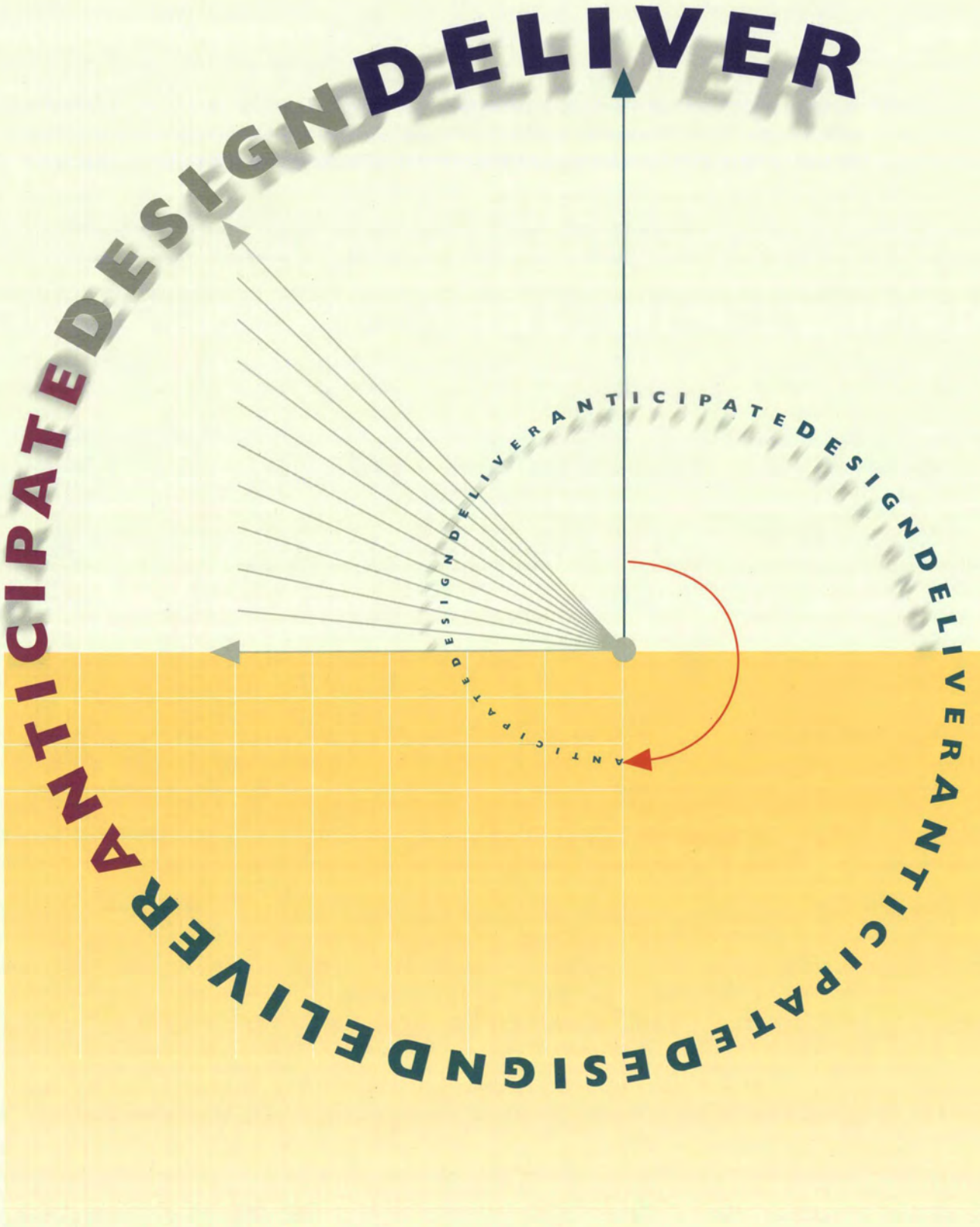
San Diego Gas & Electric

1994 Annual Report



9506020326 95053
PDR ADOCK 05000206
I PDR

CONTENTS

2 Letter from the Chairman

4 Message from the Executive Vice Presidents

6 Bucking Tradition Puts SDG&E in a Good Position

8 How SDG&E Delivers

10 From the Inside Out—Preparing for Deregulation

12 A Bear of a Year for Utility Stocks

14 Shareholder Reference Guide

16 Financial Review

24 Responsibility Report for the Consolidated Financial Statements

Independent Auditors' Report

25 Consolidated Financial Statements

32 Notes to Consolidated Financial Statements

39 Quarterly Financial Data

40 Board of Directors

41 Officers

SDG&E Service Territory

Shareholder Information

For questions about your SDG&E stock investments, contact SDG&E's transfer agent, First Interstate Bank, at **1-800-307-7343.** For other information, contact SDG&E Shareholder Services: within California, 1-800-826-5942, or outside California, 1-800-243-5454.

printed on recycled paper

The vision statement guiding SDG&E

We are the **alliance** company.

We will provide **superior value** by transcending the traditional utility business, not limited by history, structure or geography.

SDGE

SAN DIEGO GAS & ELECTRIC

- is an investor-owned gas and electric utility
- was founded in 1881
- is headquartered in San Diego, California
- attributes 93.7 percent of its revenues to electric and natural gas sales, with the remainder coming from subsidiary operations
- provides electric service to 1,138,870 customers in San Diego County and the southern portion of Orange County
- provides gas to 695,761 customers in San Diego County
- operates in a service territory encompassing 18 cities in San Diego County and seven cities in Orange County

Annual Meeting

The annual meeting of shareholders will be held on Tuesday, April 25, at 11 a.m. at the California Center for the Arts/Escondido. The record date for shareholders eligible to vote at the annual meeting is March 1, 1995.

Anticipate

SDG&E continually scans the competitive horizon, monitors industry trends and listens to constituents to accurately **anticipate** issues that could significantly affect the company's success.

DESIGN

Once those issues are identified, SDG&E **designs** and implements plans to minimize threats and maximize opportunities.

Deliver

Above all, SDG&E **delivers** results.

1994 RESULTS:

→ SDG&E increased its annual dividend to **$1.52,** ***an increase of $0.04*** over 1993. SDG&E has increased its dividend every year since 1977, with the exception of 1990, when it remained flat.

→ Remained the **lowest-cost** provider of electricity among investor-owned utilities in California for the ***sixth year in a row.***

→ Reached record high levels of customer service satisfaction, with **95 percent** of customers surveyed saying they were ***very satisfied*** with the service they received from SDG&E.

→ Improved employee productivity by ***7 percent,*** with a record **458** customers per employee, up from 427 in 1993.

→ Achieved approval for the **first** comprehensive performance-based ratemaking proposal ***in the country,*** which gives SDG&E a new opportunity to increase earnings and lower rates by cutting costs and improving productivity.

March 10, 1995

DEAR SHAREHOLDER:

More than once this past year I've reflected on the events that will eventually summarize 1994 in the history books. The California spotlight has been trained on the tragic Northridge earthquake and the media circus of the O.J. Simpson case. However, the attention of your company was captivated this year by the official notice of plans to **deregulate** the state's electric utility industry.

If you take a look at the past few years' annual reports, you'll see that deregulation is no surprise. What makes the restructuring of our industry so noteworthy is the fact that 100-year-old rules will be rewritten. **The new recommended rules are a mystery, not to be revealed until March 22 when the California Public Utilities Commission issues its policy decision, just 12 days after we've mailed this report to you.**

Don't worry. We haven't been twiddling our thumbs waiting for this decision. In fact, for more than a decade we've been preparing for what we anticipate to be the principal product of deregulation: competition for business.

This year brought with it some dramatic and well-studied steps in that preparation.

First, in 1994 we moved to wring from the books the remnants of disappointing perfor-

FINANCIAL HIGHLIGHTS

IN THOUSANDS OF DOLLARS EXCEPT PER SHARE AMOUNTS	1994	1993	CHANGE
Operating revenues	**$1,982,037**	$1,980,115	+ 0.1%
Operating expenses	**$1,660,121**	$1,686,441	– 1.6%
Net income (before preferred dividend requirements)	**$ 143,477**	$ 218,715	– 34.4%
Average common shares outstanding (thousands)	**116,484**	116,049	+ 0.4%
Number of common stock shareholders*	**70,356**	70,389	—
Earnings (loss) per common share			
Utility only	**$ 1.71**	$ 1.79	
Pacific Diversified	**(0.69)**	(0.07)	
Enova/Califia	**0.15**	0.09	
Total	**$ 1.17**	$ 1.81	– 35.4%
Dividends declared per common share	**$ 1.52**	$ 1.48	+ 2.7%
Retail energy sales			
Electric (billions of kilowatt-hours)	**15.4**	15.0	+ 2.7%
Gas (millions of therms)	**547**	562	– 2.7%
Number of utility employees*	**3,998**	4,166	– 4.0%
Return on common equity	**9.1%**	14.2%	– 35.9%

*At December 31.

mance from some investments, most notably the decreased value of our 80-percent ownership in Wahlco Environmental Systems. The consequence was a one-time writedown in the second quarter of $80 million, causing the first quarterly loss reported in 10 years. Without the writedown, SDG&E would have achieved record annual earnings of $1.85 per share.

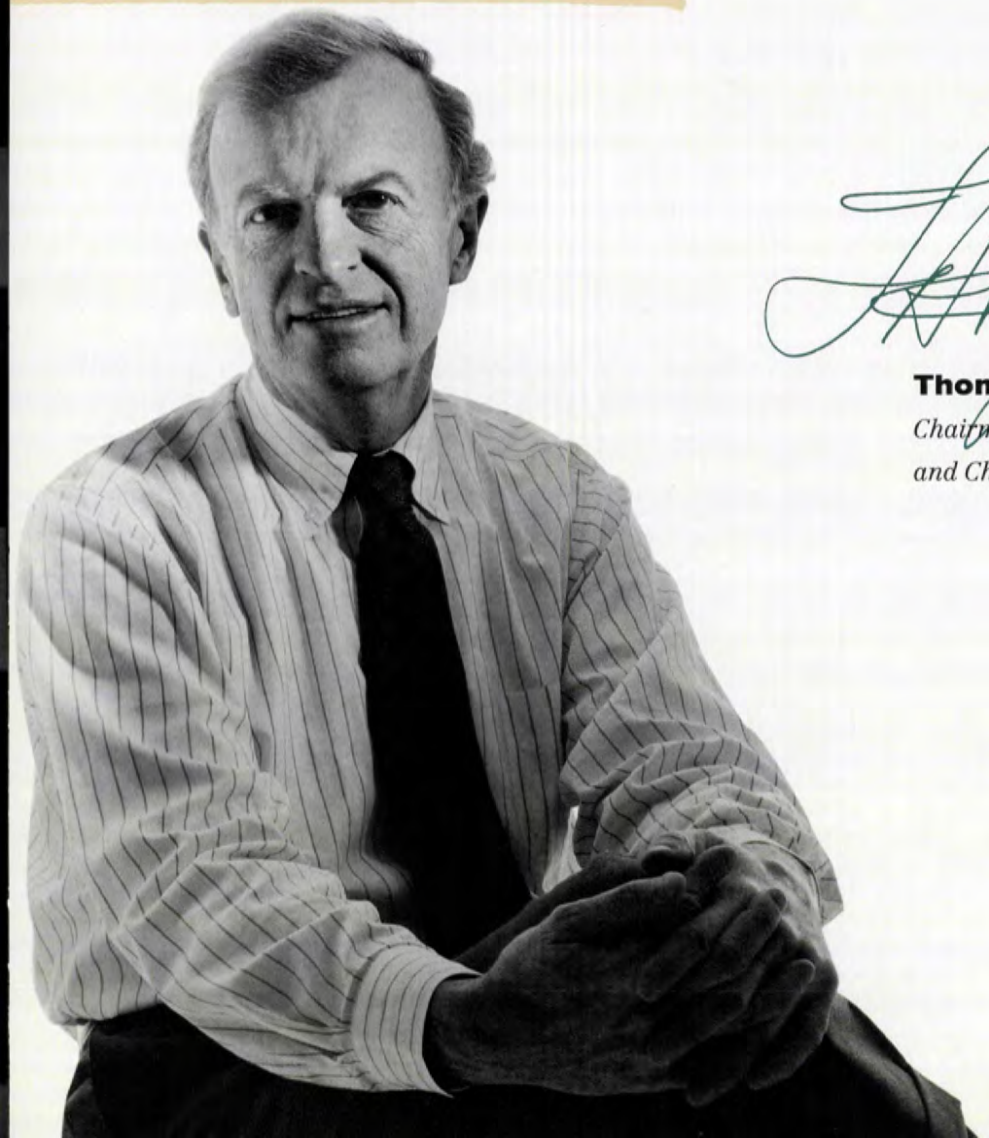
Also in 1994, we received final approval and launched implementation of the country's first comprehensive performance-based ratemaking program ever, a revolution in aligning our customers' interests with our shareholders' interests. **This is a victory for both sides.**

This new way to link customer rates and shareholder returns is on-the-job training for a deregulated industry, when the loyalty of customers will determine what we earn for our shareholders.

To overstate the obvious, nothing counts more in an era of competition than the proven ability to deliver. Deliver effectiveness. Deliver performance. Deliver results. **Deliver.**

I won't use superlatives to describe our commitment to deliver value to our shareholders and quality service to our customers. No description will be as effective and true as the results published in our reports to you during the year.

While much of our time and attention is devoted to readying ourselves for the competition for customers, there is one thing for which we will continue to fiercely compete: **your trust and confidence as an owner of this company.** It is our privilege.



Thomas A. Page
Chairman, President
and Chief Executive Officer

A MESSAGE FROM STEPHEN L. BAUM AND DONALD E. FELSINGER, EXECUTIVE VICE PRESIDENTS

Crossed arms. Arguments. Late nights spent in endless debate, awash in fluorescent lights and the smell of hours-old pizza. It's 1988, and the creative new initiative that would later thrust San Diego Gas & Electric into the national spotlight is born.

A little dramatic, yes, but the drama was earned in San Diego Gas & Electric's ongoing quest to be the first, to be the best.

The proposal that took years to deliberate and design was delivered last year with the August approval from the California Public Utilities Commission (CPUC). It is **performance-based ratemaking** — a long, cumbersome name for the fact that you, our shareholders, are now being financially rewarded for SDG&E dispensing quality customer service at a reasonable price.

NEW FORMULA FOR SUCCESS

Traditional ratemaking rewards utilities for spending money on their customers' behalf by providing an allowed return on capital investments. In a competitive world, that model rewards the wrong behavior. Now, under performance-based ratemaking, the equation has changed. If SDG&E can keep its costs down, it can increase shareholder returns. The best interests of customers and shareholders are now in alignment.

In keeping with SDG&E's belief in the value of alliances, we collaborated with the staff of the CPUC's Division of Ratepayer Advocates to define the specifics of this new ratemaking equation. Their involvement made our proposal stronger.

The performance-based ratemaking proposal which earned national headlines last year was the base rates mechanism, the third and most comprehensive of SDG&E's performance-based ratemaking initiatives. The first two mechanisms received approval in 1993 and logged their first year of implementation with $35 million in lowered costs; $27 million for customers and $8 million for shareholders — currently being requested.

BENEFIT CUSTOMERS AND SHAREHOLDERS IN DEREGULATION

Performance-based ratemaking is the well-constructed bridge that connects SDG&E with a deregulated electric utility industry. The formation and promotion of SDG&E's proposal for utility industry restructuring is a process to which SDG&E has devoted considerable time and talent. Our proposal, outlined later in this report, has two objectives, both of which mirror the California Public Utilities Commission's goal for industry deregulation: to form a competitive electric market that will ultimately lower the cost of electricity to customers, while preserving the financial integrity of the electric utility.

One positive note is the CPUC's endorsement of performance-based ratemaking as the preferred transition step to a deregulated industry.

The whole world is watching what happens in California, because this is the first state to undertake the truly imposing task of forcing the evolution of the industry.

DESIGNING A FRAMEWORK FOR FUTURE SUCCESS

A very likely outcome of deregulation is the need to draw legal lines between some of the competitive business units from what remains of the regulated utility. Therefore, SDG&E has proposed a holding company structure, for which you are being asked to cast your vote. The holding company would enable SDG&E to more rapidly respond to competitive challenges and deliver results.

CHALLENGES ANTICIPATED, RESULTS DELIVERED

Turning the focus inside the company, at the end of 1994 we reorganized the business operations of the company into five distinct units that more accurately link goals and performance to the customers each unit serves. The next phase of business planning is the design this year of a long-range strategic plan to set the company in a direction toward new and future business opportunities beyond where performance-based rates can take us.

How Will Performance Be Measured in the Future?

Under SDG&E's new performance-based rates plan, performance will be measured against a series of benchmarks relating to low rates, employee safety, customer service and system reliability. To the extent SDG&E beats those benchmarks, shareholders will earn awards.

IN ORDER TO WIN AWARDS, SDG&E MUST:

- earn a "very satisfied with service" from more than 92 percent of customers surveyed
- keep rates to below 137 percent of the national average in 1995, reducing to no greater than 132 percent of the national average by 1998
- keep the duration of outages to an average of below 70 minutes per customer per year
- keep lost-time accidents to below 1.2 per 100 employees

We have, for a long time, made it a practice to publish our goals as a meaningful exercise of the confidence that we have the ability to achieve them. This takes on critical importance in our current environment which is charged with rapid change.

It is also symbolic of our most valuable asset: intellectual capital. It is the judicious investment of our **intellectual capital** which will lead us forward, and make us leaders in a changing industry.

Stephen L. Baum
Executive Vice President

Donald E. Felsinger
Executive Vice President

Bucking Tradition Puts SDG&E in a Good Position

Deregulation of the electric utility industry took a major step forward in April of 1994, when California regulators issued a proposal calling for sweeping changes in the way power will move between seller and buyer. The goal of the proposed deregulation is to lower rates Californians pay for electricity, and to do so in a way that does not impair the financial integrity of the state's investor-owned utilities.

Deregulation is setting new standards ... and SDG&E expects to be the model utility. Not being your traditional utility company, we have long anticipated the industry's evolution to a more competitive state and we have evolved to thrive in the new world order. Rather than letting events shape our future, **we have made it our priority to help shape events.**

San Diego Gas & Electric is already well-positioned to compete. For years we have bought power in the wholesale market rather than building new plants. In 1994, for example, we purchased 54 percent of our supply of electricity. Given the abundance of power in the southwest we have been able to purchase relatively cheap power, thereby lowering our prices. For the sixth year in a row, SDG&E was the **lowest-cost provider** of electricity among investor-owned utilities in California during 1994.

Deregulation will make electricity a commodity, enabling the customer to comparison shop for the best price and availability. In turn electric utilities will need to compete against all potential sources of electricity, not only to retain their existing customers but also to gain new customers outside of their traditional service territory.

PROPOSED SCHEDULE FOR INDUSTRY CHANGE

March 22, 1995	The California Public Utilities Commission issues a proposed policy decision on deregulating the California electric industry.
April 1, 1995	Interested parties file comments on the proposed policy.
May/June 1995	The CPUC issues a policy decision (no sooner than 60 days after the issuance of its March proposal).
September 1995	Policy decision is effective (no sooner than 100 days later).

Deliver

SDG&E'S ALTERNATIVE PROPOSAL PROVIDES RELIABILITY AND FAIRNESS

SDG&E places a great deal of value on its customers — all of them, not just a select few. We feel it's important that all customers are treated with fairness and given reliable service as deregulation policy is established.

That's why when the CPUC said it would consider alternative proposals for deregulation, SDG&E offered its own proposal, one that would extend the benefits of a competitive electric market to all customers at the same time. The competitive electric market designed by SDG&E could be ready to go as soon as 1998.

There are still other issues to address. For example, SDG&E will aggressively fight the potential for not fully recovering all utility assets, a threat raised by deregulation. In the past, SDG&E invested in capital projects and improvements on its customers' behalf. These investments received full prior approval from the CPUC. SDG&E believes that the investments made under the old regulatory compact should be honored and that we should be allowed to recover the costs of these assets on behalf of our shareholders.

In short, SDG&E's proposal supports these beliefs:

- All customers should have access to the benefits of a competitive electric market.
- Reliability should be preserved and maintained as a priority under any new industry structure.
- The process of buying electricity should be as simple as possible for the customer.
- The CPUC should honor past commitments to utilities that invested capital in compliance with CPUC orders.

MOVING TOWARD A COMPETITIVE PRICE:

Cheaper electricity is an anticipated benefit from deregulating the state's electric industry, but it will take time to bring prices down significantly. Why? Because much of the electricity is produced by plants that still have the cost of construction built into the kilowatt hour price.

SDG&E, which owns 20 percent interest in the **San Onofre Nuclear Generating Station** (SONGS), has taken a major step to get those costs out of the price of SONGS-generated electricity, sooner rather than later. In November 1994, SDG&E and its SONGS partner, Southern California Edison, signed a proposal with CPUC staff to pay off the plant in eight years instead of the 19 years previously allowed. The CPUC is expected to act on the matter by fall of this year.

HOLDING COMPANY PROPOSED:

RESTRUCTURING FOR NEW INDUSTRY STRUCTURE

In response to new market opportunities anticipated in a deregulated electric utility industry, SDG&E is seeking **greater operating flexibility** by restructuring as a holding company. Currently, SDG&E's utility-related business is combined, or vertically integrated. Utility operations consist of power generation, transmission and distribution. Of these, it is likely that only the transmission over power lines and distribution into homes and businesses would remain regulated after deregulation. The holding company structure would enable SDG&E to set aside the power generation business as a subsidiary and as a separate, open-market competitor.

Under the proposed holding company, SDG&E would become a subsidiary like its four existing subsidiaries, which include Enova, a company investing in affordable housing projects; Califia, an equipment leasing firm; Enova Energy Management, an energy management consulting firm; and Pacific Diversified Capital, which holds an 80 percent stake in Wahlco Environmental Systems as well as commercial and industrial real estate holdings.

The holding company is not intended to be a large entity in its own right. It is simply a legal entity to comprise the company's separate subsidiaries. SDG&E shareholders would become shareholders of the holding company.

The board of directors of SDG&E has approved the formation of the holding company, and an application has been filed with the California Public Utilities Commission. Shareholders are being asked to approve the holding company at the 1995 annual meeting. The company hopes to have the new structure in place by mid-summer 1995.■

How SDG&E Delivers

Record customer service satisfaction and continued state leadership in low rates have been hallmarks of SDG&E's maturing focus on the customer, with a sharpened ability to respond to customer needs.

In the areas where it counts, **SDG&E has delivered.** But that's yesterday's news.

Competitors may poise themselves on the edge of our service territory, sights aimed on taking our customers, but we have anticipated and responded to the current and future needs of our customers, forging stronger customer relationships by:

→ delivering superior service and consistent performance

→ offering education and guidance, and

→ honoring the trust our customers have placed in us as corporate neighbor and citizen.■

MAJOR CUSTOMER FOCUS: DESIGN FOR SUCCESS

Would you expect the milkman to know you have different needs if you bought 100 gallons of milk a day instead of one gallon?

We understand that our high-volume customers have special needs and interests that are vastly different than our residential and small commercial customers.

With SDG&E's Major Customer Partnerships, trained and informed account executives have been assigned to the company's top 700 customers to improve our level of service as well as helping customers manage their energy use. In addition, the top 60 users of electricity receive direct attention from members of SDG&E's executive leadership.

In all of these partnerships, SDG&E representatives go **"on the other side of the meter"** to learn more about the energy needs of the large users.

→ The U.S. Navy facilities in the San Diego area, for example, have achieved the potential for more than $1.1 million in energy savings through an analysis of lighting, heating and cooling systems.

→ Sony San Diego Manufacturing Center has benefited from assistance provided by SDG&E in diminishing the disturbances created by variations in power quality on its sophisticated but highly sensitive manufacturing devices.■

SAN DIEGO'S ECONOMY REMAINS FLAT—SDG&E INGENUITY TESTED

In addition to looking for new business opportunities, the retention of customers is paramount, especially as the state and local economies remain weak. Customer growth was up only 0.8 percent in 1994.

SDG&E has participated in local economic development efforts, and has requested from the California Public Utilities Commission the ability to offer incentives to businesses that bring new jobs to the region. Our first customer to be signed to the new Economic Development Rate was Matsushita Television Corp. in January 1995.

SDG&E knows that success in a competitive environment depends on:

- → understanding the **needs** of the customer
- → delivering **value** to customers
- → increasing **service** options

ON-LINE CUSTOMER INFORMATION ANTICIPATES FUTURE BUSINESS NEEDS

In order to better serve the needs of customers and meet strategic business objectives, it will be necessary to generate, store and retrieve useful information about those customers. Enter the development of SDG&E's Customer Information System for Corporate Objectives (CISCO).

CISCO will bring SDG&E's customer information system into **the new millennium.** Currently only minimal customer information is available, with billing information being tracked by the meter, not by the customer. If a customer moves, for example, the account is closed and a new account is opened at the next meter. Except for the largest customers, no integrated link is available between the two accounts to paint a comprehensive picture of the customer's ongoing energy needs and use. The same is true for a customer who might have accounts at multiple locations.

CISCO, scheduled to go on-line in June 1997, will enable SDG&E to integrate customer information, track energy requirements and use over time, and offer new billing options. CISCO is another SDG&E strategy to build upon its record of quality service.■

Cheap Power and Competition

One of the key strategies behind lowering the cost of electricity is to avoid expensive energy in the first place. In 1994, SDG&E opted to buy out a contract to purchase power from the Bayside Cogeneration Project, a strategy that, in the long run, is expected to provide significant customer savings. Another step was SDG&E's decision not to repower its South Bay Power Plant. In a new competitive arena, it didn't make sense to make a 30-year commitment to a new power plant construction project.

One other battle being fought: the mandate requiring SDG&E to buy electricity significantly above today's market price. This is an element of regulation called the Biennial Resource Plan Update (BRPU), and SDG&E took its appeal to the federal level and won.

San Diego Gas & Electric is proud of having the lowest electric rates among the other major investor-owned utilities in California ... since 1989.

1994 Average System Rates

San Diego Gas & Electric
9.7¢ per kilowatt hour

Southern California Edison
10.4¢ per kilowatt hour
7 percent higher than SDG&E

Pacific Gas & Electric
10.5¢ per kilowatt hour
8 percent higher than SDG&E

ELECTRIC & MAGNETIC FIELD (EMF) CENTER

The medical and scientific communities have been unable to determine that electric and magnetic fields (EMF) cause health effects or to establish any standard or level of exposure that is known to be either safe or harmful. SDG&E takes seriously the concerns of its customers and workers about this issue. As a service to the community, SDG&E instituted the EMF Center to provide education on EMF.

The EMF Center is staffed by a team of SDG&E representatives who can answer questions and visit customers in their homes to measure EMF levels. SDG&E also makes available printed materials from the Environmental Protection Agency and the Department of Health Services, and contributes to state and federal EMF research, education and communications programs.

From the Inside Out—Preparing for Deregulation

To change the world around you, it's been said, look first within.

While external forces have been steadily moving the utility industry toward deregulation, SDG&E continues to concentrate on modifying its structure, its employee base and its culture in anticipation of new challenges and opportunities.

PERFORMANCE-BASED RATEMAKING—A NEW WAY OF LIFE

Performance-based ratemaking holds that if SDG&E can perform well in a competitive marketplace by fulfilling the needs of its customers, then its shareholders should be rewarded, too.

The equations below show how rates were formulated, which encouraged spending money to make money. Now, under performance-based rates, the balance has shifted to making money by spending less and improving efficiency.

TRADITIONAL RATEMAKING

Rates = *Cost* + *Profit*

PBR RATEMAKING

Rates − *Cost* = *Profit*

This makes balancing increased performance and cutting costs the order of the day. **Working harder and smarter with fewer costs.** That requires an about-face from the traditional utility mindset, because with the changes provided by deregulation, if a dollar is spent, there's no guarantee it will be recovered in customer rates.■

DOING MORE WITH LESS

During 1994, SDG&E's employee count dropped by 168 people. This left a full-time workforce at year end of 3,998 employees, a count last seen in 1976. Scaling back the workforce has been a trend since 1983 when the company reached an all-time high of 5,085 employees. During this time, the number of electric customers has increased by 41 percent, and the number of gas customers has increased by 33 percent. While it is preferable to rely on attrition to make necessary adjustments, SDG&E has had to make some **difficult business-based decisions** about precisely which kinds of functions and tasks should remain under the banner of SDG&E and which would be more economical and efficient to buy on the outside. The result has been the outsourcing of such functions as security, mainframe computing and surveying.

How are we able to do more with less? Part of the answer lies within giving employees the information and tools they need to take greater personal responsibility for setting priorities and making decisions.

Moving employees' rewards closer to corporate goal achievement is another factor in our culture change. Now in its second year, the Corporate Incentive Plan provides monetary rewards — if the company achieves *its* goals — for all employees whose personal performance meets tough performance benchmarks. Beginning in 1995, the company's union employees are also included in this incentive plan.■

SDG&E BUSINESS UNITS

Retail Energy Services

Responsible for supplying electricity and gas and related services to the retail customer.

Electric and Gas Supply

Procures energy resources, primarily to be sold to the retail customer.

Transmission/ Bulk System Operation

Responsible for moving electricity from the source of power to the buyer.

Generation

Generates electricity for SDG&E customers and to be sold on the spot market.

Corporate Services

Provides administrative support to the rest of the business units.

BUSINESS UNITS: IF THIS WERE YOUR BUSINESS...

Designing a more effective company structure is a perpetual task: as long as the industry continues to evolve, so will SDG&E. In 1994, SDG&E took another major evolutionary step by organizing its business-planning into separate units. While there are global principles which guide corporate-wide performance, such as increasing shareholder value, there are five major business concerns which are guided by different missions and distinct goals.

Retail Energy Services, for example, consists of those functions that directly support the energy user, such as Marketing and Customer Service. Corporate Services consists of the departments and divisions that provide administrative support to other SDG&E business units, such as the Accounting and Law departments.

As a result of this refined business focus, business unit employees will concentrate on those activities that affect their customers, making each employee more attentive to the needs at hand, and the company more competitive.■

The business units are made up of logical groupings of departments or divisions that are united by the customers they serve.

DESIGN

A Bear of a Year for Utility Stocks

Over the course of the past year, the price of SDG&E common stock has dropped from $24⅞ to $19¼ per share. **Why the decline in value?**

In brief, SDG&E's common stock price has moved with the utilities industry as a whole. The Dow Jones Utilities index dropped 21 percent in 1994 as investors reacted to two primary concerns: the upward move in interest rates and the momentum gained by deregulation of the electric utility industry.

Historically, utility stock prices have moved in the opposite direction of interest rates. The past year was no exception. As interest rates rose several times in 1994, utility stock prices fell.

As for the future of the industry, investors seem to perceive risks increasing in tandem with the potential increased competition in a deregulated environment. With deregulation becoming a reality in several corners of the country, including California, investors no longer view utilities as the rock-solid haven of the past.■

SDG&E REVENUES AND OPERATING INCOME UP FOR 1994 BUT NET INCOME LOWER DUE TO ONE-TIME WRITEDOWN

For the year ended December 31, 1994, San Diego Gas & Electric reported lower earnings of $1.17 per share, compared to $1.81 in 1993, due to a one-time, after-tax writedown of $0.68 per share taken in the second quarter of the year (see related story). Without the nonrecurring charge, earnings for the year would have been $1.85 per common share, the fifth straight year of earnings growth.

Consolidated operating revenues for the full-year 1994 totaled $1.98 billion, representing a 0.1 percent increase over 1993. Consolidated operating expenses were down 1.6 percent to $1.66 billion for the year, compared to $1.69 billion last year.

ONE-TIME $80 MILLION WRITEDOWN

Due to a one-time, nonrecurring after-tax writedown of $80 million, SDG&E posted a loss of 30 cents a share in the second quarter of 1994 — its first quarterly loss in a decade. Without the writedown second quarter earnings per share for the period would have been 38 cents compared to 36 cents per share in the second quarter of 1993.

The writedown was taken to reflect the decline in value of certain utility and subsidiary assets and to prepare the company for industry restructuring. The writedown had no impact on the company's dividend, which has been paid consistently since 1909 and which increased in 17 of the past 18 years.■

NEW PROGRAM OPTIONS BENEFIT SHAREHOLDERS

As a valued shareholder of San Diego Gas & Electric, you now have a number of new investment program options and benefits available to you. We are pleased to offer these additional features, along with our other existing shareholder services, and hope they help make investing in SDG&E more convenient.

CSIP CEILING RAISED

In February 1994, SDG&E's Common Stock Investment Plan, or CSIP, was changed to increase the maximum amount you can invest through the plan in any calendar quarter from $5,000 to $25,000. Shares purchased through the plan are free of any brokerage fees. In addition, your dividends are automatically reinvested into more shares of SDG&E common stock, helping your holdings compound.

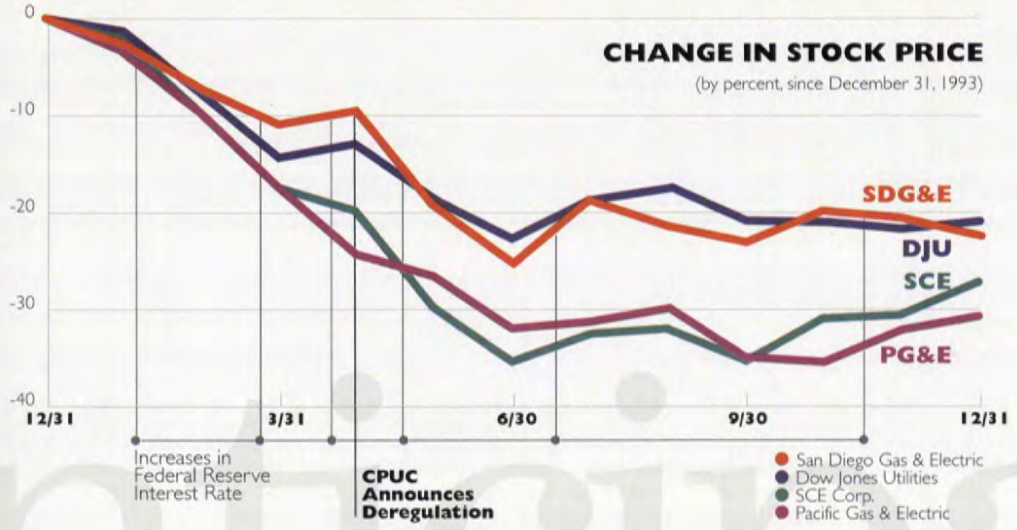
DIVIDEND DEPOSITS SIMPLIFIED

Let us deposit your dividends! Now you can send them straight to your financial institution using SDG&E's new Electronic Direct Deposit service. Now you don't have to wait for your dividend in the mail, and you can save yourself a trip to deposit your check. With Electronic Direct Deposit of Dividends, funds are safely in your account on the payment date (or on the next business day if paid on a weekend or holiday) so you don't lose interest and you don't need to worry about theft or loss. In addition, funds are cleared right away and are available for immediate use. Best of all, the new service is absolutely free. How's the program doing? Since Electronic Direct Deposit was made available by SDG&E in January 1994, more than 4,100 shareholders have enrolled.

HAVE QUESTIONS? NEW 800 HOTLINE HAS ANSWERS

Suppose you lose your stock certificate or you need to re-register your shares. Or maybe you changed your address. Who are you going to call for answers to these and other pressing questions about your SDG&E stock investments? **Call 1-800-307-7343**. That's the new toll-free information line that puts you in touch with SDG&E's transfer agent, First Interstate Bank. When you call, you'll speak directly with a bank staff member assigned specifically to respond to queries about SDG&E's stock programs. So don't hesitate to call about:

- Stock transfers
- Reregistration of stock certificates
- Your Common Stock Investment Plan (CSIP) account
- Shareholders of record direct holdings
- Electronic direct deposit of dividends
- Address changes
- Dividend payments



Shareholder Reference Guide

SHAREHOLDER SERVICES OFFICE

San Diego Gas & Electric
Office of the Secretary
Post Office Box 1831
San Diego, CA 92112-4150

WHERE TO CALL FOR INFORMATION

Stock Transfer Agent and Registrar: The company's transfer agent and not the company has the primary responsibility for stock transfers and the cancellation and issuance of stock certificates. First Interstate Bank is the transfer agent and registrar for the common, preferred and preference stocks. You can contact the agent directly.

Mailing Address:
First Interstate Bank of California
Stock Transfer Department
Encino Terrace Center, Suite 670
15821 Ventura Blvd.
Encino, CA 91436-2946
(800) 307-7343

First Interstate Bank of California
120 Broadway, 13th Floor
New York, NY 10271

Common Stock Investment Plan Agent:
First Interstate Bank of California
Dividend Reinvestment Service
Post Office Box 4326
Woodland Hills, CA 91365-9603
(800) 307-7343

SDG&E CONTACTS

Shareholders may call every business day, between 8:00 a.m. and 4:45 p.m. (Pacific time), to inquire about stock holdings:

Within California call:	(800) 826-5942
Outside California call:	(800) 243-5454

To hear a tape-recorded corporate news report and stock update:

Within California:	(800) 443-SDGE
Outside California:	(800) 521-NEWS

Inquiries from the financial community should be directed to:

Investor Relations:	(619) 696-2901

To call SDG&E headquarters: (619) 696-2000
(same mailing address as above)

STOCK LISTING AND TRADING INFORMATION

Common stock: Listed on the New York and Pacific stock exchanges under the ticker symbol SDO. Shareholders can find the previous day's closing price in the New York Stock Exchange listing table in daily newspapers under the symbol SDieGs.

Preferred and Preference Stocks: Listed on the American and Pacific stock exchanges under the ticker symbol SDO. Previous day closing prices are listed in the American Stock Exchange listing table under the symbol SDGO. (The 4.60% preferred series and the $1.7625 and $1.70 preference series are not listed.)

Where to Buy and Sell Stock: You can purchase the listed common, preferred and preference stocks through any brokerage firm. Some firms specialize in selling the unlisted series, and they can be located through your broker.

Stock Held in Brokerage Accounts ("street name"): When you purchase your stock and it is held for you by your broker, it is listed with the company in the broker's name, or "street name." SDG&E does not know the identity of individual shareholders who hold their shares in this manner — we simply know that a broker holds a certain number of shares that may be for any number of customers.

If you hold your stock in street name, you are not eligible to participate in SDG&E's Common Stock Investment Plan. Also, you receive all dividend payments, annual and quarterly reports, and proxy materials through your broker. Therefore, if you are receiving unwanted duplicate mailings, you should contact your broker, not SDG&E, to eliminate the duplications.

Lost or Stolen Certificates: If your stock certificate has been lost, stolen or in some way destroyed, you should notify the Shareholder Services office in writing immediately.

How to Transfer Stock: A transfer of stock is required whenever there is a change in the name or names in which the stock certificate is registered. This can happen when you sell the stock, make a gift of stock, or add or delete owners of the certificate. The transfer can be made by filling in the stock assignment form on the back of the stock certificate and signing it exactly as the name or names appear on the front of the certificate. The signatures of the individuals transferring the stock

must be guaranteed by either a commercial bank (not a savings and loan association) or a brokerage firm that is a member of a major stock exchange. A notary's acknowledgment is not acceptable. The certificate can then be sent to the transfer agent for transfer. It is recommended that certificates be sent by registered or certified mail.

MULTIPLE DIVIDEND CHECKS AND DUPLICATE MAILINGS

Some shareholders hold their stock on our records in similar but different names (e.g., Robert A. Johnson and R. A. Johnson). When this occurs, the law requires that we create a separate account for each name. Even though the mailing addresses are the same, we are required to mail separate dividend checks and annual and interim reports to each account.

How to Consolidate Accounts: If you want to consolidate your separate accounts into one account, you should contact the Shareholder Services office to obtain the necessary forms and instructions. When accounts are consolidated, it may be necessary to reissue the stock certificates.

How to Eliminate Duplicate Mailings: If you want to maintain more than one account but eliminate additional mailings of quarterly reports, you may do so by sending the labels (or a copy of the labels) from a company mailing to the Shareholder Services office, indicating the names you wish to keep on the mailing list for quarterly reports and the names you wish to delete. This will affect only these mailings; dividend checks, annual reports and proxy materials will continue to be sent to each account.

REPLACEMENT OF DIVIDEND CHECKS

If you do not receive your dividend check within 10 business days after the payment date, or if a check is lost or destroyed, you should notify the Shareholder Services office so that payment may be stopped on the check and a replacement issued.

ELECTRONIC DIRECT DEPOSIT OF DIVIDENDS

SDG&E now offers the electronic direct deposit of dividends. This program allows shareholders to have dividends deposited directly into any financial institution account free of charge.

COMMON STOCK INVESTMENT PLAN (CSIP)

SDG&E common stock shareholders can purchase additional shares by investing all or a portion of their quarterly dividends in additional shares.

The plan allows optional cash investments of as little as $25 per investment up to a maximum of $25,000 per calendar quarter. Shares purchased under this plan are free of any brokerage fees; however, any brokerage fees incurred by the company are taxable to the shareholder.

Call or write Shareholder Services for your CSIP prospectus or enrollment card for Electronic Direct Deposit of Dividends.

SHAREHOLDER PROFILE

As of December 31, 1994, there were 70,356 common stock shareholders of record and 1,973 preferred and preference stock shareholders. There are thousands of other stockholders whose shares are held in street name by securities brokers and nominees.

COMMON STOCK SHAREHOLDERS

By account registration:	
Joint accounts	18,225
Women	16,045
Men	19,897
Fiduciaries	15,442
Securities brokers, nominees, others	747
By geographic area:	
United States, except California	36,785
California, except SDG&E service area	18,326
SDG&E service area, excluding employees	15,076
Foreign countries	169
By shares owned:	
1-99	14,178
100-300	21,752
301-500	11,445
501-1000	12,514
1001 or more	10,467

PUBLICATIONS AVAILABLE TO SHAREHOLDERS

Annual Report: Requests for additional copies of the annual report should be directed to Shareholder Services.

Report to Investors: Reports of current activities, recent results and features of interest to shareholders are issued periodically during the year.

Form 10-K: The annual report to the Securities and Exchange Commission.

Shareholder Handbook: SDG&E has prepared a helpful shareholder handbook providing information on the company's shareholder services, stock certificates, and stock transfer systems.

TEN-YEAR SUMMARY

FOR THE YEARS ENDED DECEMBER 31 DOLLARS IN MILLIONS EXCEPT PER SHARE AMOUNTS	1994	1993	1992
Operating revenues			
Electric	$ 1,510.3	$ 1,514.6	$ 1,447.1
Gas	346.2	346.7	337.0
Diversified operations	125.5	118.8	86.8
Total	$ 1,982.0	$ 1,980.1	$ 1,870.9
Operating income	$ 321.9	$ 293.7	$ 296.3
Net income (before preferred dividend requirements)	$ 143.5	$ 218.7	$ 210.7
Earnings per common share	$ 1.17	$ 1.81	$ 1.77
Dividends declared per common share	$ 1.52	$ 1.48	$ 1.44
Pretax income/revenue	13.8%	18.5%	19.4%
Return on common equity	9.1%	14.2%	14.4%
Effective income tax rate	47.5%[B]	40.4%	42.0%
Dividend payout ratio (declared)	129.9%[B]	81.8%	81.4%
Price range of common shares	25–17 1/2	27 3/4–23 1/4	25 3/8–21 1/8
AT DECEMBER 31			
Total assets	$ 4,642.5	$ 4,702.2	$ 4,494.6
Long-term debt and preferred stock subject to mandatory redemption (excludes current portion)[C]	$ 1,480.2	$ 1,525.0	$ 1,651.9
Current assets	$ 394.5	$ 378.1	$ 354.0
Current liabilities	$ 687.2	$ 689.7	$ 589.9
Working capital	$ (292.7)	$ (311.6)	$ (235.9)
Working capital ratio	.6	.5	.6
Common shareholders' equity	$ 1,474.4	$ 1,516.2	$ 1,441.4
Number of utility customers[D]	1,138.9	1,129.3	1,122.0
Number of utility employees	3,998	4,166	4,249
Common shares outstanding[D]	116,537	116,515	115,034
Book value per common share	$ 12.65	$ 13.01	$ 12.53
Price/Earnings ratio	16.5[B]	13.7	13.6

[A] Including ($0.07) in 1989 and $0.16 in 1987 for cumulative effect of changes in accounting principles.

[B] Higher in 1994 due to the one-time $96 million (pretax) writedown described in Note 3.

[C] Includes long-term debt redeemable within one year.

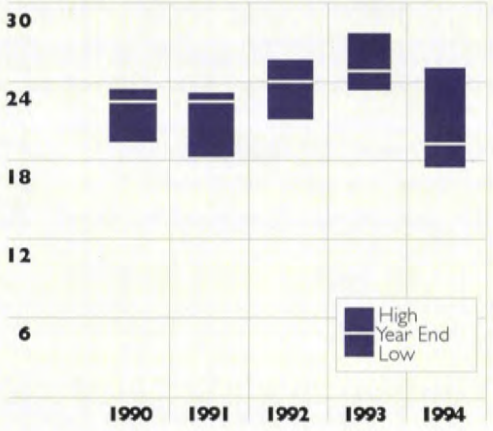
[D] In thousands.

This summary should be read in conjunction with the consolidated financial statements and notes to consolidated financial statements contained elsewhere in this report.

	1991	1990	1989	1988	1987	1986	1985
	$ 1,357.5	$ 1,356.4	$ 1,324.9	$ 1,300.0	$ 1,261.3	$ 1,333.5	$ 1,395.7
	338.2	355.1	300.4	285.4	293.8	299.2	343.0
	93.3	60.4	44.2	35.1	7.1	1.5	—
	$ 1,789.0	$ 1,771.9	$ 1,669.5	$ 1,620.5	$ 1,562.2	$ 1,634.2	$ 1,738.7
	$ 315.5	$ 314.0	$ 284.8	$ 274.6	$ 261.1	$ 282.4	$ 287.9
	$ 208.1	$ 207.8	$ 179.4	$ 189.4	$ 196.8	$ 167.3	$ 202.7
	$ 1.76	$ 1.76	$ 1.50[A]	$ 1.59	$ 1.64[A]	$ 1.30	$ 1.62
	$ 1.3875	$ 1.35	$ 1.35	$ 1.30	$ 1.25	$ 1.1725	$ 1.1025
	19.0%	20.6%	19.3%	18.7%	21.7%	21.6%	22.7%
	14.9%	15.5%	13.7%	14.6%	15.6%	12.3%	16.2%
	38.6%	43.0%	44.3%	37.5%	44.5%	52.7%	48.7%
	78.6%	76.7%	85.7%	81.8%	76.3%	90.4%	68.1%
	23–18 1/4	23 1/8–19 1/2	22 3/4–18 1/4	19 3/4–15	19–14 1/8	21 1/4–13 3/8	14 1/4–10 3/4
	$ 4,046.7	$ 3,945.2	$ 3,860.3	$ 3,532.7	$ 3,551.5	$ 3,409.2	$ 3,332.6
	$ 1,331.2	$ 1,337.1	$ 1,287.2	$ 1,357.0	$ 1,388.4	$ 1,333.2	$ 1,354.1
	$ 325.1	$ 331.7	$ 299.2	$ 319.9	$ 336.4	$ 299.7	$ 366.2
	$ 602.9	$ 572.5	$ 596.0	$ 510.1	$ 533.7	$ 450.2	$ 404.8
	$ (277.8)	$ (240.8)	$ (296.8)	$ (190.2)	$ (197.3)	$ (150.5)	$ (38.6)
	.5	.6	.5	.6	.6	.7	.9
	$ 1,350.0	$ 1,295.6	$ 1,248.4	$ 1,229.9	$ 1,197.4	$ 1,159.9	$ 1,153.0
	1,111.3	1,095.2	1,069.6	1,032.6	990.4	940.7	893.9
	4,215	4,175	4,209	4,420	4,612	4,815	4,860
	112,496	111,898	111,843	111,797	111,745	111,696	111,646
	$ 12.00	$ 11.58	$ 11.16	$ 11.00	$ 10.72	$ 10.39	$ 10.33
	12.8	12.7	14.3	12.0	9.1	9.9	8.3

DIVIDENDS PER SHARE
(DECLARED, IN DOLLARS)

COMMON STOCK PRICE TREND
(IN DOLLARS)



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

San Diego Gas & Electric Company is an operating public utility engaged in the electric and gas businesses. SDG&E generates and purchases electric energy and distributes it to 1.1 million customers in San Diego County and an adjacent portion of Orange County, California. It also purchases and distributes natural gas to 696,000 customers in San Diego County. SDG&E also transports electricity and gas for others. SDG&E has diversified into other businesses. Enova Corporation invests in limited partnerships representing approximately 550 affordable-housing projects located throughout the United States. Califia Company leases computer equipment. The investments in Enova and Califia are expected to provide income tax benefits over the next several years. Enova Energy Management is an energy management consulting firm offering services to utilities and large consumers. Pacific Diversified Capital is a holding company for non-utility subsidiaries, Phase One Development, Inc. which is engaged in real estate development and Wahlco Environmental Systems, Inc. (80 percent owned). Wahlco designs and manufactures air-pollution control and power-efficiency equipment for electric utilities and other power producers, refineries and other manufacturers. Additional information regarding SDG&E's subsidiaries is described in Notes 1 through 3 of the notes to consolidated financial statements.

Revenues Electric revenues did not change significantly in 1994 and increased 5 percent in 1993. The 1993 increase reflects higher authorized costs and increased sales to other utilities.

Gas revenues did not change significantly in 1994 and increased 3 percent in 1993. Gas revenues in 1994 reflect higher authorized costs offset by lower sales volumes as a result of customers' purchases of gas directly from other suppliers. The 1993 increase reflects higher authorized costs, partially offset by lower sales volume as a result of customers' purchases of gas directly from other suppliers.

Revenues from diversified operations increased in 1994 and 1993 primarily due to Califia's leasing activities. Wahlco's revenues declined in 1994 as a result of the continuing poor market for air pollution control products. There was no significant change in Wahlco's revenues in 1993. Additional information concerning Wahlco is described in Notes 1 through 3 of the notes to consolidated financial statements.

Operating Expenses Electric fuel expense decreased 18 percent in 1994 and did not change significantly in 1993. The decrease in 1994 was primarily due to lower prices for natural gas and the replacement of fossil fuel generation with lower-cost nuclear generation as a result of San Onofre Nuclear Generating Station Units 2 and 3 completing their refueling cycles.

Purchased-power expenses increased 5 percent in 1994 and 1993. The increase in 1994 is primarily due to increased purchases from higher-cost independent power producers. The increase in 1993 reflects increased purchases of short-term energy as a result of the refueling of the SONGS Units 2 and 3 in 1993 and the permanent shutdown of Unit 1 in late 1992.

Gas purchased for resale decreased 12 percent in 1994 and did not change significantly in 1993. The decrease in 1994 was primarily due to lower prices for natural gas and lower sales volumes due to customers' purchases of gas directly from others.

Other operating expenses did not change significantly in 1994. The increase in 1993 is primarily due to higher utility operating and maintenance expenses, higher subsidiary operating expenses arising from Califia's increased leasing activities and higher depreciation as a result of the accelerated recovery of SDG&E's remaining investment in SONGS Unit 1.

Other Income and Deductions Other income and deductions decreased in 1994 and did not change significantly in 1993. The decrease in 1994, including the decrease in "Other — net," was primarily due to the writedowns described in Note 3 of the notes to consolidated financial statements.

Earnings In 1994 earnings per common share were $1.17, compared to earnings of $1.81 in 1993 and $1.77 in 1992. The decrease in 1994 was primarily due to the writedowns described in Note 3 of the notes to consolidated financial statements. The increase in earnings in 1993 is due primarily to the increase in the investment activities of Califia and Enova. Califia and Enova's contributions to earnings were 15 cents in 1994, 9 cents in 1993 and 1 cent in 1992.

Liquidity and Capital Resources

Utility operations continue to be a major source of liquidity for SDG&E. In addition, SDG&E's financing needs are met primarily through issuances of short-term and long-term debt and of common and preferred stock. These capital resources are expected to remain available. Cash requirements include plant construction and other capital expenditures, subsidiaries' affordable-housing and leasing investments, and retirements of long-term debt. In addition to changes described elsewhere, major changes in cash flows are described below.

Cash Flows from Operating Activities The major changes in cash flows from operations among the three years result from changes in regulatory balancing accounts, income taxes, and accounts payable and other current liabilities. The changes in cash flows related to regulatory balancing accounts were due primarily to changes in prices for natural gas and the replacement of lower-cost nuclear generation with purchased power and gas-fired generation in 1993 due to the refuelings of SONGS Units 2 and 3 and the shutdown of SONGS Unit 1 in late 1992. The changes in cash flows related to income taxes were due primarily to the differences in timing of income tax payments related to regulatory balancing account activity in 1994 and due to higher income tax payments in 1992 in connection with a preliminary settlement with the Internal Revenue Service on the timing of certain deductions in prior years. The changes in accounts payable and other current liabilities were

primarily due to higher construction activity and higher employee compensation in 1993.

Cash Flows from Financing Activities SDG&E had only short-term financing needs during 1994. SDG&E did not issue additional stock or long-term debt in 1994 and does not plan any issuances in 1995 other than refinancings. SDG&E's utility capital structure is one factor that has enabled it to obtain long-term financing at attractive rates. The following table shows the percentages of capital represented by the various components. The capital structures are net of the construction funds held by a trustee in 1992 and 1993.

	1990	1991	1992	1993	1994	Goal
Common equity	45%	47%	47%	47%	48%	45–48%
Preferred stock	6	5	5	4	4	5–7
Debt and leases	49	48	48	49	48	46–49
Total	100%	100%	100%	100%	100%	100%

During 1994 the major credit-rating agencies placed the three large California electric utilities under review following an announcement by the California Public Utilities Commission of its plan to restructure California's electric utility industry. The review lead to an affirmation of SDG&E's A+ long-term bond rating by Standard & Poor's and a downgrade in SDG&E's long-term bond rating from Aa3 to A1 by Moody's Investors Service. The rating agencies indicated that the outlook for the California utilities would remain negative due to the long-term risk associated with the CPUC's proposal and due to the concerns about the burden the CPUC has placed on California utilities to buy high-cost power from independent power producers. Additional information concerning electric industry restructuring and SDG&E's purchased-power commitments is described under "Competition" and "Resource Planning" below and in Notes 10 and 11 of the notes to consolidated financial statements.

SDG&E periodically enters into interest rate swap and cap agreements to moderate its exposure to interest rate changes and to lower its overall cost of borrowing. SDG&E would be exposed to interest rate fluctuations on the underlying debt should other parties to the agreement not perform. Such nonperformance is not anticipated. Additional information on derivative financial instruments is provided in Note 9 of the notes to consolidated financial statements.

Cash Flows from Investing Activities Sources of cash for investing activities in 1994 included the withdrawal of the remaining $58 million in the construction trust fund. Cash used in investing activities in 1994 included utility construction expenditures and payments to the nuclear decommissioning trust. Construction expenditures, excluding nuclear fuel and the allowance for equity funds used during construction, were $264 million in 1994 and are estimated to be about $240 million in 1995. SDG&E continuously reviews its construction, investment and financing programs and revises them in response to changes in competition, customer growth, inflation, customer rates, the cost of capital, and environmental and regulatory requirements. Among other things, the level of expenditures in the next few years after 1995 will depend heavily on the impacts of the CPUC's industry restructuring proposal, on the timing of expenditures to comply with air emission reduction and other environmental requirements, and on whether SDG&E proceeds with its plan to transport natural gas to Mexico. These matters are discussed below.

Payments to the nuclear decommissioning trust are expected to continue until SONGS is decommissioned, which is not expected to occur before 2014. Although Unit 1 was permanently shut down in 1992, it is expected to be decommissioned concurrently with Units 2 and 3.

Regulatory Matters

Base Rates On August 3, 1994 the CPUC adopted the base-rate component of SDG&E's performance-based ratemaking mechanism for an experimental period beginning in 1994 and ending in 1998, thereby replacing the traditional general rate case process. The base-rate mechanism includes a formula similar to the traditional attrition mechanism used to determine SDG&E's annual revenue requirement for operating, maintenance and capital costs. It also sets performance standards for customer rates, employee safety, electric system reliability and customer satisfaction. Each indicator specifies a range of possible shareholder benefits and risks. Finally, the mechanism provides for revenue sharing with customers should SDG&E earn one percent or more above its authorized rate of return.

On December 21, 1994 the CPUC authorized a $48 million increase in electric and gas rates. The increase is based on the PBR base-rate mechanism's formula for operating and maintenance expenses, SONGS refueling costs, and capital-related costs (including depreciation).

On November 22, 1994 the CPUC issued its decision on the 1995 Cost of Capital proceeding, authorizing returns on equity ranging from 11.30 percent to 12.10 percent for the six California investor-owned utilities. This is an increase from their 1994 authorized returns, which ranged from 10.85 percent to 11.10 percent. The Commission indicated that the higher returns were authorized to maintain the utilities' financial integrity, to compensate investors for the increased costs of doing business, and to recognize the increased levels of risk arising from industry restructuring. SDG&E was authorized a return on equity of 12.05 percent for an overall rate of return of 9.76 percent and an increase in electric and gas rates of $36 million. SDG&E's 1994 authorized return on equity and rate of return were 10.85 percent and 9.03 percent, respectively.

Although the revenue increases for base rates and cost of capital are effective January 1, 1995, the electric portion of the increases will be combined with SDG&E's request for a rate decrease in its Energy Cost Adjustment Clause application (as described in "Electric Fuel and Energy Rates" below) and included in rates effective May 1, 1995. The gas portion of the increases was included in rates on January 1, 1995 (as described in "Gas Rates" below).

Electric Fuel and Energy Rates On March 9, 1994 the CPUC issued its Energy Cost Adjustment Clause decision finding

SDG&E's electric fuel and purchased-power expenses to be reasonable for the year ended July 31, 1992. This decision included the finding that SDG&E's administration of its Portland General Electric purchased-power contract was reasonable during the three-year period ended July 31, 1992. In May 1994 the CPUC's Division of Ratepayer Advocates issued its report on SDG&E's 1993 Energy Cost Adjustment Clause reasonableness review for the year ended July 31, 1993. The DRA generally found SDG&E's expenses and operations reasonable. A CPUC decision is expected in the first quarter of 1995.

On April 20, 1994 the CPUC issued its decision on the forecast phase of SDG&E's 1994 Energy Cost Adjustment Clause proceeding, approving a $57 million increase in electric rates to cover higher expected fuel and purchased-power expenses and to recover prior undercollections from customers. The fuel and purchased-power portion of the forecast also established the generation and dispatch benchmark for shareholder gains and losses under the performance-based ratemaking mechanism for the year beginning May 1, 1994. The rate increase was effective May 1, 1994.

On October 17, 1994 SDG&E filed its 1995 Energy Cost Adjustment Clause application with the CPUC, requesting a decrease of $67 million in electric rates. The request reflects lower expected fuel and purchased-power costs, and the amortization of previous overcollections from customers, including a refund of $15 million of unspent revenues for demand-side management programs, partially offset by the two-year amortization of the Bayside cogeneration contract termination payment (for additional information see "Cogeneration" below). On December 20 the CPUC's Division of Ratepayer Advocates issued its report on SDG&E's 1995 ECAC application, recommending a $79 million rate decrease. The difference is primarily due to the DRA's assumptions concerning future prices for fuel and purchased power. A CPUC decision is expected in April 1995, with rates effective May 1, 1995.

Under SDG&E's performance-based ratemaking generation and dispatch mechanism and gas procurement mechanism, fuel and energy operations and expenses are not normally subject to CPUC reasonableness reviews. However, SDG&E's nuclear operations and gas storage operations remain subject to review. The current review will cover those operations for the period from August 1993 to July 1994. A CPUC decision is expected in August 1995.

On October 31, 1994 SDG&E filed reports with the CPUC on the results of the generation and dispatch and the gas procurement mechanisms for the year ended July 31, 1994. SDG&E's fuel and purchased-power expenses fell below the benchmarks for these mechanisms by $35 million. SDG&E's ECAC application (see above) and its current Biennial Cost Allocation Proceeding application request a shareholder reward of $8 million, and that the remainder of these savings be given to customers through lower rates.

Gas Rates On December 21, 1994 the CPUC issued its decision on SDG&E's 1993 Biennial Cost Allocation Proceeding, authorizing a $32 million decrease in gas rates. The decrease reflects lower prices for natural gas, transportation and storage, and the amortization of prior overcollections from customers, partially offset by SDG&E's share of a settlement with Southern California Gas Company and others concerning SDG&E's obligation under long-term natural gas supply contracts. SDG&E is recovering its remaining share of the settlement costs over the two-year period ending in 1996. The change in gas rates was effective on January 1, 1995.

San Onofre Nuclear Generating Station SDG&E is currently recovering its investment in San Onofre Nuclear Generating Station Unit 1 over a four-year period that began in November 1992, when the CPUC issued a decision to permanently shut down the unit. The decision authorized Southern California Edison (majority owner and operator of SONGS) and SDG&E to recover their investments in Unit 1, of which SDG&E's share was $111 million. SDG&E is recovering its investment, earning a return of 9.1 percent.

On November 15, 1994 SDG&E, Edison and the CPUC's Division of Ratepayer Advocates signed a settlement agreement on the accelerated recovery of SONGS Units 2 and 3 capital costs. The agreement would allow SDG&E to recover more than $750 million over an eight-year period beginning in February 1996, rather than over the anticipated operational life of the units, which is expected to extend to 2013. During the eight-year period, the authorized rate of return would be reduced from 9.76 percent to 7.52 percent (SDG&E's 1995 authorized cost of debt). The agreement also includes a performance incentive plan that would encourage continued, efficient operation of the plant. However, continued operation of SONGS beyond the eight-year period would be at the owners' discretion. Under the plan, customers would pay about four cents per kilowatt-hour during the eight-year period. This pricing plan would replace the traditional method of recovering the units' operating expenses and capital improvements. This is intended to make the plants more competitive with other sources. SDG&E is unable to predict the impact of this proposal, if approved, on the results of its operations. However, it is expected to be considered in conjunction with the CPUC's industry restructuring proposal. A CPUC decision is expected in the first half of 1995. Additional information on industry restructuring is provided under "Competition" below, and in Note 11 of the notes to consolidated financial statements.

Competition

Electric In April 1994 the CPUC announced its proposal to restructure California's regulated electric utility industry to stimulate competition and to lower rates. The proposed regulatory framework would be phased in over a six-year period. Beginning in 1996, the utilities' largest customers would be allowed to purchase their energy from either utility or nonutility suppliers. Other industrial and commercial customers would have this choice by between 1997 and 1999, depending on their energy requirements. Residential customers would have this choice by 2002. The utilities would continue to provide transmission and distribution services to customers that switch to other suppliers. The CPUC also proposed that the cost of providing these services and the cost of serving remaining utility customers would be recovered through a

performance-based ratemaking process, replacing traditional cost-of-service ratemaking.

The CPUC is holding several hearings to address comments on its proposal. These hearings involve discussions of whether the CPUC's proposal or some other form of a competitive market should be developed, whether direct access and retail competition would be necessary for the CPUC to achieve its industry restructuring objectives, how such a market would be structured, and how the cost of the transition to competition and the cost of the various utility-sponsored social programs should be shared.

Both the Federal Energy Regulatory Commission and the California legislature have raised the issue of whether the CPUC has the authority to unilaterally change the way rates are determined and power is sold, since several California statutes would need to be changed to accommodate the proposal and since the FERC has jurisdiction over interstate power sales and transmission involving California's network.

The California legislature has passed a resolution forming an oversight committee to ensure the legislature's involvement in the policies proposed by the CPUC, and that the policies comply with federal and state laws and achieve the objectives of both competition and the various social programs that are currently funded through utility rates.

On December 7, 1994 the CPUC issued an interim decision ordering the utilities and interested parties to form a working group to consider how existing social, economic, conservation and environmental programs could be sustained under three broad restructuring concepts and to indicate where applicable laws would need to be changed: 1) complete market reform, allowing all customers to choose any supplier; 2) market reform with a mandatory pool through which all business is transacted; and 3) wholesale-only reform through which the suppliers transact business and retail consumers purchase through their current utility provider.

SDG&E has proposed a multi-step process for the transition to competition, including: the establishment of a schedule for the transition to a competitive market that would allow the recovery of the above-market cost of existing generating plants (including the SONGS units), related regulatory assets, power-purchase contracts and other long-term commitments, decommissioning, and environmental-mitigation costs, without having a significant rate increase or an adverse impact on SDG&E's earnings; the development of a fully competitive, pool-based wholesale market with open access to the transmission system for all power generators; and, to avoid self-dealing concerns, the separation of fossil-fuel generation (power plants and cogeneration contracts), transmission, and distribution assets through the formation of a holding company (see "Holding Company" below). SDG&E's proposal also foresees: the renegotiation of long-term purchased-power contracts, including contracts with independent power producers, to lower the cost of those contracts to market price and to allow the recovery of any excess contract costs and other transition costs by allocating these costs to all utility customers through a distribution charge included in retail rates, which would not be subject to potential bypass; the replacement of mandated long-term resource commitments (such as the Biennial Resource Plan Update process) with short-term resource procurement; and, once the wholesale market is in place, the establishment of access to the competitive wholesale market for all customers at the same time through a local distribution company. SDG&E would make the necessary regulatory filings no later than January 1996 and implement its proposal as soon as regulatory approvals are granted, rather than over the phase-in period ending in 2002 as proposed by the CPUC.

Some interested participants in the proceedings support the CPUC's direct access proposal, but prefer a longer phase-in period to avoid stranded investments (those costs that are in excess of what will be recoverable via market-based pricing structures). Others, who are planning to enter the electric-generation business in California, favor retail wheeling whereby customers may purchase directly from any supplier and avoid paying utilities' fixed costs. They also suggest that a shorter period for the transition to a competitive market is possible.

On January 31, 1995 SDG&E filed with the CPUC its position regarding certain legal issues. SDG&E asserted, among other things: that federal law prohibits the CPUC from denying recovery of prudently incurred costs; that the CPUC cannot constitutionally compel retail wheeling or divestiture without compensation for above-market assets; and that implementation of the CPUC's retail wheeling proposal would require major changes to state law.

As the restructuring of the industry evolves, SDG&E will become more vulnerable to competition. However, many issues and complications still need to be resolved. California utilities' rates are significantly higher than the national average. However, among the investor-owned utilities in California, SDG&E has been the lowest-cost provider and has a lower concentration of industrial customers, which make its customers a less likely target for outside competitors. In addition, SDG&E has not built a power plant in over 10 years, which lowers the risk associated with the recovery of its power-plant investment.

Utility plant in service by major functional categories at December 31, 1994 are: electric generation $1.7 billion, electric distribution $2.0 billion, electric transmission $0.7 billion, gas $0.7 billion and other $0.2 billion. Accumulated depreciation and decommissioning at December 31, 1994 are $2.0 billion and $0.2 billion, respectively. The balances at December 31, 1993 were substantially the same.

If the CPUC proceeds with the move to a competitive environment, if the prices of competing suppliers are as anticipated, and if the regulatory process does not provide for complete recovery of stranded costs, SDG&E would have to incur a charge against earnings for a significant portion of its generating facilities, the related regulatory assets and the long-term commitments. Additional information on potential stranded costs and SDG&E's long-term purchased-power commitments is described below under "Resource Planning" and in Notes 10 and 11 of the notes to consolidated financial statements. Additional information concerning the recovery of SONGS is described under "San Onofre Nuclear Generating Station."

The CPUC plans to issue a preliminary recommendation setting forth policy conclusions on March 22, 1995, followed by a comment period and a full panel hearing on April 24, 1995. The CPUC has indicated that the implementation of a final policy decision would not occur before September 1995. SDG&E cannot predict the impact of the CPUC's final decision and the transition to a more competitive environment on SDG&E's financial condition and results of operations.

Holding Company On November 7, 1994 SDG&E filed an application with the CPUC to form a holding company. Under the proposed structure, SDG&E would become a subsidiary of the parent company, as would SDG&E's existing subsidiaries. SDG&E would exchange its outstanding common shares for an equal number of holding company shares. Shareholders will be asked to vote on the proposal at the annual shareholder meeting on April 25, 1995. SDG&E has applied to other regulatory bodies for approval of the proposal and hopes to have the holding company in place by mid 1995. SDG&E believes that changes in the California utility industry and the movement toward a more competitive marketplace will require SDG&E to change its corporate structure. Under the holding company structure the customers of its remaining, regulated utility business would be shielded from the financial effects of the holding company's non-utility or competitive ventures.

Gas The ongoing restructuring of the gas utility industry has allowed customers to bypass utilities as suppliers and transporters of natural gas. Currently nonutility electricity producers and other large customers may use a utility's facilities to transport gas purchased from nonutility suppliers. Also, smaller customers may form groups to buy gas from another supplier. SDG&E would face significant competition if a major pipeline were to operate in or near SDG&E's service territory.

In 1993 SDG&E and SoCal Gas submitted a joint proposal to transport natural gas to the Rosarito Power Plant in Baja California, Mexico. The project involves the construction of an 80-mile pipeline from SoCal Gas' service territory to the Mexican border, and is competing with two other proposed pipelines. Mexico has postponed a decision on this project. In 1994 SDG&E and SoCal Gas began negotiations with Mexico for service to Mexicali in Baja California through SoCal Gas' existing system in the Imperial Valley. The recent economic unrest in Mexico has affected progress, and the full impact on the project is unknown.

Resource Planning

South Bay Repower Project In 1994 the CPUC and the California Energy Commission approved SDG&E's requests to withdraw its applications for the proposed 500-mw South Bay Repower project. SDG&E indicated that the long-term commitment needed for this project would create significant risk, given the uncertainty of the impact of competition resulting from the CPUC's proposed utility industry restructuring.

Biennial Resource Plan Update Proceeding On December 21, 1994 the CPUC issued a decision ordering SDG&E, Pacific Gas and Electric, and Southern California Edison to proceed with the BRPU auction. SDG&E was ordered to begin negotiating contracts (ranging from 17 to 30 years) to purchase 500 mw of power from independent power producers at an estimated cost of $4.8 billion beginning in 1997. Final contracts must be filed with the CPUC for all firm bids by May 28, 1995. SDG&E expects that prices for BRPU energy will be significantly higher than market prices. However, the CPUC refused to let the utilities include contract provisions that would allow for adjustments to reflect changes in market prices or other economic effects of industry restructuring, contending that utilities already have such rights. The CPUC did not guarantee full recovery of BRPU costs and indicated that the recovery of potential stranded costs would be addressed in the electric industry restructuring proceedings. Additional information on potential stranded costs and SDG&E's purchased-power commitments is described under "Competition" above and in Notes 10 and 11 of the notes to consolidated financial statements.

On January 11, 1995 the Federal Energy Regulatory Commission found that states may not require utilities to purchase power at rates exceeding the purchasing utility's avoided cost. The FERC held that the Public Utility Regulatory Policies Act (PURPA) preempts a Connecticut statute that requires that state's utilities to purchase power from municipal power plants at rates exceeding the utilities' avoided cost. The FERC indicated that requiring utilities to pay cogenerators more than avoided cost in the new competitive environment conflicts with the Energy Policy Act of 1992. On January 17, 1995 SDG&E filed a petition with the FERC, contending that the CPUC's BRPU orders and auction rules do not comply with PURPA and that the FERC should require the CPUC to comply with PURPA. On February 22, 1995 the FERC ruled favorably on SDG&E's petition. A final order is expected shortly. Edison filed a similar petition with the FERC.

Cogeneration On July 20, 1994 SDG&E entered into an agreement to terminate its long-term power-purchase agreement with the owners of the 50-mw Bayside cogeneration project proposed for development in San Diego. SDG&E estimates that the termination of the agreement will result in significant savings to SDG&E's customers over the life of the contract. On December 21, 1994 the CPUC approved SDG&E's recovery of the contract termination costs.

Sources of Fuel and Energy SDG&E's primary sources of fuel and purchased power include natural gas from Canada and the Southwest, surplus power from other utilities in the Southwest and the Northwest, and uranium from Canada. SDG&E expects its fuel and purchased-power costs to remain relatively low in the next few years due to the continued availability of surplus power in the Southwest and the continued availability of natural gas. Although short-term natural gas supplies and prices are volatile due to weather and other conditions, these sources should provide SDG&E with an adequate supply of low-cost natural gas. SDG&E is currently involved in litigation concerning its long-term contracts for natural gas with certain Canadian suppliers. SDG&E cannot predict the outcome of the litigation but does not expect that an unfavorable outcome would have a material effect on its financial condition or results of operations.

Environmental Matters

SDG&E's operations are conducted in accordance with federal, state and local environmental laws and regulations governing hazardous wastes, air and water quality, land use, and solid waste disposal. SDG&E incurs significant costs to operate its facilities in compliance with these laws and regulations, and to clean up the environment as a result of prior operations of SDG&E or of others. The costs of compliance with environmental laws and regulations are normally recovered in customer rates. The CPUC is expected to continue allowing the recovery of such costs, subject to reasonableness reviews.

Capital expenditures to comply with environmental laws and regulations were $5 million in 1994 and $8 million in 1993, and are expected to be $90 million over the next 5 years. These expenditures primarily include the estimated cost of retrofitting SDG&E's power plants to reduce air emissions. They do not include potential expenditures to comply with water-discharge requirements for the Encina, South Bay and SONGS power plants, which are discussed below.

Hazardous Wastes On May 4, 1994 the CPUC issued its decision on the Hazardous Waste Collaborative, approving a mechanism for utilities to recover their hazardous-waste costs, including those related to Superfund sites or similar sites requiring cleanup. Basically, the decision allows utilities to recover 90 percent of their cleanup costs and related third party litigation costs and 70 percent of the related insurance litigation expenses.

On December 6, 1993 SDG&E received notification that the California Department of Toxic Substances Control had assumed responsibility for remediation activities at the Rosen's Electrical Equipment Supply Company site in Pico Rivera, California. Contamination from polychlorinated biphenyls (PCBs) was previously found on and near the site. SDG&E sold transformers to Rosens in the early 1980s and has been identified as a Potentially Responsible Party (PRP) for the site under California law. SDG&E, seven other named PRPs and others may be held liable for the cost of assessment and remediation of the site. The state has indicated that SDG&E may be held responsible for about 7 percent of the hazardous waste at the site. SDG&E is investigating this matter. The state has received documentation and information regarding any possible dealings various PRPs may have had with Rosens, but is awaiting similar information from Rosens before determining whether it will issue a cleanup order to Rosens alone or to all PRPs including Rosens. Based on available information, SDG&E is unable to estimate the range of liability, if any, it may have for remediating this site.

SDG&E has identified or has been associated with various other sites that may require remediation under federal, state or local environmental laws. SDG&E may be held partially or indirectly responsible for remediation of some of these sites. However, SDG&E is unable to estimate the extent of its responsibility for remediation. Furthermore, the timing for assessing the costs of remediation at these sites and the number and identities of other parties that may also be responsible (and their respective ability to share in the cost of the remediation) are also unknown.

Electric and Magnetic Fields SDG&E and other utilities are involved in litigation concerning electric and magnetic fields. An unfavorable outcome of this litigation could have a significant impact on the future operations of the electric utility industry, especially if relocation of existing power lines is ultimately required. To date, science has demonstrated no cause-and-effect relationship between cancer and exposure to the type of EMFs emitted by utilities' transmission lines and generating facilities. To respond to public concerns, the CPUC has directed the California utilities to adopt a low-cost EMF-reduction policy that requires reasonable design changes to achieve noticeable reduction of EMF field levels that are anticipated from new projects. However, consistent with the major scientific reviews of available research literature, the CPUC has previously indicated that no health risk has been identified with exposure to EMFs.

Air Quality In 1996 SDG&E must begin to comply with nitrogen dioxide emission limits imposed by the San Diego Air Pollution Control District. Full compliance is required by 2001. The cost of compliance includes retrofitting SDG&E's power plants and is estimated to be $110 million in capital costs and increased operating costs.

Water Quality In 1989 SDG&E submitted applications to the San Diego Regional Water Quality Control Board to renew the discharge permits for its South Bay and Encina power plants. Supplemental applications were submitted in 1993. The Regional Board issued SDG&E a new discharge permit for its Encina power plant in November 1994. SDG&E anticipates that the Regional Board will make its determination in 1995 regarding SDG&E's South Bay power plant. The permits are required to enable SDG&E to discharge its cooling water and its treated in-plant waste water to the ocean and to San Diego Bay and are, therefore, prerequisites to the continued operation of its power plants.

In addition, increasingly stringent cooling-water and treated-waste-water discharge limitations may be imposed and SDG&E may be required to build additional facilities to comply with these requirements. Such facilities could include waste-water treatment facilities, cooling towers or offshore discharge pipelines.

The California Coastal Commission required a study of the offshore impact on the marine environment from the cooling-water discharge by SONGS Units 2 and 3. The study concluded that some environmental damage is caused by the discharge. To mitigate the environmental damage, the California Coastal Commission ordered Edison and SDG&E to improve the plant's fish-protection system, build a 300-acre artificial reef to help restore kelp beds, and restore 150 acres of coastal wetlands. SDG&E may be required to incur capital costs of up to $30 million to comply with this order.

Tree-Trimming Safety The CPUC is investigating the adequacy of utilities' tree-trimming safety precautions. As a result of a farmworker's death in 1992 in SDG&E's service territory, the CPUC may require SDG&E to pay a fine and implement safety programs. A CPUC decision is expected in April 1995. SDG&E cannot predict the ultimate outcome of this matter.

RESPONSIBILITY REPORT FOR THE CONSOLIDATED FINANCIAL STATEMENTS

SDG&E is responsible for the consolidated financial statements and other data in this annual report. To meet its responsibility for the reliability of the consolidated financial statements, SDG&E has developed a system of internal accounting controls and engages a firm of independent auditors. The board of directors of SDG&E carries out its responsibility for the consolidated financial statements through its audit committee, composed of directors who are not officers or employees of SDG&E.

Management maintains the system of internal accounting controls, which it believes is adequate to provide reasonable, but not absolute, assurance that its assets are safeguarded, that transactions are executed in accordance with its objectives, and that the financial records and reports are reliable for preparing the consolidated financial statements in accordance with generally accepted accounting principles.

The concept of reasonable assurance recognizes that the cost of a system of internal accounting controls should not exceed the benefits derived and that management makes estimates and judgments of these cost/benefit factors. The system of internal accounting controls is supported by an extensive program of internal audits, selection and training of qualified personnel, and written policies and procedures.

SDG&E's independent auditors, Deloitte & Touche LLP, are engaged to audit SDG&E's consolidated financial statements in accordance with generally accepted auditing standards for the purpose of expressing their opinion as to whether SDG&E's consolidated financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles.

The audit committee discusses with SDG&E's internal auditors and the independent auditors the overall scope and specific plans for their respective audits. The committee also discusses SDG&E's consolidated financial statements and the adequacy of SDG&E's internal controls. The committee met twice during the fiscal year with the internal auditors, the independent auditors and management to discuss the results of their examinations, their evaluations of SDG&E's internal controls, and the overall quality of SDG&E's financial reporting. The internal auditors and the independent auditors have full and free access to the committee throughout the year.

SDG&E's management has prepared the consolidated financial statements and other data in this annual report. In the opinion of SDG&E, the consolidated financial statements, which include amounts based on estimates and judgments of management, have been prepared in conformity with generally accepted accounting principles.

Frank H. Ault
Vice President and Controller

INDEPENDENT AUDITORS' REPORT

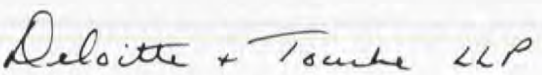
To the Shareholders and Board of Directors of San Diego Gas & Electric Company:

We have audited the accompanying consolidated balance sheets and the consolidated statements of capital stock and of long-term debt of San Diego Gas & Electric Company and subsidiaries as of December 31, 1994 and 1993, and the related consolidated statements of income, changes in capital stock and retained earnings, cash flows, and financial information by segments of business for each of the three years in the period ended December 31, 1994. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of San Diego Gas & Electric Company and subsidiaries as of December 31, 1994 and 1993, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1994 in conformity with generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, the Company is considering alternative strategies related to its 80 percent-owned subsidiary, Wahlco Environmental Systems, Inc., which may result in a charge to the Company's future earnings.



DELOITTE & TOUCHE LLP
San Diego, California
February 27, 1995

STATEMENTS OF CONSOLIDATED INCOME

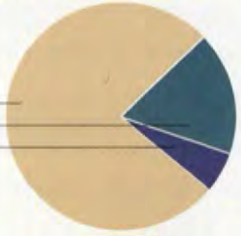
FOR THE YEARS ENDED DECEMBER 31 IN THOUSANDS EXCEPT PER SHARE AMOUNTS		1994	1993	1992
Operating Revenues				
Electric	a	**$1,510,320**	$ 1,514,608	$ 1,447,118
Gas		**346,183**	346,658	336,992
Diversified operations	b	**125,534**	118,849	86,790
Total operating revenues		**1,982,037**	1,980,115	1,870,900
Operating Expenses				
Electric fuel	c	**143,339**	174,444	174,849
Purchased power	d	**342,612**	325,966	311,046
Gas purchased for resale	e	**146,579**	165,876	167,385
Maintenance		**70,776**	81,788	73,040
Depreciation and decommissioning		**265,244**	250,619	213,661
Property and other taxes		**44,746**	44,902	45,769
Other	f	**496,755**	494,369	439,569
Income taxes		**150,070**	148,477	149,274
Total operating expenses		**1,660,121**	1,686,441	1,574,593
Operating Income		**321,916**	293,674	296,307
Other Income and (Deductions)				
Writedown of intangibles	g	**(59,116)**	—	—
Writedown of real estate	g	**(25,000)**	—	—
Allowance for equity funds used during construction		**6,274**	17,909	7,547
Taxes on nonoperating income		**20,299**	202	(3,177)
Other — net	g	**(15,552)**	8,229	16,294
Total other income and (deductions)		**(73,095)**	26,340	20,664
Income Before Interest Charges		**248,821**	320,014	316,971
Interest Charges				
Long-term debt		**93,076**	93,402	100,776
Short-term debt and other		**14,926**	12,142	9,123
Allowance for borrowed funds used during construction		**(2,658)**	(4,245)	(3,585)
Net interest charges		**105,344**	101,299	106,314
Net Income (before preferred dividend requirements)		**143,477**	218,715	210,657
Preferred Dividend Requirements		**7,663**	8,565	9,600
Earnings Applicable to Common Shares		**$ 135,814**	$ 210,150	$ 201,057
Average Common Shares Outstanding		**116,484**	116,049	113,806
Earnings Per Common Share		**$ 1.17**	$ 1.81	$ 1.77
Dividends Declared Per Common Share		**$ 1.52**	$ 1.48	$ 1.44

See notes to consolidated financial statements.

1994 Revenue Dollar

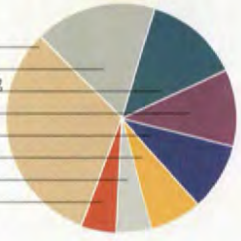
Source

76.2¢ Electric Sales
17.5¢ Gas Sales
6.3¢ Diversified Operations



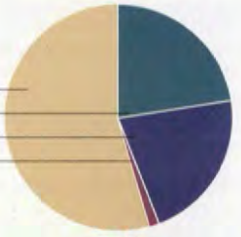
Disposition

31.9¢ Fuel and Purchased Power
17.1¢ Other Operating Expenses
13.4¢ Depreciation and Decommissioning
10.9¢ Total Taxes
9.6¢ Salaries and Benefits
7.2¢ Net Income
5.0¢ Cost of Money—Net of AFDC
4.9¢ Writedowns (Note 3)



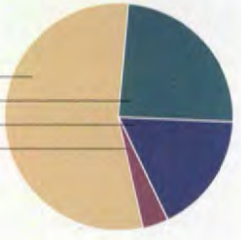
1994 Fuel Mix

54.4 Purchased Power
22.4 Natural Gas
21.8 Nuclear Fuel
1.4 Fuel Oil



1993 Fuel Mix

54.7 Purchased Power
24.4 Natural Gas
17.2 Nuclear Fuel
3.7 Fuel Oil



(by percent)

EXCERPTS FROM MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

a. Electric revenues increased in 1993 due to higher authorized costs and increased sales to other utilities.

b. Revenues from diversified operations increased in 1994 and 1993 primarily due to Califia's leasing activities. Wahlco's revenues declined in 1994 as a result of the continuing poor market for air pollution control products.

c. Electric fuel expense decreased in 1994 due to lower prices for natural gas and the replacement of higher-cost short-term energy with lower-cost nuclear generation as a result of SONGS 2 and 3 completing their refuelings in 1993.

d. Purchased-power expenses increased in 1994 due to increased purchases from higher-cost independent power producers. The increase in 1993 reflects increased purchases of short-term energy to replace lower-cost nuclear generation resulting from the refuelings of SONGS 2 and 3 in 1993 and the shutdown of SONGS 1 in late 1992.

e. Gas purchased for resale decreased in 1994 due to lower natural gas prices and lower sales volumes due to customers' purchases of gas directly from other suppliers.

f. The increase in other operating expenses in 1993 was due to Califia's leasing activities and to generally higher utility operating expenses.

g. Other income and deductions decreased in 1994 due to the writedowns of intangibles, real estate and other assets as described in Note 3.

CONSOLIDATED BALANCE SHEETS

BALANCE AT DECEMBER 31 IN THOUSANDS OF DOLLARS		1994	1993
Assets			
Utility plant — at original cost	a	$ 5,329,179	$ 5,134,251
Accumulated depreciation and decommissioning		(2,180,087)	(2,016,618)
Utility plant — net		3,149,092	3,117,633
Investments and other property		466,864	464,101
Current assets			
Cash and temporary investments		32,526	17,450
Accounts receivable		213,358	205,712
Notes receivable		31,806	29,201
Inventories		80,794	84,922
Other		36,010	40,810
Total current assets		394,494	378,095
Construction funds held by trustee	a	—	58,042
Goodwill	b	—	53,921
Deferred taxes recoverable in rates		305,717	311,564
Deferred charges and other assets		326,284	318,880
Total		$ 4,642,451	$ 4,702,236
Capitalization and Liabilities			
Capitalization (see Statements of Consolidated Capital Stock and of Long-Term Debt)			
Common equity	c	$ 1,474,430	$ 1,516,240
Preferred stock not subject to mandatory redemption		93,493	93,493
Preferred stock subject to mandatory redemption		25,000	25,000
Long-term debt		1,340,237	1,411,948
Total capitalization		2,933,160	3,046,681
Current liabilities			
Short-term borrowings		89,325	131,197
Long-term debt redeemable within one year		115,000	88,000
Current portion of long-term debt		35,465	76,161
Accounts payable	d	138,764	166,622
Dividends payable		46,200	44,962
Taxes accrued		5,641	24,844
Interest accrued		23,627	20,396
Regulatory balancing accounts overcollected — net	e	111,731	33,179
Other		121,456	104,353
Total current liabilities		687,209	689,714
Customer advances for construction		36,250	41,729
Accumulated deferred income taxes — net		523,680	532,062
Accumulated deferred investment tax credits		109,161	114,159
Deferred credits and other liabilities	f	352,991	277,891
Contingencies and commitments (Notes 2, 10 and 11)		—	—
Total		$ 4,642,451	$ 4,702,236

See notes to consolidated financial statements.

EXCERPTS FROM MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

a. The final $58 million was withdrawn from the construction trust fund during 1994 to finance utility plant additions.

b. Goodwill, arising from acquisitions by Pacific Diversified Capital, was written off during 1994, as described in Note 3.

c. The decrease in common equity in 1994 is due to the writedowns recorded related to the utility and its subsidiaries, as described in Note 3.

d. The decrease in accounts payable in 1994 is due to lower construction activity and wages payable.

e. The increase in regulatory balancing accounts in 1994 is due to lower natural gas prices and the availability of lower-cost nuclear generation resulting from the refuelings of SONGS 2 and 3 completed in 1993.

f. The increase in deferred credits is due to the recognition of liabilities related to various regulatory issues which will be recovered in future rates.

STATEMENTS OF CONSOLIDATED CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31 IN THOUSANDS OF DOLLARS		1994	1993	1992
Cash Flows from Operating Activities				
Net Income	a	**$ 143,477**	$ 218,715	$ 210,657
Adjustments to reconcile net income to net cash provided by operating activities				
Writedown of intangibles and real property	a	**96,116**	—	—
Depreciation and decommissioning		**265,244**	250,619	213,661
Amortization of deferred charges and other assets		**12,944**	12,309	3,091
Amortization of deferred credits and other liabilities		**(30,370)**	(18,616)	(1,168)
Allowance for equity funds used during construction		**(6,274)**	(17,909)	(7,547)
Deferred income taxes and investment tax credits	b	**(54,152)**	45,606	(11,031)
Other — net		**54,257**	10,227	(2,752)
Changes in working capital components net of effects from purchases of subsidiaries				
Accounts and notes receivable		**(10,251)**	(10,479)	(1,326)
Regulatory balancing accounts	c	**78,552**	(13,245)	24,647
Inventories		**4,128**	4,616	7,401
Other current assets		**4,800**	5,039	(2,360)
Accrued interest and taxes	b	**18,661**	(19,141)	(30,682)
Accounts payable and other current liabilities	d	**(10,755)**	19,691	(16,952)
Net cash provided by operating activities		**566,377**	487,432	385,639
Cash Flows from Financing Activities				
Dividends paid		**(183,492)**	(178,708)	(172,211)
Short-term borrowings — net		**(41,872)**	48,448	38,781
Issuance of long-term debt		**—**	369,893	509,200
Repayment of long-term debt		**(92,468)**	(531,526)	(236,994)
Sale (redemption) of common stock		**(558)**	38,850	58,176
Issuance of preferred stock		**—**	50,636	24,733
Redemption of preferred stock		**—**	(65,228)	(40,195)
Net cash provided (used) by financing activities		**(318,390)**	(267,635)	181,490
Cash Flows from Investing Activities				
Utility construction expenditures	e	**(263,709)**	(354,391)	(280,281)
Withdrawals from (contributions to) construction trust funds — net		**58,042**	190,225	(248,267)
Contributions to decommissioning funds		**(22,038)**	(22,038)	(22,038)
Leasing investments		**—**	(19,729)	(13,353)
Other — net		**(5,206)**	(7,493)	(9,027)
Net cash used by investing activities		**(232,911)**	(213,426)	(572,966)
Net increase (decrease)		**15,076**	6,371	(5,837)
Cash and temporary investments beginning of period		**17,450**	11,079	16,916
Cash and temporary investments end of period		**$ 32,526**	$ 17,450	$ 11,079
Supplemental Schedule of Noncash Investing and Financing Activities				
Leasing investments		**$ —**	$ 150,880	$ 83,077
Real estate investments		**28,311**	84,278	31,977
Total assets acquired		**28,311**	235,158	115,054
Cash paid		**(452)**	(28,209)	(14,368)
Liabilities assumed		**$ 27,859**	$ 206,949	$ 100,686

See notes to consolidated financial statements.

EXCERPTS FROM MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)

a. During 1994 SDG&E recorded writedowns related to the utility and its subsidiaries, as described in Note 3.

b. The change in cash flows related to income taxes was due to differences in the timing of income tax payments related to regulatory balancing account activity in 1994 and to higher income tax payments in 1992 in connection with a preliminary settlement with the Internal Revenue Service on the timing of certain prior years' deductions.

c. The change in cash flows related to regulatory balancing accounts was due to changes in natural gas prices and the replacement of lower-cost nuclear generation with higher-cost purchased power and gas-fired generation in 1993 related to the refuelings of SONGS 2 and 3 in 1993 and the shutdown of SONGS 1 in late 1992.

d. The changes in cash flows related to accounts payable and other current liabilities are due to lower construction activity and wages payable.

e. Utility construction expenditures were $264 million in 1994 and are estimated to be about $240 million in 1995.

STATEMENTS OF CONSOLIDATED CHANGES IN CAPITAL STOCK AND RETAINED EARNINGS

FOR THE YEARS ENDED DECEMBER 31, 1992, 1993, 1994 IN THOUSANDS OF DOLLARS

	Preferred Stock				
	Not Subject to Mandatory Redemption	Subject to Mandatory Redemption	Common Stock	Premium on Capital Stock	Retained Earnings
Balance, December 31, 1991	$ 87,493	$ 52,000	$ 281,240	$ 480,519	$ 588,227
Net income					210,657
Common stock sold (2,491,284 shares)			6,228	50,728	
Long-term incentive plan activity — net			117	1,103	
Preferred stock sold (1,000,000 shares)		25,000		(267)	
Preferred stock retired (1,070,000 shares)	(25,000)	(7,000)		(2,597)	(940)
Sinking fund requirement		(1,800)			
Dividends declared					
Preferred stock					(9,533)
Common stock					(164,043)
Balance, December 31, 1992	62,493	68,200	287,585	529,486	624,368
Net income					218,715
Common stock sold (1,457,756 shares)			3,644	33,612	
Long-term incentive plan activity — net			59	1,535	
Preferred stock sold (2,040,000 shares)	51,000			(364)	
Preferred stock retired (633,700 shares)	(20,000)	(43,200)		850	(2,878)
Dividends declared					
Preferred stock					(8,526)
Common stock					(171,846)
Balance, December 31, 1993	93,493	25,000	291,288	565,119	659,833
Net income					**143,477**
Long-term incentive plan activity — net			**53**	**(611)**	
Dividends declared					
Preferred stock					**(7,663)**
Common stock					**(177,066)**
Balance, December 31, 1994	**$93,493**	**$25,000**	**$291,341**	**$564,508**	**$618,581**

See notes to consolidated financial statements.

STATEMENTS OF CONSOLIDATED CAPITAL STOCK

BALANCE AT DECEMBER 31 IN THOUSANDS OF DOLLARS EXCEPT CALL PRICE	Trading Symbol[B]	Call Price	1994	1993
Common Equity				
Common stock, without par value, authorized 255,000,000 shares, outstanding: 1994, 116,536,535 shares; 1993, 116,515,073 shares			**$ 291,341**	$ 291,288
Premium on capital stock			**564,508**	565,119
Retained earnings			**618,581**	659,833
Total common equity			**$1,474,430**	$1,516,240
Preferred Stock[A]				
Not subject to mandatory redemption				
$20 par value, authorized 1,375,000 shares				
5% Series, 375,000 shares outstanding	SDOPrA	$ 24.00	**$ 7,500**	$ 7,500
4½% Series, 300,000 shares outstanding	SDOPrB	21.20	**6,000**	6,000
4.40% Series, 325,000 shares outstanding	SDOPrC	21.00	**6,500**	6,500
4.60% Series, 374,650 shares outstanding	—	20.25	**7,493**	7,493
Without par value[C]				
$7.20 Series, 150,000 shares outstanding	SDOPrG	101.00	**15,000**	15,000
$1.70 Series, 1,400,000 shares outstanding	—	25.85[D]	**35,000**	35,000
$1.82 Series, 640,000 shares outstanding	SDOPrH	26.00[D]	**16,000**	16,000
Total not subject to mandatory redemption			**$ 93,493**	$ 93,493
Subject to mandatory redemption				
Without par value[C]				
$1.7625 Series, 1,000,000 shares outstanding[E]	—	$ 25.00[D]	**$ 25,000**	$ 25,000
Total subject to mandatory redemption			**$ 25,000**	$ 25,000

[A] All series of preferred stock have cumulative preferences as to dividends. The $20 par value preferred stock has two votes per share, whereas the no par value preferred stock is nonvoting. The $20 par value preferred stock has a liquidation value at par. The no par value preferred stock has a liquidation value of $25 per share, except for the $7.20 series, which has a liquidation value of $100 per share.

[B] All listed shares are traded on the American and Pacific Stock Exchanges.

[C] Authorized 10,000,000 shares total (both subject to and not subject to mandatory redemption).

[D] The $1.70 and $1.7625 series are not callable until 2003; the $1.82 series is not callable until 1998.

[E] The $1.7625 series has a sinking fund requirement to redeem 50,000 shares per year from 2003 to 2007. The remaining 750,000 shares must be redeemed in 2008.

See notes to consolidated financial statements.

STATEMENTS OF CONSOLIDATED LONG-TERM DEBT

BALANCE AT DECEMBER 31 IN THOUSANDS OF DOLLARS	FIRST CALL DATE	1994	1993
First mortgage bonds			
5 1/2% Series I, due March 1, 1997		**$ 25,000**	$ 25,000
5 1/2% Series U-2, due September 1, 1994		**—**	8,468
4.25% Series CC, due May 1, 2008[A]		**53,000**	53,000
4.25% Series DD, due December 1, 2008[A]		**27,000**	27,000
9 1/4% Series EE, due September 1, 2020[B]	9/1/95	**74,350**	74,350
4.25% Series FF, due December 1, 2007[A]		**35,000**	35,000
7 5/8% Series GG, due July 1, 2021[B]	7/1/96	**44,250**	44,250
7 3/8% Series HH, due December 1, 2021[B]	12/1/96	**81,350**	81,350
8 3/4% Series II, due March 1, 2023[B]	9/1/97	**25,000**	25,000
9 5/8% Series JJ, due April 15, 2020	4/15/00	**100,000**	100,000
6.8% Series KK, due June 1, 2015[A]		**14,400**	14,400
8.5% Series LL, due April 1, 2022	4/1/02	**60,000**	60,000
7 5/8% Series MM, due June 15, 2002		**80,000**	80,000
6.1% and 6.4% Series NN, due September 1, 2018 and 2019[B]	9/1/02	**118,615**	118,615
Various % Series OO, due December 1, 2027[C]	12/1/02	**250,000**	250,000
5.9% Series PP, due June 1, 2018[B]	6/1/03	**70,795**	70,795
Various % Series QQ, due June 1, 2018[B]		**14,915**	14,915
5.85% Series RR, due June 1, 2021[A]	6/1/03	**60,000**	60,000
5.9% Series SS, due September 1, 2018[B]	9/1/03	**92,945**	92,945
Total		**1,226,620**	1,235,088
Capitalized leases		**103,575**	124,782
Debt incurred to acquire limited partnerships, various rates, payable annually through 2003		**109,473**	94,301
Bank loans, various rates, due 1995–2000		**18,681**	84,421
Other long-term debt		**40,264**	45,837
Unamortized discount on long-term debt		**(7,911)**	(8,320)
Long-term debt redeemable within one year		**(115,000)**	(88,000)
Current portion of long-term debt		**(35,465)**	(76,161)
Total		**$1,340,237**	$1,411,948

[A] Issued to secure the company's obligation under a series of loan agreements with the California Pollution Control Financing Authority under which the Authority loaned proceeds from the sale of $115 million of variable rate/demand and $74 million in fixed-rate pollution control revenue bonds to the company to finance certain qualifying facilities associated with the company's 20 percent interest in San Onofre Units 2 and 3.

[B] Issued to secure the company's obligation under a series of loan agreements with the City of San Diego under which the City loaned the proceeds from the sale of $522 million in industrial development revenue bonds to the company to finance certain qualifying facilities.

[C] Issued to secure the company's obligation under a loan agreement with the City of Chula Vista under which the City loaned the proceeds from the sale of $250 million in tax-exempt industrial development revenue bonds to the company to finance certain qualified facilities.

See notes to consolidated financial statements.

STATEMENTS OF CONSOLIDATED FINANCIAL INFORMATION BY SEGMENTS OF BUSINESS

AT DECEMBER 31 OR FOR THE YEARS THEN ENDED IN THOUSANDS OF DOLLARS	1994	1993	1992
Operating Revenues[A], [B]	**$1,982,037**	$1,980,115	$1,870,900
Operating Income			
Electric operations	**$ 255,768**	$ 242,143	$ 270,172
Gas operations	**50,375**	46,071	37,234
Diversified operations[B]	**15,773**	5,460	(11,099)
Total	**$ 321,916**	$ 293,674	$ 296,307
Depreciation and Decommissioning			
Electric operations	**$ 220,811**	$ 210,890	$ 178,513
Gas operations	**31,009**	28,215	27,667
Diversified operations[B]	**13,424**	11,514	7,481
Total	**$ 265,244**	$ 250,619	$ 213,661
Utility Plant Additions[C]			
Electric operations	**$ 203,887**	$ 291,456	$ 236,918
Gas operations	**59,822**	62,935	43,363
Total	**$ 263,709**	$ 354,391	$ 280,281
Identifiable Assets			
Utility plant — net			
Electric operations	**$2,725,624**	$2,724,139	$2,623,058
Gas operations	**423,468**	393,494	355,634
Total	**3,149,092**	3,117,633	2,978,692
Inventories			
Electric operations	**56,209**	57,410	62,170
Gas operations	**19,398**	18,703	14,056
Diversified operations[B]	**5,187**	8,809	10,839
Total	**80,794**	84,922	87,065
Other identifiable assets			
Electric operations	**732,941**	744,335	861,236
Gas operations	**149,199**	139,631	175,156
Diversified operations[B]	**391,021**	504,359	288,914
Total	**1,273,161**	1,388,325	1,325,306
Other Assets	**139,404**	111,356	103,509
Total Assets	**$4,642,451**	$4,702,236	$4,494,572

[A] The detail to operating revenues is provided in the Statements of Consolidated Income. The gas operating revenues shown therein include $18 million in 1994, $16 million in 1993 and $17 million in 1992, representing the gross margin on sales to the electric segment. These margins arose from interdepartmental transfers of $119 million in 1994, $141 million in 1993 and $142 million in 1992, based on transfer pricing approved by the California Public Utilities Commission in tariff rates.

[B] As discussed in Note 2, SDG&E is considering alternative strategies relative to its investment in Wahlco Environmental Systems, Inc. Included in the totals for diversified operations for 1994 are the following amounts for Wahlco: $70 million in operating revenues, $12 million in operating losses, $3 million in depreciation, $5 million in inventories, and $43 million in other identifiable assets.

[C] Excluding allowance for equity funds used during construction.

Utility income taxes and corporate expenses are allocated between electric and gas operations in accordance with regulatory accounting requirements.

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 Summary of Accounting Policies

Nature of Operations San Diego Gas & Electric is an operating public utility. The principal market for SDG&E's electric and gas business is in San Diego County and an adjacent portion of Orange County, California. SDG&E has diversified into other businesses, including subsidiaries Califia Company, Enova Corporation, Enova Energy Management, Inc. and Pacific Diversified Capital Company. Califia and Enova are engaged in non-utility investment activities throughout the United States. Enova Energy Management is an energy management consulting firm offering services to utilities and large consumers. Pacific Diversified Capital is a holding company for non-utility subsidiaries, Phase One Development, Inc., which is engaged in real estate development in San Diego and Colorado Springs, and Wahlco Environmental Systems, Inc. (80 percent owned). Wahlco designs and manufactures air-pollution control and power-efficiency equipment for electric utilities and other power producers, refineries, and other manufacturers throughout the world. In 1994 these diversified operations contributed 5 percent to operating income (2 percent in 1993). See additional information regarding Wahlco in Notes 2 and 3.

Utility Plant and Depreciation Utility plant represents the buildings, equipment and other facilities used to provide electric and gas service. The cost of utility plant includes labor, material, contract services and other related items, and an allowance for funds used during construction. The cost of retired depreciable utility plant, plus removal costs minus salvage value is charged to accumulated depreciation. Information regarding industry restructuring and its effect on utility plant is included in Note 11.

Depreciation expense reflects the straight-line remaining useful life method. The provisions for depreciation as a percentage of average depreciable utility plant (by major functional categories) are: electric generation 4.04 in 1994 (4.03 in 1993, 3.70 in 1992), electric distribution 4.35 in 1994 (4.35 in 1993, 4.13 in 1992), electric transmission 3.24 in 1994 (3.26 in 1993, 3.55 in 1992), gas 4.11 in 1994 (4.16 in 1993, 4.36 in 1992) and other 5.88 in 1994 (5.80 in 1993, 6.12 in 1992).

Inventories At December 31, 1994 inventories include $49 million of materials and supplies ($55 million in 1993), and $32 million of fuel oil and natural gas ($30 million in 1993). Materials and supplies are valued at average cost; fuel oil and natural gas are valued by the last-in first-out (LIFO) method.

Other Current Assets Included in other current assets at December 31, 1994 is $28 million of investment in SONGS 1 which will be recovered in 1995. The noncurrent portion of $17 million is included in "Deferred Charges and Other Assets" on the Consolidated Balance Sheets.

Allowance for Funds Used During Construction The allowance represents the cost of funds used to finance the construction of utility plant and is added to the cost of utility plant. AFDC also increases income, partly as an offset to interest charges shown in the Statements of Consolidated Income, although it is not a current source of cash.

Revenues and Regulatory Balancing Accounts Revenues from utility customers consist of deliveries to customers and the changes in regulatory balancing accounts. Earnings fluctuations from changes in the costs of fuel oil, purchased energy and natural gas, and consumption levels for electricity and the majority of natural gas are eliminated by balancing accounts authorized by the California Public Utilities Commission. The balances of these accounts represent amounts that will be recovered from, or repaid to, customers by adjustments to future prices, generally over a one-year cycle.

Goodwill Goodwill arose from the acquisition of certain businesses by Pacific Diversified Capital. In 1994 the remaining balance of goodwill was written off as a result of the depressed air pollution-control market and increasing competition. See additional information in Notes 2 and 3.

Deferred Charges and Other Assets Deferred charges include unrecovered premium on early retirement of debt and other regulatory-related expenditures that SDG&E expects to recover in future rates. These items are amortized as recovered in rates. Additional information is included in Note 11.

Use of Estimates in the Preparation of Financial Statements The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Statements of Consolidated Cash Flows Temporary investments are highly liquid investments with original maturities of three months or less.

Other Certain prior year amounts have been reclassified for comparability.

2 Investment in Wahlco Environmental Systems, Inc.

SDG&E's investment in and advances to Wahlco aggregate $21 million at December 31, 1994 after the writedown of Wahlco's goodwill and other assets as described below and in Note 3. At December 31, 1994, Wahlco had consolidated net assets of $7 million. During the years ended December 31, 1992, 1993 and 1994, Wahlco's net loss was $13 million, $11 million and $66 million. During those years Wahlco's cash flow provided by (used in) operations was ($7 million), ($5 million) and $2 million.

Historically, Wahlco's primary and most profitable product line has been flue gas conditioning equipment, which is sold to utilities with coal-fired generating plants. Since the passage of the 1990

Clean Air Act Amendments, Wahlco's prospects for future profitability have been significantly associated with the size and timing of flue gas conditioning equipment orders from utilities responding to that legislation. Phase I of that legislation required certain utilities to be in compliance by January 1, 1995. Phase II requires the remaining utilities with coal-fired generation to be in compliance by January 1, 2000.

Thus far, sales of and orders for flue gas conditioning equipment have not reached anticipated levels in the United States as a result of many companies' delaying decisions on how to comply with the Clean Air Act, and as a result of increasing competition from the availability of federal pollution credits, aggressive pricing strategies by competitors, alternative methods of compliance, such as fuel blending, and other options. In late 1993 Wahlco recorded a restructuring charge to reflect the planned relocation of Wahlco's manufacturing operations in Canada and West Virginia to its other U.S. facilities. During 1994 Wahlco continued to close down various unprofitable operations. See discussion of writedowns in Note 3. Wahlco has also reduced its number of employees by one-third and reduced its manufacturing square footage by about one-half. SDG&E continues to consider alternative strategies relative to its investment in Wahlco. Continued operating losses or the implementation of other strategies could lead to the further writeoff of a significant portion of SDG&E's remaining investment in Wahlco.

3 Writedowns

In June 1994 SDG&E recorded writedowns related to the utility and its subsidiaries. The total amount of the writedowns was $96 million before income taxes. $59 million represents the writedown of goodwill and other intangible assets at Wahlco Environmental Systems as a result of the depressed air pollution-control market and increasing competition. SDG&E also recorded a $25 million writedown of various commercial properties, including $19 million of subsidiary properties in Colorado Springs and in San Diego, to reflect continuing declines in commercial real estate values. As a result of the California Public Utilities Commission's proposal to restructure the electric utility industry and the uncertainty concerning the impact of competition, SDG&E also recorded a $12 million writedown of various non-earning utility assets, including the South Bay Repower project. Additional information on the CPUC's proposed industry restructuring and its potential impacts on SDG&E is described in Note 11.

4 Long-Term Debt

Amounts and due dates of long-term debt are shown on the Statements of Consolidated Long-Term Debt. Excluding capital leases, which are described in Note 10, combined aggregate maturities and sinking fund requirements of long-term debt are $27 million for 1995, $34 million for 1996, $53 million for 1997, $25 million for 1998 and $21 million for 1999. SDG&E has CPUC authorization to issue an additional $263 million in debt.

First Mortgage Bonds First mortgage bonds are secured by a lien on substantially all utility plant. Additional first mortgage bonds may be issued upon compliance with the provisions of the bond indenture. Certain of the first mortgage bonds may be called at SDG&E's option.

First mortgage bonds totaling $305 million have variable interest rate provisions. On $115 million, bondholders may elect to redeem their bonds at the annual interest-adjustment dates. For purposes of determining the aggregate maturities listed above, it is assumed that these issues will not be redeemed before scheduled maturity.

During 1994 SDG&E retired $8 million of first mortgage bonds at scheduled maturity.

Other Debt At December 31, 1994 SDG&E had two $50 million bank lines providing a committed source of long-term borrowings, of which no debt was outstanding. Bank lines, unless renewed by SDG&E, expire in 2000. Commitment fees are paid on the unused portion of the lines and there are no requirements for compensating balances.

Loans of $153 million and $149 million at December 31, 1994 and 1993, respectively, are secured by subsidiary equipment and real estate.

Interest Interest payments, including those applicable to short-term borrowings, amounted to $102 million in 1994, $106 million in 1993 and $108 million in 1992. Interest payments of $34 million in 1992 on income taxes in connection with a preliminary settlement with the Internal Revenue Service are included with income taxes in Note 8.

SDG&E periodically enters into interest rate swap and cap agreements to moderate its exposure to interest rate changes and to lower its overall cost of borrowings. At December 31, 1994 SDG&E had such agreements, maturing in 1996 and 2002, with underlying debt aggregating $120 million. See additional information in Note 9.

5 Short-Term Borrowings

At December 31, 1994 and 1993 short-term borrowings and weighted average interest rates thereon were:

IN MILLIONS OF DOLLARS	1994		1993	
	Balance	Interest Rate	Balance	Interest Rate
Bank loans	$58	6.4%	$ 91	3.4%
Subsidiaries' bank credit lines	31	7.1%	40	5.2%
Total	$89		$131	

At December 31, 1994 SDG&E had various bank lines, aggregating $170 million, available to support commercial paper and bank loans. SDG&E's subsidiaries had bank credit lines that provided for borrowings up to $31 million at the London Inter-Bank Offered Rate (LIBOR). Commitment fees are paid on the unused portion of the lines and there are no requirements for compensating balances.

6 Facilities Under Joint Ownership

The San Onofre nuclear power plant and the Southwest Powerlink transmission line are jointly owned with other utilities. SDG&E's interests at December 31, 1994 were:

IN MILLIONS OF DOLLARS		
Project	San Onofre	Southwest Powerlink
Percentage ownership	20	89
Utility plant in service	$1,102	$ 216
Accumulated depreciation	$ 368	$ 74
Construction work in progress	$ 22	$ —

Each participant in the projects must provide its own financing. The amounts specified above for San Onofre include nuclear production, transmission and other facilities.

SDG&E's share of operating expenses is included in its Statements of Consolidated Income.

SDG&E's share of future dismantling and decontamination costs for the San Onofre units is estimated to be $322 million in current dollars and is based on studies performed by outside consultants updated triennially. The most recent study was performed in 1993. These costs are included in setting rates and are expected to be fully recovered by 2014, the estimated last year of service. See discussion on industry restructuring and stranded investment in Note 11.

The amount accrued each year is based on the amount allowed by regulators and is currently being collected in rates. This amount is considered sufficient to cover SDG&E's share of future decommissioning costs. The depreciation and decommissioning expense reflected on the Statements of Consolidated Income includes $22 million of decommissioning expense for each of the years 1994, 1993 and 1992.

Decontamination objectives, work scope and procedures must meet the requirements of the Nuclear Regulatory Commission, the Environmental Protection Agency, the California Public Utilities Code and the requirements of other regulatory bodies.

SDG&E invests in externally managed trust funds the amounts collected in rates. In accordance with SFAS 115, Accounting for Certain Investments in Debt and Equity Securities, the securities held by the trust are considered held for sale and are adjusted to market value ($202 million at December 31, 1994, which is included in "Investments and Other Property" on the Consolidated Balance Sheets and which is net of a $10.1 million unrealized loss). The corresponding accumulated accrual is included in accumulated depreciation and decommissioning on the Consolidated Balance Sheets.

The Financial Accounting Standards Board is currently reviewing accounting for the costs of decommissioning nuclear power plants, including the recognition, measurement and classification of such costs. The Board could require, among other things, that SDG&E's future balance sheets include a liability for the estimated decommissioning costs, and an offsetting regulatory asset reflecting anticipated rate recovery of this liability to the extent not already collected from customers. This would have no effect on SDG&E's results of operations.

Additional information regarding San Onofre is included in Note 10.

7 Employee Benefit Plans

SDG&E has a defined-benefit pension plan, which covers substantially all utility employees. Benefits are related to the employees' compensation. Plan assets consist primarily of common stocks and bonds.

SDG&E funds the plan based on the aggregate cost actuarial method. Net pension cost consisted of the following for the year ended December 31:

IN THOUSANDS OF DOLLARS	1994	1993	1992
Cost related to current service	**$18,733**	$18,233	$17,838
Interest on projected benefit obligation	**33,254**	29,745	27,933
Return on plan assets	**(1,319)**	(39,351)	(23,267)
Net amortization and deferral	**(34,253)**	5,342	(9,124)
Cost pursuant to accounting standards	**16,415**	13,969	13,380
Regulatory adjustment	**(16,415)**	(13,969)	(16,201)
Net benefit	**$ —**	$ —	$ (2,821)

The plan's status was as follows at December 31:

IN THOUSANDS OF DOLLARS	1994	1993
Accumulated benefit obligation		
Vested	**$308,672**	$304,053
Nonvested	**10,480**	10,616
Total	**$319,152**	$314,669
Plan assets at fair value	**$424,455**	$435,371
Projected benefit obligation	**417,625**	457,710
Plan assets less projected benefit obligation	**6,830**	(22,339)
Unrecognized effect of accounting change	**(1,328)**	(1,517)
Unrecognized prior service cost	**12,956**	14,043
Unrecognized actuarial gains	**(71,278)**	(26,592)
Accrued liability	**$ (52,820)**	$ (36,405)

The projected benefit obligation assumes an 8.25 percent actuarial discount rate in 1994 (7.5 percent in 1993) and a 5.0 percent average annual compensation increase (6.0 percent in 1993). The expected long-term rate of return on plan assets is 8.5 percent. The impact of increasing the actuarial discount rate and decreasing the average annual salary increase was to decrease the total accumulated benefit obligation and projected benefit obligation by approximately $35 million and $89 million, respectively.

Eligible employees may make a contribution of 1 percent to 15 percent of their base pay to SDG&E's savings plan for investment in mutual funds or in SDG&E common stock. SDG&E contributes amounts equal to up to 3 percent of participants' base compensation for investment in SDG&E common stock.

SDG&E's expense for the pension and the savings plans and a supplemental retirement plan for a limited number of key employees was approximately $6 million in 1994, $6 million in 1993 and $2 million in 1992.

SDG&E has a long-term incentive stock compensation plan that provides for aggregate awards of up to 2,700,000 shares of common stock over a 10-year period ending in 1996. The plan's term was extended to April 2005 by the SDG&E board of directors, subject to approval by SDG&E shareholders. In each of the last nine years SDG&E issued approximately 40,000 shares to 60,000 shares of stock to officers and key employees for $2.50 per share, subject to buy-back over four years if certain corporate goals are not met.

SDG&E provides certain health and life insurance benefits to retired utility employees. Prior to 1993, SDG&E expensed these benefits when paid and such amounts were normally recovered in rates. Effective January 1, 1993, SDG&E adopted SFAS 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, which requires that these benefits be accrued during the employee's years of service, up to the year of benefit eligibility. The unamortized transition obligation of approximately $42 million is being amortized through 2012. SDG&E is recovering the cost of these benefits based upon actuarial calculations and funding limitations. The amounts expensed for these benefits were $5 million in 1994, $5 million in 1993 and $4 million in 1992.

8 Income Taxes

SFAS 109, Accounting for Income Taxes, requires the use of the balance sheet method of accounting for income taxes. Under this method, a deferred tax asset or liability represents the tax effect of temporary differences between the financial statement and tax bases of assets and liabilities and is measured using the latest enacted tax rates.

As a result of adopting SFAS 109, SDG&E recorded additional deferred income taxes related to the allowance for funds used during construction and other temporary differences for which deferred income taxes had not been provided. Existing deferred income taxes were reduced due to intervening income tax rate reductions, and a deferred income tax asset related to unamortized investment tax credits was recorded.

The net effect of these changes is almost entirely offset by a regulatory asset of $306 million at December 31, 1994 ($312 million at December 31, 1993). This regulatory asset is expected to be recovered in future rates and will be adjusted as it is recovered through the ratemaking process and as tax rates and laws change. See additional discussion regarding regulatory assets in Note 11.

Effective January 1, 1993 the federal statutory tax rate increased to 35 percent from 34 percent. This change increased SDG&E's net deferred tax liability by approximately $14 million. The impact on income tax expense was not significant.

Income tax payments totaled $167 million in 1994, $116 million in 1993 and $192 million in 1992.

Components of Accumulated Deferred Income Taxes

In thousands of dollars	1994	1993
Deferred tax liabilities		
Differences in financial and tax bases of utility plant	**$627,296**	$631,250
Loss on reacquired debt	**27,576**	28,572
Other	**60,222**	86,126
Total deferred tax liabilities	**715,094**	745,948
Deferred tax assets		
Unamortized investment tax credits	**74,563**	79,479
Equipment leasing activities	**49,547**	61,533
Other	**134,761**	99,494
Total deferred tax assets	**258,871**	240,506
Net deferred income tax liability	**456,223**	505,442
Current portion of deferred income taxes	**67,457**	26,620
Accumulated deferred income taxes—net	**$523,680**	$532,062

Components of Income Tax Expense

In thousands of dollars	1994	1993	1992
Current			
Federal	**$149,117**	$ 79,848	$134,635
State	**34,806**	22,821	28,847
Total current taxes	**183,923**	102,669	163,482
Deferred			
Federal	**(37,697)**	43,365	(2,248)
State	**(12,897)**	7,001	(3,638)
Total deferred taxes	**(50,594)**	50,366	(5,886)
Deferred investment tax credits—net	**(3,558)**	(4,760)	(5,145)
Total income tax expense	**$129,771**	$148,275	$152,451

Federal and state income taxes are allocated between operating income and other income.

Reconciliation of Statutory Federal Income Tax Rate to Effective Income Tax Rate

	1994	1993	1992
Statutory federal income tax rate	**35.0%**	35.0%	34.0%
Depreciation	**8.3**	5.0	3.7
Writedown of intangibles	**8.2**	—	—
State income taxes — net of federal income tax benefit	**4.6**	5.3	4.3
Tax credits	**(6.7)**	(3.9)	(2.8)
Equipment leasing activities	**(4.1)**	(1.8)	—
Repair allowance	**(3.5)**	(2.1)	(1.6)
Allowance for funds used during construction	**(0.9)**	(1.9)	(0.7)
Other—net	**6.6**	4.8	5.1
Effective income tax rate	**47.5%**	40.4%	42.0%

9 Fair Value of Financial Instruments

Due to the nature of the regulatory process, gains and losses attributable to the fair value of financial instruments generally will accrue to SDG&E customers.

The carrying amounts and related estimated fair values of SDG&E's financial instruments are as follows:

IN MILLIONS OF DOLLARS	1994		1993	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets				
Cash and temporary investments	$ 32.5	$ 32.5	$ 17.5	$ 17.5
Funds held in trust	201.9	201.9	249.4	251.2
Notes receivable	121.5	121.1	149.9	149.9
Investments in limited partnerships and other assets	170.2	182.5	150.1	158.7
Liabilities				
Dividends payable	46.2	46.2	45.0	45.0
Short-term debt and current portion of long-term debt	231.4	230.5	247.2	247.2
Deposits from customers	56.2	50.2	60.4	55.0
Long-term debt	1,245.0	1,211.1	1,295.3	1,380.5
Preferred stock subject to mandatory redemption	25.0	23.8	25.0	27.3

The estimated fair values may not be representative of actual amounts that could have been realized as of year end or that will be realized in the future.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

Cash and Temporary Investments, Short-Term Notes Receivable and Dividends Payable The carrying amount approximates fair value due to the short maturity of these items.

Noncurrent Notes Receivable The fair values of noncurrent notes receivable (included in "Deferred Charges and Other Assets" on the Consolidated Balance Sheets) are based on the present value of the estimated future cash flows discounted at current rates available for similar notes.

Funds Held in Trust Funds held in trust include the SONGS decommissioning trust (included in "Investments and Other Property" on the Consolidated Balance Sheets) and, in 1993, construction trust funds. The fair values of the funds' assets are based on quoted market values.

Investments in Limited Partnerships and Other Assets The fair values of investments in limited partnerships and other assets (included in "Investments and Other Property" on the Consolidated Balance Sheets) acquired after 1992 are estimated to approximate carrying value due to the relatively short periods of time between the purchase dates and the valuation date, and the relative market stability during those periods. Fair values of investments acquired prior to 1993 are estimated based on the present value of the estimated future cash flows discounted at yields currently available for similar investments.

Deposits from Customers Deposits from customers include deposits from residential and commercial customers (included in "Other Current Liabilities" on the Consolidated Balance Sheets) and customer advances for construction. The carrying amounts of deposits from residential and commercial customers approximate fair value due to the short maturity periods. The fair values of customer advances for construction are based on the present values of the estimated future cash flows discounted at current rates of return.

Debt and Preferred Stock Subject to Mandatory Redemption The fair values of SDG&E's first mortgage bonds and preferred stock issues are estimated based on quoted market prices for them or for similar issues, or on the current rates offered to SDG&E for debt and stock of the same maturities. The fair values of notes payable are based on the present values of the future cash flows discounted at current rates available for similar notes with comparable maturities. The carrying amount of short-term loans and notes payable approximate fair value due to the short maturities.

Off-Balance-Sheet Interest Rate Cap and Swap Agreements The fair value of these derivative financial instruments is the estimated amount that would be realized or paid upon termination of the agreements based on quotes from dealers. These agreements, if terminated, would result in net proceeds to SDG&E of $2 million at December 31, 1994 compared to an obligation of $4 million at December 31, 1993.

SDG&E's policy is to utilize derivatives only in hedging situations. SDG&E periodically enters into interest rate swap and cap agreements to moderate its exposure to interest rate changes and to lower its overall cost of borrowing. These swap and cap agreements generally remain off the balance sheet as they involve the exchange of fixed- and variable-rate interest payments without the exchange of the underlying principal amounts. The related gains or losses are reflected in the income statement as part of the expense item applicable to what is being hedged (e.g., interest expense).

At December 31, 1994 SDG&E had two such agreements, including an index cap agreement on $75 million of bonds maturing in 1996, and a floating-to-fixed rate swap associated with another $45 million of variable-rate bonds maturing in 2002. SDG&E expects to hold these derivative financial instruments to their maturity. These agreements have effectively fixed interest rates on the underlying variable-rate debt at 5.4 percent to 6.3 percent. These financial instruments are with major investment firms and, along with cash and cash equivalents and accounts receivable, expose SDG&E to market and credit risks and may at times be concentrated with certain counterparties. SDG&E would be exposed to interest rate fluctuations on the underlying debt should counterparties to the agreement not perform. Such nonperformance is not anticipated.

10 Contingencies and Commitments

Purchased Power Contracts SDG&E buys electric power under several short-term and long-term contracts. Purchases are for 2 percent to 10 percent of plant output under contracts with other utilities and up to 100 percent of plant output under contracts with independent power producers and other non-utility suppliers. No

one contract provides more than 4 percent of SDG&E's total system requirements. The contracts expire on various dates between 1995 and 2024.

At December 31, 1994 the future minimum payments under the contracts were:

IN MILLIONS OF DOLLARS

1995	$ 351
1996	216
1997	185
1998	188
1999	187
Thereafter	2,969
Total minimum payments	$4,096

These payments represent capacity charges and minimum energy purchases. SDG&E is required to pay additional amounts for actual purchases of energy under the contracts. Total payments, including energy payments, under the contracts were $277 million in 1994, $258 million in 1993 and $253 million in 1992. See discussion of the decision on the Biennial Resource Plan Update proceeding in Note 11.

Natural Gas Contracts SDG&E has a contract with Southern California Gas Company that provides SDG&E with intrastate transportation capacity on SoCal's gas pipelines through August 1995. If a new agreement is not reached by then, SoCal has a continuing obligation to deliver gas to SDG&E under a CPUC-approved tariff. SDG&E's long-term contracts with interstate pipelines for transportation capacity expire on various dates between 1995 and 2023. In 1994 SDG&E signed an agreement with SoCal for 8 billion cubic feet of natural gas storage capacity from January 1, 1995 through March 31, 1998. SDG&E also has four long-term gas supply contracts that expire between 2001 and 2004.

At December 31, 1994 the future minimum payments under natural gas contracts were:

IN MILLIONS OF DOLLARS

	Transportation and Storage	Natural Gas
1995	$ 74	$ 25
1996	28	27
1997	27	31
1998	28	35
1999	21	38
Thereafter	279	179
Total minimum payments	$457	$335

Total payments under the contracts were $125 million in 1994, $86 million in 1993 and $80 million in 1992.

Leases Nuclear fuel, office buildings, a generating facility and other properties are financed by long-term capital leases. Utility plant included $173 million at December 31, 1994 and $193 million at December 31, 1993 related to these leases. The associated accumulated amortization was $73 million and $74 million, respectively. SDG&E also leases office facilities, computer equipment and vehicles under operating leases. Certain leases on office facilities contain escalation clauses requiring annual increases in rent ranging from 2 percent to 7 percent.

The minimum rental commitments payable in future years under all noncancellable leases were:

IN MILLIONS OF DOLLARS

	Operating Leases	Capitalized Leases
1995	$ 59	$ 24
1996	57	20
1997	53	12
1998	35	12
1999	11	12
Thereafter	52	57
Total future rental commitments	$267	137
Imputed interest (6% to 9%)		(33)
Net commitment		$104

Rental payments totaled $93 million in 1994, $91 million in 1993 and $57 million in 1992. The increase from 1992 to 1993 was due to Califia's leasing activities.

Environmental Issues SDG&E's operations are conducted in accordance with federal, state and local environmental laws and regulations governing hazardous wastes, air and water quality, land use, and solid waste disposal. SDG&E incurs significant costs to operate its facilities in compliance with these laws and regulations. The costs of compliance with environmental laws and regulations are normally recovered in customer rates. The CPUC is expected to continue allowing the recovery of such costs, subject to reasonableness reviews. Capital expenditures to comply with environmental laws and regulations were $5 million in 1994 and $8 million in 1993, and are expected to be $90 million over the next 5 years. These expenditures primarily include the estimated cost of retrofitting SDG&E's power plants to reduce air emissions.

SDG&E has identified, or has been associated with, various sites which may require remediation under federal, state or local environmental laws. SDG&E may be partially or indirectly responsible for cleaning up these sites. SDG&E is unable to determine the extent of its responsibility for remediation for these sites until assessments are completed. Furthermore, the number of others who may be also responsible and their ability to share in the cost of the cleanup, is not known. Environmental liabilities that may arise from these assessments are recorded when environmental assessments and/or remedial efforts are probable, and when the minimum costs can be estimated.

In 1994 the CPUC approved a mechanism allowing utilities to recover their hazardous waste costs, including those related to Superfund sites or similar sites requiring cleanup. The decision allows recovery of 90 percent of cleanup costs and related third party litigation costs and 70 percent of the related insurance litigation expenses.

Nuclear Insurance Public liability claims that could arise from a nuclear incident are limited by law to $9 billion for each licensed nuclear facility. For this exposure, SDG&E and the co-owners of the San Onofre units have purchased primary insurance of $200 million, the maximum amount available. The remaining coverage is provided by secondary financial protection required by the Nuclear Regulatory Commission and provides for loss sharing

among utilities owning nuclear reactors if a costly accident occurs. SDG&E could be assessed retrospective premium adjustments of up to $32 million in the event of a nuclear incident involving any of the licensed, commercial reactors in the United States, if the amount of the loss exceeds $200 million.

Insurance coverage is provided for up to $2.8 billion of property damage and decontamination liability. Coverage is also provided for the cost of replacement power, which includes indemnity payments for up to two years, after a waiting period of 21 weeks. Coverage is provided primarily through mutual insurance companies owned by utilities with nuclear facilities. If losses at any of the nuclear facilities covered by the risk-sharing arrangements were to exceed the accumulated funds available for these insurance programs, SDG&E could be assessed retrospective premium adjustments of up to $9 million.

Department of Energy Decommissioning The Energy Policy Act of 1992 established a fund for the decontamination and decommissioning of the Department of Energy nuclear fuel enrichment facilities. Utilities using the DOE services are contributing a total of $2.3 billion, subject to adjustment for inflation, over a 15-year period ending in 2006. Each utility's share is based on its share of enrichment services purchased from the DOE. SDG&E's share of the contribution is $1 million per year.

Litigation SDG&E is involved in various legal matters, including those arising out of the ordinary course of business. Management believes that these matters will not have a material adverse effect on SDG&E's results of operations, financial condition or cash flows.

Distribution System Conversion Under a CPUC-mandated program and through franchise agreements with various cities, SDG&E is committed in varying amounts to convert overhead distribution facilities to underground. As of December 31, 1994 the aggregate unexpended amount of this commitment was approximately $95 million. SDG&E expended approximately $11 million in 1994, $22 million in 1993 and $18 million in 1992 under this program.

Concentration of Credit Risk SDG&E grants credit to its utility customers, substantially all of whom are located in its service territory, which covers all of San Diego County and an adjacent portion of Orange County.

11 Industry Restructuring

In April 1994 the CPUC announced its proposal to restructure California's regulated electric utility industry to stimulate competition and to lower rates. The proposed regulatory framework would be phased in by 2002, allowing utility customers to purchase their energy from either utility or nonutility suppliers. The utilities would continue to provide transmission and distribution services to customers that choose to purchase their energy from other providers. The CPUC also proposed that the cost of providing these services and the cost of serving remaining utility customers would be recovered through a performance-based ratemaking process. SDG&E is currently participating in a performance-based ratemaking process on an experimental basis which commenced in 1993 and runs through 1998. The CPUC is holding several hearings to consider whether its proposal or some other form of a competitive market should be developed and how the cost of the transition to competition should be shared among utility shareholders and customers.

In connection with the proposed restructuring, SDG&E has applied to the CPUC for permission to form a holding company. SDG&E believes that changes in the California utility industry and the movement toward a more competitive marketplace will require SDG&E to change its corporate structure. SDG&E has applied to other regulatory bodies and to shareholders for approval of the proposal.

In addition to $306 million of deferred taxes recoverable in rates, regulatory assets of $197 million are included in "Deferred Charges and Other Assets" on the Consolidated Balance Sheets. They include $60 million of unamortized loss on reacquired debt, $50 million of pension regulatory assets, $38 million of unrecovered plant and regulatory study costs, $17 million of unamortized debt expense and $32 million of various other regulatory assets. Recovery periods range from one to 30 years. It is estimated that at December 31, 1994 SDG&E had approximately $975 million of net utility plant (including $750 million of nuclear facilities) and $75 million of regulatory assets relating to generating facilities currently being recovered in rates over various periods of time. The CPUC has stated that the recovery of remaining amounts, if and when restructuring occurs, will be provided for in the new environment. In addition, as described in Note 10, SDG&E has entered into significant long-term purchased-power commitments with various utilities and other providers. The CPUC's recent Biennial Resource Plan Update decision requires SDG&E to contract for an additional 500 megawatts of power over 17-year terms at an estimated cost of $4.8 billion beginning in 1997. Prices under these contracts could significantly exceed the future market price. SDG&E is challenging the decision and has petitioned the Federal Energy Regulatory Commission to overrule the CPUC's decision. On February 22, 1995 the FERC ruled favorably on SDG&E's petition. A final order is expected shortly. If the CPUC proceeds with the move to a competitive environment, if the prices of competing suppliers are as anticipated, and if the regulatory process does not provide for complete recovery of those costs that are in excess of what will otherwise be recoverable via market-based pricing structures, SDG&E would incur a charge against earnings for a significant portion of its generating facilities, the related regulatory assets and the long-term commitments. However, as previously discussed, the CPUC has indicated that any unrecovered amounts remaining will be provided for in the new environment. The CPUC has stated its intention to issue a final decision by May 1995 and to require implementation by September 1995. SDG&E cannot predict the impact of the CPUC's final decision and the transition to a more competitive environment on SDG&E's financial condition and results of operations.

QUARTERLY FINANCIAL DATA (UNAUDITED)

QUARTER ENDED IN THOUSANDS EXCEPT PER SHARE AMOUNTS	MARCH 31	JUNE 30	SEPTEMBER 30	DECEMBER 31
1993				
Operating revenues	$ 492,343	$ 467,260	$ 495,035	$ 525,477
Operating expenses	414,557	398,881	418,178	454,825
Operating income	77,786	68,379	76,857	70,652
Other income	7,122	1,249	7,464	10,505
Net interest charges	26,331	25,399	25,223	24,346
Net income (before preferred dividend requirements)	58,577	44,229	59,098	56,811
Preferred dividend requirements	2,182	2,181	2,282	1,920
Earnings applicable to common shares	$ 56,395	$ 42,048	$ 56,816	$ 54,891
Average common shares outstanding	115,450	115,908	116,335	116,489
Earnings per common share	$ 0.49	$ 0.36	$ 0.49	$ 0.47
1994				
Operating revenues	**$504,418**	**$462,980**	**$491,486**	**$ 523,153**
Operating expenses	**424,286**	**402,752**	**408,863**	**424,220**
Operating income	**80,132**	**60,228**	**82,623**	**98,933**
Other income and (deductions)	**4,115**	**(68,165)[A]**	**4,317**	**(13,362)**
Net interest charges	**24,451**	**25,282**	**27,151**	**28,460**
Net income (loss) (before preferred dividend requirements)	**59,796**	**(33,219)**	**59,789**	**57,111**
Preferred dividend requirements	**1,916**	**1,915**	**1,916**	**1,916**
Earnings (loss) applicable to common shares	**$ 57,880**	**$ (35,134)**	**$ 57,873**	**$ 55,195**
Average common shares outstanding	**116,492**	**116,473**	**116,475**	**116,496**
Earnings (loss) per common share	**$ 0.50**	**$ (0.30)[A]**	**$ 0.50**	**$ 0.47**

[A] Reflects writedowns as described in Note 3.

These amounts are unaudited but in the opinion of SDG&E reflect all adjustments necessary for a fair presentation.

QUARTERLY COMMON STOCK DATA (UNAUDITED)

	1994				1993			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Market price								
High	**25**	**23¼**	**20⅞**	**20⅛**	26⅝	26⅞	27¾	27½
Low	**21½**	**17½**	**18**	**18⅝**	23¼	24½	25⅝	23½
Dividends declared	**38¢**	**38¢**	**38¢**	**38¢**	37¢	37¢	37¢	37¢

RATINGS AT DECEMBER 31, 1994 (UNAUDITED)

ISSUE	STANDARD & POOR'S	MOODY'S
Bonds	A+	A1
Commercial Paper	A-1	P-1
Preferred Stock	A	a2

The presentation of these ratings is not a recommendation to buy, sell or hold these securities.

BOARD OF DIRECTORS

The 10-person board of directors consists of nine outside directors and the chief executive officer of SDG&E, who serves as its chairman. The directors provide a broad perspective because of their diverse business, professional and civic backgrounds.

Thomas A. Page
Chairman of the Board
President and Chief Executive Officer
Executive Committee (Chairman)
Nominating Committee (Chairman)

Richard C. Atkinson, Ph.D.
Chancellor
University of California at San Diego
Audit Committee (Chairman)
Executive Committee

Ann Burr
President
San Diego Division of Time Warner Cable
Audit Committee
Nominating Committee

Richard A. Collato
President and Chief Executive Officer
YMCA of San Diego County
Finance Committee
Nominating Committee

Daniel W. Derbes
President
Signal Ventures
Executive Committee
Executive Compensation Committee
Finance Committee (Chairman)

Catherine T. Fitzgerald
Executive Vice President
Internationale Nederlanden Group, North America
Audit Committee
Executive Compensation Committee (Chairwoman)

Robert H. Goldsmith
Management Consultant
Executive Compensation Committee
Finance Committee

William D. Jones
President, Chief Executive Officer and Director
CityLink Investment Corporation
Finance Committee
Nominating Committee

Ralph R. Ocampo, M.D.
Physician and surgeon
Finance Committee

Thomas C. Stickel
Chairman/Founder
American Partners Capital Group, Inc.
Audit Committee
Executive Compensation Committee

Committees of the Board

Audit This committee selects an independent auditor and reviews the overall plan of the audit, financial statements, audit results, scope of internal audit procedures and the auditors' evaluation of internal controls.

Executive This committee is empowered to act in place of the full board, except in certain transactions for various board responsibilities that are reserved for the board.

Executive Compensation This committee reviews the salaries and other forms of compensation of company officers and makes compensation recommendations to the board.

Finance This committee counsels management, helps plan the company's capital requirements, proposes financing programs and capital risk exposure analyses, and reviews the general investment policy performance for the pension plan and the savings plan.

Nominating This committee considers and recommends nominees to the board, and sets criteria for board and committee composition and membership.

SDG&E MANAGEMENT TEAM

OFFICE OF THE CHAIRMAN

Thomas A. Page, 61
Chairman, President and Chief Executive Officer
16 years of service

EXECUTIVE VICE PRESIDENT TEAM

Stephen L. Baum, 53
Executive Vice President
9 years of service

Donald E. Felsinger, 47
Executive Vice President
22 years of service

EXECUTIVE LEADERSHIP TEAM

Frank H. Ault, 50
Vice President and Controller
25 years of service

Gary D. Cotton, 54
Senior Vice President – Customer Operations
19 years of service

Kathleen A. Flanagan, 43
Vice President – Corporate Communications
1 year of service

Ronald K. Fuller, 56
Vice President – Governmental and Regulatory Affairs
20 years of service

Edwin A. Guiles, 45
Senior Vice President – Energy Supply
22 years of service

Leslie E. Klein, 39
Acting Treasurer, Division Manager – Finance
13 years of service

Margot A. Kyd, 41
Vice President – Human Resources
14 years of service

John L. Laun, 47
Vice President – Marketing and Customer Service
7 years of service

Henry P. Morse, 42
Division Manager
21 years of service

Nad A. Peterson, 68
Senior Vice President, General Counsel, Corporate Secretary
2 years of service

William R. Reed, 42
Division Manager – Strategic Plans and Projects
17 years of service

(ages and years of service as of December 31, 1994)

1995 GOALS

- **Increase** shareholder value
- Move our electric rates toward the national average and maintain our position as the **lowest-cost** investor-owned provider of electric energy in California
- Build **alliances** with all our constituencies on issues of mutual interest
- Provide responsible leadership in the protection and enhancement of the **environment**
- Protect the **safety** and health of employees and our communities
- Position the company for success in **competitive** markets

SDGE San Diego Gas & Electric
Post Office Box 1831 San Diego, California 92112-4150

-NOTICE-

THE ATTACHED FILES ARE OFFICIAL RECORDS OF THE RECORDS & REPORTS MANAGEMENT BRANCH. THEY HAVE BEEN CHARGED TO YOU FOR A LIMITED TIME PERIOD AND MUST BE RETURNED TO THE RECORDS & ARCHIVES SERVICES SECTION P1-122 WHITE FLINT. PLEASE DO NOT SEND DOCUMENTS CHARGED OUT THROUGH THE MAIL. REMOVAL OF ANY PAGE(S) FROM DOCUMENT FOR REPRODUCTION MUST BE REFERRED TO FILE PERSONNEL.

-NOTICE-

50-206 9506020321 5/30/95

Selected Financial and Operating Data: 1992 - 1996

*Dollars in millions, except per-share amounts**	1996	1995	1994	1993	1992
Edison International and Subsidiaries					
Operating revenue	$ 8,545	$ 8,405	$ 8,345	$ 7,839	$ 7,984
Operating expenses	$ 7,067	$ 7,028	$ 7,046	$ 6,611	$ 6,641
Net income	$ 717	$ 739	$ 681	$ 639	$ 739
Weighted-average shares of common stock outstanding (in millions)	437	446	448	448	445
Per-share data:					
Earnings	$ 1.64	$ 1.66	$ 1.52	$ 1.43	$ 1.66
Dividends paid	$ 1.00	$ 1.00	$ 1.21	$ 1.41	$ 1.38
Dividends declared	$ 1.00	$ 1.00	$ 1.105	$ 1.415	$ 1.39
Book value at year-end	$ 15.07	$ 14.41	$ 13.72	$ 13.30	$ 13.30
Market value at year-end	$ 19 7/8	$ 17 5/8	$ 14 5/8	$ 20	$ 22
Dividend payout ratio (paid)	61.0%	60.2%	79.6%	98.6%	83.1%
Rate of return on common equity	11.1%	11.8%	11.3%	11.7%	12.5%
Price/earnings ratio	12.1	10.6	9.6	14.0	13.3
Ratio of earnings to fixed charges	2.40	2.55	2.48	2.28	2.68
Assets	$ 24,559	$ 23,946	$ 22,390	$ 21,831	$ 19,311
Retained earnings	$ 3,753	$ 3,700	$ 3,452	$ 3,266	$ 3,263
Common shareholders' equity	$ 6,397	$ 6,393	$ 6,144	$ 5,958	$ 5,954
Preferred securities:					
Not subject to mandatory redemption	$ 284	$ 284	$ 359	$ 359	$ 359
Subject to mandatory redemption	$ 425	$ 425	$ 362	$ 275	$ 278
Long-term debt	$ 7,475	$ 7,195	$ 6,347	$ 6,459	$ 6,320
Southern California Edison Company					
Operating revenue	$ 7,583	$ 7,873	$ 7,799	$ 7,397	$ 7,722
Earnings	$ 621	$ 643	$ 599	$ 637	$ 631
Earnings per Edison International common share	$ 1.42	$ 1.44	$ 1.34	$ 1.42	$ 1.42
Rate of return on common equity	12.1%	12.6%	12.0%	12.9%	13.2%
Internal generation of funds	130.2%	89%	76%	78%	83%
Peak demand in megawatts (MW)	18,207	17,548	18,044	16,475	18,413
Generation capacity at peak (MW)	21,602	21,603	20,615	20,606	20,712
Kilowatt-hour sales (in millions)	75,572	74,296	77,986	73,308	74,186
Customers (in millions)	4.22	4.18	4.15	4.12	4.11
Full-time employees**	12,057	14,886	16,351	16,585	16,922
Edison Mission Energy					
Revenue	$ 844	$ 467	$ 381	$ 291	$ 183
Net income	$ 92	$ 64	$ 55	$ 2	$ 89
Earnings per Edison International common share	$ .21	$ .14	$ .12	$ .01	$ .20
Assets	$ 5,153	$ 4,374	$ 2,843	$ 2,286	$ 2,388
Rate of return on common equity	8.8%	9.5%	9.6%	0.3%	13.7%
Ownership in operating projects (MW)	4,706	4,212	2,048	1,862	1,521
Full-time employees	940	902	690	673	488
Edison Capital					
Revenue	$ 49	$ 49	$ 47	$ 39	$ 46
Net income	$ 41	$ 39	$ 33	$ 29	$ 29
Assets	$ 1,423	$ 1,063	$ 1,008	$ 972	$ 826
Rate of return on common equity	17.7%	18.5%	16.8%	14.5%	17.3%
Full-time employees	70	42	33	20	18

* Per share figures reflect the two-for-one split of Edison International common stock effective June 1, 1993.

** 1992-1994 are based on twelve-month averages.

Edison International

JOHN E. BRYSON
Chairman of the Board and CEO

BRYANT C. DANNER
Executive Vice President and General Counsel

ALAN J. FOHRER
Executive Vice President and Chief Financial Officer

ROBERT G. FOSTER
Senior Vice President, Public Affairs

WILLIAM J. HELLER
Senior Vice President, Strategic Planning and New Business Development

RICHARD K. BUSHEY
Vice President and Controller

THEODORE F. CRAVER, JR.
Vice President and Treasurer

LILLIAN R. GORMAN
Vice President, Human Resources

THOMAS J. HIGGINS
Vice President, Corporate Communications

BEVERLY P. RYDER
Corporate Secretary and Special Assistant to the Chairman/CEO

Southern California Edison

JOHN E. BRYSON
Chairman of the Board and CEO

STEPHEN E. FRANK
President and Chief Operating Officer

BRYANT C. DANNER
Executive Vice President and General Counsel

ALAN J. FOHRER
Executive Vice President and Chief Financial Officer

HAROLD B. RAY
Executive Vice President, Generation Business Unit

VIKRAM S. BUDHRAJA
Senior Vice President, Power Grid Business Unit

ROBERT G. FOSTER
Senior Vice President, Public Affairs

EMIKO BANFIELD
Vice President, Shared Services

PAMELA A. BASS
Vice President, Customer Solutions Business Unit

RICHARD K. BUSHEY
Vice President and Controller

THEODORE F. CRAVER, JR.
Vice President and Treasurer

JOHN R. FIELDER
Vice President, Regulatory Policy and Affairs

BRUCE C. FOSTER
Vice President, San Francisco Regulatory Affairs

LILLIAN R. GORMAN
Vice President, Human Resources

LAWRENCE D. HAMLIN
Vice President, Power Production

THOMAS J. HIGGINS
Vice President, Corporate Communications

R. W. KRIEGER
Vice President, Nuclear Generation

J. MICHAEL MENDEZ
Vice President, Labor Relations

DWIGHT E. NUNN
Vice President, Nuclear Engineering and Technical Services

FRANK J. QUEVEDO
Vice President, Equal Opportunity

RICHARD M. ROSENBLUM
Vice President, Distribution Business Unit

BEVERLY P. RYDER
Corporate Secretary and Special Assistant to the Chairman/CEO

Edison Mission Energy

EDWARD R. MULLER
President and CEO

ROBERT M. EDGELL
Executive Vice President

JAMES V. IACO, JR.
Senior Vice President and Chief Financial Officer

S. DANIEL MELITA
Senior Vice President

GEORGIA R. NELSON
Senior Vice President

S. LINN WILLIAMS
Senior Vice President and General Counsel

Edison Capital and Mission Land Company

THOMAS R. MCDANIEL
President and CEO, Edison Capital and Mission Land Company

CHARLES W. JOHNSON
Executive Vice President, Mission Land Company

ASHRAF T. DAJANI
Senior Vice President, Edison Capital

RICHARD E. LUCEY
Senior Vice President and Chief Financial Officer, Edison Capital

JONG C. LIMB
Vice President, Edison Capital

LARRY C. MOUNT
Vice President and General Counsel

Edison EV

DIANE O. WITTENBERG
President and CEO

Edison Source

C. ALEX MILLER
President and CEO

OWENS F. ALEXANDER, JR.
Senior Vice President

JOHN E. BRYSON[1]
Chairman of the Board and CEO, Edison International and Southern California Edison
A director since 1990

CARL F. HUNTSINGER[1,5]
General Partner, DAE Limited Partnership Ltd., Ojai, CA
A director since 1983

E. L. SHANNON, JR.[1,2]
Retired Chairman of the Board, Santa Fe International Corporation, Alhambra, CA
A director since 1977

HOWARD P. ALLEN[1,2]
Chairman of the Executive Committee, Edison International and Southern California Edison
A director since 1980

CHARLES D. MILLER[3,5]
Chairman of the Board and CEO, Avery Dennison Corporation, Pasadena, CA
A director since 1987

ROBERT H. SMITH[1,4]
Managing Director, Smith and Crowley Incorporated, Pasadena, CA
A director since 1987

WINSTON H. CHEN[2,5]
Chairman of the Paramitas Foundation and Chairman of Paramitas Investment Corporation, Santa Clara, CA
A director since 1995

LUIS G. NOGALES[2,3]
President, Nogales Partners, Los Angeles, CA
A director since 1993

THOMAS C. SUTTON[3,5]
Chairman of the Board and CEO, Pacific Mutual Life Insurance Company, Los Angeles, CA
A director since 1995

STEPHEN E. FRANK
President and Chief Operating Officer, Southern California Edison
A director since 1995

RONALD L. OLSON[2,4]
Senior Partner of Munger, Tolles and Olson, Los Angeles, CA
A director since 1995

DANIEL M. TELLEP[3,5]
Retired Chairman of the Board, Lockheed Martin Corporation, Bethesda, MD
A director since 1992

CAMILLA C. FROST[3,4]
Trustee, Chandler Trusts, Director and Secretary-Treasurer, Chandis Securities Company, Los Angeles, CA
A director since 1985

J. J. PINOLA[3,4]
Retired Chairman of the Board and CEO, First Interstate Bancorp, Los Angeles, CA
A director since 1985

JAMES D. WATKINS[2,5]
Admiral USN, Retired, President, Joint Oceanographic Institutions, Inc., and President, Consortium for Oceanographic Research and Education, Washington, D.C.
A director since 1993

JOAN C. HANLEY[4,5]
General Partner, Miramonte Vineyards, Rancho Palos Verdes, CA
A director since 1980

JAMES M. ROSSER[2,4]
President, California State University, Los Angeles Los Angeles, CA
A director since 1985

EDWARD ZAPANTA, M.D.[1,5]
Physician and Neurosurgeon, South Pasadena, CA
A director since 1984

1 Member of the executive committee
2 Member of the finance committee
3 Member of the compensation and executive personnel committee
4 Member of the nominating committee
5 Member of the audit committee

outage. These policies are issued primarily by mutual insurance companies owned by utilities with nuclear facilities. If losses at any nuclear facility covered by the arrangement were to exceed the accumulated funds for these insurance programs, SCE could be assessed retrospective premium adjustments of up to $34 million per year. Insurance premiums are charged to operating expense.

NOTE 11. INVESTMENTS IN PARTNERSHIPS AND UNCONSOLIDATED SUBSIDIARIES

Edison International's nonutility subsidiaries have equity interests in energy generation projects and real estate investment partnerships.

Summarized financial information of these investments was:

In millions *Year ended December 31,*	1996	1995	1994
Revenue	$ 40	$ 1,400	$ 1,256
Expenses	62	1,121	969
Net income/(loss)	$ (22)	$ 279	$ 287

In millions *December 31,*	1996	1995
Current assets	$ 26	$ 643
Other assets	680	4,818
Total assets	$ 706	$ 5,461
Current liabilities	$ 89	$ 490
Other liabilities	405	3,164
Equity	212	1,807
Total liabilities and equity	$ 706	$ 5,461

NOTE 12. BUSINESS SEGMENTS

Edison International's business segments include electric utility operations (SCE) and six nonutility segments: unregulated power generation (EME); financial investments (Edison Capital); real estate holdings (Mission Land Company); integrated energy solutions (Edison Source); electric vehicle charging operations (Edison EV); and consumer products and services (Edison Select). Other than EME, the nonutility segments are not individually significant and are combined for reporting purposes.

Edison International's business segment information was:

In millions	*Electric Utility*	*Unregulated Power Generation* *Domestic*	*Foreign*	*Other*	*Edison International*
1996					
Operating revenue	$ 7,583	$ 170	$ 674	$ 118	$ 8,545
Operating income	1,711	75	292	(37)[1]	2,041[2]
Depreciation and decommissioning	1,064	15	75	19	1,173
Assets	17,737	949	4,204	1,669	24,559
Additions to property and plant	616	4	116	8	744
1995					
Operating revenue	$ 7,873	$ 177	$ 290	$ 65	$ 8,405
Operating income	1,709	73	131	(8)[1]	1,905[2]
Depreciation and decommissioning	954	10	36	14	1,014
Assets	18,155	842	3,532	1,417	23,946
Additions to property and plant	773	4	1,231[3]	3	2,011
1994					
Operating revenue	$ 7,799	$ 170	$ 211	$ 165	$ 8,345
Operating income	1,602	96	85	(3)[1]	1,780[2]
Depreciation and decommissioning	891	9	31	14	945
Assets	18,076	974	1,869	1,471	22,390
Additions to property and plant	982	11	136	8	1,137

Corporate items and eliminations are not material.

[1]Excludes reported tax benefits of $80 million in 1996, $44 million in 1995 and $34 million in 1994.

[2]Excludes income taxes of $563 million in 1996, $528 million in 1995 and $481 million in 1994.

[3]Includes $1,042 million from EME's acquisition of First Hydro.

QUARTERLY FINANCIAL DATA

Unaudited

In millions, except per-share amounts	1996 *Total*	*Fourth*	*Third*	*Second*	*First*
Operating revenue	$ 8,545	$ 2,195	$ 2,568	$ 1,814	$ 1,968
Operating income	1,478	328	468	332	350
Net income	717	117	277	156	167
Per share:					
Earnings	1.64	.27	.63	.35	.38
Dividends declared	1.00	.25	.25	.25	.25
Common stock prices:					
High	$ 20 3/8	$ 20 3/8	$ 18 1/4	$ 17 5/8	$ 18 5/8
Low	15 1/8	17 1/4	15 1/8	15 1/8	16 5/8
Close	19 7/8	19 7/8	17 7/8	17 5/8	17 1/8

In millions, except per-share amounts	1995 *Total*	*Fourth*	*Third*	*Second*	*First*
Operating revenue	$ 8,405	$ 2,052	$ 2,670	$ 1,861	$ 1,822
Operating income	1,377	301	448	310	318
Net income	739	138	288	160	153
Per share:					
Earnings	1.66	.31	.65	.36	.34
Dividends declared	1.00	.25	.25	.25	.25
Common stock prices:					
High	$ 18	$ 18	$ 18	$ 18	$ 16 7/8
Low	14 3/8	14 7/8	16 3/8	15 3/8	14 3/8
Close	17 5/8	17 5/8	17 1/4	17 1/8	15 5/8

Environmental Protection

Edison International is subject to numerous environmental laws and regulations, which require it to incur substantial costs to operate existing facilities, construct and operate new facilities, and mitigate or remove the effect of past operations on the environment.

Edison International records its environmental liabilities when site assessments and/or remedial actions are probable and a range of reasonably likely cleanup costs can be estimated. Edison International reviews its sites and measures the liability quarterly, by assessing a range of reasonably likely costs for each identified site using currently available information, including existing technology, presently enacted laws and regulations, experience gained at similar sites, and the probable level of involvement and financial condition of other potentially responsible parties. These estimates include costs for site investigations, remediation, operations and maintenance, monitoring and site closure. Unless there is a probable amount, Edison International records the lower end of this reasonably likely range of costs (classified as other long-term liabilities at undiscounted amounts). While Edison International has numerous insurance policies that it believes may provide coverage for some of these liabilities, it does not recognize recoveries in its financial statements until they are realized.

Edison International's recorded estimated minimum liability to remediate its 56 identified sites (55 at SCE and 1 at EME) was $114 million at December 31, 1996. The ultimate costs to clean up Edison International's identified sites may vary from its recorded liability due to numerous uncertainties inherent in the estimation process, such as: the extent and nature of contamination; the scarcity of reliable data for identified sites; the varying costs of alternative cleanup methods; developments resulting from investigatory studies; the possibility of identifying additional sites; and the time periods over which site remediation is expected to occur. Edison International believes that, due to these uncertainties, it is reasonably possible that cleanup costs could exceed its recorded liability by up to $211 million. The upper limit of this range of costs was estimated using assumptions least favorable to Edison International among a range of reasonably possible outcomes.

The CPUC allows SCE to recover environmental-cleanup costs at 35 of its sites, representing $101 million of Edison International's recorded liability, through an incentive mechanism. SCE may request to include additional sites. Under this mechanism, SCE will recover 90% of cleanup costs through customer rates; shareholders fund the remaining 10%, with the opportunity to recover these costs through insurance carriers and other third parties. SCE has successfully settled insurance claims with a number of its carriers. Costs incurred at SCE's remaining 20 sites are expected to be recovered through customer rates. SCE has recorded a regulatory asset of $104 million for its estimated minimum environmental-cleanup costs expected to be recovered through customer rates.

Edison International's identified sites include several sites for which there is a lack of currently available information, including the nature and magnitude of contamination and the extent, if any, that Edison International may be held responsible for contributing to any costs incurred for remediating these sites. Thus, no reasonable estimate of cleanup costs can now be made for these sites.

Edison International expects to clean up its identified sites over a period of up to 30 years. Remediation costs in each of the next several years are expected to range from $4 million to $8 million. Recorded costs for 1996 were $7 million.

In 1994, SCE utilized an estimating technique to quantify its potential liability for environmental cleanup in an effort to obtain a reasonably possible objective and reliable estimate of environmental cleanup. During 1995, EME completed a similar review of some of its sites where known contamination and potential liability exist and does not believe a material liability exists as of December 31, 1996.

Based on currently available information, Edison International believes it unlikely that it will incur amounts in excess of the upper limit of the estimated range and, based upon the CPUC's regulatory treatment of environmental-cleanup costs, Edison International believes that costs ultimately recorded will not have a material adverse effect on its results of operations or financial position. There can be no assurance, however, that future developments, including additional information about existing sites or the identification of new sites, will not require material revisions to such estimates.

Nuclear Insurance

Federal law limits public liability claims from a nuclear incident to $8.9 billion. SCE and other owners of San Onofre and Palo Verde have purchased the maximum private primary insurance available ($200 million). The balance is covered by the industry's retrospective rating plan that uses deferred premium charges to every reactor licensee if a nuclear incident at any licensed reactor in the U.S. results in claims and/or costs which exceed the primary insurance at that plant site. Federal regulations require this secondary level of financial protection. The Nuclear Regulatory Commission exempted San Onofre Unit 1 from this secondary level, effective June 1994. The maximum deferred premium for each nuclear incident is $79 million per reactor, but not more than $10 million per reactor may be charged in any one year for each incident. Based on its ownership interests, SCE could be required to pay a maximum of $158 million per nuclear incident. However, it would have to pay no more than $20 million per incident in any one year. Such amounts include a 5% surcharge if additional funds are needed to satisfy public liability claims and are subject to adjustment for inflation. If the public liability limit above is insufficient, federal regulations may impose further revenue-raising measures to pay claims, including a possible additional assessment on all licensed reactor operators.

Property damage insurance covers losses up to $500 million, including decontamination costs, at San Onofre and Palo Verde. Decontamination liability and property damage coverage exceeding the primary $500 million has also been purchased in amounts greater than federal requirements. Additional insurance covers part of replacement power expenses during an accident-related nuclear unit

in the near term. Decommissioning is scheduled to begin in 2013 at San Onofre and 2024 at Palo Verde. San Onofre Unit 1, which shut down in 1992, is expected to be secured until decommissioning begins at the other San Onofre units.

Decommissioning costs, which are recovered through customer rates, are recorded as a component of depreciation expense. Decommissioning expense was $148 million in 1996, $151 million in 1995 and $122 million in 1994. The accumulated provision for decommissioning was $949 million at December 31, 1996, and $823 million at December 31, 1995. The estimated costs to decommission San Onofre Unit 1 ($263 million) are recorded as a liability.

Decommissioning funds collected in rates are placed in independent trusts, which, together with accumulated earnings, will be utilized solely for decommissioning.

Trust investments include:

In millions	*Maturity Dates*	*December 31, 1996*	*1995*
Municipal bonds	1999-2021	$ 400	$ 348
Stocks	—	549	390
U.S. government issues	1998-2024	212	145
Short-term and other	1996-2024	56	186
Trust fund balance (at cost)		$ 1,217	$ 1,069

Trust fund earnings (based on specific identification) increase the trust fund balance and the accumulated provision for decommissioning. Net earnings were $49 million in 1996, $51 million in 1995 and $26 million in 1994. Proceeds from the sale of securities (which are reinvested) were $1.0 billion in 1996 and in 1995, and $1.1 billion in 1994. Approximately 89% of the trust fund contributions were tax-deductible.

The Financial Accounting Standards Board has issued an exposure draft related to accounting practices for removal costs, including decommissioning of nuclear power plants. The exposure draft would require SCE to report its estimated decommissioning costs as a liability, rather than recognizing these costs over the term of each facility's operating license (current industry practice). SCE does not believe that the changes proposed in the exposure draft would have an adverse effect on its results of operations even after deregulation due to its current and expected future ability to recover these costs through customer rates.

Other Commitments

SCE and EME have fuel supply contracts which require payment only if the fuel is made available for purchase.

SCE has power-purchase contracts with certain qualifying facilities (cogenerators and small power producers) and other utilities. The qualifying facility contracts provide for capacity payments if a facility meets certain performance obligations and energy payments based on actual power supplied to SCE. There are no requirements to make debt-service payments.

SCE has unconditional purchase obligations for part of a power plant's generating output, as well as firm transmission service from another utility. Minimum payments are based, in part, on the debt-service requirements of the provider, whether or not the plant or transmission line is operable. The purchased-power contract is not expected to provide more than 5% of current operating capacity. SCE's minimum commitment under both contracts is approximately $205 million through 2017.

Certain commitments for the years 1997 through 2001 are estimated below:

In millions	1997	1998	1999	2000	2001
Projected construction expenditures	$ 855	$ 636	$ 664	$ 647	$ 650
Fuel supply contracts	358	325	319	340	336
Purchased-power capacity payments	696	699	701	702	695
Unconditional purchase obligations	9	10	10	10	10

EME has firm commitments to make equity and other contributions to its projects of $408 million, primarily for the Paiton project in Indonesia and the ISAB project in Italy. EME also has contingent obligations to make additional contributions of $461 million, primarily for a guarantee as a condition of obtaining a $254 million tax-exempt financing for the Brooklyn Navy Yard project (discussed further in Note 10), and equity support guarantees related to Paiton.

NOTE 10. CONTINGENCIES

In addition to the matters disclosed in these notes, Edison International is involved in legal, tax and regulatory proceedings before various courts and governmental agencies regarding matters arising in the ordinary course of business. Edison International believes the outcome of these proceedings will not materially affect its results of operations or liquidity.

Brooklyn Navy Yard Project

EME owns, through a wholly owned subsidiary, 50% of the Brooklyn Navy Yard project, but funded all of the required equity during construction. The estimated total cost is $485 million, of which $442 million had been spent through December 31, 1996. In December 1995, a tax-exempt bond financing for the project in the amount of $254 million was obtained through the New York City Industrial Development Agency (NYCIDA). EME has guaranteed the obligations of the project pursuant to the financing, as well as an indemnity agreement on behalf of NYCIDA in the amount of $40 million. In the fourth quarter of 1996, EME executed a new energy sales agreement with Consolidated Edison Company of New York, which has contracted to buy most of the project's power and steam, and began selling power and steam under that agreement. The contractor has recently asserted general monetary claims under the turnkey agreement against Brooklyn Navy Yard and has served a complaint for damages in the amount of $136.8 million against Brooklyn Navy Yard. Brooklyn Navy Yard intends to vigorously defend this action and to assert general monetary claims against the contractor. EME believes that the outcome of this litigation will not have a material adverse effect on its consolidated results of operations or financial position.

The components of postretirement benefits other than pensions expense were:

In millions *Year ended December 31,*	1996	1995	1994
Service cost for benefits earned	$ 33	$ 36	$ 30
Interest cost on benefit obligation	91	78	73
Actual return on plan assets	(43)	(28)	(20)
Amortization of loss	6	1	—
Amortization of transition obligation	27	27	36
Net expense	114	114	119
Amortization of prior funding	—	—	2
Special termination expense	72	—	—
Total expense	$ 186	$ 114	$ 121

The assumed rate of future increases in the per-capita cost of health care benefits is 8.25% for 1997, gradually decreasing to 5% for 2004 and beyond. Increasing the health care cost trend rate by one percentage point would increase the accumulated obligation as of December 31, 1996, by $206 million and annual aggregate service and interest costs by $24 million.

Employee Savings Plan

Edison International has a 401(k) defined contribution savings plan designed to supplement employees' retirement income. The plan received employer contributions of $25 million in 1996, $20 million in 1995 and $21 million in 1994.

Note 7. Jointly-Owned Utility Projects

SCE owns interests in several generating stations and transmission systems for which each participant provides its own financing. SCE's share of expenses for each project is included in the consolidated statements of income.

The investment in each project, as included in the consolidated balance sheet as of December 31, 1996, was:

In millions	*Plant in Service*	*Accumulated Depreciation*	*Under Construction*	*Ownership Interest*
Transmission systems:				
Eldorado	$ 29	$ 8	$ 2	60%
Pacific Intertie	227	72	12	50
Generating stations:				
Four Corners (coal) Units 4 and 5	458	236	2	48
Mohave (coal)	300	142	8	56
Palo Verde (nuclear)	1,596	425	6	16
San Onofre (nuclear)	4,186	1,836	28	75
Total	$ 6,796	$ 2,719	$ 58	

Note 8. Leases

Leveraged Leases

Edison Capital is the lessor in several leveraged-lease agreements with terms of 13 to 30 years. All operating, maintenance, insurance and decommissioning costs are the responsibility of the lessees. The total cost of these facilities was $1.8 billion and $1.9 billion at December 31, 1996, and 1995, respectively.

The equity investment in these facilities is 20% of the purchase price. The remainder is nonrecourse debt secured by first liens on the leased property. The lenders have accepted their security interests as their only remedy if the lessee defaults.

The net investment in leveraged leases consisted of:

In millions *December 31,*	1996	1995
Rentals receivable (net of principal and interest on nonrecourse debt)	$ 830	$ 833
Unearned income	(303)	(317)
Investment in leveraged leases	527	516
Estimated residual value	58	58
Deferred income taxes	(534)	(508)
Net investment in leveraged leases	$ 51	$ 66

Lease Commitments

Edison International has operating leases, primarily for vehicles (with varying terms, provisions and expiration dates) and a capital lease ($91 million) for a nonutility power-production facility.

Estimated remaining commitments for noncancelable leases at December 31, 1996, were:

In millions	*Operating Leases*	*Capital Lease*
Year ended December 31,		
1997	$ 25	$ 29
1998	21	28
1999	16	28
2000	14	28
2001	9	—
Thereafter	33	1
Total future commitments	$ 118	114
Amount representing interest (9.65%)		(23)
Net commitments		$ 91

Note 9. Commitments

Nuclear Decommissioning

SCE plans to decommission its nuclear generating facilities at the end of each facility's operating license by a prompt removal method authorized by the Nuclear Regulatory Commission. Decommissioning is estimated to cost $2 billion in current-year dollars, based on site-specific studies performed in 1993 for San Onofre and 1992 for Palo Verde. Changes in the estimated costs, timing of decommissioning, or the assumptions underlying these estimates could cause material revisions to the estimated total cost to decommission

The number of options exercisable and their weighted-average exercise prices at December 31, 1996, 1995 and 1994 were 1,760,766 at $20.54; 1,240,425 at $21.08 and 1,044,224 at $20.02, respectively.

Phantom Stock Options

"Phantom stock" option performance awards have been developed for two affiliate companies, EME and Edison Capital, as part of the Edison International long-term incentive compensation program for senior management. Each phantom stock option may be exercised to realize any appreciation in the deemed value of one hypothetical share of EME or Edison Capital stock over exercise prices. Exercise prices for EME and Edison Capital phantom stock are escalated on an annually-compounded basis over the grant price by 12% and 10%, respectively. The deemed values of the phantom stock are recalculated annually as determined by a formula linked to the value of its portfolio of investments, less general and administrative costs. The options have a 10-year term with one-third of the total award vesting in each of the first three years of the award term.

Compensation expense recorded with respect to phantom stock options was $17 million in 1996 and $1 million in 1995. There was no related compensation expense in 1994, the year the phantom stock option program commenced.

Pension Plan

Edison International has a noncontributory, defined-benefit pension plan that covers employees meeting minimum service requirements. Benefits are based on years of accredited service and average base pay. Edison International funds the plan on a level-premium actuarial method. These funds are accumulated in an independent trust. Annual contributions meet minimum legal funding requirements and do not exceed the maximum amounts deductible for income taxes. Prior service costs from pension plan amendments are funded over 30 years. Plan assets are primarily common stocks, corporate and government bonds, and short-term investments. In 1996, SCE recorded pension gains from a special voluntary early retirement program.

The plan's funded status was:

In millions *December 31,*	1996	1995
Actuarial present value of benefit obligation:		
Vested benefits	$ 1,679	$ 1,703
Nonvested benefits	73	214
Accumulated benefit obligation	1,752	1,917
Value of projected future compensation levels	267	487
Projected benefit obligation	2,019	2,404
Fair value of plan assets	2,171	2,636
Projected benefit obligation less than plan assets	(152)	(232)
Unrecognized net gain	294	327
Unrecognized prior service cost	(199)	(6)
Unrecognized net obligation (17-year amortization)	(45)	(51)
Pension liability (asset)	$ (102)	$ 38
Discount rate	7.75%	7.25%
Rate of increase in future compensation	5.0%	5.0%
Expected long-term rate of return on assets	8.0%	8.0%

Edison International's utility operations recognize pension expense calculated under the actuarial method used for ratemaking.

The components of pension expense were:

In millions *Year ended December 31,*	1996	1995	1994
Service cost for benefits earned	$ 51	$ 59	$ 69
Interest cost on projected benefit obligation	180	157	149
Actual return on plan assets	(345)	(457)	(28)
Net amortization and deferral	146	270	(141)
Pension expense under accounting standards	32	29	49
Special termination benefits	1	3	15
Regulatory adjustment—deferred	22	23	2
Net pension expense recognized	55	55	66
Settlement gain	(121)	—	—
Total expense (gain)	$ (66)	$ 55	$ 66

Postretirement Benefits Other Than Pensions

Employees retiring at or after age 55 with at least 10 years of service (or those eligible under the 1996 special voluntary early retirement program), are eligible for postretirement health and dental care, life insurance and other benefits. Health and dental care benefits are subject to deductibles, copayment provisions and other limitations.

Edison International is amortizing its obligation related to prior service over 20 years. SCE funds its share of these benefits (by contributions to independent trusts) up to tax-deductible limits, in accordance with rate-making practices. In 1996, SCE recorded special termination expenses due to a special voluntary early retirement program. Any difference between recognized expense and amounts authorized for rate recovery is not expected to be material (except for the impact of the early retirement program) and will be charged to earnings.

Trust assets are primarily common stocks, corporate and government bonds, and short-term investments.

The funded status of these benefits is reconciled to the recorded liability below:

In millions *December 31,*	1996	1995
Actuarial present value of benefit obligation:		
Retirees	$ 933	$ 403
Employees eligible to retire	35	103
Other employees	394	564
Accumulated benefit obligation	$ 1,362	$ 1,070
Fair value of plan assets	$ 617	$ 400
Plan assets less than accumulated benefit obligation	$ 745	$ 670
Unrecognized transition obligation	(432)	(460)
Unrecognized net gain (loss)	(236)	(203)
Recorded liability	$ 77	$ 7
Discount rate	7.75%	7.5%
Expected long-term rate of return on assets	8.5%	8.5%

The composite federal and state statutory income tax rate was 41.045% for all years presented.

The federal statutory income tax rate is reconciled to the effective tax rate below:

Year ended December 31,	1996	1995	1994
Federal statutory rate	35.0%	35.0%	35.0%
Capitalized software	(0.8)	(0.8)	(2.0)
Depreciation and other	7.3	5.1	5.6
Housing credits	(3.6)	(2.7)	(2.2)
Investment and energy tax credits	(2.7)	(2.3)	(2.2)
State tax—net of federal deduction	6.2	5.6	5.3
Effective tax rate	41.4%	39.9%	39.5%

Note 6. Employee Benefit Plans

Stock Option Plans

Under Edison International's Long-term Incentive Compensation Plan, 8.2 million shares of common stock were reserved for potential issuance under various stock compensation programs to directors, officers and senior managers of Edison International and its affiliates. Under these programs, there are currently outstanding to officers and senior managers, options on 3.6 million shares of Edison International common stock. There were 4.5 million, 5.4 million, 6.3 million and 6.5 million shares reserved for future grant at December 31, 1996, 1995, 1994 and 1993, respectively.

Each option may be exercised to purchase one share of Edison International common stock, and is exercisable at a price equivalent to the fair market value of the underlying stock at the date of grant. Edison International stock options include a dividend equivalent feature. Generally, for options issued before 1994, amounts equal to dividends accrue on the options at the same time and at the same rate as would be payable on the number of shares of Edison International common stock covered by the options. The amounts accumulate without interest. The optionee has no right to payment of these dividend equivalents until the underlying stock options are exercised. For Edison International stock options issued subsequent to 1993, dividend equivalents are subject to reduction unless certain shareholder return performance criteria are met.

Edison International stock options have a 10-year term with one-third of the total award vesting after each of the first three years of the award term. The options are not transferable, except by will or domestic relations order. If an optionee retires, dies or is permanently and totally disabled during the three-year vesting period, the unvested options will vest and be exercisable to the extent of 1/36 of the grant for each full month of service during the vesting period. Unvested options of any person who has served in the past on the Edison International or SCE Management Committee will vest and be exercisable upon the member's retirement, death or permanent and total disability. Upon retirement, death or permanent and total disability, the vested options may continue to be exercised within their original terms by the recipient or beneficiary. If an optionee is terminated other than by retirement, death or permanent and total disability, options which had vested as of the prior anniversary date of the grant are forfeited unless exercised within 180 days of the date of termination. All unvested options are forfeited on the date of termination.

Compensation expense recorded under the stock-compensation program was $9 million, $4 million and $(3) million for 1996, 1995 and 1994, respectively. A decline during 1994 in the market value of the underlying shares optioned resulted in the recapture of previously recognized expense.

Stock-based compensation expense under the fair-value method of accounting would have resulted in pro forma net income and earnings-per-share approximating the following amounts:

In millions, except per-share amounts	1996	1995
Pro forma net income	$ 714	$ 737
Pro forma earnings-per-share	$ 1.63	$ 1.65

The fair value for each option granted during 1996 and 1995, reflecting the basis for the above pro forma disclosures, was determined on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used in determining fair value through the model:

	1996	1995
Expected life	7.0 years	8.0 years
Risk-free interest rate	5.51%	7.93%
Expected volatility	17%	17%

The recognition of dividend equivalents results in no dividends assumed for purposes of fair-value determination. The application of fair-value accounting in arriving at the pro forma disclosures above is not an indication of future income statement effects. The pro forma disclosures do not reflect the effect of fair-value accounting on stock-based compensation awards granted prior to 1995.

A summary of the status of Edison International's stock options is as follows:

			Weighted-Average		
	Share Options	*Exercise Price*	*Exercise Price*	*Fair Value at Grant*	*Remaining Life*
Outstanding, Dec. 31, 1993	1,390,634	$16.00-$24.44	$20.47		7.4 years
Granted	408,800	20.19- 21.94	20.20	$8.07	
Expired	(7,712)	21.94- 23.28	22.25		
Forfeited	(25,631)	20.19- 23.28	21.41		
Exercised	—	—	—		
Outstanding, Dec. 31, 1994	1,766,091	$16.00-$24.44	$20.41		6.9 years
Granted	910,100	14.56- 17.44	14.77	$6.92	
Expired	(9,930)	20.19- 23.28	21.91		
Forfeited	(9,120)	14.56- 21.94	19.74		
Exercised	(20,900)	17.38- 17.75	17.64		
Outstanding, Dec. 31, 1995	2,636,241	$14.56-$24.44	$18.69		7.0 years
Granted	1,091,850	15.81- 18.31	17.57	$6.27	
Expired	(18,394)	14.56- 23.28	20.08		
Forfeited	(21,810)	14.56- 20.19	16.24		
Exercised	(133,131)	14.56- 23.28	18.19		
Outstanding, Dec. 31, 1996	3,554,756	$14.56-$24.44	$18.68		7.0 years

SCE's authorized shares of preferred and preference stock are: $25 cumulative preferred—24 million; $100 cumulative preferred—12 million; and preference—50 million. All cumulative preferred stocks are redeemable. Mandatorily redeemable preferred stocks are subject to sinking-fund provisions. When preferred shares are redeemed, the premiums paid are charged to common equity. There are no preferred stock redemption requirements for the next five years.

EME is a general partner and also owns, indirectly, the limited partner's share of Mission Capital L.P., which was formed solely for the purpose of holding parent company debentures. Mission Capital L.P. has 6 million authorized shares of cumulative preferred securities with a liquidation preference that obligates EME.

There are no preferred stock redemption requirements for the next five years.

Edison International subsidiaries' cumulative preferred securities consisted of:

Dollars in millions, except per-share amounts	*December 31, 1996* *Shares Outstanding*	*Redemption Price*	*December 31, 1996*	*December 31, 1995*
Not subject to mandatory redemption:				
$25 par value preferred stock:				
4.08% Series	1,000,000	$ 25.50	$ 25	$ 25
4.24	1,200,000	25.80	30	30
4.32	1,653,429	28.75	41	41
4.78	1,296,769	25.80	33	33
5.80	2,200,000	25.25	55	55
7.36	4,000,000	25.00	100	100
Total			$ 284	$ 284
Subject to mandatory redemption:				
$25 par value preferred securities:				
8.50% Series	2,500,000	$ 25.00	$ 63	$ 63
9.875	3,500,000	25.00	87	87
$100 par value preferred stock:				
6.05% Series	750,000	100.00	75	75
6.45	1,000,000	100.00	100	100
7.23	1,000,000	100.00	100	100
Total			$ 425	$ 425

In 1995, 750,000 shares of Series 7.58% preferred stock were redeemed and 2.5 million shares of Series 8.50% preferred securities were issued. In 1994, 3.5 million shares of Series 9.875% preferred securities were issued.

NOTE 5. INCOME TAXES

Edison International's subsidiaries will be included in its consolidated federal income tax and combined state franchise tax returns. Under income tax allocation agreements, each subsidiary calculates its own tax liability.

Income tax expense includes the current tax liability from operations and the change in deferred income taxes during the year. Investment tax credits are amortized over the lives of the related properties.

The components of the net accumulated deferred income tax liability were:

In millions *December 31,*	1996	1995
Deferred tax assets:		
Property-related	$ 247	$ 276
Investment tax credits	206	222
Regulatory balancing accounts	205	166
Decommissioning-related	208	73
Other	660	602
Total	$ 1,526	$ 1,339
Deferred tax liabilities:		
Property-related	$ 4,345	$ 4,346
Leveraged leases	534	508
Other	690	360
Total	$ 5,569	$ 5,214
Accumulated deferred income taxes—net	$ 4,043	$ 3,875
Classification of accumulated deferred income taxes:		
Included in deferred credits	$ 4,283	$ 4,352
Included in current assets	240	477

The current and deferred components of income tax expense were:

In millions *Year ended December 31,*	1996	1995	1994
Current:			
Federal	$ 364	$ 514	$ 319
State	108	150	110
	472	664	429
Deferred—federal and state:			
Accrued charges	(14)	1	(25)
Asset basis adjustment	(25)	12	—
Deferred alternative minimum tax credit	—	—	45
Depreciation	71	72	93
Investment and energy tax credits—net	(37)	(26)	(23)
Leveraged leases	26	38	72
Loss carryforwards	(41)	(37)	(37)
Nonutility special charges	9	(21)	(14)
Pension reserves	45	(3)	(8)
Rate phase-in plan	(31)	(46)	(51)
Regulatory balancing accounts	34	(118)	(7)
State tax privilege year	18	(9)	(12)
Other	(21)	(35)	(17)
	34	(172)	16
Total income tax expense	$ 506	$ 492	$ 445
Classification of income taxes:			
Included in operating income	$ 563	$ 528	$ 481
Included in other income	(57)	(36)	(36)

and power-sales contracts. Credit risk relates to the risk of loss that EME would incur as a result of nonperformance by counterparties (major financial institutions and domestic and foreign utilities) pursuant to the terms of their contractual obligations. EME attempts to mitigate this risk by contracting with counterparties that have a strong capacity to meet their contractual obligations and by monitoring their credit quality. In addition, EME attempts to secure long-term power-sales contracts for its projects that are expected to result in adequate cash flow under a wide range of economic and operating circumstances. To accomplish this, EME attempts to structure its long-term contracts so that fluctuations in fuel costs will produce similar fluctuations in electric energy and/or steam revenue by entering into long-term fuel supply and transportation agreements. Accordingly, EME does not anticipate a material impact to its results of operations or financial condition as a result of counterparty nonperformance.

Edison International had the following derivative financial instruments at December 31, 1996, and 1995, except where noted:

Contract Amount/Terms	*Purpose*
Interest rate swaps:	
$196 million expires 2008	fix interest rate exposure at 5.585%
$100 million expires 1999 $100 million expires 2002	convert fixed-rate debt of 7.75% and 8.125% to a floating rate capped at 9.0%
$45 million expires 1999 preferred securities due 2024	convert fixed-rate debt of 9.875% to a floating rate
$75 million expired August 1996 $50 million expires 1999	fix interest rate exposure at 7.98% fix interest rate exposure at 8.095%
10.9 billion Spanish pesetas (12/31/96) (U.S. $84 million) expires 1998-2003	convert floating-rate debt to fixed rates ranging from 8.4% to 11.38%
£45 million (12/31/96) (U.S. $77 million) £51 million (12/31/95) (U.S. $79 million) debt due 2005 expires 1997	convert floating-rate debt to a fixed rate of 12.4%
A$42 million (12/31/96) (U.S. $33 million) A$34 million (12/31/95) (U.S. $25 million) expires 2007	convert floating-rate debt to a fixed rate of 10.98%
Interest rate caps:	
$30 million expires 1997 debt due 2027	fix interest rate exposure at 6% over the variable term of the debt
A$58 million (12/31/95) (U.S. $43 million) expired November 1996	fix interest rate exposure at 11.25%
U.K. electricity rate swaps:	
1,735 MW (12/31/96) 1,500 MW (12/31/95) various expirations through 2000	fix market electricity sales rates
416 MW (12/31/96) expires March 1997	fix market electricity purchase rates

Fair values of financial instruments were:

	December 31,			
	1996		*1995*	
Instrument (in millions)	*Cost Basis*	*Fair Value*	*Cost Basis*	*Fair Value*
Financial assets:				
Decommissioning trusts	$ 1,217	$ 1,485	$ 1,069	$ 1,260
Electricity rate swaps	—	27	—	22
Equity investments	11	68	9	41
Financial liabilities:				
DOE decommissioning and decontamination fees	54	45	58	49
Interest rate swaps and caps	—	34	—	28
Long-term debt	7,475	7,712	7,195	7,531
Preferred securities subject to mandatory redemption	425	445	425	448

Financial assets are carried at their fair value, which is based on quoted market prices. Financial liabilities are recorded at cost. Financial liabilities' fair values are based on: termination costs for interest rate swaps; brokers' quotes for long-term debt, preferred stock and caps; discounted future cash flows for U.S. Department of Energy (DOE) decommissioning and decontamination fees; and discounted future cash flows for the difference between contract prices and forecasted market prices for electricity rate swaps. Amounts reported for cash equivalents and short-term debt approximate fair value, due to their short maturities.

Gross unrealized holding gains on financial assets were:

In millions	*December 31,*	1996	1995
Decommissioning trusts:			
Municipal bonds		$ 79	$ 52
Stocks		138	122
U.S. government issues		39	11
Short-term and other		12	6
		268	191
Equity investments		57	32
Total		$ 325	$ 223

There were no unrealized holding losses on financial assets for the years presented.

Note 4. Equity

The CPUC regulates SCE's capital structure, limiting the dividends it may pay Edison International. At December 31, 1996, SCE had the capacity to pay $112 million in additional dividends to Edison International and continue to maintain its authorized capital structure. These restrictions are not expected to affect Edison International's ability to meet its cash obligations.

Edison International's authorized common stock is 800 million shares with no par value.

During 1996, Edison International purchased on the open market and retired 19,216,627 shares ($344 million) of common stock.

Under Edison International's long-term incentive compensation plan, it issued 133,131 shares ($2.4 million) in 1996 and 20,900 shares ($0.4 million) in 1995. No shares were issued in 1994.

proposal for a new rate mechanism for its 15.8% share of the three units at Palo Verde. The decision adopts the Palo Verde All-Party Settlement filed with the CPUC on November 15, 1996. The settlement was based on a Memorandum of Understanding signed by all of the active parties to the Palo Verde proceeding. Under the settlement, SCE has the opportunity to recover its remaining investment (approximately $1.2 billion) in Palo Verde beginning January 1, 1997, and ending December 31, 2001, earning a reduced rate of return on rate base of 7.35% instead of the current 9.49%. Also, SCE will utilize a balancing account to pass through Palo Verde's incremental operating costs (considered reasonable as long as they do not exceed 30% of a baseline forecast and the site's gross annual capacity factor does not go below 55%) to ratepayers. Beginning January 1, 1998, this balancing account will become part of the CTC mechanism. If SCE's actual costs are less than the forecast, the difference will benefit ratepayers as a credit to the CTC mechanism. The existing nuclear unit incentive procedure will continue only for purposes of calculating a reward for performance of any unit above an 80% capacity factor for a fuel cycle. After 2001, SCE's ratepayers will receive 50% of the benefits derived from the operation of Palo Verde.

NOTE 3. FINANCIAL INSTRUMENTS

Long-Term Debt

California law prohibits SCE from incurring or guaranteeing debt for its nonutility affiliates.

Almost all SCE properties are subject to a trust indenture lien.

SCE has pledged first and refunding mortgage bonds as security for borrowed funds obtained from pollution-control bonds issued by government agencies. SCE uses these proceeds to finance construction of pollution-control facilities. Bondholders have limited discretion in redeeming certain pollution-control bonds, and SCE has arranged with securities dealers to remarket or purchase them if necessary.

Long-term debt maturities and sinking-fund requirements for the next five years are: 1997—$573 million; 1998—$560 million; 1999—$459 million; 2000—$405 million; and 2001—$500 million.

Long-term debt consisted of:

In millions *December 31,*	1996	1995
First and refunding mortgage bonds:		
1997—2000 (5.45% to 7.5%)	$ 1,025	$ 1,025
2001—2005 (5.625% to 6.25%)	450	450
2017—2026 (6.9% to 8.875%)	1,250	1,637
Pollution-control bonds:		
1999—2027 (5.4% to 7.2% and variable)	1,204	1,205
Funds held by trustees	(2)	(2)
Debentures and notes:		
1997—2026 (5% to 20% and variable)	3,891	2,717
Subordinated debentures:		
2044 (8.375%)	100	100
Commercial paper for nuclear fuel	112	70
Capital lease obligation	91	97
Current portion of capital lease obligation	(19)	(15)
Long-term debt due within one year	(573)	(25)
Unamortized debt discount—net	(54)	(64)
Total	$ 7,475	$ 7,195

Short-Term Debt

Short-term debt consisted of:

In millions *December 31,*	1996	1995
Commercial paper	$ 470	$ 508
Other short-term debt	167	350
Amount reclassified as long-term	(237)	(145)
Unamortized discount	(3)	(3)
Total	$ 397	$ 710
Weighted-average interest rate	5.6%	5.9%

At December 31, 1996, Edison International and its subsidiaries had $1.8 billion of borrowing capacity available under lines of credit totaling $2.1 billion. SCE had available lines of credit of $1.1 billion, with $600 million for short-term debt and $500 million for the long-term refinancing of its variable-rate pollution-control bonds. The nonutility subsidiaries had lines of credit of $700 million, with $575 million of borrowing capacity available to finance general cash requirements. The holding company has lines of credit totaling $350 million. At December 31, 1996, $165 million was used in support of EME's 1995 acquisition of First Hydro and Edison International's ongoing share repurchase program. Edison International's unsecured revolving lines of credit are at negotiated or bank index rates with various expiration dates; the majority have five-year terms.

Other Financial Instruments

Edison International's risk management policy allows the use of derivative financial instruments to manage financial exposure on its investments, fluctuations in interest rates, foreign exchange rates and energy prices, but prohibits the use of these instruments for speculative or trading purposes.

Projects in the United Kingdom (U.K.) sell their energy and capacity through a centralized electricity pool which establishes a half-hourly clearing price. The half-hourly price is extremely volatile, and can vary by a factor of ten or more over the course of a few hours due to large differentials in demand according to the time of day. First Hydro attempts to mitigate the market risk of the pool by entering into electricity rate swap agreements, related to either the selling or purchase price of power, whereby payments are made when pool selling prices rise above the price specified in the contract. These contracts attempt to stabilize production revenue or purchasing costs by removing one element of net exposure to pool price volatility. The Roosecote project has avoided the pool price volatility by entering into a long-term power-sales contract which provides for contract pricing.

Interest rate swaps and caps are used to reduce the potential impact of interest rate fluctuations on floating rate long-term debt. SCE's interest rate swap agreement requires the parties to pledge collateral according to bond rating and market interest rate changes. At December 31, 1996, SCE had pledged $16 million as collateral due to a decline in market interest rates. SCE is exposed to credit loss in the event of nonperformance by counterparties to these agreements, but does not expect the counterparties to fail to meet their obligations.

Edison International is subject to concentrations of credit risk as the result of elements involved in EME's financial instruments

applying a regulatory prescribed depreciation method (straight-line, remaining-life method) rather than a method that would have been applied absent the regulatory process, SCE believes that the depreciable lives of its generation-related assets would not vary significantly from that of an unregulated enterprise, as the CPUC bases depreciable lives on periodic studies that reflect the physical useful lives of the assets. SCE also believes that any depreciation-related differences would be recovered through the CTC.

If events occur during the restructuring process that result in all or a portion of the CTC being improbable of recovery, SCE could have write-offs associated with these costs if they are not recovered through another regulatory mechanism. At this time, SCE cannot predict what other revisions will ultimately be made during the restructuring process in subsequent proceedings or implementation phases, or the effect, after the transition period, that competition will have on its results of operations or financial position.

Subsequent Event

If the CPUC's restructuring is implemented as outlined, SCE would be allowed to recover its CTC (subject to a lower return on equity) and believes it should be allowed to continue to apply accounting standards that recognize the economic effects of rate regulation for its generation-related assets during the 1998-2001 transition period. However, in response to a request by the staff of the Securities and Exchange Commission (SEC), in December 1996 SCE submitted its views on the continued applicability of regulatory accounting standards for its generation-related assets. In its submittal, SCE and its independent accountants jointly concluded that, based on their current analysis, SCE will continue to meet the criteria for applying these accounting standards through the 1998-2001 transition period. In its February 1997 response, the SEC staff expressed continuing concern with SCE's conclusion and indicated that they wanted to meet further with SCE and the other major California electric utilities to resolve this matter. SCE and its independent accountants continue to believe that SCE meets such criteria and plan to meet with the SEC staff to present additional and clarifying information seeking to convince the SEC staff of the merits of SCE's position. The authority to require SCE to discontinue applying regulatory accounting standards rests with the SEC. If SCE is required to discontinue the application of these accounting standards for its generation-related assets, it would have to write off generation-related regulatory assets, which at December 31, 1996, totaled approximately $600 million on an after-tax basis, primarily for the recovery of income tax benefits previously flowed-through to customers, the Palo Verde phase-in plan and unamortized loss on reacquired debt.

SCE believes that a proper application of regulatory accounting standards will result in it no longer meeting the criteria to apply these accounting standards to all of its non-hydroelectric generation-related assets after the end of the 1998-2001 transition period. If SCE continues the application of these accounting standards during the transition period, but during the transition period events occur that result in SCE no longer meeting the criteria for applying such standards, SCE may be required to write off the remaining balance of its recorded generation-related regulatory assets existing at that time.

If a non-cash write-off is required, SCE believes that it should not affect the stranded-cost recovery plans set forth in the CPUC's December 1995 restructuring decision and legislation enacted by the State of California in September 1996.

FERC Stranded Cost/Open Access Transmission Decision

In April 1996, the FERC issued its decision on stranded cost recovery and open access transmission, effective July 1996. The decision requires all electric utilities subject to the FERC's jurisdiction to file transmission tariffs which provide competitors with increased access to transmission facilities for wholesale transactions and also establishes information requirements for the transmission utility. The decision also provides utilities with the recovery of stranded costs, which are prior-service costs incurred under the current regulatory framework. In addition to providing recovery of stranded costs associated with existing wholesale customers, the FERC directed that it would have primary jurisdiction over the recovery of stranded costs associated with retail-turned-wholesale customers, such as the formation of a new municipal electric system. Retail stranded costs resulting from a state-authorized retail direct-access program are the responsibility of the states and the FERC would only address recovery of these costs if the state has no authority to do so. In compliance with the April 1996 FERC decision, SCE filed a revised open access tariff with the FERC in July 1996. The tariff became effective on an interim basis, subject to refund, as of its filing date. Several wholesale customers have filed protests with the FERC on the transmission rate levels, and a ruling from the FERC setting the rates to be decided at formal hearings is anticipated in early 1997.

Mohave Generating Station

A 1994 CPUC decision stated that SCE was liable for expenditures related to a 1985 accident at the Mohave Generating Station. In July 1996, the CPUC approved a settlement agreement between SCE and the ORA which resulted in a $39 million (including interest) refund to SCE's customers. The refund, which had been previously reserved, was completed by year-end 1996.

Canadian Gas Contracts

In May 1994, SCE filed its testimony in the non-Qualifying Facilities phase of the 1994 Energy Cost Adjustment Clause proceeding. In May 1995, the ORA filed its report on the reasonableness of SCE's gas supply costs for both the 1993 and 1994 record periods. The report recommends a disallowance of $13.3 million for excessive costs incurred from November 1993 through March 1994 associated with SCE's Canadian gas purchase and supply contracts. The report requests that the CPUC defer finding SCE's Canadian supply and transportation agreements reasonable for the duration of their terms and that the costs under these contracts be reviewed on a yearly basis. In October 1996, the ORA issued its report for the 1995 record period recommending a $37.6 million disallowance for excessive costs incurred from April 1994 through March 1995. Both proposed disallowances have been consolidated into one proceeding. SCE and the ORA have filed several rounds of testimony on this issue. Hearings began in January 1997 and are expected to conclude in February 1997. A decision is expected in late 1997.

Palo Verde Rate-making Mechanism

On December 23, 1996, the CPUC issued a final decision on SCE's

erational control of the utilities' transmission facilities and, therefore, control the scheduling and dispatch of all electricity on the state's power grid.

- Availability of customer choice through time-of-use rates, direct customer access to generation providers with transmission arrangements through the system operator, and customer-arranged "contracts for differences" to manage price fluctuations from the PX.
- Recovery of costs to transition to a competitive market (utility investments, obligations incurred to serve customers under the existing framework and reasonable employee-related costs) through a non-bypassable charge, applied to all customers, called the CTC.
- CPUC-established incentives to encourage voluntary divestiture (through spin-off or sale to an unaffiliated entity) of at least 50% of utilities' gas-fueled generation to address market power issues.
- Performance-based ratemaking (PBR) for those utility services not subject to competition.

In April 1996, SCE, Pacific Gas & Electric Company and San Diego Gas & Electric Company filed a proposal with the FERC regarding the creation of the PX and the ISO. On November 26, 1996, the FERC conditionally accepted the proposal and directed the three utilities to file more specific information by March 31, 1997. In July 1996, the three utilities jointly filed an application with the CPUC requesting approval to establish a restructuring trust which would obtain loans up to $250 million for the development of the ISO and PX through January 1, 1998. The loans would be backed by utility guarantees; SCE's share would be 45%. Once the ISO and PX are formed, they will repay the trust's loans and recover funds from future ISO and PX customers. In August 1996, the CPUC issued an interim order establishing the restructuring trust and the funding level of $250 million which will be used to build the hardware and software systems for the ISO and PX.

Recovery of costs to transition to a competitive market would be implemented through a non-bypassable CTC. This charge would apply to all customers who were using or began using utility services on or after the December 20, 1995, decision date. In August 1996, in compliance with the CPUC's restructuring decision, SCE filed its application to estimate its 1998 transition costs. In October 1996, SCE amended its transition cost filing to reflect the effects of the legislation enacted in September 1996. Under the rate freeze codified in the legislation, the CTC will be determined residually (i.e., after subtracting other cost components for the PX, transmission and distribution (T&D), nuclear decommissioning and public benefit programs). Nevertheless, the CPUC directed that the amended application provide estimates of SCE's potential transition costs from 1998 through 2030. SCE provided two estimates between approximately $13.1 billion (1998 net present value), assuming the fossil plants have a market value equal to their net book value, and $13.8 billion (1998 net present value), assuming the fossil plants have no market value. These estimates are based on incurred costs, and forecasts of future costs and assumed market prices. However, changes in the assumed market prices could materially affect these estimates. The potential transition costs are comprised of: $7.5 billion from SCE's qualifying facility contracts, which are the direct result of legislative and regulatory mandates; and $5.6 billion to $6.3 billion from costs pertaining to certain generating plants and regulatory commitments consisting of costs incurred (whose recovery has been deferred by the CPUC) to provide service to customers. Such commitments include the recovery of income tax benefits previously flowed-through to customers, postretirement benefit transition costs, accelerated recovery of San Onofre (as discussed in Note 1) and Palo Verde, nuclear decommissioning and certain other costs.

On November 27, 1996, SCE filed an application with the CPUC to voluntarily divest, by auction, all of its oil- and gas-fueled generation assets. This application builds on SCE's March 1996 plan which outlined how SCE proposed to divest 50% of these assets. Under the new proposal, SCE would continue to operate and maintain the divested power plants for at least two years following their sale, as mandated by the recent restructuring legislation. In addition, SCE would offer workforce transition programs to those employees who may be impacted by divestiture-related job reductions. SCE's proposal is contingent on the overall electric industry restructuring implementation process continuing on a satisfactory path. CPUC approval of the oil-and gas-fueled generation divestiture was requested for late 1997.

In September 1996, the CPUC adopted a non-generation T&D PBR mechanism for SCE which began on January 1, 1997. According to the CPUC decision, beginning in 1998, the transmission portion is to be separated from non-generation PBR and subject to ratemaking under the rules of the FERC. The distribution-only PBR will extend through December 2001. Key elements of the non-generation PBR include: T&D rates indexed for inflation based on the Consumer Price Index less a productivity factor; elimination of the kilowatt-hour sales adjustment; adjustments for cost changes that are not within SCE's control; a cost of capital trigger mechanism based on changes in a bond index; standards for service reliability and safety; and a net revenue-sharing mechanism that determines how customers and shareholders will share gains and losses from T&D operations. In July 1996, SCE filed a PBR proposal for its hydroelectric plants and a proposed structure for performance-based local reliability contracts for certain fossil-fueled plants. If approved, the hydro PBR would be in effect for three years and the initial terms of the local reliability contracts, which are subject to FERC approval, would be in effect for up to three years, both beginning January 1, 1998. A final CPUC decision on hydro PBR is expected by year-end 1997.

In July 1996, SCE filed a proposal with the CPUC related to the conceptual aspects of separating the costs associated with generation, transmission, distribution, public benefit programs and the CTC. The filing was in response to CPUC and FERC directives which require electric services, such as T&D, to be functionally separate and available to all customers on a nondiscriminatory basis without cost-shifting among customers. On December 6, 1996, SCE filed a more comprehensive plan for the functional unbundling of SCE's rates for electric service, beginning on January 1, 1998. In response to CPUC and FERC orders, as well as the new restructuring legislation, this filing addressed the implementation-level detail for the functional unbundling of rates in separate charges for energy, transmission, distribution, the CTC, public benefit programs and nuclear decommissioning. The filing also included proposals for establishing new regulatory proceedings to replace current proceedings that will no longer be necessary during the rate freeze period.

Although depreciation-related differences could result from

In April 1996, the CPUC authorized, and SCE began accelerating, the recovery of its remaining investment of $2.6 billion in San Onofre Units 2 and 3. The accelerated recovery will continue through December 2001 (the original end date of 2003 was changed by legislation enacted in September 1996), earning a 7.35% fixed rate of return (compared to the current 9.49%). Future operating costs, including nuclear fuel and nuclear-fuel financing costs and incremental capital expenditures at San Onofre Units 2 and 3, are subject to an incentive pricing plan whereby SCE receives about 4¢ per kilowatt-hour through 2003. Any differences between these costs and the incentive price will flow through to the shareholders. Beginning in 2004, SCE will be required to share equally with ratepayers the benefits received from operation of the units.

Prior to January 1, 1997, the cost of nuclear fuel for Palo Verde, including disposal, was amortized to fuel expense on the basis of generation. Under CPUC rate-making procedures in effect for Palo Verde prior to January 1, 1997, nuclear-fuel financing costs were capitalized until the fuel was placed into production.

Property and Plant

Utility plant additions, including replacements and betterments, are capitalized. Such costs include direct material and labor, construction overhead and an allowance for funds used during construction (AFUDC). AFUDC represents the estimated cost of debt and equity funds that finance utility plant construction. AFUDC is capitalized during plant construction and reported in current earnings. AFUDC is recovered in rates through depreciation expense over the useful life of the related asset.

Depreciation of utility plant is computed on a straight-line, remaining-life basis. Replaced or retired property and removal costs less salvage are charged to the accumulated provision for depreciation. Depreciation expense stated as a percent of average original cost of depreciable utility plant was 4.2% for 1996, and 3.6% for both 1995 and 1994.

Nonutility property is capitalized at cost, including interest incurred on borrowed funds that finance construction. Depreciation of nonutility properties is primarily computed on a straight-line basis over their estimated useful lives. Depreciation expense stated as a percent of average original cost of depreciable nonutility property was, on a composite basis, 3.9% for 1996, 3.8% for 1995 and 5.2% for 1994.

Regulatory Balancing Accounts

The differences between CPUC-authorized and actual base-rate revenue from kilowatt-hour sales and CPUC-authorized and actual energy costs are accumulated in balancing accounts until they are refunded to, or recovered from, utility customers through authorized rate adjustments (with interest). Income tax effects on balancing account changes are deferred.

Research, Development and Demonstration (RD&D)

SCE capitalizes RD&D costs that are expected to result in plant construction. If construction does not occur, these costs are charged to expense. RD&D expenses are recorded in a balancing account and, at the end of the rate-case cycle, any authorized but unspent RD&D funds are refunded to customers. RD&D expenses were $21 million in 1996, $28 million in 1995 and $63 million in 1994.

Revenue

Electric utility revenue includes amounts for services rendered but unbilled at the end of each year.

Stock-Based Compensation

Edison International measures compensation expense relative to stock-based compensation by the intrinsic-value method.

Note 2. Regulatory Matters

Electric Utility Industry Restructuring

On September 23, 1996, the State of California enacted legislation to provide a transition to a competitive market structure. The legislation substantially adopts the CPUC's December 1995 restructuring decision (discussed below) by addressing stranded-cost recovery for utilities, providing a certain cost recovery time period for the transition costs associated with utility-owned generation-related assets. Transition costs related to power-purchase contracts would be recovered through the terms of their contracts while most of the remaining transition costs would be recovered through 2001. The legislation also includes provisions to finance a portion of the stranded costs that residential and small commercial customers would have paid between 1998 and 2001, thereby allowing SCE to give a rate reduction of at least 10% to these customers, beginning January 1, 1998. The financing would occur with securities issued by the California Infrastructure and Economic Development Bank, or an entity approved by the Bank. The legislation includes a rate freeze for all other customers, including large commercial and industrial customers, as well as provisions for continued funding for energy conservation, low-income programs and renewable resources. Despite the rate freeze, SCE expects to be able to recover its revenue requirement based on cost-of-service regulation during the 1998-2001 transition period. In addition, the legislation mandates the implementation of a non-bypassable competition transition charge (CTC) that provides utilities the opportunity to recover costs made uneconomic by electric utility restructuring. Finally, the legislation contains provisions for the recovery (through 2006) of reasonable employee-related transition costs incurred and projected for retraining, severance, early retirement, outplacement and related expenses for utility workers. In light of the legislation, the CPUC is reassessing the need to prepare an environmental impact report.

In December 1995, the CPUC issued its decision on restructuring California's electric utility industry. The transition to a new market structure, which is expected to provide competition and customer choice, would begin January 1, 1998, with all consumers participating by 2003 (changed to 2002 by the recently enacted legislation). Key elements of the CPUC decision include:

- Creation of an independent power exchange (PX) to manage electric supply and demand. California's investor-owned utilities would be required to purchase from and sell to the exchange all of their power during the transition period, while other generators could voluntarily participate.
- Creation of an independent system operator (ISO) to have op-

Note 1. Summary of Significant Accounting Policies

The consolidated financial statements include Edison International and its wholly owned subsidiaries: Southern California Edison Company (SCE), a rate-regulated electric utility which produces and supplies electric energy for its 4.2 million customers in Central and Southern California; Edison Mission Energy (EME), a market leader in the development, ownership and operation of independent power facilities; Edison Capital, a leading provider of capital and financial services; Edison Source, a provider of integrated energy solutions; Edison EV, a provider of charging products and services for electric vehicles; and Edison Select, a consumer product and services company. The latter three subsidiaries were formed in 1996. EME and Edison Capital have domestic and international projects, primarily in Europe. Edison International's subsidiaries use the equity method to account for significant investments in partnerships and subsidiaries in which they own 50% or less. In 1994, EME began reporting its share in the Loy Yang B project under the full consolidation method (with minority interest), previously reported under the proportional consolidation method. Intercompany transactions have been eliminated, except EME's profits from energy sales to SCE, which are allowed in utility rates.

SCE's accounting policies conform with generally accepted accounting principles (GAAP), including the accounting principles for rate-regulated enterprises which reflect the rate-making policies of the California Public Utilities Commission (CPUC) and the Federal Energy Regulatory Commission (FERC).

SCE currently operates in a highly regulated environment in which it has an obligation to provide electric service to customers in return for an exclusive franchise within its service territory. This regulatory environment is changing, as further discussed in Note 2 to the Consolidated Financial Statements. EME operates predominantly in one industry segment: independent, electric power generation. EME's projects generally sell power to a limited number of electric utilities pursuant to long-term (15 to 30 years) contracts. EME's plants are located in different geographic areas in order to mitigate the effects of regional markets, economic down-turns or unusual weather conditions.

Financial statements prepared in compliance with GAAP require management to make estimates and assumptions that affect the amounts reported in the financial statements and disclosure of contingencies. Actual results could differ from those estimates. Certain significant estimates related to electric utility industry restructuring, decommissioning and contingencies, are further discussed in Notes 2, 9 and 10, respectively.

Certain prior-year amounts were reclassified to conform to the December 31, 1996, financial statement presentation.

Debt Issuance and Reacquisition Expense

Debt premium, discount and issuance expenses are amortized over the life of each issue. Under CPUC rate-making procedures, debt reacquisition expenses are amortized over the remaining life of the reacquired debt or, if refinanced, the life of the new debt.

Financial Instruments

Edison International enters into interest rate swap and cap agreements to manage its interest rate exposure. Interest rate differentials and premiums for interest rate caps to be paid or received are recorded as adjustments to interest expense. EME enters into electricity rate swap agreements to manage its exposure to market (pool) price volatility. Related price differentials to be paid or received are recorded as adjustments to diversified revenue.

Fuel Inventory

Fuel inventory is valued under the last-in, first-out method for fuel oil and natural gas, and under the first-in, first-out method for coal.

Investments

Cash equivalents include tax-exempt investments ($376 million at December 31, 1996, and $313 million at December 31, 1995), and time deposits and other investments ($320 million at December 31, 1996, and $134 million at December 31, 1995) with maturities of three months or less.

Net unrealized gains (losses) in equity investments are recorded as a separate component of shareholders' equity under "Unrealized gain (loss) in equity investments—net." Unrealized gains and losses on decommissioning trust funds are recorded in the accumulated provision for decommissioning.

All investments are classified as available-for-sale.

Nuclear

The CPUC authorized rate phase-in plans to defer the collection of $200 million in revenue for each unit at the Palo Verde Nuclear Generating Station during the first four years of operation and recover the deferred revenue (including interest) evenly over the following six years. The phase-in plans ended in February 1996 and September 1996 for Units 1 and 2, respectively. The plan ends in January 1998 for Unit 3.

Decommissioning costs are accrued and recovered in rates over the term of each nuclear facility's operating license through charges to decommissioning expense (see Note 9).

Under the Energy Policy Act of 1992, SCE is liable for its share of the estimated costs to decommission three federal nuclear enrichment facilities (based on purchases). These costs, which will be paid over 15 years, are recorded as a fuel cost and recovered through customer rates.

In August 1992, the CPUC approved a settlement agreement between SCE and the CPUC's Office (formerly Division) of Ratepayer Advocates (ORA) to discontinue operation of San Onofre Nuclear Generating Station Unit 1 at the end of its then-current fuel cycle because operation of the unit was no longer cost-effective. In November 1992, SCE discontinued operation of Unit 1. As part of the agreement, SCE recovered its remaining investment over a four-year period ending August 1996, earning an 8.98% rate of return on rate base.

In October 1994, the CPUC authorized accelerated recovery of SCE's nuclear plant investments by $75 million per year, with a corresponding deceleration in recovery of its transmission and distribution assets through revised depreciation estimates over their remaining useful lives.

Consolidated Statements of Cash Flows

In millions — *Year ended December 31,*	1996	1995	1994
Cash flows from operating activities:			
Net income	$ 717	$ 739	$ 681
Adjustments for non-cash items:			
Depreciation and decommissioning	1,173	1,014	945
Amortization	96	73	134
Rate phase-in plan	79	111	123
Deferred income taxes and investment tax credits	91	(166)	22
Equity in income from partnerships and unconsolidated subsidiaries	(158)	(115)	(130)
Other long-term liabilities	80	33	44
Other—net	(94)	—	(79)
Changes in working capital:			
Receivables	68	(27)	(98)
Regulatory balancing accounts	(156)	282	(2)
Fuel inventory, materials and supplies	39	(19)	(21)
Prepayments and other current assets	13	(17)	14
Accrued interest and taxes	3	19	121
Accounts payable and other current liabilities	70	13	97
Distributions from partnerships and unconsolidated subsidiaries	176	178	205
Net cash provided by operating activities	2,197	2,118	2,056
Cash flows from financing activities:			
Long-term debt issued	1,365	1,496	314
Long-term debt repayments	(1,315)	(960)	(507)
Preferred securities issued	414	63	88
Preferred securities redemptions	—	(75)	—
Common stock repurchases	(344)	(70)	—
Short-term debt financing—net	(312)	(46)	141
Dividends paid	(440)	(447)	(549)
Other—net	45	31	(31)
Net cash used by financing activities	(587)	(8)	(544)
Cash flows from investing activities:			
Additions to property and plant	(744)	(969)	(1,137)
Purchase of nonutility power stations	—	(1,015)	—
Funding of nuclear decommissioning trusts	(148)	(151)	(130)
Investments in partnerships and unconsolidated subsidiaries	(333)	(45)	(201)
Unrealized gain in equity investments—net	15	8	10
Other—net	(10)	35	59
Net cash used by investing activities	(1,220)	(2,137)	(1,399)
Net increase (decrease) in cash and equivalents	390	(27)	113
Cash and equivalents, beginning of year	507	534	421
Cash and equivalents, end of year	$ 897	$ 507	$ 534
Cash payments for interest and taxes:			
Interest	$ 486	$ 463	$ 470
Taxes	447	642	320
Non-cash investing and financing activities:			
Obligation to fund investments in partnerships and unconsolidated subsidiaries	237	466	29
Additions to property and plant funded by the minority owner of consoldiated subsidiaries	33	77	95
Goodwill related to purchase of nonutility power stations	—	312	—

The accompanying notes are an integral part of these financial statements.

In millions, except share amounts — *December 31,*	1996	1995
CAPITALIZATION AND LIABILITIES		
Common shareholders' equity:		
Common stock (424,524,178 and 443,607,674 shares outstanding at respective dates)	$ 2,547	$ 2,660
Cumulative translation adjustments—net	64	15
Unrealized gain in equity investments—net	33	18
Retained earnings	3,753	3,700
	6,397	6,393
Preferred securities of subsidiaries:		
Not subject to mandatory redemption	284	284
Subject to mandatory redemption	425	425
Long-term debt	7,475	7,195
Total capitalization	14,581	14,297
Other long-term liabilities	424	344
Current portion of long-term debt	592	40
Short-term debt	397	710
Accounts payable	438	420
Accrued taxes	530	557
Accrued interest	131	101
Dividends payable	109	113
Regulatory balancing accounts —net	182	338
Deferred unbilled revenue and other current liabilities	1,059	973
Total current liabilities	3,438	3,252
Accumulated deferred income taxes—net	4,283	4,352
Accumulated deferred investment tax credits	372	405
Customer advances and other deferred credits	754	666
Total deferred credits	5,409	5,423
Minority interest	707	630
Commitments and contingencies (Notes 2, 8, 9 and 10)		
Total capitalization and liabilities	$ 24,559	$ 23,946

The accompanying notes are an integral part of these financial statements.

Consolidated Balance Sheets

In millions	*December 31,*	1996	1995
ASSETS			
Utility plant, at original cost		$ 20,400	$ 19,850
Less — accumulated provision for depreciation and decommissioning		9,431	8,569
		10,969	11,281
Construction work in progress		557	728
Nuclear fuel, at amortized cost		177	139
Total utility plant		11,703	12,148
Nonutility property — less accumulated provision for depreciation of $203 and $134 at respective dates		3,570	3,141
Nuclear decommissioning trusts		1,486	1,260
Investments in partnerships and unconsolidated subsidiaries		1,372	1,190
Investments in leveraged leases		584	574
Other investments		104	66
Total other property and investments		7,116	6,231
Cash and equivalents		897	507
Receivables, including unbilled revenue, less allowances of $26 and $24 for uncollectible accounts at respective dates		1,095	1,055
Fuel inventory		72	115
Materials and supplies, at average cost		154	151
Accumulated deferred income taxes—net		240	477
Prepayments and other current assets		114	126
Total current assets		2,572	2,431
Unamortized debt issuance and reacquisition expense		347	350
Rate phase-in plan		51	130
Unamortized nuclear plant — net		—	67
Income tax-related deferred charges		1,741	1,724
Other deferred charges		1,029	865
Total deferred charges		3,168	3,136
Total assets		$ 24,559	$ 23,946

The accompanying notes are an integral part of these financial statements.

Consolidated Statements of Income

In millions, except per-share amounts — *Year ended December 31,*	1996	1995	1994
Electric utility revenue	$ 7,583	$ 7,873	$ 7,799
Diversified operations	962	532	546
Total operating revenue	8,545	8,405	8,345
Fuel	768	694	896
Purchased power	2,706	2,582	2,563
Provisions for regulatory adjustment clauses—net	(226)	230	55
Other operating expenses	1,555	1,411	1,563
Maintenance	331	359	332
Depreciation and decommissioning	1,173	1,014	945
Income taxes	563	528	481
Property and other taxes	197	210	211
Total operating expenses	7,067	7,028	7,046
Operating income	1,478	1,377	1,299
Provision for rate phase-in plan	(84)	(122)	(137)
Allowance for equity funds used during construction	16	19	14
Interest income	63	65	41
Minority interest	(70)	(48)	(46)
Other nonoperating income—net	(13)	41	97
Total other income (deductions)—net	(88)	(45)	(31)
Income before interest and other expenses	1,390	1,332	1,268
Interest on long-term debt	604	539	527
Other interest expense	90	81	79
Allowance for borrowed funds used during construction	(10)	(14)	(14)
Capitalized interest	(58)	(60)	(46)
Dividends on subsidiary preferred securities	47	47	41
Total interest and other expenses—net	673	593	587
Net income	$ 717	$ 739	$ 681
Weighted-average shares of common stock outstanding	437	446	448
Earnings per share	$ 1.64	$ 1.66	$ 1.52

Consolidated Statements of Retained Earnings

In millions, except per-share amounts — *Year ended December 31,*	1996	1995	1994
Balance at beginning of year	$ 3,700	$ 3,452	$ 3,266
Net income	717	739	681
Dividends declared on common stock	(435)	(446)	(495)
Stock repurchase and retirement	(229)	(45)	—
Balance at end of year	$ 3,753	$ 3,700	$ 3,452
Dividends declared per common share	$ 1.00	$ 1.00	$ 1.105

The accompanying notes are an integral part of these financial statements.

Responsibility for Financial Reporting

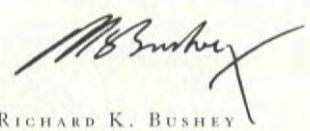
The management of Edison International is responsible for the integrity and objectivity of the accompanying financial statements. The statements have been prepared in accordance with generally accepted accounting principles applied on a consistent basis and are based, in part, on management estimates and judgment.

Edison International and its subsidiaries maintain systems of internal control to provide reasonable, but not absolute, assurance that assets are safeguarded, transactions are executed in accordance with management's authorization and the accounting records may be relied upon for the preparation of the financial statements. There are limits inherent in all systems of internal control, the design of which involves management's judgment and the recognition that the costs of such systems should not exceed the benefits to be derived. Edison International believes its systems of internal control achieve this appropriate balance. These systems are augmented by internal audit programs through which the adequacy and effectiveness of internal controls and policies and procedures are monitored, evaluated and reported to management. Actions are taken to correct deficiencies as they are identified.

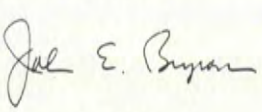
Edison International's independent public accountants, Arthur Andersen LLP, are engaged to audit the financial statements in accordance with generally accepted auditing standards and to express an informed opinion on the fairness, in all material respects, of Edison International's reported results of operations, cash flows and financial position.

As a further measure to assure the ongoing objectivity of financial information, the audit committee of the board of directors, which is composed of outside directors, meets periodically, both jointly and separately, with management, the independent public accountants and internal auditors, who have unrestricted access to the committee. The committee recommends annually to the board of directors the appointment of a firm of independent public accountants to conduct audits of its financial statements; considers the independence of such firm and the overall adequacy of the audit scope and Edison International's systems of internal control; reviews financial reporting issues; and is advised of management's actions regarding financial reporting and internal control matters.

Edison International and its subsidiaries maintain high standards in selecting, training and developing personnel to assure that their operations are conducted in conformity with applicable laws and are committed to maintaining the highest standards of personal and corporate conduct. Management maintains programs to encourage and assess compliance with these standards.



RICHARD K. BUSHEY
Vice President and Controller



JOHN E. BRYSON
Chairman of the Board and Chief Executive Officer

January 31, 1997

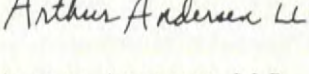
Report of Independent Public Accountants

To the Shareholders and the Board of Directors, Edison International:

We have audited the accompanying consolidated balance sheets of Edison International (a California corporation) and its subsidiaries as of December 31, 1996, and 1995, and the related consolidated statements of income, retained earnings and cash flows for each of the three years in the period ended December 31, 1996. These financial statements are the responsibility of Edison International's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Edison International and its subsidiaries as of December 31, 1996, and 1995, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.



ARTHUR ANDERSEN LLP
Los Angeles, California

January 31, 1997 (except with respect to the "Subsequent Event" discussed under "Electric Utility Industry Restructuring" in Note 2, as to which the date is February 21, 1997).

remediate its 56 identified sites (55 at SCE and 1 at EME) was $114 million at December 31, 1996. One of SCE's sites, a former pole-treating facility, is considered a federal Superfund site and represents 71% of Edison International's recorded liability. The ultimate costs to clean up Edison International's identified sites may vary from its recorded liability due to numerous uncertainties inherent in the estimation process. Edison International believes that, due to these uncertainties, it is reasonably possible that cleanup costs could exceed its recorded liability by up to $211 million. The upper limit of this range of costs was estimated using assumptions least favorable to Edison International among a range of reasonably possible outcomes.

The CPUC allows SCE to recover environmental-cleanup costs at 35 of its sites, representing $101 million of Edison International's recorded liability, through an incentive mechanism. Under this mechanism, SCE will recover 90% of cleanup costs through customer rates; shareholders fund the remaining 10%, with the opportunity to recover these costs from insurance carriers and other third parties. SCE has successfully settled insurance claims with a number of its carriers. Costs incurred at SCE's remaining 20 sites are expected to be recovered through customer rates. SCE has recorded a regulatory asset of $104 million for its estimated minimum environmental-cleanup costs expected to be recovered through customer rates.

Edison International's identified sites include several sites for which there is a lack of currently available information, including the nature and magnitude of contamination, and the extent, if any, that Edison International may be held responsible for contributing to any costs incurred for remediating these sites. Thus, no reasonable estimate of cleanup costs can now be made for these sites.

Edison International expects to clean up its identified sites over a period of up to 30 years. Remediation costs in each of the next several years are expected to range from $4 million to $8 million. Recorded costs for 1996 were $7 million.

Based on currently available information, Edison International believes it is unlikely that it will incur amounts in excess of the upper limit of the estimated range and, based upon the CPUC's regulatory treatment of environmental-cleanup costs, Edison International believes that costs ultimately recorded will not have a material adverse effect on its results of operations or financial position. There can be no assurance, however, that future developments, including additional information about existing sites or the identification of new sites, will not require material revisions to such estimates.

The 1990 federal Clean Air Act requires power producers to have emissions allowances to emit sulfur dioxide. Power companies receive emissions allowances from the federal government and may bank or sell excess allowances. SCE expects to have excess allowances under Phase II of the Clean Air Act (2000 and later). The act also calls for a study to determine if additional regulations are needed to reduce regional haze in the southwestern U.S. In addition, another study is in progress to determine the specific impact of air contaminant emissions from the Mohave Coal Generating Station on visibility in Grand Canyon National Park. The potential effect of these studies on sulfur dioxide emissions regulations for Mohave is unknown.

Edison International's projected capital expenditures to protect the environment are $900 million for the 1997-2001 period, mainly for aesthetics treatment, including undergrounding certain transmission and distribution lines.

The possibility that exposure to electric and magnetic fields (EMF) emanating from power lines, household appliances and other electric sources may result in adverse health effects is receiving increased attention. The scientific community has not yet reached a consensus on the nature of any health effects of EMF. However, the CPUC has issued a decision which provides for a rate-recoverable research and public education program conducted by California electric utilities, and authorizes these utilities to take no-cost or low-cost steps to reduce EMF in new electric facilities. SCE is unable to predict when or if the scientific community will be able to reach a consensus on any health effects of EMF, or the effect that such a consensus, if reached, could have on future electric operations.

PALO VERDE STEAM TUBE RUPTURE

In 1993, a steam generator tube ruptured at Palo Verde Unit 2; additional cracking was found in other tubes. Arizona Public Service Company (APS), the operating agent for Palo Verde, has taken, and will continue to take, remedial actions that it believes have slowed the rate of steam generator tube degradation in all three units. APS believes that the steam generators in only one of the units will have to be replaced within five to ten years. Based on APS' 100% share estimate, SCE estimates its share of the costs to be between $22 million and $24 million, plus replacement power costs. SCE is evaluating APS' analyses, conducting its own review, and has not yet decided whether it supports replacement of the steam generators.

WORKFORCE REDUCTIONS

During 1996, Edison International offered a voluntary retirement program to certain eligible employees. Approximately 3,000 employees (2,200 non-represented and 800 represented employees) accepted the terms of this program. After allowance for the effects of pension settlement gains at SCE, Edison International's net expense for this program was $7 million.

PROPOSED NEW ACCOUNTING STANDARD

During 1996, the Financial Accounting Standards Board issued an exposure draft that would establish accounting standards for the recognition and measurement of closure and removal obligations. The exposure draft would require the estimated present value of an obligation to be recorded as a liability, along with a corresponding increase in the plant or regulatory asset accounts when the obligation is incurred. If the exposure draft is approved in its present form, it would affect SCE's accounting practices for the decommissioning of its nuclear power plants, obligations for coal mine reclamation costs and any other activities related to the closure or removal of long-lived assets. SCE does not expect that the accounting changes proposed in the exposure draft would have an adverse effect on its results of operations even after deregulation due to its current and expected future ability to recover these costs through customer rates. The nonutility subsidiaries are currently reviewing what impact the exposure draft may have on their results of operations and financial position.

CTC. The filing was in response to CPUC and FERC directives which require electric services, such as T&D, to be functionally separate and available to all customers on a nondiscriminatory basis without cost-shifting among customers. On December 6, 1996, SCE filed a more comprehensive plan for the functional unbundling of SCE's rates for electric service, beginning on January 1, 1998. In response to CPUC and FERC orders, as well as the new restructuring legislation, this filing addressed the implementation-level detail for the functional unbundling of rates in separate charges for energy, transmission, distribution, the CTC, public benefit programs and nuclear decommissioning. The filing also included proposals for establishing new regulatory proceedings to replace current proceedings that will no longer be necessary during the rate freeze period.

Although depreciation-related differences could result from applying a regulatory prescribed depreciation method (straight-line, remaining-life method) rather than a method that would have been applied absent the regulatory process, SCE believes that the depreciable lives of its generation-related assets would not vary significantly from that of an unregulated enterprise, as the CPUC bases depreciable lives on periodic studies that reflect the physical useful lives of the assets. SCE also believes that any depreciation-related differences would be recovered through the CTC.

If events occur during the restructuring process that result in all or a portion of the CTC being improbable of recovery, SCE could have write-offs associated with these costs if they are not recovered through another regulatory mechanism. At this time, SCE cannot predict what other revisions will ultimately be made during the restructuring process in subsequent proceedings or implementation phases, or the effect, after the transition period, that competition will have on its results of operations or financial position.

Subsequent Event

If the CPUC's restructuring is implemented as outlined, SCE would be allowed to recover its CTC (subject to a lower return on equity) and believes it should be allowed to continue to apply accounting standards that recognize the economic effects of rate regulation for its generation-related assets during the 1998-2001 transition period. However, in response to a request by the staff of the Securities and Exchange Commission (SEC), in December 1996 SCE submitted its views on the continued applicability of regulatory accounting standards for its generation-related assets. In its submittal, SCE and its independent accountants jointly concluded that, based on their current analysis, SCE will continue to meet the criteria for applying these accounting standards through the 1998-2001 transition period. In its February 1997 response, the SEC staff expressed continuing concern with SCE's conclusion and indicated that they wanted to meet further with SCE and the other major California electric utilities to resolve this matter. SCE and its independent accountants continue to believe that SCE meets such criteria and plan to meet with the SEC staff to present additional and clarifying information seeking to convince the SEC staff of the merits of SCE's position. The authority to require SCE to discontinue applying regulatory accounting standards rests with the SEC. If SCE is required to discontinue the application of these accounting standards for its generation-related assets, it would have to write off generation-related regulatory assets, which at December 31, 1996, totaled approximately $600 million on an after-tax basis, primarily for the recovery of income tax benefits previously flowed-through to customers, the Palo Verde phase-in plan and unamortized loss on reacquired debt.

SCE believes that a proper application of regulatory accounting standards will result in it no longer meeting the criteria to apply these accounting standards to all of its non-hydroelectric generation-related assets after the end of the 1998-2001 transition period. If SCE continues the application of these accounting standards during the transition period, but during the transition period events occur that result in SCE no longer meeting the criteria for applying such standards, SCE may be required to write off the remaining balance of its recorded generation-related regulatory assets existing at that time.

If a non-cash write-off is required, SCE believes that it should not affect the stranded-cost recovery plans set forth in the CPUC's December 1995 restructuring decision and legislation enacted by the State of California in September 1996.

FERC Stranded Cost/Open Access Transmission Decision

In April 1996, the FERC issued its decision on stranded cost recovery and open access transmission, effective July 1996. The decision requires all electric utilities subject to the FERC's jurisdiction to file transmission tariffs which provide competitors with increased access to transmission facilities for wholesale transactions and also establishes information requirements for the transmission utility. The decision also provides utilities with the recovery of stranded costs, which are prior-service costs incurred under the current regulatory framework. In addition to providing recovery of stranded costs associated with existing wholesale customers, the FERC directed that it would have primary jurisdiction over the recovery of stranded costs associated with retail-turned-wholesale customers, such as the formation of a new municipal electric system. Retail stranded costs resulting from a state-authorized retail direct-access program are the responsibility of the states and the FERC would only address recovery of these costs if the state has no authority to do so. In compliance with the April 1996 FERC decision, SCE filed a revised open access tariff with the FERC in July 1996. The tariff became effective on an interim basis, subject to refund, as of its filing date. Several wholesale customers have filed protests with the FERC on the transmission rate levels, and a ruling from the FERC setting the rates to be decided at formal hearings is anticipated in early 1997.

Environmental Protection

Edison International is subject to numerous environmental laws and regulations, which require it to incur substantial costs to operate existing facilities, construct and operate new facilities, and mitigate or remove the effect of past operations on the environment.

As further discussed in Note 10 to the Consolidated Financial Statements, Edison International records its environmental liabilities when site assessments and/or remedial actions are probable and a range of reasonably likely cleanup costs can be estimated. Edison International reviews its sites and measures the liability quarterly, by assessing a range of reasonably likely costs for each identified site. Unless there is a probable amount, Edison International records the lower end of this range of costs.

Edison International's recorded estimated minimum liability to

pare an environmental impact report.

In December 1995, the CPUC issued its decision on restructuring California's electric utility industry. The transition to a new market structure, which is expected to provide competition and customer choice, would begin January 1, 1998, with all consumers participating by 2003 (changed to 2002 by the recently enacted legislation). Key elements of the CPUC decision include:

- Creation of an independent power exchange (PX) to manage electric supply and demand. California's investor-owned utilities would be required to purchase from and sell to the exchange all of their power during the transition period, while other generators could voluntarily participate.
- Creation of an independent system operator (ISO) to have operational control of the utilities' transmission facilities and, therefore, control the scheduling and dispatch of all electricity on the state's power grid.
- Availability of customer choice through time-of-use rates, direct customer access to generation providers with transmission arrangements through the system operator, and customer-arranged "contracts for differences" to manage price fluctuations from the PX.
- Recovery of costs to transition to a competitive market (utility investments, obligations incurred to serve customers under the existing framework and reasonable employee-related costs) through a non-bypassable charge, applied to all customers, called the CTC.
- CPUC-established incentives to encourage voluntary divestiture (through spin-off or sale to an unaffiliated entity) of at least 50% of utilities' gas-fueled generation to address market power issues.
- Performance-based ratemaking (PBR) for those utility services not subject to competition.

In April 1996, SCE, Pacific Gas & Electric Company and San Diego Gas & Electric Company filed a proposal with the FERC regarding the creation of the PX and the ISO. On November 26, 1996, the FERC conditionally accepted the proposal and directed the three utilities to file more specific information by March 31, 1997. In July 1996, the three utilities jointly filed an application with the CPUC requesting approval to establish a restructuring trust which would obtain loans up to $250 million for the development of the ISO and PX through January 1, 1998. The loans would be backed by utility guarantees; SCE's share would be 45%. Once the ISO and PX are formed, they will repay the trust's loans and recover funds from future ISO and PX customers. In August 1996, the CPUC issued an interim order establishing the restructuring trust and the funding level of $250 million which will be used to build the hardware and software systems for the ISO and PX.

Recovery of costs to transition to a competitive market would be implemented through a non-bypassable CTC. This charge would apply to all customers who were using or began using utility services on or after the December 20, 1995, decision date. In August 1996, in compliance with the CPUC's restructuring decision, SCE filed its application to estimate its 1998 transition costs. In October 1996, SCE amended its transition cost filing to reflect the effects of the legislation enacted in September 1996. Under the rate freeze codified in the legislation, the CTC will be determined residually (i.e., after subtracting other cost components for the PX, transmission and distribution (T&D), nuclear decommissioning and public benefit programs). Nevertheless, the CPUC directed that the amended application provide estimates of SCE's potential transition costs from 1998 through 2030. SCE provided two estimates between approximately $13.1 billion (1998 net present value), assuming the fossil plants have a market value equal to the net book value, and $13.8 billion (1998 net present value), assuming the fossil plants have no market value. These estimates are based on incurred costs, and forecasts of future costs and assumed market prices. However, changes in the assumed market prices could materially affect these estimates. The potential transition costs are comprised of: $7.5 billion from SCE's qualifying facility contracts, which are the direct result of legislative and regulatory mandates; and $5.6 billion to $6.3 billion from costs pertaining to certain generating plants and regulatory commitments consisting of costs incurred (whose recovery has been deferred by the CPUC) to provide service to customers. Such commitments include the recovery of income tax benefits previously flowed-through to customers, postretirement benefit transition costs, accelerated recovery of San Onofre (as discussed in Note 1 to the Consolidated Financial Statements) and Palo Verde, nuclear decommissioning and certain other costs.

On November 27, 1996, SCE filed an application with the CPUC to voluntarily divest, by auction, all of its oil- and gas-fueled generation assets. This application builds on SCE's March 1996 plan which outlined how SCE proposed to divest 50% of these assets. Under the new proposal, SCE would continue to operate and maintain the divested power plants for at least two years following their sale, as mandated by the recent restructuring legislation. In addition, SCE would offer workforce transition programs to those employees who may be impacted by divestiture-related job reductions. SCE's proposal is contingent on the overall electric industry restructuring implementation process continuing on a satisfactory path. CPUC approval of the oil- and gas-fueled generation divestiture was requested for late 1997.

In September 1996, the CPUC adopted a non-generation T&D PBR mechanism for SCE which began on January 1, 1997. According to the CPUC decision, beginning in 1998, the transmission portion is to be separated from non-generation PBR and subject to ratemaking under the rules of the FERC. The distribution-only PBR will extend through December 2001. Key elements of the non-generation PBR include: T&D rates indexed for inflation based on the Consumer Price Index less a productivity factor; elimination of the kilowatt-hour sales adjustment; adjustments for cost changes that are not within SCE's control; a cost of capital trigger mechanism based on changes in a bond index; standards for service reliability and safety; and a net revenue-sharing mechanism that determines how customers and shareholders will share gains and losses from T&D operations. In July 1996, SCE filed a PBR proposal for its hydroelectric plants and a proposed structure for performance-based local reliability contracts for certain fossil-fueled plants. If approved, the hydro PBR would be in effect for three years and the initial terms of the local reliability contracts, which are subject to FERC approval, would be in effect for up to three years, both beginning January 1, 1998. A final CPUC decision on hydro PBR is expected by year-end 1997.

In July 1996, SCE filed a proposal with the CPUC related to the conceptual aspects of separating the costs associated with generation, transmission, distribution, public benefit programs and the

sonably expected to correlate with foreign exchange movements. Various statistical forecasting techniques are used to help assess foreign exchange risk and the probabilities of various outcomes. There can be no assurance, however, that fluctuations in exchange rates will be fully offset by hedges or that currency movements and the relationship between certain macro economic variables will behave in a manner that is consistent with historical or forecasted relationships.

Projected Capital Requirements

Edison International's projected construction expenditures for the next five years are: 1997—$855 million; 1998—$636 million; 1999—$664 million; 2000—$647 million; and 2001—$650 million.

Long-term debt maturities and sinking fund requirements for the next five years are: 1997—$573 million; 1998—$560 million; 1999—$459 million; 2000—$405 million; and 2001—$500 million.

Regulatory Matters

SCE's 1997 CPUC-authorized rates remain unchanged from 1996 levels due to recently enacted legislation which requires that system average rates remain frozen at the June 10, 1996, level of 10.1¢ per kilowatt-hour (see discussion in Competitive Environment).

The CPUC's 1997 cost-of-capital decision authorized SCE's equity ratio to remain at 48%. SCE's return on common equity also remains at 11.6%. SCE's return on rate base was lowered from 9.55% to 9.49%. This decision, excluding the effects of other rate actions, would reduce 1997 earnings by approximately 1¢ per share.

A 1994 CPUC decision stated that SCE was liable for expenditures related to a 1985 accident at the Mohave Generating Station. In July 1996, the CPUC approved a settlement agreement between SCE and the Office of Ratepayer Advocates (ORA) which resulted in a $39 million (including interest) refund to SCE's customers. The refund, which had been previously reserved, was completed by year-end 1996.

In May 1994, SCE filed its testimony in the non-Qualifying Facilities phase of the 1994 Energy Cost Adjustment Clause proceeding. In May 1995, the ORA filed its report on the reasonableness of SCE's gas supply costs for both the 1993 and 1994 record periods. The report recommends a disallowance of $13.3 million for excessive costs incurred from November 1993 through March 1994 associated with SCE's Canadian gas purchase and supply contracts. The report requests that the CPUC defer finding SCE's Canadian supply and transportation agreements reasonable for the duration of their terms and that the costs under these contracts be reviewed on a yearly basis. In October 1996, the ORA issued its report for the 1995 record period recommending a $37.6 million disallowance for excessive costs incurred from April 1994 through March 1995. Both proposed disallowances have been consolidated into one proceeding. SCE and the ORA have filed several rounds of testimony on this issue. Hearings began in January 1997 and are expected to conclude in February 1997. A decision is expected in late 1997.

On December 23, 1996, the CPUC issued a final decision on SCE's proposal for a new rate mechanism for its 15.8% share of the three units at Palo Verde. The decision adopts the Palo Verde All-Party Settlement filed with the CPUC on November 15, 1996. The settlement was based on a Memorandum of Understanding signed by all of the active parties to the Palo Verde proceeding. Under the settlement, SCE has the opportunity to recover its remaining investment (approximately $1.2 billion) in Palo Verde beginning January 1, 1997, and ending December 31, 2001, earning a reduced rate of return on rate base of 7.35% instead of the current 9.49%. Also, SCE will utilize a balancing account to pass through Palo Verde's incremental operating costs (considered reasonable as long as they do not exceed 30% of a baseline forecast and the site's gross annual capacity factor does not go below 55%) to ratepayers. Beginning January 1, 1998, this balancing account will become part of the competition transition charge (CTC) mechanism. If SCE's actual costs are less than the forecast, the difference will benefit ratepayers as a credit to the CTC mechanism. The existing nuclear unit incentive procedure will continue only for purposes of calculating a reward for performance of any unit above an 80% capacity factor for a fuel cycle. After 2001, SCE's ratepayers will receive 50% of the benefits derived from the operation of Palo Verde. The decision is projected to reduce SCE's 1997 earnings by approximately 5¢ per share.

Competitive Environment

SCE currently operates in a highly regulated environment in which it has an obligation to provide electric service to customers in return for an exclusive franchise within its service territory. This regulatory environment is changing. The generation sector has experienced competition from nonutility power producers and regulators are restructuring California's electric utility industry.

On September 23, 1996, the State of California enacted legislation to provide a transition to a competitive market structure. The legislation substantially adopts the CPUC's December 1995 restructuring decision (discussed below) by addressing stranded-cost recovery for utilities, providing a certain cost recovery time period for the transition costs associated with utility-owned generation-related assets. Transition costs related to power-purchase contracts would be recovered through the terms of their contracts while most of the remaining transition costs would be recovered through 2001. The legislation also includes provisions to finance a portion of the stranded costs that residential and small commercial customers would have paid between 1998 and 2001, thereby allowing SCE to give a rate reduction of at least 10% to these customers, beginning January 1, 1998. The financing would occur with securities issued by the California Infrastructure and Economic Development Bank, or an entity approved by the Bank. The legislation includes a rate freeze for all other customers, including large commercial and industrial customers, as well as provisions for continued funding for energy conservation, low-income programs and renewable resources. Despite the rate freeze, SCE expects to be able to recover its revenue requirement based on cost-of-service regulation during the 1998-2001 transition period. In addition, the legislation mandates the implementation of a non-bypassable CTC that provides utilities the opportunity to recover costs made uneconomic by electric utility restructuring. Finally, the legislation contains provisions for the recovery (through 2006) of reasonable employee-related transition costs incurred and projected for retraining, severance, early retirement, outplacement and related expenses for utility workers. In light of the legislation, the CPUC is reassessing the need to pre-

requirements. Edison International's unsecured lines of credit are at negotiated or bank index rates with various expiration dates; the majority have five-year terms.

SCE's short-term debt is used to finance fuel inventories, balancing account undercollections and general cash requirements. EME uses available credit lines mainly for construction projects until long-term construction or project loans are secured. Long-term debt is used mainly to finance capital expenditures. SCE's external financings are influenced by market conditions and other factors, including limitations imposed by its articles of incorporation and trust indenture. As of December 31, 1996, SCE could issue approximately $7.9 billion of additional first and refunding mortgage bonds and $4.5 billion of preferred stock at current interest and dividend rates.

EME owns, through a wholly owned subsidiary, 50% of the Brooklyn Navy Yard project, but funded all of the required equity during construction. The estimated total cost is $485 million, of which $442 million had been spent through December 31, 1996. In December 1995, a tax-exempt bond financing for the project in the amount of $254 million was obtained through the New York City Industrial Development Agency (NYCIDA). EME has guaranteed the obligations of the project pursuant to the financing, as well as an indemnity agreement on behalf of NYCIDA in the amount of $40 million. In the fourth quarter of 1996, EME executed a new energy sales agreement with Consolidated Edison Company of New York, which has contracted to buy most of the project's power and steam, and began selling power and steam under that agreement. The contractor has recently asserted general monetary claims under the turnkey agreement against Brooklyn Navy Yard and has served a complaint for damages in the amount of $136.8 million against Brooklyn Navy Yard. Brooklyn Navy Yard intends to vigorously defend this action and to assert general monetary claims against the contractor. EME believes that the outcome of this litigation will not have a material adverse effect on its consolidated results of operations or financial position.

EME has firm commitments to make equity and other contributions to its projects of $408 million, primarily for the Paiton project in Indonesia and the ISAB project in Italy. EME also has contingent obligations to make additional contributions of $461 million, primarily for a guarantee as a condition of obtaining a $254 million tax-exempt financing for the Brooklyn Navy Yard project (further discussed in Note 10 to the Consolidated Financial Statements), and equity support guarantees related to Paiton.

EME may incur additional obligations to make equity and other contributions to projects in the future. EME believes it will have sufficient liquidity to meet these equity requirements from cash provided by operating activities, proceeds from the repayment of loans to energy projects, funds available from EME's revolving line of credit and additional corporate borrowings.

California law prohibits SCE from incurring or guaranteeing debt for its nonutility affiliates. Additionally, the CPUC regulates SCE's capital structure, limiting the dividends it may pay Edison International. At December 31, 1996, SCE had the capacity to pay $112 million in additional dividends to Edison International and continue to maintain its authorized capital structure. These restrictions are not expected to affect Edison International's ability to meet its cash obligations.

Cash Flows from Investing Activities

The primary uses of cash for investing activities are additions to property and plant, the nonutilities' investments in partnerships and unconsolidated subsidiaries, and funding of nuclear decommissioning trusts. Decommissioning costs are accrued and recovered in rates over the term of each nuclear generating facility's operating license through charges to depreciation expense. SCE estimates that it will spend approximately $12.7 billion between 2013-2070 to decommission its nuclear facilities. This estimate is based on SCE's current-dollar decommissioning costs ($2.0 billion), escalated using a 6.65% annual rate. These costs are expected to be funded from independent decommissioning trusts which receive SCE contributions of approximately $100 million per year until decommissioning begins.

Cash used for the nonutility subsidiaries' investing activities was $409 million in 1996, $1.2 billion in 1995 and $291 million in 1994. The 1995 increase was due to the acquisition of First Hydro.

Edison International's risk management policy allows the use of derivative financial instruments to mitigate risk. Changes in interest rates, electricity pool pricing and fluctuations in foreign currency exchange rates can have a significant impact on EME's results of operations. EME attempts to mitigate the risk of interest rate fluctuations by arranging for fixed rate or variable rate financing with interest rate swaps or other hedging mechanisms for the majority of its project financings. As a result of interest rate hedging mechanisms, interest expense increased $6 million in 1996, $7 million in 1995 and $8 million in 1994. The maturity dates of several of EME's interest rate swap agreements do not correspond to the term of the underlying debt. EME does not believe that interest rate fluctuations will have a material adverse effect on results of operations or financial position.

Projects in the United Kingdom sell their energy and capacity through a centralized electricity pool, which establishes a half-hourly clearing price for electric energy and capacity. The pool price is extremely volatile, and can vary by a factor of ten or more over the course of a few hours due to large differentials in demand according to the time of day. First Hydro mitigates a portion of the market risk of the pool by entering into contracts for differences (electricity rate swap agreements), related to either the selling or purchase price of power, whereby a contract specifies a price at which the electricity will be traded, and the parties to the agreements make payments, calculated based on the difference between the price in the contract and the half hourly clearing price for the element of power under contract. These contracts act as a means of stabilizing production revenue or purchasing costs by removing an element of First Hydro's net exposure to pool price volatility. First Hydro's electric revenue decreased by $5 million and $29 million, respectively, for the year ended December 31, 1996, and 1995, as a result of electricity rate swap agreements.

As EME continues to expand into foreign markets, fluctuations in foreign currency exchange rates will continue to affect the amount of its equity contributions to, distributions from, and results of operations for, its foreign projects. At times, EME has hedged a portion of its current exposure to fluctuations in foreign exchange rates where it deems appropriate through financial derivatives, offsetting obligations denominated in foreign currencies, and indexing underlying project agreements to U.S. dollars or other indices rea-

fall, resulting in lower gas purchases. In addition, the San Onofre Nuclear Generating Station units were out of service a total of five months in 1995 for refueling and maintenance, causing a decrease in nuclear fuel expense. The decline at SCE was partially offset by an increase at EME, as its Roosecote project operated for a full year in 1995 after experiencing transformer failure and scheduled maintenance for four months in 1994.

Purchased-power expense increased slightly in 1996 and 1995, due to an increase in power purchased under federally mandated contracts. SCE is required under federal law to purchase power from certain nonutility generators even though energy prices under these contracts are generally higher than other sources. In 1996, SCE paid about $1.7 billion (including energy and capacity payments) more for these power purchases than the cost of power available from other sources. The CPUC has mandated the prices for these contracts.

Provisions for regulatory adjustment clauses decreased substantially in 1996, compared to 1995. The decrease is mainly due to the energy-cost balancing account-related refund discussed above, lower base rate revenue and undercollections related to the accelerated recovery of SCE's remaining investment in San Onofre Units 2 and 3 (see discussion in Note 1 to the Consolidated Financial Statements). The provisions increased in 1995 over 1994, as CPUC-authorized fuel and purchased-power cost estimates exceeded SCE's actual energy costs. SCE's actual energy costs were lower than estimated in 1995 due to the increase in hydro generation and lower gas prices.

Other operating expenses increased 10% in 1996 when compared with 1995, as increased operating costs at EME's First Hydro, Iberian Hy-Power and Loy Yang B Unit 2 projects offset cost reductions and improved operating efficiencies at SCE. Other operating expenses decreased in 1995 when compared to 1994, primarily due to operating efficiencies at SCE. These decreases were partially offset by an increase at EME from its acquisition of First Hydro.

Maintenance expense decreased 8% in 1996, due to lower overall costs at SCE's generation, transmission and distribution operating facilities. Maintenance expense increased 8% in 1995, due to higher expenses related to the scheduled refueling and maintenance outages at San Onofre Units 2 and 3.

Depreciation and decommissioning expense increased 16% in 1996 due to higher depreciation rates, the accelerated recovery of San Onofre Units 2 and 3, and increases at EME related to its First Hydro, Loy Yang B Unit 2 and Iberian Hy-Power projects.

Income taxes increased 7% during 1996, mainly due to an increase in the deferred tax provision related to the accelerated recovery of San Onofre Units 2 and 3 and increased earnings at EME from its First Hydro project. Earnings from First Hydro are subject to a higher effective tax rate than the federal statutory rate.

Other Income and Deductions

The provision for rate phase-in plan reflects a CPUC-authorized, 10-year rate phase-in plan, which deferred the collection of revenue during the first four years of operation for the Palo Verde Nuclear Generating Station. The deferred revenue (including interest) is being collected evenly over the final six years of each unit's plan. The plan ended in February 1996 and September 1996 for Units 1 and 2, respectively. The plan ends in January 1998 for Unit 3. The provision is a non-cash offset to the collection of deferred revenue.

Minority interest expense increased 46% during 1996, primarily from higher pre-tax income at EME's Loy Yang B project.

Other nonoperating income decreased in 1996, due to additional accruals for SCE's regulatory matters, partially offset by EME's gain on the sale of four geothermal facilities. Other nonoperating income decreased in 1995, as CPUC-authorized incentive awards were below 1994 levels.

Interest and Other Expenses

Interest on long-term debt increased 12% in 1996, reflecting EME's increased ownership in Iberian Hy-Power and First Hydro.

Other interest expense increased 11% during 1996, due to a $350 million borrowing by Edison International (holding company) for the acquisition of First Hydro and for its ongoing share repurchase program.

Capitalized interest decreased during 1996, primarily due to the completion of construction activity at EME's Loy Yang B Unit 2 project. Loy Yang B is a 51% owned, 1,000-megawatt coal-fired power plant near Melbourne, Australia. Unit 2 began commercial operation on October 1, 1996.

Financial Condition

Edison International's liquidity is primarily affected by debt maturities, dividend payments, capital expenditures, and investments in partnerships and unconsolidated subsidiaries. Capital resources include cash from operations and external financings.

In June 1994, Edison International lowered its quarterly common stock dividend by 30%, due to the uncertainty of future earnings levels arising from the changing nature of California's electric utility regulation.

Currently, Edison International's board of directors has authorized the repurchase of up to $800 million of its common stock. Edison International has repurchased 27.4 million shares ($497 million) through January 31, 1997, funded by dividends from its subsidiaries and its lines of credit.

Edison International's cash flow coverage of dividends for 1996 was 5.0 times compared to 4.7 times in 1995 and 3.7 times in 1994. Edison International's dividend payout ratio for 1996 was 61%.

Cash Flows from Operating Activities

Net cash provided by operating activities totaled $2.2 billion in 1996 and $2.1 billion in both 1995 and 1994. Cash from operations exceeded capital requirements for all years presented.

Cash Flows from Financing Activities

At December 31, 1996, Edison International and its subsidiaries had $1.8 billion of borrowing capacity available under lines of credit totaling $2.1 billion. SCE had available lines of credit of $1.1 billion, with $600 million for short-term debt and $500 million for the long-term refinancing of its variable-rate pollution-control bonds. The parent company has lines of credit totaling $350 million, with $185 million of borrowing capacity available. The nonutility companies had available lines of credit of $700 million, with $575 million of borrowing capacity available to finance general cash

In the following Management's Discussion and Analysis of Results of Operations and Financial Condition and elsewhere in this annual report, the words "estimates," "expects," "anticipates," "believes," and other similar expressions, are intended to identify forward-looking information that involves risks and uncertainties. Actual results or outcomes could differ materially as a result of such important factors as the outcome of state and federal regulatory proceedings affecting the restructuring of the electric utility industry, the impacts of new laws and regulations relating to restructuring and other matters, the effects of increased competition in the electric utility business, and changes in prices of electricity and costs for fuel.

RESULTS OF OPERATIONS

Earnings

Edison International's 1996 earnings per share were $1.64, compared with $1.66 in 1995 and $1.52 in 1994. Southern California Edison (SCE) contributed $1.42 per share, compared with $1.44 in 1995 and $1.34 in 1994. Edison Mission Energy (EME), Edison Capital and Mission Land Company contributed, on a combined basis, 27¢ in 1996 compared with 23¢ in 1995 and 19¢ in 1994. Edison International's earnings include special charges of 6¢ in 1996 (a 4¢ net charge at SCE for workforce management costs and reserves, a 2¢ charge at EME for operating reserves, and a 3¢ charge for real estate reserves at Mission Land, partially offset by a 3¢ gain on the sale of four geothermal projects at EME) and 3¢ in 1995 for SCE's workforce management charges. The decline in net income in 1996 was offset by a common stock repurchase program. The reduced number of outstanding shares resulted in a 3¢ per-share benefit in 1996 compared with 1995.

During 1996, Edison International formed three new businesses, Edison Source, Edison EV and Edison Select. Expenses associated with the start-up of these new businesses, together with the parent company's interest payments on $350 million in borrowings, related to EME's acquisition of First Hydro and its ongoing share repurchase program, were responsible for 5¢ per share of expenses (after tax) compared to 1¢ in 1995.

1996 vs. 1995

Excluding special charges, SCE's 1996 earnings were $1.46, down 1¢ from 1995. The decrease is mainly attributable to a reduction in authorized rates of return and operating expenses, partially offset by improved operating performance. The combined 1996 earnings of EME, Edison Capital and Mission Land, excluding special charges, were 29¢ per share, 6¢ higher than 1995. The increase is primarily attributable to earnings from EME's First Hydro project in the United Kingdom. First Hydro was acquired in December 1995.

1995 vs. 1994

SCE's 1995 earnings before nonrecurring charges were $1.44, up 10¢ over 1994, primarily due to a higher authorized return on common equity for 1995, partially offset by the effect of the 1995 general rate case settlement. SCE recorded workforce management costs of 3¢ per share in 1995 compared with 4¢ in 1994. The nonutilities' 1995 earnings were 23¢, up 4¢ from 1994, reflecting improved results from EME's energy projects and increased investment activity at Edison Capital. The parent company incurred expenses (after-tax) of 1¢ per share in both 1995 and 1994.

Operating Revenue

Electric utility revenue decreased 4% from 1995, as increased sales volume was offset by lower average rates. The lower rates are attributable to the California Public Utilities Commission's (CPUC) decision to lower SCE's 1996 authorized revenue by 4.4%. Additionally, during 1996 SCE issued a one-time bill credit of $237 million to ratepayers as part of a CPUC-ordered refund of energy-cost balancing account overcollections. Electric utility revenue in 1995 increased slightly over 1994, as a 2.6% authorized rate increase was partially offset by a decrease in sales volume to resale cities and milder weather in 1995. Over 98% of SCE's operating revenue is from retail sales. Retail rates are regulated by the CPUC and wholesale rates are regulated by the Federal Energy Regulatory Commission (FERC).

Due to warm weather during the summer months, electric utility revenue during the third quarter of each year is materially higher than the other quarters.

The changes in electric utility revenue resulted from:

In millions *Year ended December 31,*	1996	1995	1994
Electric utility revenue-			
Rate changes	$ (522)	$ 168	$ 112
Sales volume changes	206	(129)	308
Other	26	35	(18)
Total	$ (290)	$ 74	$ 402

In March 1995, SCE announced its intention to freeze average rates for residential, small business and agricultural customers through 1996, and announced a five-year goal to reduce system average rates by 25% on an inflation-adjusted basis (from 10.7¢ per kilowatt-hour to below 10¢ per kilowatt-hour). In February 1996, the CPUC approved a system-wide rate reduction which will drop the average price per kilowatt-hour from 10.7¢ to 10.1¢. Legislation enacted in September 1996 provides for, among other things, at least a 10% rate reduction for residential and small commercial customers beginning in 1998 (see Competitive Environment).

Revenue from diversified operations increased substantially during 1996 due to an increase in EME's electric revenue from its First Hydro, Iberian Hy-Power and Loy Yang B Unit 2 projects. Revenue from diversified operations decreased 3% in 1995 from 1994. The 1995 decline was mainly due to a decrease at Mission Land, as it sold several of its real estate holdings in 1994. The decline was partially offset by an increase in electric revenue at EME's First Hydro and Roosecote projects. Roosecote was out of service for four months in 1994 due to transformer failure and scheduled maintenance.

Operating Expenses

Fuel expense increased 11% in 1996, compared to the same period in 1995, primarily due to higher gas prices and changes in the fuel mix. EME's fuel expense increased due to the inclusion of fuel costs related to First Hydro (a pumped storage facility), Loy Yang B Unit 2 and Kwinana. Fuel expense decreased 23% in 1995 from 1994, as hydro generation was up significantly in 1995 due to greater rain-

Edison EV (Electric Vehicle)

Diane O. Wittenberg

President and Chief Executive Officer

Edison EV

In its first year of operation, Edison EV established itself as a leading retailer of electric-vehicle charging equipment and developer of infrastructure for public charging of EVs. Edison EV's business is built on alliances with automakers, charging-equipment suppliers, local utilities, certified contract installers and local government agencies. At the beginning of 1996, Edison EV formed alliances with General Motors and Delco Electronics, becoming the authorized California provider of home charging equipment for General Motors' EV1 electric vehicle. By mid-year GM and Delco expanded the Edison EV alliance to Arizona. In 1997, Edison EV will support GM's launch of its electric Chevrolet S-10 truck for fleet operators.

In December, American Honda Motor Company selected Edison EV as its preferred provider and installer of charging equipment for the Honda EV PLUS. Powered by advanced-technology batteries, the EV PLUS will be available to consumers and fleets in California in spring 1997.

Edison EV worked closely with local government agencies to build a network of public EV charging stations in Southern California's San Bernardino and Riverside counties. Further expansion of public and workplace charging is planned in 1997, in collaboration with local governments and private businesses.

The future of the EV industry depends on improvements in battery technology and vehicle range. Recognizing this, Edison EV is participating, through the Electric Power Research Institute, in the battery development program of the United States Advanced Battery Consortium. Because of its achievements in 1996, Edison EV is now well positioned to grow with the electric vehicle industry.

Edison Source and Edison Select

C. Alex Miller

President and Chief Executive Officer

Edison Source

Edison Source enjoyed a solid first year as a start-up energy solutions company for large retail customers throughout the United States. The company focused on positioning itself to compete in deregulated energy markets, developing products and services and building relationships with future customers.

In 1996, Edison Source received Federal Energy Regulatory Commission approval as a power marketer, which enables the company to compete in the expanding wholesale power market. The company also obtained membership in the Western Systems Power Pool, the largest wholesale power market in the United States.

Focusing on the needs of potential commercial and industrial customers, Edison Source developed and piloted an innovative program, Applied Direct Access Planning Tools (ADAPT) to help them prepare to make informed choices about the procurement of energy and related services in competitive markets. The ADAPT program helps customers analyze their energy consumption patterns, evaluate pricing options and identify services available to them. Edison Source successfully piloted the ADAPT program at six companies in 1996, and plans to enroll at least 10 companies a month in 1997.

An internet program developed by Edison Source in 1996 will provide clients with real-time information on their energy consumption at multiple sites. The program uses software developed by the company and runs on Edison Source's internet server. In addition, an integrated energy outsourcing system that the company developed will allow Edison Source to remotely monitor the performance of a client company's energy equipment and dispatch crews to make repairs, as necessary.

Another new start-up company, Edison Select, began developing products and services for mass retail markets in 1996. Edison Select piloted its first offering, Edison OnCall, which provides wiring-service contracts for residential customers.

Technical sophistication and operational excellence

Edison Mission Energy has become a world leader by putting a premium on quality. EME is known for technologically innovative projects, such as ISAB in Italy, where high-sulfur refinery waste will be converted to low-sulfur "syngas" for power generation, and recovered sulfur will be sold to the agriculture and chemical industries. EME's Loy Yang B coal-fired power station in Australia has been recognized for its outstanding environmental quality program.

Operationally, EME has established an enviable worldwide track record as a low-cost, high-performance power plant operator. A recently completed industrywide study ranked the company as best performer in cost and quality.

EDISON CAPITAL

Edison Capital, our capital and financial services subsidiary, has more than $1.4 billion in assets, with investments in two primary areas: energy-related projects and affordable housing.

Financial results

Edison Capital earned a record $41 million in 1996, up 3% over the prior year. The company's net income has grown at an average rate of 14.5% annually since its inception in 1987. Edison Capital continued its historically strong financial performance, earning a 17.7% return on common equity. The company's return on equity has averaged 16.9% since its inception. Edison Capital's achievements in 1996 promise to further strengthen its future performance.

Thomas R. McDaniel

President and Chief Executive Officer

EDISON CAPITAL

Affordable housing

Edison Capital expanded its highly successful affordable housing business nationwide in 1996. The company acquired East Coast Capital, a leading, privately held low-income-housing tax credit syndicator based in Boston.

With this acquisition, Edison Capital established a strong origination and underwriting position in the midwestern and eastern affordable housing markets. Between them, Edison Capital and East Coast Capital have closed more than $1 billion of equity investment in affordable housing developments during the past eight years, ranking the two companies as industry leaders.

The acquisition of East Coast Capital in October provided immediate benefit to the company, contributing one-third of the record $187 million in forward commitments for new affordable housing projects underwritten in 1996. In addition, the company placed 24 new affordable housing projects in service, and closed its fourth and fifth syndication of housing commitments to two major institutional investors. At year's end, Edison Capital had 124 projects in service, totaling 8,389 units of housing.

New global reach

In 1996, Edison Capital strengthened its presence in global energy and infrastructure markets. The company plans to use its capital and financial structuring skills to help meet the significant demand for capital and to facilitate the development and privatization of energy and infrastructure projects and systems. To pursue opportunities in Europe, the company opened an office in London. Edison Capital also closed an $80 million investment in the $1 billion AIG/GE Latin American Infrastructure Fund. One of 15 investors, Edison Capital will play an active role in the fund's investment activities. In addition, the company signed a letter of agreement with Stewart & Stevenson for co-financing of packaged small power systems.

completed a non-public sale of $450 million in senior notes and bonds to institutional investors. The bulk of the proceeds was used to repay EME's corporate debt. Cash flow from EME's interests in four California cogeneration projects will be used to repay these notes and bonds, which are non-recourse to the company.

At year's end, Edison Mission Energy had $5 billion in assets and interests in 57 projects totaling more than 10,000 megawatts, including 52 projects in operation, two under construction and three in advanced development. Today, EME has 28 operating projects in the United States, four in the United Kingdom, 18 in Spain and two in Australia.

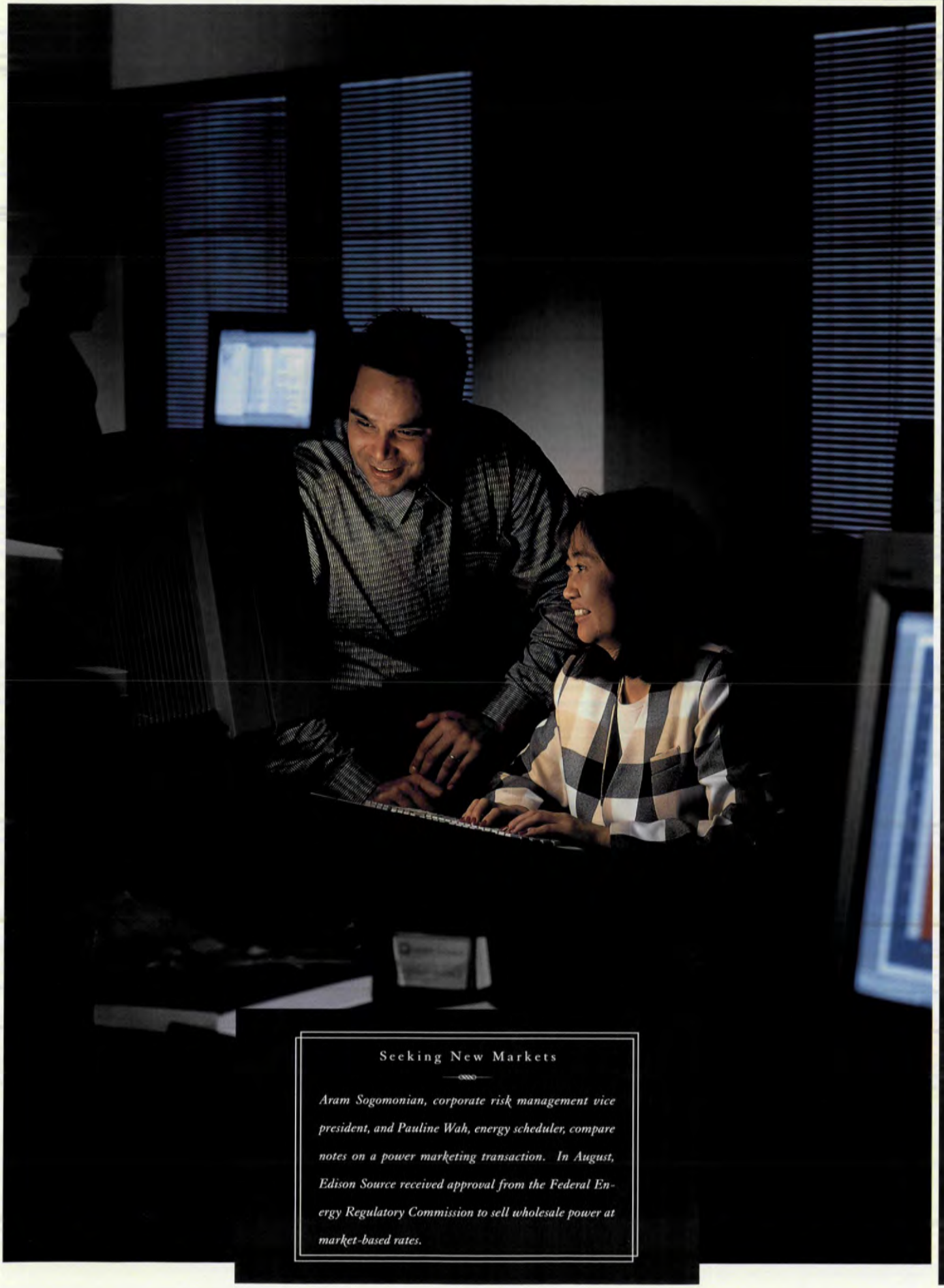
Continuing international focus

Electric utility industry restructuring will lead to new opportunities for Edison Mission Energy in the United States in the medium to long term, but the company's greatest opportunities for growth will continue to come in global markets. Markets in developing nations and developed countries where power production is being newly privatized will be especially dynamic. EME continued to strengthen its position in these markets in 1996.

A global record of accomplishment

Edison Mission Energy's position as a world leader in power production was underscored in 1996 by concrete achievements around the globe:

- United Kingdom — The company's decision in 1995 to acquire the 2,088-megawatt First Hydro facilities in Wales was well rewarded in 1996. First Hydro consists of two pumped-storage stations, the 1,728-megawatt Dinorwig plant and the 360-megawatt Ffestiniog station. First Hydro fills its reservoirs at night, when power demand is lighter and prices are lower, and releases water to produce power during the day, when demand is heavier and prices are higher. First Hydro had an excellent first year as part of EME's portfolio, achieving the best financial and operating performance in its history.
- Australia — In October, commercial operation began at the second 500-megawatt unit of the 1,000-megawatt coal-fired Loy Yang B power plant near Melbourne. EME owns 51% of the project. The remainder is owned by the State Electricity Commission of Victoria, which is also the plant's customer. EME's 116-megawatt gas-fired Kwinana cogeneration plant at the British Petroleum refinery outside Perth began commercial operation in December. This plant has the lowest nitrogen-oxide and carbon-dioxide emissions of any fossil-fueled plant in Australia.
- Indonesia — Construction of the 1,230-megawatt, coal-fired Paiton plant, one of the largest independent power projects in Asia, continues on schedule. Completion is set for early 1999.
- Italy — In April, the company closed $1.3 billion in financing for the 512-megawatt ISAB gasification project. The project is now under construction and commercial operation is scheduled for November 1999. EME owns 49% of the project, and ERG Petroli S.p.A. — owner of the ISAB refinery and an affiliate of the ERG Group — owns 51%. Electricity generated by the project will be sold under a long-term power-purchase agreement to ENEL S.p.A., Italy's state-owned utility.
- Spain — The company increased its ownership in Iberian Hy-Power (IBHV) from 34% to 100%. IBHV operates 18 run-of-the-river hydroelectric plants in Spain.
- United States — In November, the 286-megawatt Brooklyn Navy Yard Cogeneration (BNYC) project began selling electricity and steam under a long-term power-purchase agreement. BNYC is one of the cleanest fossil-fueled plants in New York state.



Seeking New Markets

Aram Sogomonian, corporate risk management vice president, and Pauline Wah, energy scheduler, compare notes on a power marketing transaction. In August, Edison Source received approval from the Federal Energy Regulatory Commission to sell wholesale power at market-based rates.

Providing Energy Solutions

Edison Source provides energy and energy-related services to businesses throughout North America. It focuses on integrated energy outsourcing and opportunities in retail energy marketing.

Edward R. Muller

President and Chief Executive Officer

EDISON MISSION ENERGY

small and medium-size businesses. In 1996, SCE assisted 106 firms, helping to retain and/or create 30,250 jobs. Since 1992, Edison has aided 425 companies and helped save more than 94,000 jobs. This effort has resulted in nearly 3 billion kilowatt-hours of energy consumed and more than $220 million in revenue for Edison.

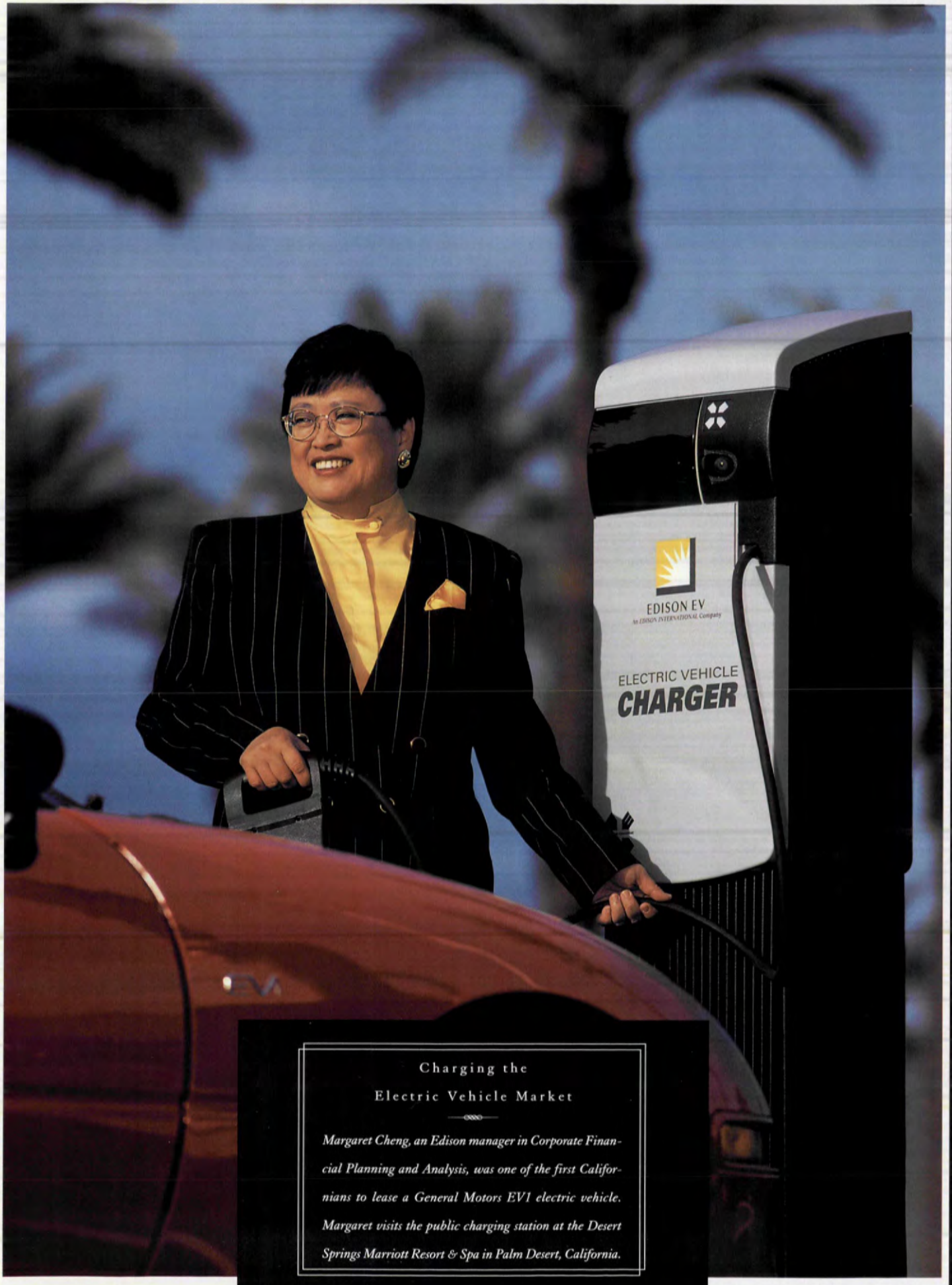
⊙ Leveraging assets — We agreed to lease more than 1,200 miles of our 1,500-mile fiber optic cable network to ICG Access Services, a telecommunications network and satellite service company. We also increased our efforts to make our considerable technical and managerial skills available to other companies. In July, Edison Operations and Maintenance Services won a contract to provide electrical and instrumentation maintenance at a major Los Angeles refinery. Meanwhile, Edison Pipeline & Terminal Company, established in 1994 to increase the value of Edison's extensive oil pipeline and storage facilities, strengthened its presence in the Southern California oil pipeline and storage market, increasing its revenues 54% over 1995, to $14.6 million.

EDISON MISSION ENERGY

Since its inception in 1986, Edison Mission Energy (EME) has steadily built its independent power production business by taking a rigorous, disciplined approach to new investments, applying diverse generation technologies to new projects and leveraging its experience with regulatory and financial issues in newly privatizing markets. Today, EME is one of the world's leading independent power producers.

Outstanding performance

1996 was a very strong year for Edison Mission Energy. Earnings grew 44% to $92 million, while revenues rose 81% to $844 million. EME closed $1.75 billion in new, non-recourse project financing and began operations at three projects totaling more than 900 megawatts. In December, the company



Charging the Electric Vehicle Market

Margaret Cheng, an Edison manager in Corporate Financial Planning and Analysis, was one of the first Californians to lease a General Motors EV1 electric vehicle. Margaret visits the public charging station at the Desert Springs Marriott Resort & Spa in Palm Desert, California.

Electricity on the Move

Edison EV supports the growing electric vehicle market by providing safe, convenient and cost-effective charging equipment and installation. Edison EV serves the charging needs of public, fleet and residential EV owners.

an opportunity to increase earnings at SONGS by operating the plant efficiently and safely at high capacity. In 1996, SONGS operated at 92% of capacity and received the Institute of Nuclear Power Operations' "1" rating, which recognizes excellence in nuclear operations. The Palo Verde nuclear facility, in which Edison holds a partial interest, also received an INPO 1 rating.

⊙ Substation automation — We automated 88 substations in 1996. This was part of our ongoing effort to automate 600 substations by the year 2000, at a total cost of $55 million. When completed, this program will reduce operations costs by $10.5 million annually.

⊙ Voluntary retirement offer — We continued to prepare Edison for the competitive utility industry of the future by further reducing the size of our work force in 1996. We extended a voluntary retirement offer which was accepted by nearly 3,000 employees. At year's end, our utility work force totaled 12,057, down 19% from the end of 1995.

Competitive initiatives

In the new electric utility industry marketplace, our customers will choose their electricity providers. We are positioning Edison to be their provider of choice. We are also leveraging our assets to provide new services to new customers, and add value for shareholders.

⊙ Flexible pricing — The CPUC approved our proposal to offer new, flexible pricing options for business customers. Our new pricing options include: real-time pricing closely corresponding to Edison's hourly generation costs; environmental pricing credits for customers who install technologies known to increase operating efficiencies and produce on-site environmental improvements; and economic development rates designed to retain existing manufacturing and film industry customers, encourage them to expand their businesses, and attract new customers to our service territory.

⊙ Regional leadership — Edison's revenues and earnings are linked to the economic health of Southern and Central California, and SCE has worked to strengthen the region's economy by supporting

A Leader in Affordable Housing

Clara Arancivia and her daughters Vanessa and Clarissa enjoy a quiet moment outside their home at the Santa Alicia housing complex in Irvine, California. Santa Alicia is one of the 124 Edison Capital projects in service at the end of 1996.

Building for the Future

Edison Capital is a leading provider of capital and financial services for energy and infrastructure projects as well as one of the country's most active investors in high-quality affordable housing.

shareholders by controlling costs, PBR will give us an opportunity to increase earnings by another $50 million a year by meeting CPUC targets for customer satisfaction, employee safety and system reliability. Failure to meet the CPUC's targets could also result in penalties of up to $50 million annually. We believe, however, that we are already well positioned to meet these targets.

⊙ Divestiture — The board of directors in November approved a plan to sell 12 fossil-fueled power plants within Edison's service territory. These plants have a combined book value of approximately $700 million and represent 100% of Edison's natural gas-fueled generating capacity in California. They will be sold in regionally bundled groups at a series of auctions beginning in mid-1997. If the auction revenues exceed the plants' book value, they will be used to accelerate investment-cost recovery.

⊙ Building the infrastructure for competition — When competition in power generation and sales begins in 1998, electricity prices will be set hourly in a spot market known as the Power Exchange (PX). While Edison and California's other investor-owned utilities will continue to own and maintain their transmission lines, the power transmission system will be run by an Independent System Operator (ISO). The ISO will dispatch the least-cost power into the system first, based on exchange prices. This framework, which will ensure all competitors fair access to a market in which prices are set openly, requires federal approval.

In April, Edison and California's other investor-owned utilities filed a proposal with the Federal Energy Regulatory Commission (FERC) to create the PX and ISO. The FERC conditionally accepted this proposal in November, clearing the way for the establishment of these critically important institutions. In March 1997, Edison and other California stakeholders will make an additional filing with the FERC, providing information on the bylaws, operational protocols, tariffs and contracts associated with the operation of the PX and ISO.

⊙ Excellent nuclear plant performance — A new Incremental Cost Incentive Pricing (ICIP) mechanism took effect at our San Onofre Nuclear Generating Station (SONGS) in April 1996. ICIP gives us

Operations & Maintenance Success

(Above) EME operators Mike Lamboley (left), and Paul Servoss are part of the Edison Mission Energy team that operates the 80-megawatt Harbor Cogeneration project in Wilmington, California. (Below) Operator Cindy Claunch changes an air-intake filter at the 90-megawatt Saguaro Power Company project in Henderson, Nevada. EME has established an enviable worldwide track record as a low-cost, high-performance power plant operator. A recently completed industrywide study ranked the company as best performer in cost and quality.