ARIZONA PUBLIC SERVICE CO
Form 10-K
February 27, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2007

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	Registrants; State of Incorporation; Addresses; 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

Securities registered pursuant to Section 12(b) of the Act:

	Title Of Each Class	Name Of Each Exchange On Which Registered
PINNACLE WEST CAPITAL CORPORATION	Common Stock, No Par Value	New York Stock Exchange
ARIZONA PUBLIC SERVICE COMPANY	None	None

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

PINNACLE WEST CAPITAL CORPORATION Yes þ No o

ARIZONA PUBLIC SERVICE COMPANY Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

PINNACLE WEST CAPITAL CORPORATION Yes o No þ

ARIZONA PUBLIC SERVICE COMPANY Yes o No þ

Indicate by check mark whether the 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or in any amendment to this Form 10-K. þ

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

PINNACLE WEST CAPITAL CORPORATION

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

ARIZONA PUBLIC SERVICE COMPANY

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether each registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No þ

State the aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of each registrant s most recently completed second fiscal quarter:

PINNACLE WEST CAPITAL CORPORATION	$3,979,906,800 as of June 30, 2007
ARIZONA PUBLIC SERVICE COMPANY	$0 as of June 30, 2007

The number of shares outstanding of each registrant s common stock as of February 21, 2008

PINNACLE WEST CAPITAL CORPORATION	100,499,104 shares
ARIZONA PUBLIC SERVICE COMPANY	Common Stock, $2.50 par value, 71,264,947 shares. Pinnacle West Capital Corporation is the sole holder of Arizona Public Service Company s Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Pinnacle West Capital Corporation s definitive Proxy Statement relating to its Annual Meeting of Shareholders to be held on May 21, 2008 are incorporated by reference into Part III hereof.

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

This combined Form 10-K 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-K 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.

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GLOSSARY

ACC Arizona Corporation Commission
ADEQ Arizona Department of Environmental Quality
AFUDC Allowance for Funds Used During Construction
ALJ Administrative Law Judge
ANPP Arizona Nuclear Power Project, also known as Palo Verde
APS Arizona Public Service Company, a subsidiary of the Company
APSES APS Energy Services Company, Inc., a subsidiary of the Company
Base Fuel Rate the portion of APS retail base rates attributable to fuel and purchased power costs
Cholla Cholla Power Plant
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
FIN FASB Interpretation Number
FIP Federal Implementation Plan
Fitch Fitch, Inc.
Four Corners Four Corners Power Plant
GAAP accounting principles generally accepted in the United States of America
IRS United States Internal Revenue Service
kW kilowatt, one thousand watts
kWh kilowatt-hour, one thousand watts per hour
Moody s Moody s Investors Service
MW megawatt, one million watts
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
Note a Note to Pinnacle West s Consolidated Financial Statements in Item 8 of this report

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NPC Nevada Power Company
NRC United States Nuclear Regulatory Commission
OCI other comprehensive income
Off-System Sales sales of electricity from generation owned or contracted 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 (PWEC) Pinnacle West Energy Corporation, a subsidiary of the Company, dissolved as of August 31, 2006
Pinnacle West Marketing & Trading Pinnacle West Marketing & Trading Co., LLC, a subsidiary of the Company
PRP potentially responsible parties under Superfund
PSA power supply adjustor approved by the ACC to provide for recovery or refund of variations in actual fuel and purchased power costs compared with the Base Fuel Rate
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
Standard & Poor s Standard & Poor s Corporation
SunCor SunCor Development Company, a subsidiary of the Company
Sundance Plant 420 megawatt generating facility located approximately 55 miles southeast of Phoenix, Arizona
Superfund Comprehensive Environmental Response, Compensation and Liability Act
2005 Deferrals PSA deferrals related to 2005 replacement power costs associated with Palo Verde outages
2006 Deferrals PSA deferrals related to 2006 replacement power costs associated with outages or reduced power operations at Palo Verde
VIE variable-interest entity
West Phoenix West Phoenix Power Plant

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INTRODUCTION

Filing Format

This Annual Report on Form 10-K is a combined report being filed by two separate registrants: Pinnacle West and APS. The information required with respect to each company is set forth within the applicable items.

The Management s Discussion and Analysis of Financial Condition and Results of Operations included under Item 7 of this report is divided into the following two sections:

Pinnacle West Consolidated This section describes the financial condition and results of operations of Pinnacle West and its subsidiaries on a consolidated basis. It includes discussions of Pinnacle West s regulated utility and non-utility operations. A substantial part of Pinnacle West s revenues and earnings is derived from its regulated utility, APS.

APS This section includes a detailed description of the results of operations and contractual obligations of APS.

Item 8 of this report includes Consolidated Financial Statements of Pinnacle West and Financial Statements of APS. Item 8 also includes Notes to Pinnacle West s Consolidated Financial Statements, the majority of which also relates to APS, and Supplemental Notes to APS Financial Statements.

PART I
ITEM 1. BUSINESS
OVERVIEW

General

Pinnacle West was incorporated in 1985 under the laws of the State of Arizona and owns all of the outstanding equity securities of APS, its major subsidiary. 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.

Pinnacle West s other principal subsidiary is SunCor, which is engaged in real estate development activities in the western United States. See Business of SunCor Development Company in this Item 1. Pinnacle West s other first-tier subsidiaries, APSES, El Dorado and Pinnacle West Marketing & Trading are discussed in Business of Other Subsidiaries in this Item 1.

Pinnacle West Energy, which owned and operated unregulated generating plants, transferred the PWEC Dedicated Assets to APS on July 29, 2005 and sold its 75% ownership interest in Silverhawk to NPC on January 10, 2006. As a result, Pinnacle West Energy no longer owned any generating plants and was dissolved as of August 31, 2006.

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Business Segments

Pinnacle West has two principal business segments (determined by products, services and the regulatory environment):

- the regulated electricity segment (accounting for 83% of operating revenues in 2007), which consists of traditional regulated retail and wholesale electricity businesses (primarily electric service to Native Load customers) and related activities, and includes electricity generation, transmission and distribution; and

- the real estate segment (accounting for 6% of operating revenues in 2007), which consists of SunCor s real estate development and investment activities.

See Note 17 for financial information about the business segments.

APS ACC Proceedings

The key issue affecting Pinnacle West s and APS financial outlook is adequate and timely retail rate treatment by the ACC. Note 3 discusses the results of APS most recent retail rate case as well as other rate matters.

Employees

At December 31, 2007, Pinnacle West employed approximately 7,600 people, including the employees of its subsidiaries. Of these employees, approximately 6,800 were employees of APS, including employees at jointly-owned generating facilities (approximately 3,000 employees) for which APS serves as the generating facility manager. Approximately 800 people were employed by Pinnacle West and its other subsidiaries. Pinnacle West s principal executive offices are located at 400 North Fifth Street, Phoenix, Arizona 85004 (telephone 602-250-1000).

Available Information

Pinnacle West makes available free of charge on or through its internet site, (*www.pinnaclewest.com*) the following filings as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC: its Annual Report on Form 10-K, its Quarterly Reports on Form 10-Q, its Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934.

Pinnacle West also has a Corporate Governance webpage. You can access Pinnacle West s Corporate Governance webpage through its internet site, *www.pinnaclewest.com,* by clicking on the About Us link to the heading Corporate Commitments. Pinnacle West posts the following on its Corporate Governance webpage:

- Corporate Governance Guidelines;

- Board Committee Summary;

- Charters for Pinnacle West s Audit Committee, Corporate Governance Committee, Finance, Nuclear and Operating Committee and Human Resources Committee;

- Code of Ethics for Financial Professionals;

- Ethics Policy and Standards of Business Practices;
- Director Independence Standards;
- Executive Officer Stock Ownership Guidelines; and
- Restricted Stock Retention Policy.

Pinnacle West will post any amendments to the Code of Ethics and Ethics Policy and Standards of Business Practices, and any waivers that are required to be disclosed by the rules of either the SEC or the New York Stock Exchange, on its internet site. The information on Pinnacle West s internet site is not incorporated by reference into this report.

You can request a copy of these documents, excluding exhibits, by contacting Pinnacle West at the following address: Pinnacle West Capital Corporation, Office of the Secretary, Station 9068, P.O. Box 53999, Phoenix, Arizona 85072-3999 (telephone 602-250-3252).

Forward-Looking Statements

This document contains forward-looking statements based on current expectations, and neither Pinnacle West nor APS assumes any obligation to update these statements or make any further statements on any of these issues, except as required by applicable law. These forward-looking statements are often identified by words such as estimate, predict, hope, may, believe, anticipate, plan, expect, require, intend, assume and similar words. B 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 results or outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Item 1A of this report, these factors include, but are not limited to:

- state and federal regulatory and legislative decisions and actions, particularly those affecting our rates and our recovery of fuel and purchased power costs;
- the outcome of regulatory, legislative and judicial proceedings, both current and future, relating to the restructuring of the electric industry and environmental matters (including those related to climate change);
- the ongoing restructuring of the electric industry, including decisions impacting wholesale competition and the introduction of retail electric competition in Arizona;
- market prices for electricity and natural gas;
- volatile market liquidity, any deteriorating counterparty credit and the use of derivative contracts in our business (including the interpretation of the subjective and complex accounting rules related to these contracts);
- power plant performance and outages;
- transmission outages and constraints;
- weather variations affecting local and regional customer energy usage;
- customer growth and energy usage;
- regional economic and market conditions, including the results of litigation and other proceedings resulting from the California and Pacific Northwest energy situations, volatile fuel and purchased power costs and the completion of generation and transmission construction in the region, which could affect customer growth and

the cost of power supplies;

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the cost of debt and equity capital and access to capital markets;

current credit ratings remaining in effect for any given period of time;

our ability to compete successfully outside traditional regulated markets (including the wholesale market);

changes in accounting principles generally accepted in the United States of America and the interpretation of those principles;

the performance of the stock market and the changing interest rate environment, which affect the value of our nuclear decommissioning trust, pension, and other postretirement benefit plan assets, the amount of required contributions to Pinnacle West s pension plan and contributions to APS nuclear decommissioning trust funds, as well as the reported costs of providing pension and other postretirement benefits;

technological developments in the electric industry;

the strength of the real estate market in SunCor s market areas, which include Arizona, Idaho, New Mexico and Utah; and

other uncertainties, all of which are difficult to predict and many of which are beyond the control of Pinnacle West and APS.

REGULATION AND COMPETITION

Retail

The ACC regulates APS retail electric rates and its issuance of securities. The ACC must also approve any transfer or encumbrance of APS property used to provide retail electric service and approve or receive prior notification of certain transactions between Pinnacle West, APS and their respective affiliates.

APS is subject to varying degrees of competition from other investor-owned utilities in Arizona (such as Southwest Gas Corporation), as well as cooperatives, municipalities, electrical districts and similar types of governmental or non-profit organizations. In addition, some customers, particularly industrial and large commercial customers, may own and operate generation facilities to meet their own energy requirements.

In 1999, the ACC approved rules for the introduction of retail electric competition in Arizona. As a result, as of January 1, 2001, all of APS retail customers were eligible to choose alternate energy suppliers. However, there are currently no active retail competitors offering unbundled energy or other utility services to APS customers. In 2000, an Arizona Superior Court found that the rules were in part unconstitutional and in other respects unlawful, the latter finding being primarily on procedural grounds, and invalidated all ACC orders authorizing competitive electric services providers to operate in Arizona. In 2004, the Arizona Court of Appeals invalidated some, but not all of the rules and upheld the invalidation of the orders authorizing competitive electric service providers. In 2005, the Arizona Supreme Court declined to review the Court of Appeals decision. To date, the ACC has taken no action on either the rules or the prior orders authorizing competitive electric service providers in response to the final Court of Appeals decision. As a result, at present only limited electric retail competition exists in Arizona and only with certain entities not regulated by the ACC. However, the ACC has scheduled a hearing during the first quarter of 2008 to consider the new application of a competitive electric service provider for authority to provide competitive electric services. Certain intervenors in that proceeding have requested the ACC to dismiss the application because of, among other reasons, the legal uncertainties

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associated with the rules, as described above. The ACC has taken this motion to dismiss under advisement. APS cannot predict when, and the extent to which, additional competitors will re-enter APS service territory.

Wholesale

General

The FERC regulates rates for wholesale power sales and transmission services. See Rate Requests for Transmission and Ancillary Services in Note 3 for information regarding APS pending rate case at the FERC. During 2007, approximately 4.4% of APS electric operating revenues resulted from such sales and services. APS wholesale activity primarily consists of managing fuel and purchased power risks in connection with the costs of serving retail customer energy requirements. APS also sells, in the wholesale market, its generation output that is not needed for APS Native Load and, in doing so, competes with other utilities, power marketers and independent power producers. Additionally, subject to specified parameters, APS markets, hedges and trades principally in electricity and fuels.

BUSINESS OF ARIZONA PUBLIC SERVICE COMPANY

General

APS was incorporated in 1920 under the laws of the state of Arizona and currently has approximately 1.1 million customers. APS does not distribute any products. During 2007, no single purchaser or user of energy accounted for more than 5.8% of electric revenues. See Overview and Regulation and Competition above for additional background information about APS.

At December 31, 2007, APS employed approximately 6,800 people, including employees at jointly-owned generating facilities for which APS serves as the generating facility manager. APS principal executive offices are located at 400 North Fifth Street, P.O. Box 53999, Phoenix, Arizona 85072-3999 (telephone 602-250-1000).

Portfolio Resources

APS sources of energy during 2007 were: coal 36.8%; purchased power 23.3%; nuclear 21.5%; and gas 18.4%. In accordance with GAAP, a substantial portion of APS purchased power expense is netted against wholesale sales on the Consolidated Statements of Income. See Note 18. The disclosure below provides a more detailed description of each of APS current sources of energy.

Generation Facilities

APS portfolio of owned or leased generating capacity is provided in the table below:

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	Capacity (kW)
Coal:	
Units 1, 2 and 3 at Four Corners	560,000
15% owned Units 4 and 5 at Four Corners	225,000
Units 1, 2 and 3 at Cholla	641,000
14% owned Units 1, 2 and 3 at the Navajo Generating Station	315,000
Subtotal	1,741,000
Gas or Oil:	
Two steam units at Ocotillo and two steam units at Saguaro	430,000
Twenty-two combustion turbine units	992,000
Seven combined cycle units	1,862,000
Subtotal	3,284,000
Nuclear:	
29.1% owned or leased Units 1, 2 and 3 at Palo Verde	1,126,752[1]
Solar	5,817
Total	6,157,569

[1] As of January 26, 2008, nuclear capacity increased to 1,147,122 kW, reflecting completion of the steam generator replacement program.

Coal Fueled Generating Facilities

Four Corners Four Corners is a coal-fired power plant located in the northwestern corner of New Mexico. APS operates the plant and owns 100% of Four Corners Units 1, 2 and 3 and 15% of Units 4 and 5. APS purchases all of Four Corners coal requirements from a supplier with a long-term lease of coal reserves with the Navajo Nation. The Four Corners coal contract runs through 2016, with options on APS part to extend the contract for five to fifteen additional years. The Four Corners plant site is leased from the Navajo Nation and is also subject to an easement from the federal government. See Plant and Transmission Line Leases and Easements on Indian Lands below for additional information.

Cholla Cholla is a coal-fired power plant located in northeastern Arizona. APS operates the plant and owns 100% of Cholla Units 1, 2 and 3. PacifiCorp owns Cholla Unit 4 and APS operates that unit for PacifiCorp. Cholla s common facilities are jointly owned by APS and PacifiCorp. APS purchases most of Cholla s coal requirements from coal suppliers that mine all of the coal under long-term leases of coal reserves with the Navajo Nation, the federal government and private landholders. There are currently two coal contracts in place with two separate suppliers for Cholla. One supplier is ramping down its supply to the plant, which will be complete in 2009, and the other is ramping up its supply to the plant to provide Cholla s full coal requirement by 2010. This agreement runs through 2024. Additionally, APS may purchase a portion of Cholla s coal requirements on the spot market to take advantage of competitive pricing options and to supplement coal required for increased operating capacity. APS believes that the current fuel contracts and

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competitive fuel supply options ensure the continued operation of Cholla for its useful life. In addition, APS has a long-term coal transportation contract.

Navajo Generating Station The Navajo Generating Station is a coal-fired power plant located in northern Arizona. Salt River Project operates the plant and APS owns a 14% interest in Navajo Units 1, 2 and 3. The Navajo Generating Station s coal requirements are purchased from a supplier with long-term leases from the Navajo Nation and the Hopi Tribe. The Navajo Generating Station is under contract with its coal supplier through 2011, with options to extend through 2019. The Navajo Generating Station plant site is leased from the Navajo Nation and is also subject to an easement from the federal government. See Plant and Transmission Line Leases and Easements on Indian Lands below for additional information.

See Legal Proceedings in Item 3 for information about a lawsuit relating to royalties for coal paid by the participants at the Navajo Generating Station.

See Note 11 for information regarding APS coal mine reclamation obligations.

Natural Gas Fueled Generating Facilities

APS has seven natural gas power plants located throughout Arizona, consisting of Redhawk, located near the Palo Verde Nuclear Generating Station; Ocotillo, located in Tempe; Sundance, located in Coolidge; West Phoenix, located in southwest Phoenix; Saguaro, located north of Tucson; Douglas, located in the town of Douglas; and Yucca, located near Yuma. APS owns and operates each plant with the exception of one combustion turbine unit and one steam unit at Yucca that are operated by APS and owned by the Imperial Irrigation District.

Nuclear Generating Facility

Palo Verde Nuclear Generating Station Palo Verde is a nuclear power plant located about 50 miles west of Phoenix, Arizona. APS operates the plant and owns 29.1% of Palo Verde Units 1 and 3 and about 17% of Unit 2. In addition, APS leases about 12.1% of Unit 2, resulting in a 29.1% combined interest in that Unit. See Palo Verde Leases below for additional information regarding the Palo Verde Unit 2 sale leaseback transactions.

Palo Verde Fuel Cycle The fuel cycle for Palo Verde is comprised of the following stages:

- mining and milling of uranium ore to produce uranium concentrates;
- conversion of uranium concentrates to uranium hexafluoride;
- enrichment of uranium hexafluoride;
- fabrication of fuel assemblies;
- utilization of fuel assemblies in reactors; and
- storage and disposal of spent nuclear fuel.

The Palo Verde participants are continually identifying their future resource needs and negotiating arrangements to fill those needs. The Palo Verde participants have contracted for all of Palo Verde s requirements for uranium concentrates and conversion services through 2008 and for approximately 50% of uranium concentrates and conversion services in 2009. The participants have

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also contracted for all of Palo Verde s enrichment services through 2013 and all of Palo Verde s fuel assembly fabrication services until at least 2015.

Spent Nuclear Fuel and Waste Disposal See Palo Verde Nuclear Generating Station in Note 11 for a discussion of spent nuclear fuel and waste disposal.

Palo Verde Leases In 1986, APS sold about 42% of its share of Palo Verde Unit 2 and certain common facilities in three separate sale leaseback transactions. APS accounts for these leases as operating leases. The leases, which have terms of 29.5 years, contain options to renew the leases and to purchase the property for fair market value at the end of the lease terms. See Notes 9 and 20 for additional information regarding the Palo Verde Unit 2 sale leaseback transactions.

Regulatory Operation of each of the three Palo Verde units requires an operating license from the NRC. The NRC issued full power operating licenses for Unit 1 in June 1985, Unit 2 in April 1986 and Unit 3 in November 1987. The full power operating licenses, each valid for a period of approximately 40 years, authorize APS, as operating agent for Palo Verde, to operate the three Palo Verde units at full power.

NRC Inspection In October 2006, the NRC conducted an inspection of the Palo Verde emergency diesel generators after a Palo Verde Unit 3 generator started, but did not provide electrical output during routine inspections on July 25 and September 22, 2006. On February 22, 2007, the NRC issued a white finding (low to moderate safety significance) for this matter. Under the NRC s Action Matrix, this finding, coupled with a previous NRC yellow finding relating to a 2004 matter involving Palo Verde s safety injection systems, resulted in Palo Verde Unit 3 being placed in the multiple/repetitive degraded cornerstone column of the NRC s Action Matrix (Column 4), which has resulted in an enhanced NRC inspection regime. Although only Palo Verde Unit 3 is in NRC s Column 4, in order to adequately assess the need for improvements, APS management has been conducting site-wide assessments of equipment and operations.

Preliminary work in support of the NRC s enhanced inspection regime took place throughout the summer of 2007. On June 21, 2007, the NRC issued an initial confirmatory action letter confirming APS commitments regarding specific actions APS will take to improve Palo Verde s performance. From October 1, 2007 through November 2, 2007, a team of NRC inspectors performed on-site in-depth inspections of Palo Verde s equipment and operations. The NRC s inspection results were presented at a public meeting on December 19, 2007, and documented in an NRC letter to APS dated February 1, 2008 (the Inspection Report). The Inspection Report indicated that the facility is being operated safely, but also identified certain performance deficiencies. On December 31, 2007, APS submitted its improvement plan to the NRC, which addresses issues identified by APS management during its site-wide assessments of equipment and operations that occurred during 2007. The NRC reviewed the adequacy of this improvement plan and issued a revised confirmatory action letter on February 15, 2008 that outlines the actions APS must take in order for the NRC to return the Palo Verde site to the NRC s routine inspection and assessment process. This revised confirmatory action letter was anticipated as part of the NRC s inspection procedure and a substantial majority of the actions required therein were contained in APS improvement plan. In March 2008, APS intends to submit to the NRC a revision to its improvement plan to address issues raised by the NRC in its Inspection Report. The NRC will continue to provide increased oversight at Palo Verde until the facility demonstrates sustained performance improvement. APS will continue cooperating fully with the NRC throughout this process.

Nuclear Decommissioning Costs The NRC rules on financial assurance requirements for the decommissioning of nuclear power plants provide that a licensee may use a trust as the exclusive financial assurance mechanism if the licensee recovers estimated total decommissioning costs through cost-of-service rates or through a non-bypassable charge. The non-bypassable systems benefits charge is the charge that the ACC has approved for APS recovery of certain types of costs, including costs for low income programs, demand side management, consumer education, environmental, renewables, etc. Non-bypassable means that if a customer chooses to take energy from an energy service provider other than APS, the customer will still have to pay this charge as part of the customer s APS electric bill.

Other mechanisms are prescribed, including prepayment, if the requirements for exclusive reliance on an external sinking fund mechanism are not met. APS currently relies on an external sinking fund mechanism to meet the NRC financial assurance requirements for its interests in Palo Verde Units 1, 2 and 3. The decommissioning costs of Palo Verde Units 1, 2 and 3 are currently included in APS ACC jurisdictional rates. Decommissioning costs are recoverable through a non-bypassable system benefits charge, which allows APS to maintain its external sinking fund mechanism. See Note 12 for additional information about APS nuclear decommissioning costs.

Palo Verde Liability and Insurance Matters See Palo Verde Nuclear Generating Station in Note 11 for a discussion of the insurance maintained by the Palo Verde participants, including APS, for Palo Verde.

Alternative Generation Sources

In connection with its ongoing resource planning efforts, APS continues to focus on increasing the percentage of its energy that is produced by renewable resources. On November 1, 2006, the ACC approved the Arizona Renewable Energy Standard and Tariff (the Renewable Energy Standard). Under the Renewable Energy Standard, covered utilities like APS must supply an increasing percentage of their retail electric energy sales from renewable resources, including solar, wind, biomass, biogas and geothermal technologies. The renewable energy requirement increases from 1.5% in 2007 to 15% in 2025. In addition, an increasing percentage of that requirement must be supplied from distributed resources (generally speaking, small-scale renewable technologies that are located on customers properties) to increase system reliability. The distributed resource requirement increases from 5% of the overall renewable energy requirement in 2007 to 30% in 2012 and subsequent years. APS currently has a diverse portfolio of renewable resources including wind from New Mexico, geothermal from California and Utah, and solar and biomass in Arizona, which collectively will generate over 120 MW of renewable energy for our customers.

On February 8, 2008, APS entered into a Renewable Energy Purchase and Sale Agreement under which APS agreed to purchase the energy and related renewable energy credits from a solar power plant for a period of thirty years after the plant begins commercial operation. The plant, which will have a nameplate rating of 280 MW and a projected annual output of 900,000 MWh, will be located near Gila Bend, Arizona, about 70 miles southwest of Phoenix, Arizona. The agreement is subject to various conditions, including ACC approval. If these conditions are met, commercial operation is expected during 2011.

APS continues to actively consider opportunities to enhance its renewable energy portfolio, both to ensure its compliance with the Renewable Energy Standard and to meet the needs of its customer base.

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Purchased Power Agreements

In addition to its own available generating capacity, APS purchases electricity under various arrangements. APS purchased power capacity under long-term contracts, as of December 31, 2007, is summarized in the table below, and does not include the recently-executed solar agreement described under Alternative Generation Sources. APS also purchases power through short-term markets to supplement its long-term resources and hedge its energy requirements.

Purchased Power Agreement	Dates Available	Capacity (MW)
Purchase Agreement (a)	Year-round through June 15, 2010	234
Exchange Agreement (b)	May 15 to September 15 annually through 2020	480
Tolling Agreement	June 2007 through May 2017	510
Tolling Agreement	June 2010 through October 2019	560
Day-Ahead Call Option Agreement	June 2007 through September 2015 (summer seasons)	500
Day-Ahead Call Option Agreement	June 2007 through summer 2016	150
Wind Agreement	December 2006 through December 2026	90
Geothermal Agreement	January 2006 through 2029	10
Landfill Gas Agreement	Deliveries expected to commence in 2008; expires 2028	3
Biomass Agreement	Deliveries expected to commence in 2008; expires 2022	14

(a) The amount of electricity available to APS under this agreement is based in large part on customer demand and is adjusted annually. Effective June 16, 2007, the seller, Salt River Project, reduced the capacity available to APS by 150 MW. Additionally, Salt River Project has elected to cancel this contract effective June 15, 2010.

(b) This is a seasonal capacity exchange agreement with PacifiCorp. Under this agreement, APS receives electricity from PacifiCorp during the summer peak season (from May 15 to September 15) and APS returns electricity to PacifiCorp during the winter season (from October 15 to February 15). Until 2020, APS and PacifiCorp each has 480 MW of capacity and a related amount of energy available to it under the agreement for its respective seasons. In 2007, APS received 571,342 MWh of energy under the capacity exchange. Additionally, under a supplemental energy sales agreement, APS must also make additional offers of energy to PacifiCorp each year through October 31, 2020. Pursuant to this requirement, during 2007, PacifiCorp received offers of 1,093,175 MWh and purchased 174,340 MWh.

APS continually assesses its need for additional capacity resources to assure system reliability. APS remains committed to seeking proposals from the competitive wholesale market for filling its future resource needs, including renewable resource capacity.

Reserve Margin

APS 2007 peak one-hour demand on its electric system was recorded on August 13, 2007 at 7,545,100 kW, compared with the 2006 peak of 7,652,000 kW recorded on July 21, 2006. Taking into account additional capacity then available to APS under long-term purchased power contracts as well as APS generating capacity, APS had capacity of 6,783,000 kW to meet system demand on August 13, 2007, for an installed reserve margin of negative 11.3%. The power actually available to

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APS from its resources fluctuates from time to time due in part to planned and unplanned plant and transmission outages and technical problems. The available capacity from sources actually operable at the time of the 2007 peak amounted to 5,839,000 kW, for a margin of a negative 33.5%. Firm purchases totaling 3,484,000 kW, including short-term seasonal purchases and unit-contingent purchases, were in place at the time of the peak, ensuring the ability to meet the load requirement with an actual reserve margin of 10.1%.

Transmission and Distribution Facilities

APS transmission facilities consist of approximately 5,759 pole miles of overhead lines and approximately 45 miles of underground lines, 5,535 miles of which are located in Arizona. APS distribution facilities consist of approximately 12,471 miles of overhead lines and approximately 16,210 miles of underground primary cable, all of which are located in Arizona. APS shares ownership of some of its transmission facilities with other companies. The following table shows APS jointly-owned interests in those transmission facilities recorded on the Consolidated Balance Sheets at December 31, 2007:

	Percent Owned (Weighted Average)
Harquahala	80.0%
Palo Verde Estrella 500KV System	55.5%
ANPP500KV System	35.8%
Navajo Southern System	31.4%
Four Corners Switchyards	27.5%
Palo Verde Yuma 500KV System	23.9%
Phoenix Mead System	17.1%

Plant and Transmission Line Leases and Easements on Indian Lands

The Navajo Generating Station and Four Corners are located on land held under leases from the Navajo Nation and also under easements from the federal government. The easement and lease for the Navajo Generating Station expire in 2019 and the easement and lease for Four Corners expire in 2016. Each of the leases contains an option to extend for an additional 25-year period from the end of the existing lease term, for a rental amount tied to the original rent payment adjusted based on an index. The easements do not contain an express renewal option and it is unclear what conditions to renewal or extension of the easements may be imposed. The ultimate cost of renewal of the Navajo Generating Station and Four Corners leases and easements is uncertain. As noted above under Portfolio Resources Coal Fueled Generating Facilities, the coal contracted for use in these plants is also located on Indian reservations.

Certain portions of the transmission lines that carry power from several of our power plants are located on Indian lands pursuant to easements or other rights-of-way that are effective for specified periods. Some of these rights-of-way have expired and our renewal applications have not yet been acted upon by the appropriate Indian tribes. Other rights expire at various times in the future and will have to be acted on for renewal by the applicable tribe at that time. The majority of our transmission lines residing on Indian lands are on the Navajo Nation. The Four Corners and Navajo Generating Station plant leases provide Navajo Nation consent to certain of the rights-of-way for transmission lines related to those plants at a specified rental rate for the original term of the rights-of-way and for a like payment in any renewal period. In addition, a 1985 amendment to the leases provides a formula for calculating payments for certain new and renewal rights-of-way. However, some of our rights-of-way are not covered by the leases, or are granted by other Indian tribes. In recent negotiations with other utilities or companies for renewal of similar rights-of-way, certain of the affected Indian tribes have required payments substantially in excess of amounts that we have paid in the past for such rights-of-way or that are typical for similar permits across non-Indian lands; however, we are unaware of the underlying agreements and/or specific circumstances surrounding these renewals. The ultimate cost of renewal of the rights-of-way for our transmission lines is uncertain. We are monitoring these rights-of-way and easement issues and are currently unable to predict the outcome of this matter.

Construction Program

During the years 2005 through 2007, APS incurred approximately $2.4 billion in capital expenditures. APS capital expenditures for the years 2008 through 2010 are expected to be primarily for expanding transmission and distribution capabilities to meet growing customer needs, for upgrading existing utility property and for environmental purposes. APS capital expenditures were approximately $900 million in 2007. APS capital expenditures, including expenditures for environmental control facilities, for the years 2008 through 2010, have been estimated as follows (dollars in millions):

		Estimate	
	2008	2009	2010
Major facilities:			
Distribution	$ 410	$ 440	$ 430
Generation	380	390	380
Transmission	220	320	290
Other	50	40	50
Total	$ 1,060	$ 1,190	$ 1,150

The above amounts do not include any impacts from the recent changes in the line extension policy (see Note 3). In addition, the amounts exclude capitalized interest costs and include capitalized property taxes. Nuclear fuel expenditures of approximately $90 million to $120 million per year are also included. As part of our planning and cost control process, APS conducts a continuing review of its construction program.

See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in Item 7 for additional information about APS construction program.

Environmental Matters

EPA Environmental Regulation

Regional Haze Rules On April 22, 1999, the EPA announced final regional haze rules. These regulations required states to submit state implementation plans (SIPs) by December 2007 to demonstrate reasonable progress towards achieving natural visibility conditions in certain Class I Areas, including several on the Colorado Plateau. SIPs are required to consider and potentially apply best available retrofit technology (BART) for certain older major stationary sources. The

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rules allow nine western states and Indian tribes to follow an alternate implementation plan and schedule for the Class I Areas. This alternate implementation plan is known as the Annex Rule.

On June 15, 2005, the EPA issued the Clean Air Visibility Rule, which amends the 1999 regional haze rules by providing guidelines, known as the BART guidelines, for states to use in determining which facilities must install controls and the type of controls the facilities must use. The EPA also issued a Revised Annex Rule on October 13, 2006 to address a previous challenge and court remand of that rule.

ADEQ is currently undertaking a rulemaking process to amend its SIP to reconcile it with the Revised Annex Rule and to implement the Clean Air Visibility Rule requirements. ADEQ s Regional Haze SIPs were due to EPA Region 9 in December 2007, but are actually expected to be submitted during 2008. As part of the rulemaking process, ADEQ is requiring certain sources in the state to conduct BART analyses. Cholla and West Phoenix received letters from ADEQ asserting that the plants are potentially subject to BART and requesting that we either perform a BART analysis on each plant or provide information demonstrating that we are not subject to BART. We recently completed a BART analysis for Cholla and submitted our BART recommendations to ADEQ on February 4, 2008. ADEQ will now review our submission and determine what constitutes BART for Cholla. Our recommendations include the installation of certain pollution control equipment that we believe constitutes BART. Once we receive ADEQ s final determination, we will have five years to complete the installation of the equipment and to achieve the emission limits established by ADEQ. However, in order to coordinate with the plant s other scheduled activities, we are currently implementing our recommended plan for Cholla on a voluntary basis. Costs related to the implementation of our recommended plan are included in our environmental expenditure estimates (see Management s Discussion and Analysis of Financial Condition and Results of Operation Capital Expenditures in Item 7).

Because we believed that ADEQ s baseline modeling for West Phoenix may have contained some errors, we re-performed the baseline modeling using correct input and have determined that West Phoenix is not subject to BART. We submitted these findings for West Phoenix to ADEQ, and ADEQ has verbally informed us that West Phoenix is not subject to BART.

In addition, EPA Region 9 requested us to perform a BART analysis for Four Corners. We recently completed the analysis and submitted it to the EPA on January 30, 2008. The EPA will now review our submission and determine what constitutes BART for Four Corners. Our recommendations include the installation of certain pollution control equipment that we believe constitutes BART. Once we receive the EPA s final determination, we will have five years to complete the installation of the equipment and to achieve the emission limits established by EPA Region 9. Until the EPA makes a final determination on this matter, we cannot accurately estimate the expenditures that may be required. As a result, our current environmental expenditure estimates (see Management s Discussion and Analysis of Financial Condition and Results of Operation Capital Expenditures in Item 7) do not include amounts for Four Corners BART expenditures.

While we continue to monitor this matter, at the present time we cannot predict whether the agencies will agree with our BART recommendations or, if the agencies disagree with our recommendations, the nature of the BART controls the agencies may ultimately mandate and the resulting financial or operational impact.

Mercury On March 15, 2005, the EPA issued the Clean Air Mercury Rule (CAMR) to control mercury emissions from coal-fired power plants. This rule establishes performance standards

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limiting mercury emissions from coal-fired power plants and establishes a two phased market-based emissions trading program. Under the trading program, the EPA has assigned each state a mercury emissions budget and each state must submit to the EPA a plan detailing how it will meet its budget. In the first phase of the program, beginning in 2010, mercury emissions from all coal-fired power plants in the country will be reduced from a total of 48 tons per year to 38 tons. In 2018, those emissions will be further reduced to 15 tons.

In November 2006, ADEQ submitted a SIP to the EPA to implement the CAMR. ADEQ s SIP generally incorporates the EPA s model cap-and-trade program, but it includes additional requirements, including the requirement to meet a 90% mercury removal control level or 0.0087 lbs/GWh, whichever is greater, the requirement to obtain mercury allowances at a 2:1 ratio for any emissions that fall below the specified control level, and the requirement, beginning in 2013, to consider clean coal technologies as part of permitting any new generation.

On February 8, 2008, the U.S. Court of Appeals for the D.C. Circuit vacated the CAMR and the EPA rule that allowed for the creation of the CAMR. While we continue to monitor this matter, we cannot predict the timing of the court s issuance of a mandate to vacate the rules, the response of ADEQ or the scope, timing or impact of any alternate rules that may be proposed to address mercury emissions.

We have installed, and may continue to install, certain of the equipment necessary to meet these mercury standards. However, due to the recent U.S. Court of Appeals decision, we will monitor the type and timing of any necessary equipment installation. The estimated costs expected to be incurred over the next three years for such equipment are included in our environmental expenditure estimates (see Management s Discussion and Analysis of Financial Condition and Results of Operation Capital Expenditures in Item 7).

Federal Implementation Plan In September 1999, the EPA proposed FIPs to set air quality standards at certain power plants, including Four Corners and the Navajo Generating Station. On September 12, 2006, the EPA proposed revised FIPs to establish air quality standards at both of these plants.

Four Corners FIP

On April 30, 2007, the EPA adopted a source specific FIP to set air quality standards at Four Corners. The FIP essentially federalizes the requirements contained in the New Mexico State Implementation Plan, which Four Corners has historically followed. The FIP also includes a requirement to maintain and enhance dust suppression methods. On July 2, 2007, APS filed a petition for review in the United States District Court of Appeals for the Tenth Circuit seeking revisions to the FIP to clarify certain requirements and allow operational flexibility. The Sierra Club has intervened in this action. On July 6, 2007, the Sierra Club and other parties filed a petition for review with the same court challenging the FIP s compliance with the Clean Air Act and we have intervened in their action. In our lawsuit, we challenge two key provisions of the FIP: a 20% opacity limit on certain fugitive dust emissions, which the EPA filed a motion to remand and vacate in early December 2007, and a 20% stack opacity limit on Units 4 and 5. Briefing in this case is now complete, and the court is next expected to determine whether to hold oral arguments on the matter, as requested by the EPA. Although we cannot predict the outcome or the timing of these matters, we do not believe that they will have a material adverse impact on our financial position, results of operations or cash flows.

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Navajo Generating Station FIP

The proposed FIP for the Navajo Generating Station is still pending. APS cannot currently predict the effect of this proposed FIP on its financial position, results of operations or cash flows, or whether the proposed FIP will be adopted in its current form.

Superfund 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 PRPs. PRPs may be strictly, and often jointly and severally, liable for clean-up. On September 3, 2003, the EPA advised APS that the EPA considers APS to be a PRP in the Motorola 52nd Street Superfund Site, Operable Unit 3 (OU3) in Phoenix, Arizona. APS has facilities that are within this Superfund site. APS and Pinnacle West have agreed with the EPA to perform certain investigative activities of the APS facilities within OU3. Because the investigation has not yet been completed and ultimate remediation requirements are not yet finalized, at the present time neither APS nor Pinnacle West can accurately estimate the expenditures that may be required.

Manufactured Gas Plant Sites APS is currently investigating properties, which it now owns or which were previously owned by it or its corporate predecessors, that were at one time sites of, or sites associated with, manufactured gas plants. APS is taking action to voluntarily remediate these sites. APS does not expect these matters to have a material adverse effect on its financial position, results of operations, cash flows or liquidity.

Navajo Nation Environmental Issues

Four Corners and the Navajo Generating Station are located on the Navajo Reservation and are held under easements granted by the federal government as well as leases from the Navajo Nation. See Portfolio Resources Coal Fueled Generating Facilities above for additional information regarding these plants.

In July 1995, the Navajo Nation enacted the Navajo Nation Air Pollution Prevention and Control Act, the Navajo Nation Safe Drinking Water Act and the Navajo Nation Pesticide Act (collectively, the Navajo Acts). The Navajo Acts purport to give the Navajo Nation Environmental Protection Agency authority to promulgate regulations covering air quality, drinking water and pesticide activities, including those activities that occur at Four Corners and the Navajo Generating Station. On October 17, 1995, the Four Corners participants and the Navajo Generating Station participants each filed a lawsuit in the District Court of the Navajo Nation, Window Rock District, challenging the applicability of the Navajo Acts as to Four Corners and the Navajo Generating Station. The Court has stayed these proceedings pursuant to a request by the parties, and the parties are seeking to negotiate a settlement.

In April 2000, the Navajo Tribal Council approved operating permit regulations under the Navajo Nation Air Pollution Prevention and Control Act. APS believes the regulations fail to recognize that the Navajo Nation did not intend to assert jurisdiction over Four Corners and the Navajo Generating Station. On July 12, 2000, the Four Corners participants and the Navajo Generating Station participants each filed a petition with the Navajo Supreme Court for review of the operating permit regulations. Those proceedings have been stayed, pending the settlement negotiations mentioned above. APS cannot currently predict the outcome of this matter.

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On May 18, 2005, APS, Salt River Project, as the operating agent for the Navajo Generating Station, and the Navajo Nation executed a Voluntary Compliance Agreement (VCA) to resolve their disputes regarding the Navajo Nation Air Pollution Prevention and Control Act. On March 21, 2006, the EPA determined that the Navajo Nation was eligible for treatment as a state for the purpose of entering into a supplemental delegation agreement with the EPA to administer the Clean Air Act Title V, Part 71 federal permit program over Four Corners and the Navajo Generating Station. The EPA entered into the supplemental delegation agreement with the Navajo Nation on the same day. Because the EPA s approval was consistent with the requirements of the VCA, APS sought dismissal of the pending litigation in the Navajo Nation Supreme Court, as well as the pending litigation in the Navajo Nation District Court to the extent the claims relate to the Clean Air Act, and the Courts have dismissed the claims accordingly. The agreement does not address or resolve any dispute relating to other Navajo Acts. APS cannot currently predict the outcome of this matter.

Climate Change

In 2007, six western states (Arizona, California, New Mexico, Oregon, Utah and Washington) and two Canadian provinces (British Columbia and Manitoba) entered into an accord, the Western Climate Initiative (the Initiative), to reduce greenhouse gas emissions from automobiles and certain industries, including utilities. In August 2007, the Initiative participants set a goal of reducing greenhouse gas emissions 15% below 2005 levels by 2020. By August 2008, the Initiative participants intend to develop a plan for implementation of this goal. Any such implementation would require independent action by each individual state s or province s legislature or Governor to adopt a version of the plan. While we continue to monitor the impact of the Initiative, at the present time we cannot predict what form it will ultimately take, whether it will be implemented or, if it is implemented, what impact it will have on our operations.

We are currently developing a Climate Management Report to comply with an ACC order in which the ACC directed APS to undertake a climate management plan, carbon emission reduction study and commitment and action plan with public input and ACC review. We expect to complete the report in 2008.

In January 2008, APS joined the Climate Registry as a Founding Reporter. Founding Reporters are companies that voluntarily join the non-profit organization before May 2008 to measure and report greenhouse gas emissions in a common, accurate and transparent manner consistent across industry sectors and borders. Pinnacle West also makes available on its website (*www.pinnaclewest.com*) its annual Corporate Responsibility Report, which provides information related to the Company, its approach to sustainability and its workplace and environmental performance. The information on Pinnacle West s website, including the Corporate Responsibility Report, is not incorporated by reference into this report.

Water Supply

Assured supplies of water are important for APS generating plants. At the present time, APS has adequate water to meet its needs. However, conflicting claims to limited amounts of water in the southwestern United States have resulted in numerous court actions.

Both groundwater and surface water in areas important to APS operations have been the subject of inquiries, claims and legal proceedings, which will require a number of years to resolve.

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APS is one of a number of parties in a proceeding, filed March 13, 1975, before the Eleventh Judicial District Court in New Mexico to adjudicate rights to a stream system from which water for Four Corners is derived. An agreement reached with the Navajo Nation in 1985, however, provides that if Four Corners loses a portion of its rights in the adjudication, the Navajo Nation will provide, for an agreed upon cost, sufficient water from its allocation to offset the loss.

A summons served on APS in early 1986 required all water claimants in the Lower Gila River Watershed in Arizona to assert any claims to water on or before January 20, 1987, in an action pending in Maricopa County, Arizona, Superior Court. Palo Verde is located within the geographic area subject to the summons. APS rights and the rights of the other Palo Verde participants to the use of groundwater and effluent at Palo Verde are potentially at issue in this action. As operating agent of Palo Verde, APS filed claims that dispute the court s jurisdiction over the Palo Verde participants groundwater rights and their contractual rights to effluent relating to Palo Verde. Alternatively, APS seeks confirmation of such rights. Five of APS other power plants are also located within the geographic area subject to the summons. APS claims dispute the court s jurisdiction over its groundwater rights with respect to these plants. Alternatively, APS seeks confirmation of such rights. In November 1999, the Arizona Supreme Court issued a decision confirming that certain groundwater rights may be available to the federal government and Indian tribes. In addition, in September 2000, the Arizona Supreme Court issued a decision affirming the lower court s criteria for resolving groundwater claims. Litigation on both of these issues has continued in the trial court. In December 2005, APS and other parties filed a petition with the Arizona Supreme Court requesting interlocutory review of a September 2005 trial court order regarding procedures for determining whether groundwater pumping is affecting surface water rights. The Court denied the petition in May 2007, and the trial court is now proceeding with implementation of its 2005 order. No trial date concerning APS water rights claims has been set in this matter.

APS has also filed claims to water in the Little Colorado River Watershed in Arizona in an action pending in the Apache County, Arizona, Superior Court, which was originally filed on September 5, 1985. APS groundwater resource utilized at Cholla is within the geographic area subject to the adjudication and, therefore, is potentially at issue in the case. APS claims dispute the court s jurisdiction over its groundwater rights. Alternatively, APS seeks confirmation of such rights. A number of parties are in the process of settlement negotiations with respect to certain claims in this matter. Other claims have been identified as ready for litigation in motions filed with the court. No trial date concerning APS water rights claims has been set in this matter.

Although the above matters remain subject to further evaluation, neither APS nor Pinnacle West expects that the described litigation will have a material adverse impact on its financial position, results of operations, cash flows or liquidity.

The Four Corners region, in which Four Corners is located, has been experiencing drought conditions that may affect the water supply for the plants if adequate moisture is not received in the watershed that supplies the area. APS is continuing to work with area stakeholders to implement agreements to minimize the effect, if any, on future operations of the plant. The effect of the drought cannot be fully assessed at this time, and APS cannot predict the ultimate outcome, if any, of the drought or whether the drought will adversely affect the amount of power available, or the price thereof, from Four Corners.

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Federal Energy Legislation

On August 8, 2005, the President signed the Energy Policy Act of 2005 into law. The Act includes a wide range of provisions addressing many aspects of the energy industry. Specifically, with respect to the electric utility industry, the Act includes provisions that, among other things, repeals the Public Utility Holding Company Act of 1935 through enactment of the Public Utility Holding Company Act of 2005, effective as of February 8, 2006, creates incentives for the construction of transmission infrastructure, eliminates the statutory restrictions on ownership of qualifying facilities by electric utilities, establishes civil penalty authority over electric utilities and expands the authority of the FERC to include overseeing the reliability of the bulk power system. While we continue to monitor the impact of this new federal legislation, we cannot predict the impact of this Act on our operations at this time.

BUSINESS OF SUNCOR DEVELOPMENT COMPANY

SunCor was incorporated in 1965 under the laws of Arizona and is a developer of residential, commercial and industrial real estate projects in Arizona, Idaho, New Mexico and Utah. The principal executive offices of SunCor are located at 80 East Rio Salado Parkway, Suite 410, Tempe, Arizona 85281 (telephone 480-317-6800). SunCor and its subsidiaries had approximately 650 employees at December 31, 2007.

At December 31, 2007, SunCor had total assets of about $670 million. SunCor s assets consist primarily of land with improvements, commercial buildings, golf courses and other real estate investments. SunCor intends to continue its focus on real estate development of master-planned communities, and mixed-use residential, commercial, office and industrial projects.

SunCor projects include six master-planned communities and several commercial and residential projects. Four of the master-planned communities and the commercial and residential projects are in Arizona. Other master-planned communities are located in Idaho, New Mexico and Utah.

SunCor s operating revenues were approximately $215 million in 2007, $400 million in 2006 and $338 million in 2005. SunCor s net income was approximately $24 million in 2007, $61 million in 2006 and $56 million in 2005. Certain components of SunCor s real estate sales activities, which are included in the real estate segment, are required to be reported as discontinued operations on Pinnacle West s Consolidated Statements of Income in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. See Note 22.

See Note 6 for information regarding SunCor s long-term debt and Liquidity and Capital Resources in Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 for a discussion of SunCor s capital requirements.

BUSINESS OF OTHER SUBSIDIARIES

APSES was incorporated in 1998 under the laws of Arizona and provides energy-related products and services (such as energy master planning, energy use consultation and facility audits, cogeneration analysis and installation, and project management) and competitive commodity-related energy services (such as direct access commodity contracts, energy procurement and energy supply consultation) to commercial and industrial retail customers in the western United States. Recently, APSES has de-emphasized its commodity-related energy services. APSES had approximately 60

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employees as of December 31, 2007. APSES principal offices are located at 400 East Van Buren Street, Phoenix, Arizona 85004 (telephone 602-250-5000).

APSES had a net loss of $4 million in 2007, a net loss of $3 million in 2006 and a net loss of $6 million in 2005. At December 31, 2007, APSES had total assets of $95 million.

El Dorado was incorporated in 1983 under the laws of Arizona. El Dorado owns minority interests in several energy-related investments and Arizona community-based ventures. El Dorado s short-term goal is to prudently realize the value of its existing investments. On a long-term basis, Pinnacle West may use El Dorado, when appropriate, for investments that are strategic to the business of generating, distributing and marketing electricity. El Dorado s offices are located at 400 North Fifth Street, Phoenix, Arizona 85004 (telephone 602-250-3517).

El Dorado had a net loss of $6 million in 2007, a net loss of $4 million in 2006 and net income of $4 million in 2005. Income taxes related to El Dorado are recorded by Pinnacle West. At December 31, 2007, El Dorado had total assets of $30 million.

Pinnacle West Marketing & Trading began operations in early 2007. These operations were conducted by a division of Pinnacle West through the end of 2006. Pinnacle West Marketing & Trading had a net loss of $11 million in 2007. At December 31, 2007, Pinnacle West Marketing & Trading had total assets of $73 million.

ITEM 1A. RISK FACTORS

In addition to the factors affecting specific business operations identified in connection with the description of these operations contained elsewhere in this report, set forth below are risks and uncertainties that could affect our financial results. Unless otherwise indicated or the context otherwise requires, the following risks and uncertainties apply to Pinnacle West and its subsidiaries, including APS.

APS is subject to comprehensive government regulation by several federal, state and local regulatory agencies that could have a material adverse impact on its business and results of operations.

APS is subject to comprehensive regulation by several federal, state and local regulatory agencies that significantly influence its business and results of operations. The ACC regulates APS retail electric rates and APS issuance of securities. The ACC must also approve any transfer of APS property used to provide retail electric service and approve or receive prior notification of certain transactions between us, APS and our respective affiliates. While approved electric rates are intended to permit APS to recover its costs of service and earn a reasonable rate of return, the profitability of APS is affected by the rates it may charge. Consequently, our financial condition and results of operations are dependent upon the satisfactory resolution of APS retail rate proceedings and ancillary matters which are before or which may come before the ACC.

APS is required to have numerous permits, approvals and certificates from the agencies that regulate APS business. The FERC, the NRC, the EPA, and the ACC regulate many aspects of our utility operations, including siting and construction of facilities, customer service and, as noted in the preceding paragraph, the rates that APS can charge customers. We believe the necessary permits, approvals and certificates have been obtained for APS existing operations and that APS business is conducted in accordance with applicable laws in all material respects. However, changes in regulations or the imposition of additional regulations could have an adverse impact on our results of operations. We are also unable to predict the impact on our business and operating results from pending or future regulatory activities of any of these agencies.

The NRC has broad authority under federal law to impose licensing and safety-related requirements for the operation of nuclear generation facilities. In the event of noncompliance, the NRC has the authority to impose monetary civil penalties or a progressively increased inspection regime that could ultimately result in the shut down of a unit, or both, depending upon the NRC s assessment of the severity of the situation, until compliance is achieved. In early 2007, the NRC placed Palo Verde Unit 3 in the multiple/repetitive degraded cornerstone column of the NRC s Action Matrix (Column 4), which has resulted in an enhanced NRC inspection regime, including on-site in-depth inspections of Palo Verde equipment and operations. Although only Palo Verde Unit 3 is in NRC s Column 4, in order to adequately assess the need for improvements, APS management has been conducting site-wide assessments of equipment and operations. APS continues to cooperate fully with the NRC throughout this process. The enhanced NRC inspection regime and APS ongoing commitment to the conservatively safe operation of Palo Verde could result in NRC action or an APS decision to shut down one or more units in the event of noncompliance with operating requirements or in light of other operational considerations.

APS is subject to numerous environmental laws and regulations that may increase its cost of operations, impact its business plans, or expose it to environmental liabilities.

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, and hazardous waste. These laws and regulations can result in increased capital, operating, and other costs, particularly with regard to enforcement efforts focused on power plant emissions obligations. These laws and regulations generally require APS to obtain and comply with a wide variety of environmental licenses, permits, inspections and other approvals. If there is a delay in obtaining any required environmental regulatory approval, or if APS fails to obtain, maintain or comply with any such approval, operations at affected facilities could be suspended or subject to additional expenses. In addition, failure to comply with applicable environmental laws and regulations could result in civil liability or criminal penalties. Both public officials and private individuals may seek to enforce applicable environmental laws and regulations. We cannot predict the outcome (financial or operational) of any related litigation that may arise.

In addition, we may be a responsible party for environmental clean up at sites identified by a regulatory body. We cannot predict with certainty the amount and timing of all future expenditures related to environmental matters because of the difficulty of estimating clean-up costs. There is also uncertainty in quantifying liabilities under environmental laws that impose joint and several liability on all potentially responsible parties.

We cannot be sure that existing environmental regulations will not be revised or that new regulations seeking to protect the environment will not be adopted or become applicable to us. Revised or additional regulations that result in increased compliance costs or additional operating restrictions, particularly if those costs incurred by APS are not fully recoverable from APS customers, could have a material adverse effect on our financial position, results of operations or cash flows.

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Concern over climate change could result in significant legislative and regulatory efforts to limit greenhouse gas emissions or related litigation, which may increase APS cost of operations.

Concern over climate change, deemed by many to be induced by rising levels of greenhouse gases in the atmosphere, has led to significant legislative and regulatory efforts to limit CO_2, which is a major byproduct of the combustion of fossil fuel, and other greenhouse gas emissions. In addition, lawsuits have been filed against companies that emit greenhouse gasses, including a recent lawsuit filed against us and several other utilities, seeking damages related to climate change. In the past several years, the United States Congress has considered bills that would regulate domestic greenhouse gas emissions, but such bills have not received sufficient Congressional approval to date to become law; however, there is growing consensus that some form of regulation or legislation is likely to occur in the near future at the federal level with respect to greenhouse gas emissions. If the United States Congress, or individual states or groups of states in which we operate, ultimately pass legislation regulating the emissions of greenhouse gases, any resulting limitations on generation facility CO_2 and other greenhouse gas emissions could result in the creation of substantial additional costs in the form of taxes, emissions allowances or required equipment upgrades and could have a material adverse impact on all fossil fuel fired generation facilities (particularly coal fired facilities), including ours.

There are inherent risks in the operation of nuclear facilities, such as environmental, health and financial risks and the risk of terrorist attack.

Through APS, we have an ownership interest in and operate, on behalf of a group of owners, Palo Verde, which is the largest nuclear electric generating facility in the United States. Palo Verde is subject to environmental, health and financial risks such as the ability to dispose of spent nuclear fuel; the ability to maintain adequate reserves for decommissioning; potential liabilities arising out of the operation of these facilities; the costs of securing the facilities against possible terrorist attacks; and unscheduled outages due to equipment and other problems. APS maintains nuclear decommissioning trust funds and external insurance coverage to minimize its financial exposure to some of these risks; however, it is possible that damages could exceed the amount of insurance coverage.

The NRC has broad authority under federal law to impose licensing and safety-related requirements for the operation of nuclear generation facilities. In the event of noncompliance, the NRC has the authority to impose monetary civil penalties or a progressively increased inspection regime, which could ultimately result in the shut down of a unit, or both, depending upon its assessment of the severity of the situation, until compliance is achieved. See the first risk factor above for a discussion of the enhanced NRC inspection regime currently in effect at Palo Verde and the related operational and regulatory implications. In addition, although we have no reason to anticipate a serious nuclear incident at Palo Verde, if an incident did occur, it could materially and adversely affect our results of operations or financial condition. A major incident at a nuclear facility anywhere in the world could cause the NRC to limit or prohibit the operation or licensing of any domestic nuclear unit.

The operation of Palo Verde requires licenses that need to be periodically renewed and/or extended. We do not anticipate any problems renewing these licenses. However, as a result of potential terrorist threats and increased public scrutiny of utilities, the licensing process could result in increased licensing or compliance costs that are difficult or impossible to predict.

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The operation of power generation facilities involves risks that could result in unscheduled power outages or reduced output, which could materially affect our results of operations.

The operation of power generation facilities involves certain risks, including the risk of breakdown or failure of equipment, fuel interruption, and performance below expected levels of output or efficiency. Unscheduled outages, including extensions of scheduled outages due to mechanical failures or other complications occur from time to time and are an inherent risk of our business. If APS facilities operate below expectations, we may lose revenue or incur additional expenses.

Deregulation or restructuring of the electric industry may result in increased competition, which could have a significant adverse impact on our business and our financial results.

In 1999, the ACC approved rules for the introduction of retail electric competition in Arizona. Retail competition could have a significant adverse financial impact on APS due to an impairment of assets, a loss of retail customers, lower profit margins or increased costs of capital. Although some very limited retail competition existed in APS service area in 1999 and 2000, there are currently no active retail competitors offering unbundled energy or other utility services to APS customers. As a result, we cannot predict when, and the extent to which, additional competitors will re-enter APS service territory.

As a result of changes in federal law and regulatory policy, competition in the wholesale electricity market has greatly increased due to a greater participation by traditional electricity suppliers, non-utility generators, independent power producers, and wholesale power marketers and brokers. This increased competition could affect APS load forecasts, plans for power supply and wholesale energy sales and related revenues. As a result of the changing regulatory environment and the relatively low barriers to entry, we expect wholesale competition to increase.

Changes in technology may adversely affect our business.

Research and development activities are ongoing to improve alternative technologies to produce power, including fuel cells, micro turbines, clean coal and coal gasification, photovoltaic (solar) cells and improvements in traditional technologies and equipment, such as more efficient gas turbines. Advances in these, or other technologies could reduce the cost of power production, making APS generating facilities less competitive. In addition, advances in technology could reduce the demand for power supply, which could adversely affect APS business.

Our results of operations can be adversely affected by weather conditions.

Weather conditions directly influence the demand for electricity and affect the price of energy commodities. Electric power demand is generally a seasonal business. In Arizona, demand for power peaks during the hot summer months, with market prices also peaking at that time. As a result, our overall operating results fluctuate substantially on a seasonal basis. In addition, APS has historically sold less power, and consequently earned less income, when weather conditions are milder. As a result, unusually mild weather could diminish our results of operations and harm our financial condition.

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Our cash flow largely depends on the performance of our subsidiaries.

We conduct our operations primarily through subsidiaries. Substantially all of our consolidated assets are held by such subsidiaries. Accordingly, our cash flow is dependent upon the earnings and cash flows of these subsidiaries and their distributions to us. The subsidiaries are separate and distinct legal entities and have no obligation to make distributions to us.

The debt agreements of some of our subsidiaries may restrict their ability to pay dividends, make distributions or otherwise transfer funds to us. An ACC financing order requires APS to maintain a common equity ratio of at least 40% and does not allow APS to pay common dividends if the payment would reduce its common equity below that threshold. The common equity ratio, as defined in the ACC order, is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt.

Our ability to meet our debt service obligations could be adversely affected because our debt securities are structurally subordinated to the debt securities and other obligations of our subsidiaries.

Because we are structured as a holding company, all existing and future debt and other liabilities of our subsidiaries will be effectively senior in right of payment to our debt securities. None of the indentures under which we or our subsidiaries may issue debt securities limits our ability or the ability of our subsidiaries to incur additional debt in the future. The assets and cash flows of our subsidiaries will be available, in the first instance, to service their own debt and other obligations. Our ability to have the benefit of their assets and cash flows, particularly in the case of any insolvency or financial distress affecting our subsidiaries, would arise only through our equity ownership interests in our subsidiaries and only after their creditors have been satisfied.

Financial market disruptions may increase our financing costs or limit our access to the credit markets, which may adversely affect our liquidity and our ability to implement our financial strategy.

We rely on access to short-term money markets, longer-term capital markets and the bank markets as a significant source of liquidity and for capital requirements not satisfied by the cash flow from our operations. We believe that we will maintain sufficient access to these financial markets based upon current credit ratings. However, certain market disruptions may increase our cost of borrowing or adversely affect our ability to access one or more financial markets. Such disruptions could include:

- an economic downturn;
- the bankruptcy of an unrelated energy company;
- increased market prices for electricity and gas;
- terrorist attacks or threatened attacks on our facilities or those of unrelated energy companies;
- changes in technology; or

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the overall health of the utility or real estate industry.

Changes in economic conditions could result in higher interest rates, which would increase our interest expense on our debt and reduce funds available to us for our current plans. Additionally, an increase in our leverage could adversely affect us by:

increasing the cost of future debt financing;

increasing our vulnerability to adverse economic and industry conditions;

requiring us to dedicate a substantial portion of our cash flow from operations to payments on our debt, which would reduce funds available to us for operations, future business opportunities or other purposes; and

placing us at a competitive disadvantage compared with our competitors that have less debt.

Recent sub-prime mortgage issues have adversely affected the overall financial markets, generally resulting in increased interest rates, reduced access to the capital markets, and actual or potential downgrades of bond insurers, among other negative matters. The interest rates on certain issues of APS pollution control bonds are periodically reset through auction processes. These bonds are supported by bond insurance policies provided by Ambac, and the interest rates on those bonds are directly affected by the rating of the bond insurer. Accordingly, interest rates on these bonds have recently increased. We do not expect, however, that any such increase will have a material adverse impact on our financial position, results of operations, cash flows or liquidity.

A reduction in our credit ratings could materially and adversely affect our business, financial condition and results of operations.

We cannot be sure that any of our current ratings will remain in effect for any given period of time or that a rating will not be lowered or withdrawn entirely by a rating agency if, in its judgment, circumstances in the future so warrant. Any downgrade could limit our access to capital and increase our borrowing costs, which would diminish our financial results. We would likely be required to pay a higher interest rate in future financings, and our potential pool of investors and funding sources could decrease. In addition, borrowing costs under certain of our existing credit facilities depend on our credit ratings. A downgrade could also require us to provide additional support in the form of letters of credit or cash or other collateral to various counterparties. If our short-term ratings were to be lowered, it could limit our access to the commercial paper market. We note that the ratings from rating agencies are not recommendations to buy, sell or hold our securities and that each rating should be evaluated independently of any other rating.

The use of derivative contracts in the normal course of our business and changing interest rates and market conditions could result in financial losses that negatively impact our results of operations.

Our operations include managing market risks related to commodity prices and, subject to specified risk parameters, engaging in marketing and trading activities intended to profit from market price movements. We are exposed to the impact of market fluctuations in the price and transportation costs of electricity, natural gas, coal, and emissions allowances. We have established procedures to manage risks associated with these market fluctuations by utilizing various commodity derivatives, including exchange-traded futures and options and over-the-counter forwards, options, and swaps. As part of our overall risk management program, we enter into derivative transactions to hedge purchases and sales of electricity, fuels, and emissions allowances and credits. The changes in market value of such contracts have a high correlation to price changes in the hedged commodity.

We are exposed to losses in the event of nonperformance or nonpayment by counterparties. We use a risk management process to assess and monitor the financial exposure of all counterparties. Despite the fact that the majority of trading counterparties are rated as investment grade by the rating agencies, there is still a possibility that one or more of these companies could default, resulting in a material adverse impact on our earnings for a given period.

Changing interest rates affect interest paid on variable-rate debt and interest earned on variable-rate securities in our pension plan, other postretirement benefit plan and nuclear decommissioning trust funds. Our policy is to manage interest rates through the use of a combination of fixed-rate and floating-rate debt. The pension plan and other postretirement benefit liabilities are also impacted by the discount rate, which is the interest rate used to discount future pension and other postretirement benefit obligations. Declining interest rates impact the discount rate, and may result in increases in pension and other postretirement benefit costs, cash contributions, regulatory assets, and charges to other comprehensive income. The pension plan, other postretirement benefit and nuclear decommissioning trust funds also have risks associated with changing market values of fixed income and equity investments. A significant portion of the pension costs and other postretirement benefit costs and all of the nuclear decommissioning costs are recovered in regulated electricity prices.

The market price of our common stock may be volatile.

The market price of our common stock could be subject to significant fluctuations in response to factors such as the following, some of which are beyond our control:

- variations in our quarterly operating results;
- operating results that vary from the expectations of management, securities analysts and investors;
- changes in expectations as to our future financial performance, including financial estimates by securities analysts and investors;
- developments generally affecting industries in which we operate, particularly the energy distribution and energy generation industries;
- announcements by us or our competitors of significant contracts, acquisitions, joint marketing relationships, joint ventures or capital commitments;
- announcements by third parties of significant claims or proceedings against us;
- favorable or adverse regulatory or legislative developments;
- our dividend policy;

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future sale of equity or equity-linked securities; and

general domestic and international economic conditions.

In addition, the stock market in general has experienced volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations may adversely affect the market price of our common stock.

We may enter into credit and other agreements from time to time that restrict our ability to pay dividends.

Payment of dividends on our common stock may be restricted by credit and other agreements entered into by us from time to time. There are currently no material restrictions on our ability to pay dividends under any such agreement.

SunCor s business and financial performance could be adversely affected by a variety of factors affecting the real estate market.

SunCor s business and financial performance could continue to be adversely affected by a variety of factors affecting the real estate market, including downward changes in general economic, real estate construction or other business conditions; the potential overvaluation of land and new homes, which could result in an economic down cycle for the homebuilding industry; future increases in interest rates, reductions in mortgage availability or increases in the effective costs of owning a home, which could prevent potential customers from buying homes in SunCor s developments; competition for homebuyers or commercial customers or partners, which could reduce SunCor s profitability; supply shortages and other risks related to the demand for skilled labor and building materials, which could increase costs and delay deliveries; government regulations, which could increase the cost and limit the availability of SunCor s development, homebuilding and commercial projects; and inflation, which could result in increased costs that SunCor may not be able to recoup if demand declines.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Neither Pinnacle West nor APS has received written comments regarding its periodic or current reports from the SEC staff that were issued 180 days or more preceding the end of its 2007 fiscal year and that remain unresolved.

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ITEM 2. PROPERTIES

Information Regarding Our Properties

See Business of Arizona Public Service Company Portfolio Resources in Item 1 for the location and a description of our principal properties.

See Business of Arizona Public Service Company Environmental Matters and Water Supply in Item 1 with respect to matters having a possible impact on the operation of certain of APS power plants.

See Business of Arizona Public Service Company Construction Program in Item 1 and Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in Item 7 for a discussion of APS construction program.

Real Estate Segment Properties

See Business of SunCor Development Company in Item 1 for information regarding SunCor s properties. Substantially all of SunCor s debt is collateralized by interests in certain real property.

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ITEM 3. LEGAL PROCEEDINGS

See Business of Arizona Public Service Company Environmental Matters and Water Supply in Item 1 with regard to pending or threatened litigation and other disputes.

See Note 3 with respect to retail rate proceedings before the ACC.

See Note 11 with regard to a lawsuit against APS and the other Navajo Generating Station participants and for information relating to the FERC proceedings on California energy market issues.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

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SUPPLEMENTAL ITEM.
EXECUTIVE OFFICERS OF PINNACLE WEST

Pinnacle West s executive officers are as follows:

Name	Age at February 27, 2008	Position(s) at February 27, 2008
William J. Post	57	Chairman of the Board and Chief Executive Officer (1)
Jack E. Davis	61	President and Chief Operating Officer, and Chief Executive Officer, APS (1)
Donald E. Brandt	53	Executive Vice President and Chief Financial Officer, and President and Chief Financial Officer of APS
Jan H. Bennett	60	Senior Vice President, Energy Delivery, APS
John R. Denman	65	Senior Vice President, Fossil Operations, APS
Randall K. Edington	54	Executive Vice President and Chief Nuclear Officer, APS
Armando B. Flores	64	Executive Vice President, Corporate Business Services, APS
Chris N. Froggatt	50	Vice President and Controller, APS
Barbara M. Gomez	53	Vice President and Treasurer
Nancy C. Loftin	54	Senior Vice President, General Counsel and Secretary
Donald G. Robinson	54	Senior Vice President, Planning and Administration, APS
Lori S. Sundberg	44	Vice President, Human Resources, APS
Steven M. Wheeler	59	Executive Vice President, Customer Service and Regulation, APS

(1) Member of the Board of Directors.

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The executive officers of Pinnacle West are elected no less often than annually and may be removed by the Board of Directors at any time. The terms served by the named officers in their current positions and their principal occupations (in addition to those stated in the table) of such officers for the past five years have been as follows:

Mr. Post was elected Chairman of the Board effective February 2001, and Chief Executive Officer effective February 1999. He has served as an officer of Pinnacle West since 1995 in the following capacities: from August 1999 to February 2001 as President; from February 1997 to February 1999 as President; and from June 1995 to February 1997 as Executive Vice President. Mr. Post is also Chairman of the Board (since February 2001) of APS. He was President of APS from February 1997 until October 1998 and he was Chief Executive Officer from February 1997 until October 2002. Mr. Post is also a director of Phelps Dodge Corporation.

Mr. Davis was elected President effective February 2001 and Chief Operating Officer effective September 2003. Prior to that time, he was Chief Operating Officer and Executive Vice President of Pinnacle West (April 2000 February 2001) and Executive Vice President, Commercial Operations of APS (September 1996 October 1998). Mr. Davis was also President of APS (October 1998 December 2006) and is Chief Executive Officer of APS (since October 2002). Mr. Davis has announced that he will retire effective March 1, 2008. He is also a director of APS.

Mr. Brandt was elected Executive Vice President of Pinnacle West in September 2003. Prior to that time, he was Senior Vice President of Pinnacle West (December 2002 September 2003). He was also elected Chief Financial Officer of Pinnacle West in December 2002. Mr. Brandt was also elected President of APS in December 2006. Prior to that time, he was Executive Vice President of APS (September 2003 December 2006) and Senior Vice President of APS (January 2003 September 2003). He was also elected Chief Financial Officer of APS in January of 2003. Effective March 1, 2008, Mr. Brandt will serve as President and Chief Operating Officer of Pinnacle West, and President and Chief Executive Officer of APS.

Mr. Bennett was elected to his present position effective November 2007. Prior to that time, he was Vice President, Customer Service of APS (May 1991 November 2007).

Mr. Denman was elected to his present position effective November 2007. Prior to that time, he was Vice President, Fossil Generation of APS (April 1997 November 2007).

Mr. Edington was elected to his present position effective November 2007. Prior to that time, he was Senior Vice President and Chief Nuclear Officer of APS (January 2007 November 2007). He was previously with Entergy Corporation, serving as Site Vice President and Chief Nuclear Officer of Cooper Generating Station (2003 January 2007) and Vice President of Operator Training, Indian Point Energy Center (2001 2003).

Mr. Flores was elected to his present position in September 2003. Prior to that time, he was Executive Vice President, Corporate Business Services of Pinnacle West (July 1999 September 2003). He was also Executive Vice President, Corporate Business Services of APS (October 1998 July 1999). Mr. Flores has announced that he will retire effective March 31, 2008.

Mr. Froggatt was elected to his present position in October 2002. Prior to that time, he was Vice President and Controller of Pinnacle West (August 1999 October 2002), Controller of Pinnacle West (July 1999 August 1999) and Controller of APS (July 1997 July 1999).

Ms. Gomez was elected to her present position in February 2004. Prior to that time, she was Treasurer of Pinnacle West (August 1999 February 2004) and Manager, Treasury Operations of APS (1997 1999). She was also elected Treasurer of APS in October 1999 and Vice President of APS in February 2004.

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Ms. Loftin was elected to her present position effective November 2007. Prior to that time, she was Vice President, General Counsel and Secretary of Pinnacle West (October 2002 November 2007) and Vice President and General Counsel (July 1999 October 2002). She was also elected Vice President and General Counsel of APS in July 1999 and Secretary of APS in October 2002.

Mr. Robinson was elected to his present position effective November 2007. Prior to that time, he was Vice President, Planning of APS (September 2003 November 2007), Vice President, Finance and Planning of APS (October 2002 September 2003), Vice President, Regulation and Planning of Pinnacle West (June 2001 October 2002) and Director, Accounting, Regulation and Planning of Pinnacle West (prior to June 2001).

Ms. Sundberg was elected Vice President, Human Resources of APS effective November 2007. Prior to that time, she was with American Express Company, serving as Vice President, Employee Relations, Safety, Compliance & Embrace (January 2007 November 2007), Vice President, HR Relationship Leader, Global Corporate Travel Division (August 2003 January 2007) and Vice President, Global Culture Initiative (January 2003 August 2003).

Mr. Wheeler was elected to his present position in September 2003. Prior to that time, he was Senior Vice President, Regulation, System Planning and Operations of APS (October 2002 September 2003) and Senior Vice President, Transmission, Regulation and Planning of Pinnacle West and APS (June 2001 October 2002).

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PART II
ITEM 5. MARKET FOR REGISTRANTS COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Pinnacle West s common stock is publicly held and is traded on the New York Stock Exchange. At the close of business on February 21, 2008, Pinnacle West s common stock was held of record by approximately 30,177 shareholders.

QUARTERLY STOCK PRICES AND DIVIDENDS PAID PER SHARE STOCK SYMBOL: PNW

2007	High	Low	Close	Dividends Per Share
1st Quarter	$51.67	$46.43	$48.25	$0.525
2nd Quarter	50.68	39.38	39.85	0.525
3rd Quarter	41.76	36.79	39.51	0.525
4th Quarter	44.50	39.04	42.41	0.525

2006	High	Low	Close	Dividends Per Share
1st Quarter	$44.14	$38.76	$39.10	$0.500
2nd Quarter	41.06	38.31	39.91	0.500
3rd Quarter	45.99	39.90	45.05	0.500
4th Quarter	51.00	45.12	50.69	0.525

APS common stock is wholly-owned by Pinnacle West and is not listed for trading on any stock exchange. As a result, there is no established public trading market for APS common stock.

The chart below sets forth the dividends paid on APS common stock for each of the four quarters for 2007 and 2006.

Common Stock Dividends
(Dollars in Thousands)

Quarter	2007	2006
1st Quarter	$42,500	$42,500
2nd Quarter	42,500	42,500
3rd Quarter	42,500	42,500
4th Quarter	42,500	42,500

The sole holder of APS common stock, Pinnacle West, is entitled to dividends when and as declared out of funds legally available therefor. As of December 31, 2007, APS did not have any outstanding preferred stock.

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Issuer Purchases of Equity Securities

The following table contains information about our purchases of our common stock during the fourth quarter of 2007.

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1 October 31, 2007	862	$ 41.90		
November 1 November 30, 2007	6	42.37		
December 1 December 31, 2007				
Total	868	$ 41.90		

(1) Represents shares of common stock withheld by Pinnacle West to satisfy tax withholding obligations upon the vesting of restricted stock.

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ITEM 6. SELECTED FINANCIAL DATA
PINNACLE WEST CAPITAL CORPORATION
SELECTED CONSOLIDATED FINANCIAL DATA

	2007	2006	2005	2004	2003
	(dollars in thousands, except per share amounts)				
OPERATING RESULTS					
Operating revenues:					
Regulated electricity segment	$ 2,918,163	$ 2,635,036	$ 2,237,145	$ 2,035,247	$ 1,978,075
Real estate segment	215,068	399,798	338,031	350,315	361,604
Marketing and trading	342,371	330,742	351,558	400,628	391,196
Other revenues	48,018	36,172	61,221	42,816	27,929
Total operating revenues	$ 3,523,620	$ 3,401,748	$ 2,987,955	$ 2,829,006	$ 2,758,804
Income from continuing operations (a)	$ 298,780	$ 317,143	$ 223,163	$ 246,590	$ 225,384
Discontinued operations net of income taxes (b)	8,363	10,112	(46,896)	(3,395)	15,195
Net income	$ 307,143	$ 327,255	$ 176,267	$ 243,195	$ 240,579
COMMON STOCK DATA					
Book value per share year-end	$ 35.15	$ 34.48	$ 34.58	$ 32.14	$ 30.97
Earnings (loss) per weighted-average common share outstanding:					
Continuing operations basic	$ 2.98	$ 3.19	$ 2.31	$ 2.70	$ 2.47
Net income basic	$ 3.06	$ 3.29	$ 1.83	$ 2.66	$ 2.64
Continuing operations diluted	$ 2.96	$ 3.17	$ 2.31	$ 2.69	$ 2.47
Net income diluted	$ 3.05	$ 3.27	$ 1.82	$ 2.66	$ 2.63
Dividends declared per share	$ 2.10	$ 2.025	$ 1.925	$ 1.825	$ 1.725
Weighted-average common shares outstanding basic	100,255,807	99,417,008	96,483,781	91,396,904	91,264,696
Weighted-average common shares outstanding diluted	100,834,871	100,010,108	96,589,949	91,532,473	91,405,134
BALANCE SHEET DATA					
Total assets	$ 11,243,712	$ 11,455,943	$ 11,322,645	$ 9,896,747	$ 9,519,042
Liabilities and equity:					
Current liabilities	$ 1,384,967	$ 1,458,560	$ 2,272,073	$ 1,625,896	$ 1,432,568
Long-term debt less current maturities	3,127,125	3,232,633	2,608,455	2,584,985	2,616,585
Deferred credits and other	3,200,009	3,318,634	3,017,153	2,735,670	2,640,110
Total liabilities	7,712,101	8,009,827	7,897,681	6,946,551	6,689,263

Common stock equity	3,531,611	3,446,116	3,424,964	2,950,196	2,829,779
Total liabilities and equity	$ 11,243,712	$ 11,455,943	$ 11,322,645	$ 9,896,747	$ 9,519,042

(a) Includes regulatory disallowance of $8 million after tax in 2007 and $84 million after tax in 2005. See Note 3.

(b) Amounts primarily related to Silverhawk and SunCor discontinued operations. See Note 22.

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SELECTED FINANCIAL DATA
ARIZONA PUBLIC SERVICE COMPANY

	2007	2006	2005	2004	2003
			(dollars in thousands)		
OPERATING RESULTS					
Electric operating revenues	$ 2,936,277	$ 2,658,513	$ 2,270,793	$ 2,197,121	$ 2,104,931
Fuel and purchased power costs	1,151,392	969,767	688,982	763,254	703,431
Operating expenses	1,358,890	1,290,804	1,200,198	1,104,886	1,103,342
Operating income	425,995	397,942	381,613	328,981	298,158
Other income (deductions)	20,870	27,584	(69,171)	15,328	26,347
Interest deductions net	162,925	155,796	141,963	144,682	143,568
Net income	$ 283,940	$ 269,730	$ 170,479	$ 199,627	$ 180,937
BALANCE SHEET DATA					
Total assets	$ 10,402,905	$ 10,513,692	$ 9,707,441	$ 8,098,552	$7,722,533
Liabilities and equity:					
Common stock equity	$ 3,351,441	$ 3,207,473	$ 2,985,225	$ 2,232,402	$ 2,203,630
Long-term debt less current maturities	2,876,881	2,877,502	2,479,703	2,267,094	2,135,606
Total capitalization	6,228,322	6,084,975	5,464,928	4,499,496	4,339,236
Current liabilities	1,096,224	1,278,566	1,513,964	1,178,770	915,884
Deferred credits and other	3,078,359	3,150,151	2,728,549	2,420,286	2,467,413
Total liabilities and equity	$ 10,402,905	$ 10,513,692	$ 9,707,441	$ 8,098,552	$ 7,722,533

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ITEM 7. 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 Consolidated Financial Statements and APS Financial Statements and the related Notes that appear in Item 8 of this report.

OVERVIEW

Pinnacle West owns all of the outstanding common stock of APS. APS is a vertically-integrated electric utility that provides retail and 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 has historically accounted for a substantial part of our revenues and earnings, and is expected to continue to do so. Customer growth in APS service territory is above the national average and remains an important driver of our revenues and earnings.

Our cash flows and profitability are affected by the rates APS may charge and the timely recovery of costs through those rates. APS retail rates are regulated by the ACC and its wholesale electric rates (primarily for transmission) are regulated by the FERC. APS capital expenditure requirements, which are discussed below under Liquidity and Capital Resources, are substantial because of customer growth in APS service territory and inflationary impacts on the capital budget, highlighting APS need for the timely recovery through rates of these and other expenditures. On June 28, 2007, the ACC issued an order in a general rate case granting APS retail base rate increases. The ACC rate case decision and other retail and wholesale rate matters are discussed in Note 3.

SunCor, our real estate development subsidiary, has been an important source of earnings in recent years, although SunCor s earnings in 2007 and expected earnings in 2008 reflect a slowdown in the western United States real estate markets. See discussion below in Pinnacle West Consolidated Factors Affecting our Financial Outlook Subsidiaries. Our subsidiary, APSES, provides energy-related products and services and competitive commodity-related energy services to commercial and industrial retail customers in the western United States. Recently, APSES has de-emphasized its commodity-related energy services. El Dorado, our investment subsidiary, owns minority interests in several energy-related investments and Arizona community-based ventures.

We continue to focus on solid operational performance in our electricity generation and delivery activities. In the delivery area, we focus on superior reliability and customer satisfaction. We plan to expand long-term energy resources and our transmission and distribution systems to meet the electricity needs of our growing retail customers and sustain reliability.

See Pinnacle West Consolidated Factors Affecting Our Financial Outlook below for a discussion of several factors that could affect our future financial results.

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PINNACLE WEST CONSOLIDATED
EARNINGS CONTRIBUTION BY BUSINESS SEGMENT

Pinnacle West s two reportable business segments are:

- our regulated electricity segment, which consists of traditional regulated retail and wholesale electricity businesses (primarily electric service to Native Load customers) and related activities and includes electricity generation, transmission and distribution; and
- our real estate segment, which consists of SunCor s real estate development and investment activities.

The following table summarizes income from continuing operations for the years ended December 31, 2007, 2006 and 2005 and reconciles net income in total (dollars in millions):

	2007	2006	2005
Regulated electricity segment (a)	$ 274	$ 259	$ 167
Real estate segment	12	50	35
All other (b)	13	8	21
Income from continuing operations	299	317	223
Discontinued operations net of tax:			
Real estate (c)	11	10	17
Sale of Silverhawk (d)		1	(67)
All other (b)	(3)	(1)	3
Net income	$ 307	$ 327	$ 176

(a) Includes an $84 million after-tax regulatory disallowance of plant costs in 2005 in accordance with APS 2003 general retail rate case settlement.

(b) Includes activities related to marketing and trading, APSES and El Dorado. None of these segments is a reportable segment.

(c)

Primarily relates to sales of commercial properties.

(d) See Note 22.

PINNACLE WEST CONSOLIDATED RESULTS OF OPERATIONS

2007 Compared with 2006

Our consolidated net income for 2007 was $307 million compared with $327 million for 2006. The current period includes income from discontinued operations of $11 million related to sales of commercial properties by SunCor and a loss from discontinued operations of $3 million related to an APSES project. The prior year includes income from discontinued operations of $10 million related to sales of commercial properties by SunCor. Income from continuing operations decreased $18 million in the year-to-year comparison and is reflected in the segments as follows:

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Regulated Electricity Segment Income from continuing operations increased approximately $15 million primarily due to higher retail sales related to customer growth; the effects of weather on retail sales; and impacts of the retail rate increase. These positive factors were partially offset by higher operations and maintenance expense primarily due to increased generation costs (including increased maintenance and overhauls and the Palo Verde performance improvement plan), customer service and other costs; higher depreciation and amortization primarily due to increased plant balances; lower other income, net of expense, primarily due to miscellaneous asset sales in the prior year and lower interest income as a result of lower investment balances; and a regulatory disallowance. In addition, higher fuel and purchased power costs related to commodity price increases were substantially offset by deferral of such costs in accordance with the PSA. See Note 3 for further discussion of the regulatory disallowance and the PSA.

Real Estate Segment Income from continuing operations decreased approximately $38 million primarily due to lower sales of residential property and land parcels resulting from the continued slowdown in the western United States real estate markets.

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· Additional details on the major factors that increased (decreased) net income for the year ended December 31, 2007 compared with the prior year are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment:		
Higher retail sales primarily due to customer growth, excluding weather effects	$ 46	$ 28
Effects of weather on retail sales	37	23
Impacts of retail rate increase effective July 1, 2007:		
Revenue increase related to higher Base Fuel Rate	185	113
Decreased deferred fuel and purchased power costs related to higher Base Fuel Rate	(171)	(104)
Non-fuel rate increase	6	4
Net changes in fuel and purchased power costs related to price:		
Higher fuel and purchased power costs related to increased commodity prices	(121)	(74)
Increased deferred fuel and purchased power costs related to increased prices	115	70
Mark-to-market fuel and purchased power costs, net of related deferred fuel and purchased power costs	18	11
Regulatory disallowance (see Note 3)	(14)	(8)
Operations and maintenance increases primarily due to:		
Increased generation costs, including increased maintenance and overhauls and Palo Verde performance improvement plan	(25)	(15)
Customer service and other costs	(21)	(13)
Higher depreciation and amortization primarily due to increased plant balances	(12)	(7)
Lower other income, net of expense, primarily due to lower interest income as a result of lower investment balances and miscellaneous asset sales in prior year	(15)	(9)
Income tax benefits resolved in 2007 related to prior years		13
Income tax credits resolved in 2006 related to prior years		(14)
Miscellaneous items, net	6	(3)
Increase in regulated electricity segment net income	34	15
Lower real estate segment income from continuing operations primarily due to:		
Lower sales of residential property resulting from the continued slowdown in the western United States real estate markets	(47)	(29)
Lower sales of land parcels	(12)	(7)
Higher other costs	(5)	(2)
Higher marketing and trading contribution primarily due to higher mark-to-market gains resulting from changes in forward prices and higher unit margins	8	5
Other miscellaneous items, net	(2)	
Decrease in income from continuing operations	$ (24)	(18)
Discontinued operations:		
Increased commercial property real estate sales		1
Other discontinued operations		(3)
Decrease in net income		$ (20)

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Regulated Electricity Segment Revenues

Regulated electricity segment revenues were $283 million higher for the year ended December 31, 2007 compared with the prior year primarily because of:

- a $191 million increase in retail revenues due to a rate increase effective July 1, 2007;
- a $60 million increase in retail revenues primarily related to customer growth, excluding weather effects;
- a $50 million increase in retail revenues due to the effects of weather;
- a $3 million increase in revenues from Off-System Sales due to higher prices and volumes;
- a $35 million decrease in retail revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense (see Note 3); and
- a $14 million net increase due to miscellaneous factors.

Real Estate Segment Revenues

Real estate segment revenues were $185 million lower for the year ended December 31, 2007 compared with the prior year primarily because of:

- a $167 million decrease in residential property sales due to the continued slowdown in western United States real estate markets; and
- an $18 million decrease primarily due to lower sales of land parcels.

All Other Revenues

Marketing and trading revenues were $12 million higher for the year ended December 31, 2007 compared with the prior year primarily because of higher mark-to-market gains resulting from changes in forward prices and higher competitive retail sales volumes in California.

Other revenues were $12 million higher for the year ended December 31, 2007 compared with the prior year primarily as a result of increased sales by APSES of energy-related products and services.

2006 Compared with 2005

Our consolidated net income for 2006 was $327 million compared with $176 million for the comparable prior-year period. The prior year included a net loss from discontinued operations of $47 million, which was related to the sale and operations of Silverhawk, partially offset by income from sales of real estate commercial properties at SunCor. Income from continuing operations increased $94 million in the period-to-period comparison, reflecting the following changes in earnings by segment:

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Regulated Electricity Segment Income from continuing operations increased approximately $92 million primarily due to an $84 million after-tax regulatory disallowance of plant costs recorded in 2005. Income also increased due to higher retail sales volumes due to customer growth; income tax credits related to prior years resolved in 2006; and increased other income due to higher interest income on higher investment balances. These positive factors were partially offset by higher operations and maintenance expense related to generation and customer service; and higher depreciation and amortization primarily due to increased plant asset balances, partially offset by lower depreciation rates. In addition, higher fuel and purchased power costs of $74 million after-tax were partially offset by the deferral of $45 million after-tax of costs in accordance with the PSA.

Real Estate Segment Income from continuing operations increased approximately $15 million primarily due to increased margins on residential sales and the sale of certain joint venture assets, partially offset by higher general and administrative expenses. Income from discontinued operations decreased $7 million due to lower commercial property sales.

Other Income from continuing operations decreased approximately $13 million primarily due to lower mark-to-market gains, partially offset by higher unit margins on wholesale sales and competitive retail sales in California.

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Additional details on the major factors that increased (decreased) net income for the year ended December 31, 2006 compared with the prior year are contained in the following table (dollars in millions):

	Increase (Decrease)	
	Pretax	After Tax
Regulated electricity segment:		
Higher fuel and purchased power costs	$ (121)	$ (74)
Increased deferred fuel and purchased power costs (deferrals began April 1, 2005)	73	45
Higher retail sales volumes due to customer growth, excluding weather effects	87	53
Regulatory disallowance of plant costs in 2005, in accordance with APS 2003 general retail rate case settlement	139	84
Operations and maintenance increases primarily due to:		
Generation costs, including increased maintenance and overhauls	(41)	(25)
Customer service costs, including regulatory demand-side management programs and planned maintenance	(16)	(10)
Miscellaneous items, net	3	2
Higher depreciation and amortization primarily due to increased plant asset balances partially offset by lower depreciation rates	(11)	(7)
Higher other income, net of expense, primarily due to miscellaneous asset sales and increased interest income on higher investment balances	13	8
Income tax credits related to prior years resolved in 2006		14
Miscellaneous items, net	(4)	2
Increase in regulated electricity segment net income	122	92
Lower marketing and trading contribution primarily related to lower mark-to-market gains, partially offset by higher unit margins on wholesale sales and competitive retail sales in California	(18)	(11)
Higher real estate segment contribution primarily related to increased margins on residential sales and the sale of certain joint venture assets	25	15
Miscellaneous items, net	(5)	(2)
Increase in income from continuing operations	$ 124	94
Discontinued operations:		
Silverhawk loss in 2005		68
Lower commercial property real estate sales		(7)
Income in 2005 related to sale of NAC		(4)
Increase in net income		$ 151

Regulated Electricity Segment Revenues

Regulated electricity segment revenues were $398 million higher for 2006 compared with the prior-year period primarily as a result of:

- a $265 million increase in revenues related to recovery of PSA deferrals, which had no earnings effect because of amortization of the same amount recorded as fuel and purchased power expense;

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a $124 million increase in retail revenues related to customer growth, excluding weather effects;

a $6 million increase in Off-System Sales primarily resulting from $12 million of sales previously reported in marketing and trading that were classified beginning in April 2005 as sales in the regulated electricity segment in accordance with APS 2003 general retail rate case settlement, partially offset by $6 million of lower Off-System Sales in 2006; and

a $3 million increase due to miscellaneous factors.

Real Estate Segment Revenues

Real estate segment revenues were $62 million higher for 2006 compared with the prior-year period primarily as a result of:

a $55 million increase in residential sales due to higher prices and volumes; and

a $7 million increase in commercial real estate sales.

Other Revenues

Other revenues were $25 million lower for 2006 compared with the prior-year period primarily as a result of decreased sales-related products and services by APSES.

Marketing and trading revenues were $21 million lower for 2006 compared with the prior-year period primarily as a result of:

a $20 million decrease in mark-to-market gains on contracts for future delivery due to changes in forward prices;

a $12 million decrease in Off-System Sales due to the absence of sales previously reported in marketing and trading that were classified beginning in April 2005 as sales in the regulated electricity segment in accordance with APS 2003 general retail rate case settlement;

a $23 million increase from higher prices on competitive retail sales in California; and

a $12 million decrease due to miscellaneous factors.

LIQUIDITY AND CAPITAL RESOURCES Pinnacle West Consolidated

Operating Cash Flows

Net cash provided by operating activities was $658 million for 2007, compared with $394 million for 2006, an increase in net cash flow of $264 million. This change was primarily due to a decrease in 2007 in the amount of cash collateral and margin cash returned to counterparties as a result of changes in commodity prices.

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Net cash provided by operating activities was $394 million for 2006, compared with $730 million for 2005, a decrease in net cash flow of $336 million. This change was primarily due to an increase in 2006 in the amount of cash collateral and margin cash returned to counterparties as a result of changes in commodity prices.

Investing Cash Flows

Net cash used for investing activities was $873 million for 2007, compared with $569 million for 2006, a decrease in net cash flow of $304 million.

This cash flow decrease was primarily due to:

A decrease in cash provided by investing activities related to proceeds of $208 million received in 2006 from the sale of Silverhawk; and

An increase in cash used for capital expenditures and capitalized interest of $183 million (see table and discussion below).

The cash flow decreases were partially offset by:

A decrease of $65 million in cash invested in securities at APS;

An increase of $19 million cash provided by sale of real estate investments; and

A net increase of $3 million due to miscellaneous factors.

Net cash used for investing activities was $569 million for 2006, compared with $585 million for 2005, an increase in net cash flow of $16 million.

This cash flow increase was primarily due to:

Proceeds of $208 million received in 2006 from the sale of Silverhawk; and

Less cash used for capital expenditures (including the 2005 acquisition of the Sundance Plant) and capitalized interest of approximately $72 million (see table and discussion below).

The cash flow increases were partially offset by:

An increase of $214 million in cash invested in securities at APS;

A decrease of $43 million in cash provided by sale of real estate investments; and

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A net decrease of $7 million due to miscellaneous factors.

Financing Cash Flows

Net cash provided by financing activities was $185 million for 2007, compared with $108 million for 2006, an increase in net cash flow of $77 million.

This cash flow increase was primarily due to a net increase of $295 million in short-term borrowings to fund day-to-day operations and liquidity needs.

The cash flow increases were partially offset by:

A decrease of $161 million in net new long-term debt (issuances net of redemptions and refinancing) to fund our construction program and for other general corporate purposes; and

A net decrease of $57 million due to miscellaneous factors.

Net cash provided by financing activities was $108 million for 2006, compared with net cash used for financing activities in 2005 of $155 million, an increase in net cash flow of $263 million.

This cash flow increase was primarily due to:

An increase of $429 million in net new long-term debt (issuances net of redemptions and refinancing) to fund our construction program and for other general corporate purposes;

A net increase of $56 million in short-term borrowings to fund day-to-day operations and liquidity needs; and

A net increase of $37 million due to miscellaneous factors.

The cash flow increases were partially offset by:

A decrease of $259 million related to common stock issuance, primarily due to a 2005 public offering.

Liquidity

Capital Expenditure Requirements

The following table summarizes the actual capital expenditures for 2005, 2006 and 2007 and estimated capital expenditures for the next three years:

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CAPITAL EXPENDITURES
(dollars in millions)

	Actual			Estimated		
	2005	2006	2007	2008	2009	2010
APS						
Distribution	$ 325	$ 357	$ 372	$ 410	$ 440	$ 430
Generation (a)	356	176	353	380	390	380
Transmission	92	113	138	220	320	290
Other (b)	36	16	37	50	40	50
Subtotal	809	662	900	1,060	1,190	1,150
SunCor (c)	106	201	161	100	90	100
Other	13	7	3	20	20	10
Total	$ 928	$ 870	$ 1,064	$ 1,180	$ 1,300	$ 1,260

(a) Includes $185 million in 2005 for the acquisition of the Sundance Plant.

(b) Primarily information systems and facilities projects.

(c) Consists primarily of capital expenditures for residential, land development and retail and office building construction reflected in Real estate investments and Capital expenditures on the Consolidated Statements of Cash Flows.

Distribution and transmission capital expenditures are comprised of infrastructure additions and upgrades, capital replacements, new customer construction and related information systems and facility costs. Examples of the types of projects included in the forecast include power lines, substations, line extensions to new residential and commercial developments and upgrades to customer information systems. In addition, these amounts do not include any impacts from the recent changes in the line extension policy (see Note 3). Major transmission projects are driven by regional customer growth.

Generation capital expenditures are comprised of various improvements to APS 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. Installation of new steam generators in Palo Verde Unit 3 was completed in the fourth quarter of 2007 at an approximate cost of $70 million (APS share), which completed the steam generator replacement program for all three units. Environmental expenditures are estimated at approximately $70 million to $120 million per year for 2008, 2009 and 2010. We are also monitoring the status of certain environmental matters, which, depending on their final outcome, could require additional environmental expenditures. (See Business of Arizona Public Service Company Environmental Matters Regional Haze Rules in Item 1.) Generation also includes nuclear fuel expenditures of approximately $90 million to $120 million per year for 2008, 2009 and 2010.

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

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Pinnacle West (Parent Company)

Our primary cash needs are for dividends to our shareholders and principal and interest payments on our long-term debt. The level of our common stock dividends and future dividend growth will be dependent on a number of factors including, but not limited to, payout ratio trends, free cash flow and financial market conditions.

On January 23, 2008, the Pinnacle West Board of Directors declared a quarterly dividend of $0.525 per share of common stock, payable on March 3, 2008, to shareholders of record on February 1, 2008.

Our primary sources of cash are dividends from APS, external debt and equity financings and cash distributions from our other subsidiaries, primarily SunCor. For the years 2005 through 2007, total dividends from APS were $510 million and total distributions from SunCor were $70 million. For 2007, cash contributions from APS were $170 million and distributions from SunCor were $10 million. An existing ACC order requires APS to maintain a common equity ratio of at least 40% and prohibits APS from paying common stock dividends if the payment would reduce its common equity below that threshold. As defined in the ACC order, the common equity ratio is common equity divided by the sum of common equity and long-term debt, including current maturities of long-term debt. At December 31, 2007, APS common equity ratio, as defined, was approximately 54%.

At December 31, 2007, Pinnacle West s outstanding long-term debt, including current maturities, was $175 million. Pinnacle West has a $300 million revolving credit facility that terminates in December 2010. This line of credit is available to support the issuance of up to $250 million in commercial paper or to be used as bank borrowings, including issuances of letters of credit. At December 31, 2007, Pinnacle West had no borrowings outstanding under its revolving line of credit. At December 31, 2007, we had $115 million of commercial paper outstanding.

Pinnacle West sponsors a qualified defined benefit and account balance pension plan and a non-qualified supplemental excess benefit retirement plan for the employees of Pinnacle West and our subsidiaries. IRS regulations require us to contribute a minimum amount to the qualified plan. We contribute at least the minimum amount required under IRS 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 obligation. The assets in the plan are comprised of fixed-income, equity and short-term investments. Future year contribution amounts are dependent on plan asset performance and plan actuarial assumptions. We contributed approximately $52 million in 2007. The contribution to our pension plan in 2008 is estimated to be approximately $50 million. The expected contribution to our other postretirement benefit plans in 2008 is estimated to be approximately $20 million. APS and other subsidiaries fund their share of the contributions. APS share is approximately 96% of both plans.

Significant Financing Activities 2007. On January 4, 2007, the FERC issued an order permitting Pinnacle West to transfer its market-based rate tariff and wholesale power sales agreements to a newly-created Pinnacle West subsidiary, Pinnacle West Marketing & Trading. Pinnacle West completed the transfer on February 1, 2007, which resulted in Pinnacle West no longer being a public utility under the Federal Power Act. As a result, Pinnacle West is no longer subject to FERC jurisdiction in connection with its issuance of securities or its incurrence of long-term debt.

In May 2007, Pinnacle West infused approximately $40 million of equity into APS, consisting of proceeds of stock issuances in 2006 under Pinnacle West s Investors Advantage Plan (direct stock purchase and dividend reinvestment plan) and employee stock plans.

Significant Financing Activities 2006. In January 2006, Pinnacle West infused into APS $210 million of the proceeds from the sale of Silverhawk.

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.

APS

APS capital requirements consist primarily of capital expenditures and optional and mandatory redemptions of long-term debt. APS pays for its capital requirements with cash from operations, equity infusions from Pinnacle West and, to the extent necessary, external financings. APS has historically paid its dividends to Pinnacle West with cash from operations. See Pinnacle West (Parent Company) above for a discussion of the common equity ratio that APS must maintain in order to pay dividends to Pinnacle West. As noted above, in May 2007, Pinnacle West infused approximately $40 million of equity into APS.

APS outstanding long-term debt, including current maturities, was approximately $2.9 billion at December 31, 2007. APS has two committed lines of credit totaling $900 million that are available either to support the issuance of up to $250 million in commercial paper or to be used for bank borrowings, including issuances of letters of credit. The $400 million line terminates in December 2010 and the $500 million line terminates in September 2011. At December 31, 2007, APS had borrowings of $218 million under its revolving line of credit. The amount drawn was used for general corporate purposes.

Significant Financing Activities 2007. Although provisions in APS articles of incorporation and ACC financing orders establish maximum amounts of preferred stock and debt that APS may issue, APS does not expect any of these provisions to limit its ability to meet its capital requirements. On October 30, 2007, the ACC issued a financing order in which it approved APS request, subject to specified parameters and procedures, to increase (a) APS short-term debt authorization from 7% of APS capitalization to (i) 7% of APS capitalization plus (ii) $500 million and (b) APS long-term debt authorization from approximately $3.2 billion to $4.2 billion in light of the projected growth of APS and its customer base and the resulting projected financing needs.

Significant Financing Activities 2006. 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 was used to pay at maturity approximately $84 million of APS

6.75% Senior Notes due November 15, 2006. The remainder was used to fund its construction program and other general corporate purposes.

On September 28, 2006, APS put in place the $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.

Other Financing Matters See Note 3 for information regarding the PSA approved by the ACC. Although APS defers actual retail fuel and purchased power costs on a current basis, APS recovery of the deferrals from its ratepayers is subject to annual and, if necessary, periodic PSA adjustments.

See Cash Flow Hedges in Note 18 for information related to decreased collateral provided to us by counterparties and the change in our margin account.

Other Subsidiaries

During the past three years, SunCor funded its cash requirements with cash from operations and its own external financings. SunCor s capital needs consist primarily of capital expenditures for land development and retail and office building construction. See the capital expenditures table above for actual capital expenditures during 2007 and projected capital expenditures for the next three years. SunCor expects to fund its future capital requirements with cash from operations and external financings.

SunCor entered into a secured construction loan on April 13, 2007, in the amount of $60 million, of which $48 million was outstanding at December 31, 2007. The loan matures on April 19, 2009, and may be extended one year if certain conditions are met.

On July 31, 2007, SunCor borrowed $12 million under a new secured construction loan. The loan matures on July 31, 2009, and may be extended annually up to two years.

SunCor s total outstanding debt was approximately $246 million as of December 31, 2007, including $94 million of debt classified as current maturities of long-term debt under revolving lines of credit totaling $170 million. SunCor s long-term debt, including current maturities, was $238 million and total short-term debt was $8 million at December 31, 2007. See Note 6.

El Dorado expects minimal capital requirements over the next three years and intends to focus on prudently realizing the value of its existing investments.

APSES expects minimal capital expenditures over the next three years.

Debt Provisions

Pinnacle West s and APS debt covenants related to their respective bank financing arrangements include debt to capitalization ratios. Certain of APS bank financing arrangements also include an interest coverage test. Pinnacle West and APS comply with these covenants and each anticipates it will continue to meet these and other significant covenant requirements. For both Pinnacle West and APS, these covenants require that the ratio of consolidated debt to total consolidated capitalization not exceed 65%. At December 31, 2007, the ratio was approximately 50% for Pinnacle West and 47% for APS. The provisions regarding interest coverage require minimum cash coverage of two times the interest requirements for APS. The interest coverage was approximately 4.7 times under APS bank financing agreements as of December 31, 2007. 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 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 financial agreements contain a pricing grid in which the interest costs we pay 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 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 revolver borrowings.

See Note 6 for further discussions.

Credit Ratings

The ratings of securities of Pinnacle West and APS as of February 25, 2008 are shown below. 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 securities and serve to increase the cost of and access to capital. It may also require additional collateral related to certain derivative instruments, natural gas transportation, fuel supply, and other energy-related contracts.

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	Moody s	Standard & Poor s	Fitch
Pinnacle West			
Senior unsecured (a)	Baa3 (P)	BB+ (prelim)	N/A
Commercial paper	P-3	A-3	F3
Outlook	Negative	Stable	Negative
APS			
Senior unsecured	Baa2	BBB-	BBB
Secured lease obligation bonds	Baa2	BBB-	BBB
Commercial paper	P-2	A-3	F3
Outlook	Negative	Stable	Stable

(a) Pinnacle West has a shelf registration under SEC Rule 415. Pinnacle West currently has no outstanding, rated senior unsecured securities. However, Moody s assigned a provisional (P) rating and Standard & Poor s assigned a preliminary (prelim) rating to the senior unsecured securities that can be issued under such shelf registration.

Off-Balance Sheet Arrangements

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 (see Note 9).

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 December 31, 2007, APS would have been required to assume approximately $194 million of debt and pay the equity participants approximately $170 million.

Guarantees and Letters of Credit

We have issued parental guarantees and letters of credit and obtained surety bonds on behalf of our subsidiaries. Our parental guarantees for Pinnacle West Marketing & Trading and APS relate to commodity energy products. Our credit support instruments enable APSES to offer energy-related products and commodity energy. Non-performance or non-payment under the original contract by our subsidiaries would require us to perform under the guarantee or surety bond. No liability is currently recorded on the Consolidated Balance Sheets related to Pinnacle West s current outstanding guarantees on behalf of our subsidiaries. Our guarantees have no recourse or collateral provisions to allow us to recover amounts paid under the guarantees. We generally agree to indemnification provisions related to liabilities arising from or related to certain of our agreements, with limited exceptions depending on the particular agreement. See Note 21 for additional information regarding guarantees and letters of credit.

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Contractual Obligations

The following table summarizes Pinnacle West s consolidated contractual requirements as of December 31, 2007 (dollars in millions):

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