

SEMPRA ENERGY



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At Sempra Energy, we are building tomorrow's energy company today. We're helping to reinvent the energy services business to provide integrated solutions worldwide. Our people spark the ideas that enable Sempra Energy not only to meet – but also to shape – customer expectations. Our ongoing commitment is to find new ways to create value for our shareholders and customers, develop growth opportunities for our employees and support the communities we serve.



SOUTHERN CALIFORNIA GAS COMPANY

Headquarters: Los Angeles

Line of Business: Natural gas distribution

Southern California Gas Company (SoCalGas) is the nation's largest natural gas distribution utility serving 18 million people in a territory stretching from San Luis Obispo in the north to the Mexican border in the south. SoCalGas' Energy Distribution Services (EDS) unit serves residential and small commercial and industrial customers, while its Energy Transportation Services (ETS) unit focuses on large and midsized commercial, industrial, electric-generation and wholesale customers.

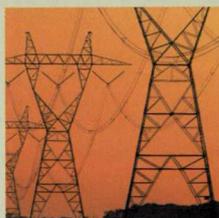
In 1998, SoCalGas reported its highest overall customer satisfaction ratings in the past six years. The company also achieved a four-year high in pipeline throughput and eight-year high in peak-day send-out of gas.

During the year, SoCalGas continued its aggressive program to promote the installation of gas appliances in new construction, with more than 46,000 new meters added. Some 85 percent of new single-family-home construction in the company's service territory included the installation of at least six natural gas appliances.

SAN DIEGO GAS & ELECTRIC

Headquarters: San Diego

Line of Business: Electric and natural gas distribution



San Diego Gas & Electric (SDG&E) traditionally enjoys high customer satisfaction ratings among the 3 million people to whom it provides electric and natural gas service in San Diego and southern Orange counties.

Adapting to its changing role in California's restructured electric-utility industry, SDG&E has shifted its focus to becoming a world-class energy delivery company. This new focus, along with regulatory obligations, spurred the company to begin selling its generating assets.

In late 1998, SDG&E signed sale agreements for both its San Diego-area fossil fuel power plants. The pending sale of the two plants at prices well above book value is expected to enable SDG&E to recover its competition transition costs this summer — more than two years ahead of the schedule set by California regulators and legislators — lowering electric rates for its customers and protecting the past investments of Sempra Energy's shareholders.



SEMPRA ENERGY SOLUTIONS

Headquarters: Los Angeles

Line of Business: Retail marketing of electricity and natural gas; energy management consulting; energy information services; efficiency contracting and facility management

Sempra Energy Solutions provides energy-related products and services to commercial, industrial, government, institutional and consumer markets.

The company specializes in developing integrated solutions for customers that include everything from the purchase of natural gas and electricity and energy-efficiency consulting to central plant operations and information management services. In 1998, Sempra Energy Solutions secured major new contracts with Lockheed Martin, PETCO Animal Supplies, Foodmaker, Inc. (the parent company of Jack-in-the-Box restaurants) and the San Diego Unified School District.

CES/Way International, a unit of Sempra Energy Solutions, is a leader in energy-efficiency contracting for government and institutional customers. CES/Way was one of six companies chosen by the U.S. Dept. of Energy to provide energy-efficiency contracting for select federal facilities. CES/Way's current projects and contract backlog are valued at \$150 million.

SEMPRA ENERGY RESOURCES

Headquarters: San Diego

Line of Business: Power plant development; operation of natural gas storage, production and transportation assets



Sempra Energy Resources acquires and develops power plants for the competitive market and operates natural gas storage, production and transportation assets that support the Sempra Energy family of companies. Sempra Energy Resources' power plants use state-of-the-art, combined-cycle, power generation technology and clean-burning natural gas to generate electricity for the wholesale market and retail electric providers, including other utilities, marketers and large energy users.

The company has several power plant projects in various stages of development in the Southwestern and Northeastern United States. Joining with Reliant Energy Power Generation, Inc., Sempra Energy Resources is building El Dorado Energy, a 480-megawatt merchant power plant just outside of Las Vegas. Upon its completion at the end of 1999, El Dorado Energy will sell power in the California, Arizona and Nevada energy markets.

DELIVERING ENERGY SOLUTIONS TODAY



Sempra Energy is a Fortune 500 company with the

resources and financial strength to sell, generate,



manage, trade and deliver energy anywhere in the

world. Sempra Energy



has the largest customer

base of any energy services company in the United

States. Through its eight principal subsidiaries, the

company provides world-class



regulated energy

distribution services and delivers integrated

solutions for the competitive market to help customers

meet their energy needs more efficiently.



To accelerate the market development in California, San Diego Gas & Electric (SDG&E) is divesting itself of its generating assets. The high return the company will receive on the pending sale of its two fossil fuel power plants will benefit both our shareholders and SDG&E customers. SDG&E customers will enjoy lower electric rates since the competition transition charge on their bills is now expected to be paid off by July of this year — more than two years ahead of the schedule set by state legislators and regulators. Shareholders now have greater assurance that SDG&E will recover the stranded costs authorized under California's electric industry restructuring plan. The divestiture of the two power plants also enables SDG&E to concentrate on developing its new role in the marketplace as an energy delivery company.

Operating under its performance-based-regulation plan, Southern California Gas Company (SoCalGas) is focusing on maximizing efficiencies, increasing gas throughput in its system and expanding its customer base. Additionally, there are a growing number of gas bypass options for larger commercial and industrial customers. SoCalGas is working hard to retain their business and build on its base of 18 million people served through 4.9 million meters.

INTEGRATING SOLUTIONS IN THE COMPETITIVE MARKET

The key to our future success will be our ability to integrate energy solutions for customers. We will do this by combining the strengths of our competitive businesses to provide customers a complete energy services package.

Two good examples of the success we had with this approach are the contracts we recently won with Lockheed Martin for energy management services and with the Mexican government for supplying gas to the *Presidente Juárez* power plant in Rosarito, Baja California. In both cases, our competitive businesses will be joining forces to provide comprehensive solutions to the customer.

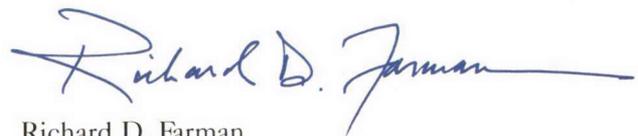
Energy customers now expect a full slate of services and products delivered in a competitively priced, seamless and reliable manner. While there is a lot of talk nationwide about buying and selling electricity and gas, we believe that what brings the most long-term value to our customers is astute management of their total energy supply chain.

A UNIQUE OPPORTUNITY

In forming Sempra Energy, we have a unique opportunity to create the model energy services company for the 21st century — and we are putting in place the infrastructure to support it. In addition to bringing all of our critical computer systems into compliance with Year 2000 standards by June of this year, we also are instituting enterprise software companywide. Enterprise software is a new, computer-based cohesive system binding together key functions of the company to enhance customer service.

With the pending addition of KN Energy, we are creating a company with the resources, know-how and financial strength to sell, generate, trade, manage and deliver energy anywhere in the world. We have a new organization and new leadership that builds on the century-old tradition of performance, service excellence and community involvement of SDG&E and SoCalGas.

Being a new enterprise charting a course in the new marketplace is exciting. We are putting the resources in place to make this journey a success — one that brings long-term value to you, our shareholders.



Richard D. Farman
Chairman and Chief Executive Officer



Stephen L. Baum
Vice Chairman, President and Chief Operating Officer

CORE VALUES

Any new enterprise needs to identify its core values. We are no exception. We have adopted values that we believe not only define us as leaders in the industry and in the communities we serve, but also enable us to build shareholder value. Among the most important of these core values are our commitments to:

- ◆ Focus on the customer.
- ◆ Practice open, honest communications.
- ◆ Encourage individual initiative and innovation among our employees.
- ◆ Support workforce and supplier diversity that reflects the communities we serve.
- ◆ Deliver superior shareholder value.

In addition, we have established a corporate motto:

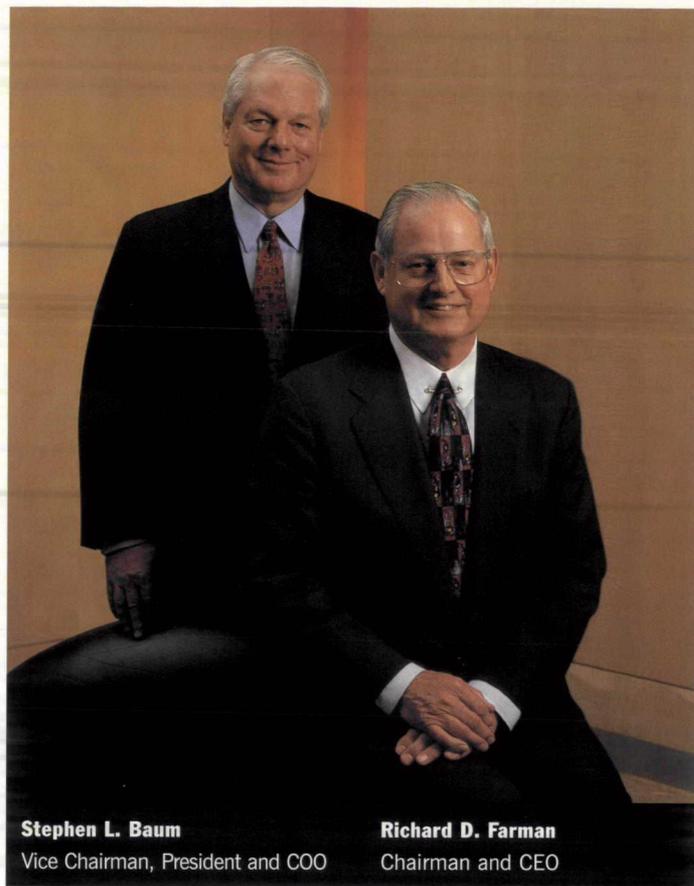
“Have fun, make money, be proud.”

AGILITY A CRITICAL ATTRIBUTE

The developing energy marketplace is characterized by a convergence of the electricity and gas businesses, along with the emergence of a broad range of competitive energy-related services. Customers want the convenience of one-stop shopping, low-cost service and reliability.

States are moving at varying speeds toward open markets, with those in the West and Northeast leading the way. Since the transformation to competition is moving at an uncertain pace, one of the most important attributes of our new company is agility: Our strategic response must be adaptable to the tempo of change in the marketplace.

Based in California — a state leading the way in energy deregulation — we already have experience in the new marketplace that few other energy firms can hope to duplicate. California officially opened its electric market to competition April 1, 1998, ushering in a new era of choice for consumers and businesses.



Stephen L. Baum
Vice Chairman, President and COO

Richard D. Farman
Chairman and CEO

In the November 1998 elections, voters in both California and Massachusetts overwhelmingly defeated ballot initiatives seeking to overturn the states' deregulation plans, ensuring that electric industry restructuring could progress and the utilities' recovery of stranded costs would be protected. The vote sent a critical message to legislators and regulators in other states considering energy deregulation plans: Energy competition should move forward.

UTILITIES FOCUS ON EFFICIENCY, MARKET PENETRATION

Our formula for success relies on maintaining and extending our solid foundation of utility service, while realizing growth from our new, competitive energy services businesses.

O

n June 26, 1998, Sempra Energy, a new Fortune 500 corporation, was created from the merger of Pacific Enterprises and Enova Corporation. While many new companies spend years developing market muscle, we began our new life with more than \$10 billion in assets and \$6 billion in market capitalization, nearly 12,000 employees and 6 million metered customers, the largest customer base of any energy services company in the United States.

Sempra Energy already is a major player in the energy services business, but our goals are much more ambitious. Within the next decade, we aspire to be one of the top five energy services companies in the creation of shareholder value.

While our corporate earnings were impacted in 1998 by merger-related transition costs, our balance sheet and credit ratings remain strong with \$400 million in cash on hand at the end of last year. Sempra Energy earned \$379 million, or \$1.60 per diluted share, for the year, excluding business-combination costs.

On February 22, 1999, we took a major step toward our goal of becoming one of the nation's premier energy services companies by announcing a definitive agreement to combine with KN Energy, the nation's second-largest natural gas pipeline and storage operator and sixth-largest integrated natural gas company. Based on 1998 results, the combined company — which would be called Sempra

Energy and remain headquartered in San Diego — would have revenues of about \$9.9 billion, assets of \$20 billion, more than 15,000 employees and a large geographic footprint that stretches from the Gulf Coast to Chicago and across the Rockies to California.

The transaction, which will require the approval of you, our shareholders, as well as KN Energy's shareholders and several state and federal agencies, would allow the combined company to aggressively pursue the considerable opportunities of the deregulated energy services marketplace. Both companies' strategic objectives, assets and activities are complementary, and we believe this combination will enhance shareholder value far faster than either company could achieve on a standalone basis.

SEMPRA ENERGY AND KN ENERGY

	Sempra Energy	KN Energy
NYSE Ticker Symbol	SRE	KNE
Headquarters	San Diego	Lakewood, Colo.
Total Revenue	\$5.5 billion	\$4.4 billion
Net Income	\$294 million	\$60 million
Total Assets	\$10 billion	\$10 billion
Total Debt	\$3 billion	\$5 billion
Market Value	\$6.1 billion	\$1.7 billion
Employees	12,000	3,300
Concentration of Customers	Southern and central California	Midwest, Rockies, Gulf Coast

Statistical Information, as of December 31, 1998.

Financial Highlights

At December 31 or for the year then ended
(Dollars in millions except per share amounts)

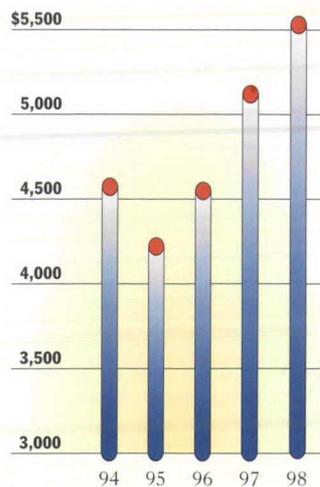
	1998	1997	Change
CONSOLIDATED FINANCIAL DATA			
Revenues and Other Income	\$ 5,525	\$ 5,127	+ 7.8%
Net Income	\$ 294	\$ 432	- 31.9%
Net Income Per Share of Common Stock			
Basic	\$ 1.24	\$ 1.83	- 32.2%
Diluted	\$ 1.24	\$ 1.82	- 31.9%
Diluted, Excluding Business-Combination Costs	\$ 1.60	\$ 1.91	- 16.2%
Weighted Average Number of Common			
Shares Outstanding (diluted, in millions)	237.1	237.2	—
Total Assets	\$ 10,456	\$ 10,756	- 2.8%
Common Dividends Declared Per Share	\$ 1.56	\$ 1.27	+ 22.8%
Dividend Payout Ratio (diluted)	125.8%	69.8%	+ 80.2%
Debt to Total Capitalization	50.4%	54.0%	- 6.6%
Book Value Per Share	\$ 12.29	\$ 12.56	- 2.1%
STATISTICS			
Natural Gas Throughput (in billions of cubic feet)	962	930	+ 3.4%
Average Cost of Natural Gas Purchased			
(per thousand cubic feet)	\$ 2.22	\$ 2.69	- 17.5%
Electric Energy On-System Sales (in billions of kilowatt hours)	17.2	16.7	+ 3.0%
Average Cost of Electric Energy (per kilowatt hour)	3.07¢	2.64¢	+ 16.3%
Number of Meters (in millions)			
Natural Gas	5.6	5.5	+ 1.8%
Electricity	1.2	1.2	—
Return on Common Equity ^(a)			
SoCalGas	14.1%	16.7%	- 15.5%
SDG&E	17.5%	16.3%	+ 7.3%
Number of Employees ^(b)	11,148	11,387	- 2.1%

(a) Excluding business-combination costs.

(b) Excludes contract and part-time employees.

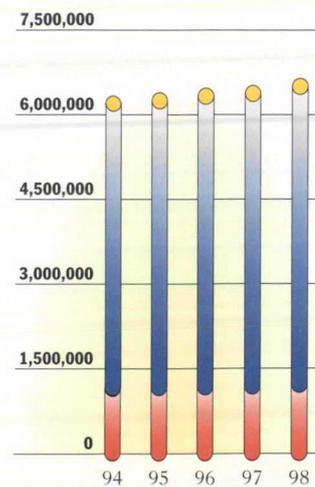
OPERATING REVENUES

IN MILLIONS OF DOLLARS



UTILITY CUSTOMERS

■ GAS ■ ELECTRIC





SEMPRA ENERGY TRADING

Headquarters: Stamford, Conn.

Line of Business: Wholesale marketing and trading of physical and financial energy products

Sempra Energy Trading is a wholesale trader of physical and financial energy products, including natural gas, power, crude oil and associated commodities.

Sempra Energy Trading serves a broad range of customers, including electric and gas utilities, industrial and large commercial end users and major energy marketers. Specializing in high-volume transactions, Sempra Energy Trading provides its customers with customized energy delivery and pricing programs, managed by a highly experienced risk management team.

On a typical day, Sempra Energy Trading's commodity and financial transactions involve more than 40 billion cubic feet of natural gas — an amount equal to one half of all the natural gas consumed every day in both the United States and Canada.

In July 1998, Sempra Energy Trading acquired CNG Energy Services Corporation, a subsidiary of Consolidated Natural Gas Company, expanding Sempra Energy Trading's portfolio to become one of the largest energy traders in the nation.



SEMPRA ENERGY INTERNATIONAL

Headquarters: San Diego

Line of Business: Energy-infrastructure investment, development and operations outside the United States

Sempra Energy International is involved with energy-infrastructure projects, including natural gas transmission and distribution systems and power generation facilities, outside the United States.

To date, Sempra Energy International has formed gas distribution partnerships in Mexico, Argentina and Uruguay. These projects have helped boost economic development in those regions and provided cleaner environments by using natural gas as a replacement for other fuels.

In August 1998, the company was awarded a 10-year agreement by the Mexican Federal Electric Commission to provide a complete energy supply package for the *Presidente Juárez* power plant in Rosarito, Baja California. The contract calls for delivery of up to 300 million cubic feet per day of natural gas, transportation services in the U.S. and construction of a 23-mile pipeline from the U.S.-Mexico border to the plant. Delivery of natural gas is expected to begin in December 1999.

SEMPRA ENERGY UTILITY VENTURES

Headquarters: Los Angeles

Line of Business: Acquisition, development and operation of smaller regulated energy utilities



Sempra Energy Utility Ventures acquires, develops and operates small- to medium-sized regulated energy utilities in the United States and Canada.

Currently, Sempra Energy Utility Ventures has several natural gas distribution projects under development. A subsidiary, Frontier Energy, is constructing a new natural gas distribution system to serve customers across seven counties in North Carolina. Gas started flowing to the first customers in December 1998. Sempra Energy Utility Ventures also teamed up with Bangor Hydro-Electric Company to form a joint venture, Bangor Gas. This new local distribution company will provide natural gas service to residential, commercial and industrial customers in a dozen communities in the greater Bangor area of central Maine.

Sempra Atlantic Gas, another Sempra Energy Utility Ventures unit, was formed in the spring of 1998 to pursue natural gas distribution opportunities in Canada.

SEMPRA ENERGY FINANCIAL

Headquarters: San Diego

Line of Business: Financial investments



Sempra Energy Financial enhances the earnings of Sempra Energy by investing as a limited partner in affordable housing and alternative fuels. Affordable housing, in critical short supply across the country, benefits moderate- to low-income families by making attractive housing available at rents they can afford. The federal government reduces income tax payments as an incentive for individuals and businesses to invest in these projects. Currently, Sempra Energy Financial's portfolio includes more than 1,250 properties throughout the United States, Puerto Rico and the Virgin Islands.

*“How do you
keep our nation’s
most famous
Lady lit for future
generations?”*

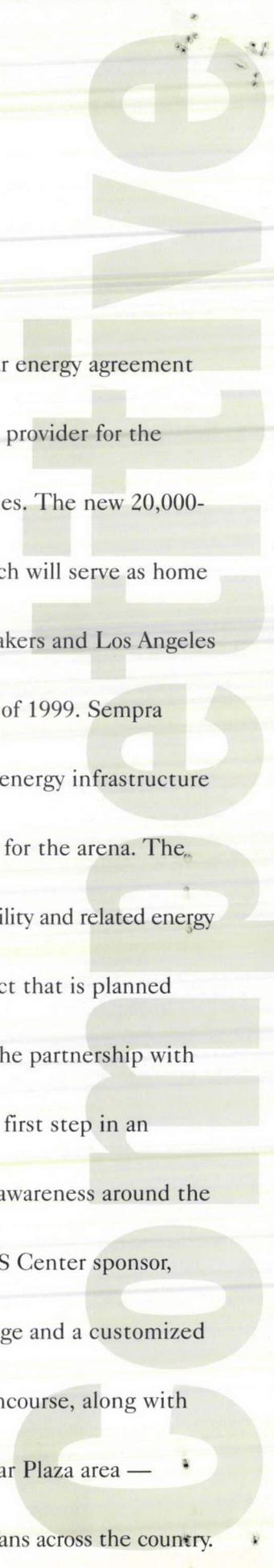
For generations, the Statue of Liberty has stood in New York Harbor, near Ellis Island, as a beacon for democracy, freedom and opportunity. Keeping the Lady’s lights burning efficiently became the job of Sempra Energy’s CES/Way International unit. CES/Way installed a state-of-the-art, energy-management-control system and the energy-efficient lighting at both the Statue of Liberty Monument and Ellis Island, which was the one-time port of entry for more than 12 million U.S. immigrants. The result: The Monument became eligible for \$1.3 million in rebates from its local utility and now saves \$172,000 annually in energy costs. Additionally, this retrofitting helped reduce undesirable air emissions by more than two million pounds each year, while the special filters installed on the more than 1,200 lights help protect museum artifacts — ultimately keeping our most famous Lady lit for many years to come.

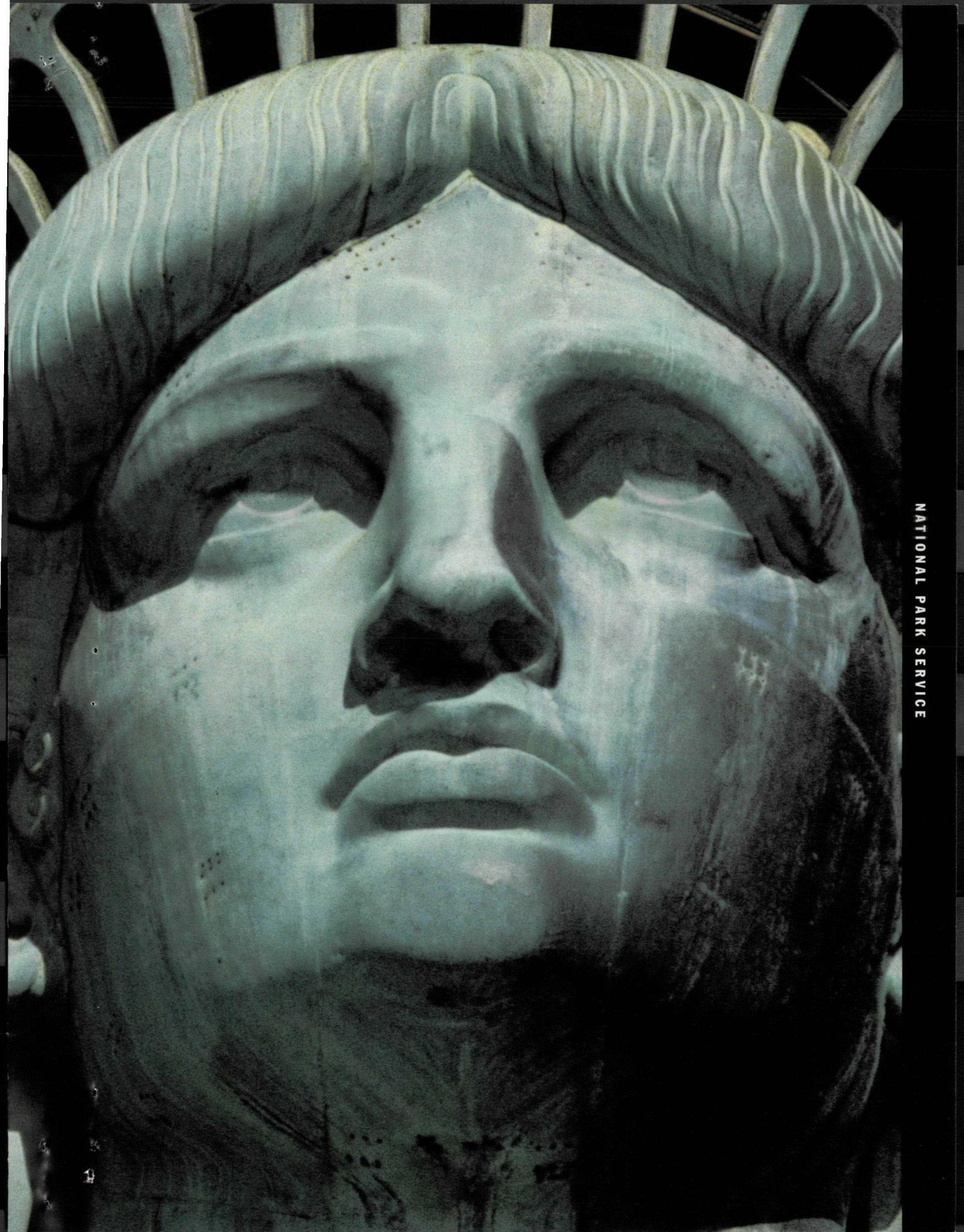
“Can one small
change energize a
whole region?
¡Sí, señora!”

Sempra Energy International is leading the way in bringing much-needed natural gas to Baja California, Mexico, helping fuel economic development and improve the environment in the region. The company is providing a complete energy supply package for the *Presidente Juárez* power plant in Rosarito to enable the plant operators to switch the generation fuel from oil to cleaner-burning natural gas and expand the plant's output by 1,300 megawatts. Sempra Energy International will own, design, construct and operate a 23-mile pipeline from the U.S.-Mexico border to the plant, which also will serve as the trunk line for a future natural gas distribution system in Tijuana, one of Mexico's fastest-growing urban centers. Currently, businesses and residents of Tijuana and most other cities in Baja California use propane gas to meet their energy needs. Under a 10-year, \$1 billion agreement, Sempra Energy Trading will procure up to 300 million cubic feet per day of natural gas to supply the pipeline — and spark dynamic growth in the region.

**"Sometimes scoring
a goal isn't the
most difficult feat.
Keeping the fans
comfortable is."**

Sempra Energy has entered into a 10-year energy agreement as a founding partner and energy services provider for the STAPLES Center in downtown Los Angeles. The new 20,000-seat sports and entertainment arena, which will serve as home to the Los Angeles Kings, Los Angeles Lakers and Los Angeles Clippers, is scheduled to open in the fall of 1999. Sempra Energy Solutions will operate the entire energy infrastructure and provide energy procurement services for the arena. The company also is helping design a cooling facility and related energy infrastructure for an entertainment district that is planned for development adjacent to the arena. The partnership with the STAPLES Center is Sempra Energy's first step in an aggressive nationwide campaign to build awareness around the new corporate brand. As a major STAPLES Center sponsor, Sempra Energy will have permanent signage and a customized interactive display in the arena's main concourse, along with an outdoor video display at the public Star Plaza area — beaming Sempra Energy's name to sports fans across the country.



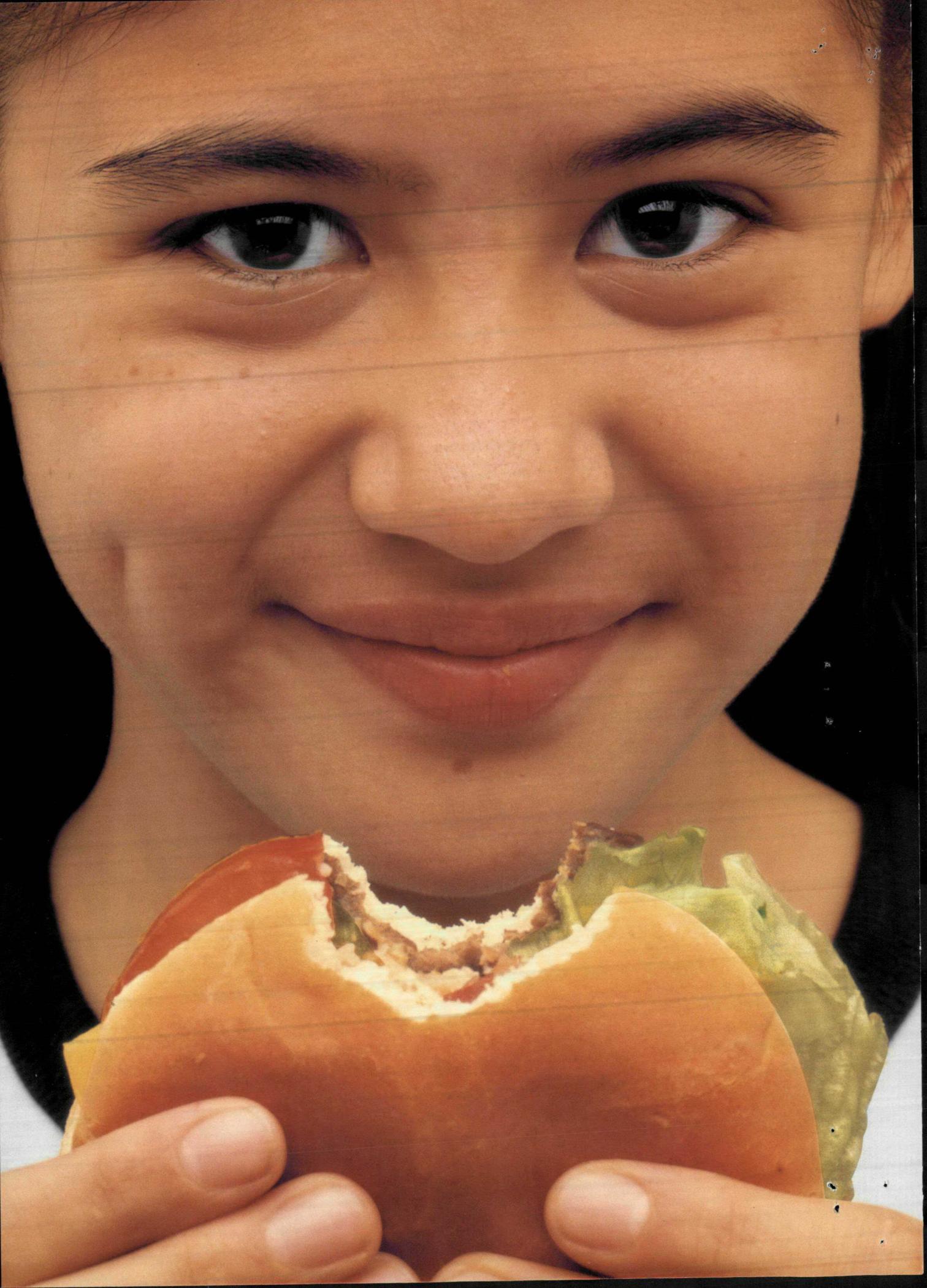


NATIONAL PARK SERVICE

PRESIDENTE JUÁREZ POWER PLANT







“Most of us have
a few mouths to
feed. How about
700,000?”

Sempra Energy’s Southern California Gas Company (SoCalGas)

unit is helping the Los Angeles Unified School District
run one of the largest school meal programs in the nation more
efficiently. More than 140 million meals are provided

annually to 700,000 students at 650 Los Angeles schools. The

District owns and operates approximately 2,000 convection
ovens and, each year, must purchase as many as 200 replacement
ovens. One of many initiatives underway at SoCalGas is to
help its customers make the best use of natural gas appliances.

SoCalGas assists the Los Angeles Unified School District in
identifying more reliable and easy-to-repair ovens. At SoCalGas’

Energy Resource Center, District officials can test the
performance of natural gas cooking equipment by preparing
sample menu items and evaluating cooking quality and time, new
design features and efficiency — all to keep the meals cooking.

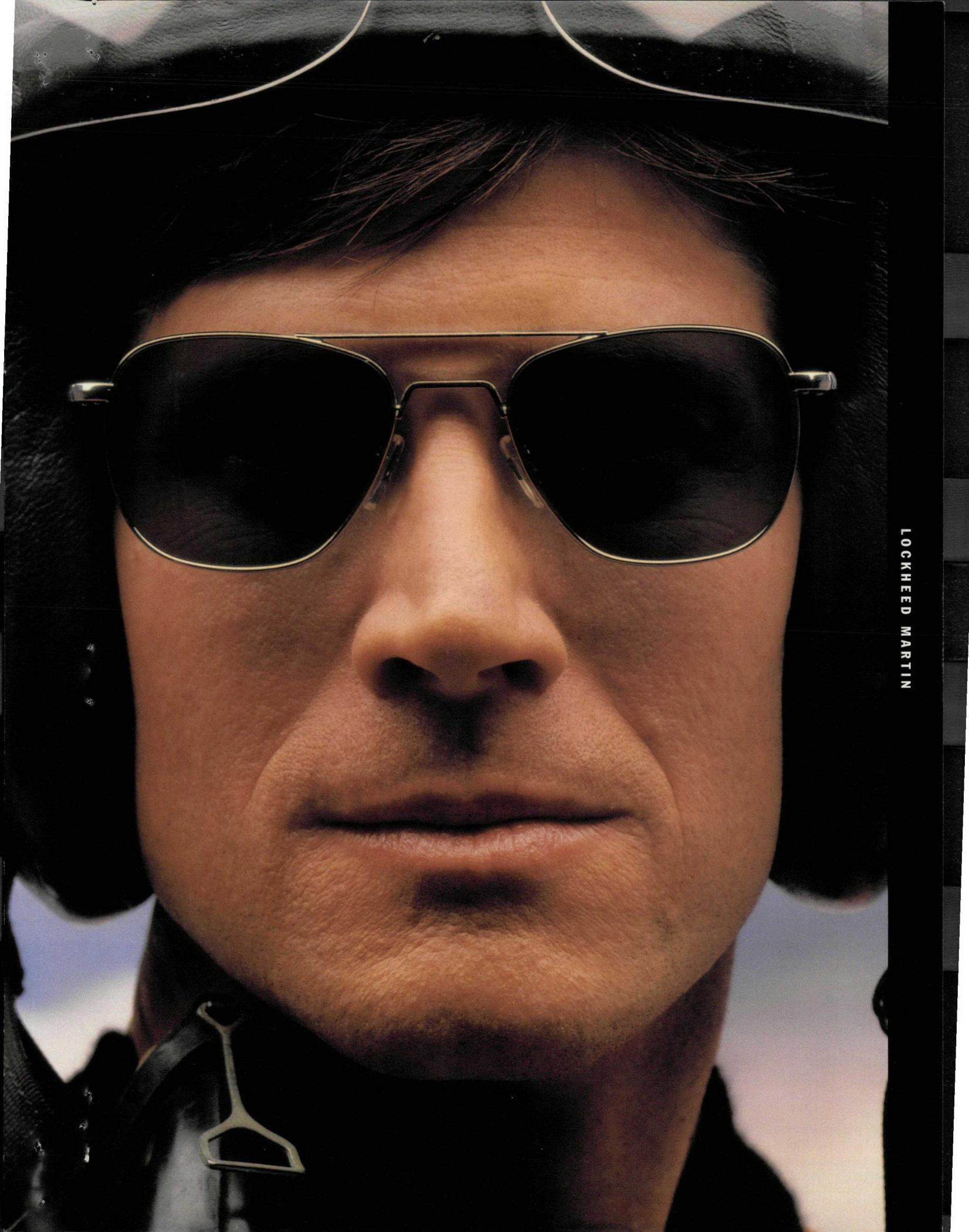
Sempra Energy Solutions

CES/Way International

Sempra Energy Trading

"Do you realize how much electricity it takes to launch a rocket into space?"

Sempra Energy has developed a full range of energy-efficiency services that will help Lockheed Martin, one of the world's largest aerospace/defense firms, keep its facility costs from skyrocketing. CES/Way International will oversee energy-efficient retrofit projects that are expected to cut Lockheed Martin's annual energy bills by as much as 20 percent at sites in 26 states in the eastern United States. Sempra Energy Trading will offer natural gas and electricity to the facilities where customers can choose third-party energy providers. Additionally, Sempra Energy Solutions will provide billing and information management services, and energy education and training to facilities management employees at all Lockheed Martin domestic facilities. Initial audits at 10 of these sites indicate about \$50 million in energy system retrofit opportunities, which could save Lockheed Martin about \$9 million annually in energy costs at these facilities alone — launching powerful savings.



LOCKHEED MARTIN

KAISER PERMANENTE



“How do you keep a 256,000-square-foot health care facility from running a temperature?”

As part of its “Savings Through Design” program, Sempra Energy’s San Diego Gas & Electric (SDG&E) unit teamed with Kaiser Permanente, the leading health care organization in the United States, to design an environmentally friendly, energy-efficient new \$56 million Outpatient Medical Center in the Otay Mesa area of San Diego. Design innovations include a completely automated lighting-control system that can be programmed to respond to time-of-day or daylight conditions. Extensive use of natural daylight minimizes air-conditioning and lighting costs, while maintaining an open, spacious architecture. Two 400-ton chillers in the facility’s central plant are engineered to use outside air for free cooling. The energy-efficient design measures recommended by SDG&E will help Kaiser keep the focus on providing patients with quality care — and save the health care provider an expected

- \$130,000 annually.

SEMPRA ENERGY FINANCIAL STATEMENTS

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Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

This section includes management's analysis of operating results from 1996 through 1998, and is intended to provide information about the capital resources, liquidity and financial performance of Sempra Energy and its subsidiaries (the company). This section also focuses on the major factors expected to influence future operating results and discusses investment and financing plans. It should be read in conjunction with the Consolidated Financial Statements included in this Annual Report.

The company is a California-based Fortune 500 energy services company whose principal subsidiaries are San Diego Gas & Electric (SDG&E), which provides electric and natural gas service to San Diego County and southern Orange County, and Southern California Gas Company (SoCalGas), the nation's largest natural gas distribution utility, serving 4.8 million meters throughout most of southern California and part of central California. Together, the two utilities serve approximately 7 million meters. Sempra Energy Trading is engaged in the wholesale trading and marketing of natural gas, power and petroleum. Sempra Energy Solutions is engaged in the buying and selling of natural gas for large users, integrated energy-management services targeted at large governmental and commercial facilities, and consumer-market products and services. Sempra Energy Financial invests in limited partnerships representing 1,250 affordable-housing properties throughout the United States. Through other subsidiaries, the company owns and operates interstate and offshore natural gas pipelines and centralized heating and cooling for large building complexes, and is involved in domestic and international energy-utility operations, nonutility electric generation and other energy-related products and services.

BUSINESS COMBINATIONS

Sempra Energy was formed to serve as a holding company for Pacific Enterprises (the parent corporation of the Southern California Gas Company) and Enova Corporation (the parent corporation of San Diego Gas & Electric Company) in connection with a business combination that became effective on June 26, 1998 (the PE/Enova Business Combination). In January 1998, PE and Enova jointly acquired CES/Way International, Inc. Expenses incurred in connection with these business combinations are \$85 million, aftertax, and \$20 million, aftertax, for the years ended December 31, 1998, and 1997, respectively. These costs consist primarily of employee-related costs, and investment banking, legal, regulatory and consulting fees.

In connection with the PE/Enova Business Combination, the holders of common stock of PE and Enova became the holders of the company's common stock. PE's common shareholders received 1.5038 shares of the company's common stock for each share of PE common stock, and Enova's common shareholders received one share of the company's common stock for each share of Enova common stock. The preferred stock of PE remained outstanding. The combination was approved by the shareholders of both companies on March 11, 1997, and was a tax-free transaction. The Consolidated Financial Statements of the company gave effect to the combination using the pooling-of-interests method and are preserved as if the companies were combined during all periods included therein.

CAPITAL RESOURCES AND LIQUIDITY

The company's utility operations continue to be a major source of liquidity. In addition, working capital requirements are met primarily through the issuance of short- and long-term debt. Cash requirements primarily include capital investments in the utility operations. Nonutility cash requirements include investments in Sempra Energy Resources, Sempra Energy Utility Ventures, Sempra Energy Solutions, Sempra Energy Trading, CES/Way International, and other domestic and international ventures.



Additional information on sources and uses of cash during the last three years is summarized in the following condensed statement of consolidated cash flows:

SOURCES AND (USES) OF CASH

Year Ended December 31 (Dollars in millions)	1998	1997	1996
Operating Activities	\$1,323	\$ 918	\$1,164
Investing Activities:			
Capital expenditures	(438)	(397)	(413)
Acquisitions of subsidiaries	(191)	(206)	(50)
Other	(50)	1	(51)
Total Investing Activities	(679)	(602)	(514)
Financing Activities:			
Common stock dividends	(325)	(301)	(300)
Sale of common stock	34	17	8
Repurchase of common stock	(1)	(122)	(24)
Redemption of preferred stock	(75)	—	(225)
Long-term debt – net	(356)	382	(155)
Short-term debt – net	(311)	92	29
Total Financing Activities	(1,034)	68	(667)
Increase (decrease) in cash and cash equivalents	\$ (390)	\$ 384	\$ (17)

CASH FLOWS FROM INVESTING ACTIVITIES

Cash flows from investing activities primarily represent capital expenditures and investments in new businesses.

CAPITAL EXPENDITURES

Capital expenditures were \$41 million higher in 1998 than in 1997 due to greater capital spending at the company's corporate center related to facility improvements and equipment purchases, and at SDG&E related to industry-restructuring needs and improvements to the electric distribution system, partially offset by lower capital spending at SoCalGas.

Capital expenditures were \$16 million lower in 1997 than in 1996 due to changes in the scope and timing of several major capital projects primarily related to information systems. SoCalGas had lower capital spending related to the customer information system's being completed in early 1996 and other nonrecurring computer system expenditures in 1996. The decrease was partially offset by higher capital expenditures related to the purchase of a data processing facility and a plant expansion at a nonutility subsidiary. SDG&E's capital expenditures were lower due to changes in scope and timing of several major capital projects.

At SDG&E, payments to the nuclear-decommissioning trusts are expected to continue until San Onofre Nuclear Generating Station (SONGS) is decommissioned, which is not expected to occur before 2013. Unit 1, although permanently shut down in 1992, was scheduled to be decommissioned concurrently with Units 2 and 3. However, SDG&E and the other owners of SONGS have requested that the CPUC grant authority to begin decommissioning Unit 1 on January 1, 2000. See Note 6 of the notes to the Consolidated Financial Statements for additional information.

The decision of the CPUC approving the PE/Enova Business Combination required, among other things, that SDG&E divest itself of all its fossil fueled generation facilities. In December 1998, SDG&E entered into agreements to accomplish that. Completion is pending regulatory approvals and is

CASH FLOWS FROM OPERATING ACTIVITIES

The increase in cash flows from operating activities in 1998 was primarily due to lower working-capital requirements for natural gas operations in 1998. This was caused by higher throughput compared to 1997, combined with natural gas costs that were lower than amounts being collected in rates, which resulted in overcollected regulatory balancing accounts at year-end 1998. This increase was partially offset by expenses incurred in connection with the business combinations. The fluctuation in cash flows from operations was also affected by electric-industry restructuring, including the acceleration of depreciation of electric-generating assets, offset by recovery of stranded costs via the competition transition charge and the 10-percent rate reduction reflected in customers' bills in 1998.

The decrease in cash flows from operating activities in 1997 was primarily due to greater working-capital requirements for natural gas operations in 1997. This was caused by natural gas costs being higher than amounts collected in rates, resulting in undercollected regulatory balancing accounts at year-end 1997. The cash flow from electric operations for 1997 was consistent with results from 1996.

expected during the first half of 1999. See "Electric-Generation Assets" below for further discussion of the divestiture. Anticipated proceeds from these plant assets, net of the assets' book value, the costs of the sales and certain environmental cleanup costs, will be applied for accounting purposes directly to the recovery of SDG&E's other transition costs. On a cash basis, the proceeds will be available for general corporate purposes. However, the divestiture of the facilities will eventually lead to reduced cash flow from operations.

Capital expenditures at the utilities are estimated to be \$419 million in 1999. They will be financed primarily by internally generated funds and will largely represent investment in utility operations. The level of capital expenditures in the next few years will depend heavily on the impact of electric-industry restructuring and the timing and extent of expenditures to comply with environmental requirements.

INVESTMENTS

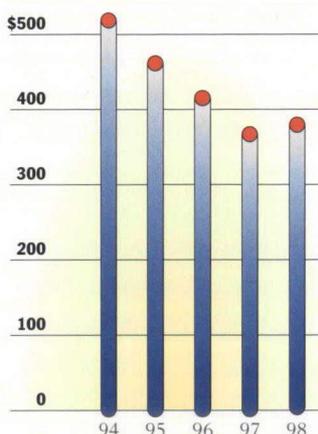
In December 1997, PE and Enova jointly acquired Sempra Energy Trading for \$225 million. In July 1998, Sempra Energy Trading purchased a subsidiary of Consolidated Natural Gas, a wholesale trading and commercial marketing operation, for \$36 million to expand its operation in the Eastern United States.

In December 1997, Sempra Energy Resources and Reliant Energy Power Generation formed El Dorado Energy, a joint venture to build, own and operate a natural gas power plant in Boulder City, Nevada. Sempra Energy Resources invested \$19.7 million and \$2.3 million in El Dorado Energy in 1998 and 1997, respectively. Total cost of the project is projected to be \$263 million. In October 1998, El Dorado Energy obtained a 15-year, \$158-million, senior-secured-credit facility to finance the project. This financing represents approximately 60 percent of the estimated total project costs.

In September 1997, Sempra Energy Utility Ventures formed a joint venture with Bangor Hydro to build, own and operate a \$40 million natural gas distribution system in Bangor,

UTILITY CAPITAL EXPENDITURES

IN MILLIONS OF DOLLARS
AT DECEMBER 31, 1998



Maine. The project is under construction and is expected to be operational in the fourth quarter of 1999. In December 1997, Sempra Energy Utility Ventures entered into a partnership with Frontier Utilities of North Carolina to build and operate a \$55 million natural gas-distribution system in North Carolina. Gas delivery began in December 1998. Subsequent to December 31, 1998, Sempra Energy Utilities Ventures acquired 100 percent ownership of the system.

In May 1997, Sempra Energy Solutions, together with Conectiv Thermal Systems, Inc., formed two joint ventures to provide integrated energy-management services to commercial and industrial customers. Specific projects of these joint ventures are described in Note 3 of the notes to Consolidated Financial Statements.

As noted above, Sempra Energy Solutions acquired CES/Way International, Inc. (CES/Way) in 1998. CES/Way provides energy-efficiency services, including energy audits, engineering design, project management, construction, financing and contract maintenance.

In March 1998, the company increased its existing investment in two Argentine natural gas utility holding companies from 12.5 percent to 21.5 percent by purchasing an additional interest for \$40 million.

Fluctuations in Sempra Energy's level of investments in the next few years will depend primarily on the activities of its subsidiaries other than SoCalGas and SDG&E.

CASH FLOWS FROM FINANCING ACTIVITIES

Net cash used in financing activities increased in 1998 due to greater short- and long-term debt repayments and the redemption of preferred stock in 1998, and the issuance of rate-reduction bonds in 1997, partially offset by the repurchase of common stock in 1997.

Net cash was provided by financing activities in 1997 compared to net cash being used in 1996 due to the issuance of rate-reduction bonds and lower repayments of long-term debt in 1997, and the redemption of preferred stock in 1996, partially offset by the redemption of common stock in 1997.



LONG-TERM DEBT

In December 1997, \$658 million of rate-reduction bonds were issued on SDG&E's behalf at an average interest rate of 6.26 percent. A portion of the bond proceeds was used to retire variable-rate, taxable Industrial Development Bonds (IDBs). Additional information concerning the rate-reduction bonds is provided below under "Electric-Industry Restructuring." In 1998, cash was used for the repayment of \$247 million of first-mortgage bonds, and \$66 million of rate-reduction bonds. Short-term debt repayments included repayment of \$94 million of debt issued to finance SoCalGas' Comprehensive Settlement as discussed in Note 14 of the notes to Consolidated Financial Statements.

In 1997, cash was used for the repayment of \$96 million of debt issued to finance the Comprehensive Settlement and repayment of \$252 million of SoCalGas' first-mortgage bonds. This was partially offset by the issuance of \$120 million in medium-term notes and short-term borrowings used to finance working capital requirements at SoCalGas.

SDG&E has \$83 million of temporary investments that will be maintained into the future to offset, for regulatory purposes, a like amount of long-term debt. The specific debt series being offset consists of variable-rate IDBs. The CPUC has approved specific ratemaking treatment which allows SDG&E to offset IDBs as long as there is at least a like amount of temporary investments. If and when SDG&E requires all or a portion of the \$83 million of IDBs to meet future needs for long-term debt, such as to finance new construction, the amount of investments which are being maintained will be reduced below \$83 million and the level of IDBs being offset will be reduced by the same amount.

STOCK PURCHASES AND REDEMPTIONS

The company, through PE and Enova, repurchased \$1 million, \$122 million and \$24 million of common stock in 1998, 1997, and 1996, respectively. The stock repurchase programs of PE and Enova were suspended as a result of the PE/Enova Business Combination. Sempra Energy does not have a stock-repurchase program.

On February 2, 1998, SoCalGas redeemed all outstanding shares of its 7 3/4% Series Preferred Stock at a cost of \$25.09 per share, or \$75.3 million including accrued dividends.

DIVIDENDS

Dividends paid on common stock amounted to \$325 million in 1998, compared to approximately \$300 million in 1997 and 1996. The increase in 1998 is the result of the company's paying dividends on its common stock at the rate previously paid by Enova, which, on an equivalent-share basis, is higher than the rate paid by PE.

Dividends are paid quarterly to shareholders. The payment of future dividends and the amount thereof are within the discretion of the board of directors.

CAPITALIZATION

The debt-to-capitalization ratio was 50 percent at year-end 1998, below the 54-percent ratio in 1997. The decrease was primarily due to the repayment of debt. The debt-to-capitalization ratio increased to 54 percent in 1997 from 50 percent in 1996, primarily due to the issuance of SDG&E's rate-reduction bonds.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents were \$424 million at December 31, 1998. This cash is available for investment in energy-related domestic and international projects, and the retirement of debt and other corporate purposes.

The company anticipates that cash required in 1999 for capital expenditures and dividend and debt payments will be provided by cash generated from operating activities and existing cash balances.

In addition to cash from ongoing operations, the company has multiyear credit agreements that permit term borrowings of up to \$995 million, of which \$43 million is outstanding at December 31, 1998. For further discussion, see Note 4 of the notes to Consolidated Financial Statements.



RESULTS OF OPERATIONS

1998 COMPARED TO 1997

Net income for 1998 decreased to \$294 million, or \$1.24 per share of common stock (diluted) in 1998, compared to net income of \$432 million, or \$1.82 per share of common stock (diluted) in 1997.

The decrease in net income is primarily due to the costs associated with the business combinations, and a lower base margin established at SoCalGas in its Performance-Based Regulation decision (SoCalGas PBR Decision) which became effective on August 1, 1997, as further described in Note 14 of the notes to Consolidated Financial Statements. Expenses related to the business combinations were \$85 million (\$0.36 per share) and \$20 million (\$0.08 per share), aftertax, for 1998 and 1997, respectively.

Also contributing to lower net income for 1998 were significant start-up costs at Sempra Energy Solutions and at Sempra Energy Trading as discussed under "Other Operations" below.

For the fourth quarter, net income decreased compared to the prior fourth quarter due to PBR and Demand-Side Management awards in the 1997 quarter, electric seasonality effects compared to 1997, and the factors that affected the annual comparison.

Book value per share decreased to \$12.29 from \$12.56, due to common dividends' exceeding the decreased net income in 1998.

1997 COMPARED TO 1996

Net income for 1997 increased to \$432 million, or \$1.82 per share of common stock (diluted), compared to net income of \$427 million, or \$1.77 per share (diluted), in 1996. The increase in net income per share is due primarily to the repurchases of common stock, which caused the weighted average number of shares of common stock outstanding to decrease 2 percent in 1997. The increase in net income is primarily due to increased net income from utility operations, partially offset by costs related to the PE/Enova Business Combination and the start-up of unregulated operations.

Book value per share increased to \$12.56 from \$12.21, due to net income's exceeding the combined effect of common dividends and the stock repurchases.

UTILITY OPERATIONS

To understand the operations and financial results of SoCalGas and SDG&E, it is important to understand the ratemaking procedures that SoCalGas and SDG&E follow.

SoCalGas and SDG&E are regulated by the CPUC. It is the responsibility of the CPUC to determine that utilities operate in the best interests of their customers and have the opportunity to earn a reasonable return on investment. In response to utility-industry restructuring, SoCalGas and SDG&E have received approval from the CPUC for PBR.

PBR replaces the general rate case (GRC) procedure and certain other regulatory proceedings. Under ratemaking procedures in effect prior to PBR, SoCalGas and SDG&E typically filed a GRC with the CPUC every three years. In a GRC, the CPUC establishes a base margin, which is the amount of revenue to be collected from customers to recover authorized operating expenses (other than the cost of fuel, natural gas and purchased power), depreciation, taxes and return on rate base.

Under PBR, regulators allow income potential to be tied to achieving or exceeding specific performance and productivity measures, rather than relying solely on expanding utility rate base in a market where a utility already has a highly developed infrastructure. See additional discussion of PBR in Note 14 of the notes to Consolidated Financial Statements.

In September 1996, California enacted a law restructuring California's electric-utility industry. The legislation adopted the December 1995 CPUC policy decision restructuring the industry to stimulate competition and reduce rates. Beginning on March 31, 1998, customers were able to buy their electricity through the California Power Exchange (PX) that obtains power from qualifying facilities, nuclear units and, lastly, from the lowest-bidding suppliers. The PX serves as a wholesale power pool, allowing all energy producers to participate competitively.

The natural gas industry experienced an initial phase of restructuring during the 1980s by deregulating natural gas sales to noncore customers. In January 1998, the CPUC initiated a project to assess the current market and regulatory framework for California's natural gas industry. The general goals of the plan are to consider reforms to the current regulatory framework emphasizing market-oriented policies.



See additional discussion of electric-industry and natural gas-industry restructuring below in "Electric-Industry Restructuring" and "Gas-Industry Restructuring" and in Note 14 of the notes to Consolidated Financial Statements.

The table below summarizes the components of utility natural gas and electric volumes and revenues by customer class for 1998, 1997, and 1996.

GAS SALES, TRANSPORTATION & EXCHANGE

(Dollars in millions, volumes in billion cubic feet)	Gas Sales		Transportation & Exchange		Total	
	Throughput	Revenue	Throughput	Revenue	Throughput	Revenue
1998:						
Residential	304	\$ 2,234	3	\$ 11	307	\$2,245
Commercial and Industrial	102	571	329	277	431	848
Utility Electric Generation*	57	9	139	66	196	75
Wholesale			28	7	28	7
	463	\$ 2,814	499	\$ 361	962	3,175
Balancing accounts and other						(403)
Total						\$2,772

1997:

Residential	268	\$ 1,957	3	\$ 10	271	\$1,967
Commercial and Industrial	102	617	332	273	434	890
Utility Electric Generation*	49	14	158	76	207	90
Wholesale			18	12	18	12
	419	\$ 2,588	511	\$ 371	930	2,959
Balancing accounts and other						5
Total						\$2,964

1996:

Residential	264	\$ 1,809	3	\$ 10	267	\$1,819
Commercial and Industrial	104	573	314	257	418	830
Utility Electric Generation*	43	9	139	70	182	79
Wholesale			17	10	17	10
	411	\$ 2,391	473	\$ 347	884	2,738
Balancing accounts and other						(28)
Total						\$2,710

* The portion representing SDG&E's sales for electric generation includes margin only.

ELECTRIC DISTRIBUTION

(Dollars in millions, volumes in millions of Kwhrs)	1998		1997		1996	
	Volumes	Revenue	Volumes	Revenue	Volumes	Revenue
Residential	6,282	\$ 637	6,125	\$ 684	5,936	\$ 647
Commercial	6,821	643	6,940	680	6,467	625
Industrial	3,097	233	3,607	268	3,567	261
Direct access	964	44	—	—	—	—
Street and highway lighting	85	8	76	7	75	7
Off-system sales	706	15	4,919	116	650	13
	17,955	1,580	21,667	1,755	16,695	1,553
Balancing accounts and other		285		14		38
Total	17,955	\$ 1,865	21,667	\$ 1,769	16,695	\$1,591



1998 COMPARED TO 1997

Utility natural gas revenues decreased 6 percent in 1998 primarily due to the lower natural gas margin established in the SoCalGas PBR Decision, a decrease in the average cost of natural gas and a decrease in sales to utility electric-generation customers, partially offset by increased sales to residential customers due to colder weather in 1998.

Electric revenues increased 5 percent in 1998 compared to 1997, primarily due to the recovery of stranded costs via the competition transition charge (CTC), and to alternate costs incurred (including fuel and purchased power) due to the delay from January 1 to March 31, 1998, in the start-up of operations of the PX and Independent System Operator (ISO). These factors were partially offset by a decrease in retail revenue as a result of the 10-percent small-customer rate reduction, which became effective in January 1998, and by a decrease in sales to other utilities, due to the start-up of the PX. The 10-percent rate reduction and PX are described further under "Factors Influencing Future Performance" and in Note 14 of the notes to Consolidated Financial Statements.

Revenues from the ISO/PX reflect sales from the company's power plants and from long-term purchased-power contracts to the ISO/PX commencing April 1, 1998.

The company's cost of natural gas distributed decreased 18 percent in 1998, largely due to a decrease in the average cost of natural gas purchased, partially offset by increases in sales volume.

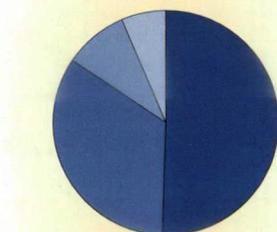
Purchased power decreased 34 percent in 1998 primarily as a result of ISO/PX purchases replacing short-term energy sources commencing April 1, 1998.

Depreciation and amortization expense increased 54 percent in 1998, primarily due to the recovery of stranded costs via the CTC. The earnings impact of the increase is offset by CTC revenue (see above).

Operating expenses increased 16 percent in 1998, primarily due to the higher business-combination costs (\$142 million in 1998, compared to \$30 million in 1997) and additional operating expenses due to start-up operations in 1998, including the acquisitions of Sempra Energy Trading and CES/Way.

SOURCES OF REVENUES

IN MILLIONS OF DOLLARS
AT DECEMBER 31, 1998



■ GAS
■ ELECTRIC
■ PX/ISO POWER
■ OTHER OPERATING REVENUES

1997 COMPARED TO 1996

Utility natural gas revenues increased 9 percent in 1997 primarily due to an increase in the average unit cost of natural gas, which is recoverable in rates. To a lesser extent, the increase was due to increased throughput to utility electric-generation customers due to increased demand for electricity. The increase was partially offset by an increase in customer purchases of natural gas directly from other suppliers.

Utility electric revenues increased 11 percent in 1997, primarily due to an increase in sales for resale to other utilities and increased retail sales volume due to weather.

Utility cost of natural gas distributed increased 22 percent in 1997, largely due to an increase in the average cost of natural gas purchased and increases in sales volume.

Purchased power increased 42 percent in 1997, primarily due to increased volume, which resulted from lower nuclear-generation availability due to refuelings at SONGS and increased use of purchased power due to decreased purchased-power prices.

Operating expenses increased 15 percent in 1997, primarily due to the start-up of unregulated operations, partially offset by lower utility operating expenses. The extent of this offset was lessened by reduced costs in 1996 from favorable litigation settlements.

FACTORS INFLUENCING FUTURE PERFORMANCE

Performance of the company in the near future will depend primarily on the results of SDG&E and SoCalGas. Because of the ratemaking and regulatory process, electric- and natural gas-industry restructuring, and the changing energy marketplace, there are several factors that will influence future financial performance. These factors are summarized below.

KN ENERGY ACQUISITION

On February 22, 1999, the company announced a definitive agreement to acquire KN Energy, Inc., subject to approval by the shareholders of both companies and by various regulatory agencies. See Note 16 of the notes to Consolidated Financial Statements for additional information.

ELECTRIC-INDUSTRY RESTRUCTURING

As discussed above, in September 1996, California enacted a law restructuring California's electric-utility industry (AB 1890). Consumers now have the opportunity to choose to continue to purchase their electricity from the local utility under regulated tariffs, to enter into contracts with other energy service providers (direct access) or to buy their power from the PX that serves as a wholesale power pool allowing all energy producers to participate competitively. The local utility continues to provide distribution service regardless of which source the consumer chooses. See Note 14 of the notes to Consolidated Financial Statements for additional information.



TRANSITION COSTS

AB 1890 allows utilities, within certain limits, the opportunity to recover their stranded costs incurred for certain above-market CPUC-approved facilities, contracts and obligations through the establishment of the CTC.

Utilities are allowed a reasonable opportunity to recover their stranded costs through December 31, 2001. Stranded costs include sunk costs, as well as ongoing costs the CPUC finds reasonable and necessary to maintain generation facilities through December 31, 2001. These costs also include other items SDG&E has accrued under traditional cost-of-service regulation.

Through December 31, 1998, SDG&E has recovered transition costs of \$500 million for nuclear generation and \$200 million for nonnuclear generation. Excluding the costs of purchased power and other costs whose recovery is not limited to the pre-2002 period, the balance of SDG&E's stranded assets at December 31, 1998, is \$600 million, consisting of \$400 million for the power plants and \$200 million of related deferred taxes and undercollections. During the 1998 - 2001 period, recovery of transition costs is limited by a rate cap. See Note 14 of the notes to Consolidated Financial Statements for additional information.

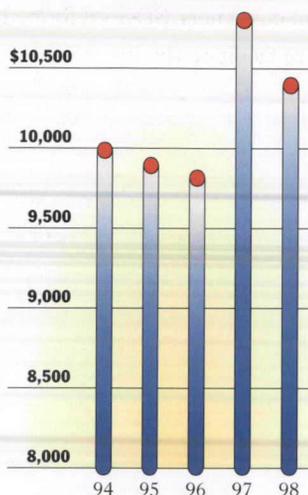
ELECTRIC-GENERATION ASSETS

In November 1997, SDG&E adopted a plan to auction its power plants and other electric-generating assets so that it could continue to concentrate its business on the transmission and distribution of electricity and natural gas as California opens its electric-utility industry to competition. This plan included the divestiture of SDG&E's fossil-fueled power plants and combustion turbines, its 20-percent interest in SONGS and its portfolio of long-term purchased-power contracts. The power plants, including the interest in SONGS, have a net book value as of December 31, 1998, of \$400 million (\$100 million for fossil and \$300 million for SONGS).

The March 1998 decision of the CPUC approving the PE/Enova Business Combination required, among other things, the divestiture by SDG&E of its fossil-fueled generation units. On December 11, 1998, SDG&E entered into agreements for the sale of its South Bay Power Plant, Encina Power Plant and 17 combustion-turbine generators. The sales are subject to regulatory approval and are expected to close during the first half of 1999. See Note 14 of the notes to Consolidated Financial Statements for additional information.

TOTAL ASSETS

IN MILLIONS OF DOLLARS
AT DECEMBER 31, 1998



As mentioned above, Septra Energy Resources and Reliant Energy Power Generation formed a joint venture to build, own and operate a natural gas power plant (El Dorado) in Boulder City, Nevada. The joint venture plans to sell the plant's electricity into the wholesale market, which, in turn, sells to utilities throughout the Western United States. The new plant will employ an advanced combined-cycle gas-turbine technology, enabling it to become one of the most efficient and environmentally

friendly power plants in the nation. Its proximity to existing natural gas pipelines and electric transmission lines will allow El Dorado to actively compete in the deregulated electric-generation market. The project, funded equally by the company and Reliant, began in the first quarter of 1998, with an expected operational date set for the fourth quarter of 1999.

ELECTRIC RATES

AB 1890 provides for a 10-percent reduction in rates for residential and small commercial customers effective in January 1998, and provided for the issuance of rate-reduction bonds by an agency of the state of California to enable its investor-owned utilities (IOUs) to achieve this rate reduction. In December 1997, \$658 million of rate-reduction bonds were issued on behalf of SDG&E at an average interest rate of 6.26 percent. These bonds are being repaid over 10 years by SDG&E's residential and small-commercial customers via a nonbypassable charge on their electricity bills. In September 1997, SDG&E and the other California IOUs received a favorable ruling by the Internal Revenue Service on the tax treatment of the bond transaction. The ruling states, among other things, that the receipt of the bond proceeds does not result in gross income to SDG&E at the time of issuance, but rather the proceeds are taxable over the life of the bonds. The Securities and Exchange Commission determined that these bonds should be reflected



on the utilities' balance sheets as debt, even though the bonds are not secured by, or payable from, utility assets, but rather by the future revenue streams collected from customers. SDG&E formed a subsidiary, SDG&E Funding LLC, to facilitate the issuance of the rate-reduction bonds. In exchange for the bond proceeds, SDG&E sold to SDG&E Funding LLC all of its rights to the revenue streams. Consequently, the revenue streams are not the property of SDG&E and are not available to creditors of SDG&E.

AB 1890 also included a rate freeze for all customers. Until the earlier of March 31, 2002, or when transition-cost recovery is complete, SDG&E's average system rate will be held at 9.64 cents per kilowatt-hour (kwh), except for the impacts of fuel-cost changes and the 10-percent rate reduction described above.

Beginning in 1998, system-average rates were fixed at 9.43 cents per kwh, which includes the maximum permitted increase related to fuel-cost increases and the mandatory rate reduction.

SDG&E's ability to recover its transition costs is dependent on its total revenues under the rate freeze exceeding traditional cost-of-service revenues during the transition period by at least the amount of the CTC less the net proceeds from the sale of electric-generating assets. During the transition period, SDG&E will not earn awards from special programs, such as Demand-Side Management, unless total revenues are also adequate to cover the awards. Fuel-price volatility is one of the more significant uncertainties in the ability of SDG&E to recover its transition costs and program awards.

In early 1999, SDG&E filed with the CPUC for an interim mechanism to deal with electric rates after the rate freeze ends, noting the possibility that the SDG&E rate freeze could end in 1999.

PERFORMANCE-BASED REGULATION

As discussed above, under PBR, regulators allow future income potential to be tied to achieving or exceeding specific performance and productivity measures, as well as cost reductions, rather than by relying solely on expanding utility rate base. See additional discussion of PBR in Note 14 of the notes to Consolidated Financial Statements.

REGULATORY ACCOUNTING STANDARDS

SoCalGas and SDG&E are accounting for the economic effects of regulation on all of their utility operations, except for electric generation, in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation." Under SFAS No. 71, a regulated entity

records a regulatory asset if it is probable that, through the rate-making process, the utility will recover the asset from customers. Regulatory liabilities represent future reductions in revenues for amounts due to customers. See Notes 2 and 14 of the notes to Consolidated Financial Statements for additional information.

AFFILIATE TRANSACTIONS

On December 16, 1997, the CPUC adopted rules establishing uniform standards of conduct governing the manner in which California IOUs conduct business with their affiliates. The objective of these rules, which became effective January 1, 1998, is to ensure that the utilities' energy affiliates do not gain an unfair advantage over other competitors in the marketplace and that utility customers do not subsidize affiliate activities.

The CPUC excluded utility-to-utility transactions between SDG&E and SoCalGas from the affiliate-transaction rules in its March 1998 decision approving the PE/Enova Business Combination. As a result, the affiliate-transaction rules will not substantially impact the company's ability to achieve anticipated synergy savings. See Notes 1 and 14 of the notes to Consolidated Financial Statements for additional information.

ALLOWED RATE OF RETURN

For 1998, SoCalGas was authorized to earn a rate of return on rate base of 9.49 percent and a rate of return on common equity of 11.6 percent, which is unchanged from 1997. SDG&E was authorized to earn a rate of return on rate base of 9.35 percent and a rate of return on common equity of 11.6 percent, unchanged from 1997. See additional discussion in Note 14 of the notes to Consolidated Financial Statements.

MANAGEMENT CONTROL OF EXPENSES AND INVESTMENT

In the past, management has been able to control operating expenses and investment within the amounts authorized to be collected in rates.



It is the intent of management to control operating expenses and investments within the amounts authorized to be collected in rates in the PBR decision. The utilities intend to make the efficiency improvements, changes in operations and cost reductions necessary to achieve this objective and earn their authorized rates of return. However, in view of the earnings-sharing mechanism and other elements of the PBR, it is more difficult to exceed authorized returns to the degree experienced in past years. See additional discussion of PBR in Note 14 of the notes to Consolidated Financial Statements.

GAS-INDUSTRY RESTRUCTURING

The natural gas industry experienced an initial phase of restructuring during the 1980s by deregulating natural gas sales to noncore customers. On January 21, 1998, the CPUC initiated a project to assess the current market and regulatory framework for California's natural gas industry. The general goals of the plan are to consider reforms to the current regulatory framework emphasizing market-oriented policies benefiting California natural gas consumers. On August 25, 1998, California enacted a law prohibiting the CPUC from enacting any natural gas industry restructuring decision for core customers prior to January 1, 2000. The CPUC continues to study the issue.

NONCORE BYPASS

SoCalGas' throughput to enhanced oil recovery (EOR) customers in the Kern County area has decreased significantly since 1992 because of the bypass of SoCalGas' system by competing interstate pipelines. The decrease in revenues from EOR customers has not had a material impact on SoCalGas' earnings.

Bypass of other markets also may occur, and SoCalGas is fully at risk for a reduction in non-EOR, noncore volumes due to bypass. However, significant additional bypass would require construction of additional facilities by competing pipelines. SoCalGas is continuing to reduce its costs to maintain cost competitiveness in order to retain transportation customers.

NONCORE PRICING

To respond to bypass, SoCalGas has received authorization from the CPUC for expedited review of long-term gas-transportation service contracts with some noncore customers at lower-than-tariff rates. In addition, the CPUC approved changes in the methodology that eliminates subsidization of core-customer rates by noncore customers. This allocation flexibility, together with negotiating authority, has enabled SoCalGas to better compete with new interstate pipelines for noncore customers.

NONCORE THROUGHPUT

SoCalGas' earnings may be adversely impacted if natural gas throughput to its noncore customers varies from estimates adopted by the CPUC in establishing rates. There is a continuing risk that an unfavorable variance in noncore volumes may result from external factors such as weather, electric deregulation, the increased use of hydroelectric power, competing pipeline bypass of SoCalGas' system and a downturn in general economic conditions. In addition, many noncore customers are especially sensitive to the price relationship between natural gas and alternate fuels, as they are capable of readily switching from one fuel to another, subject to air-quality regulations. SoCalGas is at risk for the lost revenue.

Through July 31, 1999, any favorable earnings effect of higher revenues resulting from higher throughput to noncore customers has been limited as a result of the Comprehensive Settlement discussed in Note 14 of the notes to Consolidated Financial Statements.

EXCESS INTERSTATE PIPELINE CAPACITY

Existing interstate pipeline capacity into California exceeds current demand by over one billion cubic feet (Bcf) per day. This situation has reduced the market value of the capacity well below the Federal Energy Regulatory Commission's (FERC) tariffs.

SoCalGas has exercised its step-down option on both the El Paso and Transwestern systems, thereby reducing its firm interstate capacity obligation from 2.25 Bcf per day to 1.45 Bcf per day.

FERC-approved settlements have resulted in a reduction in the costs that SoCalGas possibly may have been required to pay for the capacity released back to El Paso and Transwestern that cannot be remarketed. Of the remaining 1.45 Bcf per day of capacity, SoCalGas' core customers use 1.05 Bcf per day at the full FERC tariff rate. The remaining 0.4 Bcf per day of capacity is marketed at significant discounts. Under existing California regulation, unsubscribed capacity costs associated with the remaining 0.4 Bcf per day are recoverable in customer rates. While including the unsubscribed pipeline cost in rates may impact SoCalGas' ability to compete in highly contested markets, SoCalGas does not believe its inclusion will have a significant impact on volumes transported or sold.



ENVIRONMENTAL MATTERS

The company's operations are conducted in accordance with applicable federal, state and local environmental laws and regulations governing such things as hazardous wastes, air and water quality, and the protection of wildlife.

These costs of compliance are normally recovered in customer rates. Whereas it is anticipated that the environmental costs associated with natural gas operations and with electric transmission and generation operations will continue to be recoverable in rates, the restructuring of the California electric-utility industry, described above under "Electric-Industry Restructuring," will change the way utility rates are set and costs associated with electric generation are recovered. Capital costs related to environmental regulatory compliance for electric generation are intended to be included in transition costs for recovery through 2001. However, depending on the final outcome of industry restructuring and the impact of competition, the costs of future compliance with environmental regulations may not be fully recoverable.

Capital expenditures to comply with environmental laws and regulations were \$1 million in 1998, \$5 million in 1997 and \$9 million in 1996, and are not expected to be significant during the next five years. These projected expenditures primarily consist of the estimated cost of reducing air emissions by retrofitting power plants. This estimate anticipates that SDG&E completes the planned sale of its fossil-fueled power plants during the first half of 1999. Additional information on SDG&E's divestiture of its electric generating assets is discussed above under "Electric Generation Assets" and in Note 14 of the notes to Consolidated Financial Statements.

HAZARDOUS SUBSTANCES

In 1994, the CPUC approved the Hazardous Waste Collaborative, a mechanism which allows SoCalGas, SDG&E and other utilities to recover, through rates, costs associated with the cleanup of sites contaminated with hazardous waste. In general, utilities are allowed to recover 90 percent of their cleanup costs and any related costs of litigation through rates. In early 1998, the CPUC modified this mechanism to exclude these costs related to electric-generation activities. These costs are now eligible for inclusion in the Competition Transition Cost (CTC) recovery process described above.

During the early 1900s, SDG&E, SoCalGas and their predecessors manufactured gas from coal or oil, the sites of which have often become contaminated with the hazardous residual by-products of the process. SDG&E has identified three former manufactured-gas plant sites. One of these sites has been remediated and a site-closure letter has been received from the San Diego County Department of Environmental Health. An environmental site assessment has been conducted and the estimated cost to remediate the other two sites is \$6 million. SoCalGas has identified 42 former manufactured-gas plant sites at which it (together with other utilities of these sites) may have cleanup obligations. As of December 31, 1998, 12 of these sites have been remediated and a certificate of closure has been received from the California Environmental Protection Agency for 10 of the sites. A preliminary environmental site assessment has been conducted on 39 of the sites and it is estimated that the cost for the remaining sites is \$68 million. In addition, other company subsidiaries have been named as potentially responsible parties ("PRPs") in relation to two landfills and three industrial waste disposal sites, and it is estimated that the subsidiaries' share of the costs to remediate such sites is \$5 million. Ninety percent of SoCalGas and SDG&E's costs to clean up the gas plants and to meet their PRP obligations, a total estimated to be \$75 million, is recoverable through the Hazardous Waste Collaborative mechanism.

As a part of its sale of the South Bay and Encina power plants and 17 combustion turbines (described above), SDG&E retained limited remediation obligations for contamination existing on these sites upon the closing of the sales. SDG&E's costs to perform its remediation obligations as a part of such sales is estimated to be \$10 million. These costs are eligible for inclusion in the CTC recovery process.

AIR AND WATER QUALITY

California's air quality standards are more restrictive than federal standards. However, due to the sale of the electric-generating power plants, the company's primary air-quality issue, compliance with these standards will be less significant in the future.



In connection with the issuance of operating permits, SDG&E and the other owners of SONGS reached agreement with the California Coastal Commission to mitigate the environmental damage to the marine environment attributed to the cooling-water discharge from SONGS Units 2 and 3. This mitigation program includes an enhanced fish-protection system, a 150-acre artificial reef and restoration of 150 acres of coastal wetlands. In addition, the owners must deposit \$3.6 million with the state for the enhancement of marine fish hatchery programs and pay for monitoring and oversight of the mitigation projects. SDG&E's share of the cost is estimated to be \$23 million. The pricing structure contained in the CPUC's decision regarding accelerated recovery of SONGS Units 2 and 3 is expected to accommodate most of these added mitigation costs.

The environmental laws and regulations regarding natural gas affect the operations of customers as well as the company's regulated natural gas entities. Increasingly complex administrative and reporting requirements of environmental agencies applicable to commercial and industrial customers utilizing natural gas are not generally required of those using electricity. However, anticipated advancements in natural gas technologies are expected to enable natural gas equipment to remain competitive with alternate energy sources.

The transmission and distribution of natural gas require the operation of compressor stations, which are subject to increasingly stringent air-quality standards. Costs to comply with these standards are recovered in rates.

INTERNATIONAL OPERATIONS

Empira Energy International (SEI) was formed in June 1998, merging the international operations of PE and Enova. Prior to the business combination, PE and Enova were already partners in two natural gas distribution projects in Mexico. In addition, PE held an interest in two natural gas utility holding companies in Argentina.

SEI develops, operates and invests in energy-infrastructure systems and power-generation facilities outside the United States. SEI has interests in natural gas transmission and distribution projects in Mexico, Argentina and Uruguay and is pursuing projects in other parts of Latin America and in Asia.

In March 1998, PE increased its existing investment in two Argentine natural gas utility holding companies (Sodigas Pampeana S.A and Sodigas Sur S.A.) by purchasing an additional 9-percent interest for \$40 million. With this purchase, PE's interest in the holding companies was increased to 21.5 percent. The distribution companies serve 1.2 million customers in central and southern Argentina, respectively, and have a combined sendout of 650 million cubic feet per day.

SEI is part of a binational consortium named Distribuidora de Gas Natural de Mexicali, S. de R.L. de C.V. (DGN-Mexicali), a Mexican company that won the first license awarded to a private company to build a natural gas distribution system in Mexico. On August 20, 1997, DGN-Mexicali began to deliver natural gas to customers in Mexicali, Baja California. DGN-Mexicali will invest up to \$25 million to provide service to 25,000 customers during the first five years of operation. Proxima Gas, S.A. de C.V. (Proxima), a group of prominent Mexican businesspeople, is the project partner. SEI owns a 60-percent interest in the Mexicali project.

SEI also has partnered with Proxima to form Distribuidora de Gas Natural de Chihuahua, S. de R.L. de C.V. (DGN-Chihuahua), which distributes natural gas to the city of Chihuahua, Mexico and surrounding areas. On July 9, 1997, DGN-Chihuahua assumed ownership of a 16-mile transmission pipeline serving 20 industrial customers. DGN-Chihuahua will invest nearly \$50 million to provide service to 50,000 customers in the first five years of operation. SEI owns a 95-percent interest in DGN-Chihuahua.

On August 27, 1998, SEI was awarded a 10-year agreement by the Mexican Federal Electric Commission to provide natural gas for the *Presidente Juárez* power plant in Rosarito, Baja California. The contract includes provisions for delivery of up to 300 million cubic feet per day of natural gas transportation services in the United States and construction of a 23-mile pipeline from the U.S. - Mexico border to the plant. This pipeline will also serve other customers in the region. In today's dollars, future revenues under the contract could approach \$1 billion.

In May 1998, PE was awarded a concession by the government of Uruguay to build a natural gas and propane distribution system to serve most of the country, excluding Montevideo. SEI is currently in discussions with regards to the terms of the concession agreement with the Uruguayan government.

The net losses for international operations were \$4 million and \$9 million, after tax, for 1998 and 1997, respectively.



OTHER OPERATIONS

Sempra Energy Trading (SET), a leading natural gas power marketing firm headquartered in Stamford, Connecticut, was jointly acquired by PE and Enova on December 31, 1997. For the year ended December 31, 1998, SET recorded after-tax income of \$1 million from its operations and a net loss of \$13 million after amortization of costs associated with the acquisition. Additional information concerning SET is provided in Note 10 of the notes to Consolidated Financial Statements.

Sempra Energy Solutions (Solutions), formed in 1997 as a joint venture of PE and Enova, incorporates several existing unregulated businesses from each of PE and Enova. It is pursuing a variety of opportunities, including buying and selling natural gas for large users, integrated energy-management services targeted at large governmental and commercial facilities, and consumer-market products and services such as earthquake shutoff valves. CES/Way International, Inc. (CES/Way), which was acquired by Solutions in January 1998, provides energy-efficiency services including energy audits, engineering design, project management, construction, financing and contract maintenance.

Solutions' operating losses were \$27 million and \$14 million, aftertax, for the years ended December 31, 1998, and 1997, respectively. The losses are primarily due to start-up costs.

OTHER INCOME, INTEREST EXPENSE AND INCOME TAXES

OTHER INCOME

Other income, which primarily consists of interest income from short-term investments and regulatory-balancing accounts, decreased in 1998 to \$44 million from \$58 million in 1997. The decrease was a result of lower interest income from short-term investments. The increase to \$58 million from \$28 million in 1996 was due to higher interest from short-term investments during much of 1997.

INTEREST EXPENSE

Interest expense for 1998 increased slightly to \$207 million from \$206 million in 1997. Interest expense for 1997 increased to \$206 million from \$200 million in 1996, as a result of a higher long-term debt balance.

INCOME TAXES

Income tax expense for 1998 was \$138 million, less than the \$301 million for 1997. The effective income tax rate was 32 percent for 1998 and 41 percent for 1997. The decrease in income tax expense is primarily due to the decrease in pretax income, combined with an increase in affordable-housing tax credits.

DERIVATIVE FINANCIAL INSTRUMENTS

The company's policy is to use derivative financial instruments to manage exposure to fluctuations in interest rates, foreign currency exchange rates and energy prices. The company also uses and trades derivative financial instruments in its energy trading and marketing activities. Transactions involving these financial instruments are with reputable firms and major exchanges. The use of these instruments may expose the company to market and credit risks. At times, credit risk may be concentrated with certain counterparties, although counterparty nonperformance is not anticipated.

Sempra Energy Trading derives a substantial portion of its revenue from risk management and trading activities in natural gas, petroleum and electricity. Profits are earned as SET acts as a dealer in structuring and executing transactions that assist its customers in managing their energy-price risk. In addition, SET may, on a limited basis, take positions in energy markets based on the expectation of future market conditions. These positions include options, forwards, futures and swaps. See Note 10 of the notes to Consolidated Financial Statements and the following "Market Risk Management Activities" section for additional information regarding SET's use of derivative financial instruments.

The company's regulated operations periodically enter into interest-rate swap and cap agreements to moderate exposure to interest-rate changes and to lower the overall cost of borrowing. These swap and cap agreements generally remain off the balance sheet as they involve the exchange of fixed-rate 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 interest expense. The company would be exposed to interest-rate fluctuations on the underlying debt should other parties to the agreement not perform. Such nonperformance is not anticipated. At December 31, 1998, the notional amount of swap transactions associated with the regulated operations totaled \$45 million. See Note 5 of the notes to Consolidated Financial Statements for further information regarding these swap transactions.

The company's regulated operations use energy derivatives to manage natural gas price risk associated with servicing their load requirements. In addition, they make limited use of natural gas derivatives for trading purposes. These instruments include forward contracts, futures, swaps, options and other contracts, with maturities ranging from 30 days to 12 months. In the case of both price-risk management and trading activities, the use of derivative financial instruments by the company's regulated operations is subject to certain limitations imposed by established company policy and regulatory requirements. See Note 10 of the notes to Consolidated Financial Statements and the "Risk Management Activities" section below for further information regarding the use of energy derivatives by the company's regulated operations.



MARKET RISK MANAGEMENT ACTIVITIES

Market risk is the risk of erosion of the company's cash flows, net income and asset values due to adverse changes in interest and foreign-currency rates, and in prices for equity and energy. The company has adopted corporate-wide policies governing its market-risk management and trading activities. An Energy Risk Management Oversight Committee, consisting of senior corporate officers, oversees company-wide energy-price risk management and trading activities to ensure compliance with the company's stated energy risk management and trading policies. In addition, all affiliates have groups that monitor and control energy-price risk management and trading activities independently from the groups responsible for creating or actively managing these risks.

Along with other tools, the company uses Value at Risk (VaR) to measure its exposure to market risk. VaR is an estimate of the potential loss on a position or portfolio of positions over a specified holding period, based on normal market conditions and within a given statistical confidence level. The company has adopted the variance/covariance methodology in its calculation of VaR, and uses a 95 percent confidence level. Holding periods are specific to the types of positions being measured, and are determined based on the size of the position or portfolios, market liquidity, tenor and other factors. Historical volatilities and correlations between instruments and positions are used in the calculation.

The following is a discussion of the company's primary market-risk exposures as of December 31, 1998, including a discussion of how these exposures are managed.

INTEREST-RATE RISK

The company is exposed to fluctuations in interest rates primarily as a result of its fixed-rate long-term debt. The company has historically funded utility operations through long-term bond issues with fixed interest rates. With the restructuring of the regulatory process, greater flexibility has been permitted within the debt-management process. As a result, recent debt offerings have been selected with short-term maturities to take advantage of yield curves or used a combination of fixed- and floating-rate debt. Interest-rate swaps, subject to regulatory constraints, may be used to adjust interest-rate exposures when appropriate, based upon market conditions.

A portion of the company's borrowings are denominated in foreign currencies, which expose the company to market risk associated with exchange-rate movements. The company's policy generally is to hedge major foreign-currency cash exposures through swap transactions. These contracts are entered into with major international banks, thereby minimizing the risk of credit loss.

The VaR on the company's fixed-rate long-term debt is estimated at approximately \$312 million as of December 31, 1998, assuming a one-year holding period. The VaR attributable to currency exchange rates nets to zero as a result of a currency swap that is directly matched to the company's Swiss franc debt obligation, its only non-dollar-denominated debt.

ENERGY-PRICE RISK

Market risk related to physical commodities is based upon potential fluctuations in natural gas, petroleum and electricity commodity exchange prices and basis. The company's market risk is impacted by changes in volatility and liquidity in the markets in which these instruments are traded. The company's regulated and unregulated affiliates are exposed, in varying degrees, to price risk in the natural gas, petroleum and electricity markets. The company's policy is to manage this risk within a framework that considers the unique markets, operating and regulatory environment of each affiliate.

SEMPRA ENERGY TRADING

Sempra Energy Trading derives a substantial portion of its revenue from risk management and trading activities in natural gas, petroleum and electricity. As such, SET is exposed to price volatility in the domestic and international natural gas, petroleum and electricity markets. SET conducts these activities within a structured and disciplined risk management and control framework that is based on clearly communicated policies and procedures, position limits, active and ongoing management monitoring and oversight, clearly defined roles and responsibilities, and daily risk measurement and reporting.

Market risk of SET's portfolio is measured using a variety of methods, including VaR. SET computes the VaR of its portfolio based on a three-day holding period. As of December 31, 1998, the diversified VaR of SET's portfolio was \$5.3 million.

SDG&E

SDG&E is exposed to market risk in its natural gas purchase, sale and storage activities whenever natural gas prices fall outside the PBR tolerance band. SDG&E manages this risk within the parameters of the company's market-risk management and trading framework. As of December 31, 1998, the total VaR of SDG&E's natural gas positions was not material.



SDG&E is exposed to market risk on its electricity purchases and sales under the electricity rate cap. See Note 14 of the notes to Consolidated Financial Statements and the discussion under "Factors Influencing Future Performance" for further information regarding the electricity rate cap.

SoCalGas

SoCalGas is exposed to market risk on its natural gas purchase, sale and storage activities whenever natural gas prices fall outside the Gas Cost Incentive Mechanism tolerance band. SoCalGas manages this risk within the parameters of the company's market risk management and trading framework. As of December 31, 1998, the total VaR of SoCalGas' natural gas positions was not material.

CREDIT RISK

Credit risk relates to the risk of loss that would be incurred as a result of nonperformance by counterparties pursuant to the terms of their contractual obligations. The company avoids concentration of counterparties and maintains credit policies with regard to counterparties that management believes significantly minimize overall credit risk. These policies include an evaluation of potential counterparties' financial condition (including credit rating), collateral requirements under certain circumstances, and the use of standardized agreements that allow for the netting of positive and negative exposures associated with a single counterparty.

The company monitors credit risk through a credit-approval process and the assignment and monitoring of credit limits. These credit limits are established based on risk and return considerations under terms customarily available in the industry.

YEAR 2000 ISSUES

Most companies are affected by the inability of many automated systems and applications to process the year 2000 and beyond. The Year 2000 issues are the result of computer programs and other automated processes using two digits to identify a year, rather than four digits. Any of the company's computer programs that include date-sensitive software may recognize a date using "00" as representing the year 1900, instead of the year 2000, or "01" as 1901, etc., which could lead to system malfunctions. The Year 2000 issues impact both Information Technology (IT) systems and also non-IT systems, including systems incorporating "embedded processors." To address this problem, in 1996, both Pacific Enterprises and Enova Corporation established company-wide Year 2000 programs. These programs have now been consolidated into the company's overall Year 2000 readiness effort. The company has established a central Year 2000 Program Office, which reports to the company's Chief Information Technology Officer and reports periodically to the audit committee of the board of directors.

THE COMPANY'S STATE OF READINESS

Sempra Energy is identifying all IT and non-IT systems that might not be Year 2000 ready and categorizing them in the following areas: IT applications, computer hardware and software infrastructure, telecommunications, embedded systems and third parties. The company is currently evaluating its exposure in all of these areas. These systems and applications are being tracked and measured through four key phases: inventory, assessment, remediation/testing, and Year 2000 readiness. Those applications and systems, which, if not appropriately remediated, may have a significant impact on energy delivery, revenue collection or the safety of personnel, customers or facilities, are being assessed and modified/replaced first. The testing effort includes functional testing of Year 2000 dates and validating that changes have not altered existing functionality. The company uses an independent, internal-review process to verify that the appropriate testing has occurred.

Inventory and assessment for all company systems were completed by January 1999 and ongoing inventory and assessment will be performed, as necessary, on any new applications. The project is on schedule and the company estimates that by June 30, 1999, all critical systems will be suitable for continued use into the year 2000 with no significant operational problems.

The company's current schedule for Year 2000 testing, readiness and development of contingency plans is subject to change depending upon the remediation and testing phases of the company's compliance effort and upon developments that may arise as the company continues to assess its computer-based systems and operations. In addition, this schedule is dependent upon the efforts of third parties, such as suppliers (including energy producers) and customers. Accordingly, delays by third parties may cause the company's schedule to change.

COSTS TO ADDRESS THE COMPANY'S YEAR 2000 ISSUES

Sempra Energy's budget for the Year 2000 program is \$48 million, of which \$38 million has been spent. As the company continues to assess its systems and as the remediation and testing efforts progress, cost estimates may change. The company's Year 2000 readiness effort is being funded entirely by operating cash flows.

THE RISKS OF THE COMPANY'S YEAR 2000 ISSUES

Based upon its current assessment and testing of the Year 2000 issue, the company believes the reasonably likely worst-case Year 2000 scenarios would have the following impacts upon Sempra Energy and its operations. With respect to the company's ability



to provide energy to its domestic utility customers, the company believes that the reasonably likely worst-case scenario is for small, localized interruptions of natural gas or electrical service which are restored in a time frame that is within normal service levels. With respect to services that are essential to Sempra Energy's operations, such as customer service, business operations, supplies and emergency response capabilities, the scenario is for minor disruptions of essential services with rapid recovery and all essential information and processes ultimately recovered.

To assist in preparing for and mitigating these possible scenarios, Sempra Energy is a member of several industry-wide efforts established to deal with Year 2000 problems affecting embedded systems and equipment used by the nation's natural gas and electric power companies. Under these efforts, participating utilities are working together to assess specific vendors' system problems and to test plans. These assessments will be shared by the industry as a whole to facilitate Year 2000 problem solving.

A portion of this risk is due to the various Year 2000 schedules of critical third-party suppliers and customers. The company is in the process of contacting its critical suppliers and customers to survey their Year 2000 remediation programs. While risks related to the lack of Year 2000 readiness by third parties could materially and adversely affect the company's business, results of operations and financial condition, the company expects its Year 2000 readiness efforts to reduce significantly the company's level of uncertainty about the impact of third party Year 2000 issues on both its IT systems and non-IT systems.

COMPANY'S CONTINGENCY PLANS

Sempra Energy's contingency plans for interruptions related to Year 2000 issues are being incorporated into the company's existing overall emergency preparedness plans. To the extent appropriate, such plans will include emergency backup and recovery procedures, remediation of existing systems parallel with installation of new systems, replacing electronic applications with manual processes, identification of alternate suppliers and increasing inventory levels. The company expects these contingency plans to be completed by June 30, 1999. Due to the speculative and uncertain nature of contingency planning, there can be no assurances that such plans actually will be sufficient to reduce the risk of material impacts on the company's operations due to Year 2000 issues.

NEW ACCOUNTING STANDARDS

In April 1998, the American Institute of Certified Public Accountants issued Statement of Position 98-5 "Reporting on the Costs of Start-up Activities." This statement is effective for 1999, but is not expected to have a significant effect on the company's Consolidated Financial Statements.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities." This statement, which is effective January 1, 2000, requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position, measure those instruments at fair value and recognize changes in the fair value of derivatives in earnings in the period of change unless the derivative qualifies as an effective hedge that offsets certain exposures. The effect of this standard on the company's Consolidated Financial Statements has not yet been determined.

INFORMATION REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report includes forward-looking statements within the definition of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words "estimates," "believes," "expects," "anticipates," "plans" and "intends," variations of such words, and similar expressions, are intended to identify forward-looking statements that involve risks and uncertainties which could cause actual results to differ materially from those anticipated. These statements are necessarily based upon various assumptions involving judgments with respect to the future including, among others, local, regional, national and international economic, competitive, political, and regulatory conditions and developments, technological developments, capital market conditions, inflation rates, interest rates, energy markets, weather conditions, business and regulatory or legal decisions, the pace of deregulation of retail natural gas and electricity industries, the timing and success of business development efforts, and other uncertainties, all of which are difficult to predict and many of which are beyond the control of the company. Accordingly, while the company believes that the assumptions are reasonable, there can be no assurance that they will approximate actual experience, or that the expectations will be realized. Readers are urged to carefully review and consider the risks, uncertainties and other factors which affect the company's business described in this annual report and other reports filed by the company from time to time with the Securities and Exchange Commission.

Five-Year Summary

For the years ended December 31

(Dollars in millions except per share amounts)

	1998	1997	1996	1995	1994
REVENUES AND OTHER INCOME					
Gas	\$ 2,772	\$ 2,964	\$ 2,710	\$ 2,542	\$ 2,948
Electric	1,865	1,769	1,591	1,504	1,510
PX/ISO	500	—	—	—	—
Other	388	394	223	155	81
Total	\$ 5,525	\$ 5,127	\$ 4,524	\$ 4,201	\$ 4,539
Operating income	\$ 639	\$ 939	\$ 927	\$ 886	\$ 867
Net income	\$ 294	\$ 432	\$ 427	\$ 401	\$ 296
Net income per common share:					
Basic	\$ 1.24	\$ 1.83	\$ 1.77	\$ 1.67	\$ 1.23
Diluted	\$ 1.24	\$ 1.82	\$ 1.77	\$ 1.67	\$ 1.23
Dividends declared per common share	\$ 1.56	\$ 1.27	\$ 1.24	\$ 1.22	\$ 1.16
Pretax income/revenue	7.9%	14.5%	16.2%	16.0%	14.1%
Return on common equity	10.0%	14.7%	14.9%	14.6%	11.3%
Effective income tax rate	31.9%	41.1%	41.3%	39.7%	43.4%
Dividend payout ratio:					
Basic	125.8%	69.4%	70.1%	73.1%	94.3%
Diluted	125.8%	69.8%	70.1%	73.1%	94.3%
Price range of common shares	29 ⁵ / ₁₆ —23 ³ / ₄	*	*	*	*
AT DECEMBER 31					
Current assets	\$ 2,458	\$ 2,761	\$ 1,592	\$ 1,520	\$ 1,566
Total assets	\$ 10,456	\$ 10,756	\$ 9,762	\$ 9,837	\$ 9,931
Current liabilities	\$ 2,466	\$ 2,211	\$ 1,572	\$ 1,578	\$ 1,704
Long-term debt (excludes current portion)	\$ 2,795	\$ 3,175	\$ 2,704	\$ 2,721	\$ 2,889
Shareholders' equity	\$ 2,913	\$ 2,959	\$ 2,930	\$ 2,815	\$ 2,684
Common shares outstanding (in millions)	237.0	235.6	240.0	240.6	240.0
Book value per common share	\$ 12.29	\$ 12.56	\$ 12.21	\$ 11.70	\$ 11.18
Price/earnings ratio	20.5	*	*	*	*
Number of meters (in thousands):					
Natural gas	5,639	5,551	5,501	5,436	5,388
Electricity	1,216	1,178	1,164	1,151	1,139

*Not presented as the formation of Sempra Energy was not completed until June 26, 1998.



Statement of Management Responsibility for Consolidated Financial Statements

The consolidated financial statements have been prepared by management in accordance with generally accepted accounting principles. The integrity and objectivity of these financial statements and the other financial information in the Annual Report, including the estimates and judgments on which they are based, are the responsibility of management. The financial statements have been audited by Deloitte & Touche LLP, independent certified public accountants appointed by the board of directors. Their report is shown below. Management has made available to Deloitte & Touche LLP all of the company's financial records and related data, as well as the minutes of shareholders' and directors' meetings.

Management maintains a system of internal accounting control which it believes is adequate to provide reasonable, but not absolute, assurance that assets are properly safeguarded and accounted for, that transactions are executed in accordance with management's authorization and are properly recorded and reported, and for the prevention and detection of fraudulent financial reporting. The concept of reasonable assurance recognizes that the cost of a system of internal controls should not exceed the benefits derived and that management makes estimates and judgments of these cost/benefit factors.

Management monitors the system of internal control for compliance through its own review and a strong internal auditing program which also independently assesses the effectiveness of the internal controls. In establishing and maintaining internal controls, the company must exercise judgment in determining whether the benefits derived justify the costs of such controls.

Management acknowledges its responsibility to provide financial information (both audited and unaudited) that is representative of the company's operations, reliable on a consistent basis, and relevant for a meaningful financial assessment of the company.

Management believes that the control process enables it to meet this responsibility.

Management also recognizes its responsibility for fostering a strong ethical climate so that the company's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in the company's code of corporate conduct, which is publicized throughout the company. The company maintains a systematic program to assess compliance with this policy.

The board of directors has an audit committee composed solely of directors who are not officers or employees. The committee recommends for approval by the full board the appointment of the independent auditors. The committee meets regularly with management, with the company's internal auditors and with the independent auditors. The independent auditors and the internal auditors periodically meet alone with the audit committee and have free access to the audit committee at any time.



Neal E. Schmale
Executive Vice President and Chief Financial Officer



Frank H. Ault
Vice President and Controller

Independent Auditors' Report

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF SEMPRA ENERGY:

We have audited the accompanying consolidated balance sheets of Sempra Energy and subsidiaries (the "company") as of December 31, 1998, and 1997, and the related statements of consolidated income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. 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 Sempra Energy and subsidiaries as of December 31, 1998, and 1997, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.



San Diego, California
January 27, 1999, except for Note 16 as to which the date is
February 22, 1999

Statements of Consolidated Income

For the years ended December 31 (Dollars in millions, except per share amounts)

	1998	1997	1996
REVENUES AND OTHER INCOME			
Utility revenues:			
Natural gas	\$2,772	\$2,964	\$2,710
Electric	1,865	1,769	1,591
PX/ISO power	500	—	—
Other operating revenues	344	336	195
Other income	44	58	28
Total	5,525	5,127	4,524
EXPENSES			
Cost of natural gas distributed	954	1,168	958
PX/ISO power	468	—	—
Purchased power	292	441	311
Electric fuel	177	164	134
Operating expenses	1,872	1,615	1,405
Depreciation and amortization	929	604	587
Franchise payments and other taxes	182	178	180
Preferred dividends of subsidiaries	12	18	22
Total	4,886	4,188	3,597
INCOME BEFORE INTEREST AND INCOME TAXES	639	939	927
INTEREST	207	206	200
INCOME BEFORE INCOME TAXES	432	733	727
INCOME TAXES	138	301	300
NET INCOME	\$ 294	\$ 432	\$ 427
NET INCOME PER SHARE OF COMMON STOCK (BASIC)	\$ 1.24	\$ 1.83	\$ 1.77
NET INCOME PER SHARE OF COMMON STOCK (DILUTED)	\$ 1.24	\$ 1.82	\$ 1.77
COMMON DIVIDENDS DECLARED PER SHARE	\$ 1.56	\$ 1.27	\$ 1.24

See notes to Consolidated Financial Statements.

Consolidated Balance Sheets

At December 31 (Dollars in millions)

1998

1997

ASSETS

Current assets:

Cash and cash equivalents	\$ 424	\$ 814
Accounts receivable—trade	586	633
Accounts and notes receivable—other	159	202
Deferred income taxes	93	15
Energy trading assets	906	587
Inventories	151	111
Regulatory balancing accounts—net	—	297
Other	139	102
Total current assets	2,458	2,761

Investments and other assets:

Regulatory assets	980	1,186
Nuclear-decommissioning trusts	494	399
Investments	548	429
Other assets	535	439
Total investments and other assets	2,557	2,453

Property, plant and equipment:

Property, plant and equipment	11,235	10,902
Less accumulated depreciation and amortization	(5,794)	(5,360)
Total property, plant and equipment—net	5,441	5,542
Total assets	\$10,456	\$10,756

See notes to Consolidated Financial Statements.



LIABILITIES

Current liabilities:

Short-term debt	\$ 43	\$ 354
Accounts payable—trade	702	625
Accrued income taxes	27	5
Energy trading liabilities	805	557
Dividends and interest payable	168	121
Regulatory balancing accounts—net	120	—
Long-term debt due within one year	330	270
Other	271	279
Total current liabilities	2,466	2,211

Long-term debt:

Long-term debt	2,795	3,045
Debt of Employee Stock Ownership Plan	—	130
Total long-term debt	2,795	3,175

Deferred credits and other liabilities:

Customer advances for construction	72	72
Post-retirement benefits other than pensions	240	248
Deferred income taxes	634	741
Deferred investment tax credits	147	155
Deferred credits and other liabilities	985	916
Total deferred credits and other liabilities	2,078	2,132

Preferred stock of subsidiaries

204	279
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Commitments and contingent liabilities (Note 13)

SHAREHOLDERS' EQUITY

Common stock	1,883	1,849
Retained earnings	1,075	1,157
Less deferred compensation relating to Employee Stock Ownership Plan	(45)	(47)
Total shareholders' equity	2,913	2,959
Total liabilities and shareholders' equity	\$10,456	\$10,756

See notes to Consolidated Financial Statements.

Statements of Consolidated Cash Flows

For the years ended December 31 (Dollars in millions)

	1998	1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 294	\$ 432	\$ 427
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	929	604	587
Deferred income taxes and investment tax credits	(199)	(16)	26
Other—net	(180)	62	56
Net changes in other working capital components	479	(164)	68
Net cash provided by operating activities	1,323	918	1,164
CASH FLOWS FROM INVESTING ACTIVITIES			
Expenditures for property, plant and equipment	(438)	(397)	(413)
Acquisitions of subsidiaries	(191)	(206)	(50)
Contributions to decommissioning trusts	(22)	(22)	(22)
Other	(28)	23	(29)
Net cash used in investing activities	(679)	(602)	(514)
CASH FLOWS FROM FINANCING ACTIVITIES			
Common stock dividends	(325)	(301)	(300)
Sale of common stock	34	17	8
Repurchase of common stock	(1)	(122)	(24)
Redemption of preferred stock	(75)	—	(225)
Issuances of other long-term debt	75	140	304
Issuance of rate-reduction bonds	—	658	—
Payment on long-term debt	(431)	(416)	(459)
Increase (decrease) in short-term debt—net	(311)	92	29
Net cash provided by (used in) financing activities	(1,034)	68	(667)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(390)	384	(17)
CASH AND CASH EQUIVALENTS, JANUARY 1	814	430	447
CASH AND CASH EQUIVALENTS, DECEMBER 31	\$ 424	\$ 814	\$ 430

See notes to Consolidated Financial Statements.

Statements of Consolidated Cash Flows

For the years ended December 31 (Dollars in millions)

1998

1997

1996

CHANGES IN OTHER WORKING CAPITAL COMPONENTS

(Excluding cash and cash equivalents, short-term debt
and long-term debt due within one year)

Accounts and notes receivable	\$ 90	\$(129)	\$(58)
Net trading assets	(71)	—	—
Inventories	(40)	(2)	32
Regulatory balancing accounts	417	48	9
Other current assets	(26)	41	40
Accounts payable and other current liabilities	109	(122)	45
Net change in other working capital components	<u>\$479</u>	<u>\$(164)</u>	<u>\$ 68</u>

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Cash paid during the year for:

Interest (net of amounts capitalized)	\$211	\$ 193	\$205
Income taxes (net of refunds)	\$366	\$ 274	\$268

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES

Acquisitions of Sempra Energy Trading :

Assets acquired	—	\$ 609	—
Cash paid	—	(225)	—
Liabilities assumed	—	\$ 384	—

Liabilities assumed for real estate investments

\$ 36	\$ 126	\$ 97
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Nonutility electric generation assets sold:

Book value of assets sold	—	\$ 77	—
Cash received	—	(20)	—
Loss on sale	—	(6)	—
Note receivable obtained	—	\$ 51	—

See notes to Consolidated Financial Statements.



Statements of Consolidated Changes in Shareholders' Equity

For the years ended December 31, 1998, 1997, and 1996 (Dollars in millions)	Common Stock	Retained Earnings	Deferred Compensation Relating to ESOP	Total Shareholders' Equity
Balance at December 31, 1995	\$1,968	\$ 899	\$(52)	\$2,815
Net income		427		427
Common stock dividends declared		(300)		(300)
Sale of common stock	8			8
Repurchase of common stock	(24)			(24)
Common stock released from ESOP			3	3
Long-term incentive plan	1			1
Balance at December 31, 1996	1,953	1,026	(49)	2,930
Net income		432		432
Common stock dividends declared		(301)		(301)
Sale of common stock	17			17
Repurchase of common stock	(122)			(122)
Common stock released from ESOP			2	2
Long-term incentive plan	1			1
Balance at December 31, 1997	1,849	1,157	(47)	2,959
Net income		294		294
Common stock dividends declared		(376)		(376)
Sale of common stock	34			34
Repurchase of common stock	(1)			(1)
Common stock released from ESOP			2	2
Long-term incentive plan	1			1
Balance at December 31, 1998	\$1,883	\$1,075	\$(45)	\$2,913

See notes to Consolidated Financial Statements.



1

BUSINESS COMBINATION

On June 26, 1998, Enova Corporation (Enova) and Pacific Enterprises (PE) combined into a new company named Sempra Energy (the company). As a result of the combination, (i) each outstanding share of common stock of Enova was converted into one share of common stock of Sempra Energy, (ii) each outstanding share of common stock of PE was converted into 1.5038 shares of common stock of Sempra Energy and (iii) the preferred stock and preference stock of Enova's principal subsidiary, San Diego Gas & Electric Company (SDG&E); PE; and PE's principal subsidiary, Southern California Gas Company (SoCalGas) remained outstanding. The combination was approved by the shareholders of both companies on March 11, 1997, and was a tax-free transaction.

As required by the March 1998 decision of the California Public Utilities Commission (CPUC) approving the business combination, SDG&E has entered into agreements to sell its fossil-fueled generation units. The sales are subject to regulatory approvals and are expected to close during the first half of 1999. Additional information concerning the sale of SDG&E's power plants is provided in Note 14. In addition, SoCalGas has sold its options to purchase the California portions of the Kern River and Mojave Pipeline natural gas-transmission facilities. The Federal Energy Regulatory Commission's (FERC) approval of the combination includes conditions that the combined company will not unfairly use any potential market power regarding natural gas transportation to fossil-fueled electric-generation plants. The FERC also specifically noted that the divestiture of SDG&E's fossil-fueled generation plants would eliminate any concerns about vertical market power arising from transactions between SDG&E and SoCalGas.

The Consolidated Financial Statements are those of the company and its subsidiaries and give effect to the business combination using the pooling-of-interests method and,

therefore, are presented as if the companies were combined during all periods included therein. The per-share data shown on the Statements of Consolidated Income reflect the conversion of Enova common stock and of PE common stock into Sempra Energy common stock as described above. All significant intercompany transactions, including SoCalGas' sales of natural gas transportation and storage to SDG&E, have been eliminated. These sales amounted to approximately \$60 million in each of the years presented.

The results of operations for PE and Enova as reported as separate companies through June 30, 1998, are as follows:

(Dollars in millions)	Six months ended June 30, 1998	1997	1996
PACIFIC ENTERPRISES			
Revenue and Other Income	\$1,263	\$2,777	\$2,588
Net Income	\$ 50	\$ 180	\$ 196
ENOVA			
Revenue and Other Income	\$1,299	\$2,224	\$1,996
Net Income	\$ 68	\$ 252	\$ 231

2

SIGNIFICANT ACCOUNTING POLICIES

PROPERTY, PLANT AND EQUIPMENT This primarily represents the buildings, equipment and other facilities used by SDG&E and SoCalGas to provide natural gas and utility electric service. The cost of utility plant includes labor, materials, contract services and 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 electric-industry restructuring and its



effect on utility plant is included in Note 14. Utility plant balances by major functional categories at December 31, 1998, are: natural gas operations \$7.0 billion, electric distribution \$2.4 billion, electric transmission \$0.7 billion, electric generation \$0.6 billion and other electric \$0.3 billion. The corresponding amounts at December 31, 1997, were essentially the same. Accumulated depreciation and decommissioning of natural gas and electric utility plant in service at December 31, 1998, are \$3.5 billion and \$2.2 billion, respectively, and at December 31, 1997, were \$3.3 billion and \$2.0 billion, respectively. Depreciation expense is based on the straight-line method over the useful lives of the assets or a shorter period prescribed by the CPUC. The provisions for depreciation as a percentage of average depreciable utility plant (by major functional categories) in 1998, 1997, and 1996, respectively are: natural gas operations 4.32, 4.31, 4.35, electric generation 6.49, 5.60, 5.60, electric distribution 4.49, 4.39, 4.38, electric transmission 3.31, 3.28, 3.25, and other electric 6.29, 6.02, 5.95. The increase for electric generation in 1998 reflects the accelerated recovery of generation facilities. See Note 14 for additional discussion of generation facilities and industry restructuring.

INVENTORIES

Included in inventories at December 31, 1998, are \$61 million of utility materials and supplies (\$56 million in 1997), and \$78 million of natural gas and fuel oil (\$47 million in 1997). Materials and supplies are generally valued at the lower of average cost or market; fuel oil and natural gas are valued by the last-in first-out method.

TRADING INSTRUMENTS

Trading assets and trading liabilities are recorded on a trade-date basis at fair value and include option premiums paid and received, and unrealized gains and losses from exchange-traded futures and options, over the counter (OTC) swaps, forwards, and options. Unrealized gains and losses on OTC transactions reflect amounts which would be received from or paid to a third party upon settlement of the contracts. Unrealized gains and losses on OTC transactions are reported separately as assets and liabilities unless a legal

right of setoff exists under a master netting arrangement enforceable by law. Revenues are recognized on a trade-date basis and include realized gains and losses, and the net change in unrealized gains and losses.

Futures and exchange-traded option transactions are recorded as contractual commitments on a trade-date basis and are carried at fair value based on closing exchange quotations. Commodity swaps and forward transactions are accounted for as contractual commitments on a trade-date basis and are carried at fair value derived from dealer quotations and underlying commodity-exchange quotations. OTC options are carried at fair value based on the use of valuation models that utilize, among other things, current interest, commodity and volatility rates, as applicable. For long-dated forward transactions, where there are no dealer or exchange quotations, fair values are derived using internally developed valuation methodologies based on available market information. Where market rates are not quoted, current interest, commodity and volatility rates are estimated by reference to current market levels. Given the nature, size and timing of transactions, estimated values may differ from realized values. Changes in the fair value are recorded currently in income.

EFFECTS OF REGULATION

SDG&E and SoCalGas accounting policies conform with generally accepted accounting principles for regulated enterprises and reflect the policies of the CPUC and the FERG. The company's interstate natural gas transmission subsidiary follows accounting policies authorized by the FERC.

SDG&E and SoCalGas have been preparing their financial statements in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation," under which a regulated utility may record a regulatory asset if it is probable that, through the ratemaking process, the utility will recover that asset from customers. Regulatory liabilities represent future reductions in rates for amounts due to customers. To the extent that portions of the utility operations were no longer subject to SFAS No. 71, or recovery was no longer probable as a result of changes in regulation or their competitive position, the related regulatory assets



and liabilities would be written off. In addition, SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," affects utility plant and regulatory assets such that a loss must be recognized whenever a regulator excludes all or part of an asset's cost from rate base. As discussed in Note 14, California enacted a law restructuring the electric-utility industry. The law adopts the December 1995 CPUC policy decision, and allows California electric utilities the opportunity to recover existing utility plant and regulatory assets over a transition period that ends in 2001. In 1997, SDG&E ceased the application of SFAS No. 71 with respect to its electric-generation business. The application of SFAS No. 121 continues to be evaluated as industry restructuring progresses. Additional information concerning regulatory assets and liabilities is described below in "Revenues and Regulatory Balancing Accounts" and in Note 14.

REVENUES AND REGULATORY BALANCING ACCOUNTS

Revenues from utility customers consist of deliveries to customers and the changes in regulatory balancing accounts. The amounts included in regulatory balancing accounts at December 31, 1998, represent a \$129 million net payable for SoCalGas combined with a \$9 million net receivable for SDG&E. The corresponding amounts at December 31, 1997, were \$355 million net receivable and \$58 million net payable for SoCalGas and SDG&E, respectively.

Previously, 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 were eliminated by balancing accounts authorized by the CPUC. This is still the case for most natural gas operations. However, as a result of California's electric-restructuring law, overcollections recorded in SDG&E's Energy Cost Adjustment Clause and Electric Revenue Adjustment Mechanism balancing accounts were transferred to the Interim Transition Cost Balancing Account, which is being applied to transition cost recovery, and fluctuations in costs and consumption levels can affect earnings from electric operations. Additional information on electric-industry restructuring is included in Note 14.

REGULATORY ASSETS

Regulatory assets include San Onofre Nuclear Generating Station (SONGS), unrecovered premium on early retirement of debt, post-retirement benefit costs, deferred income taxes recoverable in rates and other regulatory-related expenditures that the utilities expect to recover in future rates. See Note 14 for additional information.

NUCLEAR-DECOMMISSIONING LIABILITY

Deferred credits and other liabilities at December 31, 1998, include \$146 million (\$117 million in 1997) of accumulated decommissioning costs associated with SDG&E's SONGS Unit 1, which was permanently shut down in 1992. Additional information on SONGS Unit 1 decommissioning costs is included in Note 6. The corresponding liability for Units 2 and 3 is included in accumulated depreciation and amortization.

COMPREHENSIVE INCOME

In 1998, the company adopted SFAS No. 130, "Reporting Comprehensive Income." This statement requires reporting of comprehensive income and its components (revenues, expenses, gains and losses) in any complete presentation of general-purpose financial statements. Comprehensive income describes all changes, except those resulting from investments by owners and distributions to owners, in the equity of a business enterprise from transactions and other events including, as applicable, foreign-currency items, minimum pension liability adjustments and unrealized gains and losses on certain investments in debt and equity securities. Comprehensive income was equal to net income for the years ended December 31, 1998, 1997, and 1996.

QUASI-REORGANIZATION

In 1993, PE completed a strategic plan to refocus on its natural gas utility and related businesses. The strategy included the divestiture of its merchandising operations and all of its oil and gas exploration and production business. In connection with the divestitures, PE effected a quasi-reorganization for financial reporting purposes, effective December 31, 1992. Certain of the liabilities established in connection with discontinued operations and the quasi-reorganization will be resolved in future years. Management believes the provisions previously established for these matters are adequate at December 31, 1998.



USE OF ESTIMATES IN THE PREPARATION OF THE FINANCIAL STATEMENTS

The preparation of the consolidated 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

Cash equivalents are highly liquid investments with original maturities of three months or less, or investments that are readily convertible to cash.

BASIS OF PRESENTATION

Certain prior-year amounts have been reclassified from the predecessor companies' classifications to conform to the format of these financial statements.

NEW ACCOUNTING STANDARD

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities." This statement, which is effective January 1, 2000, requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position, measure those instruments at fair value and recognize changes in the fair value of derivatives in earnings in the period of change unless the derivative qualifies as an effective hedge that offsets certain exposures. The effect of this standard on the company's Consolidated Financial Statements has not yet been determined.

3

ACQUISITIONS AND JOINT VENTURES

SEMPRA ENERGY TRADING In December 1997, PE and Enova jointly acquired Sempra Energy Trading (SET) for \$225 million. SET is a wholesale-energy trading company based in Stamford, Connecticut. It participates in marketing and trading physical and financial energy products, including natural gas, power, crude oil and associated commodities.

In July 1998, SET purchased CNG Energy Services Corporation, a subsidiary of Pittsburgh-based Consolidated Natural Gas Company, for \$36 million. The acquisition expands

SET's business volume by adding large, commodity-trading contracts with local distribution companies, municipalities and major industrial corporations in the eastern United States.

SEMPRA ENERGY RESOURCES

In December 1997, Sempra Energy Resources (SER) in partnership with Reliant Energy Power Generation, formed El Dorado Energy. In April 1998, El Dorado Energy began construction on a 480-megawatt power plant near Boulder City, Nevada. SER invested \$2.3 million in 1997 and \$19.7 million in 1998 on this \$263-million project. In October 1998, El Dorado Energy obtained a \$158-million senior secured credit facility, which entails both construction and 15-year term financing for the project. This financing represents approximately 60 percent of estimated total project costs.

SEMPRA ENERGY UTILITY VENTURES

In September 1997, Sempra Energy Utility Ventures (SEUV) formed a joint venture with Bangor Hydro to build, own and operate a \$40-million natural gas distribution system in Bangor, Maine. Construction began in June 1998. The new Bangor Gas Company expects to begin deliveries in the fourth quarter of 1999.

In December 1997, SEUV formed Frontier Energy with Frontier Utilities of North Carolina to build and operate a \$55-million natural gas distribution system in North Carolina. Natural gas delivery began in December 1998. Subsequent to December 31, 1998, SEUV purchased Frontier Utilities' interest and acquired 100 percent ownership of the system.

SEMPRA ENERGY SOLUTIONS

In January 1998, Sempra Energy Solutions completed the acquisition of CES/Way International, a national leader in energy-service performance contracting headquartered in Houston, Texas. CES/Way provides energy-efficiency services, including energy audits, engineering design, project management, construction, financing and contract maintenance.



In May 1997, Sempra Energy Solutions entered into a joint venture agreement with Conectiv Thermal Systems, Inc. (formerly Atlantic Thermal System, Inc.) to form Atlantic-Pacific Las Vegas, with each receiving a 50-percent interest. Atlantic-Pacific Las Vegas provides integrated energy-management services to commercial and industrial customers, including the construction of facilities. In May 1997, Atlantic-Pacific Las Vegas entered into an energy-services agreement with three other parties to finance, own, operate and maintain an integrated thermal-energy production facility at the site of the future Venetian Casino Resort in Las Vegas. Construction costs incurred to date are \$48 million.

A second joint venture agreement was entered into with Conectiv Thermal Systems to form Atlantic-Pacific Glendale in August 1997, with each receiving a 50-percent interest. Atlantic-Pacific Glendale entered into an integrated energy-management services agreement with Dreamworks Animation, LLC to develop, manage and finance the construction and operation of a central chiller plant, emergency power generators and chilled-water distribution and circulation system at Dreamworks' Glendale facilities. The cost of the project, completed in May 1998, was \$7 million.

INTERNATIONAL NATURAL GAS PROJECTS

Sempra Energy International (SEI) is a wholly owned subsidiary of Sempra Energy. Sempra Energy International and Proxima Gas S.A. de C.V., partners in the Mexican companies Distribuidora de Gas Natural (DGN) de Mexicali and Distribuidora de Gas Natural de Chihuahua, are the licensees to build and operate natural gas distribution systems in Mexicali and Chihuahua. DGN-Mexicali will invest up to \$25 million during the first five years of the 30-year license period. DGN-Chihuahua will invest up to \$50 million over the first five years of operation. DGN-Mexicali and DGN-Chihuahua assumed ownership of natural gas distribution facilities during the third quarter of 1997. SEI owns interests of 60 and 95 percent in the DGN-Mexicali and DGN-Chihuahua projects, respectively. In August 1998, SEI was awarded a 10-year agreement by the Mexican Federal

Electric Commission to provide a complete energy-supply package for a power plant in Rosarito, Baja California. The contract includes provisions for delivery of up to 300 million cubic feet per day of natural gas, transportation services in the U.S. and construction of a 23-mile pipeline from the U.S.-Mexico border to the plant. The pipeline is expected to cost approximately \$35 million and take a year to build. Delivery of natural gas is expected to commence in December 1999.

SEI also has interests in Argentina and Uruguay. In March 1998, SEI increased its existing investment in two Argentine natural gas utility holding companies (Sodigas Pampeana S.A. and Sodigas Sur S.A.) from 12.5 percent to 21.5 percent by purchasing an additional interest for \$40 million.

4

SHORT-TERM BORROWINGS

PE has a \$300 million multiyear credit agreement. SoCalGas has an additional \$400 million multiyear credit agreement. These agreements expire in 2001 and bear interest at various rates based on market rates and the companies' credit ratings. SoCalGas' lines of credit are available to support commercial paper. At December 31, 1998, PE had \$43 million of bank loans under the credit agreement outstanding, due and paid in January 1999. SoCalGas' bank line of credit was unused. At December 31, 1997, both bank lines of credit were unused.

SDG&E has \$30 million of bank lines available to support commercial paper and \$265 million of bank lines available to support variable-rate, long-term debt. The credit agreements expire at varying dates from 1999 through 2000 and bear interest at various rates based on market rates and the company's credit rating. SDG&E's bank lines of credit were unused at both December 31, 1998, and 1997.

At December 31, 1998, there were no commercial-paper obligations outstanding. At December 31, 1997, SoCalGas had \$354 million of commercial-paper obligations outstanding, of which approximately \$94 million related to the restructuring costs associated with certain long-term gas-supply contracts under the Comprehensive Settlement. See Note 14 for additional information.



5 LONG-TERM DEBT

(Dollars in millions)	December 31,	
	1998	1997
LONG-TERM DEBT		
First mortgage bonds		
5.25% March 1, 1998	\$ —	\$ 100
7.625% June 15, 2002	28	80
6.875% August 15, 2002	100	100
5.75% November 15, 2003	100	100
6.8% June 1, 2015	14	14
5.9% June 1, 2018	71	71
5.9% September 1, 2018	93	93
6.1% and 6.4% September 1, 2018 and 2019	118	118
9.625% April 15, 2020	10	54
Variable rates September 1, 2020	58	75
5.85% June 1, 2021	60	60
8.75% October 1, 2021	150	150
8.5% April 1, 2022	10	44
7.375% March 1, 2023	100	100
7.5% June 15, 2023	125	125
6.875% November 1, 2025	175	175
Various rates December 1, 2027	250	250
Total	1,462	1,709
Rate-reduction bonds	592	658
Debt incurred to acquire limited partnerships, secured by real estate, at 6.8% to 9.0%, payable annually through 2008	305	313
Various unsecured bonds at 4.15% to 10% from 1998 to 2006	453	296
Various unsecured bonds at 5.9% or at variable rates (4.3% to 5.0% at December 31, 1998) from 2014 to 2023	254	254
Capitalized leases	76	106
Total	3,142	3,336
Less:		
Current portion of long-term debt	330	270
Unamortized discount on long-term debt	17	21
	347	291
Total	\$2,795	\$3,045

Excluding capital leases, which are described in Note 13, maturities of long-term debt, including PE's Employees Stock Ownership Plan, are \$271 million in 1999, \$96 million in 2000, \$186 million in 2001, \$193 million in 2002 and \$241 million in 2003. SDG&E and SoCalGas have CPUC authorization to issue an additional \$752 million in long-term debt. Although holders of variable-rate bonds may elect to redeem them prior to scheduled maturity, for purposes of determining the maturities listed above, it is assumed the bonds will be held to maturity.

FIRST-MORTGAGE BONDS

First-mortgage bonds are secured by a lien on substantially all utility plant. In addition, certain nonutility subsidiary assets are pledged as collateral for SoCalGas' first-mortgage bonds. SDG&E and SoCalGas may issue additional first-mortgage bonds upon compliance with the provisions of their bond indentures, which provide for, among other things, the issuance of additional first-mortgage bonds (\$1.5 billion as of December 31, 1998).

During 1998, the company retired \$247 million of first-mortgage bonds, of which \$147 million was retired prior to scheduled maturity.

Certain first-mortgage bonds may be called at SDG&E's or SoCalGas' option. SoCalGas has no variable-rate bonds; SDG&E has \$188 million of bonds with variable interest-rate provisions that are callable at various dates within one year. Of the company's remaining callable bonds, \$10 million are callable in the year 2000, \$150 million in 2001, \$203 million in 2002, and \$624 million in 2003. \$242 million of the bonds are not callable.

RATE-REDUCTION BONDS

In December 1997, \$658 million of rate-reduction bonds were issued on behalf of SDG&E at an average interest rate of 6.26 percent. These bonds were issued to facilitate the 10-percent rate reduction mandated by California's electric-restructuring law. See Note 14 for additional information. These bonds are being repaid over 10 years by SDG&E's residential and small commercial customers via a charge on their electricity bills. These bonds are secured by the revenue streams collected from customers and are not secured by, or payable from, utility assets.



UNSECURED DEBT

Various long-term obligations totaling \$707 million are unsecured. During 1998, SoCalGas issued \$75 million of unsecured debt in medium-term notes used to finance working capital requirements. Unsecured bonds totaling \$124 million have variable-interest-rate provisions.

DEBT OF EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) AND TRUST

The Trust covers substantially all of the company's former PE employees and is used to fund part of their retirement savings program. It has an ESOP feature and holds approximately 3.1 million shares of the company's common stock. The variable-rate ESOP debt held by the Trust bears interest at a rate necessary to place or remarket the notes at par. The balance of this debt was \$130 million at December 31, 1998, and is included in the table above as part of the various unsecured bonds at 4.15 percent to 10 percent. Principal is due on November 30, 1999, and interest is payable monthly. The company is obligated to make contributions to the Trust sufficient to satisfy debt service requirements. As the company makes contributions to the Trust, these contributions, plus any dividends paid on the unallocated shares of the company's common stock held by the Trust, will be used to repay the debt. As dividends are increased or decreased, required contributions are reduced or increased, respectively. Interest on ESOP debt amounted to \$6 million each in 1998, 1997, and 1996. Dividends used for debt service amounted to \$3 million each in 1998, 1997, and 1996, and are deductible only for federal income tax purposes.

CURRENCY INTEREST-RATE SWAPS

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, 1998, SDG&E had such an agreement, maturing in 2002, with underlying debt of \$45 million.

6 FACILITIES UNDER JOINT OWNERSHIP

SONGS and the Southwest Powerlink transmission line are owned jointly with other utilities. The company's interests at December 31, 1998, are:

(Dollars in millions) Project	SONGS	Southwest Powerlink
Percentage ownership	20	89
Regulatory assets	\$ 312	—
Utility plant in service	—	\$217
Accumulated depreciation and amortization	—	\$104
Construction work in progress	\$ 18	\$ 1

The company's share of operating expenses is included in the Statements of Consolidated Income. Each participant in the project must provide its own financing. The amounts specified above for SONGS include nuclear production, transmission and other facilities. \$11 million of substation equipment included in these amounts is wholly owned by the company.

SONGS DECOMMISSIONING

Objectives, work scope and procedures for the future dismantling and decontamination of the SONGS units must meet the requirements of the Nuclear Regulatory Commission, the Environmental Protection Agency, the California Public Utilities Commission and other regulatory bodies.

The company's share of decommissioning costs for the SONGS units is estimated to be \$425 million in today's dollars and is based on a cost study completed in 1998. Cost studies are performed and updated periodically by outside consultants. Although electric-industry restructuring legislation requires that stranded costs, which include SONGS' costs, be amortized in rates by 2001, the recovery of decommissioning costs is allowed until the time that the costs are fully recovered.

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 the company's share of future decommissioning costs.



Payments to the nuclear-decommissioning trusts are expected to continue until SONGS is decommissioned, which is not expected to occur before 2013. Unit 1, although permanently shut down in 1992, was scheduled to be decommissioned concurrently with Units 2 and 3. However, the company and the other owners of SONGS have requested that the CPUC grant authority to begin decommissioning Unit 1 on January 1, 2000.

The amounts collected in rates are invested in externally managed trust funds. The securities held by the trust are considered available for sale and shown on the Consolidated Balance Sheets adjusted to market value. The fair values reflect unrealized gains of \$149 million and \$89 million at December 31, 1998, and 1997, respectively.

The Financial Accounting Standards Board is reviewing the accounting for liabilities related to closure and removal of long-lived assets, such as nuclear power plants, including the recognition, measurement and classification of such costs. The Board could require, among other things, that the company's future balance sheets include a liability for the estimated decommissioning costs, and a related increase in the cost of the asset.

Additional information regarding SONGS is included in Notes 13 and 14.

7 INCOME TAXES

The reconciliation of the statutory federal income tax rate to the effective income tax rate is as follows:

	1998	1997	1996
Statutory federal income tax rate	35.0%	35.0%	35.0%
Depreciation	6.3	7.1	6.2
State income taxes—net of			
federal income tax benefit	7.4	6.7	6.2
Tax credits	(12.9)	(5.7)	(4.8)
Equipment leasing activities	(1.5)	(1.1)	(1.4)
Capitalized expenses not deferred	0.2	(1.4)	(2.1)
Other—net	(2.6)	0.5	2.2
Effective income tax rate	31.9%	41.1%	41.3%

The components of income tax expense are as follows:

(Dollars in millions)	1998	1997	1996
CURRENT:			
Federal	\$278	\$236	\$183
State	89	63	65
Total current taxes	367	299	248
DEFERRED:			
Federal	(165)	1	52
State	(58)	7	6
Total deferred taxes	(223)	8	58
DEFERRED INVESTMENT TAX CREDITS—NET	(6)	(6)	(6)
Total income tax expense	\$138	\$301	\$300

Accumulated deferred income taxes at December 31 result from the following:

(Dollars in millions)	1998	1997
DEFERRED TAX LIABILITIES:		
Differences in financial and tax bases of utility plant	\$924	\$1,063
Regulatory balancing accounts	23	133
Regulatory assets	76	120
Partnership income	27	21
Other	71	53
Total deferred tax liabilities	1,121	1,390
DEFERRED TAX ASSETS:		
Unamortized investment tax credits	88	89
Comprehensive Settlement (see Note 14)	95	117
Postretirement benefits	76	90
Other deferred liabilities	102	140
Restructuring costs	42	54
Other	177	204
Total deferred tax assets	580	664
Net deferred income tax liability	541	726
Current portion (net asset)	93	15
Non-current portion (net liability)	\$634	\$ 741



**EMPLOYEE
BENEFIT PLANS**

The information presented below describes the plans of the company and its principal subsidiaries. In connection with the PE/Enova Business Combination described in Note 1, certain of these plans have been or will be replaced or modified, and numerous participants have been or will be transferred from the subsidiaries' plans to those of Sempra Energy.

PENSION AND OTHER POSTRETIREMENT BENEFITS

The company sponsors several qualified and nonqualified pension plans and other postretirement benefit plans for its employees. The following tables provide a reconciliation of the changes in the plans' benefit obligations and fair value of assets over the two years, and a statement of the funded status as of each year end:

(Dollars in millions)	Pension Benefits		Other Postretirement Benefits	
	1998	1997	1998	1997
WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31:				
Discount rate	6.75%	7.07%	6.75%	7.02%
Expected return on plan assets	8.50%	8.13%	8.50%	7.87%
Rate of compensation increase	5.00%	5.00%	5.00%	5.00%
Cost trend of covered health-care charges	—	—	8.00% ⁽¹⁾	7.00% ⁽²⁾
CHANGE IN BENEFIT OBLIGATION:				
Net benefit obligation at January 1	\$2,117	\$1,981	\$ 531	\$ 442
Service cost	55	53	13	15
Interest cost	148	144	36	35
Plan participants' contributions	—	—	1	1
Plan amendments	18	—	—	—
Actuarial (gain) loss	(44)	54	—	57
Special termination benefits	63	13	3	2
Gross benefits paid	(277)	(128)	(21)	(21)
Net benefit obligation at December 31	2,080	2,117	563	531
CHANGE IN PLAN ASSETS:				
Fair value of plan assets at January 1	2,653	2,373	363	286
Actual return on plan assets	407	406	64	59
Employer contributions	13	2	36	38
Plan participants' contributions	—	—	1	1
Gross benefits paid	(277)	(128)	(21)	(21)
Fair value of plan assets at December 31	2,796	2,653	443	363
Funded status at December 31	716	536	(120)	(168)
Unrecognized net actuarial gain	(926)	(733)	(107)	(66)
Unrecognized prior service cost	73	61	(13)	(14)
Unrecognized net transition obligation	3	4	—	—
Net liability at December 31 ⁽³⁾	\$ (134)	\$ (132)	\$(240)	\$(248)

⁽¹⁾ Decreasing to ultimate trend of 6.50% in 2004.

⁽²⁾ Decreasing to ultimate trend of 6.50% in 1998.

⁽³⁾ Approximates amounts recognized in the Consolidated Balance Sheets at December 31.



The following table provides the components of net periodic benefit cost for the plans:

(Dollars in millions)	Pension Benefits			Other Postretirement Benefits		
	1998	1997	1996	1998	1997	1996
Service cost	\$ 55	\$ 53	\$ 58	\$ 13	\$ 15	\$ 18
Interest cost	148	144	141	36	35	36
Expected return on assets	(196)	(178)	(161)	(24)	(22)	(19)
Amortization of:						
Transition obligation	1	1	1	2	2	2
Prior service cost	6	5	5	(1)	(1)	(1)
Actuarial (gain) loss	(23)	(18)	(4)	—	1	1
Special termination benefit	63	13	—	3	2	—
Settlement credit	(30)	—	—	—	—	—
Regulatory adjustment	—	—	(12)	9	12	12
Total net periodic benefit cost	\$ 24	\$ 20	\$ 28	\$ 38	\$ 44	\$ 49

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans.

A 1% change in assumed health care cost trend rates would have the following effects:

(Dollars in millions)	1% Increase	1% Decrease
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	\$11	\$(10)
Effect on the health care component of the accumulated postretirement benefit obligation	\$72	\$(65)

The projected benefit obligation and accumulated benefit obligation were \$55 million and \$45 million, respectively, as of December 31, 1998, and \$53 million and \$44 million, as of December 31, 1997. There were no pension plans with accumulated benefit obligations in excess of plan assets for 1998 or 1997.

Other postretirement benefits include medical benefits for retirees and their spouses (and Medicare Part B reimbursement for certain retirees) and retiree life insurance.

SAVINGS PLANS

Sempra Energy and its subsidiaries offer savings plans, administered by plan trustees, to all eligible employees. Eligibility to participate in the various employer plans ranges from one month to one year of completed service. Employees may contribute, subject to plan provisions, from 1 percent to 15 percent of their regular earnings.

Employer contributions, after one year of completed service, are made in shares of company common stock. Employer contribution methods vary by plan, but generally the contribution is equal to 50 percent of the first 6 percent of eligible base salary contributed by employees. During 1998, the SDG&E plan contribution was age-based for represented employees. The employee's contributions, at the direction of the employees, are primarily invested in company stock, mutual funds or guaranteed investment contracts. Employer contributions for the Sempra and SoCalGas plans are partially funded by the Pacific Enterprises Employee Stock Ownership Plan and Trust. Annual expense for the savings plans was \$14 million in 1998, \$11 million in 1997 and \$10 million in 1996.

The following information is presented after conversion of PE stock into company stock as described in Note 1.

Stock option activity is summarized in the following tables.

OPTIONS WITH PERFORMANCE FEATURES

	Shares Under Option	Average Exercise Price	Options Exercisable at Year End
December 31, 1995	846,188	\$16.23	—
Granted	1,030,404	17.95	
December 31, 1996	1,876,592	17.17	282,063
Granted	1,040,103	20.37	
Exercised	(359,288)	16.53	
Cancelled	(71,190)	20.37	
December 31, 1997	2,486,217	18.51	1,513,545
Granted	2,131,803	25.23	
Exercised	(512,059)	17.12	
Cancelled	(509,301)	23.00	
December 31, 1998	3,596,660	\$22.06	1,387,523

OPTIONS WITHOUT PERFORMANCE FEATURES

	Shares Under Option	Average Exercise Price	Options Exercisable at Year End
December 31, 1995	2,302,018	\$18.14	1,200,183
Exercised	(304,520)	15.00	
Cancelled	(125,417)	26.05	
December 31, 1996	1,872,081	18.12	1,197,687
Exercised	(493,848)	14.94	
Cancelled	(14,737)	35.24	
December 31, 1997	1,363,496	19.08	1,363,496
Granted	1,293,997	26.33	
Exercised	(596,629)	15.72	
Cancelled	(240,632)	29.78	
December 31, 1998	1,820,232	\$23.92	523,661

Additional information on options outstanding at December 31, 1998, is as follows:

OUTSTANDING OPTIONS

Range of Exercise Prices	Number of Shares	Average Remaining Life	Average Exercise Price
\$12.80–\$16.12	623,362	5.55	\$15.29
\$16.79–\$20.36	1,584,272	7.47	\$19.03
\$24.10–\$31.00	3,209,258	9.05	\$25.82
	5,416,892	8.19	\$22.64

EXERCISABLE OPTIONS

Range of Exercise Prices	Number of Shares	Average Exercise Price
\$12.80–\$16.12	623,362	\$15.29
\$16.79–\$20.36	1,109,878	\$18.46
\$24.11–\$31.00	177,944	\$26.70
	1,911,184	\$18.20

The fair value of each option grant (including the dividend equivalent) was estimated on the date of grant using the modified Black-Scholes option-pricing model. Weighted average fair values for options granted in 1998, 1997, and 1996 were \$8.20, \$5.23 and \$5.00, respectively.

The assumptions that were used to determine these fair values are as follows:

	Year Ended December 31		
	1998	1997	1996
Stock price volatility	16%	18%	19%
Risk-free rate of return	5.6%	6.4%	6.1%
Annual dividend yield	0%	0%	0%
Expected life	6 Years	3.8 Years	4.3 Years

Compensation expense for the stock option grants was \$11.7 million, \$16.9 million and \$5.5 million in 1998, 1997, and 1996, respectively. The differences between compensation cost included in net income and the related cost measured by the fair-value-based method defined in SFAS No. 123 are immaterial.

EMPLOYEE STOCK OWNERSHIP PLAN

The Pacific Enterprises Employee Stock Ownership Plan and Trust (Trust) covers substantially all employees of PE and SoCalGas and is used to partially fund their retirement savings plan programs. All contributions to the Trust are made by the company, and there are no contributions made by the participants. As the company makes contributions to the ESOP, the ESOP debt service is paid and shares are released in proportion to the total expected debt service.

Compensation expense is charged and equity is credited for the market value of the shares released. Income tax deductions are allowed based on the cost of the shares. Dividends on unallocated shares are used to pay debt service and are charged against liabilities. The Trust held 3.1 million and 3.3 million shares of company common stock, with fair values of \$77.9 million and \$80.3 million, at December 31, 1998, and 1997, respectively.

9 STOCK-BASED COMPENSATION

Sempra Energy has stock-based compensation plans that align employee and shareholder objectives related to the long-term growth of the company. The company's long-term incentive stock compensation plan provides for aggregate awards of Sempra Energy nonqualified stock options, incentive stock options, restricted stock, stock appreciation rights, performance awards, stock payments or dividend equivalents.

In 1995, Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," was issued. It encourages a fair-value-based method of accounting for stock-based compensation. As permitted by SFAS No. 123, the company adopted its disclosure-only requirements and continues to account for stock-based compensation in accordance with the provisions of accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees."

In 1998, 102,640 shares of Sempra Energy common stock were awarded to officers. Under the predecessor plan, in each of the last 10 years, Enova awarded between 49,000 and 75,000 shares to key executives. These awards are subject to forfeiture over four years if certain corporate goals are not met. Holders of this stock have voting rights and receive dividends prior to the time the restrictions lapse if, and to the extent, dividends are paid on Sempra Energy common stock. Compensation expense for the issuance of these restricted shares was approximately \$2 million in 1998, \$1 million in 1997 and \$1 million in 1996.

In 1998, Sempra Energy granted 3,425,800 stock options. The option price is equal to the market price of common stock at the date of grant. The grants, which vest over a four-year period, include options with and without performance-based features. The stock options expire in 10 years from the date of grant. All options granted prior to 1997 became immediately exercisable upon approval by PE's shareholders of the business combination with Enova. The options were originally scheduled to vest annually over a service period ranging from three to five years.

Sempra Energy's plans allow for the granting of dividend equivalents based upon performance goals. This feature provides grantees, upon exercise of the option, with the opportunity to receive all or a portion of the cash dividends that would have been paid on the shares if the shares had been outstanding since the grant date. Dividend equivalents are payable only if corporate goals are met and, for grants prior to July 1, 1998, if the exercise price exceeds the market value of the shares purchased. The percentage of dividends paid as dividend equivalents will depend upon the extent to which the performance goals are met.



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FINANCIAL INSTRUMENTS

FAIR VALUE The fair values of the company's financial instruments (cash, temporary investments, funds held in trust, notes receivable, investments in limited partnerships, dividends payable, short- and long-term debt, customer deposits, and preferred stock of subsidiaries) are not materially different from the carrying amounts, except for long-term debt and preferred stock of subsidiaries. The carrying amounts and fair values of long-term debt are \$3.1 billion and \$3.2 billion, respectively, at December 31, 1998, and \$3.4 billion and \$3.5 billion at December 31, 1997. The carrying amounts and fair values of subsidiaries' preferred stock are \$204 million and \$182 million, respectively, at December 31, 1998, and \$279 million and \$258 million, respectively, at December 31, 1997. The fair values of the first-mortgage and other bonds and preferred stock are estimated based on quoted market prices for them or for similar issues. The fair values of long-term notes payable are based on the present value of the future cash flows, discounted at rates available for similar notes with comparable maturities. Included in long-term debt are SDG&E's rate-reduction bonds. The carrying amounts and fair values of the bonds are \$592 million and \$607 million, respectively, at December 31, 1998.

OFF-BALANCE-SHEET FINANCIAL INSTRUMENTS

The company's policy is to use derivative financial instruments to manage its exposure to fluctuations in interest rates, foreign-currency exchange rates and energy prices. Transactions involving these financial instruments expose the company to market and credit risks which may at times be concentrated with certain counterparties, although counterparty nonperformance is not anticipated. Additional information on this topic is discussed in Note 2.

SWAP AGREEMENTS

The company periodically enters into interest-rate-swap and cap agreements to moderate exposure to interest-rate changes and to lower the overall cost of borrowing. These 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 consolidated income statement as part of interest expense.

At December 31, 1998, and 1997, SDG&E had one interest-rate-swap agreement: a floating-to-fixed-rate swap associated with \$45 million of variable-rate bonds maturing in 2002. SDG&E expects to hold this financial instrument to its maturity. This swap agreement has effectively fixed the interest rate on the underlying variable-rate debt at 5.4 percent. SDG&E would be exposed to interest-rate fluctuations on the underlying debt should the counterparty to the agreement not perform. Such nonperformance is not anticipated. This agreement, if terminated, would result in an obligation of \$3 million at December 31, 1998, and \$2 million at December 31, 1997. Additional information on this topic is included in Note 5.

ENERGY DERIVATIVES

Information on derivative financial instruments of SET is provided below. The company's regulated operations use energy derivatives for both price-risk management and trading purposes within certain limitations imposed by company policies and regulatory requirements. Energy derivatives are used to mitigate risk and better manage costs. These instruments include forward contracts, swaps, options and other contracts which have maturities ranging from 30 days to 12 months.

SoCalGas is subject to price risk on its natural gas purchases if its cost exceeds a 2-percent tolerance band above the benchmark price. This is discussed further in Note 14. SoCalGas becomes subject to price risk when positions are incurred during the buying, selling and storage of natural gas. As a result of the Gas Cost Incentive Mechanism (GCIM), SoCalGas enters into a certain amount of gas futures contracts in the open market with the intent of reducing gas



costs within the GCIM tolerance band. The CPUC has approved the use of gas futures for managing risk associated with the GCIM. For the years ended December 31, 1998, 1997, and 1996, gains and losses from natural gas futures contracts are not material to SoCalGas' financial statements.

SEMPRA ENERGY TRADING

SET derives a substantial portion of its revenue from market making and trading activities, as a principal, in natural gas, petroleum and electricity. It quotes bid and offer prices to end users and other market makers. It also earns trading profits as a dealer by structuring and executing transactions that permit its counterparties to manage their risk profiles. In addition, it takes positions in energy markets based on the expectation of future market conditions. These positions may be offset with similar positions or may be offset in the exchange-traded markets. These positions include options, forwards, futures and swaps. These financial instruments represent contracts with counterparties whereby payments are linked to or derived from energy-market indices or on terms predetermined by the contract, which may or may not be physically or financially settled by SET. For the year ended December 31, 1998, substantially all of SET's derivative transactions were held for trading and marketing purposes.

Market risk arises from the potential for changes in the value of financial instruments resulting from fluctuations in natural gas, petroleum and electricity commodity-exchange prices and basis. Market risk is also affected by changes in volatility and liquidity in markets in which these instruments are traded.

SET adjusts the book value of these derivatives to market each month with gains and losses recognized in earnings. These instruments are included in other current assets on the Consolidated Balance Sheet. Certain instruments such as swaps are entered into and closed out within the same month and, therefore, do not have any balance-sheet impact. Gains and losses are included in electric or natural gas revenue or expense, whichever is appropriate, in the Consolidated Income Statements.

SET also carries an inventory of financial instruments. As trading strategies depend on both market making and proprietary positions, given the relationships between instruments and markets, those activities are managed in concert in order to maximize trading profits.

SET's credit risk from financial instruments as of December 31, 1998, is represented by the positive fair value of financial instruments after consideration of master netting agreements and collateral. Credit risk disclosures, however, relate to the net accounting losses that would be recognized if all counterparties completely failed to perform their obligations. Options written do not expose SET to credit risk. Exchange-traded futures and options are not deemed to have significant credit exposure as the exchanges guarantee that every contract will be properly settled on a daily basis.

The following table approximates the counterparty credit quality and exposure of SET expressed in terms of net replacement value (in millions of dollars):

Counterparty credit quality:	Futures, forward and swap contracts	Purchased options	Total
AAA	\$ 32	\$ 1	\$ 33
AA	41	14	55
A	129	19	148
BBB	290	26	316
Below investment grade	69	2	71
Exchanges	30	8	38
	\$591	\$70	\$661

Financial instruments with maturities or repricing characteristics of 180 days or less, including cash and cash equivalents, are considered to be short-term and, therefore, the carrying values of these financial instruments approximate their fair values. SET's commodities owned, trading assets and trading liabilities are carried at fair value. The average fair values during the year, based on quarterly observation, for trading assets

and trading liabilities which are considered financial instruments with off-balance-sheet risk approximate \$952 million and \$890 million, respectively. The fair values are net of the amounts offset pursuant to rights of setoff based on qualifying master netting arrangements with counterparties, and do not include the effects of collateral held or pledged.

As of December 31, 1998, and 1997, SET's trading assets and trading liabilities approximate the following:

(Dollars in millions)	December 31,	
	1998	1997
TRADING ASSETS		
Unrealized gains on swaps and forwards	\$756	\$497
Due from commodity clearing organization and clearing brokers	75	41
OTC commodity options purchased	45	33
Due from trading counterparties	30	16
Total	\$906	\$587
TRADING LIABILITIES		
Unrealized losses on swaps and forwards	\$740	\$487
Due to trading counterparties	35	41
OTC commodity options written	30	29
Total	\$805	\$557

Notional amounts do not necessarily represent the amounts exchanged by parties to the financial instruments and do not measure SET's exposure to credit or market risks. The notional or contractual amounts are used to summarize the volume of financial instruments, but do not reflect the extent to which positions may offset one another. Accordingly, SET is exposed to much smaller amounts potentially subject to risk. The notional amounts of SET's financial instruments are:

(Dollars in millions)	Total
Forwards and commodity swaps	\$ 5,916
Futures and exchange options	2,915
Options purchased	1,320
Options written	1,298
Total	\$11,449

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PREFERRED STOCK OF SUBSIDIARIES

PACIFIC ENTERPRISES (Dollars in millions except call price)	Call Price	December 31,	
		1998	1997
Cumulative preferred			
without par value:			
\$4.75 Dividend, 200,000 shares authorized and outstanding	\$100.00	\$20	\$20
\$4.50 Dividend, 300,000 shares authorized and outstanding	\$100.00	30	30
\$4.40 Dividend, 100,000 shares authorized and outstanding	\$101.50	10	10
\$4.36 Dividend, 200,000 shares authorized and outstanding	\$101.00	20	20
\$4.75 Dividend, 253 shares authorized and outstanding	\$101.00	—	—
Total		\$80	\$80

All or any part of every series of presently outstanding PE preferred stock is subject to redemption at PE's option at any time upon not less than 30 days' notice, at the applicable redemption price for each series, together with the accrued and accumulated dividends to the date of redemption. All series have one vote per share and cumulative preferences as to dividends. No shares of Unclassified or Class A preferred stock are outstanding.

SoCALGAS (Dollars in millions)	December 31,	
	1998	1997
Not subject to mandatory redemption:		
\$25 par value, authorized 1,000,000 shares		
6% Series, 28,664 shares outstanding	\$ 1	\$ 1
6% Series A, 783,032 shares outstanding	19	19
Without par value, authorized 10,000,000 shares		
7.75% Series	—	75
	\$20	\$95



None of SoCalGas' series of preferred stock is callable.

All series have one vote per share and cumulative preferences as to dividends. On February 2, 1998, SoCalGas redeemed all outstanding shares of 7.75% Series Preferred Stock at a price per share of \$25 plus \$0.09 of dividends accruing to the date of redemption. The total cost to SoCalGas was approximately \$75.3 million.

SDG&E (Dollars in millions except call price)	Call Price	December 31,	
		1998	1997
Not subject to mandatory redemption			
\$20 par value, authorized			
1,375,000 shares:			
5% Series, 375,000			
shares outstanding	\$24.00	\$ 8	\$ 8
4.50% Series, 300,000			
shares outstanding	\$21.20	6	6
4.40% Series, 325,000			
shares outstanding	\$21.00	7	7
4.60% Series, 373,770			
shares outstanding	\$20.25	7	7
Without par value:			
\$1.70 Series, 1,400,000			
shares outstanding	\$25.85	35	35
\$1.82 Series, 640,000			
shares outstanding	\$26.00	16	16
Total not subject to mandatory redemption			
		\$79	\$79
Subject to mandatory redemption			
Without par value:			
\$1.7625 Series, 1,000,000			
shares outstanding	\$25.00	\$25	\$25

All series of SDG&E's preferred stock have cumulative preferences as to dividends. The \$20 par value preferred stock has two votes per share on matters being voted upon by shareholders of SDG&E and a liquidation value at par,

whereas the no-par-value preferred stock is nonvoting and has a liquidation value of \$25 per share. SDG&E is authorized to issue 10,000,000 shares of no-par-value stock (both subject to and not subject to mandatory redemption). All series are currently callable except for the \$1.70 and \$1.7625 series (callable in 2003). 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.

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SHAREHOLDERS EQUITY AND EARNINGS PER SHARE

The company's outstanding stock options represent the only forms of potential common stock at December 31, 1998, 1997, and 1996. The reconciliation between basic and diluted EPS is as follows:

	Income (in millions)	Shares (in thousands)	Earnings Per Share
1998			
Basic	\$294	236,423	\$1.24
Effect of dilutive stock options		701	
Diluted	\$294	237,124	\$1.24
1997			
Basic	\$432	236,662	\$1.83
Effect of dilutive stock options		587	
Diluted	\$432	237,249	\$1.82
1996			
Basic	\$427	240,825	\$1.77
Effect of dilutive stock options		332	
Diluted	\$427	241,157	\$1.77

The company is authorized to issue 750,000,000 shares of no-par-value common stock and 50,000,000 shares of Preferred Stock. At December 31, 1998, there were 240,026,439 shares of common stock outstanding, compared to 235,598,111 shares outstanding at December 31, 1997. No shares of Preferred Stock were issued and outstanding.



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COMMITMENTS AND CONTINGENCIES

NATURAL GAS CONTRACTS The company buys natural gas under several short-term and long-term contracts. Short-term purchases are based on monthly spot-market prices. SoCalGas has commitments for firm pipeline capacity under contracts with pipeline companies that expire at various dates through the year 2006. These agreements provide for payments of an annual reservation charge. SoCalGas recovers such fixed charges in rates.

SDG&E has long-term capacity contracts with interstate pipelines which expire on various dates between 2007 and 2023. SDG&E has long-term natural gas supply contracts (included in the table below) with four Canadian suppliers that expire between 2001 and 2004. SDG&E has been involved in negotiations and litigation with the suppliers concerning the contracts' terms and prices. SDG&E has settled with three of the suppliers. One of the three is delivering natural gas under the terms of the settlement agreement; the other two have ceased deliveries. The fourth supplier has ceased deliveries pending legal resolution. A U.S. Court of Appeal has upheld a U.S. District Court's invalidation of the contracts with two of these suppliers. If the supply of Canadian natural gas to SDG&E is not resumed to a level approximating the related committed long-term pipeline capacity, SDG&E intends to continue using the capacity in other ways, including the transport of replacement gas and the release of a portion of this capacity to third parties.

At December 31, 1998, the future minimum payments under natural gas contracts were:

(Dollars in millions)	Storage and Transportation	Natural Gas
1999	\$ 193	\$288
2000	195	170
2001	197	175
2002	197	179
2003	193	181
Thereafter	587	—
Total minimum payments	\$1,562	\$993

Total payments under the short-term and long-term contracts were \$1.0 billion in 1998, \$1.2 billion in 1997, and \$1.0 billion in 1996.

All of SDG&E's gas is delivered through SoCalGas pipelines under a short-term transportation agreement. In addition, SoCalGas provides SDG&E six billion cubic feet of natural gas storage capacity under an agreement expiring March 2000. These agreements are not included in the above table.

PURCHASED-POWER CONTRACTS

SDG&E buys electric power under several long-term contracts. The contracts expire on various dates between 1999 and 2025. Under California's Electric-Industry Restructuring law, which is described in Note 14, the California investor-owned electric utilities (IOUs) are obligated to bid their power supply, including owned generation and purchased-power contracts, into the California Power Exchange (PX). As a result, SDG&E's system requirements are met primarily through purchases from the PX.

At December 31, 1998, the estimated future minimum payments under the long-term contracts were:

(Dollars in millions)	
1999	\$ 249
2000	211
2001	174
2002	136
2003	135
Thereafter	2,001
Total minimum payments	\$2,906



These payments for actual purchases represent capacity charges and minimum energy purchases. SDG&E is required to pay additional amounts for actual purchases of energy that exceed the minimum energy commitments. Total payments, including actual energy payments, under the contracts were \$293 million in 1998, \$421 million in 1997 and \$296 million in 1996. Payments under purchased-power contracts decreased in 1998 as a result of the purchases from the PX, which commenced April 1, 1998.

SDG&E has entered into agreements to sell its power plants and other electric-generating resources (excluding SONGS), and has announced a plan to auction its long-term purchased power contracts. Additional information on this topic is provided in Note 14.

LEASES

The company has leases (primarily operating) on real and personal property expiring at various dates from 1999 to 2030. Certain leases on office facilities contain escalation clauses requiring annual increases in rent ranging from 2 percent to 7 percent. The rentals payable under these leases are determined on both fixed and percentage bases, and most leases contain options to extend, which are exercisable by the company. The company also has nuclear fuel, office buildings, a generating facility and other properties that are financed by long-term capital leases. Utility plant includes \$177 million at December 31, 1998, and \$198 million at December 31, 1997, related to these leases. The associated accumulated amortization is \$114 million and \$102 million, respectively.

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

(Dollars in millions)	Operating Leases	Capitalized Leases
1999	\$ 60	\$ 31
2000	58	14
2001	55	14
2002	52	14
2003	51	11
Thereafter	380	9
Total future rental commitment	\$656	93
Imputed interest (6% to 9%)		(17)
Net commitment		\$ 76

Rent expense totaled \$105 million in 1998, \$137 million in 1997, and \$146 million in 1996.

In connection with the quasi-reorganization described in Note 2, PE established reserves of \$102 million to fair value operating leases related to its headquarters and other leases at December 31, 1992. The remaining amount of these reserves was \$76 million at December 31, 1998. These leases are reflected in the above table.

ENVIRONMENTAL ISSUES

The company believes that its 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. SoCalGas and SDG&E incur significant costs to operate their facilities in compliance with these laws and regulations. The costs of compliance with environmental laws and regulations generally have been recovered in customer rates.

In 1994, the CPUC approved the Hazardous Waste Collaborative Memorandum account allowing utilities to recover their hazardous waste costs, including those related to Superfund sites or similar sites requiring cleanup. Recovery of 90 percent of cleanup costs and related third-party litigation costs and 70 percent of the related insurance-litigation expenses is permitted. Environmental liabilities that may arise are recorded when remedial efforts are probable and the costs can be estimated.

The company's capital expenditures to comply with environmental laws and regulations were \$1 million in 1998, \$5 million in 1997, and \$9 million in 1996, and are not expected to be significant during the next five years. These expenditures primarily include the cost of retrofitting SDG&E's power plants to reduce air emissions. These costs will be reduced significantly by SDG&E's sale of its non-nuclear generating facilities. The company has been associated with various sites which may require

remediation under federal, state or local environmental laws. The company is unable to determine fully the extent of its responsibility for remediation of these sites until assessments are completed. Furthermore, the number of others that also may be responsible, and their ability to share in the cost of the cleanup, is not known. The company does not anticipate that such costs, net of the portion recoverable in rates, will be significant.

As discussed in Note 14, restructuring of the California electric-utility industry will change the way utility rates are set and costs are recovered. SDG&E asked that the collaborative account be modified, and that electric-generation-related cleanup costs be eligible for transition-cost recovery. The final outcome of this decision is that SDG&E's costs of compliance with environmental regulations may be fully recoverable.

NUCLEAR INSURANCE

SDG&E and the co-owners of SONGS have purchased primary insurance of \$200 million, the maximum amount available, for public-liability claims. An additional \$8.7 billion of 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. In the event the public-liability limit stated above is insufficient, the Price-Anderson Act provides for Congress to enact further revenue-raising measures to pay claims, which could include an additional assessment on all licensed reactor operators.

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 three years, after a waiting period of 17 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 from these insurance programs, SDG&E could be assessed retrospective premium adjustments of up to \$6 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 which have used DOE enrichment services are being assessed 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 through 1992. SDG&E's annual assessment is approximately \$1 million. This assessment is recovered through SONGS revenue.

LITIGATION

The company 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 the company's results of operations, financial condition or liquidity.

ELECTRIC DISTRIBUTION SYSTEM CONVERSION

Under a CPUC-mandated program and through franchise agreements with various cities, SDG&E is committed, in varying amounts, to converting overhead distribution facilities to underground. As of December 31, 1998, the aggregate unexpended amount of this commitment was approximately \$104 million. Capital expenditures for underground conversions were \$17 million in 1998, \$17 million in 1997, and \$15 million in 1996.



CONCENTRATION OF CREDIT RISK

The company maintains credit policies and systems to minimize overall credit risk. These policies include, when applicable, the use of an evaluation of potential counterparties' financial condition and an assignment of credit limits. These credit limits are established based on risk and return considerations under terms customarily available in the industry. SDG&E and SoCalGas grant credit to their utility customers, substantially all of whom are located in their service territories, which together cover most of Southern California and a portion of central California.

SET monitors and controls its credit-risk exposures through various systems which evaluate its credit risk, and through credit approvals and limits. To manage the level of credit risk, SET deals with a majority of counterparties with good credit standing, enters into master netting arrangements whenever possible and, where appropriate, obtains collateral. Master netting agreements incorporate rights of setoff that provide for the net settlement of subject contracts with the same counterparty in the event of default.

14

REGULATORY MATTERS

ELECTRIC-INDUSTRY RESTRUCTURING In September 1996, California enacted a law restructuring its electric-utility industry (AB 1890). The legislation adopts the December 1995 CPUC policy decision restructuring the industry to stimulate competition and reduce rates.

Beginning on March 31, 1998, customers were given the opportunity to choose to continue to purchase their electricity from the local utility under regulated tariffs, to enter into contracts with other energy service providers (direct access) or to buy their power from the independent Power Exchange (PX) that serves as a wholesale power pool allowing

all energy producers to participate competitively. The PX obtains its power from qualifying facilities, from nuclear units and, lastly, from the lowest-bidding suppliers. The California investor-owned electric utilities (IOUs) are obligated to sell their power supply, including owned-generation and purchased-power contracts, to the PX. The IOUs are also obligated to purchase from the PX the power that they distribute. An Independent System Operator (ISO) schedules power transactions and access to the transmission system. The local utility continues to provide distribution service regardless of which source the consumer chooses. An example of these changes in the electric-utility environment is the U.S. Navy, SDG&E's largest customer. The U.S. Navy's contract to purchase energy from SDG&E was not renewed when it expired on September 30, 1998. Instead, the U.S. Navy elected to obtain energy through direct access and SDG&E continues to provide the distribution service.

Utilities are allowed a reasonable opportunity to recover their stranded costs via a competition transition charge (CTC) to customers through December 31, 2001. Stranded costs include sunk costs, as well as ongoing costs the CPUC finds reasonable and necessary to maintain generation facilities through December 31, 2001. These costs also include other items SDG&E has recorded under traditional cost-of-service regulation. Certain stranded costs, such as those related to reasonable employee-related costs directly caused by restructuring, and purchased-power contracts (including those with qualifying facilities) may be recovered beyond December 31, 2001. To the extent that the opportunity to recover stranded costs is reduced by the costs to accommodate the implementation of direct access and the ISO/PX during the rate freeze, those displaced stranded costs may be recovered after December 31, 2001. Outside of those exceptions, stranded costs not recovered through 2001 will not be collected from customers. Such costs, if any, would be written off as a charge against earnings. Nuclear decommissioning costs are nonbypassable until fully recovered, but are not included as part of transition costs. Additional information is provided in Note 10.



Through December 31, 1998, SDG&E has recovered transition costs of \$500 million for nuclear generation and \$200 million for nonnuclear generation. Excluding the costs of purchased power and other costs whose recovery is not limited to the pre-2002 period, the balance of SDG&E's stranded assets at December 31, 1998, is \$600 million, consisting of \$400 million for the power plants and \$200 million of related deferred taxes and undercollections.

In November 1997, SDG&E announced a plan to auction its power plants and other electric-generating assets. This plan includes the divestiture of SDG&E's fossil power plants and combustion turbines, its 20-percent interest in SONGS and its portfolio of long-term purchased-power contracts. The power plants, including the interest in SONGS, have a net book value as of December 31, 1998, of \$400 million (\$100 million for fossil and \$300 million for SONGS) and a combined generating capacity of 2,400 megawatts. The proceeds from the sales, net of the costs of the sales and certain environmental cleanup costs, will be applied directly to SDG&E's transition costs. The fossil-fuel assets' auction is being separated from the auction of SONGS and the purchased-power contracts. In October 1998 the CPUC issued an interim decision approving the commencement of the fossil fuel assets' auction.

On December 11, 1998, contracts were executed for the sale of SDG&E's South Bay Power Plant, Encina Power Plant and 17 combustion-turbine generators. The South Bay Power Plant is being sold to the San Diego Unified Port District for \$110 million. The Encina Power Plant and the combustion-turbine generators are being sold to a special-purpose entity owned equally by Dynegy Power Corp. and NRG Energy, Inc. for \$356 million. The sales are subject to regulatory approval and are expected to close during the first half of 1999.

During the 1998-2001 period, recovery of transition costs is limited by the rate freeze discussed below. Management believes that rates and the proceeds from the sale of electric-generating assets will be sufficient to recover all of SDG&E's approved transition costs by December 31, 2001, not including the post-2001 purchased-power contracts payments that may be recovered after 2001. However, if 1998-2001 generation costs, principally fuel costs, are greater than anticipated, SDG&E may be unable to recover all of its approved transition costs. This would result in a charge against earnings at the time it ceases to be probable that SDG&E will be able to recover all of the transition costs.

AB 1890 requires a 10-percent reduction of residential and small commercial customers' rates, beginning in January 1998, and provides for the issuance of rate-reduction bonds by an agency of the state of California to enable the IOUs to achieve this rate reduction. In December 1997, \$658 million of rate-reduction bonds were issued on behalf of SDG&E at an average interest rate of 6.26 percent. These bonds are being repaid over 10 years by SDG&E's residential and small commercial customers via a nonbypassable charge on their electric bills. In 1997, SDG&E formed a subsidiary, SDG&E Funding LLC, to facilitate the issuance of the bonds. In exchange for the bond proceeds, SDG&E sold to SDG&E Funding LLC all of its rights to certain revenue streams collected from such customers. Consequently, the transaction is structured to cause such revenue streams not to be the property of SDG&E nor to be available to satisfy any claims of SDG&E's creditors.

AB 1890 includes a rate freeze for all electric customers. Until the earlier of March 31, 2002, or when transition-cost recovery is complete, SDG&E's system-average rate will be frozen at the June 10, 1996, levels of 9.64 cents per kwh, except for the impact of fuel-cost changes and the 10-percent rate reduction described above. Beginning in 1998, system-average rates were fixed at 9.43 cents per kwh, which includes the maximum permitted increase related to fuel-cost increases and the mandatory rate reduction.



In early 1999, SDG&E filed with the CPUC for an interim mechanism to deal with electric rates after the rate freeze ends, noting the possibility that the SDG&E rate freeze could end in 1999.

As discussed in Note 2, SDG&E has been accounting for the economic effects of regulation in accordance with SFAS No. 71. The SEC indicated a concern that California's investor-owned utilities (IOUs) may not meet the criteria of SFAS No. 71 with respect to their electric-generation regulatory assets. SDG&E has ceased the application of SFAS No. 71 to its generation business, in accordance with the conclusion of the Emerging Issues Task Force of the Financial Accounting Standards Board that the application of SFAS 71 should be discontinued when legislation is issued that determines that a portion of an entity's business will no longer be subject to traditional cost-of-service regulation. The discontinuance of SFAS No. 71 applied to the IOUs' generation business did not result in a write-off of their net regulatory assets since the CPUC has approved the recovery of these assets by the distribution portion of their operations, subject to the rate freeze.

In October 1997, the FERC approved key elements of the California IOUs' restructuring proposal. This included the transfer by the IOUs of the operational control of their transmission facilities to the ISO, which is under FERC jurisdiction. The FERC also approved the establishment of the California PX to operate as an independent wholesale power pool. The IOUs pay to the PX an upfront restructuring charge (in four annual installments) and an administrative-usage charge for each megawatt hour of volume transacted. SDG&E's share of the restructuring charge is approximately \$10 million, which is being recovered as a transition cost. The IOUs have guaranteed \$300 million of commercial loans to the ISO and PX for their development and initial start-up. SDG&E's share of the guarantee is \$30 million.

Thus far, electric-industry deregulation has been confined to generation. Transmission and distribution have remained subject to traditional cost-of-service regulation. However, the CPUC is exploring the possibility of opening up electric distribution to competition. During 1999, the CPUC will be conducting a rulemaking, one objective of which may be to develop a coordinated proposal for the state legislature regarding how various distribution competition issues should be addressed. SDG&E and SoCalGas will actively participate in this effort.

GAS-INDUSTRY RESTRUCTURING

The natural gas industry experienced an initial phase of restructuring during the 1980s by deregulating gas sales to noncore customers. On January 21, 1998, the CPUC released a staff report initiating a project to assess the current market and regulatory framework for California's natural gas industry. The general goals of the plan are to consider reforms to the current regulatory framework emphasizing market-oriented policies benefiting California natural gas consumers.

On August 25, 1998, California adopted a law prohibiting the CPUC from enacting any natural gas-industry restructuring decision for customers prior to January 1, 2000. During the implementation moratorium, the CPUC will hold hearings throughout the state and intends to give the California Legislature a report for its review detailing specific recommendations for changing the natural gas market within California. SDG&E and SoCalGas will actively participate in this effort.

PERFORMANCE-BASED REGULATION (PBR)

To promote efficient operations and improved productivity and to move away from reasonableness reviews and disallowances, the CPUC has been directing utilities to use PBR. PBR has replaced the general rate case and certain other regulatory proceedings for both SoCalGas and SDG&E. Under PBR, regulators require future income potential to be tied to achieving or exceeding specific performance and productivity measures, as well as cost reductions, rather than relying solely on expanding utility rate base in a market where a utility already has a highly developed infrastructure.



SoCalGas' PBR is in effect through December 31, 2002; however, the CPUC decision allows for the possibility that changes to the PBR mechanism could be adopted in a decision to be issued in SoCalGas' 1999 Biennial Cost Allocation Proceeding, which is anticipated to become effective before year-end 1999. Key elements of the SoCalGas PBR include an initial reduction in base rates, an indexing mechanism that limits future rate increases to the inflation rate less a productivity factor, a sharing mechanism with customers if earnings exceed the authorized rate of return on rate base, and rate refunds to customers if service quality deteriorates. Specifically, the key elements of SoCalGas' PBR include the following:

- ◆ Earnings up to 25 basis points in excess of the authorized rate of return on rate base are retained 100 percent by shareholders. Earnings that exceed the authorized rate of return on rate base by greater than 25 basis points are shared between customers and shareholders on a sliding scale that begins with 75 percent of the additional earnings being given back to customers and declining to 0 percent as earned returns approach 300 basis points above authorized amounts. There is no sharing if actual earnings fall below the authorized rate of return. In 1999, SoCalGas is authorized to earn a 9.49 percent return on rate base, the same as in 1998.
- ◆ Revenue or base margin per customer is indexed based on inflation less an estimated productivity factor of 2.1 percent in the first year (1998), increasing 0.1 percent per year up to 2.5 percent in the fifth year (2002). This factor includes 1 percent to approximate the projected impact of a declining rate base.
- ◆ The CPUC decision allows for pricing flexibility for residential and small commercial customers, with any shortfalls in revenue being borne by shareholders and with any increase in revenue shared between shareholders and customers.

Under SoCalGas' PBR, annual cost of capital proceedings are replaced by an automatic adjustment mechanism if changes in certain indices exceed established tolerances. The mechanism is triggered if the 12-month trailing average of actual market interest rates increases or decreases by more than 150 basis points and is forecasted to continue to vary by at least 150 basis points for the next year. If this occurs, there would be an automatic adjustment of rates for the change in the cost of capital according to a preestablished formula which applies a percentage of the change to various capital components.

SDG&E continues to participate in a PBR process for base rates for its electric and natural gas-distribution business. In conjunction therewith, in December 1998, a Cost of Service settlement agreement among SDG&E, the CPUC's Office of Ratepayers' Advocates (ORA) and the Utility Consumers' Action Network (UCAN) was approved by the CPUC, resulting in an authorized revenue increase of \$12 million (an electric-distribution increase of \$18 million and a natural gas decrease of \$6 million). The electric-distribution increase does not affect rates during the rate freeze and, therefore, reduces the amount available for transition cost recovery. Revised rates were effective January 1, 1999.

In January 1999, an administrative law judge's proposed decision was issued on SDG&E's distribution PBR application. The proposed decision recommends a revenue-per-customer indexing mechanism (similar to the indexing mechanism in SoCalGas' PBR) rather than the rate-indexing mechanism proposed by SDG&E. In addition, the proposed decision recommends much tighter earnings sharing bands (similar to SoCalGas'). The performance indicators are as adopted in the settlement agreement, including employee safety, electric reliability, customer satisfaction, call-center responsiveness and electric-system maintenance. SDG&E would be authorized to earn or be penalized up to a maximum of \$14.5 million annually as a result of its performance in those areas.



COMPREHENSIVE SETTLEMENT OF NATURAL GAS REGULATORY ISSUES

In July 1994, the CPUC approved a comprehensive settlement for SoCalGas (Comprehensive Settlement) of a number of regulatory issues, including rate recovery of a significant portion of the restructuring costs associated with certain long-term contracts with suppliers of California-offshore and Canadian natural gas. In the past, the cost of these supplies had been substantially in excess of SoCalGas' average delivered cost for all natural gas supplies. The restructured contracts substantially reduced the ongoing delivered costs of these supplies. The Comprehensive Settlement permits SoCalGas to recover in utility rates approximately 80 percent of the contract-restructuring costs of \$391 million and accelerated amortization of related pipeline assets of approximately \$140 million, together with interest, incurred prior to January 1, 1999. In addition to the supply issues, the Comprehensive Settlement addressed the following other regulatory issues:

◆ **NONCORE CUSTOMER RATES.** The Comprehensive Settlement changed the procedures for determining noncore rates to be charged by SoCalGas for the five-year period commencing August 1, 1994. These rates are based upon SoCalGas' recorded throughput to these customers for 1991. SoCalGas will bear the full risk of any declines in noncore deliveries from 1991 levels. Any revenue enhancement from deliveries in excess of 1991 levels will be limited by a crediting account mechanism that will require a credit to customers of 87.5 percent of revenues in excess of certain limits. These annual limits above which the credit is applicable increase from \$11 million to \$19 million over the five-year period from August 1, 1994, through July 31, 1999. SoCalGas' ability to report as earnings the results from revenues in excess of SoCalGas' authorized return from noncore customers due to volume increases has been limited for the five years beginning August 1, 1994, as a result of the Comprehensive Settlement. The 1999 Biennial Cost Allocation Proceeding is intended to adopt measures to replace this aspect of the Comprehensive Settlement when it expires during 1999.

◆ **GAS COST INCENTIVE MECHANISM (GCIM).** On April 1, 1994, SoCalGas implemented a new process for evaluating its natural gas purchases, substantially replacing the previous process of reasonableness reviews. Initially a three-year pilot program, in December 1998 the CPUC extended the GCIM program indefinitely. Automatic annual extensions to the program will continue unless the CPUC issues an order stating otherwise.

GCIM compares SoCalGas' cost of natural gas with a benchmark level, which is the average price of 30-day firm spot supplies in the basins in which SoCalGas purchases the natural gas. The mechanism permits full recovery of all costs within a "tolerance band" above the benchmark price and refunds all savings within a "tolerance band" below the benchmark price. The costs or savings outside the "tolerance band" are shared equally between customers and shareholders.

The CPUC approved the use of natural gas futures for managing risk associated with the GCIM. SoCalGas enters into natural gas futures contracts in the open market on a limited basis to mitigate risk and better manage natural gas costs.

In June 1997, SoCalGas requested a shareholder award of \$11 million, which was approved by the CPUC in June 1998 and is included in pretax income in 1998. In June 1998, SoCalGas filed its annual GCIM application with the CPUC requesting an award of \$2 million for the annual period ended March 31, 1998. This request was approved by the CPUC in December 1998 and is included in pretax income in 1998.

◆ **ATTRITION ALLOWANCES.** The Comprehensive Settlement authorized SoCalGas an annual allowance for increases in operating and maintenance expenses. However, no attrition allowance was authorized for 1997 and beyond, based on an agreement reached as part of the PBR application.

PE and SoCalGas recorded the impact of the Comprehensive Settlement in 1993. Upon giving effect to liabilities previously recognized by the companies, the costs of the Comprehensive Settlement, including the restructuring of natural gas supply contracts, did not result in any future charge to PE's earnings.

BIENNIAL COST ALLOCATION PROCEEDING (BCAP)

In the second quarter of 1997, the CPUC issued a decision on SoCalGas' 1996 BCAP filing.



In this decision, the CPUC considered SoCalGas' relinquishments of interstate pipeline capacity on both the El Paso and Transwestern pipelines. This resulted in a reduction in the pipeline demand charges allocated to SoCalGas' customers and surcharges allocated to firm capacity holders through pipeline rate-case settlements adopted at the FERC. However, the CPUC and FERC are reviewing the decision.

In October 1998, SoCalGas and SDG&E filed 1999 BCAP applications requesting that new rates become effective August 1, 1999, and remain in effect through December 31, 2002. The proposed beginning date follows the conclusion of the Comprehensive Settlement (discussed above), and the proposed end date aligns with the expiration of SoCalGas' and SDG&E's PBRs. The applications seek overall decreases in natural gas revenues of \$204 million for SoCalGas and \$9 million for SDG&E.

COST OF CAPITAL

Under PBR, annual Cost of Capital proceedings were replaced by an automatic adjustment mechanism if changes in certain indices exceed established tolerances. For 1999, SoCalGas is authorized to earn a rate of return on common equity (ROE) of 11.6 percent and a 9.49 percent return on rate base (ROR), the same as in 1998, unless interest-rate changes are large enough to trigger an automatic adjustment as discussed above under "Performance-Based Regulation." For SDG&E, electric-industry restructuring is changing the method of calculating the utility's annual cost of capital. In May 1998, SDG&E filed with the CPUC its unbundled Cost of Capital application for 1999 rates. The application seeks approval to establish new, separate rates of return for SDG&E's electric-distribution and natural gas businesses. The application proposes a 12.00 percent ROE, which would produce an overall ROR of 9.33 percent. The ORA, UCAN and other intervenors have filed testimony recommending significantly lower RORs. The ORA is recommending an electric ROR of 7.68 percent and a gas

ROR of 8.01 percent. A CPUC decision is expected during the second quarter of 1999. In 1998, SDG&E's electric and natural gas-distribution operations were authorized to earn an ROE of 11.6 percent and an ROR of 9.35 percent, unchanged from 1997. In addition, the authorized rates of return on nuclear and nonnuclear generating assets are 7.14 percent and 6.75 percent, respectively.

TRANSACTIONS BETWEEN UTILITIES AND AFFILIATED COMPANIES

On December 16, 1997, the CPUC adopted rules, effective January 1, 1998, establishing uniform standards of conduct governing the manner in which IOUs conduct business with their energy-related affiliates. The objective of the affiliate-transaction rules is to ensure that these affiliates do not gain an unfair advantage over other competitors in the marketplace and that utility customers do not subsidize affiliate activities. The rules establish standards relating to nondiscrimination, disclosure and information exchange, and separation of activities.

The CPUC excluded utility-to-utility transactions between SDG&E and SoCalGas from the affiliate-transaction rules in its March 1998 decision approving the business combination of Enova and PE (see Note 1).

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SEGMENT INFORMATION

The company, primarily an energy services company, has three separately managed reportable segments comprised of SoCalGas, SDG&E and Sempra Energy Trading (SET). The two utilities operate in essentially separate service territories under separate regulatory frameworks and rate structures set by the CPUC. As described in Note 1, SDG&E provides electric and natural gas service to San Diego and southern Orange counties. SoCalGas is a natural gas distribution utility, serving customers throughout most of Southern California and part of central California. SET is based in Stamford, Connecticut, and is engaged in the nationwide wholesale trading and marketing of natural gas, power and petroleum. The accounting policies of the segments are the same as those described in Note 2, and segment performance is evaluated by management based on reported net income. Intersegment transactions generally are recorded the same as sales or transactions with third parties. Utility transactions are primarily based on rates set by the CPUC and FERC.



(Dollars in millions)	For the year ended December 31		
	1998	1997	1996
OPERATING REVENUES:			
Southern California Gas	\$2,427	\$2,641	\$2,422
San Diego Gas & Electric	2,749	2,167	1,939
Sempra Energy Trading	110	—	—
Intersegment revenues	(59)	(55)	(60)
All other	254	316	195
Total	\$5,481	\$5,069	\$4,496
INTEREST REVENUE:			
Southern California Gas	\$ 4	\$ 16	\$ 5
San Diego Gas & Electric	40	9	7
Sempra Energy Trading	3	—	—
All other interest	3	21	23
Total interest	50	46	35
Sundry income (loss)	(6)	12	(7)
Total other income	\$ 44	\$ 58	\$ 28
DEPRECIATION AND AMORTIZATION:			
Southern California Gas	\$ 254	\$ 251	\$ 248
San Diego Gas & Electric (See Note 14)	603	324	314
Sempra Energy Trading	13	—	—
All other	59	29	25
Total	\$ 929	\$ 604	\$ 587
INTEREST EXPENSE:			
Southern California Gas	\$ 80	\$ 87	\$ 86
San Diego Gas & Electric	116	86	91
Sempra Energy Trading	5	—	—
All other	6	33	23
Total	\$ 207	\$ 206	\$ 200
INCOME TAX EXPENSE (BENEFIT):			
Southern California Gas	\$ 128	\$ 178	\$ 148
San Diego Gas & Electric	142	219	198
Sempra Energy Trading	(9)	—	—
All other	(123)	(96)	(46)
Total	\$ 138	\$ 301	\$ 300
NET INCOME:			
Southern California Gas	\$ 158	\$ 231	\$ 193
San Diego Gas & Electric	185	232	216
Sempra Energy Trading	(13)	—	—
All other	(36)	(31)	18
Total	\$ 294	\$ 432	\$ 427

(Dollars in millions)	At December 31, or for the year then ended		
	1998	1997	1996
ASSETS:			
Southern California Gas	\$ 3,834	\$ 4,205	\$4,354
San Diego Gas & Electric	4,257	4,654	4,161
Sempra Energy Trading	1,225	846	—
All other	1,253	1,181	1,257
Eliminations	(113)	(130)	(10)
Total	\$10,456	\$10,756	\$9,762
CAPITAL EXPENDITURES:			
Southern California Gas	\$ 128	\$ 159	\$ 197
San Diego Gas & Electric	227	197	209
Sempra Energy Trading	—	—	—
All other	83	41	7
Total	\$ 438	\$ 397	\$ 413
GEOGRAPHIC INFORMATION:			
Long-lived assets:			
United States	\$ 5,849	\$ 5,904	\$6,647
Latin America	140	67	50
Total	\$ 5,989	\$ 5,971	\$6,697
Operating Revenues:			
United States	\$ 5,474	\$ 5,058	\$4,488
Latin America	7	11	8
Total	\$ 5,481	\$ 5,069	\$4,496

16 SUBSEQUENT EVENT

On February 22, 1999, the company and KN Energy, Inc. (KN Energy) announced that their respective boards of directors approved the company's acquisition of KN Energy, subject to approval by the shareholders of both companies and by various federal and state regulatory agencies. If the transaction is approved, holders of KN Energy common stock will receive 1.115 shares of company common stock or \$25 in cash, or some combination thereof, for each share of KN Energy common stock. In the aggregate, the cash portion of the transaction will constitute not more than 30 percent of the total consideration of \$1.7 billion. The companies anticipate that the closing will occur in six to eight months. The transaction will be treated as a purchase for accounting purposes.



Quarterly Financial Data (unaudited)

(Dollars in millions except per share amounts)	Quarter ended			
	March 31	June 30	September 30	December 31
1998				
Revenues and other income	\$1,350	\$1,335	\$1,398	\$1,442
Operating expenses	1,164	1,249	1,192	1,281
Operating income	\$ 186	\$ 86	\$ 206	\$ 161
Net income	\$ 87	\$ 31	\$ 91	\$ 85
Average common shares outstanding (diluted)	236.4	236.9	237.4	237.6
Net income per common share (diluted)	\$ 0.37	\$ 0.13	\$ 0.38	\$ 0.36
1997				
Revenues and other income	\$1,301	\$1,130	\$1,251	\$1,445
Operating expenses	1,093	878	1,018	1,199
Operating income	\$ 208	\$ 252	\$ 233	\$ 246
Net income	\$ 98	\$ 112	\$ 102	\$ 120
Average common shares outstanding (diluted)	239.2	236.3	236.2	236.6
Net income per common share (diluted)	\$ 0.41	\$ 0.47	\$ 0.43	\$ 0.51

Quarterly Common Stock Data (unaudited)

	1998				1997			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Market price								
High	*	*	28	29 ⁵ / ₁₆	*	*	*	*
Low	*	*	23 ³ / ₄	24 ⁹ / ₁₆	*	*	*	*
Dividends declared ⁽¹⁾	\$0.32	\$0.46	\$0.39	\$0.39	\$0.31	\$0.45	\$0.19	\$0.32

*Not presented as the formation of Sempra Energy was not completed until June 26, 1998.

(1) Prior to the formation of Sempra Energy on June 26, 1998, dividends declared represents the sum of dividends declared by Pacific Enterprises and Enova Corporation, divided by the sum of the combining companies' shares after the conversion of PE's shares into Sempra Energy shares as described in Note 1 to the notes to Consolidated Financial Statements.



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Sempra Energy

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Emeritus & Trustee
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San Diego, California

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Partner
O'Melveny & Myers
Los Angeles, California

From left, front center: S.L. Baum, R.D. Farman

*Second row: H.H. Berteau, R.R. Ocampo, M.D.,
W.G. Ouchi, Ph.D., D.L. Walker*

*Third row: R.H. Goldsmith, W.D. Jones, A.L. Burr,
R.A. Collato, H.L. Carter, Ph.D., I.E. Lozano, Jr.*

*Top row: D.W. Derbes, W.D. Godbold, Jr.,
T.C. Stickel, R.J. Stegemeier*







Management Team

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Chairman of the Board &
Chief Executive Officer

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Vice Chairman, President &
Chief Operating Officer

Donald E. Felsing
Group President,
Unregulated Affiliates

Warren I. Mitchell
Group President,
Regulated Business Units

John R. Light
Executive Vice President - Legal,
General Counsel

Neal E. Schmale
Executive Vice President - Finance,
Chief Financial Officer

Jerry D. Florence
Senior Vice President,
Corporate Communications

Frederick E. John
Senior Vice President,
External Affairs

Margot A. Kyd
Senior Vice President,
Chief Administrative &
Environmental Officer

G. Joyce Rowland
Senior Vice President,
Human Resources

Michael W. Allman
Vice President,
Corporate Planning & Development

Frank H. Ault
Vice President,
Controller

Jerry W. Deems
Vice President,
Chief Information Technology Officer

Charles A. McMonagle
Vice President,
Treasurer

Mark D. Randle
Vice President,
Energy Risk Management

William L. Reed
Vice President,
Chief Regulatory Officer

Thomas C. Sanger
Corporate Secretary

Thomas S. Sayles
Vice President,
Governmental & Community Affairs

SAN DIEGO GAS & ELECTRIC

Warren I. Mitchell
Chairman

Edwin A. Guiles
President

SOUTHERN CALIFORNIA GAS COMPANY

Warren I. Mitchell
Chairman & President

Debra L. Reed
President,
Energy Distribution Services

Lee M. Stewart
President,
Energy Transportation Services

SEMPRA ENERGY FINANCIAL

Nancy N. Ross
Vice President,
Investments

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Executive Vice President

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Senior Vice President - Development,
Asia Pacific

George S. Liparidis
Senior Vice President

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David R. Kuzma
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SEMPRA ENERGY SOLUTIONS

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President,
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Eric B. Nelson
President

*From left, front row: J.R. Light, D.E. Felsing,
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*Second row: S.J. Prince, L.M. Stewart,
G.J. Rowland, J.D. Florence*

*Third row: E.A. Guiles, W.G. Homan, M.A. Kyd,
D.L. Reed, F.E. John, D.R. Kuzma*

*Top row: G.S. Liparidis, D. Kelly-Cochrane,
E.B. Nelson*



Corporate Information

TRANSFER AGENT:

First Chicago Trust Company of New York,
a division of EquiServe

P.O. Box 2500

Jersey City, NJ 07303-2500

Telephone: 877-773-6772

Hearing Impaired (TDD): 201-222-4955

Fax: 201-222-4861

E-mail: fctc@em.fcncd.com

Internet: <http://www.equiserve.com>

SHAREHOLDER SERVICES:

Investors with general questions regarding Sempra Energy, San Diego Gas & Electric, Southern California Gas Co. or Pacific Enterprises stock should contact the company at:

Sempra Energy

Shareholder Services

101 Ash Street

San Diego, CA 92101

Telephone: 877-736-7727

Fax: 619-233-6875

e-mail: investor@sempra.com

Internet: <http://www.sempra.com>

NEWS AND INFORMATION: To hear corporate news reports, stock update or request materials, call 877-773-6397.

Sempra Energy's annual report to the Securities and Exchange Commission (Form 10-K) is available to shareholders at no charge by writing to Shareholder Services.

INVESTOR RELATIONS: Security analysts, portfolio managers and other members of the financial community should contact:

Clem Teng

Director of Investor Relations

Telephone: 619-696-2901

Fax: 619-696-2374

STOCK EXCHANGE LISTING:

Sempra Energy Common Stock:

Ticker Symbol: SRE

New York Stock Exchange

Pacific Stock Exchange

Pacific Enterprises Preferred Stock:

American Stock Exchange

Pacific Stock Exchange

Southern California Gas Preferred Stock:

Pacific Stock Exchange

San Diego Gas & Electric Preferred Stock:

American Stock Exchange

DIRECT COMMON STOCK INVESTMENT PLAN:

The company offers a Direct Common Stock Investment Plan as a simple, convenient and affordable way to invest in Sempra Energy. Cash dividends from a participant's account can be automatically reinvested in full or in part to purchase additional shares, or participants may choose to receive all or a portion of their cash dividends electronically or by check. Participation in the Plan requires an initial investment of as little as \$500. The Plan allows optional cash investments of as little as \$25 up to a maximum of \$150,000 per calendar year. Nonshareholders pay a \$15 fee for the initial cash investment in Sempra Energy.

Brokerage commissions incurred in the purchase of shares will be paid by Sempra Energy.

The Plan is offered only by the means of a prospectus, which can be obtained by calling the Plan Administrator, First Chicago Trust Company of New York, at 877-773-6772, or through the Internet at <http://www.netstockdirect.com>.

CREDIT RATINGS:

(As of March 1, 1999)	S&P	Moody's	Duff & Phelps
SEMPRA ENERGY			
Unsecured Debt	A	-	A
SoCALGas			
Secured Debt	AA-	A1	AA
Unsecured Debt	A+	A2	AA-
Preferred Stock	AA-	a2	A+
Commercial Paper	A-1+	P1	D1+
PACIFIC ENTERPRISES			
Preferred Stock	A+	-	A+
SDG&E			
Secured Debt	AA-	A1	AA-
Unsecured Debt	A+	A2	A+
Preferred Stock	A+	a2	A
Commercial Paper	A-1+	P1	D1+



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