

PINNACLE WEST CAPITAL CORP

Form 10-Q

July 30, 2015

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 June 30, 2015

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	Exact Name of Each Registrant as specified in its charter; State of Incorporation; Address; and Telephone Number	IRS Employer Identification No.
1-8962	PINNACLE WEST CAPITAL CORPORATION (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0512431
1-4473	ARIZONA PUBLIC SERVICE COMPANY (an Arizona corporation) 400 North Fifth Street, P.O. Box 53999 Phoenix, Arizona 85072-3999 (602) 250-1000	86-0011170

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  No   
ARIZONA PUBLIC SERVICE COMPANY                      Yes  No



## TABLE OF CONTENTS

	Page
<u>Forward-Looking Statements</u>	<u>2</u>
<u>Part I</u>	<u>3</u>
<u>Item 1.</u> <u>Financial Statements</u>	<u>3</u>
<u>Pinnacle West Capital Corporation</u>	<u>3</u>
<u>Arizona Public Service Company</u>	<u>48</u>
<u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of</u>	<u>59</u>
<u>Operations</u>	<u>59</u>
<u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>78</u>
<u>Item 4.</u> <u>Controls and Procedures</u>	<u>79</u>
 <u>Part II</u>	 <u>80</u>
<u>Item 1.</u> <u>Legal Proceedings</u>	<u>80</u>
<u>Item 1A.</u> <u>Risk Factors</u>	<u>80</u>
<u>Item 5.</u> <u>Other Information</u>	<u>80</u>
<u>Item 6.</u> <u>Exhibits</u>	<u>81</u>
<u>Signatures</u>	<u>84</u>

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 all 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.

## 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, 2014 ("2014 Form 10-K") 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;
- competition in retail and wholesale power markets;
- regulatory and judicial decisions, developments and proceedings;
- new legislation or regulation, including those relating to environmental requirements, nuclear plant operations and potential deregulation of retail electric markets;
- fuel and water supply availability;
- our ability to achieve timely and adequate rate recovery of our costs, including returns on debt and equity capital;
- 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;
- current and future economic conditions in Arizona, particularly in real estate markets;
- the development of new technologies which may affect electric sales or delivery;
- the cost of debt and equity capital and the ability to access capital markets when required;
- environmental and other concerns surrounding coal-fired generation;
- volatile fuel and purchased power costs;
- 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;
- 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; 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 2014 Form 10-K, 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.



## 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 June 30,	
	2015	2014
OPERATING REVENUES	\$890,648	\$906,264
OPERATING EXPENSES		
Fuel and purchased power	281,477	290,854
Operations and maintenance	210,965	211,222
Depreciation and amortization	122,739	105,150
Taxes other than income taxes	43,032	44,004
Other expenses	462	921
Total	658,675	652,151
OPERATING INCOME	231,973	254,113
OTHER INCOME (DEDUCTIONS)		
Allowance for equity funds used during construction	9,345	7,499
Other income (Note 9)	175	2,781
Other expense (Note 9)	(2,609)	(508)
Total	6,911	9,772
INTEREST EXPENSE		
Interest charges	48,328	51,751
Allowance for borrowed funds used during construction	(4,322)	(3,790)
Total	44,006	47,961
INCOME BEFORE INCOME TAXES	194,878	215,924
INCOME TAXES	67,371	74,540
NET INCOME	127,507	141,384
Less: Net income attributable to noncontrolling interests (Note 6)	4,605	8,926
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$122,902	\$132,458
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING — BASIC	110,986	110,565
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING — DILUTED	111,460	111,002
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING		
Net income attributable to common shareholders — basic	\$1.11	\$1.20
Net income attributable to common shareholders — diluted	\$1.10	\$1.19
DIVIDENDS DECLARED PER SHARE	\$1.19	\$1.14

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



PINNACLE WEST CAPITAL CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (unaudited)  
 (dollars in thousands)

	Three Months Ended June 30,	
	2015	2014
NET INCOME	\$127,507	\$141,384
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Derivative instruments:		
Net unrealized gain, net of tax expense of \$16 and \$26	25	40
Reclassification of net realized loss, net of tax benefit of \$556 and \$1,261	874	1,955
Pension and other postretirement benefits activity, net of tax benefit of \$74 and \$845	(117)	(1,310)
Total other comprehensive income	782	685
COMPREHENSIVE INCOME	128,289	142,069
Less: Comprehensive income attributable to noncontrolling interests	4,605	8,926
COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$123,684	\$133,143

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



PINNACLE WEST CAPITAL CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(unaudited)  
(dollars and shares in thousands, except per share amounts)

	Six Months Ended	
	June 30,	
	2015	2014
OPERATING REVENUES	\$1,561,867	\$1,592,515
OPERATING EXPENSES		
Fuel and purchased power	504,714	540,640
Operations and maintenance	425,909	424,104
Depreciation and amortization	243,688	206,922
Taxes other than income taxes	86,248	89,849
Other expenses	1,651	1,717
Total	1,262,210	1,263,232
OPERATING INCOME	299,657	329,283
OTHER INCOME (DEDUCTIONS)		
Allowance for equity funds used during construction	18,569	14,941
Other income (Note 9)	410	5,148
Other expense (Note 9)	(6,895)	(5,192)
Total	12,084	14,897
INTEREST EXPENSE		
Interest charges	96,727	104,720
Allowance for borrowed funds used during construction	(8,538)	(7,560)
Total	88,189	97,160
INCOME BEFORE INCOME TAXES	223,552	247,020
INCOME TAXES	75,318	80,945
NET INCOME	148,234	166,075
Less: Net income attributable to noncontrolling interests (Note 6)	9,210	17,851
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$139,024	\$148,224
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING — BASIC	110,958	110,546
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING — DILUTED	111,426	110,925
EARNINGS PER WEIGHTED-AVERAGE COMMON SHARE OUTSTANDING		
Net income attributable to common shareholders — basic	\$1.25	\$1.34
Net income attributable to common shareholders — diluted	\$1.25	\$1.34
DIVIDENDS DECLARED PER SHARE	\$1.19	\$1.14

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

PINNACLE WEST CAPITAL CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (unaudited)  
 (dollars in thousands)

	Six Months Ended June 30,	
	2015	2014
NET INCOME	\$148,234	\$166,075
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Derivative instruments:		
Net unrealized loss, net of tax expense of \$489 and \$624	(775	) (381
Reclassification of net realized loss, net of tax benefit of \$923 and \$2,584	2,850	5,070
Pension and other postretirement benefits activity, net of tax benefit (expense) of \$(793) and \$128	466	(853
Total other comprehensive income	2,541	3,836
COMPREHENSIVE INCOME	150,775	169,911
Less: Comprehensive income attributable to noncontrolling interests	9,210	17,851
COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDERS	\$141,565	\$152,060

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

PINNACLE WEST CAPITAL CORPORATION  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (unaudited)  
 (dollars in thousands)

	June 30, 2015	December 31, 2014
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$13,557	\$7,604
Customer and other receivables	289,236	297,740
Accrued unbilled revenues	185,216	100,533
Allowance for doubtful accounts	(2,518)	(3,094)
Materials and supplies (at average cost)	231,101	218,889
Fossil fuel (at average cost)	43,196	37,097
Deferred income taxes	77,841	122,232
Income tax receivable (Note 5)	—	3,098
Assets from risk management activities (Note 7)	14,722	13,785
Deferred fuel and purchased power regulatory asset (Note 3)	—	6,926
Other regulatory assets (Note 3)	134,578	129,808
Other current assets	44,827	38,817
Total current assets	1,031,756	973,435
<b>INVESTMENTS AND OTHER ASSETS</b>		
Assets from risk management activities (Note 7)	18,513	17,620
Nuclear decommissioning trust (Note 12)	723,582	713,866
Other assets	51,987	54,047
Total investments and other assets	794,082	785,533
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	15,926,594	15,543,063
Accumulated depreciation and amortization	(5,497,350)	(5,397,751)
Net	10,429,244	10,145,312
Construction work in progress	638,285	682,807
Palo Verde sale leaseback, net of accumulated depreciation (Note 6)	119,320	121,255
Intangible assets, net of accumulated amortization	127,742	119,755
Nuclear fuel, net of accumulated amortization	156,608	125,201
Total property, plant and equipment	11,471,199	11,194,330
<b>DEFERRED DEBITS</b>		
Regulatory assets (Note 3)	1,081,113	1,054,087
Assets for other postretirement benefits (Note 4)	168,755	152,290
Other	154,578	153,857
Total deferred debits	1,404,446	1,360,234
<b>TOTAL ASSETS</b>	<b>\$14,701,483</b>	<b>\$14,313,532</b>

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

PINNACLE WEST CAPITAL CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(unaudited)  
(dollars in thousands)

	June 30, 2015	December 31, 2014
<b>LIABILITIES AND EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$326,119	\$295,211
Accrued taxes (Note 5)	155,812	140,613
Accrued interest	54,547	52,603
Common dividends payable	65,933	65,790
Short-term borrowings (Note 2)	157,500	147,400
Current maturities of long-term debt (Note 2)	102,723	383,570
Customer deposits	72,785	72,307
Liabilities from risk management activities (Note 7)	60,673	59,676
Deferred fuel and purchased power regulatory liability (Note 3)	16,209	—
Liabilities for asset retirements (Note 15)	28,543	32,462
Other regulatory liabilities (Note 3)	136,273	130,549
Other current liabilities	162,742	178,962
Total current liabilities	1,339,859	1,559,143
LONG-TERM DEBT LESS CURRENT MATURITIES (Note 2)	3,565,857	3,031,215
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	2,614,274	2,582,636
Regulatory liabilities (Note 3)	1,016,991	1,051,196
Liabilities for asset retirements (Note 15)	419,072	358,288
Liabilities for pension benefits (Note 4)	425,002	453,736
Liabilities from risk management activities (Note 7)	87,689	50,602
Customer advances	120,063	123,052
Coal mine reclamation	200,155	198,292
Deferred investment tax credit	176,389	178,607
Unrecognized tax benefits (Note 5)	14,311	19,377
Other	196,178	188,286
Total deferred credits and other	5,270,124	5,204,072
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		
<b>EQUITY</b>		
Common stock, no par value; authorized 150,000,000 shares, 110,865,030 and 110,649,762 issued at respective dates	2,526,945	2,512,970
Treasury stock at cost; 53,559 and 78,400 shares at respective dates	(1,765	) (3,401
Total common stock	2,525,180	2,509,569
Retained earnings	1,933,256	1,926,065
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(57,290	) (57,756
Derivative instruments	(8,310	) (10,385
Total accumulated other comprehensive loss	(65,600	) (68,141
Total shareholders' equity	4,392,836	4,367,493
Noncontrolling interests (Note 6)	132,807	151,609
Total equity	4,525,643	4,519,102

TOTAL LIABILITIES AND EQUITY	\$14,701,483	\$14,313,532
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See Notes to Pinnacle West's Condensed Consolidated Financial Statements.

8

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PINNACLE WEST CAPITAL CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)  
(dollars in thousands)

	Six Months Ended	
	June 30,	
	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$148,234	\$166,075
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	282,218	246,371
Deferred fuel and purchased power	11,711	1,315
Deferred fuel and purchased power amortization	11,424	18,399
Allowance for equity funds used during construction	(18,569)	(14,941)
Deferred income taxes	65,377	32,611
Deferred investment tax credit	(2,218)	28,875
Change in derivative instruments fair value	(225)	49
Changes in current assets and liabilities:		
Customer and other receivables	(17,402)	(64,986)
Accrued unbilled revenues	(84,683)	(75,648)
Materials, supplies and fossil fuel	(18,311)	(9,435)
Income tax receivable	3,098	135,517
Other current assets	(8,728)	(14,038)
Accounts payable	36,634	30,725
Accrued taxes	15,199	30,709
Other current liabilities	(13,138)	19,978
Change in margin and collateral accounts — assets	(4,552)	(2,107)
Change in margin and collateral accounts — liabilities	26,853	(22,425)
Change in other long-term assets	(4,817)	(19,243)
Change in other long-term liabilities	(33,811)	(22,735)
Net cash flow provided by operating activities	394,294	465,066
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(531,035)	(388,752)
Contributions in aid of construction	41,010	12,646
Allowance for borrowed funds used during construction	(8,538)	(7,560)
Proceeds from nuclear decommissioning trust sales	225,779	199,224
Investment in nuclear decommissioning trust	(234,651)	(207,848)
Other	(2,068)	(678)
Net cash flow used for investing activities	(509,503)	(392,968)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt	600,000	535,975
Repayment of long-term debt	(344,847)	(503,583)
Short-term borrowings and payments — net	10,100	23,525
Dividends paid on common stock	(128,241)	(125,138)
Common stock equity issuance	12,161	12,625
Distributions to noncontrolling interest	(28,012)	(15,869)
Other	1	2
Net cash flow provided by (used for) financing activities	121,162	(72,463)

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	5,953	(365	)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	7,604	9,526	
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$13,557	\$9,161	

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

PINNACLE WEST CAPITAL CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

(unaudited)

(dollars in thousands, except per share amounts)

	Common Stock		Treasury Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total
	Shares	Amount	Shares	Amount				
Balance, January 1, 2014	110,280,703	\$2,491,558	(98,944 )	\$(4,308)	\$1,785,273	\$(78,053 )	\$145,990	\$4,340,460
Net income					148,224		17,851	166,075
Other comprehensive income						3,836		3,836
Dividends on common stock					(125,265 )			(125,265 )
Issuance of common stock	149,753	8,506						8,506
Purchase of treasury stock (a)			(82,474 )	(4,535 )				(4,535 )
Stock-based compensation and other			157,594	8,654				8,654
Net capital activities by noncontrolling interests							(15,869 )	(15,869 )
Balance, June 30, 2014	110,430,456	\$2,500,064	(23,824 )	\$(189 )	\$1,808,232	\$(74,217 )	\$147,972	\$4,381,862
Balance, January 1, 2015	110,649,762	\$2,512,970	(78,400 )	\$(3,401)	\$1,926,065	\$(68,141 )	\$151,609	\$4,519,102
Net income					139,024		9,210	148,234
Other comprehensive income						2,541		2,541
Dividends on common stock					(131,833 )			(131,833 )
Issuance of common stock	215,268	13,975						13,975
Purchase of treasury stock (a)			(93,280 )	(6,096 )				(6,096 )
Stock-based compensation and other			118,121	7,732				7,732
Net capital activities by							(28,012 )	(28,012 )



noncontrolling  
interests

Balance, June 30, 2015 110,865,030 \$2,526,945 (53,559 ) \$(1,765) \$1,933,256 \$(65,600 ) \$132,807 \$4,525,643

(a) Primarily represents shares of common stock withheld from certain stock awards for tax purposes.

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

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, Bright Canyon Energy Corporation ("BCE") and El Dorado Investment Company ("El Dorado"). 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 have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in conformity with GAAP have been condensed or omitted pursuant to such regulations, although we believe that the disclosures provided are adequate to make the interim information presented not misleading.

Supplemental Cash Flow Information

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

	Six Months Ended	
	June 30,	
	2015	2014
Cash paid (received) during the period for:		
Income taxes, net of refunds	\$1,834	\$(131,154 )
Interest, net of amounts capitalized	84,008	90,707
Significant non-cash investing and financing activities:		
Accrued capital expenditures	\$38,985	\$19,668
Dividends accrued but not yet paid	65,933	62,656

2. Long-Term Debt and Liquidity Matters

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

Pinnacle West's \$200 million revolving credit facility matures in May 2019. At June 30, 2015, the facility was available to refinance indebtedness of the Company and for other general corporate purposes,



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

including credit support for its \$200 million commercial paper program. Pinnacle West has the option to increase the size of the facility up to a maximum of \$300 million upon the satisfaction of certain conditions and with the consent of the lenders. At June 30, 2015, Pinnacle West had no outstanding borrowings under its credit facility, no letters of credit outstanding and no commercial paper borrowings.

#### APS

On January 12, 2015, APS issued \$250 million of 2.20% unsecured senior notes that mature on January 15, 2020. The net proceeds from the sale were used to repay commercial paper borrowings and replenish cash used to fund capital expenditures.

On May 19, 2015, APS issued \$300 million of 3.15% unsecured senior notes that mature on May 15, 2025. The net proceeds from the sale were used to repay short-term indebtedness consisting of commercial paper borrowings and drawings under our revolving credit facilities, incurred in connection with the payment at maturity of our \$300 million aggregate principal amount of 4.65% Notes due May 15, 2015.

On May 28, 2015, APS purchased all \$32 million of Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds, 2009 Series B, due 2029 in connection with the mandatory tender provisions for this indebtedness.

On June 26, 2015, APS entered into a \$50 million term loan facility that matures June 26, 2018. Interest rates are based on APS's senior unsecured debt credit ratings. APS used the proceeds to repay and refinance existing short-term indebtedness.

At June 30, 2015, APS had two credit facilities totaling \$1 billion, including a \$500 million credit facility that matures in April 2018 and a \$500 million facility that matures in May 2019. APS may increase the size 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.

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 June 30, 2015, APS had \$158 million of commercial paper outstanding and no outstanding borrowings or letters of credit under these credit facilities.

See "Financial Assurances" in Note 8 for a discussion of APS's separate outstanding letters of credit.

#### Debt Fair Value

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. Certain of our debt instruments contain third-party credit enhancements and, in accordance with GAAP, we do not consider the effect of these credit enhancements when determining fair value. The following table represents the estimated fair value of our long-term debt, including current maturities (dollars in millions):



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	As of June 30, 2015		As of December 31, 2014	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Pinnacle West	\$125	\$125	\$125	\$125
APS	3,544	3,818	3,290	3,714
Total	\$3,669	\$3,943	\$3,415	\$3,839

#### 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 June 30, 2015, APS was in compliance with this common equity ratio requirement. Its total shareholder equity was approximately \$4.5 billion, and total capitalization was approximately \$8.2 billion. APS would be prohibited from paying dividends if the payment would reduce its total shareholder equity below approximately \$3.3 billion, assuming APS's total capitalization remains the same.

PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

### 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 by approximately 6.6%. On January 6, 2012, APS and other parties to the general retail rate case entered into an agreement (the "2012 Settlement Agreement") detailing the terms upon which the parties agreed to settle the rate case. On May 15, 2012, the ACC approved the 2012 Settlement Agreement without material modifications.

#### Settlement Agreement

The 2012 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.

Other key provisions of the 2012 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 increases in property taxes 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 acquisition of additional interests in Units 4 and 5 and the related closure of Units 1-3 of the Four Corners Power Plant ("Four Corners") (APS made its filing under this provision on December 30, 2013, see "Four Corners" below);

• Implementation of a Lost Fixed Cost Recovery ("LFCR") rate mechanism to support energy efficiency and distributed renewable generation;

• Modifications to the Environmental Improvement Surcharge ("EIS") to allow for the recovery of carrying costs for capital expenditures associated with government-mandated environmental





PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 APS's 2009 retail rate case settlement agreement (the "2009 Settlement Agreement");

- 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

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 2012 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 2009 Settlement Agreement to process subsequent rate cases within twelve months of sufficiency findings from the ACC staff, which generally occurs within 30 days after the filing of a rate case.

#### 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 July 12, 2013, APS filed its annual RES implementation plan, covering the 2014-2018 timeframe and requesting a 2014 RES budget of approximately \$143 million. In a final order dated January 7, 2014, the ACC approved the requested budget. Also in 2013, the ACC conducted a hearing 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. On February 6, 2014, the ACC established a proceeding to modify the renewable energy rules to establish a process for compliance with the renewable energy requirement that is not based solely on the use of renewable energy credits. On September 9, 2014, the ACC authorized a rulemaking process to modify the RES rules. The proposed changes would permit the ACC to find that utilities have complied with the distributed energy requirement in light of all available information. The ACC adopted these changes on December 18, 2014. The revised rules went into effect on April 21, 2015.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

In accordance with the ACC's decision on the 2014 RES plan, on April 15, 2014, APS filed an application with the ACC requesting permission to build an additional 20 Megawatt ("MW") of APS-owned utility scale solar under the AZ Sun Program. In a subsequent filing, APS also offered an alternative proposal to replace the 20 MW of utility scale solar with 10 MW (approximately 1,500 customers) of APS-owned residential solar that will not be under the AZ Sun Program. On December 19, 2014, the ACC voted that it had no objection to APS implementing its residential rooftop solar program. The first stage of the residential rooftop solar program is to be 8 MW followed by a 2 MW second stage that will only be deployed if coupled with an appropriate amount of distributed storage. The program will target specific distribution feeders in an effort to maximize potential system benefits, as well as make systems available to limited-income customers who cannot easily install solar through transactions with third parties. The ACC expressly reserved that any determination of prudence of the residential rooftop solar program for rate making purposes shall not be made until the project is fully in service and APS requests cost recovery in a future rate case.

On July 1, 2014, APS filed its 2015 RES implementation plan and proposed a RES budget of approximately \$154 million. On December 31, 2014, the ACC issued a decision approving the 2015 RES implementation plan with minor modifications, including reducing the budget to approximately \$152 million.

On July 1, 2015, APS filed its 2016 RES implementation plan and proposed a RES budget of approximately \$148 million.

**Demand Side Management Adjustor Charge.** The ACC Electric Energy Efficiency Standards require APS to submit a Demand Side Management Implementation Plan ("DSM Plan") for review by and approval of the ACC.

On June 1, 2012, APS filed its 2013 DSM Plan. In 2013, the standards required 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.

On March 11, 2014, the ACC issued an order approving APS's 2013 DSM Plan. The ACC approved a budget of \$68.9 million for each of 2013 and 2014. The ACC also approved a Resource Savings Initiative that allows APS to count towards compliance with the ACC Electric Energy Efficiency Standards, savings for improvements to APS's transmission and delivery system, generation and facilities that have been approved through a DSM Plan.

On March 20, 2015, APS filed an application with the ACC requesting a budget of \$68.9 million for 2015 and minor modifications to its DSM portfolio going forward, including for the first time three resource savings projects which reflect energy savings on APS's system. Consistent with the ACC's March 11, 2014 order, APS intends to continue its other approved DSM programs in 2015.

On June 1, 2015, APS filed its 2016 DSM Plan requesting a budget of \$68.9 million and minor modifications to its DSM portfolio to increase energy savings and cost effectiveness of the programs. The DSM Plan also proposed a reduction in the DSMAC of approximately 12%.

#### Electric Energy Efficiency

On June 27, 2013, the ACC voted to open a new docket investigating whether the Electric Energy Efficiency Standards should be modified. The ACC held a series of three workshops in March and April 2014



PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

to investigate methodologies used to determine cost effective energy efficiency programs, cost recovery mechanisms, incentives, and potential changes to the Electric Energy Efficiency and Resource Planning Rules.

On November 4, 2014, the ACC staff issued a request for informal comment on a draft of possible amendments to Arizona's Electric Energy Efficiency Standards. The draft proposed substantial changes to the rules and energy efficiency standards. The ACC accepted written comments and took public comment regarding the possible amendments on December 19, 2014. A formal rule making has not been initiated and there has been no additional action on the draft to date.

PSA Mechanism and Balance. The PSA provides for the adjustment of retail rates to reflect variations in retail fuel and purchased power costs. The following table shows the changes in the deferred fuel and purchased power regulatory asset (liability) for 2015 and 2014 (dollars in millions):

	Six Months Ended	
	June 30,	
	2015	2014
Beginning balance	\$7	\$21
Deferred fuel and purchased power costs — current period	(12	) (1
Amounts charged to customers	(11	) (19
Ending balance	\$(16	) \$1

The PSA rate for the PSA year beginning February 1, 2015 is \$0.000887 per kWh, as compared to \$0.001557 per kWh for the prior year. This new rate is comprised of a forward component of \$0.001131 per kWh and a historical component of \$(0.000244) per kWh. Any uncollected (overcollected) deferrals during the 2015 PSA year will be included in the calculation of the PSA rate for the PSA year beginning February 1, 2016.

Transmission Rates, Transmission Cost Adjustor and Other Transmission Matters. 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 2012 Settlement Agreement, however, an adjustment to rates to recover the Retail Transmission Charges will be made annually each June 1 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.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Effective June 1, 2014, APS's annual wholesale transmission rates for all users of its transmission system increased by approximately \$5.9 million for the twelve-month period beginning June 1, 2014 in accordance with the FERC-approved formula. An adjustment to APS's retail rates to recover FERC-approved transmission charges went into effect automatically on June 1, 2014.

Effective June 1, 2015, APS's annual wholesale transmission rates for all users of its transmission system decreased by approximately \$17.6 million for the twelve-month period beginning June 1, 2015 in accordance with the FERC-approved formula. An adjustment to APS's retail rates to recover FERC-approved transmission charges went into effect automatically on June 1, 2015.

APS's formula rate protocols have been in effect since 2008. Recent FERC orders suggest that FERC is examining the structure of formula rate protocols and may require companies such as APS to make changes to their protocols in the future.

**Lost Fixed Cost Recovery 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 rooftop solar arrays. The fixed costs recoverable by the LFCR mechanism were established in the 2012 Settlement Agreement and amount to approximately 3.1 cents per residential kWh lost and 2.3 cents per non-residential kWh lost. The LFCR adjustment has a year-over-year cap of 1% of retail revenues. Any amounts left unrecovered in a particular year because of this cap can be carried over for recovery in a future year. 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 files for a LFCR adjustment every January. APS filed its 2014 annual LFCR adjustment on January 15, 2014, requesting a LFCR adjustment of \$25.3 million, effective March 1, 2014. The ACC approved APS's LFCR adjustment without change on March 11, 2014, which became effective April 1, 2014. APS filed its 2015 annual LFCR adjustment on January 15, 2015, requesting an LFCR adjustment of \$38.5 million, which was approved on March 2, 2015, effective for the first billing cycle of March.

#### Deregulation

On May 9, 2013, the ACC voted to re-examine the facilitation of a deregulated retail electric market in Arizona. The ACC subsequently opened a docket for this matter and received comments from a number of interested parties on the considerations involved in establishing retail electric deregulation in the state. One of these considerations is whether various aspects of a deregulated market, including setting utility rates on a "market" basis, would be consistent with the requirements of the Arizona Constitution. On September 11, 2013, after receiving legal advice from the ACC staff, the ACC voted 4-1 to close the current docket and await full Arizona Constitutional authority before any further examination of this matter. The motion approved by the ACC also included opening one or more new dockets in the future to explore options to offer more rate choices to customers and innovative changes within the existing cost-of-service regulatory model that could include elements of competition. The ACC opened a new docket on November 4, 2013 to explore technological advances and innovative changes within the electric utility industry. A series of workshops in this docket were held in 2014 and early 2015. No further action has been taken by the ACC to date.





PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### Net Metering

On July 12, 2013, APS filed an application with the ACC proposing a solution to address the cost shift brought by the current net metering rules. On December 3, 2013, the ACC issued its order on APS's net metering proposal. The ACC instituted a charge on customers who install rooftop solar panels after December 31, 2013. The charge of \$0.70 per kilowatt became effective on January 1, 2014, and is estimated to collect \$4.90 per month from a typical future rooftop solar customer to help pay for their use of the electricity grid. The fixed charge does not increase APS's revenue because it is credited to the LFCR.

In making its decision, the ACC determined that the current net metering program creates a cost shift, causing non-solar utility customers to pay higher rates to cover the costs of maintaining the electrical grid. The ACC acknowledged that the \$0.70 per kilowatt charge addresses only a portion of the cost shift. In its December 2013 order, the ACC directed APS to provide quarterly reports on the pace of rooftop solar adoption to assist the ACC in considering further increases.

On April 2, 2015, APS filed an application with the ACC seeking to increase the fixed grid access charge to \$3.00 per kilowatt, or approximately \$21 per month for a typical new residential solar customer, effective August 1. Customers who installed rooftop solar panels prior to January 1, 2014 would continue to be grandfathered and would not pay a grid access charge, and those who installed panels between January 1, 2014 and the effective date of the requested change would continue paying a charge of \$0.70 per kilowatt. Solar customers that take electric service under APS's demand-based ECT-2 residential rate, an existing rate that includes time-of-use rates with a demand charge, are not subject to the grid access charge.

APS cannot predict the outcome of this filing. The proposed grid access charge adjustment is designed to moderate the cost shift discussed above on an interim basis until the issue is further addressed in APS's next general rate case.

On September 29, 2014, the staff of the ACC filed in a new docket a proposal for permitting a utility to request ACC approval of its proposed rate design outside of and before a general rate case. On October 20, 2014, APS and other interested stakeholders filed comments to this proposal. No further action has been taken in this docket.

#### Four Corners

On December 30, 2013, APS purchased Southern California Edison Company's ("SCE's") 48% ownership interest in each of Units 4 and 5 of Four Corners. The 2012 Settlement Agreement includes a procedure to allow APS to request rate adjustments prior to its next general rate case related to APS's acquisition of the additional interests in Units 4 and 5 and the related closure of Units 1-3 of Four Corners. APS made its filing under this provision on December 30, 2013. On December 23, 2014, the ACC approved rate adjustments resulting in a revenue increase of \$57.1 million on an annual basis. This includes the deferral for future recovery of all non-fuel operating costs for the acquired SCE interest in Four Corners, net of the non-fuel operating costs savings resulting from the closure of Units 1-3 from the date of closing of the purchase through its inclusion in rates. The 2012 Settlement Agreement also provides for deferral for future recovery of all unrecovered costs incurred in connection with the closure of Units 1-3. The deferral balance related to the acquisition of SCE's interest in Units 4 and 5 and the closure of Units 1-3 was \$74 million as of June 30, 2015 and is being amortized in rates over 10 years. On February 23, 2015, the Arizona School Boards Association and the Association of Business Officials filed a notice of appeal in Division 1 of the Arizona Court of Appeals.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

of the ACC decision approving the rate adjustments. APS has intervened and will actively participate in the proceeding. We cannot predict when or how this appeal will be resolved.

As part of APS's acquisition of SCE's interest in Units 4 and 5, APS and SCE agreed, via a "Transmission Termination Agreement" that, upon closing of the acquisition, the companies would terminate an existing transmission agreement ("Transmission Agreement") between the parties that provides transmission capacity on a system (the "Arizona Transmission System") for SCE to transmit its portion of the output from Four Corners to California. APS previously submitted a request to FERC related to this termination, which resulted in a FERC order denying rate recovery of \$40 million that APS agreed to pay SCE associated with the termination. APS and SCE negotiated an alternate arrangement under which SCE would assign its 1,555 MW capacity rights over the Arizona Transmission System to third-parties, including 300 MW to APS's marketing and trading group. However, this alternative arrangement was not approved by FERC. Although APS and SCE continue to evaluate potential paths forward, it is possible that the terms of the Transmission Termination Agreement may again control. APS believes that the original denial by FERC of rate recovery under the Transmission Termination Agreement constitutes the failure of a condition that relieves APS of its obligations under that agreement. If APS and SCE are unable to determine a resolution through negotiation, the Transmission Termination Agreement requires that disputes be resolved through arbitration. APS is unable to predict the outcome of this matter if it proceeds to arbitration. If the matter proceeds to arbitration and APS is not successful, APS may be required to record a charge to its results of operations.

#### Cholla

After considering the costs to comply with environmental regulations, on September 11, 2014, APS announced that it will close Unit 2 of the Cholla Power Plant ("Cholla") by April 2016 and cease burning coal at the other APS-owned units (Units 1 and 3) at the plant by the mid-2020s, if the United States Environmental Protection Agency ("EPA") approves a compromise proposal offered by APS to meet required environmental and emissions standards and rules. Previously, APS estimated Cholla Unit 2's end of life to be 2033. APS is currently recovering depreciation and a return on the net book value of the unit in base rates and plans to seek recovery of all of the unit's retirement-related costs in its next retail rate case. On April 14, 2015, the ACC approved APS's proposed retirement of Cholla Unit 2 in accordance with the ACC's Integrated Resource Planning rules. The ACC expressly stated that this approval does not imply any specific treatment or recommendation for rate making purposes.

If APS closes Cholla Unit 2, APS believes it will be allowed recovery of the remaining net book value of Unit 2 (\$125 million as of June 30, 2015), in addition to a return on its investment. In accordance with GAAP, in the third quarter of 2014, Unit 2's remaining net book value was reclassified from property, plant and equipment to a regulatory asset. If the ACC does not allow full recovery of the remaining net book value of Cholla Unit 2, all or a portion of the regulatory asset will be written off and APS's net income, cash flows, and financial position will be negatively impacted.

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):

	Remaining Amortization Period	June 30, 2015		December 31, 2014	
		Current	Non-Current	Current	Non-Current
Pension benefits	(a)	\$—	\$ 505	\$—	\$ 485
Income taxes — allowance for funds used during construction ("AFUDC") equity	2044	5	122	5	118
Deferred fuel and purchased power — mark-to-market (Note 7)	2018	53	62	51	46
Transmission vegetation management	2016	9	—	9	5
Coal reclamation	2026	—	6	—	7
Palo Verde VIEs (Note 6)	2046	—	26	—	35
Deferred compensation	2036	—	36	—	34
Deferred fuel and purchased power (b) (c)	2015	—	—	7	—
Tax expense of Medicare subsidy	2024	2	13	2	14
Loss on reacquired debt	2034	1	16	1	16
Income taxes — investment tax credit basis adjustment	2044	2	46	2	46
Pension and other postretirement benefits deferral	2015	—	—	4	—
Four Corners cost deferral	2024	7	67	7	70
Lost fixed cost recovery (b)	2016	45	—	38	—
Retired power plant costs	2033	10	131	10	136
Deferred property taxes	(d)	—	40	—	30
Other	Various	1	11	2	12
Total regulatory assets (e)		\$135	\$ 1,081	\$138	\$ 1,054

This asset represents the future recovery of pension and other postretirement benefit obligations through retail (a) 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. See Note 4 for further discussion.

(b) See "Cost Recovery Mechanisms" discussion above.

(c) Subject to a carrying charge.

(d) Per the provision of the 2012 Settlement Agreement.

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

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	Remaining Amortization Period	June 30, 2015		December 31, 2014	
		Current	Non-Current	Current	Non-Current
Removal costs	(a)	\$44	\$ 245	\$31	\$ 273
Asset retirement obligations	2044	—	272	—	296
Renewable energy standard (b)	2017	29	20	25	23
Income taxes — change in rates	2043	1	71	—	72
Spent nuclear fuel	2047	3	68	5	66
Deferred gains on utility property	2019	2	7	2	8
Income taxes — deferred investment tax credit	2043	3	92	4	93
Deferred fuel and purchased power (b) (c)	2016	16	—	—	—
Demand side management (b)	2017	8	27	31	—
Other postretirement benefits	(d)	33	189	32	199
Other	Various	13	26	1	21
Total regulatory liabilities		\$152	\$ 1,017	\$131	\$ 1,051

(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.

(c) Subject to a carrying charge.

(d) See Note 4.

#### 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 an other postretirement benefit plan 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 dates. On September 30, 2014, Pinnacle West announced plan design changes to the other postretirement benefit plan. Because of these plan changes in 2014, the Company is currently in the process of seeking Internal Revenue Service ("IRS") and regulatory approval to move approximately \$100 million of the other postretirement benefit trust assets into a new account to pay for active union employee medical costs.

Certain pension and other postretirement benefit costs in excess of amounts recovered in electric retail rates were deferred in 2011 and 2012 as a regulatory asset for future recovery, pursuant to APS's 2009 retail rate case settlement. Pursuant to this order, we began amortizing the regulatory asset over three years beginning in July 2012. We amortized approximately \$2 million and \$4 million for the three and six months ended June 30, 2015 and 2014, respectively. 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):

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Pension Benefits				Other Benefits			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014	2015	2014	2015	2014
Service cost — benefits earned during the period	\$14	\$12	\$30	\$27	\$4	\$5	\$8	\$9
Interest cost on benefit obligation	31	33	62	65	7	11	14	23
Expected return on plan assets	(45 )	(39 )	(90 )	(79 )	(9 )	(13 )	(18 )	(25 )
Amortization of:								
Prior service cost	—	—	—	—	(9 )	—	(19 )	—
Net actuarial loss	8	3	16	5	—	—	2	—
Net periodic benefit cost	\$8	\$9	\$18	\$18	\$(7 )	\$3	\$(13 )	\$7
Portion of cost charged to expense	\$5	\$5	\$11	\$11	\$(2 )	\$3	\$(4 )	\$5

#### Contributions

We have made voluntary contributions of \$80 million to our pension plan year-to-date in 2015. The minimum required contributions for the pension plan are zero for the next three years. We expect to make voluntary contributions totaling up to \$300 million for the next three years (up to \$100 million each year in 2015, 2016, and 2017). We expect to make contributions of approximately \$1 million in each of the next three years to our other postretirement benefit plans.

#### 5. Income Taxes

On September 13, 2013, the U.S. Treasury Department released final income tax regulations on the deduction and capitalization of expenditures related to tangible property. These final regulations apply to tax years beginning on or after January 1, 2014. Several of the provisions within the regulations require a tax accounting method change to be filed with the IRS prior to September 15, 2015, resulting in a tax-effected cumulative effect adjustment of approximately \$82 million. The anticipated impact of these final regulations were accounted for in the Condensed Consolidated Balance Sheets as of December 31, 2014.

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.

As of June 30, 2015, the tax year ended December 31, 2011 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 2009.

#### 6. Palo Verde Sale Leaseback Variable Interest Entities

In 1986, APS entered into agreements with three separate VIE lessor trust entities in order to sell and lease back interests in Palo Verde Unit 2 and related common facilities. These lease agreements include fixed rate renewal

periods. On July 7, 2014, APS notified the lessor trust entities of APS's intent to exercise the fixed rate lease renewal options. The length of the renewal options will result in APS retaining the assets

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

through 2023 under one lease and 2033 under the other two leases. APS will be required to make payments relating to these leases of approximately \$49 million in 2015, \$23 million annually for the period 2016 through 2023, and \$16 million annually for the period 2024 through 2033. At the end of the lease renewal periods, APS will have the option to purchase the leased assets at their fair market value, extend the leases for up to 2 years, or return the assets to the lessors.

The fixed rate renewal periods give APS the ability to utilize the assets for a significant portion of the assets' 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.

As a result of consolidation, we eliminate lease accounting and instead recognize depreciation and interest expense, resulting in an increase in net income for the three and six months ended June 30, 2015 of \$5 million and \$9 million, respectively, and for the three and six months ended June 30, 2014 of \$9 million and \$18 million, respectively, entirely attributable to the noncontrolling interests. The income attributable to the noncontrolling interests decreased because of lower rent income resulting from the July 7, 2014 lease extensions.

In accordance with the regulatory treatment, higher depreciation expense and a regulatory liability were recorded in consolidation to offset the decrease in the noncontrolling interests' share of net income. Accordingly, income attributable to Pinnacle West shareholders was not impacted by the consolidation or the lease extensions. 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 June 30, 2015 and December 31, 2014 include the following amounts relating to the VIEs (in millions):

	June 30, 2015	December 31, 2014
Palo Verde sale leaseback property plant and equipment, net of accumulated depreciation	\$ 119	\$ 121
Current maturities of long-term debt	1	13
Equity — Noncontrolling interests	133	152

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.

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 June 30, 2015, APS would have been required to pay the noncontrolling equity participants approximately \$114 million and assume \$1 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.

24

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PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For regulatory ratemaking purposes, the agreements 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 cash flow 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 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. When amounts have been reclassified from accumulated OCI to earnings, they will be subject to deferral in accordance with the PSA. 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 11 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 sales 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



PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

For its regulated operations, APS defers for future rate treatment 100% of the unrealized gains and losses 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 June 30, 2015, we had the following outstanding gross notional volume of derivatives, which represent both purchases and sales (does not reflect net position):

Commodity	Quantity	
Power	3,808	GWh
Gas	188	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 during the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

	Financial Statement Location	Three Months Ended		Six Months Ended	
		June 30, 2015	2014	June 30, 2015	2014
Commodity Contracts					
Gain (loss) recognized in OCI on derivative instruments (effective portion)	OCI — derivative instruments	\$41	\$66	\$(286)	\$243
Loss reclassified from accumulated OCI into income (effective portion realized) (a)	Fuel and purchased power (b)	(1,430)	(3,216)	(3,773)	(7,654)

(a) During the three and six months ended June 30, 2015 and 2014, we had no amounts reclassified from accumulated OCI 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 \$4 million before income taxes will be reclassified from accumulated OCI as an offset to the effect of market price changes for the related hedged transactions. In accordance with the PSA, most of these amounts will be recorded as either a regulatory asset or liability and have no immediate effect on earnings.

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table provides information about gains and losses from derivative instruments not designated as accounting hedging instruments during the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

	Financial Statement Location	Three Months Ended		Six Months Ended June	
		June 30, 2015	2014	30, 2015	2014
Commodity Contracts					
Net gain (loss) recognized in income	Operating revenues (a)	\$(66 )	\$155	\$(114 )	\$63
Net gain (loss) recognized in income	Fuel and purchased power (a)	10,613	4,805	(34,190 )	22,912
Total		\$10,547	\$4,960	\$(34,304 )	\$22,975

(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 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 a 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 June 30, 2015 and December 31, 2014, each include gross liabilities of \$4 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 as of June 30, 2015 and December 31, 2014. 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.

PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of June 30, 2015: (Dollars in thousands)	Gross Recognized Derivatives (a)	Amounts Offset (b)	Net Recognized Derivatives	Other (c)	Amount Reported on E Sheet
Current assets	\$25,485	\$(12,925)	) \$12,560	\$2,162	\$14,722
Investments and other assets	20,560	(4,787)	) 15,773	2,740	18,513
Total assets	46,045	(17,712)	) 28,333	4,902	33,235
Current liabilities	(83,203)	) 30,626	(52,577)	) (8,096)	) (60,673)
Deferred credits and other	(92,475)	) 4,786	(87,689)	) —	) (87,689)
Total liabilities	(175,678)	) 35,412	(140,266)	) (8,096)	) (148,362)
Total	\$(129,633)	) \$17,700	\$(111,933)	) \$(3,194)	) \$(115,127)

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

(b) Includes cash collateral provided to counterparties of \$17,700.

Represents cash collateral, cash margin and option premiums that are not subject to offsetting. Amounts relate to non-derivative instruments, derivatives qualifying for scope exceptions, or collateral and margin posted in excess of the recognized derivative instrument. Includes cash collateral received from counterparties of \$8,096, cash margin provided to counterparties of \$2,162 and option premiums of \$2,740.

As of December 31, 2014: (Dollars in thousands)	Gross Recognized Derivatives (a)	Amounts Offset (b)	Net Recognized Derivatives	Other (c)	Amount Reported on Balance Sheet
Current assets	\$28,562	\$(15,127)	) \$13,435	\$350	\$13,785
Investments and other assets	24,810	(7,190)	) 17,620	—	17,620
Total assets	53,372	(22,317)	) 31,055	350	31,405
Current liabilities	(86,062)	) 33,829	(52,233)	) (7,443)	) (59,676)
Deferred credits and other	(82,990)	) 32,388	(50,602)	) —	) (50,602)
Total liabilities	(169,052)	) 66,217	(102,835)	) (7,443)	) (110,278)
Total	\$(115,680)	) \$43,900	\$(71,780)	) \$(7,093)	) \$(78,873)

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

(b) Includes cash collateral provided to counterparties of \$43,900.

Represents cash collateral and margin that is not subject to offsetting. Amounts relate to non-derivative instruments, derivatives qualifying for scope exceptions, or collateral and margin posted in excess of the recognized derivative instrument. Includes cash collateral received from counterparties of \$7,443, and cash margin provided to counterparties of \$350.

#### 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 one counterparty for which our exposure represents approximately 81% of Pinnacle West's \$33 million of risk management assets as of June 30, 2015. This exposure relates to a long-term traditional wholesale contract with a counterparty that has a high credit quality. Our risk

management process assesses and monitors the financial exposure of all counterparties.

28

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PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 subjective events and/or conditions. 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).

The following table provides information about our derivative instruments that have credit-risk-related contingent features at June 30, 2015 (dollars in millions):

	June 30, 2015
Aggregate fair value of derivative instruments in a net liability position	\$ 176
Cash collateral posted	18
Additional cash collateral in the event credit-risk-related contingent features were fully triggered (a)	89

(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 \$161 million if our debt credit ratings were to fall below investment grade.

## 8. 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 ("Court of Federal Claims"). The lawsuit seeks to recover damages incurred due to DOE's breach of the Contract for Disposal of Spent Nuclear Fuel and/or High Level Radioactive Waste ("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. On August 18, 2014, APS and DOE entered into a settlement agreement, stipulating to a dismissal of the lawsuit and payment of \$57.4 million by DOE to the Palo Verde owners for certain specified





PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

costs incurred by Palo Verde during the period January 1, 2007 through June 30, 2011. APS's share of this amount is \$16.7 million. Amounts recovered in the lawsuit and settlement were recorded as adjustments to a regulatory liability and had no impact on income. In addition, the settlement agreement provides APS with a method for submitting claims and getting recovery for costs incurred through 2016.

On March 11, 2015, the DOE notified APS that it had approved APS's claim for damages incurred due to DOE's breach of the Standard Contract for the period July 1, 2011 through June 30, 2014. The claim for this period was the first claim made pursuant to the terms of the August 18, 2014 settlement agreement. The amount claimed was \$42.0 million; APS's share of this amount is \$12.2 million. The settlement payment was received on June 1, 2015. APS's \$12.2 million share was recorded as an adjustment to a regulatory liability and had no impact on income.

#### 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 commercial 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 \$13.4 billion per occurrence. Palo Verde maintains the maximum available nuclear liability insurance in the amount of \$375 million, which is provided by American Nuclear Insurers ("ANI"). The remaining balance of \$12.98 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 retrospective premium assessment per reactor under the program for each nuclear liability incident is approximately \$127.3 million, subject to an annual limit of \$19 million per incident, to be periodically adjusted for inflation. Based on APS's ownership interest in the three Palo Verde units, APS's maximum potential retrospective premium assessment per incident for all three units is approximately \$111 million, with a maximum annual retrospective premium assessment of approximately \$16.5 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. APS has also secured insurance against portions of any increased cost of replacement generation or purchased power and business interruption resulting from a sudden and unforeseen accidental outage of any of the three units. The property damage, decontamination, and replacement power coverages are provided by Nuclear Electric Insurance Limited ("NEIL"). APS is subject to retrospective premium 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 \$23.1 million for each retrospective premium 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 \$61.7 million of collateral assurance within 20 business days of a rating downgrade to non-investment grade. The insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions, sublimits and exclusions.

#### Contractual Obligations

During the quarter our purchase obligations have increased by about \$170 million relating to gas generation projects. The expected payments to be made are \$26 million in 2015, \$89 million in 2016, \$46 million in 2017 and \$9 million in 2018.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Other than the item described above, there have been no material changes outside the normal course of business in contractual obligations from the information provided in our 2014 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, EPA advised APS that EPA considers APS to be a PRP in the Motorola 52<sup>nd</sup> 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.

On August 6, 2013, the Roosevelt Irrigation District ("RID") filed a lawsuit in Arizona District Court against APS and 24 other 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. The allegations against APS arise out of APS's current and former ownership of facilities in and around OU3. As part of a state governmental investigation into groundwater contamination in this area, on January 25, 2015, the Arizona Department of Environmental Quality ("ADEQ") sent a letter to APS seeking information concerning the degree to which, if any, APS's current and former ownership of these facilities may have contributed to groundwater contamination in this area. We are unable to predict the outcome of these matters; however, we do not expect the outcome to have a material impact on our financial position, results of operations or cash flows.

#### 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.

On September 6, 2013, a purported consumer class action complaint was filed in Federal District Court in San Diego, California, naming APS and Pinnacle West as defendants and seeking damages for loss of perishable inventory and sales as a result of interruption of electrical service. APS and Pinnacle West filed a motion to dismiss, which the court granted on December 9, 2013. On January 13, 2014, the plaintiffs appealed the lower court's decision. The appeal is now fully briefed and pending before the United States Court of Appeals for the Ninth Circuit. We are unable to predict the outcome of this matter.

#### Clean Air Act Citizen 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

PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

participants alleging violations of the New Source Review ("NSR") provisions of 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 environmental plaintiffs sought to have the court enjoin operations at Four Corners until APS applied for and obtained any required NSR permits and complied with the NSPS. The plaintiffs further requested the court to order the payment of civil penalties, including a beneficial mitigation project. The case was held in abeyance while APS negotiated a settlement with the United States Department of Justice ("DOJ") and environmental plaintiffs. In March 2015, the parties agreed in principle on final proposed language to settle the case, and on June 24, 2015, DOJ lodged the proposed consent decree with the United States District Court for the District of New Mexico. On that same day, DOJ also published notice of the filing in the Federal Register, which opened a 30-day period for public comment. The settlement would resolve claims by the government and environmental plaintiffs that the co-owners violated the Clean Air Act by modifying Four Corners Units 4 and 5 without first obtaining a pre-construction permit from EPA. The settlement would require installation of pollution control technology and implementation of other measures to reduce sulfur dioxide and nitrogen oxide emissions from the two units, although installation of much of this equipment was already planned in order to comply with EPA's Regional Haze Rule best available retrofit technology ("BART") requirements. The settlement would also require Four Corners co-owners to pay a civil penalty of \$1.5 million and spend \$6.2 million for certain environmental mitigation projects to benefit the Navajo Nation. APS would be responsible for 15 percent of these costs based on its ownership interest in the units at the time of the alleged violations, which does not result in a material impact on our financial position, results of operations or cash flows. APS expects DOJ to file a motion to enter the consent decree with the court after expiration of the 30-day comment period.

#### 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 ("CCRs"). 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, Cholla and the Navajo Generating Station ("Navajo Plant"). EPA and ADEQ will require these plants to install pollution control equipment that constitutes BART to lessen the impacts of emissions on visibility surrounding the plants.

**Four Corners.** Based on EPA's final standards, APS estimates that its 63% share of the cost of these controls for Four Corners Units 4 and 5 would be approximately \$400 million. In addition, APS and El Paso entered into an asset purchase agreement providing for the purchase by APS, or an affiliate of APS, of El Paso's 7% interest in Four Corners Units 4 and 5. The cost of the controls related to the 7% interest is approximately \$45 million.

**Navajo Plant.** APS estimates that its share of costs for upgrades at the Navajo Plant, based on EPA's Federal Implementation Plan ("FIP"), could be up to approximately \$200 million. In October 2014, a coalition of environmental groups, an Indian tribe and others filed petitions for review in the United States Court of Appeals for the Ninth Circuit asking the Court to review EPA's final BART rule for the Navajo Plant. We cannot predict the outcome of this review process.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Cholla. APS believes that EPA's final rule as it applies to Cholla, which would require installation of selective catalytic reduction ("SCR") controls with a cost to APS of approximately \$200 million, 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 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. Briefing in the case was completed in February 2014. In September 2014, APS met with EPA to propose a compromise BART strategy wherein, pending certain regulatory approvals, APS would permanently close Cholla Unit 2 by April 2016 and cease burning coal at Units 1 and 3 by the mid-2020s. (See Note 3 for details related to the resulting regulatory asset.) APS made the proposal with the understanding that additional emission control equipment is unlikely to be required in the future because retiring and converting the units as contemplated in the proposal is more cost effective than, and will result in increased visibility improvement over, the current BART requirements for NO<sub>x</sub> imposed on the Cholla units under EPA's BART FIP. APS's proposal involves state and federal rule-making processes. In light of these ongoing administrative proceedings, on February 19, 2015, APS, PacifiCorp (owner of Cholla Unit 4), and EPA jointly moved the court to sever and hold in abeyance those claims in the litigation pertaining to Cholla pending regulatory actions by the state and EPA. The court granted the parties' unopposed motion on February 20, 2015. On June 10, 2015, ADEQ issued for public comment the draft Cholla permit, which memorializes APS's proposal, and a proposed revision to the SIP, which would incorporate the new permit terms. APS is unable to predict when or whether APS's proposal may ultimately be approved.

Mercury and Air Toxic Standards ("MATS"). 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 \$130 million for Cholla, which would be avoided if EPA approves APS's compromise proposal discussed above. No additional equipment is needed for Four Corners Units 4 and 5 to comply with these rules. Salt River Project Agricultural Improvement and Power District ("SRP"), the operating agent for the Navajo Plant, estimates that APS's share of costs for equipment necessary to comply with the rules is approximately \$1 million. The United States Supreme Court's recent decision in *Michigan vs. EPA* reversed and remanded the MATS rule. This decision does not materially impact APS. Regardless of whether the MATS rule is ultimately vacated by the lower court, the Arizona State Mercury Rule, the stringency of which is roughly equivalent to that of MATS, would still apply to Cholla.

Coal Combustion Waste. On December 19, 2014, EPA issued its final regulations governing the handling and disposal of CCR, such as fly ash and bottom ash. The rule regulates CCR as a non-hazardous waste under Subtitle D of the Resource Conservation and Recovery Act ("RCRA") and establishes national minimum criteria for existing and new CCR landfills and surface impoundments and all lateral expansions consisting of location restrictions, design and operating criteria, groundwater monitoring and corrective action, closure requirements and post closure care, and recordkeeping, notification, and Internet posting requirements. The rule generally requires any existing unlined CCR surface impoundment that is contaminating groundwater above a regulated constituent's groundwater protection standard to stop receiving CCR and either retrofit or close, and further requires the closure of any CCR landfill or surface impoundment that cannot meet the applicable performance criteria for location restrictions or structural integrity.

Because the Subtitle D rule is self-implementing, the CCR standards apply directly to the regulated facility, and facilities are directly responsible for ensuring that their operations comply with the rule's requirements. While EPA has chosen to regulate the disposal of CCR in landfills and surface impoundments as non-hazardous waste under the final rule, the agency makes clear that it will continue to evaluate any risks





PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

associated with CCR disposal and leaves open the possibility that it may regulate CCR as a hazardous waste under RCRA Subtitle C in the future.

APS currently disposes of CCR in ash ponds and dry storage areas at Cholla and Four Corners. APS estimates that its share of incremental costs to comply with the CCR rule for Four Corners is approximately \$15 million, and its share of incremental costs for Cholla is approximately \$85 million. The Navajo Plant currently disposes of CCR in a dry landfill storage area. APS estimates that its share of incremental costs to comply with the CCR rule for the Navajo Plant is approximately \$1 million.

Other future environmental rules that could involve material compliance costs include those related to effluent limitations, the ozone national ambient air quality standard, greenhouse gas ("GHG") emissions (such as the EPA's proposed "Clean Power Plan" rule), and other rules or matters involving the Clean Air Act, Clean Water 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.

#### New Mexico Tax Matter

On May 23, 2013, the New Mexico Taxation and Revenue Department issued a notice of assessment for coal severance surtax, penalty, and interest totaling approximately \$30 million related to coal supplied under the coal supply agreement for Four Corners (the "Assessment"). APS's share of the Assessment is approximately \$12 million. For procedural reasons, on behalf of the Four Corners co-owners, including APS, the coal supplier made a partial payment of the Assessment and immediately filed a refund claim with respect to that partial payment in August 2013. The New Mexico Taxation and Revenue Department denied the refund claim. On December 19, 2013, the coal supplier and APS, on its own behalf and as operating agent for Four Corners, filed a complaint with the New Mexico District Court contesting both the validity of the Assessment and the refund claim denial. On June 30, 2015, the court ruled that the Assessment was not valid and further ruled that APS and the other Four Corners co-owners receive a refund of all of the contested amounts previously paid under the applicable tax statute. The New Mexico Taxation and Revenue Department has indicated it intends to appeal the decision. We cannot predict the timing or outcome of any appeal; however, we do not expect the outcome to have a material impact on our financial position, results of operations or cash flows.

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

### Financial Assurances

APS has entered into various agreements that require letters of credit for financial assurance purposes. At June 30, 2015, 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. Two of these letters of credit expire in 2016 and one expires in 2017. 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 on December 31, 2015, and totaled approximately \$20 million at June 30, 2015. Additionally, APS has issued letters of credit to support collateral obligations under certain risk management arrangements, including a natural gas tolling contract entered into with a third party. At June 30, 2015, \$35 million of such letters of credit were outstanding that will expire in 2015 and 2016.

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 has provided indemnification under certain surety bonds for APS which were not material at June 30, 2015.

### 9. Other Income and Other Expense

The following table provides detail of other income and other expense for the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2015	2014	2015	2014
Other income:				
Interest income	\$184	\$495	\$294	\$746
Miscellaneous	(9	) 2,286	116	4,402
Total other income	\$175	\$2,781	\$410	\$5,148
Other expense:				
Non-operating costs	\$(1,952	) \$(2,620	) \$(4,200	) \$(4,992
Investment losses — net	(650	) (105	) (1,145	) (246
Miscellaneous	(7	) 2,217	(1,550	) 46
Total other expense	\$(2,609	) \$(508	) \$(6,895	) \$(5,192

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

### 10. Earnings Per Share

The following table presents the calculation of Pinnacle West's basic and diluted earnings per share for the three and six months ended June 30, 2015 and 2014 (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2015	2014	2015	2014
Net income attributable to common shareholders	\$ 122,902	\$ 132,458	\$ 139,024	\$ 148,224
Weighted average common shares outstanding — basic	110,986	110,565	110,958	110,546
Net effect of dilutive securities:				
Contingently issuable performance shares and restricted stock units	474	437	468	379
Weighted average common shares outstanding — diluted	111,460	111,002	111,426	110,925
Earnings per average common share attributable to common shareholders — basic	\$ 1.11	\$ 1.20	\$ 1.25	\$ 1.34
Earnings per average common share attributable to common shareholders — diluted	\$ 1.10	\$ 1.19	\$ 1.25	\$ 1.34

### 11. 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 U.S. 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 that are redeemable and valued based on NAV, such as common and collective trusts and commingled funds.

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



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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 7 in the 2014 Form 10-K for the fair value discussion of plan assets held in our retirement and other benefit plans.

#### 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 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, characteristics of the product, 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 the 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.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

#### 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 Net Asset Value ("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 certificates of deposit, variable rate notes, time deposit accounts, U.S. Treasury and Agency obligations, U.S. Treasury repurchase agreements, and commercial paper. We may transact in this commingled fund on a daily basis at the NAV.

Fixed income securities issued by the U.S. Treasury held directly by the nuclear decommissioning trust are valued using quoted active market prices and are typically 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.

We price securities using information provided by our trustee for our nuclear decommissioning trust assets. Our trustee uses 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 12 for additional discussion about our nuclear decommissioning trust.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Fair Value Tables

The following table presents the fair value at June 30, 2015, 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 June 30, 2015
<b>Assets</b>					
Risk management activities — derivative instruments:					
Commodity contracts	\$—	\$16	\$30	\$(13 ) (b)	\$33
Nuclear decommissioning trust:					
U.S. commingled equity funds	—	314	—	—	314
Cash and cash equivalent funds	—	11	—	(4 ) (c)	7
Fixed income securities:					
U.S. Treasury	93	2	—	—	95
Corporate debt	—	116	—	—	116
Mortgage-backed securities	—	87	—	—	87
Municipal bonds	—	86	—	—	86
Other	—	19	—	—	19
Subtotal nuclear decommissioning trust	93	635	—	(4 )	724
Total	\$93	\$651	\$30	\$(17 )	\$757
<b>Liabilities</b>					
Risk management activities — derivative instruments:					
Commodity contracts	\$—	\$(103 )	\$(73 )	\$28 (b)	\$(148 )

(a) Primarily consists of heat rate options and other 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.

PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the fair value at December 31, 2014, 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, 2014
<b>Assets</b>					
Risk management activities — derivative instruments:					
Commodity contracts	\$—	\$21	\$33	\$(23 ) (b)	\$31
Nuclear decommissioning trust:					
U.S. commingled equity funds	—	310	—	—	310
Fixed income securities:					
U.S. Treasury	119	—	—	—	119
Cash and cash equivalent funds	—	11	—	(7 ) (c)	4
Corporate debt	—	109	—	—	109
Mortgage-backed securities	—	89	—	—	89
Municipal bonds	—	69	—	—	69
Other	—	14	—	—	14
Subtotal nuclear decommissioning trust	119	602	—	(7 )	714
<b>Total</b>	<b>\$119</b>	<b>\$623</b>	<b>\$33</b>	<b>\$(30 )</b>	<b>\$745</b>
<b>Liabilities</b>					
Risk management activities — derivative instruments:					
Commodity contracts	\$—	\$(95 )	\$(74 )	\$59 (b)	\$(110 )

(a) Primarily consists of heat rate options and other 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).

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 at June 30, 2015 for these instruments include electricity prices, and

40

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PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

volatilities. The significant unobservable inputs at December 31, 2014 for these instruments include electricity prices, gas prices and volatilities. If electricity prices and electricity price 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 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 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 tables provide information regarding our significant unobservable inputs used to value our risk management derivative Level 3 instruments at June 30, 2015 and December 31, 2014:

Commodity Contracts	June 30, 2015		Valuation Technique	Significant Unobservable Input	Range	Weighted-Average	
	Assets	Liabilities					
Electricity:							
Forward Contracts (a)	\$28	\$57	Discounted cash flows	Electricity forward price (per MWh)	\$21.07 - \$67.74	\$	31.46
Option Contracts (b)	—	12	Option model	Electricity forward price (per MWh)	\$32.85 - \$67.74	\$	46.13
				Electricity price volatilities	26% - 115%	68	%
				Natural gas price volatilities	27% - 42%	31	%
Natural Gas:							
Forward Contracts (a)	2	4	Discounted cash flows	Natural gas forward price (per MMBtu)	\$2.69 - \$3.61	\$	3.23
Total	\$30	\$73					

(a) Includes swaps and physical and financial contracts.

(b) Electricity and natural gas price volatilities are estimated based on historical forward price movements due to lack of market quotes for implied volatilities.

PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Commodity Contracts	December 31, 2014		Valuation Technique	Significant Unobservable Input	Range	Weighted-Average	
	Assets	Liabilities					
Electricity:							
Forward Contracts (a)	\$30	\$56	Discounted cash flows	Electricity forward price (per MWh)	\$19.51 - \$56.72	\$	35.27
Option Contracts (b)	—	15	Option model	Electricity forward price (per MWh)	\$32.14 - \$66.09	\$	45.83
				Natural gas forward price (per MMBtu)	\$3.18 - \$3.29	\$	3.25
				Electricity price volatilities	23% - 63%	41	%
				Natural gas price volatilities	23% - 41%	31	%
Natural Gas:							
Forward Contracts (a)	3	3	Discounted cash flows	Natural gas forward price (per MMBtu)	\$2.98 - \$4.13	\$	3.45
Total	\$33	\$74					

(a) Includes swaps and physical and financial contracts.

(b) Electricity and natural gas price volatilities are estimated based on historical forward price movements due to lack of market quotes for implied volatilities.

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 and six months ended June 30, 2015 and 2014 (dollars in millions):

	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Commodity Contracts				
Net derivative balance at beginning of period	\$(49)	\$(49)	\$(41)	\$(49)
Total net gains (losses) realized/unrealized:				
Deferred as a regulatory asset or liability	6	3	(5)	6
Settlements	5	4	5	5
Transfers into Level 3 from Level 2	(4)	1	(4)	(2)
Transfers from Level 3 into Level 2	(1)	—	2	(1)
Net derivative balance at end of period	\$(43)	\$(41)	\$(43)	\$(41)
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 fuel and purchased power depending on the nature of the underlying contract.



PINNACLE WEST CAPITAL CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 from any other hierarchy level. Transfers in or out of Level 3 are typically related to our 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 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.

#### 12. 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 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 11 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 June 30, 2015 and December 31, 2014 (dollars in millions):

	Fair Value	Total Unrealized Gains	Total Unrealized Losses
June 30, 2015			
Equity securities	\$314	\$160	\$—
Fixed income securities	414	13	(3 )
Net payables (a)	(4 )	—	—
Total	\$724	\$173	\$(3 )
	Fair Value	Total Unrealized Gains	Total Unrealized Losses
December 31, 2014			
Equity securities	\$310	\$159	\$—
Fixed income securities	411	17	(1 )
Net payables (a)	(7 )	—	—
Total	\$714	\$176	\$(1 )

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





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 gains and losses and proceeds from the sale of securities by the nuclear decommissioning trust funds (dollars in millions):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2015	2014	2015	2014
Realized gains	\$1	\$1	\$2	\$2
Realized losses	(1	) (1	) (2	) (3
Proceeds from the sale of securities (a)	110	96	226	199

(a) Proceeds are reinvested in the trust.

The fair value of fixed income securities, summarized by contractual maturities, at June 30, 2015 is as follows (dollars in millions):

	Fair Value
Less than one year	\$13
1 year – 5 years	111
5 years – 10 years	123
Greater than 10 years	167
Total	\$414

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

### 13. New Accounting Standards

In May 2014, new revenue recognition guidance was issued. This guidance provides a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance. The guidance may be adopted using a full retrospective application or a simplified transition method that allows entities to record a cumulative effect adjustment in retained earnings at the date of initial application. The new revenue standard will be effective for us on January 1, 2018. We are currently evaluating this new guidance and the impacts it may have on our financial statements.

In February 2015, new guidance was issued that amends the consolidation accounting guidance. The amendments modify many aspects of the guidance relating to the analysis and consolidation of variable interest entities. These changes include impacts on the following: limited partnerships, fees paid to decision makers, related parties, and the determination of whether an entity qualifies as a variable interest entity. The new guidance is effective for us on January 1, 2016, and may be adopted using either a full retrospective or modified retrospective approach. We are currently evaluating this amended guidance and the impacts it may have on our financial statements.

In April 2015, the Financial Accounting Standards Board issued new guidance that changes the balance sheet presentation of debt issuance costs. Currently, debt issuance costs are presented on the balance sheet as assets. The new guidance requires us to reflect debt issuance costs as a reduction to the related debt liabilities, consistent with the presentation of debt discounts. The new guidance is effective for us during the first quarter of 2016, and must be adopted retrospectively. We do not expect these presentation changes to be material to our balance sheet. The adoption of this new guidance will not impact our results of operations or cash flows.

### 14. Changes in Accumulated Other Comprehensive Loss

The following tables show the changes in accumulated other comprehensive loss, including reclassification adjustments, net of tax, by component for the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

	Three Months Ended June 30, 2015			Three Months Ended June 30, 2014		
	Derivative Instruments	Pension and Other Postretirement Benefits	Total	Derivative Instruments	Pension and Other Postretirement Benefits	Total
Beginning balance, April 1	\$(9,209 )	\$(57,173 )	\$(66,382 )	\$(20,364 )	\$(54,538 )	\$(74,902 )
OCI (loss) before reclassifications	25	(969 )	(944 )	40	(2,072 )	(2,032 )
Amounts reclassified from accumulated other comprehensive loss	874	(a) 852	(b) 1,726	1,955	(a) 762	(b) 2,717
Net current period OCI (loss)	899	(117 )	782	1,995	(1,310 )	685
Ending balance, June 30	\$(8,310 )	\$(57,290 )	\$(65,600 )	\$(18,369 )	\$(55,848 )	\$(74,217 )

- (a) These amounts represent realized gains and losses and are included in the computation of fuel and purchased power costs and are subject to the PSA. See Note 7.
- (b) These amounts primarily represent amortization of actuarial loss, and are included in the computation of net periodic pension cost. See Note 4.

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Six Months Ended June 30, 2015			Six Months Ended June 30, 2014		
	Derivative Instruments	Pension and Other Postretirement Benefits	Total	Derivative Instruments	Pension and Other Postretirement Benefits	Total
Beginning balance, January 1	\$(10,385 )	\$(57,756 )	\$(68,141 )	\$(23,058 )	\$(54,995 )	\$(78,053 )
OCI (loss) before reclassifications	(775 )	(969 )	(1,744 )	(381 )	(2,072 )	(2,453 )
Amounts reclassified from accumulated other comprehensive loss	2,850 (a)	1,435 (b)	4,285	5,070 (a)	1,219 (b)	6,289
Net current period OCI (loss)	2,075	466	2,541	4,689	(853 )	3,836
Ending balance, June 30	\$(8,310 )	\$(57,290 )	\$(65,600 )	\$(18,369 )	\$(55,848 )	\$(74,217 )

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

(b) These amounts primarily represent amortization of actuarial loss, and are included in the computation of net periodic pension cost. See Note 4.

#### 15. Asset Retirement Obligations

In the first quarter of 2015, an updated decommissioning study was completed for the Four Corners coal-fired plant, which resulted in an increase to the asset retirement obligation ("ARO") in the amount of \$18 million.

In the second quarter of 2015, there was a revision in estimated cash flows for the Four Corners decommissioning, which resulted in an increase to the ARO in the amount of \$6 million. In addition, APS recognized an ARO for Cholla as a result of new CCR environmental rulings that were published in the Federal Register in the second quarter of 2015. See Note 8 for additional information related to the CCR environmental rulings. This resulted in an increase to the ARO in the amount of \$39 million, an increase in plant in service of \$23 million and a reduction of the regulatory liability of \$16 million.

PINNACLE WEST CAPITAL CORPORATION  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following schedule shows the change in our asset retirement obligations for the six months ended June 30, 2015 (dollars in millions):

Asset retirement obligations at January 1, 2015	\$391	
Changes attributable to:		
Accretion expense	12	
Settlements	(18	)
Estimated cash flow revisions	24	
Newly incurred liabilities	39	
Asset retirement obligations at June 30, 2015	\$448	

Decommissioning activities for Four Corners Units 1-3 began in January 2014; thus, \$29 million of the total asset retirement obligation of \$448 million at June 30, 2015, is classified as a current liability on the balance sheet.

In accordance with regulatory accounting, APS accrues removal costs for its regulated utility assets, even if there is no legal obligation for removal. See detail of regulatory liabilities in Note 3.

ARIZONA PUBLIC SERVICE COMPANY  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
 (unaudited)  
 (dollars in thousands)

	Three Months Ended	
	June 30,	
	2015	2014
ELECTRIC OPERATING REVENUES	\$889,723	\$905,578
OPERATING EXPENSES		
Fuel and purchased power	281,477	290,854
Operations and maintenance	208,031	208,059
Depreciation and amortization	122,716	105,127
Income taxes	71,672	77,371
Taxes other than income taxes	43,123	43,773
Total	727,019	725,184
OPERATING INCOME	162,704	180,394
OTHER INCOME (DEDUCTIONS)		
Income taxes	2,980	1,568
Allowance for equity funds used during construction	9,345	7,499
Other income (Note S-1)	710	3,221
Other expense (Note S-1)	(2,449)	(1,477)
Total	10,586	10,811
INTEREST EXPENSE		
Interest on long-term debt	44,826	48,462
Interest on short-term borrowings	1,705	1,637
Debt discount, premium and expense	1,103	1,054
Allowance for borrowed funds used during construction	(4,311)	(3,790)
Total	43,323	47,363
NET INCOME	129,967	143,842
Less: Net income attributable to noncontrolling interests (Note 6)	4,605	8,926
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER	\$125,362	\$134,916

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

ARIZONA PUBLIC SERVICE COMPANY  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (unaudited)  
 (dollars in thousands)

	Three Months Ended June 30,	
	2015	2014
NET INCOME	\$129,967	\$143,842
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Derivative instruments:		
Net unrealized gain, net of tax expense of \$16 and \$26	25	40
Reclassification of net realized loss, net of tax benefit of \$556 and \$1,261	874	1,954
Pension and other postretirement benefits activity, net of tax benefit of \$47 and \$828	(74)	(1,283)
Total other comprehensive income	825	711
COMPREHENSIVE INCOME	130,792	144,553
Less: Comprehensive income attributable to noncontrolling interests	4,605	8,926
COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER	\$126,187	\$135,627

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

ARIZONA PUBLIC SERVICE COMPANY  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(unaudited)  
(dollars in thousands)

	Six Months Ended June 30,	
	2015	2014
ELECTRIC OPERATING REVENUES	\$1,560,391	\$1,591,123
OPERATING EXPENSES		
Fuel and purchased power	504,714	540,640
Operations and maintenance	417,978	416,344
Depreciation and amortization	243,642	206,875
Income taxes	83,911	87,849
Taxes other than income taxes	86,109	89,386
Total	1,336,354	1,341,094
OPERATING INCOME	224,037	250,029
OTHER INCOME (DEDUCTIONS)		
Income taxes	5,131	2,778
Allowance for equity funds used during construction	18,569	14,941
Other income (Note S-1)	1,349	5,983
Other expense (Note S-1)	(7,803)	(6,533)
Total	17,246	17,169
INTEREST EXPENSE		
Interest on long-term debt	90,254	97,358
Interest on short-term borrowings	2,879	3,050
Debt discount, premium and expense	2,237	2,065
Allowance for borrowed funds used during construction	(8,527)	(7,560)
Total	86,843	94,913
NET INCOME	154,440	172,285
Less: Net income attributable to noncontrolling interests (Note 6)	9,210	17,851
NET INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER	\$145,230	\$154,434

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



ARIZONA PUBLIC SERVICE COMPANY  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 (unaudited)  
 (dollars in thousands)

	Six Months Ended June 30,	
	2015	2014
NET INCOME	\$154,440	\$172,285
OTHER COMPREHENSIVE INCOME, NET OF TAX		
Derivative instruments:		
Net unrealized loss, net of tax expense of \$489 and \$624	(775	) (381
Reclassification of net realized loss, net of tax benefit of \$923 and \$2,584	2,850	5,070
Pension and other postretirement benefits activity, net of tax benefit (expense) of \$(722) and \$222	607	(717
Total other comprehensive income	2,682	3,972
COMPREHENSIVE INCOME	157,122	176,257
Less: Comprehensive income attributable to noncontrolling interests	9,210	17,851
COMPREHENSIVE INCOME ATTRIBUTABLE TO COMMON SHAREHOLDER	\$147,912	\$158,406

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

ARIZONA PUBLIC SERVICE COMPANY  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(unaudited)  
(dollars in thousands)

	June 30, 2015	December 31, 2014
<b>ASSETS</b>		
<b>PROPERTY, PLANT AND EQUIPMENT</b>		
Plant in service and held for future use	\$15,923,342	\$15,539,811
Accumulated depreciation and amortization	(5,494,236 )	(5,394,650 )
Net	10,429,106	10,145,161
Construction work in progress	636,927	682,807
Palo Verde sale leaseback, net of accumulated depreciation (Note 6)	119,320	121,255
Intangible assets, net of accumulated amortization	127,587	119,600
Nuclear fuel, net of accumulated amortization	156,608	125,201
Total property, plant and equipment	11,469,548	11,194,024
<b>INVESTMENTS AND OTHER ASSETS</b>		
Nuclear decommissioning trust (Note 12)	723,582	713,866
Assets from risk management activities (Note 7)	18,513	17,620
Other assets	33,976	33,362
Total investments and other assets	776,071	764,848
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	7,973	4,515
Customer and other receivables	281,609	297,712
Accrued unbilled revenues	185,216	100,533
Allowance for doubtful accounts	(2,518 )	(3,094 )
Materials and supplies (at average cost)	231,101	218,889
Fossil fuel (at average cost)	43,196	37,097
Assets from risk management activities (Note 7)	14,722	13,785
Deferred fuel and purchased power regulatory asset (Note 3)	—	6,926
Other regulatory assets (Note 3)	134,578	129,808
Deferred income taxes	54,789	55,253
Other current assets	44,168	38,693
Total current assets	994,834	900,117
<b>DEFERRED DEBITS</b>		
Regulatory assets (Note 3)	1,081,113	1,054,087
Assets for other postretirement benefits (Note 4)	165,682	149,260
Unamortized debt issue costs	27,843	24,642
Other	125,694	128,026
Total deferred debits	1,400,332	1,356,015
<b>TOTAL ASSETS</b>	<b>\$14,640,785</b>	<b>\$14,215,004</b>

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

ARIZONA PUBLIC SERVICE COMPANY  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(unaudited)  
(dollars in thousands)

	June 30, 2015	December 31, 2014
<b>LIABILITIES AND EQUITY</b>		
<b>CAPITALIZATION</b>		
Common stock	\$ 178,162	\$ 178,162
Additional paid-in capital	2,379,696	2,379,696
Retained earnings	1,982,150	1,968,718
Accumulated other comprehensive loss:		
Pension and other postretirement benefits	(37,341)	(37,948)
Derivative instruments	(8,310)	(10,385)
Total shareholder equity	4,494,357	4,478,243
Noncontrolling interests (Note 6)	132,807	151,609
Total equity	4,627,164	4,629,852
Long-term debt less current maturities (Note 2)	3,440,857	2,906,215
Total capitalization	8,068,021	7,536,067
<b>CURRENT LIABILITIES</b>		
Short-term borrowings (Note 2)	157,500	147,400
Current maturities of long-term debt (Note 2)	102,723	383,570
Accounts payable	321,860	289,930
Accrued taxes (Note 5)	199,492	131,110
Accrued interest	54,314	52,358
Common dividends payable	65,900	65,800
Customer deposits	72,785	72,307
Liabilities from risk management activities (Note 7)	60,673	59,676
Liabilities for asset retirements (Note 15)	28,543	32,462
Deferred fuel and purchased power regulatory liability (Note 3)	16,209	—
Other regulatory liabilities (Note 3)	136,273	130,549
Other current liabilities	132,800	167,302
Total current liabilities	1,349,072	1,532,464
<b>DEFERRED CREDITS AND OTHER</b>		
Deferred income taxes	2,601,294	2,571,365
Regulatory liabilities (Note 3)	1,016,991	1,051,196
Liabilities for asset retirements (Note 15)	419,072	358,288
Liabilities for pension benefits (Note 4)	397,160	424,508
Liabilities from risk management activities (Note 7)	87,689	50,602
Customer advances	120,063	123,052
Coal mine reclamation	200,155	198,292
Deferred investment tax credit	176,389	178,607
Unrecognized tax benefits (Note 5)	45,305	45,740
Other	159,574	144,823
Total deferred credits and other	5,223,692	5,146,473
<b>COMMITMENTS AND CONTINGENCIES (SEE NOTES)</b>		
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>\$ 14,640,785</b>	<b>\$ 14,215,004</b>

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

53

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ARIZONA PUBLIC SERVICE COMPANY  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)  
(dollars in thousands)

	Six Months Ended	
	June 30,	
	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$154,440	\$172,285
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization including nuclear fuel	282,172	246,324
Deferred fuel and purchased power	11,711	1,315
Deferred fuel and purchased power amortization	11,424	18,399
Allowance for equity funds used during construction	(18,569)	(14,941)
Deferred income taxes	24,442	34,133
Deferred investment tax credit	(2,218)	28,875
Change in derivative instruments fair value	(225)	49
Changes in current assets and liabilities:		
Customer and other receivables	(9,250)	(65,603)
Accrued unbilled revenues	(84,683)	(75,648)
Materials, supplies and fossil fuel	(18,311)	(9,435)
Income tax receivable	—	135,179
Other current assets	(8,193)	(14,120)
Accounts payable	37,656	28,465
Accrued taxes	68,382	38,381
Other current liabilities	(31,408)	31,296
Change in margin and collateral accounts — assets	(4,552)	(2,107)
Change in margin and collateral accounts — liabilities	26,853	(22,425)
Change in other long-term assets	(6,765)	(18,703)
Change in other long-term liabilities	(27,136)	(24,467)
Net cash flow provided by operating activities	405,770	487,252
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capital expenditures	(530,850)	(388,752)
Contributions in aid of construction	41,010	12,646
Allowance for borrowed funds used during construction	(8,527)	(7,560)
Proceeds from nuclear decommissioning trust sales	225,779	199,224
Investment in nuclear decommissioning trust	(234,651)	(207,848)
Other	(614)	(678)
Net cash flow used for investing activities	(507,853)	(392,968)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of long-term debt	600,000	535,975
Short-term borrowings — net	10,100	19,650
Repayment of long-term debt	(344,847)	(503,583)
Dividends paid on common stock	(131,700)	(125,100)
Noncontrolling interests	(28,012)	(15,869)
Net cash flow provided by (used for) financing activities	105,541	(88,927)
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>3,458</b>	<b>5,357</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>4,515</b>	<b>3,725</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$7,973</b>	<b>\$9,082</b>

Supplemental disclosure of cash flow information

Cash paid (received) during the period for:

Income taxes, net of refunds	\$184	\$(134,399 )
Interest, net of amounts capitalized	\$82,651	\$88,461
Significant non-cash investing and financing activities:		
Accrued capital expenditures	\$38,985	\$19,668
Dividends declared but not yet paid	\$65,900	\$62,600

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

ARIZONA PUBLIC SERVICE COMPANY  
 CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY  
 (unaudited)  
 (dollars in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total
	Shares	Amount					
Balance, January 1, 2014	71,264,947	\$178,162	\$2,379,696	\$1,804,398	\$(53,372)	\$145,990	\$4,454,874
Net income				154,434		17,851	172,285
Other comprehensive income					3,972		3,972
Dividends on common stock				(125,200)			(125,200)
Other				3			3
Net capital activities by noncontrolling interests						(15,869)	(15,869)
Balance, June 30, 2014	71,264,947	\$178,162	\$2,379,696	\$1,833,635	\$(49,400)	\$147,972	\$4,490,065
Balance, January 1, 2015	71,264,947	\$178,162	\$2,379,696	\$1,968,718	\$(48,333)	\$151,609	\$4,629,852
Net income				145,230		9,210	154,440
Other comprehensive income					2,682		2,682
Dividends on common stock				(131,800)			(131,800)
Other				2			2
Net capital activities by noncontrolling interests						(28,012)	(28,012)
Balance, June 30, 2015	71,264,947	\$178,162	\$2,379,696	\$1,982,150	\$(45,651)	\$132,807	\$4,627,164

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



Certain notes to APS's Condensed Consolidated Financial Statements are combined with the Notes to Pinnacle West's Condensed Consolidated Financial Statements. Listed below are the Condensed Consolidated Notes to Pinnacle West's Condensed Consolidated Financial Statements, the majority of which also relate to APS's Condensed Consolidated Financial Statements. In addition, listed below are the Supplemental Notes that are required disclosures for APS and should be read in conjunction with Pinnacle West's Condensed Consolidated Notes.

	Condensed Consolidated Note Reference	APS's Supplemental Note Reference
Consolidation and Nature of Operations	Note 1	—
Long-Term Debt and Liquidity Matters	Note 2	—
Regulatory Matters	Note 3	—
Retirement Plans and Other Benefits	Note 4	—
Income Taxes	Note 5	—
Palo Verde Sale Leaseback Variable Interest Entities	Note 6	—
Derivative Accounting	Note 7	—
Commitments and Contingencies	Note 8	—
Other Income and Other Expense	Note 9	Note S-1
Earnings Per Share	Note 10	—
Fair Value Measurements	Note 11	—
Nuclear Decommissioning Trusts	Note 12	—
New Accounting Standards	Note 13	—
Changes in Accumulated Other Comprehensive Loss	Note 14	Note S-2
Asset Retirement Obligations	Note 15	—

ARIZONA PUBLIC SERVICE COMPANY  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

S-1. Other Income and Other Expense

The following table provides detail of APS's other income and other expense for the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2015	2014	June 30, 2015	2014
Other income:				
Interest income	\$6	\$417	\$73	\$554
Gain on disposition of property	478	328	685	645
Miscellaneous	226	2,476	591	4,784
Total other income	\$710	\$3,221	\$1,349	\$5,983
Other expense:				
Non-operating costs (a)	\$(1,878)	\$(2,868)	\$(4,395)	\$(5,455)
Loss on disposition of property	(251)	(285)	(894)	(468)
Miscellaneous	(320)	1,676	(2,514)	(610)
Total other expense	\$(2,449)	\$(1,477)	\$(7,803)	\$(6,533)

(a) As defined by FERC, includes below-the-line non-operating utility expense (items excluded from utility rate recovery).

ARIZONA PUBLIC SERVICE COMPANY  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## S-2. Changes in Accumulated Other Comprehensive Loss

The following tables show the changes in accumulated other comprehensive loss, including reclassification adjustments, net of tax, by component for the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

	Three Months Ended June 30, 2015			Three Months Ended June 30, 2014		
	Derivative Instruments	Pension and Other Postretirement Benefits	Total	Derivative Instruments	Pension and Other Postretirement Benefits	Total
Beginning balance, April 1	\$(9,209 )	\$(37,267 )	\$(46,476 )	\$(20,364 )	\$(29,747 )	\$(50,111 )
OCI (loss) before reclassifications	25	(927 )	(902 )	40	(2,041 )	(2,001 )
Amounts reclassified from accumulated other comprehensive loss	874	(a) 853	(b) 1,727	1,954	(a) 758	(b) 2,712
Net current period OCI (loss)	899	(74 )	825	1,994	(1,283 )	711
Ending balance, June 30	\$(8,310 )	\$(37,341 )	\$(45,651 )	\$(18,370 )	\$(31,030 )	\$(49,400 )

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

(b) These amounts primarily represent amortization of actuarial loss and are included in the computation of net periodic pension cost. See Note 4.

	Six Months Ended June 30, 2015			Six Months Ended June 30, 2014		
	Derivative Instruments	Pension and Other Postretirement Benefits	Total	Derivative Instruments	Pension and Other Postretirement Benefits	Total
Beginning balance, January 1	\$(10,385 )	\$(37,948 )	\$(48,333 )	\$(23,059 )	\$(30,313 )	\$(53,372 )
OCI (loss) before reclassifications	(775 )	(927 )	(1,702 )	(381 )	(2,041 )	(2,422 )
Amounts reclassified from accumulated other comprehensive loss	2,850	(a) 1,534	(b) 4,384	5,070	(a) 1,324	(b) 6,394
Net current period OCI (loss)	2,075	607	2,682	4,689	(717 )	3,972

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Ending balance,    \$(8,310    )    \$(37,341    )    \$(45,651    )    \$(18,370    )    \$(31,030    )    \$(49,400    )  
June 30

- (a) These amounts represent realized gains and losses and are included in the computation of fuel and purchased power costs and are subject to the PSA. See Note 7.
- (b) These amounts primarily represent amortization of actuarial loss and are included in the computation of net periodic pension cost. See Note 4.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### INTRODUCTION

The following discussion should be read in conjunction with Pinnacle West's Condensed Consolidated Financial Statements and APS's Condensed Consolidated Financial Statements and the related Notes that appear in Item 1 of this report. For information on factors that may cause our actual future results to differ from those we currently seek or anticipate, see "Forward-Looking Statements" at the front of this report and "Risk Factors" in Part 1, Item 1A of the 2014 Form 10-K.

### OVERVIEW

Pinnacle West owns all of the outstanding common stock of APS. APS is a vertically-integrated electric utility that provides either retail or wholesale electric service to most of the state of Arizona, with the major exceptions of about one-half of the Phoenix metropolitan area, the Tucson metropolitan area and Mohave County in northwestern Arizona. APS currently accounts for essentially all of our revenues and earnings.

#### Areas of Business Focus

##### Operational Performance, Reliability and Recent Developments.

**Nuclear.** APS operates and is a joint owner of Palo Verde. The March 2011 earthquake and tsunamis in Japan and the resulting accident at Japan's Fukushima Daiichi nuclear power station had a significant impact on nuclear power operators worldwide. In the aftermath of the accident, the NRC conducted an independent assessment to consider actions to address lessons learned from the Fukushima events. The independent assessment, named the "Near Term Task Force," recommended a number of proposed enhancements to U.S. commercial nuclear power plant equipment and emergency plans. The NRC has directed nuclear power plants to begin implementing some of the Near Term Task Force's recommendations. To implement these recommendations, Palo Verde expects to spend approximately \$19 million for capital enhancements to the plant through 2016 in addition to the approximate \$112 million that has already been spent on capital enhancements as of June 30, 2015 (APS's share is 29.1%).

**Coal and Related Environmental Matters and Transactions.** APS is a joint owner of three coal-fired power plants and acts as operating agent for two of the plants. APS is focused on the impacts on its coal fleet that may result from increased regulation and potential legislation concerning GHG emissions. On June 2, 2014, EPA proposed a rule to limit carbon dioxide emissions from existing power plants (the "Clean Power Plan"). EPA expects to finalize the proposal in summer 2015. EPA's nationwide CO<sub>2</sub> emissions reduction goal is 30% below 2005 emission levels. In the Clean Power Plan, EPA proposed the second most stringent goal in the country for the state of Arizona, a 52% reduction. EPA's proposal for Arizona could force a shift in in-state generation from coal to natural gas and renewable generation. Until EPA issues its final rule and the state of Arizona develops its implementation plan, we are unable to determine the actual impacts to APS. We expect that our plans described below to close Cholla Unit 2 in 2016, and to cease burning coal at the other APS-owned units at Cholla (Units 1 and 3) by the mid-2020s, will help to facilitate compliance with the Clean Power Plan. APS continually analyzes its long-range capital management plans to assess the potential effects of these changes, understanding that any resulting regulation and legislation could impact the economic viability of certain plants, as well as the willingness or ability of power plant participants to continue participation in such plants.



## Cholla

On September 11, 2014, APS announced that it will close its 260 megawatt Unit 2 at Cholla by April 2016 and cease burning coal at Units 1 and 3 by the mid-2020s if EPA approves a compromise proposal offered by APS to meet required environmental and emissions standards and rules. On April 14, 2015, the ACC approved APS's plan to retire Unit 2, without expressing any view on the future recoverability of APS's remaining investment in the Unit. (See Note 3 for details related to the resulting regulatory asset and Note 8 for details of the proposal.) APS believes that the environmental benefits of this proposal are greater in the long term than the benefits that would have resulted from adding the emissions control equipment.

## Four Corners

**Asset Purchase Agreement and Coal Supply Matters.** On December 30, 2013, APS purchased SCE's 48% interest in each of Units 4 and 5 of Four Corners. The final purchase price for the interest was approximately \$182 million. In connection with APS's most recent retail rate case with the ACC, the ACC reserved the right to review the prudence of the Four Corners transaction for cost recovery purposes upon the closing of the transaction. On December 23, 2014, the ACC approved rate adjustments related to APS's acquisition of SCE's interest in Four Corners resulting in a revenue increase of \$57.1 million on an annual basis. On February 23, 2015, the ACC decision approving the rate adjustments was appealed. APS intends to intervene and actively participate in the proceeding. We cannot predict when or how this appeal will be resolved.

Concurrently with the closing of the SCE transaction, BHP Billiton New Mexico Coal, Inc. ("BHP Billiton"), the parent company of BHP Navajo Coal Company ("BNCC"), the coal supplier and operator of the mine that serves Four Corners, transferred its ownership of BNCC to Navajo Transitional Energy Company, LLC ("NTEC"), a company formed by the Navajo Nation to own the mine and develop other energy projects. BHP Billiton will be retained by NTEC under contract as the mine manager and operator until July 2016. Also occurring concurrently with the closing, the Four Corners' co-owners executed a long-term agreement for the supply of coal to Four Corners from July 2016, when the current coal supply agreement expires, through 2031 (the "2016 Coal Supply Agreement"). El Paso, a 7% owner in Units 4 and 5 of Four Corners, did not sign the 2016 Coal Supply Agreement. Under the 2016 Coal Supply Agreement, APS has agreed to assume the 7% shortfall obligation. On February 17, 2015, APS and El Paso entered into an asset purchase agreement providing for the purchase by APS, or an affiliate of APS, of El Paso's 7% interest in each of Units 4 and 5 of Four Corners. The cash purchase price, which will be subject to certain adjustments at closing, is immaterial in amount, and the purchaser will assume El Paso's reclamation and decommissioning obligations associated with the 7% interest. Completion of the purchase is subject to the receipt of certain regulatory approvals and is expected to occur in July 2016.

When APS, or an affiliate of APS, ultimately acquires El Paso's interest in Four Corners, NTEC will have an option to purchase the interest within a certain timeframe pursuant to an option granted by APS to NTEC. The 2016 Coal Supply Agreement contains alternate pricing terms for the 7% shortfall obligations in the event NTEC does not exercise its option.

**Pollution Control Investments and Shutdown of Units 1, 2 and 3.** EPA, in its final regional haze rule for Four Corners, required the Four Corners' owners to elect one of two emissions alternatives to apply to the plant. On December 30, 2013, APS, on behalf of the co-owners, notified EPA that they chose the alternative BART compliance strategy requiring the permanent closure of Units 1, 2 and 3 by January 1, 2014 and installation and operation of SCR controls on Units 4 and 5 by July 31, 2018. On December 30, 2013, APS retired Units 1, 2 and 3.

**Lease Extension.** APS, on behalf of the Four Corners participants, negotiated amendments to an existing facility lease with the Navajo Nation, which extends the Four Corners leasehold interest from 2016 to 2041. The Navajo Nation approved these amendments in March 2011. The effectiveness of the amendments also requires the approval of the United States Department of the Interior ("DOI"), as does a related federal rights-of-way grant that the Four Corners participants are pursuing. A federal environmental review was undertaken as part of the DOI review process, and culminated in the issuance by DOI of a record of decision on July 17, 2015. The record of decision provides the authority for the Bureau of Indian Affairs to sign the lease amendments and rights-of-way renewals, which we anticipate will occur in the near future.

**Natural Gas.** APS has six natural gas power plants located throughout Arizona, including Ocotillo. Ocotillo is a 330 MW 4-unit gas plant located in Tempe, Arizona. In early 2014, APS announced a project to modernize the plant, which involves retiring two older 110 MW steam units, adding five 102 MW combustion turbines and maintaining two existing 55 MW combustion turbines. In total, this increases the capacity of the site by 290 MW, to 620 MW. During the ACC's Integrated Resource Planning meeting in the fall of 2014, there was clear understanding of the need to replace the existing steam units, but questions were raised on the cost effectiveness of the additional three units. To address these matters, APS issued a request for proposal ("RFP") in late January 2015 for the incremental capacity, equivalent to 3 of the 5 units. Bids were due in March and have been analyzed by APS. An independent monitor was involved throughout the entire RFP process. The RFP affirmed that APS's bid at the existing Ocotillo site was the most cost effective while it also demonstrated that a target completion date of 2019 was most appropriate (instead of 2018 as originally planned).

**Transmission and Delivery.** APS is working closely with regulators to identify and plan for transmission needs that continue to support system reliability, access to markets and renewable energy development. The capital expenditures table presented in the "Liquidity and Capital Resources" section below includes new APS transmission projects through 2017, along with other transmission costs for upgrades and replacements. APS is also working to establish and expand smart grid technologies throughout its service territory to provide long-term benefits both to APS and its customers. APS is strategically deploying a variety of technologies that are intended to allow customers to better monitor their energy use and needs, minimize system outage durations, as well as the number of customers that experience outages, and facilitate greater cost savings to APS through improved reliability and the automation of certain distribution functions, including remote meter reading and remote connects and disconnects.

**Renewable Energy.** The ACC approved the RES in 2006. The renewable energy requirement is 5% of retail electric sales in 2015 and increases annually until it reaches 15% in 2025. In the 2009 Settlement Agreement, APS agreed to exceed the RES standards, committing to use APS's best efforts to obtain 1,700 gigawatt-hour ("GWh") of new renewable resources to be in service by year-end 2015, in addition to its 2008 renewable resource commitments. Taken together, APS's commitment to renewable energy is currently estimated to be approximately 12% of APS's estimated retail energy sales by year-end 2015, which is more than double the existing RES target of 5% for that year. APS believes that it will meet this commitment. A component of the RES targets development of distributed energy systems (generally speaking, small-scale renewable technologies that are located on customers' properties).

On July 12, 2013, APS filed its annual RES implementation plan, covering the 2014-2018 timeframe and requesting a 2014 RES budget of approximately \$143 million. In a final order dated January 7, 2014, the ACC approved the requested budget. Also in 2013, the ACC conducted a hearing 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. On February 6, 2014, the ACC established a proceeding to modify the renewable energy rules to establish a process for compliance with the renewable energy requirement that is not based solely on the use of renewable energy credits. On September 9, 2014, the ACC authorized a rulemaking process to modify the RES rules. The proposed changes would permit the ACC





to find that utilities have complied with the distributed energy requirement in light of all available information. The ACC adopted these changes on December 18, 2014. The revised rules went into effect on April 21, 2015.

On July 1, 2014, APS filed its 2015 RES implementation plan and proposed a RES budget of approximately \$154 million. On December 31, 2014, the ACC issued a decision approving the 2015 RES implementation plan with minor modifications, including reducing the budget to approximately \$152 million.

On July 1, 2015, APS filed its 2016 RES implementation plan and proposed a RES budget of approximately \$148 million.

The following table summarizes renewable energy sources in APS's renewable portfolio that are in operation and under development as of July 30, 2015.

	Net Capacity in Operation (MW)	Net Capacity Planned / Under Development (MW)
Total APS Owned: Solar (a)	169	29
Purchased Power Agreements:		
Solar	310	—
Wind	289	—
Geothermal	10	—
Biomass	14	—
Biogas	6	—
Total Purchased Power Agreements	629	—
Total Distributed Energy: Solar (b)	425	27
Total Renewable Portfolio	1,223	56

(a) Included in the 169 MW number is 150 MW of solar resources procured through the AZ Sun Program.

(b) Includes rooftop solar facilities owned by third parties. Distributed generation is produced in DC and is converted to AC for reporting purposes.

APS is developing owned solar resources through the ACC-approved AZ Sun Program. Under this program to date, APS estimates its investment commitment will be approximately \$675 million. Agreements for the development and completion of future resources are subject to various conditions, including successful siting, permitting and interconnection of the project to the electric grid.

In accordance with the ACC's decision on the 2014 RES plan, on April 15, 2014, APS filed an application with the ACC requesting permission to build an additional 20 MW of APS-owned utility scale solar under the AZ Sun Program. In a subsequent filing, APS also offered an alternative proposal to replace the 20 MW of utility scale solar with 10 MW (approximately 1,500 customers) of APS-owned residential solar that will not be under the AZ Sun Program. On December 19, 2014, the ACC voted that it had no objection to APS implementing its residential rooftop solar program. The first stage of the residential rooftop solar program is to be 8 MW followed by a 2 MW second stage that will only be deployed if coupled with an appropriate amount of distributed storage. The program will target specific distribution feeders in an effort to maximize potential system benefits, as well as make systems available to limited-income customers who cannot easily install solar through transactions with third parties. The ACC expressly reserved that any determination of prudence of the residential rooftop solar program for rate making purposes shall not be made until the project is fully in service and APS requests cost recovery in a future rate case.

Demand Side Management. In December 2009, Arizona regulators placed an increased focus on energy efficiency and other demand side management programs to encourage customers to conserve energy, while incentivizing utilities to aid in these efforts that ultimately reduce the demand for energy. The ACC initiated an Energy Efficiency rulemaking, with a proposed Energy Efficiency Standard of 22% cumulative annual energy savings by 2020. The 22% figure represents the cumulative reduction in future energy usage through 2020 attributable to energy efficiency initiatives. This standard became effective on January 1, 2011.

On June 1, 2012, APS filed its 2013 DSM Plan. In 2013, the standards required 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.

On March 11, 2014, the ACC issued an order approving APS's 2013 DSM Plan. The ACC approved a budget of \$68.9 million for each of 2013 and 2014. The ACC also approved a Resource Savings Initiative that allows APS to count towards compliance with the ACC Electric Energy Efficiency Standards, savings for improvements to APS's transmission and delivery system, generation and facilities that have been approved through a DSM Plan.

On March 20, 2015, APS filed an application with the ACC requesting a budget of \$68.9 million for 2015 and minor modifications to its DSM portfolio going forward, including for the first time three resource savings projects which reflect energy savings on APS's system. Consistent with the ACC's March 11, 2014 order, APS intends to continue its other approved DSM programs in 2015.

On June 1, 2015, APS filed its 2016 DSM Plan requesting a budget of \$68.9 million and minor modifications to its DSM portfolio to increase energy savings and cost effectiveness of the programs. The DSM Plan also proposed a reduction in the DSMAC of approximately 12%.

Electric Energy Efficiency. On June 27, 2013, the ACC voted to open a new docket investigating whether the Electric Energy Efficiency Standards should be modified. The ACC held a series of three workshops in March and April 2014 to investigate methodologies used to determine cost effective energy efficiency programs, cost recovery mechanisms, incentives, and potential changes to the Electric Energy Efficiency and Resource Planning Rules.

On November 4, 2014, the ACC staff issued a request for informal comment on a draft of possible amendments to Arizona's Electric Utility Energy Efficiency Standards. The draft proposed substantial changes to the rules and energy efficiency standards. The ACC accepted written comments and took public comment regarding the possible amendments on December 19, 2014. A formal rule making has not been initiated and there has been no additional action on the draft to date.

Rate Matters. APS needs timely recovery through rates of its capital and operating expenditures to maintain its financial health. APS's retail rates are regulated by the ACC and its wholesale electric rates (primarily for transmission) are regulated by FERC. On June 1, 2011, APS filed a rate case with the ACC. APS and other parties to the retail rate case subsequently entered into the 2012 Settlement Agreement detailing the terms upon which the parties have agreed to settle the rate case. See Note 3 for details regarding the 2012 Settlement Agreement terms and for information on APS's FERC rates.

APS has several recovery mechanisms in place that provide more timely recovery to APS of its fuel and transmission costs, and costs associated with the promotion and implementation of its demand side management and renewable energy efforts and customer programs. These mechanisms are described more fully in Note 3.



As part of APS's acquisition of SCE's interest in Units 4 and 5 of Four Corners, APS and SCE agreed, via a "Transmission Termination Agreement" that, upon closing of the acquisition, the companies would terminate an existing transmission agreement ("Transmission Agreement") between the parties that provides transmission capacity on a system (the "Arizona Transmission System") for SCE to transmit its portion of the output from Four Corners to California. APS previously submitted a request to FERC related to this termination, which resulted in a FERC order denying rate recovery of \$40 million that APS agreed to pay SCE associated with the termination. APS and SCE negotiated an alternate arrangement under which SCE would assign its 1,555 MW capacity rights over the Arizona Transmission System to third parties, including 300 MW to APS's marketing and trading group. However, this alternative arrangement was not approved by FERC. Although APS and SCE continue to evaluate potential paths forward, it is possible that the terms of the Transmission Termination Agreement may again control. APS believes that the original denial by FERC of rate recovery under the Transmission Termination Agreement constitutes the failure of a condition that relieves APS of its obligations under that agreement. If APS and SCE are unable to determine a resolution through negotiation, the Transmission Termination Agreement requires that disputes be resolved through arbitration. APS is unable to predict the outcome of this matter if it proceeds to arbitration. If the matter proceeds to arbitration and APS is not successful, APS may be required to record a charge to its results of operations.

**Deregulation.** On May 9, 2013, the ACC voted to re-examine the facilitation of a deregulated retail electric market in Arizona. The ACC subsequently opened a docket for this matter and received comments from a number of interested parties on the considerations involved in establishing retail electric deregulation in the state. One of these considerations is whether various aspects of a deregulated market, including setting utility rates on a "market" basis, would be consistent with the requirements of the Arizona Constitution. On September 11, 2013, after receiving legal advice from the ACC staff, the ACC voted 4-1 to close the current docket and await full Arizona Constitutional authority before any further examination of this matter. The motion approved by the ACC also included opening one or more new dockets in the future to explore options to offer more rate choices to customers and innovative changes within the existing cost-of-service regulatory model that could include elements of competition. The ACC opened a new docket on November 4, 2013, to explore technological advances and innovative changes within the electric utility industry. A series of workshops in this docket were held in 2014 and early 2015. No further action has been taken by the ACC to date.

**Net Metering.** On July 12, 2013, APS filed an application with the ACC proposing a solution to address the cost shift brought by the current net metering rules. On December 3, 2013, the ACC issued its order on APS's net metering proposal. The ACC instituted a charge on customers who install rooftop solar panels after December 31, 2013. The charge of \$0.70 per kilowatt became effective on January 1, 2014, and is estimated to collect \$4.90 per month from a typical future rooftop solar customer to help pay for their use of the electricity grid. The fixed charge does not increase APS's revenue because it is credited to the LFCR.

In making its decision, the ACC determined that the current net metering program creates a cost shift, causing non-solar utility customers to pay higher rates to cover the costs of maintaining the electrical grid. The ACC acknowledged that the \$0.70 per kilowatt charge addresses only a portion of the cost shift. In its December 2013 order, the ACC directed APS to provide quarterly reports on the pace of rooftop solar adoption to assist the ACC in considering further increases.

On April 2, 2015, APS filed an application with the ACC seeking to increase the fixed grid access charge to \$3.00 per kilowatt, or approximately \$21 per month for a typical new residential solar customer, effective August 1. Customers who installed rooftop solar panels prior to January 1, 2014 would continue to be grandfathered and would not pay a grid access charge, and those who installed panels between January 1, 2014 and the effective date of the requested change would continue paying a charge of \$0.70 per kilowatt. Solar customers that take electric service under APS's demand-based ECT-2 residential rate, an existing rate that includes time-of-use rates with a demand charge, are not

subject to the grid access charge.

64

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APS cannot predict the outcome of this filing. The proposed grid access charge adjustment is designed to moderate the cost shift discussed above on an interim basis until the issue is further addressed in APS's next general rate case.

On September 29, 2014, the staff of the ACC filed in a new docket a proposal for permitting a utility to request ACC approval of its proposed rate design outside of and before a general rate case. On October 20, 2014, APS and other interested stakeholders filed comments to this proposal. No further action has been taken in this docket.

**Financial Strength and Flexibility.** Pinnacle West and APS currently have ample borrowing capacity under their respective credit facilities, and may readily access these facilities ensuring adequate liquidity for each company. Capital expenditures will be funded with internally generated cash and external financings, which may include issuances of long-term debt and Pinnacle West common stock.

#### Other Subsidiaries.

**Bright Canyon Energy.** On July 31, 2014, Pinnacle West announced its creation of a wholly-owned subsidiary, BCE. BCE will focus on new growth opportunities that leverage the Company's core expertise in the electric energy industry. BCE's first initiative is a 50/50 joint venture with BHE U.S. Transmission LLC, a subsidiary of Berkshire Hathaway Energy Company. The joint venture, named TransCanyon, is pursuing independent transmission opportunities within the eleven states that comprise the Western Electricity Coordinating Council, excluding opportunities related to transmission service that would otherwise be provided under the tariffs of the retail service territories of the venture partners' utility affiliates. The joint venture, in collaboration with SCE, submitted a bid into California Independent System Operator's ("CAISO") competitive solicitation process to design, build, own and operate a new 500 kV transmission line between Arizona and California, the Delaney to Colorado River Transmission Line. The CAISO announced the winner of the bidding process in early July. The TransCanyon/SCE bid was not selected. TransCanyon continues to pursue other transmission development opportunities in the western United States consistent with its strategy.

**El Dorado.** The operations of El Dorado are not expected to have any material impact on our financial results, or to require any material amounts of capital, over the next three years.

#### Key Financial Drivers

In addition to the continuing impact of the matters described above, many factors influence our financial results and our future financial outlook, including those listed below. We closely monitor these factors to plan for the Company's current needs, and to adjust our expectations, financial budgets and forecasts appropriately.

**Electric Operating Revenues.** For the years 2012 through 2014, retail electric revenues comprised approximately 93% of our total electric operating revenues. Our electric operating revenues are affected by customer growth or decline, variations in weather from period to period, customer mix, average usage per customer and the impacts of energy efficiency programs, distributed energy additions, electricity rates and tariffs, the recovery of PSA deferrals and the operation of other recovery mechanisms. These revenue transactions are affected by the availability of excess generation or other energy resources and wholesale market conditions, including competition, demand and prices.

**Customer and Sales Growth.** Retail customers in APS's service territory increased 1.2% for the six-month period ended June 30, 2015 compared with the prior-year period. For the three years 2012 through 2014, APS's customer growth averaged 1.3% per year. We currently expect annual customer growth to





average in the range of 2.0-3.0% for 2015 through 2017 based on our assessment of modestly improving economic conditions in Arizona. Retail electricity sales in kWh, adjusted to exclude the effects of weather variations, decreased 0.2% for the six-month period ended June 30, 2015 compared with the prior-year period, reflecting the effects of customer conservation and energy efficiency and distributed renewable generation initiatives, partially offset by improving economic conditions and customer growth. For the three years 2012 through 2014, APS experienced annual decreases in retail electricity sales averaging 0.2%, adjusted to exclude the effects of weather variations. We currently estimate that annual retail electricity sales in kWh will increase on average in the range of 0.5-1.5% during 2015 through 2017, including the effects of customer conservation and energy efficiency and distributed renewable generation initiatives, but excluding the effects of weather variations. A slower recovery of the Arizona economy could further impact these estimates.

Actual sales growth, excluding weather-related variations, may differ from our projections as a result of numerous factors, such as economic conditions, customer growth, usage patterns and energy conservation, impacts of energy efficiency programs and growth in distributed generation, and responses to retail price changes. Based on past experience, a reasonable range of variation in our kWh sales projections attributable to such economic factors under normal business conditions can result in increases or decreases in annual net income of up to \$10 million.

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

**Fuel and Purchased Power Costs.** Fuel and purchased power costs included on our Condensed Consolidated Statements of Income are impacted by our electricity sales volumes, existing contracts for purchased power and generation fuel, our power plant performance, transmission availability or constraints, prevailing market prices, new generating plants being placed in service in our market areas, changes in our generation resource allocation, our hedging program for managing such costs and PSA deferrals and the related amortization.

**Operations and Maintenance Expenses.** Operations and maintenance expenses are impacted by customer and sales growth, power plant operations, maintenance of utility plant (including generation, transmission, and distribution facilities), inflation, outages, renewable energy and demand side management related expenses (which are offset by the same amount of operating revenues) and other factors. On September 30, 2014, Pinnacle West announced plan design changes to the group life and medical postretirement benefit plan, which reduced net periodic benefit costs. See Note 4.

**Depreciation and Amortization Expenses.** Depreciation and amortization expenses are impacted by net additions to utility plant and other property (such as new generation, transmission, and distribution facilities), and changes in depreciation and amortization rates. See "Capital Expenditures" below for information regarding the planned additions to our facilities. See Note 3 regarding deferral of certain costs pursuant to an ACC order.

**Property Taxes.** Taxes other than income taxes consist primarily of property taxes, which are affected by the value of property in-service and under construction, assessment ratios, and tax rates. The average property tax rate in Arizona for APS, which owns essentially all of our property, was 10.7% of the assessed value for 2014 and 10.5% for 2013. We expect property taxes to increase as we add new generating units and continue with improvements and expansions to our existing generating units, transmission and distribution facilities. (See Note 3 for property tax deferrals contained in the 2012 Settlement Agreement).



**Income Taxes.** Income taxes are affected by the amount of pretax book income, income tax rates, certain deductions and non-taxable items, such as AFUDC. In addition, income taxes may also be affected by the settlement of issues with taxing authorities.

**Interest Expense.** Interest expense is affected by the amount of debt outstanding and the interest rates on that debt (see Note 2). The primary factors affecting borrowing levels are expected to be our capital expenditures, long-term debt maturities, equity issuances and internally generated cash flow. An allowance for borrowed funds used during construction offsets a portion of interest expense while capital projects are under construction. We stop accruing AFUDC on a project when it is placed in commercial operation.

## RESULTS OF OPERATIONS

Pinnacle West's only reportable business segment is our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily retail and wholesale sales supplied to traditional cost-based rate regulation ("Native Load") customers) and related activities and includes electricity generation, transmission and distribution.

**Operating Results** — Three-month period ended June 30, 2015 compared with three-month period ended June 30, 2014.

Our consolidated net income attributable to common shareholders for the three months ended June 30, 2015 was \$123 million, compared with consolidated net income of \$132 million for the prior-year period. The results reflect a decrease of approximately \$10 million for the regulated electricity segment primarily due to higher depreciation and amortization, the effects of weather, and lower transmission revenues, partially offset by the Four Corners related rate change and lower interest charges.

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

	Three Months Ended June 30,		
	2015	2014	Net Change
	(dollars in millions)		
<b>Regulated Electricity Segment:</b>			
Operating revenues less fuel and purchased power expenses	\$608	\$615	\$(7)
Operations and maintenance	(211)	(211)	) —
Depreciation and amortization	(123)	(105)	) (18)
Taxes other than income taxes	(43)	(44)	) 1
All other income and expenses, net	9	10	(1)
Interest charges, net of allowance for borrowed funds used during construction	(44)	(48)	) 4
Income taxes	(68)	(75)	) 7
Less income related to noncontrolling interests (Note 6)	(5)	(9)	) 4
Regulated electricity segment net income	123	133	(10)
All other	—	(1)	) 1
Net Income Attributable to Common Shareholders	\$123	\$132	\$(9)

Operating revenues less fuel and purchased power expenses. Regulated electricity segment operating revenues less fuel and purchased power expenses were \$7 million lower for the three months ended June 30, 2015 compared with the prior-year period. The following table summarizes the major components of this change:

	Increase (Decrease)		
	Operating	Fuel and	Net change
	revenues	purchased	
		power	
		expenses	
	(dollars in millions)		
Effects of weather	\$(16	) \$(5	) \$(11
Lower transmission revenues	(8	) —	(8
Changes in long-term wholesale contracted sales	(11	) (7	) (4
Four Corners related rate change	15	—	15
Miscellaneous items, net	4	3	1
Total	\$(16	) \$(9	) \$(7

Operations and maintenance. Operations and maintenance expenses were comparable in total for the three months ended June 30, 2015 compared with the prior-year period and included the following:

- A decrease of \$18 million for lower employee benefit costs primarily related to lower costs for other postretirement benefits, group insurance claims, and stock compensation;

- An increase of \$10 million in fossil generation costs, primarily due to higher planned fossil plant maintenance costs as a result of more work being completed in the second quarter of 2015 compared with the second quarter of 2014; and

- An increase of \$8 million related to higher nuclear generation costs.

Depreciation and amortization. Depreciation and amortization expenses were \$18 million higher for the three months ended June 30, 2015 compared with the prior-year period primarily related to:

- An increase of \$6 million related to the 2015 amortization of the Four Corners cost deferrals and acquisition adjustment;

- An increase of \$5 million due to increased plant in service;

- An increase of \$5 million related to the regulatory treatment of the Palo Verde sale leaseback, which is offset in noncontrolling interests; and

- An increase of \$2 million due to other miscellaneous factors.

Interest charges, net of allowance for borrowed funds used during construction. Interest charges, net of allowance for borrowed funds used during construction, decreased \$4 million for the three months ended June 30, 2015 compared with the prior-year period, primarily because of lower interest rates in the current year.

Income Taxes. Income taxes were \$7 million lower for the three months ended June 30, 2015 compared with the prior-year period, primarily because of lower taxable income in the current year.

Operating Results — Six-month period ended June 30, 2015 compared with six-month period ended June 30, 2014.

Our consolidated net income attributable to common shareholders for the six months ended June 30, 2015 was \$139 million, compared with consolidated net income of \$148 million for the prior-year period. The results reflect a decrease of approximately \$9 million for the regulated electricity segment primarily due to higher depreciation and amortization, partially offset by the Four Corners related rate change and lower interest charges.

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

	Six Months Ended		Net Change
	2015	2014	
	June 30,		
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$1,056	\$1,051	\$5
Operations and maintenance	(426	) (424	) (2
Depreciation and amortization	(244	) (207	) (37
Taxes other than income taxes	(86	) (90	) 4
All other income and expenses, net	13	15	(2
Interest charges, net of allowance for borrowed funds used during construction	(88	) (97	) 9
Income taxes	(76	) (81	) 5
Less income related to noncontrolling interests (Note 6)	(9	) (18	) 9
Regulated electricity segment net income	140	149	(9
All other	(1	) (1	) —
Net Income Attributable to Common Shareholders	\$139	\$148	\$(9

Operating revenues less fuel and purchased power expenses. Regulated electricity segment operating revenues less fuel and purchased power expenses were \$5 million higher for the six months ended June 30, 2015 compared with the prior-year period. The following table summarizes the major components of this change:

	Increase (Decrease)		
	Operating	Fuel and	Net change
	revenues	purchased	
		power	
		expenses	
	(dollars in millions)		
Four Corners related rate change	\$26	\$—	\$26
Changes in long-term wholesale contracted sales	(19	) (12	) (7
Lower transmission revenues	(5	) —	(5
Effects of weather	(5	) (1	) (4
Lower retail sales due to changes in customer usage patterns and related pricing, partially offset by customer growth	(5	) (1	) (4
Changes in net fuel and purchased power costs, including off-system sales margins and related deferrals	(24	) (22	) (2
Miscellaneous items, net	1	—	1
Total	\$(31	) \$(36	) \$5

Operations and maintenance. Operations and maintenance expenses increased \$2 million for the six months ended June 30, 2015 compared with the prior-year period primarily because of:

- An increase of \$16 million in fossil generation costs, primarily due to higher planned fossil plant maintenance costs as a result of more work being completed in the first half of 2015 compared with the first half of 2014;

- An increase of \$9 million related to higher nuclear generation costs;

- A decrease of \$22 million for lower employee benefit costs primarily related to lower costs for other postretirement benefits and stock compensation; and

- A decrease of \$1 million related to other miscellaneous factors.

Depreciation and amortization. Depreciation and amortization expenses were \$37 million higher for the six months ended June 30, 2015 compared with the prior-year period primarily related to:

- An increase of \$11 million related to the 2015 amortization of the Four Corners cost deferrals and acquisition adjustment;

- An increase of \$9 million related to the absence of 2014 Four Corners cost deferrals;

- An increase of \$9 million due to increased plant in service;

- An increase of \$10 million related to the regulatory treatment of the Palo Verde sale leaseback, which is offset in noncontrolling interests; and

- A decrease of \$2 million due to other miscellaneous factors.



Interest charges, net of allowance for borrowed funds used during construction. Interest charges, net of allowance for borrowed funds used during construction, decreased \$9 million for the six months ended June 30, 2015 compared with the prior-year period, primarily because of lower interest rates in the current year.

## LIQUIDITY AND CAPITAL RESOURCES

### Overview

Pinnacle West's primary cash needs are for dividends to our shareholders and principal and interest payments on our indebtedness. The level of our common stock dividends and future dividend growth will be dependent on declaration by our Board of Directors and based on a number of factors, including our financial condition, payout ratio, free cash flow and other factors.

Our primary sources of cash are dividends from APS and external debt and equity issuances. An ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the related ACC order, the common equity ratio is defined as total shareholder equity divided by the sum of total shareholder equity and long-term debt, including current maturities of long-term debt. At June 30, 2015, APS's common equity ratio, as defined, was 55%. Its total shareholder equity was approximately \$4.5 billion, and total capitalization was approximately \$8.2 billion. Under this order, APS would be prohibited from paying dividends if such payment would reduce its total shareholder equity below approximately \$3.3 billion, assuming APS's total capitalization remains the same. This restriction does not materially affect Pinnacle West's ability to meet its ongoing cash needs or ability to pay dividends to shareholders.

APS's capital requirements consist primarily of capital expenditures and maturities of long-term debt. APS funds its capital requirements with cash from operations and, to the extent necessary, external debt financing and equity infusions from Pinnacle West.

### Summary of Cash Flows

The following tables present net cash provided by (used for) operating, investing and financing activities for the six months ended June 30, 2015 and 2014 (dollars in millions):

#### Pinnacle West Consolidated

	Six Months Ended		Net Change
	June 30,		
	2015	2014	
Net cash flow provided by operating activities	\$394	\$465	\$(71)
Net cash flow used for investing activities	(509)	(393)	(116)
Net cash flow provided by (used for) financing activities	121	(72)	193
Net increase in cash and cash equivalents	\$6	\$—	\$6



## Arizona Public Service Company

	Six Months Ended		Net
	June 30,		
	2015	2014	Change
Net cash flow provided by operating activities	\$406	\$487	\$(81 )
Net cash flow used for investing activities	(508 )	(393 )	(115 )
Net cash flow provided by (used for) financing activities	106	(89 )	) 195
Net increase in cash and cash equivalents	\$4	\$5	\$(1 )

## Operating Cash Flows

Six-month period ended June 30, 2015 compared with six-month period ended June 30, 2014. Pinnacle West's consolidated net cash provided by operating activities was \$394 million in 2015 compared to \$465 million in 2014, a decrease of \$71 million in net cash provided. The decrease is primarily related to a \$135 million income tax refund received in the first quarter of 2014. The decrease is partially offset by a \$47 million change in cash collateral posted, and other changes in working capital.

Other. Pinnacle West sponsors a qualified defined benefit pension plan and a non-qualified supplemental excess benefit retirement plan for the employees of Pinnacle West and our subsidiaries. The requirements of the Employee Retirement Income Security Act of 1974 ("ERISA") require us to contribute a minimum amount to the qualified plan. We contribute at least the minimum amount required under ERISA regulations, but no more than the maximum tax-deductible amount. The minimum required funding takes into consideration the value of plan assets and our pension benefit obligations. Under ERISA, the qualified pension plan was 118% funded as of January 1, 2014 and 116% funded as of January 1, 2015. Under GAAP, the qualified pension plan was 90% funded as of January 1, 2014 and 89% funded as of January 1, 2015. The assets in the plan are comprised of fixed-income, equity, real estate, and short-term investments. Future year contribution amounts are dependent on plan asset performance and plan actuarial assumptions. We have made voluntary contributions of \$80 million to our pension plan year-to-date in 2015. The minimum required contributions for the pension plan are zero for the next three years. We expect to make voluntary contributions totaling up to \$300 million for the next three years (up to \$100 million each year in 2015, 2016, and 2017). We expect to make contributions of approximately \$1 million in each of the next three years to our other postretirement benefit plans.

## Investing Cash Flows

Six-month period ended June 30, 2015 compared with six-month period ended June 30, 2014. Pinnacle West's consolidated net cash used for investing activities was \$509 million in 2015, compared to \$393 million in 2014, an increase of \$116 million in net cash used primarily related to increased capital expenditures.

Capital Expenditures. The following table summarizes the estimated capital expenditures for the next three years:

Capital Expenditures  
(dollars in millions)

	Estimated for the Year Ended		
	December 31,		
	2015	2016	2017
APS			
Generation:			
Nuclear Fuel	\$78	\$87	\$79
Renewables	80	1	2
Environmental	43	178	180
New Gas Generation	62	81	264
Other Generation	176	184	204
Distribution	325	375	331
Transmission	192	113	146
Other (a)	100	92	79
Total APS	\$1,056	\$1,111	\$1,285

(a) Primarily information systems and facilities projects.

Generation capital expenditures are comprised of various improvements to APS's existing fossil and nuclear plants. Examples of the types of projects included in this category are additions, upgrades and capital replacements of various power plant equipment, such as turbines, boilers and environmental equipment. The estimated Renewables expenditures include 20 MW of utility-scale solar projects which were approved by the ACC in the 2014 RES Implementation Plan and the residential rooftop solar program. We have not included estimated costs for Cholla's compliance with MATS or EPA's regional haze rule since we have challenged the regional haze rule judicially and we have proposed a compromise strategy to EPA, which, if approved, would allow us to avoid expenditures related to environmental control equipment. The portion of estimated costs through 2017 for installation of pollution control equipment needed to ensure Four Corners' compliance with EPA's regional haze rules have been included in the table above. The portion of estimated costs through 2017 for incremental costs to comply with the CCR rule for Four Corners and Cholla have also been included in the table above. On February 17, 2015, APS and El Paso entered into an asset purchase agreement providing for the purchase by APS, or an affiliate of APS, of El Paso's 7% interest in each of Units 4 and 5 of Four Corners. The table above does not include capital expenditures related to El Paso's 7% interest in Four Corners Units 4 and 5 of \$3 million in 2015, \$21 million in 2016 and \$26 million in 2017. We are monitoring the status of other environmental matters, which, depending on their final outcome, could require modification to our planned environmental expenditures.

Distribution and transmission capital expenditures are comprised of infrastructure additions and upgrades, capital replacements, and new customer construction. Examples of the types of projects included in the forecast include power lines, substations, and line extensions to new residential and commercial developments.

Capital expenditures will be funded with internally generated cash and external financings, which may include issuances of long-term debt and Pinnacle West common stock.

## Financing Cash Flows and Liquidity

Six-month period ended June 30, 2015 compared with six-month period ended June 30, 2014. Pinnacle West's consolidated net cash provided by financing activities was \$121 million in 2015, compared to \$72 million of net cash used in 2014, an increase of \$193 million in net cash provided. The increase in net cash provided by financing activities is primarily due to \$159 million lower repayments of long-term debt and \$64 million higher issuances of long-term debt.

**Significant Financing Activities.** On June 17, 2015, the Pinnacle West Board of Directors declared a dividend of \$0.595 per share of common stock, payable on September 1, 2015 to shareholders of record on August 3, 2015.

On January 12, 2015, APS issued \$250 million of 2.20% unsecured senior notes that mature on January 15, 2020. The net proceeds from the sale were used to repay commercial paper borrowings and replenish cash used to fund capital expenditures.

On May 19, 2015, APS issued \$300 million of 3.15% unsecured senior notes that mature on May 15, 2025. The net proceeds from the sale were used to repay short-term indebtedness consisting of commercial paper borrowings and drawings under our revolving credit facilities, incurred in connection with the payment at maturity of our \$300 million aggregate principal amount of 4.65% Notes due May 15, 2015.

On May 28, 2015, APS purchased all \$32 million of Maricopa County, Arizona Pollution Control Corporation Pollution Control Revenue Refunding Bonds, 2009 Series B, due 2029 in connection with the mandatory tender provisions for this indebtedness.

On June 26, 2015, APS entered into a \$50 million term loan facility that matures June 26, 2018. Interest rates are based on APS's senior unsecured debt credit ratings. APS used the proceeds to repay and refinance existing short-term indebtedness.

**Available Credit Facilities.** 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's \$200 million revolving credit facility matures in May 2019. At June 30, 2015, the facility 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 size of the facility up to a maximum of \$300 million upon the satisfaction of certain conditions and with the consent of the lenders. At June 30, 2015, Pinnacle West had no outstanding borrowings under its credit facility, no letters of credit outstanding and no commercial paper borrowings.

At June 30, 2015, APS had two credit facilities totaling \$1 billion, including a \$500 million credit facility that matures in April 2018 and a \$500 million facility that matures in May 2019. APS may increase the size 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.

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 June 30, 2015, APS had \$158 million of commercial paper outstanding and no outstanding borrowings or letters of credit under these credit facilities.

See "Financial Assurances" in Note 8 for a discussion of APS's separate outstanding letters of credit.



Other Financing Matters. See Note 3 for information regarding the PSA approved by the ACC.

See Note 7 for information related to the change in our margin and collateral accounts.

#### Debt Provisions

Pinnacle West's and APS's debt covenants related to their respective bank financing arrangements include maximum debt to capitalization ratios. Pinnacle West and APS comply with this covenant. For both Pinnacle West and APS, this covenant requires that the ratio of consolidated debt to total consolidated capitalization not exceed 65%. At June 30, 2015, the ratio was approximately 48% for Pinnacle West and 46% for APS. Failure to comply with such covenant levels would result in an event of default which, generally speaking, would require the immediate repayment of the debt subject to the covenants and could "cross-default" other debt. See further discussion of "cross-default" provisions below.

Neither Pinnacle West's nor APS's financing agreements contain "rating triggers" that would result in an acceleration of the required interest and principal payments in the event of a rating downgrade. However, our bank credit agreements and term loan facilities contain a pricing grid in which the interest rates we pay for borrowings thereunder are determined by our current credit ratings.

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

See Note 2 for further discussions of liquidity matters.

## Credit Ratings

The ratings of securities of Pinnacle West and APS as of July 24, 2015 are shown below. We are disclosing these credit ratings to enhance understanding of our cost of short-term and long-term capital and our ability to access the markets for liquidity and long-term debt. The ratings reflect the respective views of the rating agencies, from which an explanation of the significance of their ratings may be obtained. There is no assurance that these ratings will continue for any given period of time. The ratings may be revised or withdrawn entirely by the rating agencies if, in their respective judgments, circumstances so warrant. Any downward revision or withdrawal may adversely affect the market price of Pinnacle West's or APS's securities and/or result in an increase in the cost of, or limit access to, capital. Such revisions may also result in substantial additional cash or other collateral requirements related to certain derivative instruments, insurance policies, natural gas transportation, fuel supply, and other energy-related contracts. At this time, we believe we have sufficient available liquidity resources to respond to a downward revision to our credit ratings.

	Moody's	Standard & Poor's	Fitch
Pinnacle West			
Corporate credit rating	A3	A-	A-
Commercial paper	P-2	A-2	F2
Outlook	Stable	Stable	Stable
APS			
Corporate credit rating	A2	A-	A-
Senior unsecured	A2	A-	A
Secured lease obligation bonds	A2	A-	A
Commercial paper	P-1	A-2	F2
Outlook	Stable	Stable	Stable

## Off-Balance Sheet Arrangements

See Note 6 for a discussion of the impacts on our financial statements of consolidating certain VIEs.

## Contractual Obligations

During the quarter our purchase obligations have increased by about \$170 million relating to gas generation projects. The expected payments to be made are \$26 million in 2015, \$89 million in 2016, \$46 million in 2017, and \$9 million in 2018.

Other than the item described above, there have been no material changes outside the normal course of business in contractual obligations from the information provided in our 2014 Form 10-K.

## CRITICAL ACCOUNTING POLICIES

In preparing the financial statements in accordance with GAAP, management must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex, and actual results could differ from those estimates. There have been no changes to our critical accounting policies since our 2014 Form 10-K. See "Critical Accounting Policies" in Item 7 of the 2014 Form 10-K for further details about our critical accounting policies.



## OTHER ACCOUNTING MATTERS

We are currently evaluating the impacts of adopting two new accounting standards: consolidation analysis guidance that will be adopted on January 1, 2016, and revenue recognition guidance that will be effective for us on January 1, 2018. Additionally, new guidance relating to balance sheet presentation of debt issuance costs will be effective for us during the first quarter of 2016. See Note 13.

## MARKET AND CREDIT RISKS

## Market Risks

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

## Interest Rate and Equity Risk

We have exposure to changing interest rates. Changing interest rates will affect interest paid on variable-rate debt and the market value of fixed income securities held by our nuclear decommissioning trust fund (see Note 11 and Note 12) and benefit plan assets. The nuclear decommissioning trust fund and benefit plan assets also have risks associated with the changing market value of their equity and other non-fixed income investments. Nuclear decommissioning and benefit plan costs are recovered in regulated electricity prices.

## Commodity Price Risk

We are exposed to the impact of market fluctuations in the commodity price and transportation costs of electricity and natural gas. Our risk management committee, consisting of officers and key management personnel, oversees company-wide energy risk management activities to ensure compliance with our stated energy risk management policies. We manage risks associated with these market fluctuations by utilizing various commodity instruments that may qualify as derivatives, including futures, forwards, options and swaps. As part of our risk management program, we use such instruments to hedge purchases and sales of electricity and fuels. The changes in market value of such contracts have a high correlation to price changes in the hedged commodities.

The following table shows the net pretax changes in mark-to-market of our derivative positions for the six months ended June 30, 2015 and 2014 (dollars in millions):

	Six Months Ended		
	June 30,		
	2015	2014	
Mark-to-market of net positions at beginning of year	\$(115	) \$(73	)
Decrease (increase) in regulatory asset/liability	(18	) 21	
Recognized in OCI:			
Mark-to-market losses realized during the period	3	8	
Change in valuation techniques	—	—	
Mark-to-market of net positions at end of period	\$(130	) \$(44	)

The table below shows the fair value of maturities of our derivative contracts (dollars in millions) at June 30, 2015 by maturities and by the type of valuation that is performed to calculate the fair values, classified in their entirety based on the lowest level of input that is significant to the fair value measurement.





See Note 1, "Derivative Accounting" and "Fair Value Measurements," in Item 8 of our 2014 Form 10-K and Note 11 for more discussion of our valuation methods.

Source of Fair Value	2015	2016	2017	2018	2019	Years thereafter	Total fair value
Observable prices provided by other external sources	\$(34 )	\$(29 )	\$(20 )	\$(4 )	\$—	\$—	\$(87 )
Prices based on unobservable inputs	(8 )	(14 )	(8 )	(6 )	(5 )	(2 )	(43 )
Total by maturity	\$(42 )	\$(43 )	\$(28 )	\$(10 )	\$(5 )	\$(2 )	\$(130 )

The table below shows the impact that hypothetical price movements of 10% would have on the market value of our risk management assets and liabilities included on Pinnacle West's Condensed Consolidated Balance Sheets at June 30, 2015 and December 31, 2014 (dollars in millions):

Mark-to-market changes reported in: Regulatory asset (liability) or OCI (a)	June 30, 2015		December 31, 2014	
	Gain (Loss)		Gain (Loss)	
	Price Up 10%	Price Down 10%	Price Up 10%	Price Down 10%
Electricity	\$2	\$(2 )	\$3	\$(3 )
Natural gas	37	(37 )	29	(29 )
Total	\$39	\$(39 )	\$32	\$(32 )

(a) These contracts are economic hedges of our forecasted purchases of natural gas and electricity. The impact of these hypothetical price movements would substantially offset the impact that these same price movements would have on the physical exposures being hedged. To the extent the amounts are eligible for inclusion in the PSA, the amounts are recorded as either a regulatory asset or liability.

#### Credit Risk

We are exposed to losses in the event of non-performance or non-payment by counterparties. See Note 7 for a discussion of our credit valuation adjustment policy.

#### Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See "Key Financial Drivers" and "Market and Credit Risks" in Item 2 above for a discussion of quantitative and qualitative disclosures about market risks.

Item 4. CONTROLS AND PROCEDURES

(a) Disclosure Controls and Procedures

The term "disclosure controls and procedures" means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (the "Exchange Act") (15 U.S.C. 78a et seq.), is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to a company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Pinnacle West's management, with the participation of Pinnacle West's Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of Pinnacle West's disclosure controls and procedures as of June 30, 2015. Based on that evaluation, Pinnacle West's Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, Pinnacle West's disclosure controls and procedures were effective.

APS's management, with the participation of APS's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of APS's disclosure controls and procedures as of June 30, 2015. Based on that evaluation, APS's Chief Executive Officer and Chief Financial Officer have concluded that, as of that date, APS's disclosure controls and procedures were effective.

(b) Changes in Internal Control Over Financial Reporting

The term "internal control over financial reporting" (defined in SEC Rule 13a-15(f)) refers to the process of a company that is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

No change in Pinnacle West's or APS's internal control over financial reporting occurred during the fiscal quarter ended June 30, 2015 that materially affected, or is reasonably likely to materially affect, Pinnacle West's or APS's internal control over financial reporting.

PART II -- OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

See "Business of Arizona Public Service Company — Environmental Matters" in Item 1 of the 2014 Form 10-K with regard to pending or threatened litigation and other disputes.

See Note 3 for ACC and FERC-related matters.

See Note 8 for information regarding environmental matters, Superfund-related matters, matters related to a September 2011 power outage and a New Mexico tax matter.

Item 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A — Risk Factors in the 2014 Form 10-K, which could materially affect the business, financial condition, cash flows or future results of Pinnacle West and APS. The risks described in the 2014 Form 10-K are not the only risks facing Pinnacle West and APS. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect the business, financial condition, cash flows and/or operating results of Pinnacle West and APS.

Item 5. OTHER INFORMATION

Environmental Matters

See "Environmental Matters - Mercury and Air Toxic Standards" in Note 8 for information regarding a recent United States Supreme Court decision related to MATS.

## Item 6. EXHIBITS

## (a) Exhibits

Exhibit No.	Registrant(s)	Description
10.1	Pinnacle West APS	Term Loan Agreement dated as of June 26, 2015 among Arizona Public Service Company, as Borrower, Toronto Dominion (Texas) LLC, as Agent, Citibank, N.A., as Syndication Agent, and such institutions comprising the lenders party thereto
12.1	Pinnacle West	Ratio of Earnings to Fixed Charges
12.2	APS	Ratio of Earnings to Fixed Charges
12.3	Pinnacle West	Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividend Requirements
31.1	Pinnacle West	Certificate of Donald E. Brandt, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.2	Pinnacle West	Certificate of James R. Hatfield, Executive Vice President and Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended

81

31.3	APS	Certificate of Donald E. Brandt, Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
31.4	APS	Certificate of James R. Hatfield, Executive Vice President and Chief Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended
32.1*	Pinnacle West	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	APS	Certification of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	Pinnacle West APS	XBRL Instance Document
101.SCH	Pinnacle West APS	XBRL Taxonomy Extension Schema Document
101.CAL	Pinnacle West APS	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	Pinnacle West APS	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	Pinnacle West APS	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	Pinnacle West APS	XBRL Taxonomy Definition Linkbase Document

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\*Furnished herewith as an Exhibit.

In addition, Pinnacle West and APS hereby incorporate the following Exhibits pursuant to Exchange Act Rule 12b-32 and Regulation §229.10(d) by reference to the filings set forth below:

Exhibit No.	Registrant(s)	Description	Previously Filed as Exhibit(1)	Date Filed
3.1	Pinnacle West	Pinnacle West Capital Corporation Bylaws, amended as of May 19, 2010	3.1 to Pinnacle West/APS June 30, 2010 Form 10-Q Report, File Nos. 1-8962 and 1-4473	8/3/2010
3.2	Pinnacle West	Articles of Incorporation, restated as of May 21, 2008	3.1 to Pinnacle West/APS June 30, 2008 Form 10-Q Report, File Nos. 1-8962 and 1-4473	8/7/2008
3.3	APS	Articles of Incorporation, restated as of May 25, 1988	4.2 to APS's Form S-3 Registration Nos. 33-33910 and 33-55248 by means of September 24, 1993 Form 8-K Report, File No. 1-4473	9/29/1993
3.4	APS	Amendment to the Articles of Incorporation of Arizona Public Service Company, amended May 16, 2012	3.1 to Pinnacle West/APS May 22, 2012 Form 8-K Report, File Nos. 1-8962 and 1-4473	5/22/2012
3.5	APS	Arizona Public Service Company Bylaws, amended as of December 16, 2008	3.4 to Pinnacle West/APS December 31, 2008 Form 10-K, File Nos. 1-8962 and 1-4473	2/20/2009

(1) Reports filed under File Nos. 1-4473 and 1-8962 were filed in the office of the Securities and Exchange Commission located in Washington, D.C.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, each registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PINNACLE WEST CAPITAL CORPORATION  
(Registrant)

Dated: July 30, 2015

By: /s/ James R. Hatfield  
James R. Hatfield  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer and  
Officer Duly Authorized to sign this Report)

ARIZONA PUBLIC SERVICE COMPANY  
(Registrant)

Dated: July 30, 2015

By: /s/ James R. Hatfield  
James R. Hatfield  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial Officer and  
Officer Duly Authorized to sign this Report)