of under-funded pension and other postretirement benefit obligations through retail rates. If these costs are disallowed by the ACC, this regulatory asset would be charged to other comprehensive income (OCI) and result in lower future revenues.

(b) See Cost Recovery Mechanisms discussion above.

(c) Subject to a carrying charge.

(d) There are no regulatory assets for which the ACC has allowed recovery of costs but not allowed a return by exclusion from rate base. FERC rates are set using a formula rate as described in Transmission Rates and Transmission Cost Adjustor.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

	Remaining Amortization Period	March 31, 2013		December 31, 2012	
		Current	Non-Current	Current	Non-Current
Removal costs	(a)	\$ 28	\$ 320	\$ 27	\$ 321
Asset retirement obligations	(a)		273		256
Renewable energy standard (b)	2014	29	16	43	
Income taxes change in rates	2042		66		66
Spent nuclear fuel	2047	5	38	10	36
Deferred gains on utility property	2019	2	12	2	12
Income taxes deferred investment tax credit	2042	2	63	2	52
Other	Various	11	17	4	16
Total regulatory liabilities		\$ 77	\$ 805	\$ 88	\$ 759

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

(b) See Cost Recovery Mechanisms discussion above.

4. Retirement Plans and Other Benefits

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a non-qualified supplemental excess benefit retirement plan, and other postretirement benefit plans for the employees of Pinnacle West and our subsidiaries. Pinnacle West uses a December 31 measurement date for its pension and other postretirement benefit plans. The market-related value of our plan assets is their fair value at the measurement date.

Certain pension and other postretirement benefit costs in excess of amounts recovered in electric retail rates were deferred as a regulatory asset for future recovery, pursuant to an ACC regulatory order. We deferred pension and other postretirement benefit costs of approximately \$9 million for the three months ended March 31, 2012. Pursuant to an ACC regulatory order, we began amortizing the regulatory asset in July 2012. We amortized approximately \$2 million for the three months ended March 31, 2013. The following table provides details of the plans' net periodic benefit costs and the portion of these costs charged to expense (including administrative costs and excluding amounts capitalized as overhead construction, billed to electric plant participants or charged or amortized to the regulatory asset) (dollars in millions):

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Pension Benefits Three Months Ended March 31,		Other Benefits Three Months Ended March 31,	
	2013	2012	2013	2012
Service cost - benefits earned during the period	\$ 17	\$ 16	\$ 6	\$ 7
Interest cost on benefit obligation	29	30	10	12
Expected return on plan assets	(37)	(35)	(11)	(11)
Amortization of net actuarial loss	9	11	3	6
Net periodic benefit cost	\$ 18	\$ 22	\$ 8	\$ 14
Portion of cost charged to expense	\$ 10	\$ 6	\$ 5	\$ 3

Contributions

We have contributed \$56 million to our pension plan year to date in 2013. The minimum contributions for the pension plan due in 2013, 2014, and 2015 under the recently enacted Moving Ahead for Progress in the 21st Century Act (MAP-21) are estimated to be zero, \$89 million, and \$112 million, respectively. We expect to make voluntary contributions totaling \$140 million to the pension plan in 2013, and contributions up to approximately \$175 million in each of 2014 and 2015. The contributions to our other postretirement benefit plans for 2013, 2014 and 2015 are expected to be approximately \$20 million each year.

5. Income Taxes

The \$71 million long-term income tax receivable on the Condensed Consolidated Balance Sheets represents the anticipated refunds related to an APS tax accounting method change approved by the Internal Revenue Service (IRS) in the third quarter of 2009. This amount is classified as long-term, as there remains uncertainty regarding the timing of this cash receipt. Further clarification of the timing is expected from the IRS within the next twelve months.

Net Income associated with the Palo Verde sale leaseback variable interest entities is not subject to tax (see Note 6). As a result, there is no income tax expense associated with the VIEs recorded on the Condensed Consolidated Statements of Income.

It is reasonably possible that within the next twelve months the IRS will finalize the examination of tax returns for the years ended December 31, 2008 and 2009. At this time, a reasonable estimate of the range of possible change in the uncertain tax position cannot be made. However, we do not expect the ultimate outcome of this examination to have a material adverse impact on our financial position or results of operations.

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The American Taxpayer Relief Act of 2012, signed into law on January 2, 2013, includes provisions making qualified property placed into service in 2013 eligible for 50% bonus depreciation for federal income tax purposes. Full recognition of the cash benefit of this provision is expected to delay realization of approximately \$78 million in federal general business income tax credit carryforwards which were classified as current deferred income taxes as of December 31, 2012. These federal general business tax credit carryforwards have been reclassified to long-term deferred income taxes as of March 31, 2013 as they are no longer expected to be realized within the next twelve months.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

As of March 31, 2013, the tax year ended December 31, 2008 and all subsequent tax years remain subject to examination by the IRS. With few exceptions, we are no longer subject to state income tax examinations by tax authorities for years before 2008.

6. Palo Verde Sale Leaseback Variable Interest Entities

In 1986, APS entered into agreements with three separate VIE lessor trusts in order to sell and lease back interests in Palo Verde Unit 2 and related common facilities. APS will pay approximately \$49 million per year for the years 2013 to 2015 related to these leases. The lease agreements include fixed rate renewal periods, which gives APS the ability to utilize the asset for a significant portion of the asset's economic life, and therefore provide APS with the power to direct activities of the VIEs that most significantly impact the VIEs' economic performance. Predominately due to the fixed rate renewal periods, APS has been deemed the primary beneficiary of these VIEs and therefore consolidates the VIEs.

On December 31, 2012, APS notified the lessor trust entities that APS would retain the assets beyond 2015 by either exercising the fixed rate lease renewals or by purchasing the assets. If APS elects to purchase the assets, the purchase price will be based on the fair market value of the assets at the end of 2015. If APS elects to extend the leases, we will be required to make payments beginning in 2016 of approximately \$23 million annually. The length of the lease extensions is unknown at this time as it must be determined through an appraisal process. APS must give notice to the lessor trusts by June 30, 2014 notifying them which of these two options (lease renewal or purchasing the assets) it will exercise. The December 31, 2012 notification does not impact APS's consolidation of the VIEs, as APS continues to be deemed the primary beneficiary of the VIEs.

As a result of consolidation, we eliminate rent expense and recognize depreciation and interest expense, resulting in an increase in net income for the three months ended March 31, 2013 of \$8 million and for the three months ended March 31, 2012 of \$8 million, entirely attributable to the noncontrolling interests. Income attributable to Pinnacle West shareholders remains the same. Consolidation of these VIEs also results in changes to our Condensed Consolidated Statements of Cash Flows, but does not impact net cash flows.

Our Condensed Consolidated Balance Sheets at March 31, 2013 and December 31, 2012 include the following amounts relating to the VIEs (in millions):

	March 31, 2013	December 31, 2012
Palo Verde sale leaseback property plant and equipment, net of accumulated depreciation	\$ 128	\$ 129
Current maturities of long-term debt	27	27
Palo Verde sale leaseback lessor notes long-term debt excluding current maturities	39	39

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Equity Noncontrolling interests

138

129

Assets of the VIEs are restricted and may only be used to settle the VIEs' debt obligations and for payment to the noncontrolling interest holders. Other than the VIEs' assets reported on our consolidated financial statements, the creditors of the VIEs have no other recourse to the assets of APS or Pinnacle West, except in certain circumstances such as a default by APS under the lease.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

APS is exposed to losses relating to these VIEs upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the United States Nuclear Regulatory Commission (NRC) issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to make specified payments to the VIEs noncontrolling equity participants, assume the VIEs debt, 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 March 31, 2013, APS would have been required to pay the noncontrolling equity participants approximately \$139 million and assume \$66 million of debt. Since APS consolidates these VIEs, the debt APS would be required to assume is already reflected in our Condensed Consolidated Balance Sheets.

For regulatory ratemaking purposes, the leases continue to be treated as operating leases and, as a result, we have recorded a regulatory asset relating to the arrangements.

7. Derivative Accounting

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity, natural gas, coal, emissions allowances and in interest rates. We manage risks associated with market volatility by utilizing various physical and financial derivative instruments, including futures, forwards, options and swaps. As part of our overall risk management program, we may use derivative instruments to hedge purchases and sales of electricity and fuels. Derivative instruments that meet certain hedge accounting criteria may be designated as cash flow hedges and are used to limit our exposure to cash flow variability on forecasted transactions. The changes in market value of such instruments have a high correlation to price changes in the hedged transactions. We also enter into derivative instruments for economic hedging purposes. While we believe the economic hedges mitigate exposure to fluctuations in commodity prices, these instruments have not been designated as accounting hedges. Contracts that have the same terms (quantities, delivery points and delivery periods) and for which power does not flow are netted, which reduces both revenues and fuel and purchased power costs in our Condensed Consolidated Statements of Income, but does not impact our financial condition, net income or cash flows.

On June 1, 2012, we elected to discontinue cash flow hedge accounting treatment for the significant majority of our contracts that had previously been designated as accounting hedges. This discontinuation is due to changes in PSA recovery (see Note 3), which now allows for 100% deferral of the unrealized gains and losses relating to these contracts. For those contracts that were de-designated, all changes in fair value after May 31, 2012 are no longer recorded through other comprehensive income (OCI), but are deferred through the PSA. The amounts previously recorded in accumulated OCI relating to these instruments will remain in accumulated OCI, and will transfer to earnings in the same period or periods during which the hedged transaction affects earnings or sooner if we determine it is probable that the forecasted transaction will not occur. Cash flow hedge accounting treatment will continue for a limited number of contracts that are not subject to PSA recovery.

Our derivative instruments, excluding those qualifying for a scope exception, are recorded on the balance sheet as an asset or liability and are measured at fair value; see Note 12 for a discussion of fair value measurements. Derivative instruments may qualify for the normal purchases and normal sales scope exception if they require physical delivery and the quantities represent those transacted in the normal course of business. Derivative instruments qualifying for the normal purchases and normal sales

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

scope exception are accounted for under the accrual method of accounting and excluded from our derivative instrument discussion and disclosures below.

Hedge effectiveness is the degree to which the derivative instrument contract and the hedged item are correlated and is measured based on the relative changes in fair value of the derivative instrument contract and the hedged item over time. We assess hedge effectiveness both at inception and on a continuing basis. These assessments exclude the time value of certain options. For accounting hedges that are deemed an effective hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of OCI and reclassified into earnings in the same period during which the hedged transaction affects earnings. We recognize in current earnings, subject to the PSA, the gains and losses representing hedge ineffectiveness, and the gains and losses on any hedge components which are excluded from our effectiveness assessment. As cash flow hedge accounting has been discontinued for the significant majority of our contracts, after May 31, 2012, effectiveness testing is no longer being performed for these contracts.

Prior to the Settlement Agreement, for its regulated operations, APS deferred for future rate treatment approximately 90% of unrealized gains and losses on certain derivatives pursuant to the PSA mechanism that would otherwise be recognized in income. Due to the Settlement Agreement, for its regulated operations, APS now defers for future rate treatment 100% of the unrealized gains and losses for delivery periods after June 30, 2012 on derivatives pursuant to the PSA mechanism that would otherwise be recognized in income. Realized gains and losses on derivatives are deferred in accordance with the PSA to the extent the amounts are above or below the Base Fuel Rate (see Note 3). Gains and losses from derivatives in the following tables represent the amounts reflected in income before the effect of PSA deferrals.

As of March 31, 2013, we had the following outstanding gross notional volume of derivatives, which represent both purchases and sales (does not reflect net position):

Commodity		Quantity
Power	7,628	gigawatt hours
Gas	127	Bcfs (a)

(a) Bcf is Billion Cubic Feet.

Gains and Losses from Derivative Instruments

The following table provides information about gains and losses from derivative instruments in designated cash flow accounting hedging relationships (dollars in thousands):

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Gain (Loss) Recognized in OCI on Derivative Instruments (Effective Portion)	Other comprehensive income (loss) - derivative instruments	\$	96	\$	(41,903)
Loss Reclassified from Accumulated Other Comprehensive Income into Income (Effective Portion Realized)					
(a)	Fuel and purchased power (b)		(8,353)		(14,500)
Gain Recognized in Income (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Fuel and purchased power (b)				85

(a) During the three months ended March 31, 2013 and 2012, we had no amounts reclassified from AOCI to earnings related to discontinued cash flow hedges.

(b) Amounts are before the effect of PSA deferrals.

During the next twelve months, we estimate that a net loss of \$40 million before income taxes will be reclassified from accumulated other comprehensive income as an offset to the effect of market price changes for the related hedged transactions. In accordance with the PSA, substantially all of these amounts will be recorded as either a regulatory asset or liability and have no immediate effect on earnings.

The following table provides information about gains and losses from derivative instruments not designated as accounting hedging instruments during the three months ended March 31, 2013 and 2012 (dollars in thousands):

Commodity Contracts	Financial Statement Location	Three Months Ended			
		2013	March 31, 2012		
Net Loss Recognized in Income	Operating revenues (a)	\$	(117)	\$	(326)
Net Gain (Loss) Recognized in Income	Fuel and purchased power expense (a)		17,350		(25,052)
Total		\$	17,233	\$	(25,378)

(a) Amounts are before the effect of PSA deferrals.

Derivative Instruments in the Condensed Consolidated Balance Sheets

Our derivative transactions are typically executed under standardized or customized agreements, which include collateral requirements and in the event of a default would allow for the netting of positive and negative exposures associated with a single counterparty. Agreements that allow for the offsetting of positive and negative exposures associated with a single counterparty are considered master netting arrangements. Transactions with counterparties that have master netting arrangements are offset and

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

reported net on the Condensed Consolidated Balance Sheets. Transactions that do not allow for offsetting of positive and negative positions are reported gross on the Condensed Consolidated Balance Sheets.

We do not offset a counterparty's current derivative contracts with the counterparty's non-current derivative contracts, although our master netting arrangements would allow current and non-current positions to be offset in the event of default. Additionally, in the event of a default, our master netting arrangements would allow for the offsetting of all transactions executed under the master netting arrangement. These types of transactions may include non-derivative instruments, derivatives qualifying for scope exceptions, trade receivables and trade payables arising from settled positions, and other forms of non-cash collateral (such as letters of credit). These types of transactions are excluded from the offsetting tables presented below.

The significant majority of our derivative instruments are not currently designated as hedging instruments. The Condensed Consolidated Balance Sheets as of March 31, 2013 and December 31, 2012, include gross liabilities of \$5 million of derivative instruments designated as hedging instruments.

The following tables provide information about the fair value of our risk management activities reported on a gross basis, and the impacts of offsetting. These amounts relate to commodity contracts and are located in the assets and liabilities from risk management activities lines of our Condensed Consolidated Balance Sheets.

As of March 31, 2013: (dollars in thousands)	Gross Recognized Derivatives (a)	Amounts Offset (b)	Net Recognized Derivatives	Other (c)	Amount Reported on Balance Sheet
Current Assets	\$ 38,623	\$ (18,344)	\$ 20,279	\$ 67	\$ 20,346
Investments and Other Assets	39,467	(5,420)	34,047		34,047
Total Assets	78,090	(23,764)	54,326	67	54,393
Current Liabilities	(78,412)	38,521	(39,891)	(25,463)	(65,354)
Deferred Credits and Other	(93,215)	10,339	(82,876)		(82,876)
Total Liabilities	(171,627)	48,860	(122,767)	(25,463)	(148,230)
Total	\$ (93,537)	\$ 25,096	\$ (68,441)	\$ (25,396)	\$ (93,837)

(a) All of our gross recognized derivative instruments were subject to master netting arrangements.

(b) Includes cash collateral provided to counterparties of \$25,096.

(c) Other represents cash collateral and margin relating to non-derivative instruments or derivatives qualifying for scope exceptions. Includes cash collateral received from counterparties of \$25,463, and cash margin provided to counterparties of \$67. This amount is not subject to offsetting.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2012: (dollars in thousands)	Gross Recognized Derivatives (a)	Amounts Offset (b)	Net Recognized Derivatives	Other (c)	Amount Reported on Balance Sheet
Current Assets	\$ 42,495	\$ (17,797)	\$ 24,698	\$ 1,001	\$ 25,699
Investments and Other Assets	41,563	(5,672)	35,891		35,891
Total Assets	84,058	(23,469)	60,589	1,001	61,590
Current Liabilities	(105,324)	57,046	(48,278)	(25,463)	(73,741)
Deferred Credits and Other	(100,986)	15,722	(85,264)		(85,264)
Total Liabilities	(206,310)	72,768	(133,542)	(25,463)	(159,005)
Total	\$ (122,252)	\$ 49,299	\$ (72,953)	\$ (24,462)	\$ (97,415)

(a) All of our gross recognized derivative instruments were subject to master netting arrangements.

(b) Includes cash collateral provided to counterparties of \$49,299.

(c) Other represents cash collateral relating to non-derivative instruments or derivatives qualifying for scope exceptions. Includes cash collateral provided to counterparties of \$1,001, and cash collateral received from counterparties of \$25,463. This amount is not subject to offsetting.

Credit Risk and Credit Related Contingent Features

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We have risk management contracts with many counterparties, including two counterparties for which our exposure represents approximately 83% of Pinnacle West's \$54 million of risk management assets as of March 31, 2013. This exposure relates to long-term traditional wholesale contracts with counterparties that have high credit quality. Our risk management process assesses and monitors the financial exposure of all counterparties. Despite the fact that the great majority of trading counterparties' debt is rated as investment grade by the credit rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material impact on consolidated earnings for a given period. Counterparties in the portfolio consist principally of financial institutions, major energy companies, municipalities and local distribution companies. We maintain credit policies that we believe minimize overall credit risk to within acceptable limits. Determination of the credit quality of our counterparties is based upon a number of factors, including credit ratings and our evaluation of their financial condition. To manage credit risk, we employ collateral requirements and standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty. Valuation adjustments are established representing our estimated credit losses on our overall exposure to counterparties.

Certain of our derivative instrument contracts contain credit-risk-related contingent features including, among other things, investment grade credit rating provisions, credit-related cross default provisions, and adequate assurance provisions. Adequate assurance provisions allow a counterparty with reasonable grounds for uncertainty to demand additional collateral based on a subjective event and/or condition. For those derivative instruments in a net liability position, with investment grade credit contingencies, the counterparties could demand additional

collateral if our debt credit rating were to fall below investment grade (below BBB- for Standard & Poor's or Fitch or Baa3 for Moody's).

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The following table provides information about our derivative instruments that have credit-risk-related contingent features at March 31, 2013 (dollars in millions):

	March 31, 2013
Aggregate Fair Value of Derivative Instruments in a Net Liability Position	\$ 172
Cash Collateral Posted	25
Additional Cash Collateral in the Event Credit-Risk Related Contingent Features were Fully Triggered (a)	106

(a) This amount is after counterparty netting and includes those contracts which qualify for scope exceptions, which are excluded from the derivative details above.

We also have energy related non-derivative instrument contracts with investment grade credit-related contingent features which could also require us to post additional collateral of approximately \$174 million if our debt credit ratings were to fall below investment grade.

8. Changes in Equity

The following tables show Pinnacle West's changes in shareholders' equity and changes in equity of noncontrolling interests for the three months ended March 31, 2013 and 2012 (dollars in thousands):

	Three Months Ended March 31, 2013			Three Months Ended March 31, 2012		
	Common Shareholders	Noncontrolling Interests	Total	Common Shareholders	Noncontrolling Interests	Total
Beginning balance, January 1	\$ 3,972,806	\$ 129,483	\$ 4,102,289	\$ 3,821,850	\$ 108,736	\$ 3,930,586
Net income (loss)	24,444	8,392	32,836	(8,257)	7,776	(481)
Other comprehensive income (loss)	6,077		6,077	(15,614)		(15,614)
Total comprehensive income (loss)	30,521	8,392	38,913	(23,871)	7,776	(16,095)
Issuance of capital stock	2,574		2,574	2,700		2,700

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Purchase of treasury stock net	(6,271)	(6,271)	(1,754)	(1,754)
Other (primarily stock compensation)	14,825	14,825	3,350	3,350
Dividends on common stock			(57,358)	(57,358)
Ending balance, March 31	\$ 4,014,455	\$ 137,875	\$ 4,152,330	\$ 3,744,917
			\$ 116,512	\$ 3,861,429

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

9. Commitments and Contingencies

Palo Verde Nuclear Generating Station

Spent Nuclear Fuel and Waste Disposal

On December 19, 2012, APS, acting on behalf of itself and the participant owners of Palo Verde, filed a breach of contract lawsuit against the United States Department of Energy (DOE) in the United States Court of Federal Claims. The lawsuit seeks to recover APS' s damages incurred due to DOE' s breach of the Standard Contract for failing to accept Palo Verde spent nuclear fuel and high level waste from January 1, 2007 through June 30, 2011, as it was required to do pursuant to the terms of the Standard Contract and the Nuclear Waste Policy Act.

APS currently estimates it will incur \$122 million over the current life of Palo Verde for its share of the costs related to the on-site interim storage of spent nuclear fuel. At March 31, 2013, APS had a regulatory liability of \$43 million that represents amounts recovered in retail rates in excess of amounts spent for on-site interim spent fuel storage.

Nuclear Insurance

Public liability for incidents at nuclear power plants is governed by the Price-Anderson Nuclear Industries Indemnity Act (Price-Anderson Act), which limits the liability of nuclear reactor owners to the amount of insurance available from both private sources and an industry retrospective payment plan. In accordance with the Price-Anderson Act, the Palo Verde participants are insured against public liability for a nuclear incident up to \$12.6 billion per occurrence. Palo Verde maintains the maximum available nuclear liability insurance in the amount of \$375 million, which is provided by commercial insurance carriers. The remaining balance of \$12.2 billion of liability coverage is provided through a mandatory industry-wide retrospective assessment program. If losses at any nuclear power plant covered by the program exceed the accumulated funds, APS could be assessed retrospective premium adjustments. The maximum assessment per reactor under the program for each nuclear incident is approximately \$118 million, subject to an annual limit of \$18 million per incident, to be periodically adjusted for inflation. Based on APS' s interest in the three Palo Verde units, APS' s maximum potential retrospective assessment per incident for all three units is approximately \$103 million, with an annual payment limitation of approximately \$15 million.

The Palo Verde participants maintain all risk (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of \$2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. Effective April 1, 2013, a sublimit of \$1.5 billion for non-nuclear property damage losses has been imposed on the primary policy offered by Nuclear Electric Insurance Limited (NEIL). APS has also secured insurance against portions of any increased cost of generation or purchased

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power and business interruption resulting from a sudden and unforeseen accidental outage of any of the three units. Effective April 1, 2013, a sublimit of \$327.6 million has been imposed on the non-nuclear losses of the accidental outage policy (NEIL I policy). The property damage, decontamination, and replacement power coverages are provided by NEIL. APS is subject to retrospective assessments under all NEIL policies if NEIL's losses in any policy year exceed accumulated funds. The maximum amount APS could incur under the current NEIL policies totals approximately \$18 million for each retrospective assessment declared by NEIL's Board of Directors due to losses. In addition, NEIL policies contain rating triggers that would result in APS providing approximately \$48 million of collateral assurance within 20 business days of a rating downgrade to non-

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

investment grade. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions, sublimits and exclusions.

Contractual Obligations

There have been no material changes outside the normal course of business in contractual obligations from the information provided in our 2012 Form 10-K.

Superfund-Related Matters

The Comprehensive Environmental Response, Compensation and Liability Act (Superfund) establishes liability for the cleanup of hazardous substances found contaminating the soil, water or air. Those who generated, transported or disposed of hazardous substances at a contaminated site are among those who are potentially responsible parties (PRPs). PRPs may be strictly, and often are jointly and severally, liable for clean-up. On September 3, 2003, the United States Environmental Protection Agency (EPA) advised APS that EPA considers APS to be a PRP in the Motorola 52nd Street Superfund Site, Operable Unit 3 (OU3) in Phoenix, Arizona. APS has facilities that are within this Superfund site. APS and Pinnacle West have agreed with EPA to perform certain investigative activities of the APS facilities within OU3. In addition, on September 23, 2009, APS agreed with EPA and one other PRP to voluntarily assist with the funding and management of the site-wide groundwater remedial investigation and feasibility study work plan. We estimate that our costs related to this investigation and study will be approximately \$2 million. We anticipate incurring additional expenditures in the future, but because the overall investigation is not complete and ultimate remediation requirements are not yet finalized, at the present time expenditures related to this matter cannot be reasonably estimated.

The Roosevelt Irrigation District (RID) filed a lawsuit in Arizona District Court against over 40 defendants, alleging that RID 's groundwater wells were contaminated by the release of hazardous substances from facilities owned or operated by the defendants. The lawsuit also alleges that, under Superfund laws, the defendants are jointly and severally liable to RID. On February 21, 2013, certain of the defendants filed third-party complaints against additional parties, including APS. The allegations against APS arise out of APS 's current and former ownership of facilities in and around OU3. We are unable to determine a range of potential losses that are reasonably possible of occurring.

Climate Change Lawsuit

In February 2008, the Native Village of Kivalina and the City of Kivalina, Alaska filed a lawsuit in federal court in the Northern District of California against nine oil companies, fourteen power companies (including Pinnacle West), and a coal company, alleging that the defendants emissions of carbon dioxide contribute to global warming and constitute a public and private nuisance under both federal and state law. The

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plaintiffs also allege that the effects of global warming will require the relocation of the village, and they are seeking an unspecified amount of monetary damages. In June 2008, the defendants filed motions to dismiss the action, which were granted. The plaintiffs filed an appeal with the United States Court of Appeals for the Ninth Circuit in November 2009.

On September 21, 2012, a three-judge panel of the Ninth Circuit affirmed the district court's dismissal of the *Kivalina* plaintiffs' federal common law public nuisance action. The court declined to address any other issue raised by the parties, including the plaintiffs' state nuisance law claim. On

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

October 4, 2012, the plaintiffs filed a petition for rehearing by the entire Ninth Circuit, but on November 27, 2012, the court denied plaintiffs petition. On February 25, 2013, plaintiffs requested the United States Supreme Court to hear the case. The Court has not yet ruled on this request. APS continues to believe the action in *Kivalina* is without merit and will continue to defend against both the federal and state claims.

Southwest Power Outage

On September 8, 2011 at approximately 3:30 PM, a 500 kilovolt (kV) transmission line running between the Hassayampa and North Gila substations in southwestern Arizona tripped out of service due to a fault that occurred at a switchyard operated by APS. Approximately ten minutes after the transmission line went off-line, generation and transmission resources for the Yuma area were lost, resulting in approximately 69,700 APS customers losing service.

Within the same time period that APS' s Yuma customers lost service, a series of transmission and generation disruptions occurred across the systems of several utilities that resulted in outages affecting portions of southern Arizona, southern California and northern Mexico. A total of approximately 7,900 megawatts (MW) of firm load and 2.7 million customers were reported to have been affected. Service to all affected APS customers was restored by 9:15 PM on September 8. Service to customers affected by the wider regional outages was restored by approximately 3:25 AM on September 9.

The FERC and the North American Electric Reliability Corporation (NERC) conducted a joint inquiry into the outages and, on May 1, 2012, they issued a report (the Joint Report) with their analysis and conclusions as to the causes of the events. The report includes recommendations to help industry operators prevent similar outages in the future, including increased data sharing and coordination among the western utilities and entities responsible for bulk electric system reliability coordination. The Joint Report does not address potential reliability violations or an assessment of responsibility of the parties involved. APS continues to analyze business practices and procedures related to the September 8 events.

APS cannot predict the timing, results or potential impacts of enforcement actions that may be brought against APS relating to the September 8 events, or any claims that may be made as a result of the outages. If violations of NERC Reliability Standards are ultimately determined to have occurred, FERC has the legal authority to assert a possible fine of up to \$1 million per violation per day that a violation is found to have been in existence.

Clean Air Act Lawsuit

On October 4, 2011, Earthjustice, on behalf of several environmental organizations, filed a lawsuit in the United States District Court for the District of New Mexico against APS and the other Four Corners participants alleging violations of the New Source Review (NSR) provisions of

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the Clean Air Act. Subsequent to filing its original Complaint, on January 6, 2012, Earthjustice filed a First Amended Complaint adding claims for violations of the Clean Air Act's New Source Performance Standards (NSPS) program. Among other things, the plaintiffs seek to have the court enjoin operations at Four Corners until APS applies for and obtains any required NSR permits and complies with the NSPS. The plaintiffs further request the court to order the payment of civil penalties, including a beneficial mitigation project. On April 2, 2012, APS and the other Four Corners participants filed motions to dismiss. The case is being held in abeyance while the parties seek to negotiate a settlement. On March 30, 2013, upon joint motion of the parties, the court issued an order deeming the motions to dismiss withdrawn without prejudice during pendency of the stay. At such time as the stay is lifted, APS and the other Four Corners

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

participants may reinstate their motions to dismiss without risk of default. We are unable to determine a range of potential losses that are reasonably possible of occurring.

Environmental Matters

APS is subject to numerous environmental laws and regulations affecting many aspects of its present and future operations, including air emissions, water quality, wastewater discharges, solid waste, hazardous waste, and coal combustion residuals (CCR). These laws and regulations can change from time to time, imposing new obligations on APS resulting in increased capital, operating, and other costs. Associated capital expenditures or operating costs could be material. APS intends to seek recovery of any such environmental compliance costs through our rates, but cannot predict whether it will obtain such recovery. The following proposed and final rules involve material compliance costs to APS.

Regional Haze Rules. APS has received the final rulemaking imposing new requirements on Four Corners and the Cholla Power Plant (Cholla) and is currently awaiting a final rulemaking from EPA that could impose new requirements on the Navajo Generating Station (Navajo Plant). EPA and Arizona Department of Environmental Quality (ADEQ) will require these plants to install pollution control equipment that constitutes the best available retrofit technology to lessen the impacts of emissions on visibility surrounding the plants. Based on EPA 's final standards, APS 's share of its total costs for Four Corners (assuming the consummation of its purchase of SCE 's interest in Units 4 and 5 and subsequent shut down of Units 1-3) could be approximately \$300 million. APS 's share of costs for upgrades at Navajo, based on EPA 's Federal Implementation Plan (FIP) proposal, could be up to approximately \$158 million. APS has filed a Petition for Review of EPA 's rule as it applies to Cholla, which, if not successful, will require installation of controls with a cost to APS of approximately \$187 million.

Mercury and Other Hazardous Air Pollutants. In 2011, EPA issued rules establishing maximum achievable control technology standards to regulate emissions of mercury and other hazardous air pollutants from fossil-fired plants. APS estimates that the cost for the remaining equipment necessary to meet these standards is approximately \$124 million for Cholla Units 1-3. Estimated costs for Four Corners Units 1-3 are not included in our current environmental expenditure estimates since our estimates assume the consummation of APS 's purchase of SCE 's interest in Four Corners Units 4 and 5 and the subsequent shut down of Units 1-3. Salt River Project Agricultural Improvement and Power District (SRP), the operating agent for the Navajo Plant, is still evaluating compliance options under the rules.

Other future environmental rules that could involve material compliance costs include those related to cooling water intake structures, coal combustion waste, effluent limitations, ozone national ambient air quality, greenhouse gas emissions and other rules or matters involving the Clean Air Act, Endangered Species Act, the Navajo Nation, and water supplies for our power plants. The financial impact of complying with these and other future environmental rules could jeopardize the economic viability of our coal plants or the willingness or ability of power plant participants to fund any required equipment upgrades or continue their participation in these plants. The economics of continuing to own certain resources, particularly our coal plants, may deteriorate, warranting early retirement of those plants, which may result in asset impairments. APS would seek recovery in rates for the book value of any remaining investments in the plants as well as other costs related to early retirement, but cannot predict whether it would obtain such recovery.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Regional Haze Rules – Cholla

APS believes that EPA's final rule as it applies to Cholla is unsupported and that EPA had no basis for disapproving Arizona's State Implementation Plan (SIP) and promulgating a FIP that is inconsistent with the state's considered best available retrofit technology (BART) determinations under the regional haze program. Accordingly, on February 1, 2013, APS filed a Petition for Review of the final BART rule in the United States Court of Appeals for the Ninth Circuit. In addition, on February 4, 2013, APS filed a Petition for Reconsideration and Stay of the final BART rule with EPA. On March 22, 2013, APS filed a motion with the court to suspend the compliance deadlines under the BART rule until the court rules on the matter. The State of Arizona and three other utilities also filed similar petitions and motions.

Financial Assurances

APS has entered into various agreements that require letters of credit for financial assurance purposes. At March 31, 2013, approximately \$76 million of letters of credit were outstanding to support existing pollution control bonds of a similar amount. The letters of credit are available to fund the payment of principal and interest of such debt obligations. One of these letters of credit expires in 2015 and two expire in 2016. APS has also entered into letters of credit to support certain equity participants in the Palo Verde sale leaseback transactions (see Note 6 for further details on the Palo Verde sale leaseback transactions). These letters of credit will expire December 31, 2015, and totaled approximately \$34 million at March 31, 2013. Additionally, APS has issued letters of credit to support collateral obligations under certain risk management arrangements including certain natural gas tolling contracts entered into with third parties. At March 31, 2013, \$65 million of such letters of credit were outstanding that will expire in 2013 and 2015.

We enter into agreements that include indemnification provisions relating to liabilities arising from or related to certain of our agreements; most significantly, APS has agreed to indemnify the equity participants and other parties in the Palo Verde sale leaseback transactions with respect to certain tax matters. Generally, a maximum obligation is not explicitly stated in the indemnification provisions and, therefore, the overall maximum amount of the obligation under such indemnification provisions cannot be reasonably estimated. Based on historical experience and evaluation of the specific indemnities, we do not believe that any material loss related to such indemnification provisions is likely.

Pinnacle West has issued parental guarantees and surety bonds for APS which were not material at March 31, 2013.

10. Other Income and Other Expense

The following table provides detail of other income and other expense for the three months ended March 31, 2013 and 2012 (dollars in thousands):

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Three Months Ended	
	March 31,	
	2013	2012
Other income:		
Interest income	\$ 76	\$ 605
Miscellaneous	682	155
Total other income	\$ 758	\$ 760
Other expense:		
Non-operating costs	\$ (1,932)	\$ (1,850)
Investment losses net	(112)	(53)
Miscellaneous	(1,708)	(2,165)
Total other expense	\$ (3,752)	\$ (4,068)

11. Earnings Per Share

The following table presents earnings per weighted average common share outstanding for the three months ended March 31, 2013 and 2012:

	Three Months Ended	
	March 31,	
	2013	2012
Basic earnings per share:		
Income (loss) from continuing operations attributable to common shareholders	\$ 0.22	\$ (0.07)
Loss from discontinued operations		(0.01)
Earnings (loss) per share basic	\$ 0.22	\$ (0.08)
Diluted earnings per share:		
Income (loss) from continuing operations attributable to common shareholders	\$ 0.22	\$ (0.07)
Loss from discontinued operations		(0.01)
Earnings (loss) per share diluted	\$ 0.22	\$ (0.08)

Performance shares and restricted stock units (which are contingently issuable) increased the weighted average common shares outstanding by approximately 1,003,000 shares for the three months ended March 31, 2013. For the three months ended March 31, 2012, the weighted average common shares outstanding were the same for both basic and diluted shares.

For the three months ended March 31, 2013 and 2012, there were no common stock options that were excluded from the computation of diluted earnings per share as a result of the options exercise prices being greater than the average market price of the common shares.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

12. Fair Value Measurements

We classify our assets and liabilities that are carried at fair value within the fair value hierarchy. This hierarchy ranks the quality and reliability of the inputs used to determine fair values, which are then classified and disclosed in one of three categories. The three levels of the fair value hierarchy are:

Level 1 Unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access at the measurement date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide information on an ongoing basis. This category includes exchange-traded equities, exchange-traded derivative instruments, cash equivalents, and investments in United States Treasury securities.

Level 2 Utilizes quoted prices in active markets for similar assets or liabilities; quoted prices in markets that are not active; and model-derived valuations whose inputs are observable (such as yield curves). This category includes non-exchange traded contracts such as forwards, options, swaps and certain investments in fixed income securities. This category also includes investments in common and collective trusts and commingled funds that are redeemable and valued based on the funds' net asset value (NAV).

Level 3 Valuation models with significant unobservable inputs that are supported by little or no market activity. Instruments in this category include long-dated derivative transactions where valuations are unobservable due to the length of the transaction, options, and transactions in locations where observable market data does not exist. The valuation models we employ utilize spot prices, forward prices, historical market data and other factors to forecast future prices.

Assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Thus, a valuation may be classified in Level 3 even though the valuation may include significant inputs that are readily observable. We maximize the use of observable inputs and minimize the use of unobservable inputs. We rely primarily on the market approach of using prices and other market information for identical and/or comparable assets and liabilities. If market data is not readily available, inputs may reflect our own assumptions about the inputs market participants would use. Our assessment of the inputs and the significance of a particular input to the fair value measurement requires judgment and may affect the valuation of fair value assets and liabilities as well as their placement within the fair value hierarchy levels. We assess whether a market is active by obtaining observable broker quotes, reviewing actual market activity, and assessing the volume of transactions. We consider broker quotes observable inputs when the quote is binding on the broker, we can validate the quote with market activity, or we can determine that the inputs the broker used to arrive at the quoted price are observable.

Recurring Fair Value Measurements

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We apply recurring fair value measurements to certain cash equivalents, derivative instruments, investments held in our nuclear decommissioning trust and plan assets held in our retirement and other benefit plans. See Note 8 in the 2012 Form 10-K for the fair value discussion of plan assets held in our retirement and other benefit plans.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Cash Equivalents

Cash equivalents represent short-term investments with original maturities of three months or less in exchange traded money market funds that are valued using quoted prices in active markets.

Risk Management Activities Derivative Instruments

Exchange traded commodity contracts are valued using unadjusted quoted prices. For non-exchange traded commodity contracts, we calculate fair market value based on the average of the bid and offer price, discounted to reflect net present value. We maintain certain valuation adjustments for a number of risks associated with the valuation of future commitments. These include valuation adjustments for liquidity and credit risks. The liquidity valuation adjustment represents the cost that would be incurred if all unmatched positions were closed out or hedged. The credit valuation adjustment represents estimated credit losses on our net exposure to counterparties, taking into account netting agreements, expected default experience for the credit rating of the counterparties and the overall diversification of the portfolio. We maintain credit policies that management believes minimize overall credit risk.

Certain non-exchange traded commodity contracts are valued based on unobservable inputs due to the long-term nature of contracts or the unique location of the transactions. Our long-dated energy transactions consist of observable valuations for the near-term portion and unobservable valuations for the long-term portions of the transaction. We rely primarily on broker quotes to value these instruments. When our valuations utilize broker quotes, we perform various control procedures to ensure the quote has been developed consistent with fair value accounting guidance. These controls include assessing the quote for reasonableness by comparison against other broker quotes, reviewing historical price relationships, and assessing market activity. When broker quotes are not available, the primary valuation technique used to calculate fair value is the extrapolation of forward pricing curves using observable market data for more liquid delivery points in the same region and actual transactions at more illiquid delivery points.

Option contracts are primarily valued using a Black-Scholes option valuation model which utilizes both observable and unobservable inputs such as broker quotes, interest rates and price volatilities.

When the unobservable portion is significant to the overall valuation of the transaction, the entire transaction is classified as Level 3. Our classification of instruments as Level 3 is primarily reflective of the long-term nature of our energy transactions and the use of option valuation models with significant unobservable inputs.

Our energy risk management committee, consisting of officers and key management personnel, oversees our energy risk management activities to ensure compliance with our stated energy risk management policies. We have a risk control function that is responsible for valuing our

derivative commodity instruments in accordance with established policies and procedures. The risk control function reports to the chief financial officer's organization.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Investments Held in our Nuclear Decommissioning Trust

The nuclear decommissioning trust invests in fixed income securities and equity securities. Equity securities are held indirectly through commingled funds. The commingled funds are valued based on the concept of NAV, which is a value primarily derived from the quoted active market prices of the underlying equity securities. We may transact in these commingled funds on a semi-monthly basis at the NAV, and accordingly classify these investments as Level 2. The commingled funds, which are similar to mutual funds, are maintained by a bank and hold investments in accordance with the stated objective of tracking the performance of the S&P 500 index. Because the commingled fund shares are offered to a limited group of investors, they are not considered to be traded in an active market.

Cash equivalents reported within Level 2 represent investments held in a short-term investment commingled fund, valued using NAV, which invests in United States government fixed income securities. We may transact in this commingled fund on a daily basis at the NAV.

Fixed income securities issued by the United States Treasury held directly by the nuclear decommissioning trust are valued using quoted active market prices and are classified as Level 1. Fixed income securities issued by corporations, municipalities, and other agencies including mortgage-backed instruments are valued using quoted inactive market prices, quoted active market prices for similar securities, or by utilizing calculations which incorporate observable inputs such as yield curves and spreads relative to such yield curves. These instruments are classified as Level 2. Whenever possible, multiple market quotes are obtained which enables a cross-check validation. A primary price source is identified based on asset type, class, or issue of securities.

Our trustee provides valuation of our nuclear decommissioning trust assets by using pricing services that utilize the valuation methodologies described to determine fair market value. We have internal control procedures designed to ensure this information is consistent with fair value accounting guidance. These procedures include assessing valuations using an independent pricing source, verifying that pricing can be supported by actual recent market transactions, assessing hierarchy classifications, comparing investment returns with benchmarks, and obtaining and reviewing independent audit reports on the trustee's internal operating controls and valuation processes. See Note 13 for additional discussion about our nuclear decommissioning trust.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS***Fair Value Tables*

The following table presents the fair value at March 31, 2013 of our assets and liabilities that are measured at fair value on a recurring basis (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (a) (Level 3)	Other	Balance at March 31, 2013
Assets					
Risk management activities derivative instruments:					
Commodity contracts	\$	\$ 28	\$ 50	\$(24)(b)	\$ 54
Nuclear decommissioning trust:					
U.S. commingled equity funds		226			226
Fixed income securities:					
U.S. Treasury	115				115
Cash and cash equivalent funds	5	17		\$(9)(c)	13
Corporate debt		80			80
Mortgage-backed securities		89			89
Municipality bonds		63			63
Other		10			10
Subtotal nuclear decommissioning trust	120	485		\$(9)	596
Total	\$ 120	\$ 513	\$ 50	\$(33)	\$ 650
Liabilities					
Risk management activities derivative instruments:					
Commodity contracts	\$	\$(69)	\$(103)	\$ 24(b)	\$(148)

- (a) Primarily consists of heat rate options and long-dated electricity contracts.
- (b) Primarily represents counterparty netting, margin and collateral (see Note 7).
- (c) Represents nuclear decommissioning trust net pending securities sales and purchases.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the fair value at December 31, 2012 of our assets and liabilities that are measured at fair value on a recurring basis (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (a) (Level 3)	Other	Balance at December 31, 2012
Assets					
Cash equivalents	\$ 16	\$	\$	\$	\$ 16
Risk management activities derivative instruments:					
Commodity Contracts		22	62	(22)(b)	62
Nuclear decommissioning trust:					
U.S. commingled equity funds		204			204
Fixed income securities:					
U.S. Treasury	104				104
Cash and cash equivalent funds	6	13		(4)(c)	15
Corporate debt		80			80
Mortgage-backed securities		83			83
Municipality bonds		74			74
Other		11			11
Subtotal nuclear decommissioning trust	110	465		(4)	571
Total	\$ 126	\$ 487	\$ 62	\$ (26)	\$ 649
Liabilities					
Risk management activities derivative instruments:					
Commodity contracts	\$	\$ (96)	\$ (110)	\$ 47(b)	\$ (159)

(a) Primarily consists of heat rate options and long-dated electricity contracts.

(b) Represents counterparty netting, margin and collateral (see Note 7).

(c) Represents nuclear decommissioning trust net pending securities sales and purchases.

Fair Value Measurements Classified as Level 3

The significant unobservable inputs used in the fair value measurement of our energy derivative contracts include broker quotes that cannot be validated as an observable input primarily due to the long term nature of the quote and option model inputs. Significant changes in these inputs

in isolation would result in significantly higher or lower fair value measurements. Changes in our derivative contract fair values, including changes relating to unobservable inputs, typically will not impact net income due to regulatory accounting treatment (see Note 3).

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Because our forward commodity contracts classified as Level 3 are currently in a net purchase position, we would expect price increases of the underlying commodity to result in increases in the net fair value of the related contracts. Conversely, if the price of the underlying commodity decreases, the net fair value of the related contracts would likely decrease.

Our option contracts classified as Level 3 primarily relate to purchase heat rate options. The significant unobservable inputs for these instruments include electricity prices, gas prices and implied volatilities. If electricity prices and electricity price implied volatilities increase, we would expect the fair value of these options to increase, and if these valuation inputs decrease, we would expect the fair value of these options to decrease. If natural gas prices and natural gas price implied volatilities increase, we would expect the fair value of these options to decrease, and if these inputs decrease, we would expect the fair value of the options to increase. The commodity prices and implied volatilities do not always move in corresponding directions. The options' fair values are impacted by the net changes of these various inputs.

Other unobservable valuation inputs include credit and liquidity reserves which do not have a material impact on our valuations; however, significant changes in these inputs could also result in higher or lower fair value measurements.

The following table provides information regarding our significant unobservable inputs used to value our Level 3 instruments:

Commodity Contracts	March 31, 2013 Fair Value (millions)		Valuation Technique	Significant Unobservable Input	Range	Weighted- Average
	Assets	Liabilities				
Electricity:						
Forward Contracts (a)	\$ 49	\$ 73	Discounted cash flows	Electricity forward price (per MWh)	\$24.88 - \$65.92	\$ 44.47
Option Contracts		29	Option model	Electricity forward price (per MWh)	\$42.37 - \$90.46	\$ 61.70
				Natural gas forward price (per mmbtu)	\$4.09 - \$4.22	\$ 4.17
				Implied electricity price volatilities	15% - 74%	40%
				Implied natural gas price volatilities	16% - 31%	22%
Natural Gas:						
Forward Contracts (a)	1	1	Discounted cash flows	Natural gas forward price (per mmbtu)	\$3.81 - \$4.48	\$ 4.29
Total	\$ 50	\$ 103				

(a) Includes swaps and physical and financial contracts.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Commodity Contracts	December 31, 2012 Fair Value (millions)		Valuation Technique	Significant Unobservable Input	Range	Weighted- Average
	Assets	Liabilities				
Electricity:						
Forward Contracts (a)	\$ 57	\$ 82	Discounted cash flows	Electricity forward price (per MWh)	\$23.06 - \$64.20	\$ 43.16
Option Contracts		27	Option model	Electricity forward price (per MWh)	\$36.66 - \$92.19	\$ 60.97
				Natural gas forward price (per mmbtu)	\$4.10 - \$4.25	\$ 4.20
				Implied electricity price volatilities	15% - 66%	39%
				Implied natural gas price volatilities	17% - 36%	23%
Natural Gas:						
Forward Contracts (a)			Discounted cash flows	Natural gas forward price (per mmbtu)	\$3.25 - \$4.44	\$ 3.93
Total	\$ 62	\$ 110				

(a) Includes swaps and physical and financial contracts.

The following table shows the changes in fair value for our risk management activities assets and liabilities that are measured at fair value on a recurring basis using Level 3 inputs for the three months ended March 31, 2013 and 2012 (dollars in millions):

Commodity Contracts	Three Months Ended March 31,	
	2013	2012
Net derivative balance at beginning of period	\$ (48)	\$ (51)
Total net gains (losses) realized/unrealized:		
Included in earnings		1
Included in OCI		(5)
Deferred as a regulatory asset or liability	(1)	(5)
Settlements	(2)	1
Transfers into Level 3 from Level 2	(1)	2
Transfers from Level 3 into Level 2	(1)	(1)
Net derivative balance at end of period	\$ (53)	\$ (58)
Net unrealized gains included in earnings related to instruments still held at end of period	\$	\$

Amounts included in earnings are recorded in either operating revenues or purchased power depending on the nature of the underlying contract.

Transfers reflect the fair market value at the beginning of the period and are triggered by a change in the lowest significant input as of the end of the period. We had no significant Level 1 transfers to or

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

from any other hierarchy level. Transfers in or out of Level 3 are typically related to our heat rate options and long-dated energy transactions that extend beyond available quoted periods.

Financial Instruments Not Carried at Fair Value

The carrying value of our net accounts receivable, accounts payable and any short-term borrowings approximate fair value. Our short-term borrowings are classified within Level 2 of the fair value hierarchy. For our long-term debt fair values, see Note 2.

13. Nuclear Decommissioning Trusts

To fund the costs APS expects to incur to decommission Palo Verde, APS established external decommissioning trusts in accordance with NRC regulations. Third-party investment managers are authorized to buy and sell securities per their stated investment guidelines. The trust funds are invested in fixed income securities and equity securities. APS classifies investments in decommissioning trust funds as available for sale. As a result, we record the decommissioning trust funds at their fair value on our Condensed Consolidated Balance Sheets. See Note 12 for a discussion of how fair value is determined and the classification of the nuclear decommissioning trust investments within the fair value hierarchy. Because of the ability of APS to recover decommissioning costs in rates and in accordance with the regulatory treatment for decommissioning trust funds, we have deferred realized and unrealized gains and losses (including other-than-temporary impairments on investment securities) in other regulatory liabilities. The following table includes the unrealized gains and losses based on the original cost of the investment and summarizes the fair value of APS's nuclear decommissioning trust fund assets at March 31, 2013 and December 31, 2012 (dollars in millions):

	Fair Value		Total Unrealized Gains		Total Unrealized Losses
March 31, 2013					
Equity securities	\$ 226	\$	87	\$	
Fixed income securities	379		21		(1)
Net payables (a)	(9)				
Total	\$ 596	\$	108	\$	(1)

(a) Net payables relate to pending securities sales and purchases.

Fair Value		Total Unrealized		Total Unrealized
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			Gains		Losses
December 31, 2012					
Equity securities	\$	204	\$	67	\$
Fixed income securities		371		24	
Net payables (a)		(4)			
Total	\$	571	\$	91	\$

(a) Net payables relate to pending securities sales and purchases.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

The costs of securities sold are determined on the basis of specific identification. The following table sets forth approximate realized gains and losses and proceeds from the sale of securities by the nuclear decommissioning trust funds (dollars in millions):

	Three Months Ended				
	2013		March 31,		2012
Realized gains	\$	2	\$	2	2
Realized losses		(1)		(1)	(1)
Proceeds from the sale of securities (a)		135		92	92

(a) Proceeds are reinvested in the trust.

The fair value of fixed income securities, summarized by contractual maturities, at March 31, 2013 is as follows (dollars in millions):

	Fair Value	
Less than one year	\$	17
1 year - 5 years		105
5 years - 10 years		100
Greater than 10 years		157
Total	\$	379

14. New Accounting Standards

During 2013, we adopted, on a retrospective basis, new guidance relating to balance sheet offsetting disclosures. The new guidance requires enhanced disclosures regarding an entity's ability to offset certain instruments on the balance sheet and how offsetting impacts the balance sheet. The adoption of this guidance resulted in expanded disclosures relating to our derivative instruments (see Note 7), but did not impact our financial statement results.

During 2013, we also adopted, on a prospective basis, new guidance relating to reporting amounts reclassified from accumulated other comprehensive income. This guidance requires new disclosures relating to accumulated other comprehensive income and how reclassifications from accumulated other comprehensive income impact net income. As a result of adopting this new guidance, we have included a new footnote disclosure to provide the information required by the new standard (see Notes 15 and S-3). The adoption of this guidance did not impact our financial statement results.

Table of Contents**PINNACLE WEST CAPITAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****15. Changes in Accumulated Other Comprehensive Loss**

The following table shows the changes in accumulated other comprehensive loss, including reclassification adjustments, by component for the three-month period ended March 31, 2013 (dollars in thousands):

	Derivative Instruments	Pension and Other Postretirement Benefits	Total
Beginning balance, January 1	\$ (49,592)	\$ (64,416)	\$ (114,008)
Other comprehensive income before reclassifications, net of tax expense of \$38	58		58
Amounts reclassified from accumulated other comprehensive loss:			
Net realized loss, net of tax benefit of \$3,300	5,053		5,053
Amortization of actuarial loss, net of tax benefit of \$582		890	890
Amortization of prior service cost, net of tax benefit of \$49		76	76
Total reclassifications for the period, net of tax benefit of \$3,300, \$631 and \$3,931	5,053(a)	966(b)	6,019
Net current period other comprehensive income, net of tax expense of \$3,338, \$631 and \$3,969	5,111	966	6,077
Ending balance, March 31	\$ (44,481)	\$ (63,450)	\$ (107,931)

(a) These amounts are included in the computation of fuel and purchased power costs and are subject to the PSA. See Note 7.

(b) These amounts are included in the computation of net periodic pension cost. See Note 4.

Table of Contents**ARIZONA PUBLIC SERVICE COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited)

(dollars in thousands)

	Three Months Ended March 31,	
	2013	2012
ELECTRIC OPERATING REVENUES	\$ 685,827	\$ 620,248
OPERATING EXPENSES		
Fuel and purchased power	230,679	216,309
Operations and maintenance	220,752	208,447
Depreciation and amortization	103,706	100,085
Income taxes	16,060	(814)
Taxes other than income taxes	39,768	42,226
Total	610,965	566,253
OPERATING INCOME	74,862	53,995
OTHER INCOME (DEDUCTIONS)		
Income taxes	2,332	1,706
Allowance for equity funds used during construction	6,864	4,756
Other income (Note S-2)	1,343	510
Other expense (Note S-2)	(6,296)	(4,624)
Total	4,243	2,348
INTEREST EXPENSE		
Interest on long-term debt	46,221	52,737
Interest on short-term borrowings	1,429	2,035
Debt discount, premium and expense	1,011	1,060
Allowance for borrowed funds used during construction	(3,990)	(3,151)
Total	44,671	52,681
NET INCOME	34,434	3,662
Less: Net income attributable to noncontrolling interests (Note 6)	8,392	7,767
NET INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDER	\$ 26,042	\$ (4,105)

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

Table of Contents**ARIZONA PUBLIC SERVICE COMPANY****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(unaudited)

(dollars in thousands)

	Three Months Ended March 31,	
	2013	2012
NET INCOME	\$ 34,434	\$ 3,662
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX		
Derivative instruments:		
Net unrealized gain (loss), net of tax benefit (expense) of (\$38) and \$16,554	58	(25,348)
Reclassification of net realized loss, net of tax benefit of \$3,300 and \$5,728	5,052	8,772
Pension and other postretirement benefits activity, net of tax expense of \$576 and \$536	882	821
Total other comprehensive income (loss)	5,992	(15,755)
COMPREHENSIVE INCOME (LOSS)	40,426	(12,093)
Less: Comprehensive income attributable to noncontrolling interests	8,392	7,767
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO COMMON SHAREHOLDER	\$ 32,034	\$ (19,860)

See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

Table of Contents

ARIZONA PUBLIC SERVICE COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)

	March 31, 2013	December 31, 2012
ASSETS		
PROPERTY, PLANT AND EQUIPMENT		
Plant in service and held for future use	\$ 14,490,460	\$ 14,342,501
Accumulated depreciation and amortization	(4,993,480)	(4,925,990)
Net	9,496,980	9,416,511
Construction work in progress	498,124	565,716
Palo Verde sale leaseback, net of accumulated depreciation (Note 6)	128,027	128,995
Intangible assets, net of accumulated amortization	162,823	161,995
Nuclear fuel, net of accumulated amortization	140,909	122,778
Total property, plant and equipment	10,426,863	10,395,995
INVESTMENTS AND OTHER ASSETS		
Nuclear decommissioning trust (Note 13)	596,168	570,625
Assets from risk management activities (Note 7)	34,047	35,891
Other assets	32,120	31,650
Total investments and other assets	662,335	638,166
CURRENT ASSETS		
Cash and cash equivalents	7,328	3,499
Customer and other receivables	266,994	274,815
Accrued unbilled revenues	90,147	94,845
Allowance for doubtful accounts	(2,537)	(3,340)
Materials and supplies (at average cost)	223,605	218,096
Fossil fuel (at average cost)	35,211	31,334
Deferred fuel and purchased power regulatory asset (Note 3)	41,315	72,692
Other regulatory assets (Note 3)	52,872	71,257
Deferred income taxes	59,807	74,420
Assets from risk management activities (Note 7)	20,346	25,699
Other current assets	39,354	37,666
Total current assets	834,442	900,983
DEFERRED DEBITS		
Regulatory assets (Note 3)	1,097,389	1,099,900
Unamortized debt issue costs	22,889	22,492
Income tax receivable (Note 5)	71,223	70,784
Other	114,903	114,222
Total deferred debits	1,306,404	1,307,398
TOTAL ASSETS	\$ 13,230,044	\$ 13,242,542

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See Notes to Pinnacle West's Condensed Consolidated Financial Statements and Supplemental Notes to Arizona Public Service Company's Condensed Consolidated Financial Statements.

Table of Contents

ARIZONA PUBLIC SERVICE COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands)

	March 31, 2013	December 31, 2012
LIABILITIES AND EQUITY		
CAPITALIZATION		
Common stock	\$ 178,162	\$ 178,162
Additional paid-in capital	2,379,696	2,379,696
Retained earnings	1,650,277	1,624,237
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(38,621)	(39,503)
Derivative instruments	(44,482)	(49,592)
Total shareholder equity	4,125,032	4,093,000
Noncontrolling interests (Note 6)	137,875	129,483
Total equity (Note S-1)	4,262,907	4,222,483
Long-term debt less current maturities	3,140,589	3,035,219
Palo Verde sale leaseback lessor notes less current maturities (Note 6)	38,869	