

when

why

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what

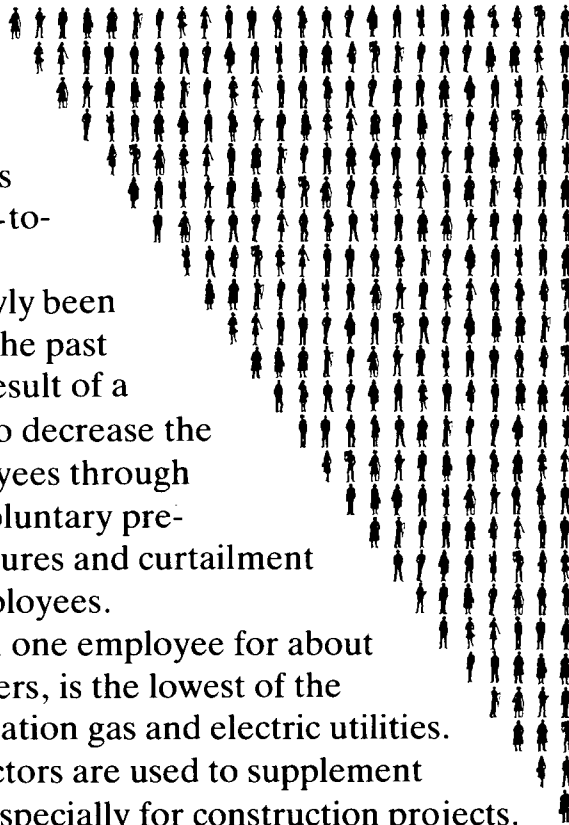
who

1985 Annual Report
San Diego Gas & Electric

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Operating expenses were kept in check in 1985. One factor was the company's improved worker-to-

customer ratio. The ratio has slowly been declining during the past three years as a result of a company policy to decrease the number of employees through retirement and voluntary pre-retirement departures and curtailment of hiring new employees. The current ratio, one employee for about every 300 customers, is the lowest of the 25 largest combination gas and electric utilities. However, contractors are used to supplement this work force, especially for construction projects.



A test of natural gas as a fuel for cars and trucks was begun in 1985 when 30 company vehicles were converted to be able to use either natural gas or gasoline. The objectives: to provide documentation on fleet experience, to determine potential markets and to assess the future value to the company of marketing the fuel for vehicle use (page 9).

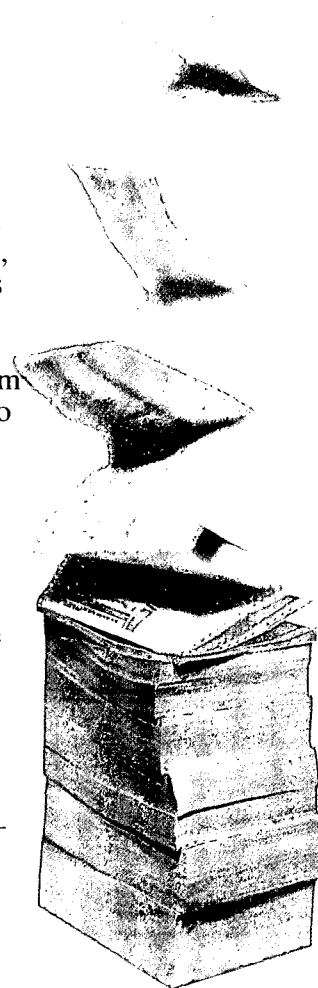
A \$14.3 million general rate increase was granted by the California Public Utilities Commission to cover gas and electric expenses. The increase was effective January 1, 1986. This was far below the company's final request for a \$78.6 million increase (page 5).

Looking ahead a decade, an electric resource plan was published in November 1985. It projects how much energy may be needed by 1995, where it could come from and what the most cost-effective ways of providing the energy might be. No small task, some 2,000 alternatives were analyzed in the process (page 6).



The Heber geothermal plant, a renewable energy research project, was completed on schedule in May and dedicated, with considerable ceremony, in December 1985. A consortium of public and private organizations, including SDG&E, is funding the research project. Heber is attracting visitors from around the world who are interested in learning how the plant's methodology, using 360-degree brine from deep in the earth, produces energy that will serve the needs of 45,000 people (page 7).

The Heber geothermal research plant, completed in 1985, is a plant without walls. The red pipes are part of the safety system.



1985: The Beginning Point

Beginnings are a most exciting time, whether it is the entry into the world of a new life, the first drive in a brand new car or the start of a new business enterprise. With that excitement goes an increased sense of responsibility toward that new life, new possession or new investment. 1985 was such a beginning point for the company.

San Diego Gas & Electric's structure was changed in early 1985. Pacific Diversified Capital Company, a subsidiary created in 1983, was activated and its management was given the responsibility for managing all nonutility operations (page 4). The management of the utility's gas and electric operations was realigned and given the challenge of finding ways to use the utility's facilities and energy resources to greater advantage (pages 6-11).

Shareholders overwhelmingly approved the formation of a holding company at a special meeting of shareholders held November 1, 1985. Hearings before the California Public Utilities Commission on the holding company proposal and on the company's diversification plans were held from October to December 1985. The commission was to announce its decision during the first quarter of 1986.

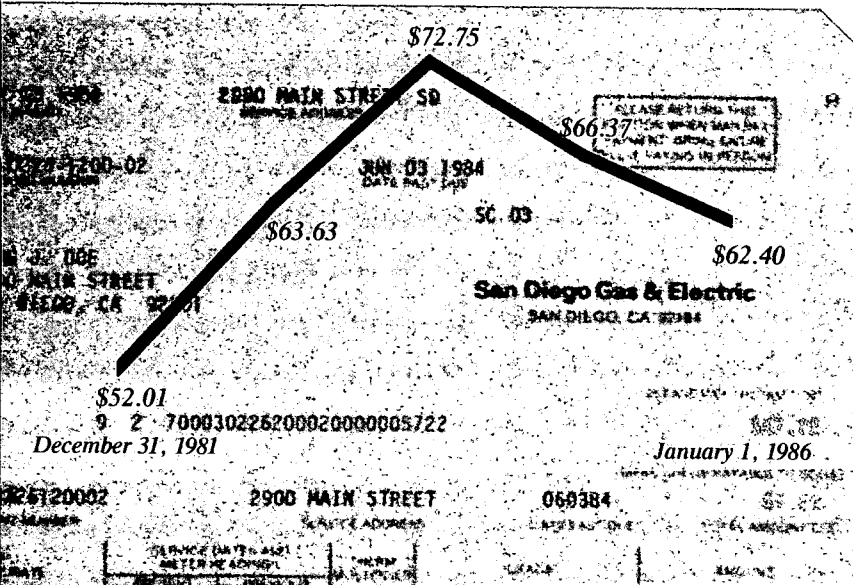
For the third year in a row, the company's bond rating was improved. In June 1985, Moody's Investors Service, Inc. boosted the rating by two levels, from A2 to Aa3. This change gave the company an unusual three tier rating from the nation's leading financial rating agencies. Standard & Poor's rates the company's bonds at A+ and Duff & Phelps rates them at 7, both lower than Moody's rating.

Aa3

One hundred million dollars in industrial development bonds and \$35 million in pollution control bonds were sold during 1985. Of the company's total debt, tax-exempt bonds represent about 50 percent. This is one of the highest percentages in the gas and electric utility industry (page 5).

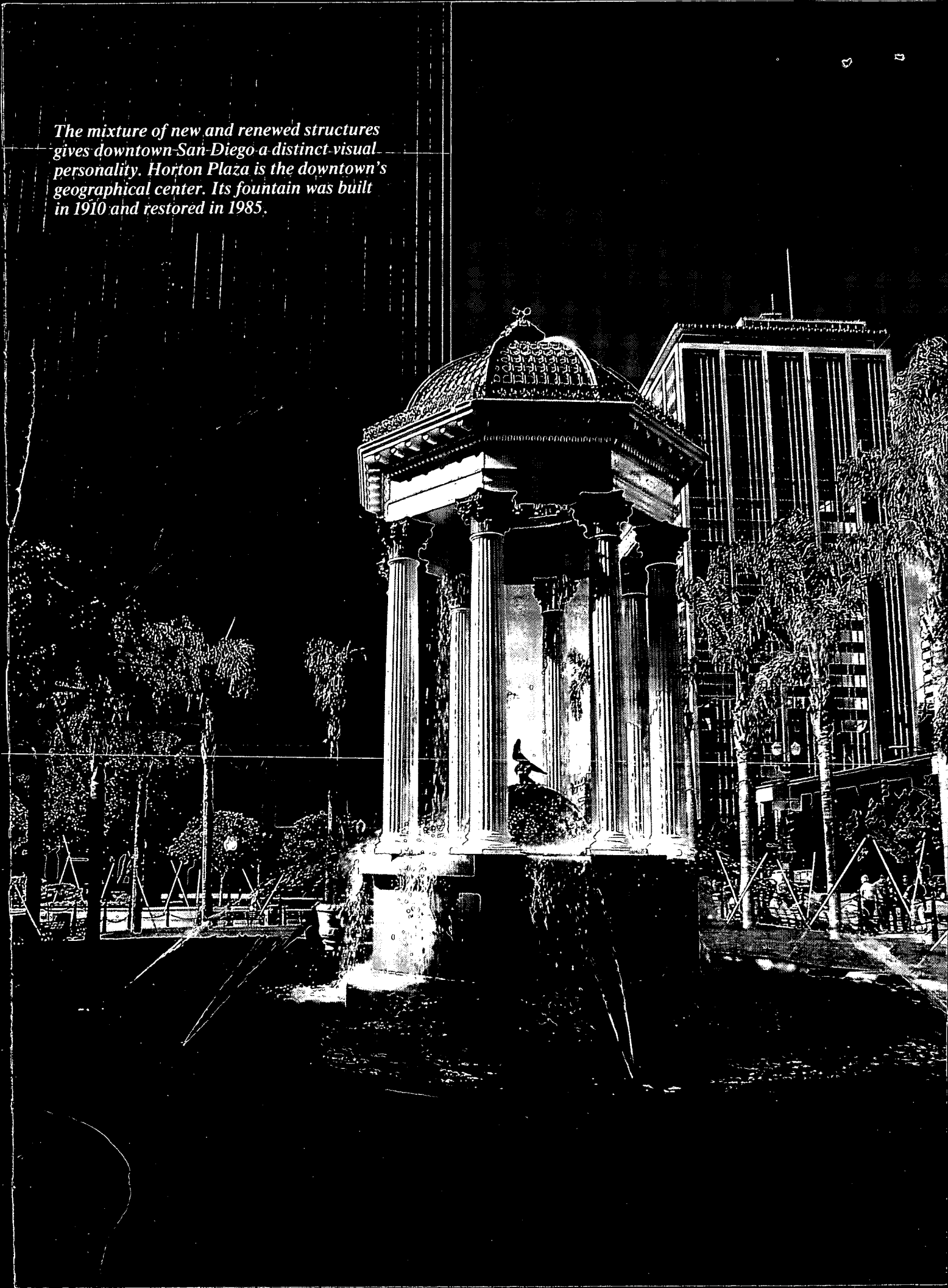
More high-interest bonds were redeemed in 1985. For example, in April, \$13.2 million of 16 percent bonds (Series S) were called and in August, \$75 million of 13.625 percent bonds (Series T) were called. Both series were issued in 1980 when the cost of money was high and the company's bond ratings were low. By comparison, the two 1985 tax-exempt bond issues, which have much improved ratings, carry interest rates of 5.625, a variable rate, and 9.25 percent. This means a multi-million dollar savings in future finance charges for customers.

The combined gas and electric bill for the typical residential customer declined again in 1985. Lowering rates continues as a primary corporate goal (page 5).

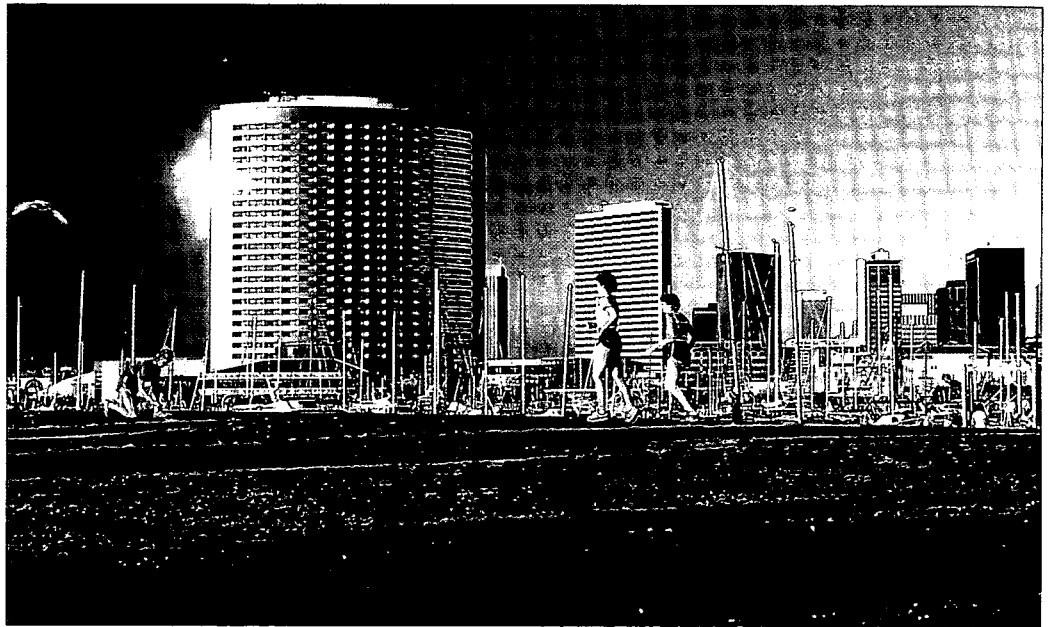


Extensive hearings before the California Public Utilities Commission began in December 1985 on the reasonableness of the construction costs for San Onofre Nuclear Generating Station units 2 and 3. The hearings are scheduled to end in May 1986. A decision is expected in late 1986. Southern California Edison, which is the majority owner and developing partner in the project, is presenting extensive evidence to show that the costs incurred during construction were justified.

The mixture of new and renewed structures gives downtown San Diego a distinct visual personality. Horton Plaza is the downtown's geographical center. Its fountain was built in 1910 and restored in 1985.



Predicting customer growth requires a good crystal ball these days. More than 40,000 new electric customers were added during the year (many with gas service, too), establishing a single year record for the company. This robust growth of 4.7 percent far surpassed expectations for 1985. While the customer growth rate should decline to an average of three percent during the rest of the decade, the service area will still be one of the fastest-growing in the country. Accommodating the new customers' needs will be quite a challenge. Meanwhile, a renaissance of downtown San Diego is in full swing (pages 12-15).

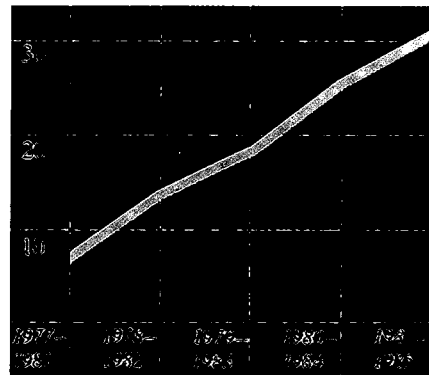


Parks, promenades, marinas and restaurants line the shore of San Diego Bay adjacent to the downtown area. Lunch-time joggers are a frequent sight.

The price of the common stock reached an all-time high of \$28.375 on June 6, 1985. It remained above the 1984 high of \$23.75 throughout the remainder of the year.

The annual dividend on the common stock was increased in May 1985 by 6.7 percent to \$2.24 per share, the ninth consecutive year the dividend has been increased. It was the fourth year in a row that the increase was greater than the rate of inflation.

Earnings in 1985 were a record \$3.25 per share. Another vital measure of financial health, funds re-invested, increased seven percent to \$254 million.



Overall return to shareholders reached 31 percent, placing the company in the top 12 percent of the 80 largest electric and combination utilities. This financial performance measurement compares the average compounded dividend return, plus stock price appreciation, during a five-year period (Shareholder Reference Guide, pages 38-41).

The California section of the Southwest Powerlink transmission line between San Diego and Arizona was upgraded in 1985 to increase the line's capacity from 700 to 1,000 megawatts. Upgrading of the Arizona section is expected to be completed in early 1986. The 280-mile-long line gives the company access to several energy sources in the United States and Mexico. During 1985, the company imported 44 percent of its total energy requirements from other utilities over the expanding transmission line network.



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The future is designed by those who have financial means, imagination and discipline. In 1985, the management of your company sketched in bold strokes the outlines of the company's future.

Today, your company has the financial strength, the resource strength and the organizational strength it must have to succeed in a competitive marketplace. In 1986, and for many years ahead, this company will be using these strengths, gained from a five-year, company-wide renewal effort, to take advantage of many new opportunities.

Financial strength: In 1985, the company had record earnings of \$3.25 per share and its cash flow position improved as well.

In early January 1986, there was more good news. The company sold all of its stockholdings in Energy Factors, Inc. for \$24.6 million. The stock sale will contribute 25 cents a share to the company's 1986 earnings. That's a nice start for the year.

However, San Diego Gas & Electric will be involved with a California regulatory proceeding in 1986 that could result in a disallowance of some of the costs it is charging to customers. This may affect future earnings.

This proceeding is the reasonableness review of the construction costs of San Onofre nuclear units 2 and 3, of which your company owns 20 percent. These units were built faster and at lower cost than many other units under construction at the same time and we are supporting the efforts of Southern California Edison, the majority owner and project manager, to prove that the construction costs were reasonable. We think we have a very strong case.

These "hindsight" reasonableness reviews of operations by the California Public Utilities Commission have added an element of unpredictability to utility company earnings in the past few years.

In 1985, the cost disallowances for SDG&E from reasonableness reviews were \$19 million. While this was substantially less than the 1984 disallowances, it was the sole factor that prevented SDG&E from earning its allowed rate of return, as it also was in 1984.

Resource strength: San Onofre is proving to be an excellent plant. It will serve our electric customers well for many decades. While capital costs are high, its fuel cost is very low, about one cent per kilowatt-hour, and it's a domestic energy resource.

Nonetheless, the San Onofre units will be the last major generating plants that we will participate in financing for the foreseeable future, as we've stated before.

Because of the utility's geographic location and the area's lack of natural resources for generating energy, we believe that in the future we can meet both the



growing energy needs of customers and the interests of shareholders best by improving transmission links to other regions of the country instead of building large generating plants. We have achieved, and intend to maintain, a safe, diversified resource mix through a combination of generation and transmission of energy.

I believe that improved electric energy transmission systems must be built to serve many regions of this country, not only San Diego.

The Organization of Petroleum Exporting Countries has not lost its potential for harming this country, and this company, in the future as it did in the mid-1970s.

A more efficient national energy transmission system will help resist the impact of oil cartel policies in the 1990s. Utilities must be able to move energy from where there is a surplus to where there is a need. The Southwest Powerlink, our transmission line to Arizona, is giving us access to many sources of energy today and energy independence for the future.

Organizational strength: In 1985, we made some fundamental corporate changes. A restructuring of the utility, early in the year, was designed to make it more competitive in a changing energy marketplace.

As an important part of the reorganization, manage-

Your company has the financial strength, the resource strength and the organizational strength it must have to succeed.”

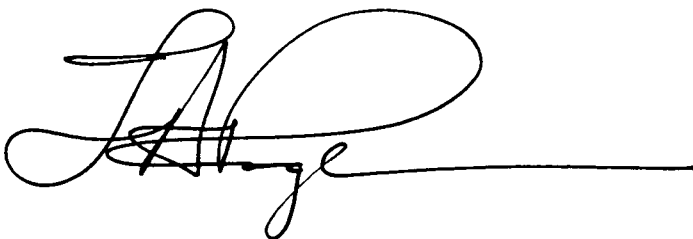
ment took a close look at its natural gas operations and its future value to the company. The business has been a gem. It hasn't caused us any financial headaches over the years; it continually earns its rate of return; and its service gets excellent ratings from customers.

We're going to make it an even better business in the years ahead. Through marketing the use of natural gas aggressively, the Gas Operations division intends to expand its business, give more customers an energy option, and help keep the peak load growth of Electric Operations in check.

Another fundamental change in the company's operations, and a very important decision for future profitability, was to diversify into nonutility areas.

It may take several years before the diversified operations have a continuing significant impact of, say, 50 or even 25 cents per share on the corporation's annual earnings, but even a few cents per share a year, for the near term, from these enterprises will be welcome.

Management strength: It's part of my responsibility to you, the owners of this corporation, that every member of the management group continues to be alert and responsive to opportunity.



This has become a very strong management team. The officers helped design and achieve the financial and operations recovery programs of the early 1980s. Some have been hired within the past few years to add special expertise or experience gained from working in other types of businesses.

The diversity of the background of the officers has given us a broad management perspective. We do not always agree. Debate is often vigorous. But, as the 1985 record shows, everyone at the company worked very hard. As a result, the typical customer's bill was lower and earnings for shareholders were higher.

Opportunity, U.S.A.: San Diego is one of the areas of highest residential growth in the country. It has become a center of new information services, biomedical research development and scientific industries, too.

With a strategic location on the Pacific coast, the city and this company are becoming involved with the countries to the West and to the South as partners in the growing international Pacific basin trading region. Furthermore, the San Diego area is one of the loveliest places in the world.

Opportunity is at our doorstep.

Thomas A. Page
Chairman, President and
Chief Executive Officer

February 10, 1986

Financial Highlights

(Dollars in Thousands Except Per Share Amounts)

	1985	1984	Percent Change
Operating revenues	\$1,738,702	\$1,620,701	+ 7.3
Operating expenses	\$1,450,835	\$1,369,151	+ 6.0
Net income (before preferred dividend requirements)	\$ 202,722	\$ 183,467	+ 10.5
Earnings applicable to common shares	\$ 178,925	\$ 159,295	+ 12.3
Average common shares outstanding (thousands)	55,125	52,868	+ 4.3
Common stock shareholders (at December 31)	81,471	85,272	- 4.5
Earnings per common share	\$ 3.25	\$ 3.01	+ 8.0
Dividends declared per common share	\$ 2.205	\$ 2.065	+ 6.8
Total energy sales			
Electric (billions of kilowatt-hours)	11.66	11.13	+ 4.8
Gas (millions of therms)	529	452	+ 17.0

Richard Korpan,
President, Pacific Diversified
Capital Company:

“**D**iversification
will gradually
change the
profile of SDG&E.”



What

The need to find new sources of profits for shareholders became apparent to management during San Diego Gas & Electric's first comprehensive strategic planning process, conducted in 1984. Then, in 1985, management made diversification a primary corporate goal. This decision marked a turning point for the corporation. The responsibility for developing new sources of profits for shareholders through diversification was given to the management of corporate strategic planning and of an existing, but not-then-active, subsidiary, Pacific Diversified Capital Company.

Where

The diversification effort will not be limited to Southern California. Acquired or developed businesses may operate anywhere in the United States or in other countries.

Why

A slower growth rate is predicted for utility-based profits:

- Risk in the investment has increased. Regulatory agencies have been unwilling to allow utilities to be fully repaid in rates for the costs of some major construction projects and this means that investors may not be fully compensated.
- In the energy marketplace there is excess generating capacity available. SDG&E new capital investment will be primarily on transmission and distribution system projects.

When

Pacific Diversified will complete its own multi-year strategic plan in the spring of 1986. "Diversification is a difficult thing to do successfully," says Richard Korpan, president of Pacific Diversified and, throughout the period of SDG&E's financial

recovery, the utility's chief financial officer. "It will require a well thought out plan and a disciplined approach. We will do everything we must do to be successful."

New companies will be carefully acquired, Korpan promises. "We expect to look at 100 companies for every one we buy. We would like to acquire at least one medium size company a year as a new subsidiary of Pacific Diversified," says Korpan. "Of course, we would want the existing management of the acquired companies to stay with them."

How

In 1985, Pacific Diversified's assets included cash and stock, which came from the 1983 sale of an SDG&E cogeneration subsidiary to Energy Factors, Inc. The stock represented a 20 percent interest in Energy Factors that was part of the sales price. In January 1986, Pacific Diversified sold the stock to Energy Factors for \$24.6 million, giving Pacific Diversified a total equity of \$65.7 million. This equity capital will be used to acquire companies and to develop existing subsidiaries:

Real estate: Japatul Corporation, which was a land-holding subsidiary of SDG&E, is now the real estate development subsidiary of Pacific Diversified.

"We will be starting from scratch with Japatul," says Korpan. "We will participate in all areas of real estate eventually—residential, commercial and industrial. What we do will depend upon the market and the opportunities that arise."

Computer services: Integrated Information Systems is a new company. It already has completed several contracts and has begun a feasibility study for Malaysia Electric Company. "This company could benefit not only shareholders but utility customers," says Korpan, "because Integrated Information Systems will pay a royalty to the utility for some of the products it markets."

Energy technology investments: Pacific Energy, another subsidiary, will watch for companies achieving technological breakthroughs in the energy business and invest in those companies.

"It's likely to take several years before the diversification efforts begin to have a significant impact on earnings," says Korpan. "Diversification is not a short-term effort but a long-term commitment by management that will gradually change the profile of SDG&E."

Meeting goals is important to management and in 1985 four of the five current financial goals were met and progress was made toward meeting the fifth by 1987.

"I'm particularly pleased that the company generated all of its construction funds from internal sources in 1985," says Lee Haney, who is vice president and treasurer. "That's quite a change from just a few years ago.

"The company now is ranked among the top 25 percent of the largest electric and combination utilities in its ability to generate funds from internal sources, a key indicator of a good cash flow. A very important measure of a company's financial health is its cash flow," says Haney.

Internal generation measures how much of a construction budget is funded with the company's cash flow. There were two important elements in reaching this goal in 1985.

- The percentage of capital spent on construction: A company goal is to keep construction costs limited to no more than 10 percent of capitalization. The company achieved this in 1984 and 1985 because its major construction projects have been completed.

Nonetheless, in 1985 the utility spent about \$240 million on construction. It probably will spend about the same amount for several more years to upgrade and extend facilities.

- Depreciation: This element shows how quickly the company can recover its original capital investment in generation, transmission and distribution. In 1985, depreciation increased, thereby providing more funds because the Southwest Powerlink transmission line and San Onofre Nuclear Generating Station were fully included in the utility's rate base.

"Finding ways to limit increases in costs is important to us," says Haney. "We have been doing this, in part, through issuing lower-cost financings."

The cost of financing: The utility has few peers in obtaining and placing low-cost, tax-exempt financings. Several years ago San Diego Gas & Electric became one of only a few utilities to qualify for tax-exempt industrial development bonds. Since then the utility has taken maximum advantage of this. Between 1983 and 1985, the city of San Diego issued \$400 million in industrial development bonds on behalf of SDG&E at rates of 9.25 to 10 percent. And, in 1984 and 1985, SDG&E also qualified for, and issued, \$115 million in variable rate pollution control bonds. As of December 31, 1985 the

interest rates ranged from 5 $\frac{5}{8}$ to 8 $\frac{1}{2}$ percent.

To further reduce its cost of financing, in 1985 SDG&E repurchased more than \$100 million in higher cost debt. This included the call of the rest of its 16 percent Series S bonds and all of its 13 $\frac{5}{8}$ percent Series T bonds.

The utility has about 50 percent of its debt now in tax-exempt issues, a percentage exceeded by few others in the United States. "The cost savings to customers are significant," says Haney. "They will add up to more than \$400 million during the lives of the various bond issues."

Reducing rates: "The combination of a lower cost of debt, rate reductions and other rate decisions by the California Public Utilities Commission combined to reduce utility rates for the second year in a row for a typical residential customer using gas and electricity during 1985."

Further electric and gas rate reductions were announced by the CPUC in December 1985 for 1986. At the same time, the CPUC announced that the General Rate Case increase for 1986 is limited to \$14 million. The net reduction to the monthly bill of the typical residential customer was another \$3.79.

"The General Rate Case decision set the company's allowed rate of return on equity at 15 percent for 1986. This rate is less than the 16 percent the company formerly was allowed to earn. It's a disappointment and lower than other California utilities' rates of return," Haney noted.

"It's still comparable with other companies nationally and we are determined to earn that rate of return."

The five financial performance goals are discussed more on pages 17, 18 and 38.

R. Lee Haney,
Vice President
and Treasurer:



“A very important measure of a company's financial health is its cash flow.”

Finance and Ratemaking Terminology

Cash flow

This is a measure of a company's financial health. The progress SDG&E has made can be seen in the "Funds Reinvested" line of the financial statements page called "Sources of Funds for Construction."

General Rate Case

A proceeding before the California Public Utilities Commission that sets the allowed rate of return and the other non-fuel costs a utility is allowed to recover. The 1986 General Rate Case allows a rate of return on rate base of 12.37 percent, incorporating a return on equity of 15 percent.

Internal generation of funds

The percentage of the cost of utility plant additions that is financed by the cash flow of the company.

Gary Cotton,
Senior Vice President—
Electric Operations:



“**T**ransmission of
electricity is vital
to our future.”

What

The primary basis of the corporation's growth, for more than 60 years, has been the growth of the company's electric system, especially of its own generating capacity. This is changing.

Where

San Diego no longer is an electric island, isolated from resources located elsewhere. Today, because of transmission links, it is part of the western power region, which extends from Mexico to the south, New Mexico to the east and Canada to the north. Still, additional resources to meet growing customer needs are required and SDG&E's Electric Operations plans to extend its access via transmission lines to new sources of energy in the Northwest and the Southwest.

Why

The marketplace is growing rapidly; it is changing in character even more rapidly.

- In 1985, Electric Operations added 4.7 percent more customers, mostly residential, one of the highest growth rates of any electric utility. This should simmer down to about three percent annually for the next five years, but it still will be one of the highest growth rates in the country.
- An offsetting trend to this customer growth forecast is that existing large commercial and industrial customers are installing cogeneration systems to generate some or all of their own power. In each month of 1985, Electric Operations lost some of the business of a large commercial customer.
- Pressure is mounting to allow one commercial customer to sell electric energy directly to another by using Electric Operations' distribution lines. This is called retail wheeling and it is opposed by utilities because it would cause the rates of other customers to go up.
- On the supply side, there is a surplus of power in the West and San Diego Gas &

Electric is taking advantage of it to develop long-term purchased power contracts.

- Non-regulated consortiums of plant financiers, builders and operators may develop power plants in the Southwest. If they do, they will sell the energy to utilities. Those that have transmission capability will be able to take advantage of the new energy sources.

When

Looking ahead to 1995, and beyond, Electric Operations' computers digested about 2,000 different possibilities. From this effort a new resource plan was developed and announced to the public in the fall of 1985.

How

The resource plan predicts that about 35 percent of the electric system's energy needs in 1995 will be provided by power purchased from other utilities. In November 1985, 175 megawatts was secured under two long-term purchase contracts. To take advantage of opportunities like these, the Southwest Powerlink's transmission capacity has been increased.

A successful beginning: 1985 was the first full year of an operating relationship between SDG&E and Mexico's national electric utility, Comisión Federal de Electricidad. The two utilities routinely bought and sold power to and from each other to mutual advantage. It was transmitted on the Southwest Powerlink and two interconnections, completed in 1984. "We consider San Diego and Mexico to be part of a common operating region now," says Gary Cotton, senior vice president of Electric Operations.

Future links: The company will participate in building a third transmission line to Oregon and in 1985 it helped pay for initial studies. Licensing hearings before the California Public Utilities Commission will begin in 1986.

The line is expected to be completed in 1990. **The customer generation potential:** One alternative resource that is potentially important to Electric Operations, but may also pose a

problem, is cogeneration by customers. Cogeneration now accounts for about three percent of the utility's energy resource plan and it is expected to increase rapidly to eight to ten percent in the 1990s.

Still, there is the mandated utility responsibility, from the California Public Utilities Commission, for SDG&E to serve these customers in the event their self-generation units don't perform, and these costs must not be unfairly allocated to the company's remaining customers.

"These are complex issues and will have to be worked out, over time, between the company, its customers and the commission," Cotton explains. "We want to create a rate structure that will reflect our true cost so cogenerators will pay for the benefits they receive."

Getting the most out of the system: Marketing is a word that hasn't appeared much in plans for electric utilities in recent years. But marketing techniques are being used to help Electric Operations make its existing generating system operate more efficiently by leveling out its peak load, shifting some demand into its off-peak valleys.

In San Diego, the peak demand time for electricity is during the day. At night, the system may be operating at only 50 percent of capacity. The initial thrust of the marketing program, developed in 1985, is to find ways to reduce the growth rate of that daytime peak without reducing total energy sales.

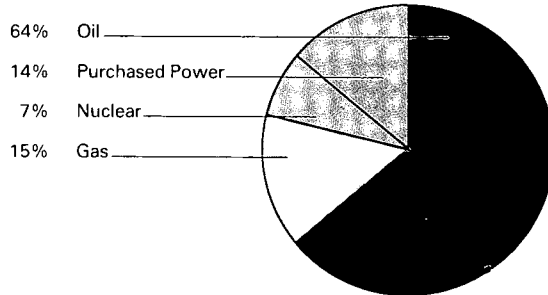
Lower off-peak rates offered: As of January 1, 1986, there are new commercial and industrial off-peak rates of less than 6 cents per kilowatt-hour, 54 percent less than on-peak rates.

One promising program designed to shift

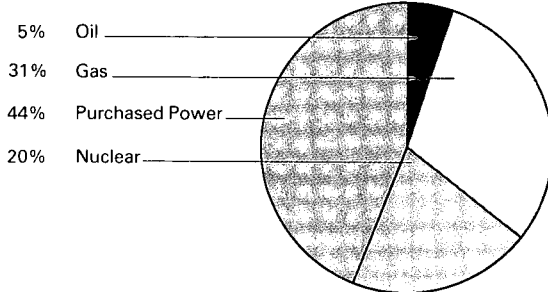
load off peak that's already being promoted by Electric Operations is thermal energy storage. The company is offering cash inducements to offset the initial higher cost of the thermal energy storage equipment. This program encourages commercial and industrial customers to run air conditioning equipment at night to benefit from off-peak rates

Electric System Energy Mix

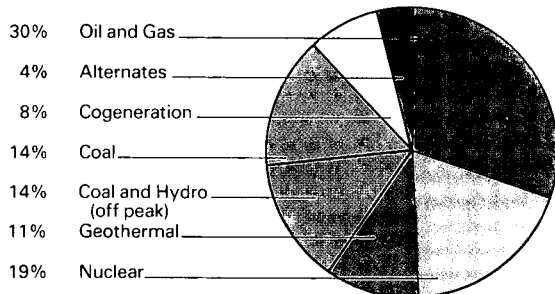
1975



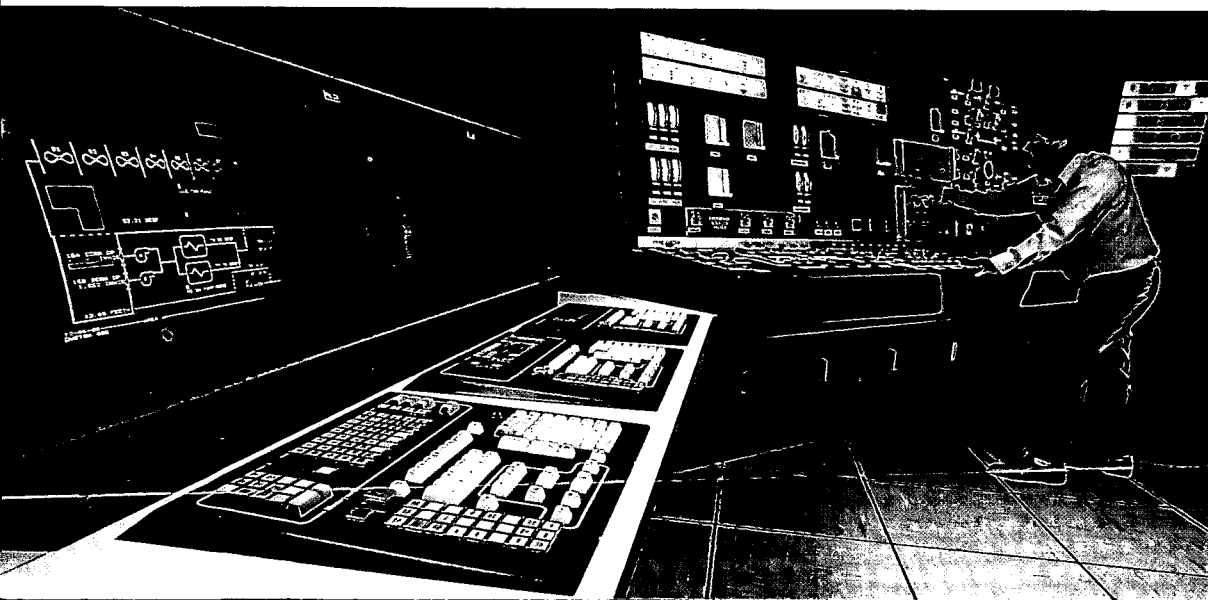
1985



1995



Achieving a diversified resource mix has been a primary company goal. The change from dependence upon fossil fuel generating units in 1975, to more nuclear and purchased energy in 1985, shows the success of the program. By 1995, other sources of energy will be available.



The Heber geothermal plant, completed in 1985, is initially a research facility, so monitors, sensors and probes are located throughout the plant site. They gather data and feed it to computers that provide extensive reports. This is the control room at the Heber plant.

and store the energy as chilled water, ice or cool salt for cooling the building during the day.

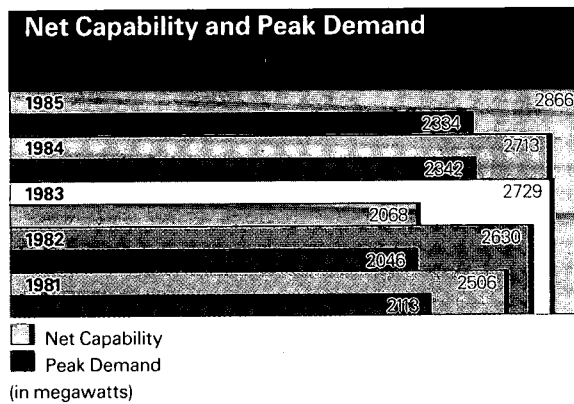
Testing electric vans: A research program that began in early 1986 is using three electric-powered vans as fleet vehicles to determine how commercial customers might use them to their advantage. Performance and cost data are being carefully documented. Electric vans can be recharged in the evening when the electric system is being under used and costs are lower.

"We have to look well into the future and identify ways to use our system more efficiently," says Cotton. "Some projects, like thermal energy storage, may begin to help within five years while others, like the electric van project, may take 10 years."

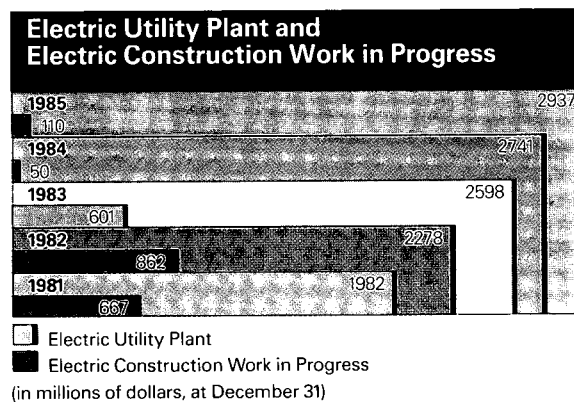
How the plans affect shareholders' financial interest: The company's strategy of not building major generating plants will help minimize capital requirements and the risks associated with building these plants.

The company plans to invest in a number of transmission facilities between now and the year 2000 that will slowly add to the asset growth of the utility. These transmission ex-

tensions will be short-term construction projects, most likely in partnership with other utilities. Meanwhile, Electric Operations' new marketing efforts are being designed with the objective of keeping the utility profitable through improved use of the system.



Peak demand decreased slightly in 1985 due, in part, to milder weather patterns in the service area.



Although work in progress increased in 1985, this program is in line with corporate goals and far smaller than the 1981-1983 period when SDG&E was involved in major transmission and nuclear unit construction.

Electric Terminology

Cogeneration

The production and use of thermal and electrical energy from one primary fuel.

Megawatt

One million watts or roughly the amount of electricity that meets the needs of 1,000 people.

Net resource capability

Enough energy, plus a reserve, to meet anticipated peak demand.

Peak demand

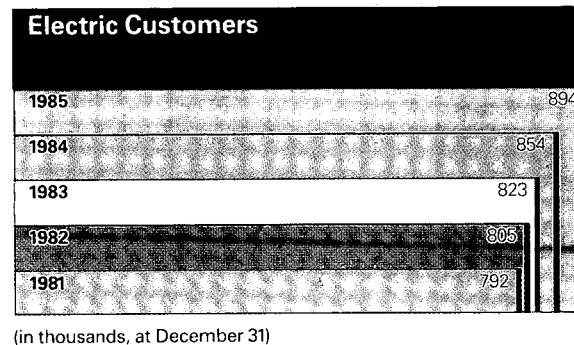
The time, or season, when there is the greatest customer demand for energy. For Electric Operations, this occurs during the day in the summer.

Purchased power

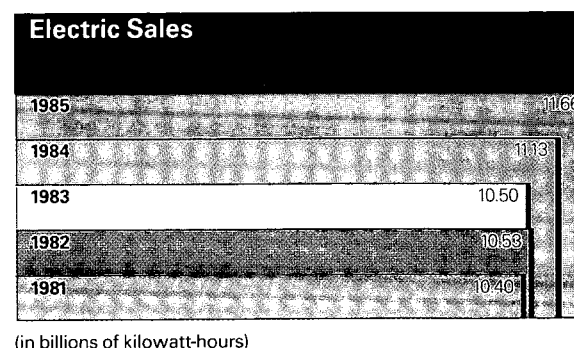
In 1985, this included coal, geothermal and hydropower, amounting to 44 percent of the system's total energy, transmitted from sources in Mexico, Canada, Arizona, Oregon, Washington and California.

Retail wheeling

The use of a utility's distribution system, by a nonutility company, to transmit energy to selected customers of the utility. This is not allowed in California.



The number of customers who rely upon SDG&E for electric service continues to increase dramatically as evidenced by 1985's record 40,300 new customers.



Sales of electricity in 1985 represented an increase of five percent over 1984.

Alton Davis,
Senior Vice President—
Gas Operations:

What

In 1985, natural gas was plentiful, the reverse of the situation just a few years ago. The outlook: ample supplies of natural gas, at least until the year 2000. As a corollary to this ample supply, the price of natural gas came down sharply, particularly in 1985, and the rates charged to SDG&E customers were lowered four times in the past two years as a result. Historically, natural gas has been less expensive than electricity for SDG&E customers. Today, this difference is greater than ever.

Where

An additional opportunity to purchase natural gas at competitive prices on the spot, or noncontract, market was made possible by decisions announced during 1985 by the Federal Energy Regulatory Commission and the California Public Utilities Commission.

For Gas Operations, this means that the company's sole supplier, Southern California Gas Company, will be required to transport through its system any natural gas that SDG&E's Gas Operations may purchase from other suppliers outside of California. This ability to tap the spot market for gas is expected to result in further cost savings to customers and to make natural gas more desirable to them as an energy source. Southern California Gas, however, will remain the company's major supplier, for at least the near term.

Why

Why not take advantage of the lower cost and greater availability of natural gas to develop the sales of Gas Operations, help manage the growth in peak electric demand, and offer more customers the economical option of natural gas?

Those questions were answered during the company's 1984-1985 strategic planning process. The strategic planning effort made it clear that it would be beneficial to investors and to customers to expand and develop Gas Operations, rather than to sell it, as some other combination utilities have done.

When

Now. In 1985, Gas Operations adopted a marketing plan that is premised on extensive research of customer needs.



“There aren't many problems; there are lots of opportunities.”

How

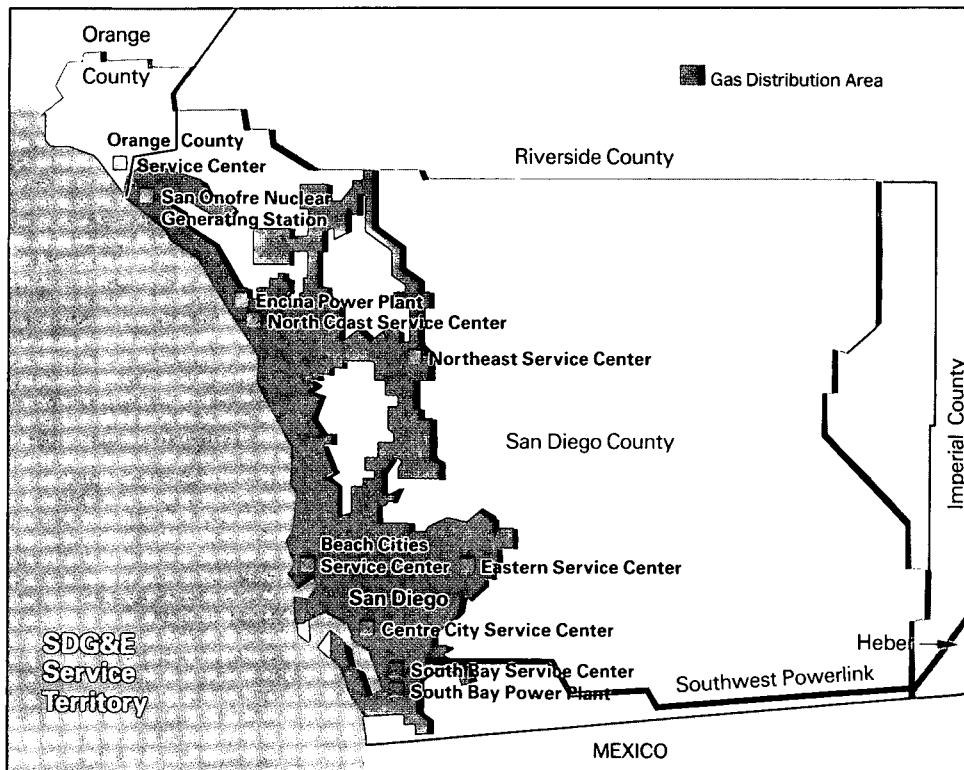
Residential use of gas: Natural gas is used to heat about 73 percent of the homes in the region served by Gas Operations. This does not include the Orange County section of the service territory or some of the outlying areas of San Diego County.

In 1986, the company will develop new programs to make customers more aware of the lower life cycle energy cost of gas. This educational effort began in late 1985.

Gas Operations' management is also assessing whether it would be cost effective to expand the natural gas territory in the future.

“We must let our customers know that there is ample natural gas, that the price is

The SDG&E service territory covers 4,100 square miles. Gas service, available in only part of the territory, will be extended to additional areas as part of a marketing program that will give customers an energy alternative.





coming down, and that they can benefit by this," says Alton Davis, senior vice president of Gas Operations. "The marketplace is not yet fully aware of the change in the gas price-availability situation," notes Davis. "In 1985, we turned our own Gas Operations around because we foresaw many new opportunities for us. Now, we have to let our customers know how they may benefit, too. There aren't many problems for us; there are lots of opportunities.

"Our own operational interest is to increase gas sales during our gas distribution 'valley' times—that's the summer season or daytime hours. If we use our existing facilities more efficiently, we will be able to lower the cost of gas to customers.

"Just as important, we want to give more customers the option of choosing between electricity and gas where it is economically possible to do so."

An ideal solution: Gas air conditioning for commercial and industrial customers is gaining acceptance in San Diego, as it is elsewhere in the United States. Japanese companies have perfected the technology during the past 15 years and they have begun

marketing these products more vigorously in the United States as the gas supply-price situation has changed.

SDG&E will be working with builders, architects and engineers to encourage them to install gas, rather than electric, air conditioning.

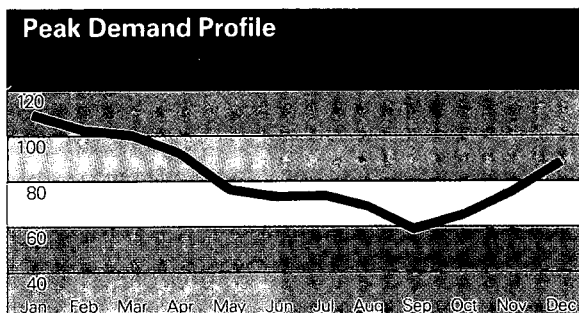
San Diego's bayfront convention center, for which ground was broken in 1985, will use gas air conditioning as a result of Gas Operations' marketing effort. The company estimates that the city may save more than \$250,000 per year in operating costs, compared with electric air conditioning, once the convention center is fully operational. Of course, this will depend upon the comparative rates of gas and electricity in the years ahead.

This program is very good for Electric Operations, too. "If an electric air conditioning system were to be installed instead," says Davis, "it would add four megawatts of demand. Furthermore, it would be in operation during the electric system's summer peak demand time. By using gas air conditioning in this huge facility, it will keep down the growth in our electric peak and improve the

Construction began in 1985 on San Diego's convention center, adjacent to a park and overlooking San Diego Bay. It will use a gas air conditioning system, as a result of marketing efforts by SDG&E's Gas Operations division.

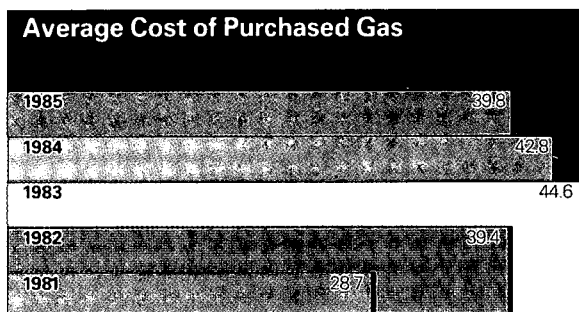
During the summer months, gas demand is low. Through marketing, Gas Operations intends to increase its summer volume.

use of our gas system. It's an ideal solution." **Natural gas for vehicles:** In Canada, natural gas is gaining general acceptance as a vehicle fuel and service stations are installing pumps to accommodate customers. SDG&E, along with a number of other U.S. utilities, is researching this potential market.



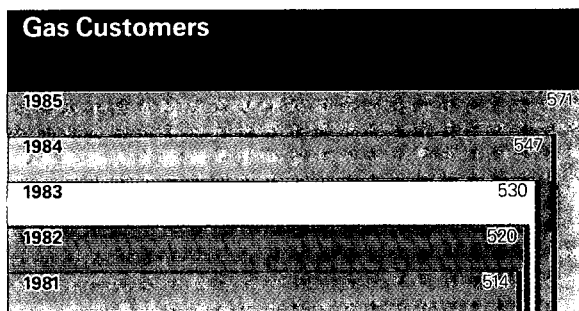
(in millions of therms)

The cost of gas to the company decreased in 1985 for the second year in a row.



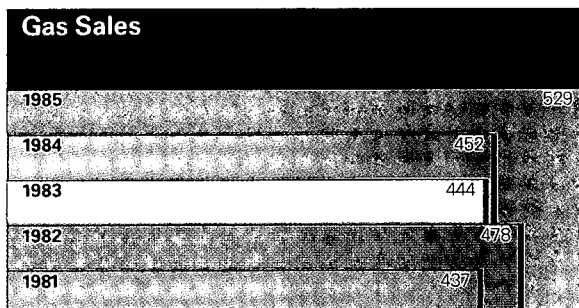
(in cents per therm)

SDG&E provided gas service to approximately 24,000 more customers in 1985 than in 1984.



(in thousands, at December 31)

Sales of natural gas to SDG&E customers reached a record high in 1985, surpassing 1984 figures by 17 percent.



(excludes interdepartmental transfers)
(in millions of therms)

In 1985, 30 of the company's fleet vehicles were converted to run on either compressed natural gas or gasoline. Natural gas has a higher octane rating than gasoline. It burns cleaner and thus maintenance costs are lower.

The company's own experience will help it to assess whether this is a market that can be developed in San Diego, based on a cost analysis of the actual experience of operating the vehicles.

How the plans affect shareholders' financial interest: By using the gas system to greater advantage, the company will continue to have a profitable gas business. The complementary effect on the electric business, however, may provide the greater benefit: the gas marketing efforts will help the company to manage its growth in peak electric load, thus delaying the need to build costly new electric generating plants. Since new plants have been a source of increasing financial risk for electric utilities throughout the United States, Gas Operations will be playing a vital role for the company by postponing the need to add new electric generating capacity.

Additional gas transmission and distribution lines may have to be built in the future to tap into new sources, such as importing natural gas from Mexico, or to extend customer service beyond the present limited boundaries. These projects would require additional capital expenditures but, unlike building generating plants, they would be relatively short-term, low-risk projects.

Gas Terminology

Compressed natural gas
High pressure natural gas, commonly contained in cylinders, which is now being used on a test basis in modified SDG&E fleet vehicles.

Cost of gas
In 1985, the wholesale commodity cost of natural gas delivered to SDG&E declined from \$3.81 to \$3.31 per million Btu, a 13 percent drop.

Life cycle energy costs
The cost of operating a gas or electric appliance during the typical useful life of the appliance.

Spot market
The noncontract market, formerly open only to wholesalers and distributors with transmission access.

Jack E. Thomas
Executive Vice President—
Utility Operations:

The growth,
renewal and
changes were
especially dramatic
in 1985.”



Many new restaurants have opened throughout the downtown area. Some cater to business people who wish to meet for an early breakfast. Piret's is one of these meeting spots.



San Diego is growing, renewing, changing. In 1985, the pace accelerated and a record 40,300 new customers were added to San Diego Gas & Electric's system.

In the downtown area, the growth, renewal and changes were especially dramatic in 1985. Your company is involved in every project, in many different ways, and it's helping to bring about this downtown renaissance.

There's a parallel between what's happening in the city and at SDG&E. In 1985, we reorganized our utility operations to meet the needs of a changing marketplace. These changes will help us offer improved quality of services.

We provide ideas to help customers avoid unnecessary energy costs; schedule work to meet customers' convenience; continue to improve the quality of electric service and to expand the range of the gas service.

It's an exciting beginning point for the city and for the company.”

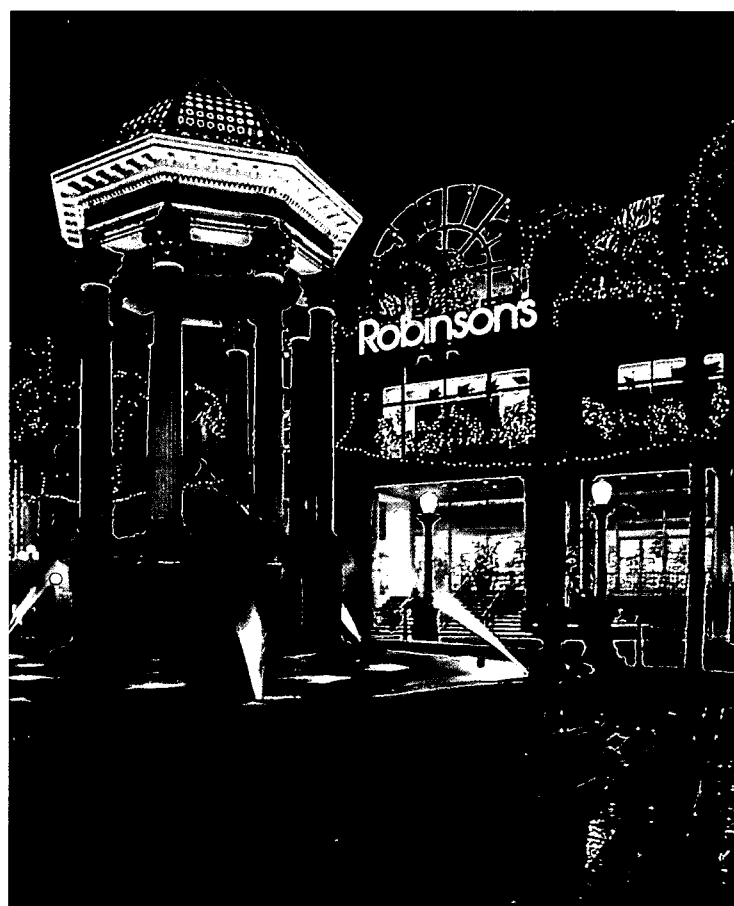
Horton Plaza, an unusual shopping area that opened in mid-1985, is important to the entire downtown renewal effort. It's proving to be the magnet that's drawing people back to the city's center for shopping, dining and entertainment.





A century after it first opened, a very elegant U.S. Grant Hotel was re-opened in 1985 after an \$80 million renovation. In many downtown areas, SDG&E is replacing low-voltage circuits with ones that can accommodate the increasing electric energy demand. Close coordination with the city's Centre City Development Corporation and private companies is part of SDG&E's customer service orientation. Oftentimes, SDG&E employees must work on weekends to meet customer deadlines or to minimize service disruption to other customers, especially in commercial districts.

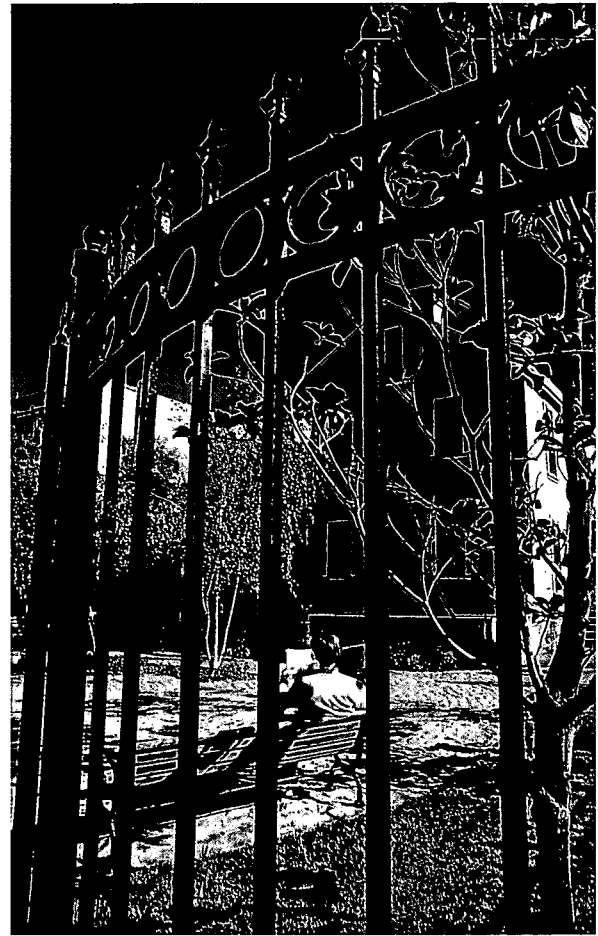
SDG&E's New Business Design Review program has already helped 62 customers save nearly one million dollars annually in energy costs. J.W. Robinson Company took advantage of the service for its new Horton Plaza store. SDG&E energy analysts evaluated the store's blueprints before construction began and made recommendations for saving energy. ▷





The San Diego Symphony inaugurated its new home, a totally refurbished downtown theater that was designed in 1929, with a gala opening celebration in November 1985. San Diego Gas & Electric contributed \$50,000 to the renovation effort and offered \$75,000 as a challenge grant to encourage development of the San Diego Symphony's contributor base.

The William Heath Davis house is the oldest structure in downtown San Diego, so it's an appropriate home for a museum that shows the lifestyles between 1850 and 1900. Its little park is a quiet spot, just a short walk from many high rise office buildings. ▸



Many projects are just beginning and there are entire blocks that renewal has yet to touch. One unusual restoration approach is the Horton Grand Hotel. It's being created using parts of two Victorian era hotels that were moved to this downtown site. ▸

