PINNACLE WEST CAPITAL CORP
Form 10-Q
July 30, 2015

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

OR

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

For the transition period from to

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

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

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

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

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

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

PINNACLE WEST CAPITAL CORPORATION

Large accelerated filer x Accelerated filer o Non-accelerated filer o Smaller reporting company o

ARIZONA PUBLIC SERVICE COMPANY

Large accelerated filer o Accelerated filer o Non-accelerated filer x Smaller reporting company o

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

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

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

PINNACLE WEST CAPITAL CORPORATION	Number of shares of common stock, no par value, outstanding as of July 24, 2015: 110,813,659
ARIZONA PUBLIC SERVICE COMPANY	Number of shares of common stock, $2.50 par value, outstanding as of July 24, 2015: 71,264,947

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

TABLE OF CONTENTS

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

FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements based on current expectations. These forward-looking statements are often identified by words such as "estimate," "predict," "may," "believe," "plan," "expect," "require," "intend," "assume" and similar words. Because actual results may differ materially from expectations, we caution readers not to place undue reliance on these statements. A number of factors could cause future results to differ materially from historical results, or from outcomes currently expected or sought by Pinnacle West or APS. In addition to the Risk Factors described in Part I, Item 1A of the Pinnacle West/APS Annual Report on Form 10-K for the fiscal year ended December 31, 2014 ("2014 Form 10-K") and in Part I, Item 2 — "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this report, these factors include, but are not limited to:

- our ability to manage capital expenditures and operations and maintenance costs while maintaining reliability and customer service levels;
- variations in demand for electricity, including those due to weather, the general economy, customer and sales growth (or decline), and the effects of energy conservation measures and distributed generation;
- power plant and transmission system performance and outages;
- competition in retail and wholesale power markets;
- regulatory and judicial decisions, developments and proceedings;
- new legislation or regulation, including those relating to environmental requirements, nuclear plant operations and potential deregulation of retail electric markets;
- fuel and water supply availability;
- our ability to achieve timely and adequate rate recovery of our costs, including returns on debt and equity capital;
- our ability to meet renewable energy and energy efficiency mandates and recover related costs;
- risks inherent in the operation of nuclear facilities, including spent fuel disposal uncertainty;
- current and future economic conditions in Arizona, particularly in real estate markets;
- the development of new technologies which may affect electric sales or delivery;
- the cost of debt and equity capital and the ability to access capital markets when required;
- environmental and other concerns surrounding coal-fired generation;
- volatile fuel and purchased power costs;
- the investment performance of the assets of our nuclear decommissioning trust, pension, and other postretirement benefit plans and the resulting impact on future funding requirements;
- the liquidity of wholesale power markets and the use of derivative contracts in our business;
- potential shortfalls in insurance coverage;
- new accounting requirements or new interpretations of existing requirements;
- generation, transmission and distribution facility and system conditions and operating costs;
- the ability to meet the anticipated future need for additional baseload generation and associated transmission facilities in our region;
- the willingness or ability of our counterparties, power plant participants and power plant land owners to meet contractual or other obligations or extend the rights for continued power plant operations; and
- restrictions on dividends or other provisions in our credit agreements and Arizona Corporation Commission ("ACC") orders.

These and other factors are discussed in the Risk Factors described in Part I, Item 1A of our 2014 Form 10-K, which readers should review carefully before placing any reliance on our financial statements or disclosures. Neither Pinnacle West nor APS assumes any obligation to update these statements, even if our internal estimates change, except as required by law.

PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

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

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

3

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TOTAL LIABILITIES AND EQUITY	$14,701,483	$14,313,532

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

8

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

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

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

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

PINNACLE WEST CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(unaudited)
(dollars in thousands, except per share amounts)

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

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

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

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

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Consolidation and Nature of Operations

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

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

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

Supplemental Cash Flow Information

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

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

2. Long-Term Debt and Liquidity Matters

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

Pinnacle West

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

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

APS

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

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

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

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

At June 30, 2015, APS had two credit facilities totaling $1 billion, including a $500 million credit facility that matures in April 2018 and a $500 million facility that matures in May 2019. APS may increase the size of each facility up to a maximum of $700 million upon the satisfaction of certain conditions and with the consent of the lenders. APS will use these facilities to refinance indebtedness and for other general corporate purposes. Interest rates are based on APS’s senior unsecured debt credit ratings.

The facilities described above are available to support APS’s $250 million commercial paper program, for bank borrowings or for issuances of letters of credit. At June 30, 2015, APS had $158 million of commercial paper outstanding and no outstanding borrowings or letters of credit under these credit facilities.

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

Debt Fair Value

Our long-term debt fair value estimates are based on quoted market prices for the same or similar issues, and are classified within Level 2 of the fair value hierarchy. Certain of our debt instruments contain third-party credit enhancements and, in accordance with GAAP, we do not consider the effect of these credit enhancements when determining fair value. The following table represents the estimated fair value of our long-term debt, including current maturities (dollars in millions):

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

Debt Provisions

An existing ACC order requires APS to maintain a common equity ratio of at least 40%. As defined in the ACC order, the common equity ratio is total shareholder equity divided by the sum of total shareholder equity and long-term debt, including current maturities of long-term debt. At June 30, 2015, APS was in compliance with this common equity ratio requirement. Its total shareholder equity was approximately $4.5 billion, and total capitalization was approximately $8.2 billion. APS would be prohibited from paying dividends if the payment would reduce its total shareholder equity below approximately $3.3 billion, assuming APS's total capitalization remains the same.

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

3. Regulatory Matters

Retail Rate Case Filing with the Arizona Corporation Commission

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

Settlement Agreement

The 2012 Settlement Agreement provides for a zero net change in base rates, consisting of: (1) a non-fuel base rate increase of $116.3 million; (2) a fuel-related base rate decrease of $153.1 million (to be implemented by a change in the base fuel rate for fuel and purchased power costs ("Base Fuel Rate") from $0.03757 to $0.03207 per kilowatt hour ("kWh"); and (3) the transfer of cost recovery for certain renewable energy projects from the Arizona Renewable Energy Standard and Tariff ("RES") surcharge to base rates in an estimated amount of $36.8 million.

Other key provisions of the 2012 Settlement Agreement include the following:

- An authorized return on common equity of 10.0%;
- A capital structure comprised of 46.1% debt and 53.9% common equity;
- A test year ended December 31, 2010, adjusted to include plant that is in service as of March 31, 2012;
- Deferral for future recovery or refund of property taxes above or below a specified 2010 test year level caused by changes to the Arizona property tax rate as follows:
- Deferral of increases in property taxes of 25% in 2012, 50% in 2013 and 75% for 2014 and subsequent years if Arizona property tax rates increase; and
- Deferral of 100% in all years if Arizona property tax rates decrease;
- A procedure to allow APS to request rate adjustments prior to its next general rate case related to APS's acquisition of additional interests in Units 4 and 5 and the related closure of Units 1-3 of the Four Corners Power Plant ("Four Corners") (APS made its filing under this provision on December 30, 2013, see "Four Corners" below);
- Implementation of a Lost Fixed Cost Recovery ("LFCR") rate mechanism to support energy efficiency and distributed renewable generation;
- Modifications to the Environmental Improvement Surcharge ("EIS") to allow for the recovery of carrying costs for capital expenditures associated with government-mandated environmental

controls, subject to an existing cents per kWh cap on cost recovery that could produce up to approximately $5 million in revenues annually;

- Modifications to the Power Supply Adjustor ("PSA"), including the elimination of the 90/10 sharing provision;
- A limitation on the use of the RES surcharge and the Demand Side Management Adjustor Charge ("DSMAC") to recoup capital expenditures not required under the terms of APS's 2009 retail rate case settlement agreement (the "2009 Settlement Agreement");
- Allowing a negative credit that existed in the PSA rate to continue until February 2013, rather than being reset on the anticipated July 1, 2012 rate effective date;
- Modification of the transmission cost adjustor ("TCA") to streamline the process for future transmission-related rate changes; and
- Implementation of various changes to rate schedules, including the adoption of an experimental "buy-through" rate that could allow certain large commercial and industrial customers to select alternative sources of generation to be supplied by APS.

The 2012 Settlement Agreement was approved by the ACC on May 15, 2012, with new rates effective on July 1, 2012. This accomplished a goal set by the parties to the 2009 Settlement Agreement to process subsequent rate cases within twelve months of sufficiency findings from the ACC staff, which generally occurs within 30 days after the filing of a rate case.

Cost Recovery Mechanisms

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

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

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

15

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

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

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

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

On June 1, 2012, APS filed its 2013 DSM Plan. In 2013, the standards required APS to achieve cumulative energy savings equal to 5% of its 2012 retail energy sales. Later in 2012, APS filed a supplement to its plan that included a proposed budget for 2013 of $87.6 million.

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

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

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

Electric Energy Efficiency

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

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

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

Transmission Rates, Transmission Cost Adjustor and Other Transmission Matters. In July 2008, the United States Federal Energy Regulatory Commission ("FERC") approved an Open Access Transmission Tariff for APS to move from fixed rates to a formula rate-setting methodology in order to more accurately reflect and recover the costs that APS incurs in providing transmission services. A large portion of the rate represents charges for transmission services to serve APS's retail customers ("Retail Transmission Charges"). In order to recover the Retail Transmission Charges, APS was previously required to file an application with, and obtain approval from, the ACC to reflect changes in Retail Transmission Charges through the TCA. Under the terms of the 2012 Settlement Agreement, however, an adjustment to rates to recover the Retail Transmission Charges will be made annually each June 1 and will go into effect automatically unless suspended by the ACC.

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

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

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

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

Lost Fixed Cost Recovery Mechanism. The LFCR mechanism permits APS to recover on an after-the-fact basis a portion of its fixed costs that would otherwise have been collected by APS in the kWh sales lost due to APS energy efficiency programs and to distributed generation such as rooftop solar arrays. The fixed costs recoverable by the LFCR mechanism were established in the 2012 Settlement Agreement and amount to approximately 3.1 cents per residential kWh lost and 2.3 cents per non-residential kWh lost. The LFCR adjustment has a year-over-year cap of 1% of retail revenues. Any amounts left unrecovered in a particular year because of this cap can be carried over for recovery in a future year. The kWh's lost from energy efficiency are based on a third-party evaluation of APS's energy efficiency programs. Distributed generation sales losses are determined from the metered output from the distributed generation units or if metering is unavailable, through accepted estimating techniques.

APS files for a LFCR adjustment every January. APS filed its 2014 annual LFCR adjustment on January 15, 2014, requesting a LFCR adjustment of $25.3 million, effective March 1, 2014. The ACC approved APS's LFCR adjustment without change on March 11, 2014, which became effective April 1, 2014. APS filed its 2015 annual LFCR adjustment on January 15, 2015, requesting an LFCR adjustment of $38.5 million, which was approved on March 2, 2015, effective for the first billing cycle of March.

Deregulation

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

Net Metering

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

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

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

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

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

Four Corners

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

19

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

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

Cholla

After considering the costs to comply with environmental regulations, on September 11, 2014, APS announced that it will close Unit 2 of the Cholla Power Plant ("Cholla") by April 2016 and cease burning coal at the other APS-owned units (Units 1 and 3) at the plant by the mid-2020s, if the United States Environmental Protection Agency ("EPA") approves a compromise proposal offered by APS to meet required environmental and emissions standards and rules. Previously, APS estimated Cholla Unit 2's end of life to be 2033. APS is currently recovering depreciation and a return on the net book value of the unit in base rates and plans to seek recovery of all of the unit's retirement-related costs in its next retail rate case. On April 14, 2015, the ACC approved APS's proposed retirement of Cholla Unit 2 in accordance with the ACC's Integrated Resource Planning rules. The ACC expressly stated that this approval does not imply any specific treatment or recommendation for rate making purposes.
If APS closes Cholla Unit 2, APS believes it will be allowed recovery of the remaining net book value of Unit 2 ($125 million as of June 30, 2015), in addition to a return on its investment. In accordance with GAAP, in the third quarter of 2014, Unit 2's remaining net book value was reclassified from property, plant and equipment to a regulatory asset. If the ACC does not allow full recovery of the remaining net book value of Cholla Unit 2, all or a portion of the regulatory asset will be written off and APS's net income, cash flows, and financial position will be negatively impacted.

Regulatory Assets and Liabilities

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

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

(a) This asset represents the future recovery of pension and other postretirement benefit obligations through retail rates. If these costs are disallowed by the ACC, this regulatory asset would be charged to Other Comprehensive Income ("OCI") and result in lower future revenues. See Note 4 for further discussion.

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

(c) Subject to a carrying charge.

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

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

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

(a) In accordance with regulatory accounting guidance, APS accrues for removal costs for its regulated assets, even if there is no legal obligation for removal.
(b) See "Cost Recovery Mechanisms" discussion above.
(c) Subject to a carrying charge.
(d) See Note 4.

4. Retirement Plans and Other Benefits

Pinnacle West sponsors a qualified defined benefit and account balance pension plan, a non-qualified supplemental excess benefit retirement plan, and an other postretirement benefit plan for the employees of Pinnacle West and our subsidiaries. Pinnacle West uses a December 31 measurement date for its pension and other postretirement benefit plans. The market-related value of our plan assets is their fair value at the measurement dates. On September 30, 2014, Pinnacle West announced plan design changes to the other postretirement benefit plan. Because of these plan changes in 2014, the Company is currently in the process of seeking Internal Revenue Service ("IRS") and regulatory approval to move approximately $100 million of the other postretirement benefit trust assets into a new account to pay for active union employee medical costs.

Certain pension and other postretirement benefit costs in excess of amounts recovered in electric retail rates were deferred in 2011 and 2012 as a regulatory asset for future recovery, pursuant to APS's 2009 retail rate case settlement. Pursuant to this order, we began amortizing the regulatory asset over three years beginning in July 2012. We amortized approximately $2 million and $4 million for the three and six months ended June 30, 2015 and 2014, respectively. The following table provides details of the plans' net periodic benefit costs and the portion of these costs charged to expense (including administrative costs and excluding amounts capitalized as overhead construction, billed to electric plant participants or charged or amortized to the regulatory asset) (dollars in millions):

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

Contributions

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

5. Income Taxes

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

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

As of June 30, 2015, the tax year ended December 31, 2011 and all subsequent tax years remain subject to examination by the IRS. With few exceptions, we are no longer subject to state income tax examinations by tax authorities for years before 2009.

6. Palo Verde Sale Leaseback Variable Interest Entities

In 1986, APS entered into agreements with three separate VIE lessor trust entities in order to sell and lease back interests in Palo Verde Unit 2 and related common facilities. These lease agreements include fixed rate renewal periods. On July 7, 2014, APS notified the lessor trust entities of APS's intent to exercise the fixed rate lease renewal options. The length of the renewal options will result in APS retaining the assets through 2023 under one lease and 2033 under the other two leases. APS will be required to make payments relating to these leases of approximately $49 million in 2015, $23 million annually for the period 2016 through 2023, and $16 million annually for the period 2024 through 2033. At the end of the lease renewal periods, APS will have the option to purchase the leased assets at their fair market value, extend the leases for up to 2 years, or return the assets to the lessors.

The fixed rate renewal periods give APS the ability to utilize the assets for a significant portion of the assets' economic life, and therefore provide APS with the power to direct activities of the VIEs that most significantly impact the VIEs' economic performance. Predominately due to the fixed rate renewal periods, APS has been deemed the primary beneficiary of these VIEs and therefore consolidates the VIEs.

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

In accordance with the regulatory treatment, higher depreciation expense and a regulatory liability were recorded in consolidation to offset the decrease in the noncontrolling interests' share of net income. Accordingly, income attributable to Pinnacle West shareholders was not impacted by the consolidation or the lease extensions. Consolidation of these VIEs also results in changes to our Condensed Consolidated Statements of Cash Flows, but does not impact net cash flows.

Our Condensed Consolidated Balance Sheets at June 30, 2015 and December 31, 2014 include the following amounts relating to the VIEs (in millions):

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

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

APS is exposed to losses relating to these VIEs upon the occurrence of certain events that APS does not consider to be reasonably likely to occur. Under certain circumstances (for example, the United States Nuclear Regulatory Commission ("NRC") issuing specified violation orders with respect to Palo Verde or the occurrence of specified nuclear events), APS would be required to make specified payments to the VIEs' noncontrolling equity participants, assume the VIEs' debt, and take title to the leased Unit 2 interests, which, if appropriate, may be required to be written down in value. If such an event had occurred as of June 30, 2015, APS would have been required to pay the noncontrolling equity participants approximately $114 million and assume $1 million of debt. Since APS consolidates these VIEs, the debt APS would be required to assume is already reflected in our Condensed

Consolidated Balance Sheets.

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

7. Derivative Accounting

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

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

Our derivative instruments, excluding those qualifying for a scope exception, are recorded on the balance sheet as an asset or liability and are measured at fair value. See Note 11 for a discussion of fair value measurements. Derivative instruments may qualify for the normal purchases and normal sales scope exception if they require physical delivery and the quantities represent those transacted in the normal course of business. Derivative instruments qualifying for the normal purchases and sales scope exception are accounted for under the accrual method of accounting and excluded from our derivative instrument discussion and disclosures below.

Hedge effectiveness is the degree to which the derivative instrument contract and the hedged item are correlated and is measured based on the relative changes in fair value of the derivative instrument contract and the hedged item over time. We assess hedge effectiveness both at inception and on a continuing basis. These assessments exclude the time value of certain options. For accounting hedges that are deemed an effective hedge, the effective portion of the gain or loss on the derivative instrument is reported as a component of OCI and reclassified into earnings in the same period during which the hedged transaction affects earnings. We recognize in current earnings, subject to the PSA, the gains and losses representing hedge ineffectiveness, and the gains and losses on any hedge components which are excluded from our effectiveness assessment. As cash

25

flow hedge accounting has been discontinued for the significant majority of our contracts, after May 31, 2012, effectiveness testing is no longer being performed for these contracts.

For its regulated operations, APS defers for future rate treatment 100% of the unrealized gains and losses on derivatives pursuant to the PSA mechanism that would otherwise be recognized in income. Realized gains and losses on derivatives are deferred in accordance with the PSA to the extent the amounts are above or below the Base Fuel Rate (see Note 3). Gains and losses from derivatives in the following tables represent the amounts reflected in income before the effect of PSA deferrals.

As of June 30, 2015, we had the following outstanding gross notional volume of derivatives, which represent both purchases and sales (does not reflect net position):

Commodity	Quantity	
Power	3,808	GWh
Gas	188	Billion cubic feet

Gains and Losses from Derivative Instruments

The following table provides information about gains and losses from derivative instruments in designated cash flow accounting hedging relationships during the three and six months ended June 30, 2015 and 2014 (dollars in thousands):

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

(a) During the three and six months ended June 30, 2015 and 2014, we had no amounts reclassified from accumulated OCI to earnings related to discontinued cash flow hedges.
(b) Amounts are before the effect of PSA deferrals.

During the next twelve months, we estimate that a net loss of $4 million before income taxes will be reclassified from accumulated OCI as an offset to the effect of market price changes for the related hedged transactions. In accordance with the PSA, most of these amounts will be recorded as either a regulatory asset or liability and have no immediate effect on earnings.

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

Derivative Instruments in the Condensed Consolidated Balance Sheets

Our derivative transactions are typically executed under standardized or customized agreements, which include collateral requirements and, in the event of a default, would allow for the netting of positive and negative exposures associated with a single counterparty. Agreements that allow for the offsetting of positive and negative exposures associated with a single counterparty are considered master netting arrangements. Transactions with counterparties that have master netting arrangements are offset and reported net on the Condensed Consolidated Balance Sheets. Transactions that do not allow for offsetting of positive and negative positions are reported gross on the Condensed Consolidated Balance Sheets.

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

The significant majority of our derivative instruments are not currently designated as hedging instruments. The Condensed Consolidated Balance Sheets as of June 30, 2015 and December 31, 2014, each include gross liabilities of $4 million of derivative instruments designated as hedging instruments.

The following tables provide information about the fair value of our risk management activities reported on a gross basis, and the impacts of offsetting as of June 30, 2015 and December 31, 2014. These amounts relate to commodity contracts and are located in the assets and liabilities from risk management activities lines of our Condensed Consolidated Balance Sheets.

PINNACLE WEST CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

(a) All of our gross recognized derivative instruments were subject to master netting arrangements.
(b) Includes cash collateral provided to counterparties of $17,700.
(c) Represents cash collateral, cash margin and option premiums that are not subject to offsetting. Amounts relate to non-derivative instruments, derivatives qualifying for scope exceptions, or collateral and margin posted in excess of the recognized derivative instrument. Includes cash collateral received from counterparties of $8,096, cash margin provided to counterparties of $2,162 and option premiums of $2,740.

As of December 31, 2014: (Dollars in thousands)	Gross Recognized Derivatives (a)	Amounts Offset (b)	Net Recognized Derivatives	Other (c)	Amount Reported on Balance Sheet
Current assets	$28,562	$(15,127)	$13,435	$350	$13,785
Investments and other assets	24,810	(7,190)	17,620	—	17,620