

Pinnacle West Capital Corporation
Earnings Variance Explanations
For Three-Month and Nine-Month Periods Ended September 30, 2012 and 2011

The following earnings variance explanations were excerpted from the Pinnacle West Capital Corporation (“Pinnacle West”)/Arizona Public Service Company (“APS”) Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2012 (the “September 2012 Form 10-Q”). We suggest that this discussion be read in connection with the Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and the September 2012 Form 10-Q. Additional operating and financial statistics and a glossary of terms are available on our website (www.pinnaclewest.com).

RESULTS OF OPERATIONS

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

Operating Results – Three-month period ended September 30, 2012 compared with three-month period ended September 30, 2011

Our consolidated net income attributable to common shareholders for the three months ended September 30, 2012 was \$245 million, compared with net income of \$255 million for the comparable prior-year period. Income from discontinued operations decreased \$9 million primarily due to absence of the 2011 gain on the sale of our investment in APSES.

The regulated electricity segment results of \$246 million were comparable to the prior-year period. The results reflect increases related to the retail regulatory settlement effective July 1, 2012 (see Note 3), higher retail transmission revenues, lower net interest charges due to lower debt balances and lower interest rates in the current period, and lower depreciation and amortization due to 20-year Palo Verde license extensions received in 2011. These positive factors were offset by the effects of milder weather as compared with the prior-year period and an increase in operations and maintenance expenses.

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

	Three Months Ended September 30,		
	2012	2011	Net Change
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses	\$ 806	\$ 786	\$ 20
Operations and maintenance	(221)	(210)	(11)
Depreciation and amortization	(100)	(106)	6
Taxes other than income taxes	(37)	(34)	(3)
Other income (expenses), net	2	4	(2)
Interest charges, net of allowance for borrowed funds used during construction	(48)	(55)	7
Income taxes	(148)	(132)	(16)
Less income related to noncontrolling interests (Note 7)	(8)	(7)	(1)
Regulated electricity segment net income	246	246	--
All other	(1)	--	(1)
Income from Continuing Operations			
Attributable to Common Shareholders	245	246	(1)
Income from Discontinued Operations			
Attributable to Common Shareholders (a)	--	9	(9)
Net Income Attributable to Common Shareholders	\$ 245	\$ 255	\$ (10)

(a) Includes activities related to APSES and SunCor.

Operating revenues less fuel and purchased power expenses Regulated electricity segment operating revenues less fuel and purchased power expenses were \$20 million higher for the three months ended September 30, 2012 compared with the prior-year period. The following table summarizes the major components of this change:

	Increase (Decrease)		
	Operating revenues	Fuel and purchased power expenses	Net change
	(dollars in millions)		
Impacts of retail regulatory settlement effective July 1, 2012 (a)	\$ 39	\$ --	\$ 39
Higher retail transmission revenues	16	--	16
Effects of weather	(44)	(12)	(32)
Lower fuel and purchased power costs, net of related deferrals and off-system sales	(18)	(17)	(1)
Miscellaneous items, net	(8)	(6)	(2)
Total	<u>\$ (15)</u>	<u>\$ (35)</u>	<u>\$ 20</u>

(a) Includes a retail non-fuel base rate increase which is offset by other rate changes below (see Note 3).

Operations and maintenance Operations and maintenance expenses increased \$11 million for the three months ended September 30, 2012 compared with the prior-year period primarily because of:

- An increase of \$7 million related to employee benefit costs, including \$3 million of higher stock compensation costs resulting from an improved company stock price and estimated performance results;
- An increase of \$5 million related to amortization of pension and other postretirement benefit costs in 2012 compared with deferral of such costs in 2011;
- An increase of \$4 million in fossil generation costs as a result of more planned maintenance being completed in the current year quarter than in the same quarter a year ago;
- A decrease of \$8 million related to costs for demand-side management, renewable energy and similar regulatory programs, which were largely offset in operating revenues; and
- An increase of \$3 million due to other miscellaneous factors.

Depreciation and amortization Depreciation and amortization expenses were \$6 million lower for the three months ended September 30, 2012 compared with the prior-year period primarily due to impacts of the Palo Verde operating license extensions, partially offset by increased plant in service.

Interest charges, net of allowance for borrowed funds used during construction Interest charges, net of allowance for borrowed funds used during construction, decreased \$7 million for the three months ended September 30, 2012 compared with the prior-year period primarily because of lower debt balances in the current period.

Income taxes Income taxes were \$16 million higher for the three months ended September 30, 2012 compared with the prior-year period primarily due to higher pretax income in the current period and a lower effective tax rate in 2011.

Discontinued Operations

Income from discontinued operations decreased \$9 million due to absence of a gain of approximately \$10 million after income taxes related to the sale of our investment in APSES in 2011.

Operating Results – Nine-month period ended September 30, 2012 compared with nine-month period ended September 30, 2011

Our consolidated net income attributable to common shareholders for the nine months ended September 30, 2012 was \$359 million, compared with net income of \$327 million for the comparable prior-year period. The results reflect an increase of approximately \$47 million for the regulated electricity segment primarily due to increases related to the retail regulatory settlement effective July 1, 2012 (see Note 3), higher retail transmission revenues, lower depreciation and amortization due to 20-year Palo Verde license extensions received in 2011, and lower net interest charges due to lower debt balances and lower interest rates in the current year period.

The \$12 million decrease in discontinued operations is primarily due to the 2011 gain on sale of our investment in APSES.

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

	Nine Months Ended September 30,		Net Change
	2012	2011	
	(dollars in millions)		
Regulated Electricity Segment:			
Operating revenues less fuel and purchased power expenses (a)	\$ 1,823	\$ 1,777	\$ 46
Operations and maintenance (a)	(648)	(676)	28
Depreciation and amortization	(301)	(320)	19
Taxes other than income taxes	(120)	(112)	(8)
Other income (expenses), net	7	14	(7)
Interest charges, net of allowance for borrowed funds used during construction	(152)	(169)	17
Income taxes	(221)	(177)	(44)
Less income related to noncontrolling interests (Note 7)	(24)	(20)	(4)
Regulated electricity segment net income	364	317	47
All other	(4)	(1)	(3)
Income from Continuing Operations Attributable to Common Shareholders	360	316	44
Income (Loss) from Discontinued Operations Attributable to Common Shareholders (b)	(1)	11	(12)
Net Income Attributable to Common Shareholders	\$ 359	\$ 327	\$ 32

(a) Includes effects of 2011 settlement of certain transmission right-of-way costs, which did not affect net income, but increased both electric operating revenues and operations and maintenance expenses by \$28 million. Costs related to the settlement were offset by related revenues from SCE, which leases the related transmission line from APS.

(b) Includes activities related to APSES and SunCor.

Operating revenues less fuel and purchased power expenses Regulated electricity segment operating revenues less fuel and purchased power expenses were \$46 million higher for the nine months ended September 30, 2012 compared with the prior-year period. The following table summarizes the major components of this change:

	Increase (Decrease)		
	Operating	Fuel and purchased power expenses	Net change
	revenues		
	(dollars in millions)		
Impacts of retail regulatory settlement effective July 1, 2012 (a)	\$ 39	\$ --	\$ 39
Higher retail transmission revenues	31	--	31
Lower fuel and purchased power costs, net of related deferrals and off-system sales	(1)	(9)	8
Effects of weather	7	3	4
Lower usage per customer	(14)	(2)	(12)
Settlement in 2011 of certain prior-period transmission right-of-way revenues	(28)	--	(28)
Miscellaneous items, net	2	(2)	4
Total	<u>\$ 36</u>	<u>\$ (10)</u>	<u>\$ 46</u>

(a) Includes a retail non-fuel base rate increase which is offset by other rate changes below (see Note 3).

Operations and maintenance Operations and maintenance expenses decreased \$28 million for the nine months ended September 30, 2012 compared with the prior-year period primarily because of:

- A decrease of \$28 million related to settlement in 2011 of certain transmission right-of-way costs, which was offset in operating revenues;
- A decrease of \$15 million related to costs for demand-side management, renewable energy and similar regulatory programs, which were largely offset in operating revenues;
- A decrease of \$9 million in generation costs, primarily related to lower nuclear generation costs;
- An increase of \$9 million related to higher stock compensation costs resulting from an improved company stock price and estimated performance results;
- An increase of \$10 million related to employee benefit costs; and
- An increase of \$5 million due to other miscellaneous factors.

Depreciation and amortization Depreciation and amortization expenses were \$19 million lower for the nine months ended September 30, 2012 compared with the prior-year

period primarily due to the impacts of Palo Verde operating license extensions, partially offset by increased plant in service.

Taxes other than income taxes Taxes other than income taxes increased \$8 million for the nine months ended September 30, 2012 compared with the prior-year period primarily because of higher property tax rates in the current period.

Interest charges, net of allowance for borrowed funds used during construction Interest charges, net of allowance for borrowed funds used during construction, decreased \$17 million for the nine months ended September 30, 2012 compared with the prior-year period primarily because of lower debt balances in the current period.

Income taxes Income taxes were \$44 million higher for the nine months ended September 30, 2012 compared with the prior-year period primarily due to higher pre-tax income in the current period and a lower effective tax rate in 2011.

Discontinued Operations

Income from discontinued operations decreased \$12 million because of absence of a gain of approximately \$10 million after income taxes related to the sale of our investment in APSES in 2011.