FORM 10-Q

Securities and Exchange Commission

Washington, D.C. 20549

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

For the quarterly period ended June 30, 1999

OR

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

For the transition period from \_\_\_\_\_\_\_\_\_\_\_\_\_\_ to \_\_\_\_\_\_\_\_\_\_\_\_\_\_

Commission file number 1-8962

PINNACLE WEST CAPITAL CORPORATION

------------------------------------------------------

(Exact name of registrant as specified in its charter)

|  |  |
| --- | --- |
| Arizona | 86-0512431 |
| - ------------------------------- | ------------------- |
| (State or other jurisdiction of | (I.R.S. Employer |
| incorporation or organization) | Identification No.) |
| 400 E. Van Buren St., P.O. Box 52132, Phoenix, Arizona | 85072-2132 |
| - ------------------------------------------------------ | ---------- |
| (Address of principal executive offices) | (Zip Code) |
| Registrant's telephone number, including area code: | (602) 379-2500 |

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(Former name, former address and former fiscal year,

if changed since last report)

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.

Yes [X] No [ ]

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

Number of shares of common stock, no par value,

outstanding as of August 12, 1999: 84,764,309

Glossary

ACC - Arizona Corporation Commission

ACC Staff - Staff of the Arizona Corporation Commission

APS - Arizona Public Service Company

APS Energy Services - APS Energy Services Company, Inc., a direct access electricity provider

Company - Pinnacle West Capital Corporation

DOE - United States Department of Energy

EITF - Emerging Issues Task Force

EITF 97-4 - Emerging Issues Task Force Issue No. 97-4, "Deregulation of the Pricing of Electricity -- Issues Related to the Applications of FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No. 101, Regulated Enterprises -- Accounting for the Discontinuation of Application of FASB Statement No. 71"

El Dorado - El Dorado Investment Company

EPA - Environmental Protection Agency

FASB - Financial Accounting Standards Board

FERC - Federal Energy Regulatory Commission

ITC - Investment tax credit

March 10-Q - Pinnacle West Capital Corporation Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 1999

1998 10-K - Pinnacle West Capital Corporation Annual Report on Form 10-K for the fiscal year ended December 31, 1998

MW - Megawatt, one million watts

Palo Verde - Palo Verde Nuclear Generating Station

Pinnacle West - Pinnacle West Capital Corporation

Power Coordination Agreement - 1955 agreement between the Company and Salt River Project that provides for certain electric system and power sales

SFAS No. 71 - Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation"

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SFAS No. 133 - Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities"

Salt River Project - Salt River Project Agricultural Improvement and Power District

SunCor - SunCor Development Company

Territorial Agreement - 1955 agreement between the Company and Salt River Project that has provided exclusive retail service territories in Arizona for each party

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

PINNACLE WEST CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(Dollars in thousands, except per share amounts)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Three Months Ended | | |
|  |  | June 30, | |  |
|  | ---------------------------- | | | |
|  |  | 1999 |  | 1998 |
|  | ------------ | | ------------ | |
| Operating Revenues |  |  |  |  |
| Electric | $ | 511,434 | $ | 441,715 |
| Real estate |  | 32,697 |  | 28,916 |
|  | ------------ | | ------------ | |
| Total |  | 544,131 |  | 470,631 |
|  | ------------ | | ------------ | |
| Operating Expenses |  |  |  |  |
| Fuel and purchased power |  | 132,543 |  | 95,585 |
| Utility operations and maintenance |  | 106,234 |  | 102,713 |
| Real estate operations |  | 29,401 |  | 26,213 |
| Depreciation and amortization |  | 97,383 |  | 93,585 |
| Taxes other than income taxes |  | 29,602 |  | 29,930 |
|  | ------------ | | ------------ | |
| Total |  | 395,163 |  | 348,026 |
|  | ------------ | | ------------ | |
| Operating Income |  | 148,968 |  | 122,605 |
|  | ------------ | | ------------ | |
| Other Income (Expense) |  |  |  |  |
| Preferred stock dividend requirements of APS |  | -- |  | (2,435) |
| Net other income and expense |  | 399 |  | 192 |
|  | ------------ | | ------------ | |
| Total |  | 399 |  | (2,243) |
|  | ------------ | | ------------ | |
| Income Before Interest and Income Taxes |  | 149,367 |  | 120,362 |
|  | ------------ | | ------------ | |
| Interest Expense |  |  |  |  |
| Interest charges |  | 41,105 |  | 42,441 |
| Capitalized interest |  | (4,189) |  | (4,874) |
|  | ------------ | | ------------ | |
| Total |  | 36,916 |  | 37,567 |
|  | ------------ | | ------------ | |
| Income Before Income Taxes |  | 112,451 |  | 82,795 |
| Income Taxes |  | 43,749 |  | 33,798 |
|  | ------------ | | ------------ | |
| Net Income | $ | 68,702 | $ | 48,997 |
|  | ============ | | ============ | |
| Average Common Shares Outstanding - Basic |  | 84,716,175 |  | 84,810,790 |
| Average Common Shares Outstanding - Diluted |  | 85,093,421 |  | 85,416,069 |
| Earnings Per Average Common Share Outstanding |  |  |  |  |
| Net income - basic | $ | 0.81 | $ | 0.58 |
| Net income - diluted | $ | 0.81 | $ | 0.57 |
| Dividends Declared Per Share | $ | 0.65 | $ | 0.60 |
|  | ============ | | ============ | |

See Notes to Condensed Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(Dollars in thousands, except per share amounts)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Six Months Ended | | |
|  |  | June 30, | |  |
|  | ---------------------------- | | | |
|  |  | 1999 |  | 1998 |
|  | ------------ | | ------------ | |
| Operating Revenues |  |  |  |  |
| Electric | $ | 925,417 | $ | 822,138 |
| Real estate |  | 57,230 |  | 63,077 |
|  | ------------ | | ------------ | |
| Total |  | 982,647 |  | 885,215 |
|  | ------------ | | ------------ | |
| Operating Expenses |  |  |  |  |
| Fuel and purchased power |  | 231,784 |  | 169,502 |
| Utility operations and maintenance |  | 205,318 |  | 199,129 |
| Real estate operations |  | 51,636 |  | 56,449 |
| Depreciation and amortization |  | 194,293 |  | 186,415 |
| Taxes other than income taxes |  | 59,049 |  | 60,278 |
|  | ------------ | | ------------ | |
| Total |  | 742,080 |  | 671,773 |
|  | ------------ | | ------------ | |
| Operating Income |  | 240,567 |  | 213,442 |
|  | ------------ | | ------------ | |
| Other Income (Expense) |  |  |  |  |
| Preferred stock dividend requirements of APS |  | (1,016) |  | (5,313) |
| Net other income and expense |  | (1,938) |  | 4,551 |
|  | ------------ | | ------------ | |
| Total |  | (2,954) |  | (762) |
|  | ------------ | | ------------ | |
| Income Before Interest and Income Taxes |  | 237,613 |  | 212,680 |
|  | ------------ | | ------------ | |
| Interest Expense |  |  |  |  |
| Interest charges |  | 81,874 |  | 85,363 |
| Capitalized interest |  | (8,263) |  | (9,530) |
|  | ------------ | | ------------ | |
| Total |  | 73,611 |  | 75,833 |
|  | ------------ | | ------------ | |
| Income Before Income Taxes |  | 164,002 |  | 136,847 |
| Income Taxes |  | 64,610 |  | 56,764 |
|  | ------------ | | ------------ | |
| Net Income | $ | 99,392 | $ | 80,083 |
|  | ============ | | ============ | |
| Average Common Shares Outstanding - Basic |  | 84,693,115 |  | 84,798,120 |
| Average Common Shares Outstanding - Diluted |  | 85,135,423 |  | 85,375,609 |
| Earnings Per Average Common Share Outstanding |  |  |  |  |
| Net income - basic | $ | 1.17 | $ | 0.94 |
| Net income - diluted | $ | 1.17 | $ | 0.94 |
| Dividends Declared Per Share | $ | 0.975 | $ | 0.90 |
|  | ============ | | ============ | |

See Notes to Condensed Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(Dollars in thousands, except per share amounts)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Twelve Months Ended | | |
|  |  | June 30, | | |
|  | ---------------------------- | | | |
|  |  | 1999 |  | 1998 |
|  | ------------ | | ------------ | |
| Operating Revenues |  |  |  |  |
| Electric | $ | 2,109,677 | $ | 1,862,919 |
| Real estate |  | 118,341 |  | 129,841 |
|  | ------------ | | ------------ | |
| Total |  | 2,228,018 |  | 1,992,760 |
|  | ------------ | | ------------ | |
| Operating Expenses |  |  |  |  |
| Fuel and purchased power |  | 599,783 |  | 421,350 |
| Utility operations and maintenance |  | 420,230 |  | 421,385 |
| Real estate operations |  | 110,518 |  | 120,014 |
| Depreciation and amortization |  | 387,557 |  | 370,289 |
| Taxes other than income taxes |  | 115,677 |  | 121,269 |
|  | ------------ | | ------------ | |
| Total |  | 1,633,765 |  | 1,454,307 |
|  | ------------ | | ------------ | |
| Operating Income |  | 594,253 |  | 538,453 |
|  | ------------ | | ------------ | |
| Other Income (Expense) |  |  |  |  |
| Preferred stock dividend requirements of APS |  | (5,406) |  | (11,295) |
| Net other income and expense |  | (5,880) |  | 74 |
|  | ------------ | | ------------ | |
| Total |  | (11,286) |  | (11,221) |
|  | ------------ | | ------------ | |
| Income Before Interest and Income Taxes |  | 582,967 |  | 527,232 |
|  | ------------ | | ------------ | |
| Interest Expense |  |  |  |  |
| Interest charges |  | 165,656 |  | 176,207 |
| Capitalized interest |  | (17,329) |  | (19,223) |
|  | ------------ | | ------------ | |
| Total |  | 148,327 |  | 156,984 |
|  | ------------ | | ------------ | |
| Income Before Income Taxes |  | 434,640 |  | 370,248 |
| Income Taxes |  | 172,439 |  | 146,873 |
|  | ------------ | | ------------ | |
| Net Income | $ | 262,201 | $ | 223,375 |
|  | ============ | | ============ | |
| Average Common Shares Outstanding - Basic |  | 84,722,147 |  | 84,767,601 |
| Average Common Shares Outstanding - Diluted |  | 85,232,428 |  | 85,298,571 |
| Earnings Per Average Common Share Outstanding |  |  |  |  |
| Net income - basic | $ | 3.09 | $ | 2.64 |
| Net income - diluted | $ | 3.08 | $ | 2.62 |
| Dividends Declared Per Share | $ | 1.30 | $ | 1.20 |
|  | ============ | | ============ | |

See Notes to Condensed Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

(Thousands of Dollars)

|  |  |  |  |
| --- | --- | --- | --- |
|  | June 30, | December 31, | |
|  | 1999 |  | 1998 |
|  | (Unaudited) |  |  |
|  | ---------- | ---------- | |
| Current Assets |  |  |  |
| Cash and cash equivalents | $ 32,511 | $ | 20,538 |
| Customer and other receivables--net | 185,701 |  | 233,876 |
| Accrued utility revenues | 98,046 |  | 67,740 |
| Materials and supplies | 70,919 |  | 69,074 |
| Fossil fuel | 17,786 |  | 13,978 |
| Deferred income taxes | 4,058 |  | 3,999 |
| Other current assets | 55,923 |  | 47,594 |
|  | ---------- | ---------- | |
| Total current assets | 464,944 |  | 456,799 |
|  | ---------- | ---------- | |
| Investments and Other Assets |  |  |  |
| Real estate investments--net | 335,977 |  | 331,021 |
| Other assets | 262,586 |  | 236,562 |
|  | ---------- | ---------- | |
| Total investments and other assets | 598,563 |  | 567,583 |
|  | ---------- | ---------- | |
| Utility Plant |  |  |  |
| Electric plant in service and held for future use | 7,370,852 |  | 7,265,604 |
| Less accumulated depreciation and amortization | 2,941,878 |  | 2,814,762 |
|  | ---------- | ---------- | |
| Total | 4,428,974 |  | 4,450,842 |
| Construction work in progress | 247,910 |  | 228,643 |
| Nuclear fuel, net of amortization | 50,446 |  | 51,078 |
|  | ---------- | ---------- | |
| Net utility plant | 4,727,330 |  | 4,730,563 |
|  | ---------- | ---------- | |
| Deferred Debits |  |  |  |
| Regulatory asset for income taxes | 373,417 |  | 400,795 |
| Rate synchronization cost deferral | 276,055 |  | 303,660 |
| Other deferred debits | 363,912 |  | 365,146 |
|  | ---------- | ---------- | |
| Total deferred debits | 1,013,384 |  | 1,069,601 |
|  | ---------- | ---------- | |
| Total Assets | $6,804,221 | $6,824,546 | |
|  | ========== | ========== | |

See Notes to Condensed Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

LIABILITIES AND EQUITY

(Thousands of Dollars)

|  |  |  |
| --- | --- | --- |
|  | June 30, | December 31, |
|  | 1999 | 1998 |
|  | (Unaudited) |  |
|  | ---------- | ---------- |
| Current Liabilities |  |  |
| Accounts payable | $ 127,791 | $ 155,800 |
| Accrued taxes | 158,195 | 62,520 |
| Accrued interest | 32,972 | 31,866 |
| Dividends payable | 27,552 | -- |
| Short-term borrowings | 223,950 | 178,830 |
| Current maturities of long-term debt | 17,810 | 168,045 |
| Customer deposits | 25,943 | 28,510 |
| Other current liabilities | 5,806 | 14,632 |
|  | ---------- | ---------- |
| Total current liabilities | 620,019 | 640,203 |
|  | ---------- | ---------- |
| Long-Term Debt Less Current Maturities | 2,164,459 | 2,048,961 |
|  | ---------- | ---------- |
| Deferred Credits and Other |  |  |
| Deferred income taxes | 1,319,340 | 1,343,536 |
| Deferred investment tax credit | 19,672 | 27,345 |
| Unamortized gain - sale of utility plant | 75,499 | 77,787 |
| Other | 435,351 | 428,122 |
|  | ---------- | ---------- |
| Total deferred credits and other | 1,849,862 | 1,876,790 |
|  | ---------- | ---------- |
| Commitments and contingencies (Notes 5, 6, 9 and 10) |  |  |
| Minority Interests |  |  |
| Non-redeemable preferred stock of APS | -- | 85,840 |
|  | ---------- | ---------- |
| Redeemable preferred stock of APS | -- | 9,401 |
|  | ---------- | ---------- |
| Common Stock Equity |  |  |
| Common stock, no par value | 1,540,437 | 1,550,643 |
| Retained earnings | 629,444 | 612,708 |
|  | ---------- | ---------- |
| Total common stock equity | 2,169,881 | 2,163,351 |
|  | ---------- | ---------- |
| Total Liabilities and Equity | $6,804,221 | $6,824,546 |
|  | ========== | ========== |

See Notes to Condensed Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(THOUSANDS OF DOLLARS)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Six Months Ended | | |
|  |  | June 30, | | |
|  | ---------------------- | | | |
|  |  | 1999 |  | 1998 |
|  | --------- | | --------- | |
| CASH FLOWS FROM OPERATING ACTIVITIES |  |  |  |  |
| Net Income | $ | 99,392 | $ | 80,083 |
| Items not requiring cash |  |  |  |  |
| Depreciation and amortization |  | 194,293 |  | 186,415 |
| Nuclear fuel amortization |  | 15,673 |  | 16,580 |
| Deferred income taxes--net |  | (21,477) |  | 5,645 |
| Deferred investment tax credit |  | (7,673) |  | (7,895) |
| Other--net |  | 1,096 |  | 782 |
| Changes in current assets and liabilities |  |  |  |  |
| Customer and other receivables--net |  | 48,175 |  | 12,544 |
| Accrued utility revenues |  | (30,306) |  | (8,363) |
| Materials, supplies and fossil fuel |  | (5,653) |  | (8,912) |
| Other current assets |  | (8,329) |  | (5,314) |
| Accounts payable |  | (25,465) |  | (12,438) |
| Accrued taxes |  | 95,675 |  | (8,081) |
| Accrued interest |  | 1,106 |  | (349) |
| Other current liabilities |  | (5,307) |  | 5,339 |
| Decrease (increase) in land held |  | (4,642) |  | 15,084 |
| Other--net |  | (16,382) |  | (7,364) |
|  | --------- | | --------- | |
| Net Cash Flow Provided By Operating Activities |  | 330,176 |  | 263,756 |
|  | --------- | | --------- | |
| CASH FLOWS FROM INVESTING ACTIVITIES |  |  |  |  |
| Capital expenditures |  | (153,730) |  | (144,580) |
| Capitalized interest |  | (8,263) |  | (9,530) |
| Other--net |  | 1,282 |  | 15,485 |
|  | --------- | | --------- | |
| Net Cash Flow Used For Investing Activities |  | (160,711) |  | (138,625) |
|  | --------- | | --------- | |
| CASH FLOWS FROM FINANCING ACTIVITIES |  |  |  |  |
| Issuance of long-term debt |  | 193,691 |  | 99,375 |
| Short-term borrowings--net |  | 45,120 |  | 82,735 |
| Dividends paid on common stock |  | (55,101) |  | (50,878) |
| Repayment of long-term debt |  | (235,755) |  | (220,782) |
| Redemption of preferred stock |  | (96,499) |  | (31,209) |
| Other--net |  | (8,948) |  | (215) |
|  | --------- | | --------- | |
| Net Cash Flow Used For Financing Activities |  | (157,492) |  | (120,974) |
|  | --------- | | --------- | |
| Net Cash Flow |  | 11,973 |  | 4,157 |
| Cash and Cash Equivalents at Beginning of Period |  | 20,538 |  | 27,484 |
|  | ========= | | ========= | |
| Cash and Cash Equivalents at End of Period | $ | 32,511 | $ | 31,641 |
|  | ========= | | ========= | |
| Supplemental Disclosure of Cash Flow Information: |  |  |  |  |
| Cash paid during the period for: |  |  |  |  |
| Interest, net of amounts capitalized | $ | 68,341 | $ | 72,863 |
| Income taxes | $ | 940 | $ | 64,820 |

See Notes to Condensed Consolidated Financial Statements.

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PINNACLE WEST CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. The condensed consolidated financial statements include the accounts of Pinnacle West and its subsidiaries: APS, Suncor, El Dorado, and APS Energy Services. All significant intercompany balances have been eliminated. We have reclassified certain prior year amounts to conform to the current year presentation.
2. Our unaudited condensed consolidated financial statements reflect all adjustments which we believe are necessary for the fair presentation of our financial position and results of operations for the periods presented. These adjustments are of a normal recurring nature. We suggest that these condensed consolidated financial statements and notes to condensed consolidated financial statements be read along with the consolidated financial statements and notes to consolidated financial statements included in our 1998 10-K.
3. Weather conditions can have a significant impact on APS' results for interim periods. For this and other reasons, results for interim periods do not necessarily represent results to be expected for the year.
4. See "Liquidity and Capital Resources" in Part I, Item 2 of this report for changes in capitalization for the six months ended June 30, 1999.
5. Regulatory Accounting

APS prepares its financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation." SFAS No. 71 requires a cost-based, rate-regulated enterprise to reflect the impact of regulatory decisions in its financial statements. APS' existing regulatory orders and the current regulatory environment support its accounting practices related to regulatory assets, which amounted to about $850 million at June 30, 1999. Under the 1996 regulatory agreement (see Note 7), the ACC accelerated the amortization of substantially all of APS' regulatory assets to an eight-year period that will end June 30, 2004.

During 1997, the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) issued EITF 97-4. EITF 97-4 requires that SFAS No. 71 be discontinued no later than when legislation is passed or a rate order is issued that contains sufficient detail to determine its effect on the portion of the business being deregulated, which could result in write-downs or write-offs of physical and/or regulatory assets. Additionally, the EITF determined that regulatory assets should not be written off if they are to be recovered from a portion of the entity which continues to apply SFAS No. 71.

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Although rules have been proposed for the transition of generation services to competition, there are many unresolved issues. APS continues to apply SFAS No. 71 to its generation operations. If rate recovery of regulatory assets is no longer probable, whether due to competition or regulatory action, APS would be required to write off the remaining balance as an extraordinary charge to expense. See Note 6 for a discussion of a proposed settlement agreement which, if approved, would result in the discontinuation of SFAS No. 71 for generation operations.

1. Regulatory Matters -- Electric Industry Restructuring

STATE

PROPOSED SETTLEMENT AGREEMENT As of May 14, 1999, APS entered into a comprehensive Settlement Agreement with various other parties, including representatives of major consumer groups, related to the implementation of retail electric competition. Hearings before the ACC on the Settlement Agreement ended in July 1999, and a final ACC order, which is a condition to the agreement's effectiveness, has not yet been issued. By the terms of the Settlement Agreement, unless ACC approval has been obtained on or before August 1, 1999, each party has the right to unilaterally withdraw from the Settlement Agreement. To date, no party has elected to withdraw.

The following are the major provisions of the Settlement Agreement:

* APS will reduce rates for standard offer service for customers with loads less than 3 megawatts in a series of annual rate reductions of 1.5% beginning July 1, 1999 through July 1, 2003, for a total of 7.5%. The first reduction includes the July 1, 1999 retail price decrease related to the 1996 regulatory agreement. See Note 7. For customers having loads 3 megawatts or greater, standard offer rates will be reduced in annual increments that total 5% through 2002.
* Unbundled rates being charged by APS for competitive direct access service (for example, distribution services) will become effective as of July 1, 1999, and will be subject to annual reductions, that vary by rate class, through 2003.
* There will be a moratorium on retail rate changes for standard offer and unbundled competitive direct access rates until July 1, 2004, except for the price reductions described above and certain other limited circumstances.
* APS will be permitted to defer for later recovery prudent and reasonable costs of complying with the ACC electric competition rules, system benefits costs in excess of the levels included in current rates, and costs associated with APS' "provider of last resort" and standard offer obligations for service after July 1, 2004. These costs are to be recovered through an adjustment clause or clauses commencing on July 1, 2004.

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* APS' distribution system will be open for retail access upon approval of the Settlement Agreement. Customers will be eligible for retail access in accordance with the phase-in program expected to be ultimately adopted by the ACC under the electric competition rules when such rules become effective, with an additional 140 megawatts being made available to eligible non-residential customers. Unless subject to judicial or regulatory restraint, APS will open its distribution system to retail access for all customers on January 1, 2001.
* APS is currently recovering substantially all of its regulatory assets through July 1, 2004, pursuant to the 1996 regulatory agreement. See Note 7. In addition, the Settlement Agreement states that APS has demonstrated that its allowable stranded costs, after mitigation and exclusive of regulatory assets, are at least $533 million net present value. APS will not be allowed to recover $183 million net present value of the above amounts. The Settlement Agreement provides that APS will have the opportunity to recover $350 million net present value through a competitive transition charge (CTC) that will remain in effect through December 31, 2004, at which time it will terminate. Any over/under-recovery will be credited/debited against the costs subject to recovery under the adjustment clause described above.
* APS will form a separate corporate affiliate or affiliates and transfer thereto its generating assets and competitive services by December 31, 2002.
* Upon final approval of the Settlement Agreement by the ACC in an order no longer subject to judicial review, APS will move to dismiss all of its litigation pending against the ACC as of the date of the Settlement Agreement.

Upon final ACC order, APS will discontinue the application of Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," for its generation operations. This means that regulatory assets, unless reestablished as recoverable through ongoing regulated cash flows, are to be eliminated and the generation assets must be tested for impairment. The regulatory disallowance, which removes $234 million pre-tax ($183 million net present value) from ongoing regulatory cash flows, will be recorded as a net reduction of regulatory assets. This reduction will be reported as an extraordinary charge on the income statement. The regulatory assets to be recovered under this Settlement Agreement would be amortized as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  | (Millions) |  |  |  |
|  |  |  |  |  | 1/1 - 6/30 |  |
| 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | Total |
| - -------- | -------- | -------- | -------- | -------- | -------- | -------- |
| $164 | $158 | $145 | $115 | $86 | $18 | $686 |

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PROPOSED RETAIL ELECTRIC COMPETITION RULES In December 1996, the ACC adopted rules that provide a framework for the introduction of retail electric competition in Arizona. The ACC adopted certain modifications to these rules on August 10, 1998, and on December 11, 1998, the ACC adopted the amended rules, without any modifications that would have a significant impact on APS, on a permanent basis. We believe that certain provisions of the 1996 ACC rules and the amended rules are deficient and APS has filed lawsuits to protect its legal rights regarding the 1996 rules and the amended rules. These lawsuits are pending but two related cases filed by other utilities have been partially decided in a manner adverse to those utilities' positions.

On January 11, 1999, the ACC issued an order which stayed the amended rules, granted reconsideration of the decision to make the rules permanent, and directed the hearing division of the ACC to establish a procedural order for further action on these rules. The order also granted waivers from compliance with the rules for APS, and all affected utilities.

On February 5, 1999, the ACC Hearing Division issued recommendations for changes to the amended rules. The recommended changes to the amended rules were further modified by a Procedural Order of the ACC Hearing Division dated March 12, 1999. On April 14, 1999, the ACC voted to notice, for further rulemaking, the Hearing Division's recommended changes, with certain exceptions (the "Proposed Rules"). The Proposed Rules approved by the ACC for further rulemaking include the following major provisions:

* They would apply to virtually all Arizona electric utilities regulated by the ACC, including APS.
* The Proposed Rules require each affected utility, including APS, to make available at least 20% of its 1995 system retail peak demand for competitive generation supply beginning when the ACC makes a final decision on each utility's stranded costs and unbundled rates (Final Decision Date) or January 1, 2001, whichever is earlier, and 100% beginning January 1, 2001.
* Subject to the 20% requirement, all utility customers with single premise loads of one megawatt or greater will be eligible for competitive electric services on the Final Decision Date. Customers with single premise loads of 40 kilowatts or greater may aggregate loads to meet this one megawatt requirement.
* When effective, residential customers will be phased in at 1 1/4% per quarter calculated beginning on January 1, 1999, subject to the 20% requirement above.
* Electric service providers that get Certificates of Convenience and Necessity (CC&Ns) from the ACC can supply only competitive services, including electric generation, but not electric transmission and distribution.

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* Affected utilities must file ACC tariffs with separate pricing for electric services provided for noncompetitive services.
* The ACC shall allow a reasonable opportunity for recovery of unmitigated stranded costs (see "Stranded Costs" below).
* Absent an ACC waiver, prior to January 1, 2001, each affected utility must transfer all competitive generation assets and services either to an unaffiliated party or to a separate corporate affiliate.

The Proposed Rules will not become final and effective until approved by the ACC following formal rulemaking proceedings under Arizona law. In compliance with statutory procedural requirements, ACC oral proceedings on the matter were held in June 1999, and a final order has not yet been issued.

We cannot currently predict when or if the Proposed Rules will become effective, when or if the stay of the amended rules will be lifted, or when retail electric competition will be introduced in Arizona. See "Proposed Settlement Agreement" above for discussion of APS' proposals regarding the introduction of retail electric competition in Arizona.

STRANDED COSTS On June 22, 1998, the ACC issued an Order on stranded cost determination and recovery. APS believes that certain provisions of the stranded cost order are deficient and in August 1998, APS filed two lawsuits to protect its legal rights relating to the order.

On February 5, 1999, the ACC Hearing Division issued recommended changes to the June 1998 stranded cost order. These recommended changes were further amended by an ACC Procedural Order dated March 12, 1999. On April 14, 1999, the ACC voted to adopt the Hearing Division's changes to the June 1998 stranded cost order. The amended stranded cost order became effective on April 27, 1999, and allows each affected utility to choose from any one of five options for the recovery of stranded costs:

* Net Revenues Lost Methodology is the difference between generation revenues under traditional regulation and generation revenues under competition. This option provides for declining recovery percentages for stranded costs over a five-year recovery period. Regulatory assets are to be fully recovered under their presently authorized amortization schedule. In accordance with a 1996 regulatory agreement, the ACC accelerated the amortization of substantially all of APS' regulatory assets to an eight-year period that ends June 30, 2004.
* Divestiture/Auction Methodology allows a utility to divest all or substantially all of its generating assets, including regulatory assets associated with generation, in order to collect 100 percent of the difference between net sales price and book value of generating assets divested over a ten-year period, with no return on the unamortized balance.

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* Financial Integrity Methodology allows a utility "sufficient revenues to meet minimum financial ratios" for a period of ten years.
* Settlement Methodology allows a settlement to be agreed upon by the ACC and a utility.
* Any combination of the above, if shown to be in the best interests of all affected parties.

See "Proposed Settlement Agreement" above, for a discussion of the methodology APS proposed.

LEGISLATIVE INITIATIVES An Arizona joint legislative committee studied electric utility industry restructuring issues in 1996 and 1997. In conjunction with that study, the Arizona legislative counsel prepared memoranda in late 1997 related to the legal authority of the ACC to deregulate the Arizona electric utility industry. The memoranda raise a question as to the degree to which the ACC may, under the Arizona Constitution, deregulate any portion of the electric utility industry and allow rates to be determined by market forces. This latter issue has been subsequently decided by lower courts in favor of the ACC in four separate lawsuits, two of which are unrelated.

In May 1998, a law was enacted to facilitate implementation of retail electric competition in Arizona. The law includes the following major provisions:

* Arizona's largest government-operated electric utility (Salt River Project) and, at their option, smaller municipal electric systems must (i) make at least 20% of their 1995 retail peak demand available to electric service providers by December 31, 1998 and for all retail customers by December 31, 2000; (ii) decrease rates by at least 10% over a ten-year period beginning as early as January 1, 1991; (iii) implement procedures and public processes comparable to those already applicable to public service corporations for establishing the terms, conditions, and pricing of electric services as well as certain other decisions affecting retail electric competition;
* describes the factors which form the basis of consideration by Salt River Project in determining stranded costs; and
* metering and meter reading services must be provided on a competitive basis during the first two years of competition only for customers having demands in excess of one megawatt (and that are eligible for competitive generation services), and thereafter for all customers receiving competitive electric generation.

In addition, the Arizona legislature will review and make recommendations for the 1999 legislative session on certain competitive issues.

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GENERAL Until the manner of implementation of competition, including addressing stranded costs, is determined, we cannot accurately predict the impact of full retail competition on our financial position, cash flows, or results of operation. As competition in the electric industry continues to evolve, we will continue to evaluate strategies and alternatives that will position us to compete in the new regulatory environment. See "Proposed Settlement Agreement" above.

FEDERAL The Energy Policy Act of 1992 and recent rulemakings by FERC have promoted increased competition in the wholesale electric power markets. APS does not expect these rules to have a material impact on its financial statements.

Several electric utility industry restructuring bills have been introduced during the 106th Congress. Several of these bills are written to allow consumers to choose their electricity suppliers beginning in 2000 and beyond. These bills, other bills that are expected to be introduced, and ongoing discussions at the federal level suggest a wide range of opinion that will need to be narrowed before any substantial restructuring of the electric utility industry can occur.

7. 1996 Regulatory Agreement

In April 1996, the ACC approved a regulatory agreement between the ACC Staff and

APS. The major provisions of this agreement are:

* An annual rate reduction of approximately $48.5 million ($29 million after income taxes), or 3.4% on average for all customers except certain contract customers, effective July 1, 1996.
* Recovery of substantially all of APS' present regulatory assets through accelerated amortization over an eight-year period that will end June 30, 2004, increasing annual amortization by approximately $120 million ($72 million after income taxes).
* A formula for sharing future cost savings between customers and shareholders (price reduction formula), referencing a return on equity (as defined) of 11.25%.
* A moratorium on filing for permanent rate changes prior to July 2, 1999, except under the price reduction formula and under certain other limited circumstances.
* Infusion of $200 million of common equity into APS by the parent company, in annual payments of $50 million starting in 1996.

Based on the price reduction formula, the ACC approved retail price decreases of approximately $17.6 million ($10.5 million after income taxes), or 1.2%, effective July 1, 1997, and approximately $17 million ($10 million after income taxes), or 1.1%, effective July 1, 1998. In May 1999, APS filed with the ACC for another retail price decrease of approximately $10.8 million annually ($6.5 million after income taxes), which would become effective as of July 1, 1999. The amount and timing of the price decrease are subject to ACC approval. This will be the last price decrease under the 1996 regulatory

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agreement and will be included in the first rate reduction under the proposed Settlement Agreement discussed in Note 6. See "Proposed Settlement Agreement" above for a discussion of the price decrease.

8. Agreement with Salt River Project

On April 25, 1998, APS entered into a Memorandum of Agreement with Salt River Project in anticipation of, and to facilitate, the opening of the Arizona electric industry. The Agreement contains the following major components:

* Both parties amended the Territorial that agreement to the provision of non-distribution services.

Agreement to remove any barriers in competitive electricity supply and

* Both parties would amend the Power Coordination Agreement to lower the price that APS will pay Salt River Project for purchased power by approximately $17 million (pretax) during the first full year that the Agreement is effective and by lesser annual amounts during the next seven years.
* Both parties agreed on certain legislative positions regarding electric utility restructuring at the state and federal level.

Certain provisions of the Agreement (including those relating to the amendments of the Territorial Agreement and the Power Coordination Agreement) are affected by the timing of the introduction of competition. See Note 6. On February 18, 1999, the ACC approved the Agreement.

9. Nuclear Insurance

The Palo Verde participants have insurance for public liability payments resulting from nuclear energy hazards to the full limit of liability under federal law. This potential liability is covered by primary liability insurance provided by commercial insurance carriers in the amount of $200 million and the balance by an industry-wide retrospective assessment program. If losses at any nuclear power plant covered by the programs exceed the accumulated funds, APS could be assessed retrospective premium adjustments. The maximum assessment per reactor under the program for each nuclear incident is approximately $88 million, subject to an annual limit of $10 million per incident. Based upon APS' 29.1% interest in the three Palo Verde units, APS' maximum potential assessment per incident is approximately $77 million, with an annual payment limitation of approximately $9 million.

The Palo Verde participants maintain "all risk" (including nuclear hazards) insurance for property damage to, and decontamination of, property at Palo Verde in the aggregate amount of $2.75 billion, a substantial portion of which must first be applied to stabilization and decontamination. APS has also secured insurance against portions of any increased cost of generation or purchased power and business interruption resulting from a sudden and unforeseen outage of any of the three units. The

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insurance coverage discussed in this and the previous paragraph is subject to certain policy conditions and exclusions.

10. Accounting Matters

In June 1998 the Financial Accounting Standards Board (FASB) issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 requires that entities recognize all derivatives as either assets or liabilities on the balance sheet and measure those instruments at fair value. The standard also provides specific guidance for accounting for derivatives designated as hedging instruments. The statement was to have been effective for us in 2000; however, the FASB has moved the effective date to 2001. We are currently evaluating what impact this standard will have on our financial statements.

11. Memorandum of Understanding with Calpine Corporation

On April 23, 1999, we entered into a memorandum of understanding with Calpine Corporation, an independent power producer located in San Jose, California, for

* potential $220 million, 500 megawatt expansion at the site of APS' West Phoenix Power Plant. We entered into a further memorandum of understanding with Calpine dated as of August 4, 1999, relating to the timing of the definitive agreements and the operation of the joint project. The joint project is the second phase of a potential 750 megawatt expansion at West Phoenix, the first phase of which includes the installation of a 120 megawatt combined cycle unit, the cost of which is expected to be approximately $60 million, although that amount is currently subject to negotiation. Assuming approvals are granted, construction is scheduled to begin in mid-2000, with commercial operation of the first phase in mid-2001 and the second phase in early 2002.

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PINNACLE WEST CAPITAL CORPORATION

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

In this section, we explain our results of operations, general financial condition, and outlook for Pinnacle West and our subsidiaries: APS, SunCor, El Dorado, and APS Energy Services, including:

* the changes in our earnings for the periods presented
* the factors impacting our business, including competition and electric industry restructuring
* the effects of regulatory agreements on our results
* our capital needs and resources and
* Year 2000 technology issues.

We suggest this section be read along with the 1998 10-K. Throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations, we refer to specific "Notes" in the Notes to Condensed Consolidated Financial Statements. These Notes add further details to the discussion.

OPERATING RESULTS

OPERATING RESULTS - THREE-MONTH PERIOD ENDED JUNE 30, 1999 COMPARED WITH THREE-MONTH PERIOD ENDED JUNE 30, 1998

Consolidated net income for the three months ended June 30, 1999 was $68.7 million compared with $49.0 million for the same period in the prior year. Net income increased in the three-month comparison primarily because of higher earnings at APS.

APS' earnings increased $19.8 million in the three-month comparison primarily because of the effects of warmer weather, an increase in customers, and increased contributions from power marketing and trading activities, partially offset by a retail price reduction, and higher depreciation and amortization expense. See Note 7 for information on the price reduction.

Electric operating revenues increased $70 million because of:

* increased power marketing and trading revenues ($36 million)
* the effects of warmer weather ($21 million) and
* increases in the number of customers ($17 million).

As mentioned above, these positive factors were partially offset by the effect of a reduction in retail prices ($4 million).

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Power marketing and trading activities are predominantly short-term opportunity wholesale sales. The increase in power marketing revenues resulted primarily from increased activity in western bulk power markets. The increase in power marketing and trading revenues was accompanied by increases in purchased power expenses.

Fuel expenses increased $37 million primarily because of increased wholesale and retail sales volume and higher purchased power prices.

Depreciation and amortization expense increased $4 million because APS had more plant in service.

OPERATING RESULTS - SIX-MONTH PERIOD ENDED JUNE 30, 1999 COMPARED WITH SIX-MONTH PERIOD ENDED JUNE 30, 1998

Consolidated net income for the six months ended June 30, 1999 was $99.4 million compared with $80.1 million for the same period in the prior year. Net income increased in the six-month comparison primarily because of higher earnings at APS, partially offset by lower earnings at El Dorado.

APS earnings increased $23.5 million in the six-month comparison primarily because of an increase in customers, increased contributions from power marketing and trading activities, and the effects of warmer weather, partially offset by a retail price reduction, and higher depreciation and amortization expense. See Note 7 for information on the price reduction.

Electric operating revenues increased $103 million because of:

* increased power marketing and trading revenues ($70 million)
* increases in the number of customers ($29 million)
* the effects of warmer weather ($10 million) and
* miscellaneous factors ($2 million).

As mentioned above, these positive factors were partially offset by the effect of a reduction in retail prices ($8 million).

Power marketing and trading activities are predominantly short-term opportunity wholesale sales. The increase in power marketing revenues resulted from increased activity in western bulk power markets. The increase in power marketing and trading revenues was accompanied by increases in purchased power expenses.

Fuel expenses increased $62 million primarily because of increased wholesale and retail sales volume and higher purchased power prices.

Depreciation and amortization expense increased $8 million because APS had more plant in service.

El Dorado's earnings decreased $4 million because of investment sales in 1998.

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OPERATING RESULTS - TWELVE-MONTH PERIOD ENDED JUNE 30, 1999 COMPARED WITH TWELVE-MONTH PERIOD ENDED JUNE 30, 1998

Consolidated net income for the twelve months ended June 30, 1999 was $262.2 million compared with $223.4 million for the same period in the prior year. Net income increased in the twelve-month comparison primarily because of higher earnings at APS and lower financing costs at the parent, partially offset by lower contributions to earnings by the other subsidiaries.

APS earnings increased $42.9 million in the twelve-month comparison primarily because of an increase in customers, increased contributions from power marketing and trading activities, the effects of warmer weather, and lower financing costs. In the comparison, these positive factors more than offset the effects of two fuel-related settlements recorded in the third quarter of 1997, a retail price reduction that became effective July 1, 1998, and higher depreciation and amortization expense. See Note 7 for additional information about the price reduction.

Operating revenues increased $247 million primarily because of:

* increased power marketing and trading revenues ($164 million)
* increases in the number of customers and the average amount of electricity used by customers ($79 million)
* the effects of warmer weather ($15 million) and
* miscellaneous factors ($7 million).

As mentioned above, these positive factors were partially offset by the effect of a reduction in retail prices ($18 million).

Power marketing and trading activities are predominantly short-term opportunity wholesale sales. The increase in power marketing revenues resulted from increased activity in Western bulk power markets, higher prices, and increased sales to large customers in California. The increase in power marketing and trading revenues was accompanied by increases in purchased power expenses.

Fuel expense increased $178 million primarily because of increased wholesale and retail sales volumes, the effects of two fuel-related settlements in the third quarter of 1997, and higher purchased power prices. The settlements increased pretax earnings in the twelve months ended June 30, 1998 by approximately $21 million. The income statement reflects these settlements as reductions in fuel expense and as other income.

Depreciation and amortization expense increased $17 million because APS had more plant in service.

APS decreased its financing costs by $10 million primarily because of lower amounts of outstanding debt and preferred stock and lower interest rates.

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Parent company financing costs decreased $7 million as we paid down debt and took advantage of lower interest rates.

El Dorado's earnings decreased $5 million in the twelve-month period because of investment sales in 1998 and 1997.

APS Energy Services, which was incorporated in late 1998, reported a loss of $3 million for the twelve-month period.

OTHER INCOME

As part of a 1994 rate settlement with the ACC, APS accelerated amortization of substantially all deferred ITCs over a five-year period that ends on December 31, 1999. The amortization of ITCs decreases annual consolidated income tax expense by approximately $24 million. Beginning in 2000, no further benefits will be reflected in income tax expense.

LIQUIDITY AND CAPITAL RESOURCES

PARENT COMPANY

The parent company's cash requirements and its ability to fund those requirements are discussed under "Capital Needs and Resources" in Management's Discussion and Analysis of Financial Condition and Results of Operation in Part II, Item 7 of the 1998 10-K.

During the six-months ended June 30, 1999, the parent company redeemed approximately $19 million of its long-term debt with cash from operations and proceeds from long-term borrowings.

As a result of the 1996 regulatory agreement (see Note 7), the parent company has invested $50 million in APS in 1996, 1997 and 1998 and will make the final investment of $50 million in 1999.

On April 23, 1999, we entered into a memorandum of understanding with Calpine Corporation, an independent power producer located in San Jose, California, for

* potential $220 million, 500 megawatt expansion at the site of APS' West Phoenix Power Plant. We entered into a further memorandum of understanding with Calpine dated as of August 4, 1999, relating to the timing of the definitive agreements and the operation of the joint project. The joint project is the second phase of a potential 750 megawatt expansion at West Phoenix, the first phase of which includes the installation of a 120 megawatt combined cycle unit, the cost of which is expected to be approximately $60 million, although that amount is currently subject to negotiation. Assuming approvals are granted, construction is scheduled to begin in mid-2000, with commercial operations of the first phase in mid-2001 and of the second phase in early 2002. We are also considering additional expansion over the next several years, which may result in additional expenditures. We currently believe that there will be additional

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opportunities to expand our investment in generating assets in the next five years. It is expected that these and other generating assets would be organized in a non-regulated subsidiary under the parent company.

The Board declared a quarterly dividend of 32.5 cents per share of common stock, payable September 1, 1999 to shareholders of record on August 2, 1999, totaling approximately $27.6 million.

APS

For the six months ended June 30, 1999, APS incurred approximately $154 million in capital expenditures, which is approximately 47% of the most recently estimated 1999 capital expenditures. APS' projected capital expenditures for the next three years are: 1999, $328 million; 2000, $353 million; and 2001, $343 million. These amounts include about $30 - $35 million each year for nuclear fuel expenditures.

APS' long-term debt and preferred stock redemption requirements and payment obligations on a capitalized lease for the next three years are: 1999, $387 million; 2000, $115 million; and 2001, $2 million. During the six months ended June 30, 1999, APS redeemed approximately $216 million of its long-term debt and all $96 million (including premiums) of its preferred stock with cash from operations and long-term and short-term debt. In February 1999, APS issued $125 million of unsecured long-term debt. As a result of the 1996 regulatory agreement (see Note 7), Pinnacle West invested $50 million in APS in 1996, 1997, and 1998 and will make the final investment of $50 million in 1999.

Although provisions in APS' first mortgage bond indenture, articles of incorporation, and ACC financing orders establish maximum amounts of additional first mortgage bonds that we may issue, APS does not expect any of these provisions to limit its ability to meet its capital requirements.

YEAR 2000 READINESS DISCLOSURE

OVERVIEW As the year 2000 approaches, many companies face problems because many computer systems and equipment will not properly recognize calendar dates beginning with the year 2000. We are addressing the Year 2000 issue as described below. APS initiated a comprehensive company-wide Year 2000 program during 1997 to review and resolve all Year 2000 issues in mission critical systems (systems and equipment that are key to the power production, delivery, health, and safety functions) in a timely manner to ensure the reliability of electric service to its customers. This included a company-wide awareness program of the Year 2000 issue. APS has an internal audit/quality review team that is periodically reviewing the individual Year 2000 projects and their Year 2000 readiness.

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The following chart shows Year 2000 readiness of our mission critical systems as of June 30, 1999:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Inventory | Assessment | Remediation & Testing |
|  | --------- | ---------- | --------------------- |
| APS | 100% | 100% | 100% |
| Pinnacle West and |  |  |  |
| other subsidiaries |  |  |  |
| (excluding APS) | 100% | 100% | 95%(1) |

(1) Estimated to be at 100% by September 30, 1999.

DISCUSSION APS has been actively implementing and replacing systems and technology since 1995 for general business reasons unrelated to the Year 2000, and these actions have resulted in substantially all of its major information technology (IT) systems becoming Year 2000 ready. The major IT systems that were, and are being, implemented and replaced include the following:

* Work Management
* Materials Management
* Energy Management System
* Payroll
* Financial
* Human Resources
* Trouble Call Management System
* Computer and Communications Network Upgrades
* Geographic Information System
* Customer Information System and
* Palo Verde Site Work Management System.

We and our subsidiaries have made, and will continue to make, certain modifications to computer hardware, software, and application systems, including IT and non-IT systems, in an effort to ensure they are capable of handling changing business needs, including dates in the year 2000 and thereafter. In addition, other APS IT systems and non-IT systems, including embedded technology and real-time process control systems, are being analyzed for potential modifications.

Pinnacle West and its subsidiaries have inventoried and assessed essentially all mission critical IT and non-IT systems and equipment. APS is 100% complete and Pinnacle West and its other subsidiaries are 95% complete with the remediation and testing of these systems. APS notified the North American Electric Reliability Council (NERC) on June 30, 1999, that its mission critical systems are ready for date changes associated with the Year 2000, in accordance with NERC's recommended criteria. APS also notified the Nuclear Regulatory Commission (NRC) that Palo Verde is "Y2K Ready," which means that Palo Verde has followed a prescribed program to identify

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and resolve Year 2000 issues so that the plant can operate reliably while meeting commitments.

As previously reported, APS expected remediation and testing to be completed by June 30, 1999, for all mission critical systems, except for (i) Palo Verde Unit 1 systems and (ii) the continuous emissions monitoring systems (CEMS) for four of its fossil plants. See "Year 2000 Readiness Disclosure" in Part I, Item 2 of the March 10-Q. However, as of June 30, 1999, remediation and testing was completed for all mission critical systems, including Palo Verde Unit 1, but excluding CEMS, which have been removed from the mission critical systems list because the failure of the system would not lead to an unplanned shutdown of generation. This is based on NERC's June 14, 1999 clarifying pronouncement on exception reporting. APS currently expects the CEMS for the four fossil plants to be Y2K Ready no later than the fourth quarter 1999.

APS currently estimates that it will spend approximately $5 million relating to Year 2000 issues, about $4.5 million of which has been spent to date. This includes an estimated allocation of payroll costs for APS employees working on Year 2000 issues, and costs for consultants, hardware, and software. We do not separately track other internal costs. This does not include any expenditures incurred since 1995 to implement and replace systems for reasons unrelated to the Year 2000, as discussed above. Our cost to address the Year 2000 issue is charged to operating expenses as incurred and has not had, and is not expected to have, a material adverse effect on our financial position, cash flows, or results of operations. We expect to fund this cost with available cash balances and cash provided by operations.

Pinnacle West and its subsidiaries are communicating with their significant suppliers, business partners, other utilities, and large customers to determine the extent to which they may be affected by these third parties' plans to remediate their own Year 2000 issues in a timely manner. These companies have been interfacing with suppliers of systems, services, and materials in order to assess whether their schedules for analysis and remediation of Year 2000 issues are timely and to assess their ability to continue to supply required services and materials.

APS has also been working with NERC through the Western Systems Coordinating Council (WSCC) to develop operational plans for stable grid operation that will be utilized by APS and other utilities in the western United States. APS' operational plans are complete. However, APS cannot currently predict the effect on APS if the systems of these other companies are not Year 2000 ready.

We currently expect that our most reasonably likely worst case Year 2000 scenario would be intermittent loss of power to APS customers, similar to an outage during a severe weather disturbance. In this situation, APS would restore power as soon as possible by, among other things, re-routing power flows. We do not currently expect that this scenario would have a material adverse effect on our financial position, cash flows, or results of operations.

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Pinnacle West and its subsidiaries have developed their own contingency plans to handle Year 2000 issues, including the most reasonably likely worst case scenario discussed above. These plans were completed June 30, 1999.

COMPETITION AND ELECTRIC INDUSTRY RESTRUCTURING

See Note 5 for a discussion of regulatory accounting. See Note 6 for a discussion of a proposed Settlement Agreement related to the implementation of retail electric competition. See Note 8 for a discussion of a proposed amendment to a Power Coordination Agreement with Salt River Project that APS estimates would reduce its pretax costs for purchased power by approximately $17 million during the first full year that the amendment is effective and by lesser annual amounts during the next seven years.

RATE MATTERS

See Note 7 for a discussion of a proposed price reduction that would become effective as of July 1, 1999. See Note 6 for a discussion of a proposed Settlement Agreement that would, among other things, result in rate reductions over a four year period ending July 1, 2003.

FORWARD-LOOKING STATEMENTS

The above discussion contains forward-looking statements that involve risks and uncertainties. Words such as "estimates," "expects," "anticipates," "plans," "believes," "projects," and similar expressions identify forward-looking statements. These risks and uncertainties include, but are not limited to, the ongoing restructuring of the electric industry; the outcome of the regulatory proceedings relating to the restructuring; regulatory, tax, and environmental legislation; the ability of APS to successfully compete outside its traditional regulated markets; regional economic conditions, which could affect customer growth; the cost of debt and equity capital; weather variations affecting customer usage; technological developments in the electric industry; the successful completion of a large-scale construction project; Year 2000 issues; and the strength of the real estate market.

These factors and the other matters discussed above may cause future results to differ materially from historical results, or from results or outcomes we currently expect or seek.

ITEM 3. MARKET RISKS

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

Our major financial market risk exposure is changing interest rates. Changing interest rates will affect interest paid on variable rate debt and interest earned by the nuclear decommissioning trust fund. Our policy is to manage interest rates through the use of a combination of fixed and floating rate debt. The nuclear decommissioning fund also

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has risks associated with changing market values of equity investments. Nuclear decommissioning costs are recovered in rates.

APS is exposed to the impact of market fluctuations in the price and distribution costs of electricity, natural gas, coal, and emissions and therefore employs established procedures to manage its 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 its overall risk management program, APS enters into these derivative transactions for trading and to hedge certain natural gas in storage as well as purchases and sales of electricity, fuels, and emissions.

APS measures the price risk in its commodity derivative portfolio on a daily basis utilizing market sensitivity based modeling to understand expected and potential single day favorable or unfavorable impacts to income before tax. The model results are monitored daily to ensure compliance against thresholds on a commodity and portfolio basis. As of June 30, 1999, a hypothetical adverse price movement of 10% in the market price of APS' commodity derivative portfolio would decrease the fair market value of these contracts by approximately $8 million. This analysis does not include the favorable impact this same hypothetical price move would have on the underlying position being hedged with the commodity derivative portfolio.

APS is exposed to credit losses in the event of non-performance or non-payment by counterparties. APS uses a credit management process to assess and monitor the financial exposure of counterparties. APS does not expect counterparty defaults to materially impact its financial condition, results of operations, or net cash flows.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In June 1999, the Navajo Nation served Salt River Project with a lawsuit naming Salt River Project, several Peabody Coal Company entities ("Peabody"), Southern California Edison Company, and other defendants, and citing various claims in connection with the renegotiations of the coal royalty and lease agreements under which Peabody mines coal for the Navajo and Mohave Generating Stations. THE NAVAJO NATION V. PEABODY HOLDING COMPANY, INC., ET AL., United States District Court for the District of Columbia, No. CA-99-0469-EGS. APS is a 14% owner of Navajo Generating Station, which Salt River Project operates. The suit alleges, among other things, that the defendants obtained a favorable coal royalty rate by improperly influencing the outcome of a federal administrative process under which the royalty rate was to be adjusted. The suit seeks $600 million in damages, treble damages, punitive damages of not less than $1 billion, and the ejection of defendants "from all possessory interests and Navajo Tribal lands" arising out of the [primary coal lease]. Salt River Project has advised APS that it denies all charges and will vigorously defend itself. Because the litigation is in preliminary stages, APS cannot currently predict the outcome of this matter.

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

At our annual Meeting of Shareholders held on May 19, 1999 the following shareholder proposal was submitted to shareholders:

Proposal that Pinnacle

Votes

For

-----

2,413,519

Votes

Against

-------

63,160,240

Abstentions

and Broker

Non Votes

-----------

2,955,431

West refuse to use

plutonium (MOX) fuel and

refuse to generate tritium

In addition, at the same annual meeting, the following persons were elected Class II Directors with a term to expire at the 2002 annual meeting of shareholders:

|  |  |  |  |
| --- | --- | --- | --- |
|  |  |  | Abstentions |
|  | Votes | Votes | and Broker |
|  | For | Withheld | Non Votes |
|  | ----- | ------- | ----------- |
| Edward N. Basha | 78,205,297 | 1,528,855 | N/A |
| Michael L. Gallagher | 78,246,095 | 1,488,057 | N/A |
| William J. Post | 78,396,955 | 1,337,197 | N/A |

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ITEM 5. OTHER INFORMATION

CONSTRUCTION AND FINANCING PROGRAMS

See "Liquidity and Capital Resources" in Part I, Item 2 of this report for a discussion of APS' construction and financing programs.

COMPETITION AND ELECTRIC INDUSTRY RESTRUCTURING

See Note 6 of Notes to Condensed Consolidated Financial Statements in Part I, Item 1 of this report for a discussion of competition and the rules regarding the introduction of retail electric competition in Arizona and a proposed settlement agreement with the ACC.

ENVIRONMENTAL MATTERS

As previously reported, in July 1997, EPA promulgated final national ambient air quality standards for ozone and coarse and fine particulate matter. See "Environmental Matters - EPA Environmental Regulation - Clear Air Act" in Part I, Item 1 of the 1998 10-K. These standards were challenged and the court determined that EPA's promulgation of the standards violated the constitutional prohibition on delegation of legislative power. The court remanded the ozone standard, vacated the coarse particulate matter standard, and invited the parties to brief the court on vacating or remanding the fine particulate matter standard. APS cannot currently predict EPA's response to this decision.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

1. Exhibits

Exhibit No.

- -----------

10.1(a)

Description

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Key Executive Employment and Severance Agreement between

Pinnacle West and certain executive officers of Pinnacle West

and its subsidiaries

27.1 Financial Data Schedule

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1. Additional agreements, substantially identical in all material respects to this Exhibit have been entered into with additional officers of Pinnacle West and its subsidiaries. Although such additional documents may differ in other respects (such as dollar amounts and dates of execution), there are no material details in which such agreements differ from this Exhibit.

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In addition to those Exhibits shown above, the Company hereby incorporates the following Exhibits pursuant to Exchange Act Rule 12b-32 and Regulation ss.229.10(d) by reference to the filings set forth below:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| EXHIBIT NO. | DESCRIPTION | ORIGINALLY FILED AS EXHIBIT: | FILE NO.(b) | DATE EFFECTIVE |
| - ----------- | ----------- | ---------------------------- | ----------- | -------------- |
| 10.1 | Articles of Incorporation | 19.1 to the Company's | 1-8962 | 11-14-88 |
|  | restated as of July 29, 1988 | September 30, 1988 |  |  |
|  |  | Form 10-Q Report |  |  |
| 10.2 | Bylaws, amended as of | 3.1 to the Company's 1995 | 1-8962 | 4-1-96 |
|  | February 21, 1996 | Form 10-K Report |  |  |

1. Reports on Form 8-K

During the quarter ended June 30, 1999, and the period from July 1 through

August 16, 1999, we filed the following reports on Form 8-K:

Report dated March 22, 1999 relating to Pinnacle West's amended and restated stockholder rights plan, effective March 26, 1999.

Report dated May 14, 1999 regarding the settlement agreement between APS and various other parties, including representatives of major consumer groups, related to the implementation of retail electric competition.

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1. Reports filed under File No. 1-8962 were filed in the office of the Securities and Exchange Commission located in Washington, D.C.

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SIGNATURES

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

PINNACLE WEST CAPITAL CORPORATION

(Registrant)

Dated: August 16, 1999

By: George A. Schreiber, Jr.

------------------------------------

George A. Schreiber, Jr.

President and

Chief Financial Officer

(Principal Financial Officer

and Officer Duly Authorized

to sign this Report)

Exhibit 10.1

KEY EXECUTIVE EMPLOYMENT AND SEVERANCE AGREEMENT

THIS AGREEMENT, made and entered into as of the \_\_\_\_\_ day of \_\_\_\_\_\_\_\_\_\_\_\_,

1999, by and between Pinnacle West Capital Corporation, an Arizona corporation (hereinafter referred to as the "Company") and \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ (hereinafter referred to as the "Executive"):

W I T N E S S E T H

WHEREAS, the Executive has been employed by \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

("\_\_\_"), in an executive capacity, possesses intimate knowledge of the business and affairs of the Company and [Arizona Public Service Company, a subsidiary of the Company ("APS")], and has acquired certain confidential information and data with respect to the Company and APS;

WHEREAS, \_\_\_ and the Executive entered into a Key Executive Employment and Severance Agreement (the "[prior] Agreement") on or about \_\_\_\_\_\_\_\_\_\_, 199\_\_; and

WHEREAS, \_\_\_ intends to terminate the [prior] Agreement effective December 31, 1999; and

WHEREAS, however, the Company desires to insure, insofar as possible, that APS and it will continue to have the benefit of the Executive's services and to protect the confidential information and goodwill of the Company and APS; and

WHEREAS, the Company recognizes that circumstances may arise in which a change in the control of the Company or APS through acquisition or otherwise occurs thereby causing uncertainty of employment without regard to the Executive's competence or past contributions which uncertainty may result in the loss of valuable services of the Executive to the detriment of the Company, APS and their shareholders, and the Company and the Executive wish to provide reasonable security to the Executive against changes in the Executive's relationship with the Company and APS in the event of any such change in control; and

WHEREAS, both the Company and the Executive are desirous that a proposal for any change of control or acquisition will be considered by the Executive objectively and with reference only to the business interests of the Company, APS and their shareholders;

WHEREAS, the Company recognizes that the Executive will be in a better position to consider the best interests of the Company and APS if the Executive is afforded reasonable security, as provided in this Agreement, against altered conditions of employment which could result from any such change in control or acquisition; and

NOW, THEREFORE, in consideration of the foregoing and of the mutual covenants and agreements hereinafter set forth, the parties hereto mutually covenant and agree as follows:

1. Definitions.
   1. "Accrued Benefits" shall mean the benefits payable to the Executive as described in Section 6(a).
   2. "Act" shall mean the Securities Exchange Act of 1934.
   3. "Affiliate" shall mean (i) a corporation other than the Company that is a member of a "controlled group of corporations" (within the meaning of Section 414(b) of the Code as modified by Section 415(h) of the Code) or (ii) a group of trades or businesses under common control (within the meaning of Section 414(c) of the Code as modified by Section 415(h) of the Code) that also includes the Company as a member. For purposes of determining whether a transaction or event constitutes a Change of Control within the meaning of Section 1(f), "Affiliate" status shall be determined on the day immediately preceding the date of the transaction or event.
   4. "Beneficial Owner" shall have the same meaning as given to that term in Rule 13d-3 of the General Rules and Regulations of the Act, provided that any pledgee of the voting securities of the Company or APS shall not be deemed to be the Beneficial Owner thereof prior to its disposition of, or acquisition of voting rights with respect to, such securities.
   5. "Cause" shall be limited to (i) the engaging by the Executive in conduct which has caused demonstrable and serious injury to the Employer, monetary or otherwise, as evidenced by a determination in a binding and final judgment, order or decree of a court or administrative agency of competent

jurisdiction, in effect after exhaustion or lapse of all rights of appeal, in an action, suit or proceeding, whether civil, criminal, administrative or investigative, other than an action, suit or proceeding, brought by the Company or an Affiliate, the purpose of which is to establish "Cause" under this Agreement; (ii) conviction of a felony, as evidenced by a binding and final judgment, order or decree of a court of competent jurisdiction, in effect after exhaustion or lapse of all rights of appeal, which the Employer determines has a significant adverse impact on it in the conduct of its business; (iii) unreasonable neglect or refusal by the Executive to perform the Executive's duties or responsibilities (unless significantly changed without the Executive's consent); or (iv) a significant violation by the Executive of the Employer's established policies and procedures as in effect on the date of the Change of Control which could subject the Executive to disciplinary action by the Employer.

(f) "Change of Control" shall mean one (1) or more of the following

events:

1. Any Person, other than an Affiliate, through a transaction or series of transactions, is or becomes the Beneficial Owner, directly or indirectly, of securities of the Company or APS representing twenty percent

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(20%) or more of the combined voting power of the then outstanding securities of the Company or APS, as the case may be;

1. A merger or consolidation of (A) the Company with any other corporation which would result in the voting securities of the Company outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or any parent thereof), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company or an Affiliate, less than sixty percent (60%) of the combined voting power of the securities of the Company or such surviving entity or any parent thereof outstanding immediately after such merger or consolidation, or (B) APS with any other corporation which would result in the voting securities of APS outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or any parent thereof), in combination with the ownership of any trustee or other fiduciary holding securities under an employee benefit plan of the Company or an Affiliate, less than sixty percent (60%) of the combined voting power of the securities of APS or such surviving entity or any parent thereof outstanding immediately after such merger or consolidation; provided that, for purposes of this subparagraph (ii), a merger or consolidation effected to implement a recapitalization of the Company or of APS (or similar transaction) in which no Person is or becomes the Beneficial Owner, directly or indirectly, of securities of the Company or of APS representing twenty percent (20%) or more of the combined voting power of the then outstanding securities of the Company or of APS (excluding any securities acquired by that Person directly from the Company or an Affiliate) shall not result in a Change of Control;
2. The shareholders of either the Company or APS approve a sale, transfer or other disposition of all or substantially all of the assets of either the Company or APS to a Person other than the Company or an Affiliate; or
3. Individuals who, as of July 31, 1999, constitute the board of directors of the Company (the "Company Incumbent Board") or of APS (the "APS Incumbent Board") cease for any reason to constitute at least two-thirds (2/3) of the members of the Company or APS board of directors, as the case may be; provided, however, that for purposes of this subparagraph (iv), (A)(1) any person becoming a member of the Company board of directors after July 31, 1999 whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least two-thirds (2/3) of the members then comprising the Company Incumbent Board will be considered as though such person were a member of the Company Incumbent Board and (2) the Company Incumbent Board shall not include a director whose initial assumption of office as a director

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was in connection with an actual or threatened election contest relating to the election of directors; and (B)(1) any person becoming a member of the APS board of directors after July 31, 1999 whose election, or nomination for election by APS' shareholder(s), was approved by a vote of at least two-thirds (2/3) of the members then comprising the APS Incumbent Board or by the Company, as a majority shareholder of APS, will be considered as though such person were a member of the APS Incumbent Board and (2) the APS Incumbent Board shall not include a director whose initial assumption of office as a director was in connection with an actual or threatened election contest relating to the election of directors.

1. "Code" shall mean the Internal Revenue Code of 1986, as amended from time to time.
2. "Disability" shall have the same meaning as given to that term in the applicable long-term disability plan maintained by the Company or the Employer for employees.
3. "Employer" shall mean \_\_\_, and upon the transfer of the Executive to the Company or one of its other Affiliates, "Employer" shall mean the Company or such other Affiliate.
4. "Employment Period" shall mean the period commencing on the date of a Change of Control and ending on the second anniversary of such date.
5. "Good Reason" shall mean:
6. the required relocation of the Executive, without the Executive's consent, to an employment location which is more than seventy-five (75) miles from the Executive's employment location on the date of the Change of Control;
7. a significant reduction by the Employer in the compensation and/or benefits provided to the Executive as in effect on the date of the Change of Control (as the same may have been thereafter adjusted during the Employment Period), which reduction is not generally effective for all executives employed by the Employer (or its successor) in the Executive's class or category;
8. the removal of the Executive from or any failure to re-elect the Executive to any of the positions held by the Executive on the date of the Change of Control or any other positions to which the Executive shall thereafter be elected or assigned except in the event that such removal or failure to re-elect relates to the termination by the Employer of the Executive's employment for Cause or by reason of death, Disability or voluntary retirement;

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1. a significant adverse change, without the Executive's written consent, in the nature or scope of the Executive's authority, powers, functions, duties or responsibilities, or a material reduction in the level of support services, staff, secretarial and other assistance and office space available to a level below that which was provided to the Executive on the date of the Change of Control and that which is necessary to perform any additional duties assigned to the Executive following the Change of Control, which change or reduction is not generally effective for all executives employed by the Employer (or its successor) in the Executive's class or category; or
2. breach of any material provision of this Agreement by the Company.
   1. "Person" shall mean any individual, partnership, joint venture, association, trust, corporation or other entity (including a "group" as defined in Section 13(d)(3) of the Act), other than an employee benefit plan of the Company or an Affiliate or an entity organized, appointed or established pursuant to the terms of any such benefit plan.
   2. "Termination Date" shall mean, except as otherwise provided in Section 12, (i) the Executive's date of death; (ii) the date of the Executive's voluntary early retirement as agreed upon in writing by the Employer and the Executive; (iii) sixty (60) days after the delivery of the Notice of Termination terminating the Executive's employment on account of Disability pursuant to Section 9, unless the Executive returns full-time to the performance of his or her duties prior to the expiration of such period; (iv) the date of the Notice of Termination if the Executive's employment is terminated by the Executive voluntarily other than for Good Reason; and (v) sixty (60) days after the delivery of the Notice of Termination if the Executive's employment is terminated by the Employer (other than by reason of Disability) or by the Executive for Good Reason.
   3. "Termination Payment" shall mean the amount described in Section

6(b).

* 1. "Total Payments" shall mean the sum of the Termination Payment and any other payments or benefits provided to or for the benefit of the Executive in the nature of compensation, receipt of which is contingent on the Change of Control and to which Section 280G of the Code applies.

1. IMPACT ON EMPLOYMENT. The Employer and the Executive shall retain the right to terminate the employment of the Executive at any time and for any reason prior to a Change of Control. If a Change of Control occurs when the Executive is employed by the Employer, the Employer will continue thereafter to employ the Executive, and the Executive will remain in the employ of the Employer, in accordance with the terms and provisions of this Agreement, during the Employment Period.

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* 1. DUTIES. During the Employment Period, the Executive shall, in the same capacities and positions held by the Executive at the time of such Change of Control or in such other capacities and positions as may be agreed to by the Employer and the Executive in writing, devote the Executive's best efforts, attention and skill to the business and affairs of the Company, as such business and affairs now exist and as they may hereafter be conducted. The services which are to be performed by the Executive hereunder are to be rendered at an employment location which is not more than seventy-five (75) miles from the Executive's employment location on the date of the Change of Control, or in such other place or places as shall be mutually agreed upon in writing by the Executive and the Employer from time to time. The Executive shall not be required to be absent from such employment location for more than forty-five

1. consecutive days in any fiscal year without the Executive's consent.
   1. COMPENSATION. During the Employment Period, the Executive shall be compensated as follows:
2. The Executive shall receive, at such intervals and in accordance with such standard policies as may be in effect on the date of the Change of Control, an annual salary not less than the Executive's annual salary as in effect as of the date of the Change of Control, subject to adjustment as provided in Section 5;
3. The Executive shall be reimbursed, at such intervals and in accordance with such standard policies as may be in effect on the date of the Change of Control, for any and all monies advanced in connection with the Executive's employment for reasonable and necessary expenses incurred by the Executive on behalf of the Employer, including travel expenses;
4. The Executive shall be included to the extent eligible thereunder in any and all plans providing general benefits for the Employer's employees, including but not limited to, group life insurance, disability, medical, dental, pension, profit sharing, savings and stock bonus plans and be provided any and all other benefits and perquisites made available to other employees of comparable status and position, on the same terms and conditions as generally provided to employees of comparable status and position;
5. The Executive shall receive annually not less than the amount of paid vacation and not fewer than the number of paid holidays received annually immediately prior to the Change of Control or such greater amount of paid vacation and number of paid holidays as may be made available annually to other employees of comparable status and position with the Employer; and
6. The Executive shall be included in all plans providing special benefits to corporate officers, including but not limited to bonus, deferred compensation, incentive compensation, supplemental pension, stock option, stock appreciation, stock bonus and similar or comparable plans extended by the Company

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or the Employer from time to time to corporate officers, key employees and other employees of comparable status.

1. ANNUAL COMPENSATION ADJUSTMENTS. During the Employment Period, the Board of Directors of the Employer, an appropriate committee of the Board or the President of the Employer, whichever is appropriate, shall consider and appraise, at least annually, the Executive's compensation. In determining such compensation, the Board, the appropriate committee thereof or the President, whichever is appropriate, shall consider the commensurate increases given to other corporate officers and key employees generally, the scope and success of the Employer's operations, the expansion of Executive's duties and the Executive's performance of his duties.
2. PAYMENTS UPON TERMINATION.
   1. ACCRUED BENEFITS. For purposes of this Agreement, the Executive's Accrued Benefits shall include the following amounts: (i) all salary earned or accrued through the Termination Date; (ii) reimbursement for any and all monies advanced in connection with the Executive's employment for reasonable and necessary expenses incurred by the Executive through the Termination Date; (iii) any and all other cash benefits previously earned through the Termination Date and deferred at the election of the Executive or pursuant to any deferred compensation plans then in effect; (iv) a lump sum payment of the bonus or incentive compensation otherwise payable to the Executive under the terms of any bonus or incentive compensation plan or plans for the year in which termination occurs; and (v) all other payments and benefits to which the Executive may be entitled under the terms of any benefit plan of the Company or the Employer. Payment of Accrued Benefits shall be made promptly in accordance with the Employer's prevailing practice and the terms of any applicable benefit plans, contracts or arrangements.
   2. TERMINATION PAYMENT. For purposes of this Agreement, the

Executive's Termination Payment shall be an amount equal to (i) plus (ii), multiplied by (iii), where

* + 1. Equals the Executive's rate of annual salary, as in effect on the date of the Change of Control and as increased thereafter from time to time pursuant to Section 5;
    2. Equals the amount of the average annual dollar award paid to the Executive pursuant to the Employer's regular bonus plan or arrangement with respect to the four (4) years (or the number of years of the Executive's employment if less than four (4) years) preceding the Termination Date which shall be determined by dividing the total dollar amount paid to the Executive under such plan or arrangement with respect to such number of years by four (4) (or the number of years of the Executive's employment if less than four (4) years); and

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(iii) Equals three (3).

The Termination Payment shall be payable in a lump sum on the Executive's Termination Date. Such lump sum payment shall not be reduced by any present value or similar factor. The Executive shall not be required to mitigate the amount of such payment by securing other employment or otherwise and such payment shall not be reduced by reason of the Executive securing other employment or for any other reason, except as expressly provided in Section 16.

1. DEATH. If the Executive shall die during the Employment Period, but after delivery of a Notice of Termination by the Company (for reasons other than Cause or Disability) or by the Executive for Good Reason, the Executive's employment shall terminate on his or her date of death and the Executive's estate shall be entitled to receive the Executive's Accrued Benefits as of the Termination Date and, subject to the provisions of this Agreement, to such Termination Payment as the Executive would have been entitled to had the Executive survived. All benefits payable on account of the Executive's employment or death under the Company's or Employer's employee benefits plans, programs or arrangements shall be paid or distributed in accordance with the terms of such plans, programs or arrangements. The Executive's death following delivery of the Notice of Termination shall not affect his or her Termination Date which shall be determined without regard to the Executive's death, subject to the provisions of Section 12.

If the Executive shall die during the Employment Period, but prior to the delivery of a Notice of Termination, the Executive's employment shall terminate and the Executive's estate, heirs and beneficiaries shall receive all the Executive's Accrued Benefits through the Termination Date and all benefits available to them under the Company's benefit plans as in effect on the Termination Date on account of the Executive's death.

* 1. RETIREMENT. If, during the Employment Period, the Executive and the Employer shall execute an agreement providing for the voluntary retirement of the Executive from the Employer, the Executive shall receive only his or her Accrued Benefits through the Termination Date.
  2. TERMINATION FOR DISABILITY. If the Executive has been absent from his or her duties hereunder on a full-time basis for five (5) consecutive months during the Employment Period on account of a Disability, the Employer may provide a Notice of Termination, which satisfies the requirements of Section 12, and the Executive's employment shall, for purposes of this Agreement, terminate sixty

1. days thereafter, unless the Executive returns to the performance of his or her duties on a full-time basis prior to the end of the sixty (60) day period. During the term of the Executive's Disability prior to his or her Termination Date, the Executive shall continue to participate in all compensation and benefit plans, programs and arrangements in which the Executive was entitled to participate immediately prior to his or her Disability in accordance with the terms and provisions of such plans, programs and arrangements. If the Executive's employment is terminated on account of the Executive's Disability, the Executive shall

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receive his or her Accrued Benefits in accordance with Section 6(a) hereof, provided that the Executive's termination for purposes of this Agreement under this Section 9 shall not affect his or her entitlement to benefits on account of his or her Disability under any long-term disability programs of the Company or the Employer in effect at the time of such termination and in which the Executive participated immediately prior to his or her Disability.

1. TERMINATION NOT GIVING RISE TO A TERMINATION PAYMENT. If, during the Employment Period, the Executive's employment is terminated for Cause, or if the Executive voluntarily terminates his or her employment other than for Good Reason, subject to the procedures set forth in Section 12, the Executive shall be entitled to receive only his or her Accrued Benefits in accordance with Section 6(a).
2. TERMINATION GIVING RISE TO A TERMINATION PAYMENT. If, during the Employment Period, the Executive's employment is terminated by the Executive for Good Reason or by the Employer other than by reason of death, Disability pursuant to Section 9 or Cause, subject to the procedures set forth in Section 12,
   1. the Executive shall be entitled to receive and the Company or the Employer, as applicable, shall pay the Executive's Accrued Benefits in accordance with Section 6(a) and, in lieu of further salary payments for periods following the Termination Date, as severance pay, a Termination Payment;
   2. the Executive and his eligible dependents shall continue to be covered for three (3) years, under the same terms and conditions, by the medical plan, dental plan and/or group life insurance plan maintained by the Company or the Employer which covered that Executive and his eligible dependents prior to the Executive's Termination Date. Notwithstanding the foregoing, if the Company's or Employer's medical plan, dental plan and/or group life insurance plan covering the Executive on his or her Termination Date was amended, replaced or terminated on or after the Change of Control and such action would constitute Good Reason within the meaning of Section 1(k), the Executive and his or her eligible dependents shall be entitled to continued coverage for purposes of this Section 11(b) under the terms of the medical plan, dental plan and/or group life insurance plan which they participated in immediately prior to the Change of Control. If the affected plan is no longer available, the Company shall make arrangements to provide equivalent coverage to the Executive and his or her eligible dependents. For this purpose, "equivalent coverage" shall mean medical, dental and/or life insurance coverage, which, when added to the coverage provided to the Executive and his or her eligible dependents under the Company's or Employer's medical plan, dental plan and/or group life insurance plan in effect on the Executive's Termination Date, equals or exceeds the level of benefits provided under the medical plan, dental plan and/or group life insurance plan to the Executive and his or her eligible dependents on the day immediately preceding the Change of Control. The Executive and the Employer shall share the cost of the continued coverage under this Section 11(b) in the same proportions as the Employer and similarly situated active employees shared the cost of such cover-

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age on the day preceding the Executive's Termination Date. For purposes of satisfying the Company's or Employer's obligation under the Consolidated Omnibus Budget Reconciliation Act ("COBRA") to continue group health care coverage to the Executive and his eligible dependents as a result of the Executive's termination of employment, the period during which the Executive is permitted to continue to participate in the Company's or Employer's medical plans and/or dental plans under this Section 11(b) shall not be taken into account and treated as part of the period during which the Executive and his eligible dependents are entitled to continued coverage under the Company's or Employer's group health plans under COBRA. Following the end of the continuation period specified in this Section 11(b), the Executive and his eligible dependents shall be covered under such plans and arrangements only as required under the provisions of COBRA;

1. the Executive's termination shall be treated as a "Normal Termination" as defined in the Pinnacle West Capital Corporation Stock Option and Incentive Plan, as amended from time to time, and in any successor plan thereto, which shall entitle the Executive to exercise any outstanding stock options during the three (3) month period beginning on the Executive's Termination Date, and any restrictions remaining on any "Restricted Stock" (as defined in such plan) awarded to the Executive shall lapse on his or her Termination Date;
2. "out-placement" services will be provided by the Company to the Executive for a period beginning on the Executive's Termination Date. Such services shall be provided for a period beginning on the Executive's Termination Date and ending on the earlier of the date on which the Executive becomes employed in a position commensurate with his or her current salary and responsibilities or the last day of the twelve (12) month period which began on the Executive's Termination Date. The "out-placement" services shall be provided by an out-placement company selected by the Company; and
3. if all or any part of the Total Payments made to the Executive would be subject to the excise tax imposed by Section 4999 of the Code and if any interest or penalties are incurred by the Executive with respect to such excise tax (such excise tax, together with any such interest and penalties, being collectively referred to hereinafter as the "Excise Tax"), the Executive shall be entitled to receive an additional payment (a "Gross-Up Payment") in an amount such that after payment by the Executive of all taxes (including, without limitation, any income taxes and the Excise Tax, and any interest or penalties imposed with respect to such taxes), on the Gross-Up Payment, the Executive retains an amount of the Gross-Up Payment equal to the Excise Tax imposed upon the Total Payments. All determinations required to be made under this Section 11(e), including whether a Gross-Up Payment is required and the amount of such Gross-Up Payment, shall be made by a nationally recognized independent accounting firm selected by the Company (the "Accounting Firm") which shall provide detailed supporting calculations to the Company and the Executive within fifteen (15) business days following the Termination Date, if applicable, or such

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earlier time as the Company may request. All fees and expenses of the Accounting Firm shall be borne by the Company. The Gross-Up Payment, if any, as determined pursuant to this Section 11(e) shall be paid to the Executive within five (5) days following receipt by the Company of the Accounting Firm's determination. If the Accounting Firm shall determine that the Total Payments are not subject to the Excise Tax and, therefore no Gross-Up Payment is required, it shall furnish the Executive with an opinion that failure to report the Excise Tax on the Executive's applicable Federal income tax return would not result in the imposition of a negligence or similar penalty. Any determination by the Accounting Firm shall be binding upon the Company and the Executive.

1. TERMINATION NOTICE AND PROCEDURE. Any termination by the Employer or the Executive of the Executive's employment during the Employment Period shall be communicated by written Notice of Termination to the Executive if such Notice is delivered by the Company and to the Company if such Notice is delivered by the Executive, all in accordance with the following procedures:
   1. The Notice of Termination shall indicate the specific termination provision in this Agreement relied upon and shall set forth in reasonable detail the facts and circumstances alleged to provide a basis for termination.
   2. Any Notice of Termination by the Company shall be approved by a resolution duly adopted by a majority of the members of the Company's board of directors then in office.
   3. If the Company shall give a Notice of Termination for Cause or by reason of Disability and the Executive in good faith notifies the Company that a dispute exists concerning such termination within the fifteen (15) day period following the Executive's receipt of such notice, the Executive may elect to continue his or her employment during such dispute. If it is thereafter determined that (i) the reason given by the Company for termination did exist, the Executive's Termination Date shall be the earlier of (A) the date on which the dispute is finally determined, either by mutual written agreement of the parties or pursuant to Section 14, (B) the date of the Company's Notice of Termination for Cause, (C) the date of the Executive's death, or (D) one day prior to the end of the Employment Period, and the Executive shall not be entitled to a Termination Payment based on events occurring after the Company delivered its Notice of Termination; or (ii) the reason given by the Company for termination did not exist, the employment of the Executive shall continue as if the Company had not delivered its Notice of Termination and there shall be no Termination Date arising out of such notice.
   4. If the Executive shall in good faith give a Notice of Termination for Good Reason and the Company notifies the Executive that a dispute exists concerning the termination within the fifteen (15) day period following the Company's receipt of such notice, the Executive may elect to continue his or her employment during such dispute. If it is thereafter determined that (i) Good Reason did exist, the Executive's Termination Date shall be the earlier of (A) the date on which the

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dispute is finally determined, either by mutual written agreement of the parties or pursuant to Section 14, (B) the date of the Executive's death, or (C) one day prior to the end of the Employment Period, and the Executive's Termination Payment shall reflect events occurring after the Executive delivered his or her Notice of Termination; or (ii) Good Reason did not exist, the employment of the Executive shall continue after such determination as if the Executive had not delivered the Notice of Termination asserting Good Reason.

* 1. If the Executive does not elect to continue employment pending resolution of a dispute regarding a Notice of Termination under Sections 12(c) and (d), and it is finally determined that the reason for termination set forth in such Notice of Termination did not exist, if such notice was delivered by the Executive, the Executive will be deemed to have voluntarily terminated his or her employment and if delivered by the Company, the Company will be deemed to have terminated the Executive other than by reason of death, Disability or Cause.

1. OBLIGATIONS OF THE EXECUTIVE. The Executive covenants and agrees, during the Executive's employment with the Employer and following his or her Termination Date, to hold in strict confidence any and all information in the Executive's possession as a result of the Executive's employment with the Employer; provided that nothing in this Agreement shall be construed as prohibiting the Executive from reporting any suspected instance of illegal activity of any nature, any nuclear safety concern, any workplace safety concern or any public safety concern to the United States Nuclear Regulatory Commission, United States Department of Labor or any federal or state governmental agency or prohibiting the Executive from participating in any way in any state or federal administrative, judicial or legislative proceeding or investigation with respect to any such claims and matters.
2. ARBITRATION. All claims, disputes and other matters in question between the parties arising under this Agreement, other than Section 13, shall be decided by arbitration in accordance with the commercial arbitration rules of the American Arbitration Association, unless the parties mutually agree otherwise. Any arbitration required under this Agreement shall be held in Phoenix, Arizona, unless the parties mutually agree otherwise. The Company shall pay the costs of any such arbitration. The award by the arbitrator shall be final, and judgment may be entered upon it in accordance with applicable law in any state or Federal court having jurisdiction thereof.

The Company shall not be required to arbitrate claims arising under Section

1. The Company shall have the right to judicial enforcement of its rights under Section 13, including, but not limited to, injunctive relief.
   1. EXPENSES AND INTEREST. If, after a Change of Control a good faith dispute arises with respect to the enforcement of the Executive's rights under this Agreement or if any arbitration or legal proceeding shall be brought in good faith to enforce or interpret any provision contained herein, or to recover damages for breach hereof and the Executive is the prevailing party, the Executive shall recover from the Company any reasonable attorney's fees and necessary costs and disbursements in-

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curred as a result of such dispute or legal proceeding, and prejudgment interest on any money judgment obtained by the Executive calculated at the rate of interest announced by Bank One of Arizona (or any successor thereto) from time to time as its prime rate from the date that payments to the Executive should have been made under this Agreement.

1. PAYMENT OBLIGATIONS ABSOLUTE. The Company's obligation during and after the Employment Period to insure that the compensation and arrangements provided herein are provided to the Executive shall be absolute and unconditional and shall not be affected by any circumstances, provided that the Company may apply amounts payable under this Agreement to any loans or other debts then owed to the Company or an Affiliate by the Executive, the terms of which are reflected in a written document signed by the Executive. The amounts payable under this Agreement shall be in lieu of any amounts payable to the Executive under a separate severance plan, agreement or arrangement established by the Company. All amounts payable by the Company under this Agreement shall be paid without notice or demand. Each and every payment made under this Agreement by the Company shall be final. Notwithstanding the foregoing, in the event that the Company has paid an Executive more than the amount to which the Executive is entitled under this Agreement, the Company shall have the right to recover all or any part of such overpayment from the Executive or from whomsoever has received such amount.
2. SUCCESSORS.
   1. If all or substantially all of the Company's business and assets are sold, assigned or transferred to any Person, or if the Company merges into or consolidates or otherwise combines with any Person which is a continuing or successor entity, then the Company shall assign all of its right, title and interest in this Agreement as of the date of such event to the Person which is either the acquiring or successor corporation, and such Person shall assume and perform from and after the date of such assignment the terms, conditions and, provisions imposed by this Agreement upon the Company. Failure of the Company to obtain such assignment shall be a breach of this Agreement. In case of such assignment by the Company and of assumption and agreement by such Person, all further rights as well as all other obligations of the Company under this Agreement thenceforth shall cease and terminate and thereafter the expression "the Company" wherever used herein shall be deemed to mean such Person(s).
   2. This Agreement and all rights of the Executive shall inure to the benefit of and be enforceable by the Executive's personal or legal representatives, estates, executors, administrators, heirs and beneficiaries. In the event of the Executive's death, all amounts payable to the Executive under this Agreement shall be paid to the Executive's estate. This Agreement shall inure to the benefit of, be binding upon and be enforceable by, any successor, surviving or resulting corporation or other entity to which all or substantially all of the Company's business

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and assets shall be transferred whether by merger, consolida- tion, transfer or sale. This Agreement shall not be terminated by the voluntary or involuntary dissolution of the Company.

* 1. ENFORCEMENT. The provisions of this Agreement shall be regarded as divisible, and if any of said provisions or any part hereof are declared invalid or unenforceable by a court of competent jurisdiction, the validity and enforceability of the remainder of such provisions or parts hereof and the applicability thereof shall not be affected thereby.
  2. AMENDMENT OR TERMINATION. The term of this Agreement shall run until December 31, 2001, and shall continue for additional one (1) year periods thereafter, unless the Company notifies the Executive in writing six (6) months prior to December 31, 2001 (or the anniversary of that date in the event the Agreement continues beyond that date pursuant to the provisions of this Section

1. that it does not intend to continue the Agreement. Notwithstanding the foregoing, (i) if a Change of Control has occurred on or before the date on which the Agreement would be terminated by the Company in accordance with this Section 19, the Agreement shall not terminate with respect to that Change of Control until the end of the Employment Period, and (ii) this Agreement shall terminate if, prior to a Change in Control, the Executive ceases to be employed by the Employer as a corporate officer.

This Agreement sets forth the entire agreement between the Executive and the Company and any of its Affiliates with respect to the subject matter hereof, and supersedes all prior oral or written negotiations, commitments, understandings and writings with respect thereto, including, but not limited to, the Key Executive Employment and Severance Agreement by and between the Employer and the Executive executed on or about \_\_\_\_\_\_\_\_\_\_, 19\_\_.

This Agreement may not be terminated, amended or modified during its term as specified above except by written instrument executed by the Company and the Executive.

1. WITHHOLDING. The Company and the Employer shall be entitled to withhold from amounts to be paid to the Executive under this Agreement any federal, state or local withholding or other taxes or charges which it is from time to time required to withhold. The Company and the Employer shall be entitled to rely on an opinion of counsel if any question as to the amount or requirement of any such withholding shall arise.
2. VENUE; GOVERNING LAW. This Agreement and the Executive's and Company's respective rights and obligations hereunder shall be governed by and construed in accordance with the laws of the State of Arizona. Any action concerning this Agreement shall be brought in the Federal or state courts located in the County of Maricopa, Arizona, and each party consents to the venue and jurisdiction of such courts.

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1. NOTICE. Notices given pursuant to this Agreement shall be in writing and (a) if hand delivered, shall be deemed given when delivered, and (b) if mailed, shall be deemed delivered when placed in the United States mail, postage prepaid, addressed,

if to the Company, to

Board of Directors

Pinnacle West Capital Corporation

400 North Fifth Street

Phoenix, Arizona 85004

Attention: Law Department

or if to the Executive, to

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or to such other addresses as the parties may provide written notice of to each other, from time to time, in accordance with this Section 22.

1. FUNDING. Benefits payable under this Agreement shall constitute an unfunded general obligation of the Company payable from its general assets, and the Company shall not be required to establish any special fund or trust for purposes of paying benefits under this Agreement. The Executive shall not have any vested right to any particular assets of the Company as a result of execution of this Agreement and shall be a general creditor of the Company.
2. NO WAIVER. No waiver by either party at any time of any breach by the other party of, or compliance with, any condition or provision of this Agreement to be performed by the other party shall be deemed a waiver of similar or dissimilar provisions or conditions at the same time or any prior or subsequent time.
3. HEADINGS. The headings contained are for reference only and shall not affect the meaning or interpretation of any provision of this Agreement.

IN WITNESS WHEREOF, the Company has caused this Agreement to be executed by its duly authorized officer, and the Executive has executed this Agreement, on the date and year first above written.

Pinnacle West Capital Corporation

By

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Its

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-15-

ATTEST:

By

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Its

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-16-

UT

6-MOS

DEC-31-1999

JAN-01-1999

JUN-30-1999

PER-BOOK

4,727,330

598,563

464,944

1,013,384

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6,804,221

1,540,437

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629,444

2,169,881

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2,164,459

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223,950

17,810

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6,804,221

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0

99,392

82,653

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330,176

1.17

1.17