ARIZONA PUBLIC SERVICE CO
Form 10-Q
November 08, 2006

Table of Contents

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

OR

o **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 þ No o
ARIZONA PUBLIC SERVICE COMPANY Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.
PINNACLE WEST CAPITAL CORPORATION
Large accelerated filer þ Accelerated filer o Non-accelerated filer o
ARIZONA PUBLIC SERVICE COMPANY
Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether each registrant is a shell company (as defined in Exchange Act Rule 12b-2).
PINNACLE WEST CAPITAL CORPORATION Yes o No þ
ARIZONA PUBLIC SERVICE COMPANY Yes o No þ

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

PINNACLE WEST CAPITAL CORPORATION	Number of shares of common stock, no par value, outstanding as of November 3, 2006: 99,847,829
ARIZONA PUBLIC SERVICE COMPANY	Number of shares of common stock, $2.50 par value, outstanding as of November 3, 2006: 71,264,947

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

This combined Form 10-Q is separately filed by Pinnacle West Capital Corporation and Arizona Public Service Company. Each registrant is filing 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 filing any information that does not relate to such registrant, and therefore makes no representation as to any such information.

TABLE OF CONTENTS

GLOSSARY

ACC Arizona Corporation Commission
ADEQ Arizona Department of Environmental Quality
ALJ Administrative Law Judge
APB Accounting Principles Board
APS Arizona Public Service Company, a subsidiary of the Company
APS Energy Services APS Energy Services Company, Inc., a subsidiary of the Company
Clean Air Act Clean Air Act, as amended
Company Pinnacle West Capital Corporation
DOE United States Department of Energy
EITF FASB s Emerging Issues Task Force
El Dorado El Dorado Investment Company, a subsidiary of the Company
EPA United States Environmental Protection Agency
ERMC Energy Risk Management Committee
FASB Financial Accounting Standards Board
FERC United States Federal Energy Regulatory Commission
FIP Federal Implementation Plan
GAAP accounting principles generally accepted in the United States of America
IRS United States Internal Revenue Service
kWh kilowatt-hour
Moody s Moody s Investors Service
MWh megawatt-hour, one million watts per hour
NAC collectively, NAC Holding Inc. and NAC International Inc., subsidiaries of El Dorado that were sold in November 2004
Native Load retail and wholesale sales supplied under traditional cost-based rate regulation
NPC Nevada Power Company
NRC United States Nuclear Regulatory Commission
OCI other comprehensive income
Off-System Sales sales of electricity from generation owned by the Company that is over and above the amount required to serve APS retail customers and traditional wholesale contracts
Palo Verde Palo Verde Nuclear Generating Station
Pinnacle West Pinnacle West Capital Corporation, the Company
Pinnacle West Energy Pinnacle West Energy Corporation, a subsidiary of the Company
PRP potentially responsible party

Table of Contents

PSA power supply adjustor
PWEC Dedicated Assets the following power plants, each of which was transferred by Pinnacle West Energy to APS on July 29, 2005: Redhawk Units 1 and 2, West Phoenix Units 4 and 5 and Saguaro Unit 3
Salt River Project Salt River Project Agricultural Improvement and Power District
SEC United States Securities and Exchange Commission
SFAS Statement of Financial Accounting Standards
Silverhawk Silverhawk Power Station, a 570-megawatt, natural gas-fueled, combined-cycle electric generating facility located 20 miles north of Las Vegas, Nevada
Standard & Poor s Standard & Poor s Corporation
SunCor SunCor Development Company, a subsidiary of the Company
Sundance Plant 450-megawatt generating facility located approximately 55 miles southeast of Phoenix, Arizona
Superfund Comprehensive Environmental Response, Compensation and Liability Act
Trading energy-related activities entered into with the objective of generating profits on changes in market prices
2005 Form 10-K Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2005
VIE variable interest entity

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

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

	Three Months Ended September 30,	
	2006	2005
OPERATING REVENUES		
Regulated electricity segment	$ 886,979	$ 753,428
Marketing and trading segment	84,425	107,031
Real estate segment	97,871	78,755
Other revenues	7,167	16,369
Total	1,076,442	955,583
OPERATING EXPENSES		
Regulated electricity segment fuel and purchased power	314,150	203,519
Marketing and trading segment fuel and purchased power	80,906	86,945
Operations and maintenance	164,396	158,940
Real estate segment operations	78,853	67,508
Depreciation and amortization	90,390	85,763
Taxes other than income taxes	31,697	34,325
Other expense	5,610	13,521
Regulatory disallowance		143,217
Total	766,002	793,738
OPERATING INCOME	310,440	161,845
OTHER		
Allowance for equity funds used during construction	3,178	2,852
Other income (Note 14)	18,055	8,694
Other expense (Note 14)	(3,693)	(4,915)
Total	17,540	6,631
INTEREST EXPENSE		
Interest charges	50,577	46,778
Capitalized interest	(5,612)	(3,301)
Total	44,965	43,477
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	283,015	124,999
INCOME TAXES	98,836	40,305
INCOME FROM CONTINUING OPERATIONS	184,179	84,694

INCOME (LOSS) FROM DISCONTINUED OPERATIONS		
Net of income tax expense of $3 and $12,407 (Note 17)	(12)	19,043
NET INCOME	$ 184,167	$ 103,737
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC	99,491	98,697
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED	99,973	98,816
EARNINGS PER WEIGHTED AVERAGE COMMON SHARE OUTSTANDING		
Income from continuing operations basic	$ 1.85	$ 0.86
Net income basic	1.85	1.05
Income from continuing operations diluted	1.84	0.86
Net income diluted	1.84	1.05
DIVIDENDS DECLARED PER SHARE	$ 0.50	$ 0.475

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)

	Nine Months Ended September 30,	
	2006	2005
OPERATING REVENUES		
Regulated electricity segment	$ 2,065,823	$ 1,749,110
Marketing and trading segment	259,352	267,460
Real estate segment	318,328	232,950
Other revenues	28,173	46,763
Total	2,671,676	2,296,283
OPERATING EXPENSES		
Regulated electricity segment fuel and purchased power	735,489	442,532
Marketing and trading segment fuel and purchased power	227,797	215,347
Operations and maintenance	511,155	467,121
Real estate segment operations	248,595	190,555
Depreciation and amortization	267,308	262,030
Taxes other than income taxes	99,970	103,528
Other expenses	22,562	39,451
Regulatory disallowance		143,217
Total	2,112,876	1,863,781
OPERATING INCOME	558,800	432,502
OTHER		
Allowance for equity funds used during construction	10,612	8,407
Other income (Note 14)	34,448	18,019
Other expense (Note 14)	(12,953)	(12,985)
Total	32,107	13,441
INTEREST EXPENSE		
Interest charges	143,985	142,820
Capitalized interest	(14,595)	(10,134)
Total	129,390	132,686
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	461,517	313,257
INCOME TAXES	154,900	113,863
INCOME FROM CONTINUING OPERATIONS	306,617	199,394
INCOME (LOSS) FROM DISCONTINUED OPERATIONS		
Net of income tax expense (benefit) of $1,415 and $(28,586) (Note 17)	2,159	(44,474)

NET INCOME	$	308,776	$	154,920
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING BASIC		99,277		95,642
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING DILUTED		99,723		95,755
EARNINGS PER WEIGHTED AVERAGE COMMON SHARE OUTSTANDING				
Income from continuing operations basic	$	3.09	$	2.08
Net income basic		3.11		1.62
Income from continuing operations diluted		3.07		2.08
Net income diluted		3.10		1.62
DIVIDENDS DECLARED PER SHARE	$	1.50	$	1.425

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

5

Table of Contents

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

	September 30, 2006	December 31, 2005
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 128,222	$ 154,003
Investment in debt securities	203,317	
Customer and other receivables	576,107	502,681
Allowance for doubtful accounts	(5,536)	(4,979)
Materials and supplies (at average cost)	116,867	109,736
Fossil fuel (at average cost)	21,679	23,658
Assets from risk management and trading activities (Note 10)	617,440	827,779
Assets held for sale (Note 17)	22,575	202,645
Other current assets	81,145	75,869
Total current assets	1,761,816	1,891,392
INVESTMENTS AND OTHER ASSETS		
Real estate investments net	495,965	390,702
Assets from long-term risk management and trading activities (Note 10)	216,129	597,831
Decommissioning trust accounts (Note 18)	326,318	293,943
Other assets	127,153	111,931
Total investments and other assets	1,165,565	1,394,407
PROPERTY, PLANT AND EQUIPMENT		
Plant in service and held for future use	11,077,611	10,727,695
Less accumulated depreciation and amortization	3,778,560	3,622,884
Total	7,299,051	7,104,811
Construction work in progress	349,603	327,172
Intangible assets, net of accumulated amortization	93,868	90,916
Nuclear fuel, net of accumulated amortization	64,780	54,184
Net property, plant and equipment	7,807,302	7,577,083
DEFERRED DEBITS		
Deferred fuel and purchased power regulatory asset (Note 5)	209,017	172,756
Other regulatory assets	188,368	151,123
Other deferred debits	125,131	135,884

Total deferred debits	522,516	459,763
TOTAL ASSETS	$ 11,257,199	$ 11,322,645

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

Table of Contents

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

	September 30, 2006	December 31, 2005
LIABILITIES AND COMMON STOCK EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 315,027	$ 377,107
Accrued taxes	416,401	289,235
Accrued interest	43,839	31,774
Short-term borrowings	57,400	15,673
Current maturities of long-term debt	85,440	384,947
Customer deposits	69,088	60,509
Deferred income taxes	12,389	94,710
Liabilities from risk management and trading activities (Note 10)	523,797	720,693
Other current liabilities (Note 10)	157,889	297,425
Total current liabilities	1,681,270	2,272,073
LONG-TERM DEBT LESS CURRENT MATURITIES	3,237,423	2,608,455
DEFERRED CREDITS AND OTHER		
Deferred income taxes	1,174,003	1,225,253
Regulatory liabilities	588,957	592,494
Liability for asset retirements	282,060	269,011
Pension liability	267,744	264,476
Liabilities from long-term risk management and trading activities (Note 10)	194,196	256,413
Unamortized gain sale of utility plant	42,325	45,757
Other	394,149	363,749
Total deferred credits and other	2,943,434	3,017,153
COMMITMENTS AND CONTINGENCIES (Notes 5, 12, 13 and 15)		
COMMON STOCK EQUITY		
Common stock, no par value	2,094,942	2,067,377
Treasury stock	(406)	(1,245)
Total common stock	2,094,536	2,066,132
Accumulated other comprehensive income (loss) (Note 11):		
Minimum pension liability adjustment	(97,277)	(97,277)
Derivative instruments	44,200	262,397

Total accumulated other comprehensive income (loss)	(53,077)	165,120
Retained earnings	1,353,613	1,193,712
Total common stock equity	3,395,072	3,424,964
TOTAL LIABILITIES AND COMMON STOCK EQUITY	$ 11,257,199	$ 11,322,645

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

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

	Nine Months Ended September 30, 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income	$ 308,776	$ 154,920
Adjustments to reconcile net income to net cash provided by operating activities:		
Silverhawk impairment loss		91,057
Regulatory disallowance		143,217
Depreciation and amortization including nuclear fuel	288,065	292,190
Deferred fuel and purchased power	(231,388)	(142,806)
Deferred fuel and purchased power amortization	195,127	
Allowance for equity funds used during construction	(10,612)	(8,407)
Deferred income taxes	3,598	(51,045)
Change in mark-to-market valuations	16,974	(29,785)
Changes in current assets and liabilities:		
Customer and other receivables	(72,154)	(126,450)
Materials, supplies and fossil fuel	135	(15,581)
Other current assets	16,294	(33,750)
Accounts payable	(69,608)	7,505
Accrued taxes	130,137	137,853
Collateral	(176,110)	229,746
Other current liabilities	35,647	21,829
Proceeds from the sale of real estate assets	27,144	15,020
Real estate investments	(94,533)	(59,527)
Change in risk management and trading liabilities	(132,540)	171,841
Change in other long-term assets	(6,609)	(909)
Change in other long-term liabilities	54,880	90,091
Net cash flow provided by operating activities	283,223	887,009
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(534,370)	(471,274)
Capitalized interest	(14,595)	(10,134)
Purchase of Sundance Plant		(185,046)
Proceeds from the sale of Silverhawk	207,620	
Proceeds from the sale of real estate investments	2,134	82,671
Proceeds from nuclear decommissioning trust sales	170,827	136,202
Investment in nuclear decommissioning trusts	(186,383)	(149,440)
Purchases of investment securities	(739,996)	(2,567,237)
Proceeds from sale of investment securities	536,679	2,679,691
Other	(2,246)	132
Net cash flow used for investing activities	(560,330)	(484,435)

CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of long-term debt	703,283	911,815
Repayment of long-term debt	(384,800)	(734,163)
Short-term borrowings and payments net	41,659	(19,975)
Dividends paid on common stock	(148,876)	(137,234)
Common stock equity issuance	24,574	290,542
Other	15,486	(5,672)
Net cash flow provided by financing activities	251,326	305,313
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(25,781)	707,887
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	154,003	163,366
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 128,222	$ 871,253
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Income taxes paid, net of refunds	$ 71,901	$ 52,433
Interest paid, net of amounts capitalized	$ 113,408	$ 119,670

See Notes to Pinnacle West s Condensed Consolidated Financial Statements.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Consolidation and Nature of Operations

The unaudited condensed consolidated financial statements include the accounts of Pinnacle West and our wholly-owned subsidiaries: APS, Pinnacle West Energy (dissolved as of August 31, 2006), APS Energy Services, SunCor and El Dorado. All significant intercompany accounts and transactions between the consolidated companies have been eliminated. Our accounting records are maintained in accordance with 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. We have reclassified our prior year cash flow amounts related to our decommissioning trust activity to reflect the proceeds and investments separately versus a net presentation.

2. Condensed Consolidated Financial Statements

Our unaudited condensed consolidated financial statements reflect all adjustments that we believe are necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. We suggest that these condensed consolidated financial statements and notes to condensed consolidated financial statements be read along with the consolidated financial statements and notes to consolidated financial statements included in our 2005 Form 10-K.

3. Quarterly Fluctuations

Weather conditions cause significant seasonal fluctuations in our revenues. In addition, real estate and trading and wholesale marketing activities can have significant impacts on our results for interim periods. For these reasons, results for interim periods do not necessarily represent results to be expected for the year.

4. Changes in Liquidity

In January 2006, Pinnacle West infused $210 million of the proceeds from the sale of Silverhawk into APS. See Equity Infusions in Note 5 for more information.

On February 28, 2006, Pinnacle West entered into an Uncommitted Master Shelf Agreement with Prudential Investment Management, Inc. (Prudential) and certain of its affiliates. The agreement provides the terms under which Pinnacle West may offer up to $200 million of its senior notes for purchase by Prudential affiliates at any time prior to December 31, 2007. The maturity of notes issued under the agreement cannot exceed five years. Pursuant to the agreement, on February 28, 2006, Pinnacle West issued and sold to Prudential affiliates $175 million of its 5.91% Senior Notes, Series A, due February 28, 2011 (the Series A Notes).

On April 3, 2006, Pinnacle West repaid $300 million of its 6.40% Senior Notes due April 2006. Pinnacle West used the proceeds of the Series A Notes, cash on hand and commercial paper proceeds to repay these notes.

On August 3, 2006, APS issued $400 million of debt as follows: $250 million of its 6.25% Notes due 2016 and $150 million of its 6.875% Notes due 2036. A portion of the proceeds will be used to pay at maturity approximately $84 million of APS 6.75% Senior Notes due November 15,

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

2006, to fund its construction program and for other general corporate purposes. A portion of the proceeds may also be used to pay any liability determined to be payable as a result of the review by the IRS of a tax refund the Company received in 2002.

On September 28, 2006, APS put in place an additional $500 million revolving credit facility that terminates in September 2011. APS may increase the amount of the facility up to a maximum facility of $600 million upon the satisfaction of certain conditions. APS will use the facility for general corporate purposes. The facility can also be used for the issuance of letters of credit. Interest rates are based on APS senior unsecured debt credit ratings.

The following table shows principal payments due on Pinnacle West s (on a consolidated basis) and APS total long-term debt and capitalized lease requirements (dollars in millions) as of September 30, 2006:

Year	Pinnacle West	APS
2006	$ 85	$ 84
2007	4	1
2008	175	1
2009	8	1
2010	225	224
Thereafter	2,836	2,661
Total	$ 3,333	$ 2,972

Pinnacle West and APS hold investments in debt securities (auction-rate securities) for purposes other than trading. We believe that the carrying amounts of these investments represent reasonable estimates of their fair values at September 30, 2006 due to the short-term reset of interest rates.

5. Regulatory Matters

APS General Rate Case

APS Request. On October 4, 2006, APS filed with the ACC its rejoinder testimony in the general rate case it originally filed on November 4, 2005 and updated on January 31, 2006. In the rejoinder filing, APS modified the rate request to reflect a 20.4%, or $434.6 million, increase in its annual retail electricity revenues. Hearings in the general rate case began on October 10, 2006.

The updated requested rate increase is designed to recover the following (dollars in millions):

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	October 4, 2006 Filing		January 31, 2006 Filing	
	Annual Revenue Increase	Percentage Increase	Annual Revenue Increase	Percentage Increase
Increased fuel and purchased power	$ 314.4	14.8%	$ 299.0	14.0%
Capital structure update	98.3	4.6%	98.3	4.6%
Rate base update, including acquisition of Sundance Plant	46.2	2.2%	46.2	2.2%
Pension funding	41.3	1.9%	41.3	1.9%
Other items	(65.6)	(3.1)%	(30.9)	(1.4)%
Total increase	$ 434.6	20.4%	$ 453.9	21.3%

The request is based on (a) a rate base of $4.5 billion as of September 30, 2005; (b) a base rate for fuel and purchased power costs of $0.0325 per kWh based on estimated 2007 prices; and (c) a capital structure of 45% long-term debt and 55% common stock equity, with a weighted-average cost of capital of 8.73% (5.41% for long-term debt and 11.50% for common stock equity).

The updated request does not include the PSA annual adjustor rate increase of approximately 5% that took effect February 1, 2006, the PSA surcharge increase of approximately 0.7% that took effect May 1, 2006, or APS pending application for a 1.9% PSA surcharge rate increase. See Power Supply Adjustor below. If the ACC approves the requested base rate increase for fuel and purchased power costs (see clause (b) of the preceding paragraph), subsequent PSA rate adjustments and/or PSA surcharges would be reduced because more of such costs are likely to be recovered in base rates.

APS has also suggested three additional measures for the ACC s consideration to improve APS financial metrics while benefiting APS customers in the long run:

Allowing accelerated depreciation to address the large imbalance between APS capital expenditures (estimated to average more than $900 million per year from 2007 through 2009) and its recovery of those expenses (in discussing this measure, APS assumed an increase of $50 million per year in allowed depreciation expense, which would increase APS revenue requirement by that same amount);

Placing generation and distribution construction work in progress (CWIP) in rate base (in discussing this measure, APS assumed the inclusion of its June 30, 2006 CWIP balance of $261 million in rate base, which would increase APS revenue requirement by about $33 million); and

Approving an attrition adjustment to provide APS a reasonable opportunity to earn an authorized return on equity given overall cost increases and higher

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

levels of construction needed to accommodate ongoing customer growth (APS suggested a minimum attrition adjustment that would increase the allowed return on equity by 1.7% to 4.1%).

ACC Staff Recommendations. On August 18, 2006, the ACC staff and other rate case intervenors filed their initial written testimony with the ACC. Through subsequently filed testimony, the ACC staff recommends that the ACC increase APS annual retail electricity revenues by $195.8 million, which would result in a rate increase of approximately 9.2%. The principal components of the increase recommended by the ACC staff are $193.5 million, or a 9.1% increase, for increased fuel and purchased power costs; a $2.0 million rate reduction (0.1%) for non-fuel costs; and $4.3 million, or a 0.2% increase, for costs related to the ACC s environmental portfolio standard.

In arriving at its recommendations, the ACC staff proposed, among other things, that the ACC:

- Increase the base fuel amount (from which PSA deferrals are calculated) from the current $0.020743 per kWh to $0.027975 per kWh;
- Approve a weighted-average cost of capital of 8.05% based on a return on common equity of 10.25% and APS requested capital structure of 45% long-term debt and 55% common equity;
- Retain the PSA with the modifications discussed herein;
- Approve additions to rate base, including the Sundance Power Plant; and
- Establish minimum three-year capacity factor targets for Palo Verde based on a three-year average of Palo Verde performance as compared to a group of comparable nuclear plants, with the ACC to review the recovery of any incremental fuel and replacement power costs attributable to Palo Verde not meeting the minimum targets.

Other Intervenors Recommendations. Other intervenors in the rate case include the Arizona Residential Utility Consumer Office (RUCO), an office established by the Arizona legislature to represent the interests of residential utility consumers before the ACC; Arizonans for Electric Choice and Competition (AECC), a business coalition that advocates on behalf of retail electric customers in Arizona; and Phelps Dodge Mining Company (Phelps Dodge). In its filed testimony, RUCO recommended that the ACC increase APS annual retail electricity revenues by $232 million, which would result in a rate increase of approximately 10.89%. In jointly-filed testimony, AECC and Phelps Dodge recommended that the ACC reduce APS requested annual increase by at least $131 million, which would result in a rate increase of not more than $303 million, or 14%.

Interim Rate Increase

On January 6, 2006, APS filed with the ACC an application requesting an emergency interim rate increase of $299 million, or approximately 14%, to be effective April 1, 2006. APS later reduced this request to $232 million, or approximately 11%, due to a decline in expected 2006 natural gas and wholesale power prices. The purpose of the emergency interim rate increase was

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

solely to address APS under-collection of higher annual fuel and purchased power costs. On May 2, 2006, the ACC approved an order in this matter that, among other things:

- authorized an interim PSA adjustor, effective May 1, 2006, that resulted in an interim retail rate increase of approximately 8.3% designed to recover approximately $138 million of fuel and purchased power costs incurred in 2006 (this interim adjustor, combined with the $15 million PSA surcharge approved by the ACC (see Surcharge for Certain 2005 PSA Deferrals below), resulted in a rate increase of approximately 9.0% designed to recover approximately $149 million of fuel and purchased power costs during 2006);

- provided that amounts collected through the interim PSA adjustor remain subject to a prudency review at the appropriate time and that all unplanned Palo Verde outage costs for 2006 should undergo a prudence audit by [the ACC] Staff (see PSA Deferrals Related to Unplanned Palo Verde Outages below);

- encouraged parties to APS general rate case to propose modifications to the PSA that will address on a permanent basis, the issues with timing of recovery when deferrals are large and growing ;

- affirmed APS ability to defer fuel and purchased power costs above the prior annual cap of $776.2 million until the ACC decides the general rate case; and

- encouraged APS to diversify its resources through large scale, sustained energy efficiency programs, [using] low cost renewable energy resources as a hedge against high fossil fuel costs.

Power Supply Adjustor

PSA Provisions

The PSA approved by the ACC in April 2005 as part of APS 2003 rate case provides for adjustment of retail rates to reflect variations in retail fuel and purchased power costs. Such adjustments are to be implemented by use of a PSA adjustor and PSA surcharges. On January 25, 2006, the ACC modified the PSA in certain respects. The PSA, as modified, is subject to specified parameters and procedures, including the following:

- APS records deferrals for recovery or refund to the extent actual retail fuel and purchased power costs vary from the base fuel amount (currently $0.020743 per kWh);

- the deferrals are subject to a 90/10 sharing arrangement in which APS must absorb 10% of the retail fuel and purchased power costs above the base fuel amount and may retain 10% of the benefit from the retail fuel and purchased power costs that are below the base fuel amount;

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

amounts to be recovered or refunded through the PSA adjustor are limited to (a) a cumulative plus or minus $0.004 per kWh from the base fuel amount over the life of the PSA and (b) a maximum plus or minus $0.004 change in the adjustor rate in any one year;

the recoverable amount of annual retail fuel and purchased power costs through current base rates and the PSA was originally capped at $776.2 million; however, the ACC has removed the cap pending the ACC s final ruling on APS pending request in the general rate case to have the cap eliminated or substantially raised;

the PSA will remain in effect for a minimum five-year period, but the ACC may eliminate the PSA at any time, if appropriate, in the event APS files a rate case before the expiration of the five-year period (which APS did by filing the general rate case noted above) or if APS does not comply with the terms of the PSA; and

APS is prohibited from requesting PSA surcharges until after the PSA annual adjustor rate has been set each year. The amount available for potential PSA surcharges will be limited to the amount of accumulated deferrals through the prior year-end, which are not expected to be recovered through the annual adjustor or any PSA surcharges previously approved by the ACC.

PSA Annual Adjustor The annual adjustor rate will be set for twelve-month periods beginning February 1 of each year. The current PSA annual adjustor rate was set at the maximum $0.004 per kWh effective February 1, 2006. The change in the adjustor rate represented a retail rate increase of approximately 5% designed to recover $110 million of deferred fuel and purchased power costs over the twelve-month period that began February 1, 2006.

Surcharge for Certain 2005 PSA Deferrals On April 12, 2006, the ACC approved APS request to recover $15 million of 2005 PSA deferrals over a twelve-month period beginning May 2, 2006, representing a temporary rate increase of approximately 0.7%. Approximately $45 million of 2005 PSA deferrals remain subject to a pending application (see PSA Deferrals Related to Unplanned Palo Verde Outages below); the balance of the 2005 PSA deferrals is being recovered under the 2006 PSA annual adjustor described in the preceding paragraph.

PSA Deferrals Related to Unplanned Palo Verde Outages On February 2, 2006, APS filed with the ACC an application to recover approximately $45 million over a twelve-month period, representing a temporary rate increase of approximately 1.9%, proposed to begin no later than the ACC s completion of its inquiry regarding the unplanned 2005 Palo Verde outages. On August 17, 2006, the ACC staff filed a report with the ACC recommending that the ACC disallow approximately $17.4 million ($10 million after income taxes) of the $45 million request. The report alleges that four of the eleven Palo Verde outages in 2005 were avoidable, three of which resulted in the recommended disallowance. The report also finds, among other things, that:

Three of the outages were due to faulty or defective vendor supplied equipment and concludes that APS actions were not imprudent in connection with these outages. The report recommends, however, that the ACC evaluate the degree to which APS has sought appropriate legal or other remedies in connection with these outages and

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

that APS   be given the opportunity to demonstrate the steps that it has taken in this regard.

Additional investigation will be needed to determine the cause of and responsibility for   the Palo Verde Unit 1 outage resulting from vibration levels in one of the Unit s shutdown cooling lines.

The report also recommends that the ACC establish minimum three-year capacity factor targets for Palo Verde based on a three-year average of Palo Verde performance as compared to a group of comparable nuclear plants, with the ACC to review the recovery of any incremental fuel and replacement power costs attributable to Palo Verde not meeting the minimum targets.

APS disagrees with, and will contest, the report s recommendation that the ACC disallow a portion of the $45 million of PSA deferrals. Under ACC regulations, prudent investments are those   which under ordinary circumstances would be deemed reasonable and not dishonest or obviously wasteful   and   investments [are] presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent.   APS believes the expenses in question were prudently incurred and, therefore, are recoverable. At the request of the ACC staff, this matter will be addressed by the ACC as part of APS   general rate case.

As noted under   Interim Rate Increase   above, the ACC has directed the ACC staff to conduct a   prudence audit   on unplanned 2006 Palo Verde outage costs. PSA deferrals related to these 2006 outages are estimated to be about $78 million. APS believes these expenses were prudently incurred and, therefore, are recoverable.

Proposed Modifications to PSA (Requested In General Rate Case)

In its pending general rate case, APS has requested the following modifications to the PSA:

The cumulative plus or minus $0.004 per kWh limit from the base fuel amount over the life of the PSA would be eliminated, while the maximum plus or minus $0.004 kWh limit to changes in the adjustor rate in any one year would remain in effect;

The $776.2 million annual limit on the retail fuel and purchased power costs under APS   current base rates and the PSA would be removed or increased (although APS may defer fuel and purchased power costs above $776.2 million per year pending the ACC s final ruling on APS   pending request to have the cap eliminated or substantially raised);

The current provision that APS is required to file a surcharge application with the ACC after accumulated pretax PSA deferrals equal $50 million and before they equal $100 million would be eliminated, thereby giving APS flexibility in determining when a surcharge filing should be made; and

The costs of renewable energy and capacity costs attributable to purchased power obtained through competitive procurement would be excluded from the existing 90/10 sharing arrangement under which APS absorbs 10% of the retail fuel and

PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

purchased power costs above the base fuel amount and retains 10% of the benefit from retail fuel and purchased power costs that are below the base fuel amount.

In its prefiled testimony the ACC staff recommended the following potential changes to the PSA:

- Establishing the PSA annual adjustor, beginning in 2007, based on projected fuel costs rather than historical fuel costs; and

- Removing the existing limitations on fuel cost recovery.

Equity Infusions

On November 8, 2005, the ACC approved Pinnacle West s request to infuse more than $450 million of equity into APS during 2005 or 2006. These infusions consisted of about $250 million of the proceeds of Pinnacle West s common equity issuance on May 2, 2005 and about $210 million of the proceeds from the sale of Silverhawk in January 2006 (see Note 17). Pinnacle West has made these equity infusions into APS.

Federal

Price Mitigation Plan

In July 2002, the FERC adopted a price mitigation plan that constrains the price of electricity in the wholesale spot electricity market in the western United States. The FERC adopted a price cap of $250 per MWh for the period subsequent to October 31, 2002. On February 13, 2006, the FERC increased this price cap to $400 per MWh for prospective sales. Sales at prices above the cap must be justified and are subject to potential refund. We do not expect this price cap to have a material impact on our financial statements.

FERC Order

On August 11, 2004, Pinnacle West, APS, Pinnacle West Energy, and APS Energy Services (collectively, the Pinnacle West Companies) submitted to the FERC an update to its three-year market-based rate review pursuant to the FERC s order implementing a new generation market power analysis. On December 20, 2004, the FERC issued an order approving the Pinnacle West Companies market-based rates for control areas other than those of APS, Public Service Company of New Mexico (PNM) and Tucson Electric Power Company (TEP). The FERC staff required the Pinnacle West Companies to submit additional data with respect to these control areas, and the Pinnacle West Companies did so.

On April 17, 2006, the FERC issued an order revoking the Pinnacle West Companies market-based rate authority in the APS control area (the FERC Order). The FERC found that the Pinnacle West Companies failed to provide the necessary information about the APS control area to allow the FERC to make a determination about the FERC s generation market power screens in the APS control area. The FERC found that the Pinnacle West Companies may charge market-based rates in the PNM and TEP control areas.

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As a result of the FERC Order, the Pinnacle West Companies must charge cost-based rates, rather than market-based rates, in the APS control area for sales occurring after the date of the order, April 17, 2006. The Pinnacle West Companies are required to refund any amounts collected that exceed the default cost-based rates for all market rate sales within the APS control area from February 27, 2005 to April 17, 2006.

The Pinnacle West Companies filed a rehearing request of the FERC Order on May 17, 2006 and submitted a supplemental compliance filing on July 31, 2006. Based upon an analysis of the FERC Order and preliminary calculations of the refund obligations, at this time, neither Pinnacle West nor APS believes that the FERC Order will have a material adverse effect on its financial position, results of operations or cash flows.

FERC Application

On September 21, 2006, Pinnacle West and Pinnacle West Marketing & Trading Co., LLC (PW Trading), a newly-formed Pinnacle West subsidiary, filed an application with the FERC seeking authorization for Pinnacle West to transfer its market rate tariff and FERC-jurisdictional service agreements to PW Trading, effective as of January 1, 2007. This application is pending at the FERC. Once implemented, Pinnacle West would no longer be considered a public utility under the Federal Power Act, which would permit Pinnacle West to issue securities and incur long-term debt without the need for authorization from the FERC under Section 204 of the Federal Power Act. Pinnacle West is currently authorized to issue a broad range of debt and equity securities pursuant to an order issued by the FERC on May 3, 2006.

6. Retirement Plans and Other Benefits

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a nonqualified 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 plan. The market-related value of our plan assets is their fair value at the measurement date.

The following table provides details of the plans benefit costs for the three months and nine months ended September 30, 2006 and 2005. Also included is the portion of these costs charged to expense, including administrative costs and excluding amounts billed to electric plant participants or capitalized as overhead construction (dollars in millions):

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Pension Benefits				Other Benefits			
	Three Months Ended September 30,		Nine Months Ended September 30,		Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005	2006	2005	2006	2005
Service cost-benefits earned during the period	$ 12	$ 11	$ 36	$ 34	$ 5	$ 5	$ 16	$ 16
Interest cost on benefit obligation	23	22	69	66	10	9	27	26
Expected return on plan assets	(24)	(22)	(72)	(67)	(10)	(8)	(29)	(23)
Amortization of:								
Transition (asset) obligation	(1)	(1)	(1)	(3)	1	1	2	2
Prior service cost	1	1	2	2				
Net actuarial loss	6	5	18	15	2	2	7	7
Net periodic benefit cost	$ 17	$ 16	$ 52	$ 47	$ 8	$ 9	$ 23	$ 28
Portion of cost charged to expense	$ 7	$ 7	$ 22	$ 20	$ 3	$ 4	$ 10	$ 12
APS share of costs charged to expense	$ 7	$ 6	$ 20	$ 18	$ 3	$ 4	$ 9	$ 11

In September 2006, the FASB issued FASB Statement No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. See Note 19 for further details on this guidance.

Contributions

Our 2006 pension contribution of $46.5 million has been made for the year. The contribution to our other postretirement benefit plan in 2006 is estimated to be approximately $29 million. APS and other subsidiaries fund their shares of contributions. APS share is approximately 97% of both plans.

7. Business Segments

We have three principal business segments (determined by products, services and the regulatory environment):

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;

our real estate segment, which consists of SunCor s real estate development and investment activities; and

our marketing and trading segment, which consists of our competitive energy business activities, including wholesale marketing and trading and APS Energy Services commodity-related energy services.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Financial data for the three months and nine months ended September 30, 2006 and 2005 and at September 30, 2006 and December 31, 2005 by business segment is provided as follows (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Operating Revenues:				
Regulated electricity	$ 887	$ 754	$ 2,066	$ 1,749
Real estate	98	79	319	233
Marketing and trading	84	107	259	267
Other	7	16	28	47
Total	$ 1,076	$ 956	$ 2,672	$ 2,296
Net Income (Loss):				
Regulated electricity (a)	$ 170	$ 70	$ 252	$ 152
Real estate	17	21	49	42
Marketing and trading (b)	(4)	8	7	(46)
Other (c)	1	5	1	7
Total	$ 184	$ 104	$ 309	$ 155

(a) 2005 periods include an $87 million after-tax regulatory disallowance of plant costs in accordance with the APS retail rate case settlement relating to its 2003 general rate case.

(b) The nine months ended September 30, 2005 includes a $64 million after-tax loss in discontinued operations related to the sale of Silverhawk.

(c) The three months and nine months ended September 30, 2005 includes a $4 million after-tax gain related to the 2004 sale of NAC.

	As of September 30, 2006	As of December 31, 2005
Assets:		
Regulated electricity	$ 10,281	$ 9,732
Real estate	607	483
Marketing and trading	336	1,070
Other	33	38
Total	$ 11,257	$ 11,323

8. Stock-Based Compensation

Pinnacle West offers stock-based compensation plans for officers and key employees of Pinnacle West and our subsidiaries.

The 2002 Long-Term Incentive Plan (2002 Plan) allows Pinnacle West to grant performance shares, stock ownership incentive awards and non-qualified and performance-accelerated stock options to key employees. We have reserved 6 million shares of common stock for

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

issuance under the 2002 Plan. No more than 1.8 million shares may be issued in relation to performance share awards and stock ownership incentive awards. The plan also provides for the granting of new non-qualified stock options at a price per share not less than the fair market value of the common stock at the time of grant. The stock options vest over three years, unless certain performance criteria are met, which can accelerate the vesting period. The terms of the options cannot be longer than 10 years and the options cannot be repriced.

Generally, each recipient of performance shares is entitled to receive shares of common stock at the end of a three-year period based upon Pinnacle West s earnings per share growth rate during that three-year period compared to the earnings per share growth rate of all relevant companies in a specified utilities index. The number of shares of common stock a recipient is entitled to receive is determined by Pinnacle West s relative percentile ranking during the three-year period.

The 1994 Long-Term Incentive Plan (1994 Plan) includes outstanding options but no new options may be granted under the plan. Options vest one-third of the grant per year beginning one year after the date the option is granted and expire ten years from the date of the grant. The 1994 Plan also provided for the granting of any combination of shares of restricted stock, stock appreciation rights or dividend equivalents.

In the third quarter of 2002, we began applying the fair value method of accounting for stock-based compensation, as provided for in SFAS No. 123, Accounting for Stock-Based Compensation. In accordance with the transition requirements of SFAS No. 123, we applied the fair value method prospectively, beginning with 2002 stock grants. In prior years, we recognized stock compensation expense based on the intrinsic value method allowed in APB No. 25, Accounting for Stock Issued to Employees.

Effective January 1, 2006, we prospectively adopted SFAS No. 123(R), Share-Based Payment. Because the fair value recognition provisions of both SFAS No. 123 and SFAS No. 123(R) are materially consistent with respect to our stock-based compensation plans, the adoption of SFAS No. 123(R) did not have a material impact on our financial statements.

The compensation cost that has been charged against income for stock-based compensation plans was $1.6 million and $3.8 million for the three months and nine months ended September 30, 2006, respectively, compared to $2.1 million and $4.3 million for the three months and nine months ended September 30, 2005, respectively. The total income tax benefit recognized in the condensed consolidated income statement for share-based compensation arrangements was $0.6 million and $1.5 million for the three months and nine months ended September 30, 2006, respectively, compared to $0.8 million and $1.7 million for the three months and nine months ended September 30, 2005, respectively.

The following table is a summary of option activity under our equity incentive plans as of September 30, 2006 and changes during the nine months ended on that date:

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Options	Shares (in thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (dollars in thousands)
Outstanding at January 1, 2006	1,696	$ 39.65		
Exercised	326	35.12		
Forfeited or expired	20	43.23		
Outstanding at September 30, 2006	1,350	40.66	4.2	$ 6,182
Exercisable at September 30, 2006	1,344	40.68	4.2	6,141

There were no options granted during the nine months ended September 30, 2006 and 2005. The intrinsic value of options exercised during the three months ended September 30, 2006 and 2005 was $2.6 million and $2.7 million, respectively. The intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was $2.8 million and $3.8 million, respectively.

The following table is a summary of the status of stock compensation awards, other than options, as of September 30, 2006 and changes during the nine months ended on that date:

Nonvested shares	Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2006	528	$ 38.23
Granted	274	41.50
Vested	(13)	44.13
Forfeited	(228)	36.17
Nonvested at September 30, 2006	561	40.53

As of September 30, 2006, there was $7.0 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the plans. That cost is expected to be recognized over a weighted-average period of 1.7 years. No shares vested during the three months ended September 30, 2006 and 2005. The total fair value of shares vested during the nine months ended September 30, 2006 and 2005 was $0.5 million and $2.9 million, respectively.

Cash received from options exercised under our share-based payment arrangements was $10.5 million and $11.4 million for the three months ended September 30, 2006 and 2005, respectively. Cash received from options exercised under our share-based payment arrangements was $11.5 million and $17.5 million for the nine months ended September 30, 2006 and 2005, respectively. The tax benefit realized for the tax deductions from option exercises of the share-based payment arrangements was $1.0 million and $1.0 million for the three months ended September 30, 2006 and 2005, respectively. The tax benefit realized for the tax deductions from option exercises of the share-based payment arrangements was $1.1 million and $1.5 million for the nine months ended September 30, 2006 and 2005, respectively.

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Pinnacle West has a current policy of issuing new shares to satisfy share requirements for stock-based compensation plans and does not expect to repurchase any shares during 2006.

9. Variable-Interest Entities

In 1986, APS entered into agreements with three separate VIE lessors in order to sell and lease back interests in Palo Verde Unit 2. The leases are accounted for as operating leases in accordance with GAAP. We are not the primary beneficiary of the Palo Verde VIEs and, accordingly, do not consolidate them.

APS is exposed to losses under the Palo Verde sale leaseback agreements upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the NRC issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to assume the debt associated with the transactions, make specified payments to the equity participants, 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 September 30, 2006, APS would have been required to assume approximately $228 million of debt and pay the equity participants approximately $182 million.

10. Derivative and Energy Trading Accounting

We use derivative instruments (primarily forward purchases and sales, swaps, options and futures) to manage our exposure to the commodity price risk inherent in the purchase and sale of fuel, electricity and emission allowances and credits. As of September 30, 2006, we hedged exposures to the price variability of the power and gas commodities for a maximum of 3.25 years. The changes in market value of such contracts have a high correlation to price changes in the hedged transactions. In addition, subject to specified risk parameters monitored by the ERMC, we engage in marketing and trading activities intended to profit from market price movements.

Cash Flow Hedges

The changes in the fair value of our hedged positions included in the Condensed Consolidated Statements of Income, after consideration of amounts deferred under the PSA, for the three and nine months ended September 30, 2006 and 2005 are comprised of the following (dollars in thousands):

Table of Contents

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Gains (losses) on the ineffective portion of derivatives qualifying for hedge accounting	$(2,830)	$4,667	$(5,984)	$12,444
Gains (losses) from the change in options time value excluded from measurement of effectiveness	4	17	(10)	756
Gains from the discontinuance of cash flow hedges			434	385

During the next twelve months ending September 30, 2007, we estimate that a net gain of $40 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. To the extent the amounts are eligible for inclusion in the PSA, the amounts will be recorded as either a regulatory asset or liability and have no effect on earnings (see Note 5).

Our assets and liabilities from risk management and trading activities are presented in two categories, consistent with our business segments.

The following table summarizes our assets and liabilities from risk management and trading activities at September 30, 2006 and December 31, 2005 (dollars in thousands):

September 30, 2006

	Current	Investments	Deferred