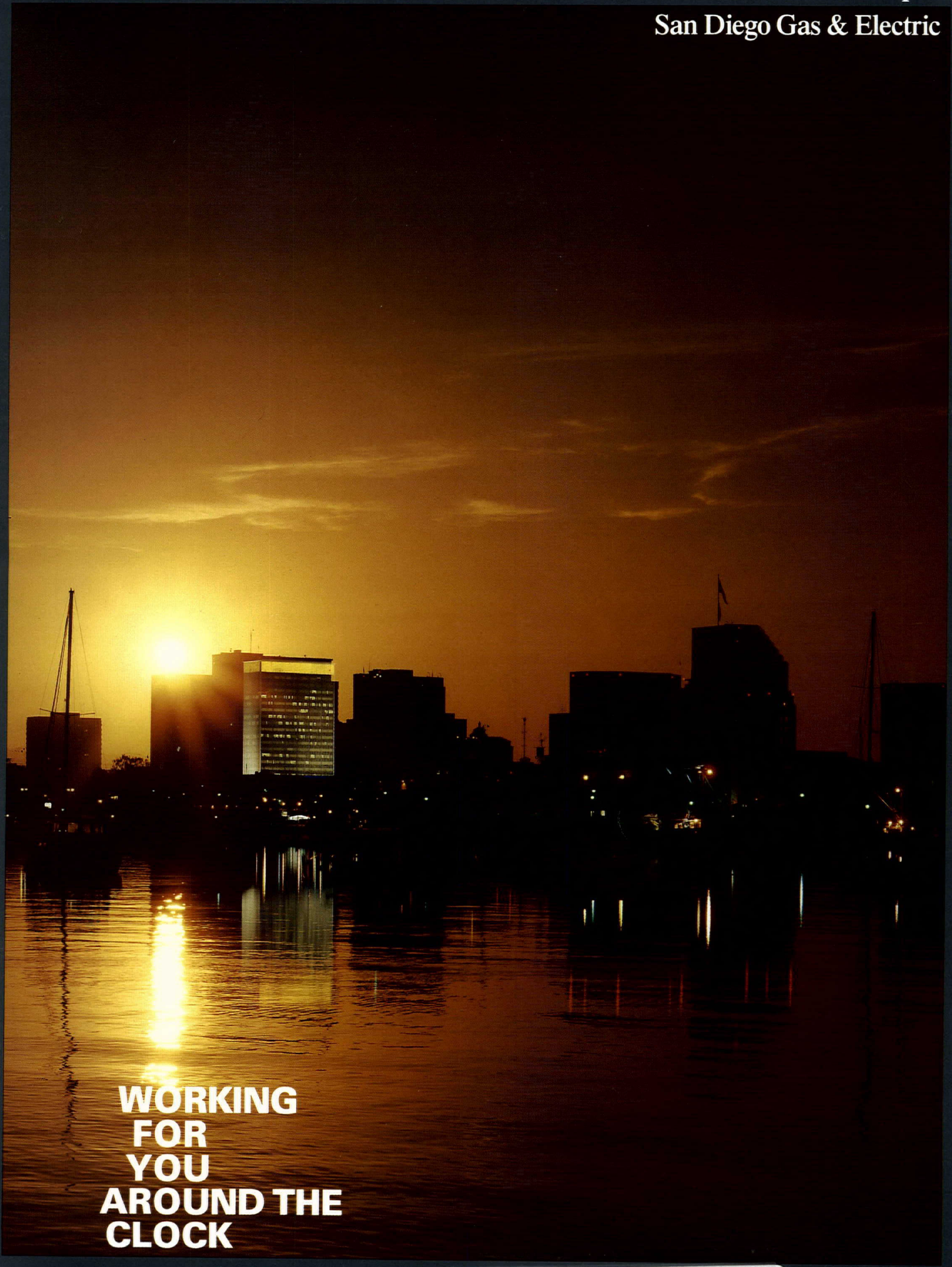
1986 Annual Report

San Diego Gas & Electric



1986

San Diego Gas & Electric's management and employees continued to set tough goals, publicize them for the investing public to monitor, and work to achieve them. Among the major corporate goals stated and achieved in 1986:

• Maintain the company's total overall return to common stock shareholders in the top 25 percent of electric and combination utilities. Results: the company was among the top 19 percent with an average annual return over five years of nearly 34 percent.

• Gain access to additional lower-cost resources. Results: SDG&E will have the right to additional electric transmission capability between California and Arizona for the 1990s when a new line is built. The company also obtained regulatory approval to purchase natural gas from out-of-state suppliers.

• Cut operating costs and reduce rates and customer bills. Results: the monthly bill for the typical residential customer using both electricity and gas declined, for the third year in a row, from a peak of $72.75 to $62.07.

• Focus marketing activities. Results: a unified approach to gas and electric marketing with some tough goals set for the future.

Record Customer Growth—Again!

Late in February 1986, the 900,000th customer was added to SDG&E's system. By year's end, the total of electric customers had reached 940,752, or 46,884 new customers in 1986. This is a customer growth rate of 5.25 percent, one of the highest in the country. The current ratio of gas and electric customers to employees is 319-to-one. Once again this may be among the best of the 25 largest combination gas and electric utilities (page 10).

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Diversification Makes News

In January, Pacific Diversified Capital, an SDG&E subsidiary, sold its 20 percent interest in Energy Factors, Inc. for $24.6 million, contributing 25 cents per share to earnings. Later PDC bought:

• the assets of Phase One Development, Inc., a San Diego-based commercial real estate development company

• all the stock of Computing Solutions, Inc., of Port Chester, New York, a computerized mapping software company

• a majority interest in Mock Resources, Inc., an Irvine, California-based marketer and distributor of natural gas and petroleum products (page 36).

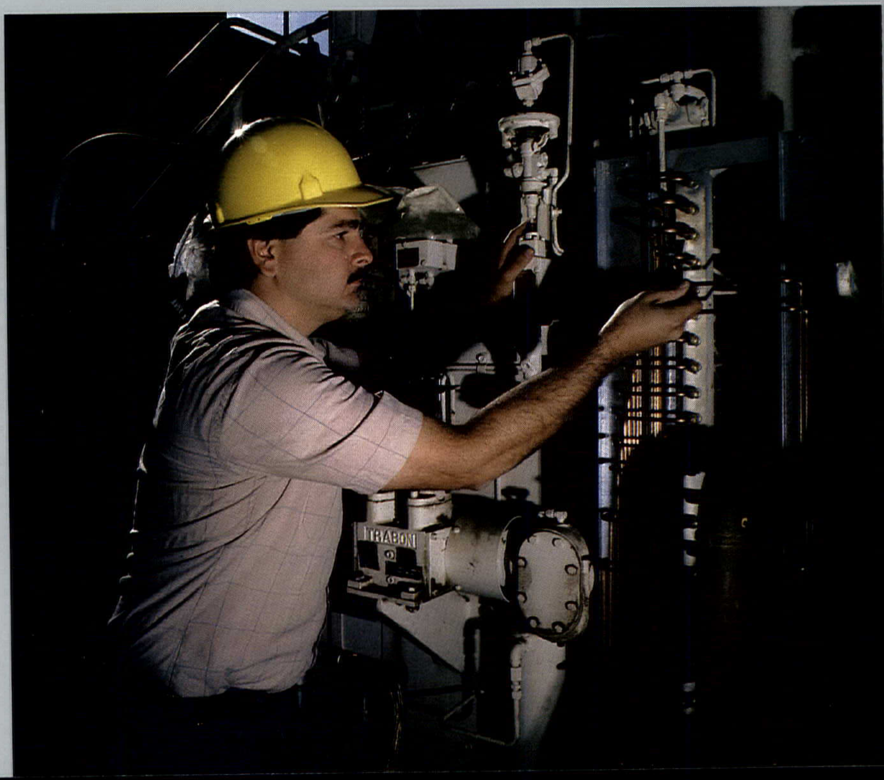
◄ Phase One Development's buildings are designed to attract today's high technology users.

Sunrise in San Diego with SDG&E's landmark Electric Building. For SDG&E, the working day began many hours earlier—at midnight. This Annual Report is dedicated to SDG&E's employees, who are working for you around the clock to achieve the company's goals.

Natural Gas Facility Enlarged

In February, the company began its only major construction project for the year, a $14.5 million addition to the utility's gas transmission system. Two new 3,000 horsepower engine-driven compressors installed as part of the project nearly doubled the capacity of the Moreno compressor station.

Jon Garcia, senior engineer, inspects installation work on a new natural gas compressor. ►



San Onofre Cost Disallowance

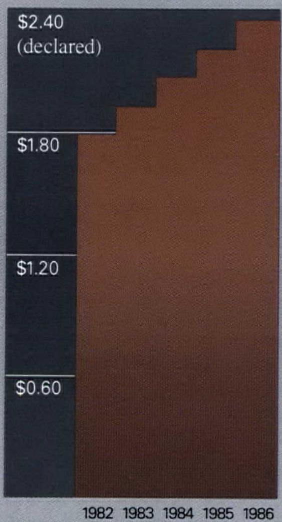
Throughout the year there was uncertainty about the outcome of the California Public Utilities Commission's review of the construction costs of units 2 and 3 at the San Onofre Nuclear Generating Station.

After extensive hearings, the administrative law judge recommended no penalty be assessed to shareholders. However, in October the commission announced that it would exclude $69 million from SDG&E's rate base for a construction cost disallowance. In December, SDG&E requested a rehearing on most of the disallowance (page 2).

Units 2 and 3 at San Onofre Nuclear Generating Station. ►

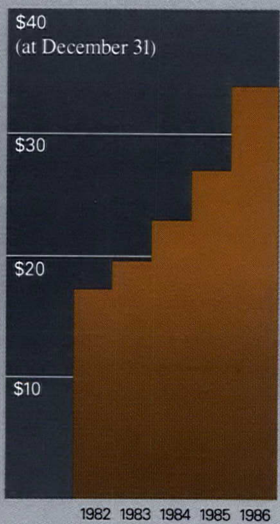
Holding Company Formation Put on Hold

In April, at the Annual Meeting, Chairman Thomas Page told shareholders of the board of director's decision not to form a holding company in 1986. Page cited several unacceptable conditions that the California Public Utilities Commission had attached to its decision when it approved the company's request to form a holding company. In early 1987, the company began to review a reapplication to the commission (page 2).



Dividends Increase Again

On July 15, shareholders received a higher dividend check. The quarterly common stock dividend was increased by 3.5 cents to 59.5 cents per share, the tenth consecutive annual increase.



Investors Like SDG&E

On September 2, the company's common stock price reached a new high of $42.50. During the year, institutional investors increased, achieving another goal (pages 38-41).

Earnings Reach a New Record

For 1986, yearly earnings were a record $3.42 per share, a 5.2 percent increase. The increase was due primarily to the sale of an investment.

Company Description

San Diego Gas & Electric is an energy management company. It operates a gas and electric utility that serves more than two million people in Southern California. Through its subsidiary, Pacific Diversified Capital, it owns four companies in other industries (pages 31-37).

Contents:

Working for You to Achieve Our Goals

Dawn is a very special part of the day. Seeing the sun come up from behind the hills and high-rises of San Diego is one of the pleasures of living in the area, whose life style, climate and varied business opportunities are attracting record numbers of new residents. Serving the region's population, which is among the fastest-growing in the nation, is a continuing challenge for SDG&E.

1986 was an excellent year for the company. Record earnings were produced and rates to customers were reduced. It was the best of both worlds!

Meeting the Competition

Although the company's residential customer base has been growing rapidly, we have been losing some of our larger commercial and industrial customers as more companies have begun generating their own electricity. To curb this loss of larger customers, we must become more competitive.

As you will read elsewhere in this report, we already have begun cutting costs aggressively, and we are providing commercial and industrial customers with attractive rate options.

We must do these things to minimize future rate increases to our residential customers, the inevitable result of the loss of larger customers. This is, in fact, the dawn of a new era of competitiveness for SDG&E.

Earnings in 1986

Earnings were $3.42 per share in 1986, a new record. This was the result of the company's own strict expense controls and two specific events.

- SDG&E's independently operated subsidiary, Pacific Diversified Capital, sold its interest in Energy Factors, Inc. for $24.6 million, which added 25 cents per share to corporate earnings.
- The California Public Utilities Commission disallowed some of the construction costs of San Onofre Nuclear Generating Station's units 2 and 3. SDG&E's 20 percent share of the disallowance was $69 million and we took part of it in the fourth quarter of 1986. This reduced total earnings by 8 cents per share.

Along with co-owner Southern California Edison, we have requested a rehearing of the remainder of the cost disallowance. However, if no change is made by the commission, 1986 and 1987 earnings will be reduced, in total, by approximately $1.30 per share.

Nevertheless, our dividends to shareholders should not be affected. The company's financial position is excellent. Our board recognizes the importance of maintaining and increasing the dividend, as we have for the past 10 years.

Earnings in the Future

In the utility industry generally, it's going to be increasingly difficult to produce incremental earnings from operations, primarily because the authorized rates of return are decreasing.

SDG&E's authorized rate of return on equity in 1987, for example, is 13.9 percent, down from 15 percent in 1986. Nevertheless, SDG&E should continue to compare favorably with other companies in financial performance.

Management is determined to work hard to achieve every dime of our authorized return. Furthermore, the CPUC has approved, on our request, an increased common equity ratio. This will partially offset the drop in authorized return by allocating a greater percentage of our return to common stock earnings.

Financial Highlights

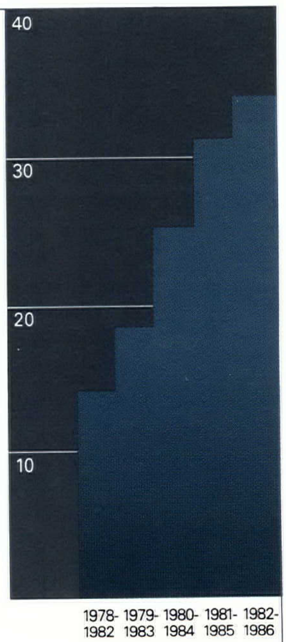
(In Thousands of Dollars Except Per Share Amounts)

	1986	1985	Percent Change
Operating revenues	**$1,634,211**	$1,738,702	−6.0
Operating expenses	**$1,351,861**	$1,450,835	−6.8
Net income (before preferred dividend requirements)	**$ 213,196**	$ 202,722	+5.2
Earnings applicable to common shares	**$ 190,771**	$ 178,925	+6.6
Average common shares outstanding (thousands)	**55,830**	55,125	+1.3
Common stock shareholders (at December 31)	**73,771**	81,471	−9.5
Earnings per common share	**$ 3.42**	$ 3.25	+5.2
Dividends declared per common share	**$ 2.345**	$ 2.205	+6.3
Total energy sales			
Electric (billions of kilowatt-hours)	**11.72**	11.66	+0.5
Gas (millions of therms)	**490**	529	−7.4

Total Annual Return to Shareholders

Stock price appreciation and dividends are the components of total annual return, measured over a five year period. SDG&E continues to be an industry leader.

(by percent)



These factors will help SDG&E reach its goal to produce maximum operating earnings per share for the regulated segment of our company. We expect the nonregulated, diversified operations to produce the incremental earnings in the years ahead. Pacific Diversified Capital made three acquisitions in 1986 for a good beginning.

To help Pacific Diversified Capital achieve its goals, we still believe that we should have a holding company structure. It would provide the best financing flexibility for PDC and the greatest separation of functions between the regulated and nonregulated operations.

As you may recall, SDG&E's shareholders in late 1985 overwhelmingly approved our proposal to form a holding company. Then the California commission in early 1986 approved the proposal. However, in doing so, the commission attached several conditions we believe are inappropriate or impractical and thus we chose not to proceed to form a holding company at that time.

We are reviewing this matter and making some preliminary preparations to reapply. We will do so, however, only if we think the commission would reconsider and eliminate those unacceptable conditions.

Reducing the Risk

In the past we've made some very important decisions that have helped the company to change from being a high investment risk to a relatively lower investment risk.

Lower interest rates, a higher dividend rate, plus the marketplace's perception of reduced risk led to a higher market price and reduced yield. In 1982, SDG&E's year-end yield was 10.55 percent, with a market price that ranged from $11.75 to $17.875. In 1986, the company's year-end yield was 7.03 percent and the market price ranged from $26.75 to $42.50.

The higher market price helped us to achieve our goal to be in the top 25 percent of the utility industry in overall return to shareholders. For the five-year period of 1982 to 1986, the average annual return was nearly 34 percent.

To serve our customers well, to reduce investment risk, to provide good earnings and, we hope, to increase further the market price of SDG&E stock, we will continue working hard and creatively toward achieving our corporate goals. We already have demonstrated we can achieve tough goals and we have the motivation and energy to do so in the years ahead.

Thomas A. Page
Chairman, President and
Chief Executive Officer

February 10, 1987

At 12:01 a.m. on January 1, 1986, the first economy energy purchase of the year was made by SDG&E: 190 megawatts of coal-fueled energy from the Salt River Project in Phoenix. It was one of thousands of transactions made during the year by the Energy Control Center staff, who work unusual 12-hour shifts, around the clock, seven days a week, monitoring the system and looking for purchase and sale opportunities.

The largest part of every dollar spent by SDG&E on behalf of its customers is for fuel and purchased power.

SDG&E has been working effectively to lower those costs. In 1982, 58 cents of every dollar spent was for fuel or purchased power. Five years later, that had dropped to 39 cents.

An ongoing goal at SDG&E is to have diversified energy resources. The ongoing benefits are to keep costs down and assure customers of a reliable energy supply. In 1986, there were major cost reduction opportunities that resulted partially from some deregulation in the energy industry, OPEC's failures, and SDG&E's preparedness to take advantage of both.

Jeannie Scranton is one of six resource coordinators who match the varying system energy demand with the lowest cost energy sources available. The energy demand projection and the actual usage for the prior day is on her computer monitor. It shows the commercial and industrial demand increase in the morning, the residential demand increase that occurs in the early evening and the tapering off of all customer demand during the night.

Purchased Power

Throughout the day and night, every day of the year, SDG&E has the operations flexibility to move back and forth between spot market or contract purchased power, electric energy bought from other sources, and its own power generation sources, according to price and demand.

Whether it's nighttime or daytime, weekends or weekdays, energy control schedulers at SDG&E take advantage of cheap energy available on the spot market.

Firm power contracts, however, provide greater reliability than spot market purchases. A very important low-cost contract for geothermal-fueled energy began in 1986 between SDG&E and Comisión Federal de Electricidad, the national electric utility of Mexico. For the next 10 years, this purchase will provide about five percent of the company's annual needs.

Two higher-cost energy contracts with utilities in New Mexico and Arizona will end in 1988 and 1989. To assure future reliable sources of purchased energy, SDG&E already has signed two new, coal-fueled energy contracts. Especially important is that the new contracts have flexible prices that will be adjusted to the actual costs of producing the power.

Transmission

Access to sources of energy continues to be the key to the company's operating plans. SDG&E's own Southwest Powerlink, a 500-kilovolt line to Arizona, plus two shorter interconnecting lines to Mexico, are the company's primary routes to energy beyond California's eastern and southern borders.

In 1986, the capacity of the Southwest Powerlink was upgraded from 700 to 1,000 megawatts. Also during the year, SDG&E negotiated an improved contract with Southern California Edison that for now provides a back-up transmission route to

Weekly management council breakfasts begin at 7:30 a.m. John Hamrick, vice president – administrative services, right, is one of 17 members. Among them they have an average of 13 years of experience with SDG&E and an average age of 46. Periodic rotation of assignments keeps executives personally challenged and provides the company with new ideas.

eastern energy sources. For the future, it will secure additional transmission capability and provide improved operating flexibility for SDG&E when SCE completes construction of a proposed line between California and Arizona.

SDG&E's primary transmission link to the north is the Pacific Intertie, a transmission system between the California-Oregon border and Los Angeles. Access to northern sources of energy is expected to be increased substantially by the early 1990s, when the present system's capacity is increased and a proposed new line is added. Studies for a new Inland Intertie transmission line between Idaho and Arizona are under way as well.

Also in 1986, SDG&E signed an agreement with 12 other utilities and power agencies that will allow open access to transmission lines throughout the western United States during 1987 and 1988. The two-year experiment will demonstrate how market-based, rather than regulated, transmission rates affect the industry and its customers' costs.

Power Plant Operations

In the early 1980s, SDG&E's management stopped thinking of the company as a "traditional" utility and began calling itself an "energy management company." At the time, not too many people, inside or outside of SDG&E, understood what it really meant to be an energy management company.

In 1986, the concept became an operating reality and work-a-day examples, particularly in the area of the company's fuel purchase activities, provide the evidence.

When oil and natural gas prices plummeted in 1986, SDG&E was well prepared to take advantage of the competitive pricing marketplace. Fuel contract personnel, skilled in negotiating for power plant fuels, including oil and uranium, moved quickly to apply those skills in the newly emerged natural gas spot market.

During early 1986, the company's last single-fuel unit at the Encina power plant was converted to use either oil or natural gas, allowing the company to purchase the lowest-cost fuel.

Significant cost savings were achieved during 1986 with 16 spot market deliveries of fuel oil from suppliers in Singapore, Australia, Alaska and California. The low-cost oil was burned until SDG&E gained access to lower-cost spot market natural gas. This was made possible when SDG&E persuaded the California Public Utilities Commission to require SDG&E's sole supplier to transport for a fee natural gas SDG&E purchased from other suppliers.

SDG&E quickly instituted an innovative spot market bidding program that attracted suppliers from around the country.

The results: Since the beginning of 1986, power plant natural gas fuel costs dropped 35 percent and the average cost of fuel oil in inventory dropped by 55 percent. So successful and unique was SDG&E's fuel switching capability and generating fuel purchase expertise, that the company's work was described in numerous national news and fuel industry trade publications.

What worked well in 1986 may not work as well in 1987 or beyond in the changing energy marketplace. Keeping one step ahead by gaining better access to more energy sources remains a fundamental challenge for SDG&E.

The sun's just up and Kelly Ward and Dan Lancaster are loading polyethylene gas pipe on their truck at the Beach Cities Service Center. About 1,400 employees begin work at or before 7:00 a.m. to meet the needs of customers.

At 8:00 a.m. on July 1, the San Francisco office of SDG&E's governmental and regulatory services division was opened. It's located just a short walk away from the offices of the California Public Utilities Commission. This office opening is indicative of the company's determination to play a pivotal role in helping redesign the energy marketplace to meet the future needs of shareholders and customers.

The California Capitol in Sacramento is familiar territory to Ronald Fuller, vice president – governmental and regulatory services, and Sacramento office staff member Jeanette Bunch. When important legislative bills are being considered, a working day may last far into the night. The division also has offices in Washington, D.C. and San Francisco.

Rates have been very high since 1981 when the company was burdened with heavy construction costs on top of higher fuel costs. Since the completion of the major construction projects, operating budgets and rates have been trimmed. The initial focus of the company's rate-cutting efforts, beginning in 1983, was on residential customers. Since then, residential bills have declined 15 percent.

Commercial and industrial customers' rates also have been lowered. However, these customers have been subsidizing residential customers' energy use because they pay more than it costs the company to serve them. Therefore, changing rate design to make commercial and industrial rates reflect the actual cost of service or benefit to them is a company goal. Residential rates are expected to fluctuate moderately from year to year during the next few years.

Beginning in mid-1985, the company increased its focus on reducing rates to commercial and industrial customers. As a first step, on January 1, 1986, some specific time of day rates were reduced by 54 percent. A second step was taken in early 1987, when the California Public Utilities Commission approved another $85.5 million reduction, much of this designed to benefit commercial and industrial customers.

Cogeneration

SDG&E's efforts to have equitable rates among its customers have meant that the rates paid to cogenerators are being scrutinized by the company. Cogeneration systems use waste heat from operations, or another fuel source, to produce thermal and electrical energy for their own use, and sometimes for sale to SDG&E.

In San Diego, 165 companies have or are planning cogeneration systems. SDG&E does count on some cogenerated energy to be available in the future. However, in 1986 alone, more than 40 companies left SDG&E's system to generate their own electricity. SDG&E has provided standby service to customers with cogeneration systems at the California commission's direction and this increases costs to other customers. The rate charged for this stand-by service doesn't come close to covering the company's costs. As an initial step toward covering those costs, beginning in 1986, the company sought a rate design change. It was approved by the California commission.

The Largest Customer

Midway through 1986, the U.S. Navy, which represents nearly 10 percent of SDG&E's electric sales, announced that it intended to have a third party build fossil fuel cogeneration plants for its use.

SDG&E launched its reply by reminding the Navy of recently effective rate reductions that they had not considered in their analysis. For the second component of its response, the company informed the media, other customers, congressmen and state legislators of the total impact of the Navy's plan: all other customers' bills would increase if the Navy takes its business away.

Next, SDG&E negotiators offered the Navy a competitive rate proposal designed to equal the benefits the Navy sought from the cogeneration systems while minimizing the impact on other customers. By year's end, the Navy and the company had begun constructive negotiations. A final decision is expected in 1987.

Management wants to keep all the customers it economically can and the company's employees are working creatively to achieve this objective.

It was close to 3:00 p.m. on November 10, 1986 when the San Diego City Council approved its fifth issue of tax-exempt industrial development bonds for SDG&E. The interest rate later was set at 7.375 percent, a pelican's plunge from the 17.375 percent interest rate that SDG&E paid for some first mortgage bonds back in 1981 when interest rates were at an all-time high.

In the early 1980s, with a large construction program under way, SDG&E was forced to raise large amounts of capital at very high interest rates. Financial improvement has been slow, steady and well-planned. Today, the company is financially strong. Furthermore, its staff is using sound financial management to achieve SDG&E's goals. This expertise is helping to cut customer costs and increase shareholder value.

Issues of Tax-Exempt Debt

Management is working long and hard to continue to qualify the company for low-cost, tax-exempt industrial development bonds and pollution control bonds. SDG&E was one of the few to qualify in the past. By the end of 1986, the city of San Diego had issued $525.6 million in IDBs for SDG&E, including $125.6 million during 1986. As of December, total annual savings to customers from IDBs and tax-exempt pollution control bond issues was approximately $20 million.

By the end of the year, the company had more than 60 percent of its debt in tax-exempt issues, one of the highest percentages of any investor-owned utility in the country.

Recall of High Cost Debt and Preferred Stock

In the past two years, with major construction activities completed, the company has had cash available to retire early $241.3 million in high interest rate first mortgage bonds and preferred stock. Of this, $127.9 million was retired in 1986.

Total savings to customers from the recall of higher cost debt and preferred stock by the end of 1986 was $5.5 million annually. In early 1987, another $41 million in higher cost preferred stock was retired for an additional $1.1 million in annual savings to customers.

Shareholders are benefiting from SDG&E's financial management expertise, too, as the company seeks higher paying investments for its cash balances.

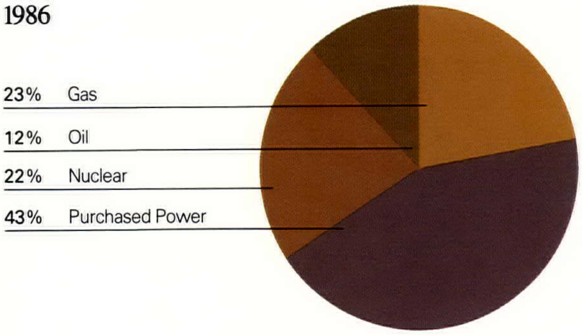
While part of the company's cash was used for the retirement of higher coupon debt and preferred issues in 1986, the balance was invested in tax-advantaged short-term investments that improved the company's after-tax rate of return.

There were signs of the financial community's growing approval of SDG&E's progress toward achieving its goals when SDG&E's stock rose to an all-time high of $42.50 per share and when the rating agency of Duff & Phelps increased the company's bond rating equivalent to an A plus.

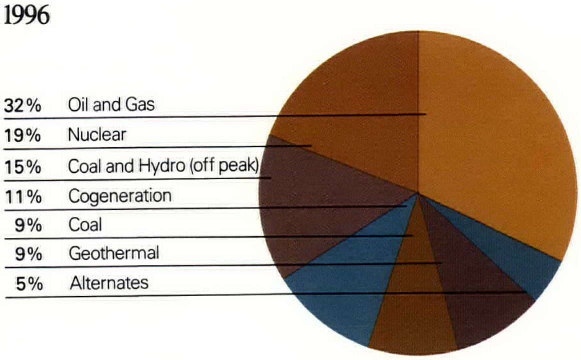
To make sure that the construction work on a major project is completed on schedule and within budget, SDG&E has on-site construction managers. Jeff Attig had that responsibility for the expansion of the Moreno gas compressor station, the company's only major construction project in 1986. He's checking an oil storage vessel.

Electric System Energy Mix

1986



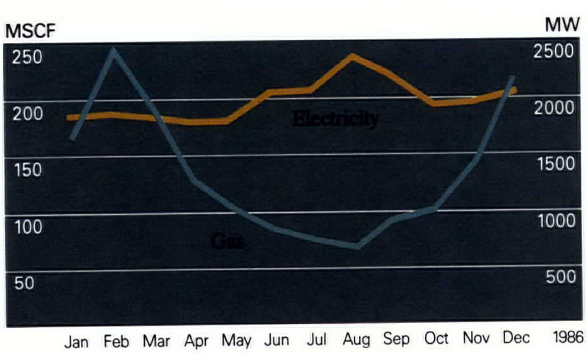
1996



SDG&E took advantage of sharply declining fuel oil prices in 1986, more than doubling its use of fuel oil from 1985. In the 1996 chart, the purchased power component shows the various sources of power to which the company expects to have access.

Peak Demand Profile

Electric system peak demand (in megawatts)
Gas system peak day sendout (in millions of standard cubic feet)



SDG&E is working to change this profile to level out the peaks and valleys by using its system more efficiently.

Electric Customers

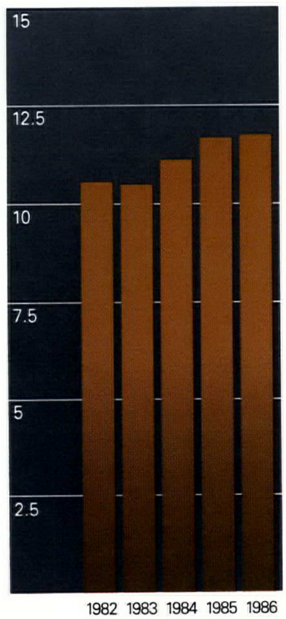
(in thousands, at December 31)

San Diego's climate and life style continued to attract people. Another customer growth record was set in 1986. To meet the demand, employees often worked longer hours. ▶

Electric Sales

(in billions of kilowatt-hours)

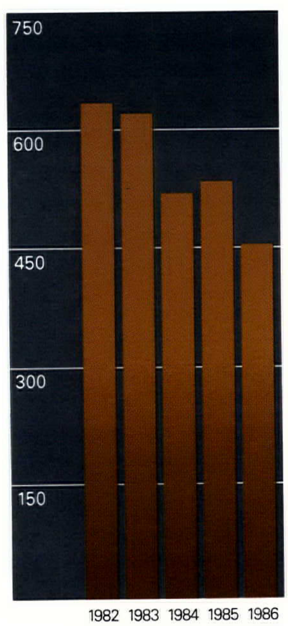
Electricity sales increased slightly in 1986, due to a record increase in residential customers. ▶



Electric Fuel and Purchased Power Costs

(in millions of dollars)

SDG&E aggressively bought lower-cost fuel oil and natural gas, chopping millions from customer fuel costs in 1986. ▶



Gas Customers

(in thousands, at December 31)

The number of natural gas customers grew by four percent in 1986. ▶

Gas Sales

(excludes interdepartmental transfers)

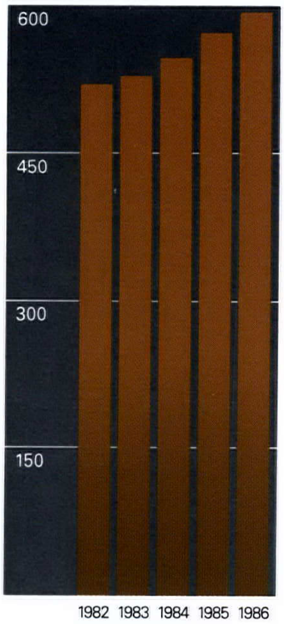
(in millions of therms)

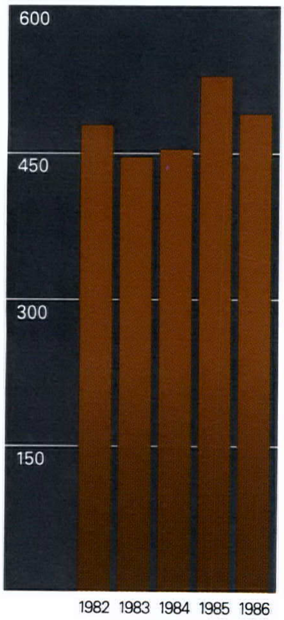
Gas sales declined because of a warmer winter in 1986. ▶

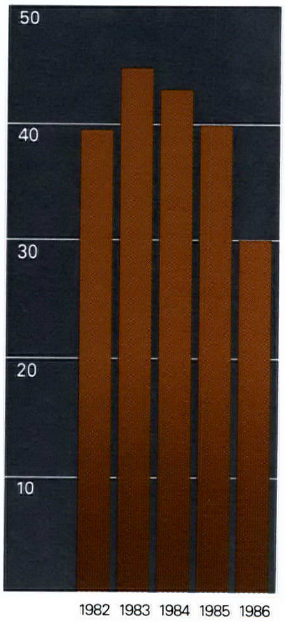
Average Cost of Purchased Gas

(in cents per therm)

Competition between natural gas and fuel oil for power plants led to a 25 percent decline in the average cost of purchased gas in 1986. ▶







When the digital watches began to beep at about 2:00 p.m. on July 11, the hubbub from the crowd in the Electric Building's auditorium subsided. The audience, SDG&E's managers and division directors, anticipated hearing from senior management the details of rumored changes ahead. This meeting was the introduction of the company's Performance Improvement Program.

Jack Thomas, SDG&E's chief operating officer, talks with workers at the Encina power plant about performance improvement and the incentive award program for employees.

The company updated its business plan in 1986 and a new goal was stated in it: develop an organization that can adapt to change and challenge.

SDG&E has 4,815 employees. Altogether they are SDG&E's most important resource. The Performance Improvement Program that was introduced in July 1986 is meant to reach into every corner of the company's operations. Since individual employees look into those corners as part of their jobs, stimulating ideas from them for cutting costs is an important element of the entire program.

Jack Thomas, executive vice president and chief operating officer, spoke at 39 employee meetings to explain why the Performance Improvement Program is so vital to SDG&E. He said repeatedly, "As we look to the future, we see an ever-increasing need to be competitive. To be successful in today's energy marketplace, SDG&E will have to deliver services to the larger commercial and industrial customers at competitive prices.

"We must find new ways to reduce our costs, without harmful effects to our customers or our shareholders. This is our next challenge. Success depends on your efforts."

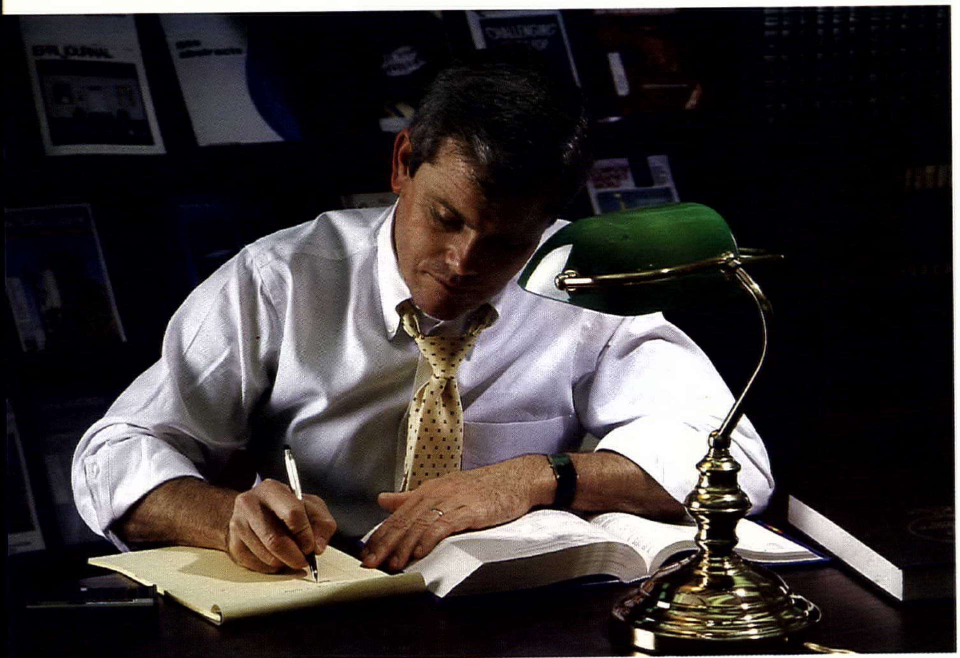
To encourage employees to contribute their ideas, the company began offering 10 percent of the first year's savings for cost-cutting ideas. Called "The 10% Solution", the program awards a maximum of $25,000.

The ideas poured in. During the first four months of the program, more than 1,000 suggestions were submitted and 44 employees won awards based on anticipated savings of $260,000 to customers. It was a good beginning.

Around 10:00 p.m. on July 24, the thermal energy storage unit at the corporate office of The Henley Group, Inc. was turned on for the first time. Since then, the company has been able to take advantage of SDG&E's cheaper nighttime electric rates to keep the building cool during the day, a year-round necessity for San Diego's commercial buildings. The Henley Group is one of 25 companies in the San Diego area that have either already taken advantage of an SDG&E financial incentive program or have contracted to do so in the near future.

Nighttime. It's of special importance to SDG&E. Persuading customers to use more energy efficiently, particularly at night, is the responsibility of the new marketing division. In December 1986, new goals were drafted, with an eye not only toward keeping operating costs down but toward improving the "earnings applicable to common shares" line of SDG&E's income statements in the years ahead.

Establishing – and then publishing – goals is one of few "traditions" at SDG&E. The new marketing goals and the reasons behind them follow.



Continuing education is important in the changing energy marketplace. Each year, hundreds of SDG&E employees take courses in the company's Management Development Center. There are other opportunities to learn, too.

Donald Felsinger, vice president – marketing, took the intensive Executive Management Program at Stanford University in 1986. He's one of several officers who have taken advanced management courses recently.

Goal One: Maintain Market Share.

Reason: Cogeneration has been capturing more commercial and industrial customers each year as the technology of cogeneration has advanced from custom-designed systems for the largest energy users to off-the-shelf models designed for small or mid-size companies.

To maintain its market share, SDG&E is planning to redesign its rates during the next few years to lower variable rates and increase fixed fee charges. Of course, the marketing division and the governmental and regulatory services division must work cooperatively to achieve this.

The cooperative spirit was tested in 1986 when the U.S. Navy announced it would become an independent energy producer. As leaders in the companywide effort to keep it as a customer, marketing developed a competitive rate proposal and regulatory affairs briefed the CPUC on the concepts and negotiation progress to ensure final approval of a Navy contract in 1987, if SDG&E and the Navy reach an agreement.

Maintaining market share also will require attracting new commercial and industrial customers. SDG&E has one of the highest customer growth rates in the country. In 1986, customers increased by a record 46,884 to 940,752, a 5.25 percent growth rate. Most are residential customers attracted by the climate and life style San Diego offers. To draw more industry, SDG&E will begin a new economic development program in 1987 in cooperation with the San Diego Economic Development Corporation.

The current cost of energy may be a deterrent to attracting businesses. Therefore, there will be continuing efforts to lower the average commercial and industrial rates, to develop market research on how to add value to commercial and industrial operations, and to provide new pricing options for commercial and industrial customers.

Goal Two: Increase Earnings.

Reason: Earnings growth in the industry in recent years has been based mostly on the growth of capital investment. Like others in the industry, SDG&E's rate of growth in capital investment will be declining. Like other industry leaders, SDG&E will use its marketing expertise to increase sales as the company continues to seek ways to cut costs.

Deregulation is not a far-off concept. It's already happening, as nonregulated competitors slowly take away market share from regulated companies like SDG&E.

In 1986, and again in early 1987, SDG&E took some steps to be more competitive by sharply reducing rates to commercial and industrial customers. The company's marketing employees will

Information processing goes on around the clock. Proserfina Quiambao, computer operator, works the 3:30 p.m. to midnight shift in the computer room, where all of the corporate data is handled. By morning, stacks of printed reports will be ready for employees throughout the company.

continue to work hard explaining the new alternatives to customers.

Goal Three: Improve Generating System Use. Reason: To postpone the need for building new generating plants, which increase customer costs, SDG&E must improve the usage of its existing plants.

Marketing can make a vital contribution to improving the system's use by minimizing the growth in energy demand. To do so, the company must persuade customers to shift some of their energy demand to the dusk-to-dawn hours, known as off-peak time.

Thermal energy storage, which encourages commercial and industrial customers to run air conditioning equipment at night, is a specific program being promoted successfully. Another is the gas air conditioning program, which encourages commercial and industrial customers to shift conventional air conditioning from the electric system's peak time to the gas system's low-use time. Financial incentives are being offered by SDG&E to spur customers to shift their energy use away from the daytime peak period.

SDG&E has been evolving from the "traditional" utility it was into a competitive energy management company. "In the early 1970s," recalls Jack Thomas, then a newly elected vice president of the company and now its chief operating officer, "the company estimated its budget and hoped for the best. Of course, that was before the two energy crises of the 1970s.

"In the early 1980s, we made sure rates matched our budgets. Because we had huge construction programs, the rates and the budgets soared.

"By 1986 we had accepted deregulation as a reality in the industry and realized that to compete we had to change," says Thomas. "Therefore, in 1987 we are focusing our efforts on marketing and cutting costs and rates to be competitive, to increase sales and to provide earnings growth."

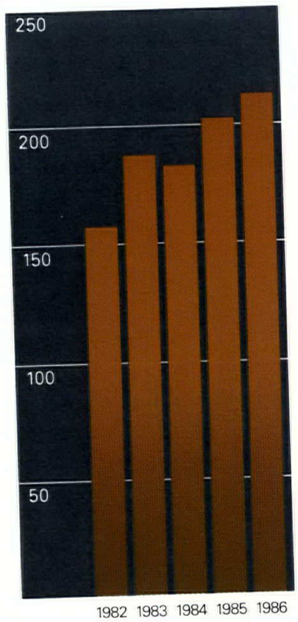
Sharon Mayer begins work at 9:30 p.m. She's a night messenger and spends most of the night driving hundreds of miles to pick up and deliver mail between offices. Communications, even in this day of computers, still means paper. The mail center handles up to 15,000 items every day – and night.

(In Thousands of Dollars Except Per Share Amounts) *For the Years Ended December 31*	1986	1985	1984	1983	1982
Operating revenues	**$1,634,211**	$1,738,702	$1,620,701	$1,530,207	$1,430,948
Operating income	**282,350**	287,867	251,550	174,155	169,861
Net income (before preferred dividend requirements)	**213,196**	202,722	183,467	187,370	157,303
Earnings per common share	**3.42**	3.25	3.01	3.20	2.90
Dividends declared per common share	**2.345**	2.205	2.065	1.925	1.785
Funds provided by operations	**412,090**	399,453	370,855	267,429	196,084
Funds provided (used) by long-term financing	**(44,233)**	(8,890)	69,419	284,265	141,173
Additions to utility plant (excluding allowance for funds used during construction)	**242,648**	241,219	197,775	291,999	252,790
At December 31					
Total assets	**3,227,177**	3,085,962	2,950,695	2,840,195	2,411,676
Long-term debt and preferred stock subject to mandatory redemption (excludes current portion)	**1,105,378**	1,112,567	1,148,290	1,099,903	893,043

The Financial Review should be read in conjunction with the financial statements, notes to financial statements and statistical data contained elsewhere in this report.

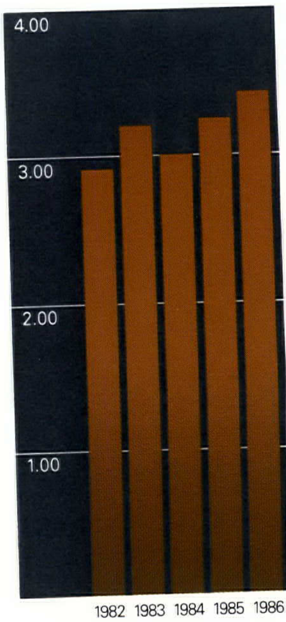
Net Income
(in millions of dollars)

Sale of an investment in Energy Factors, Inc. resulted in higher earnings. ▶



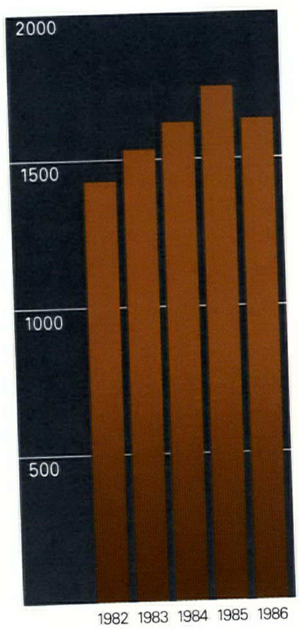
Earnings Per Share
(in dollars)

The 1986 earnings per share established a new record. ▶



Revenues
(in millions of dollars)

Revenues declined, due to much lower fuel costs in 1986. ▶



Total Assets
(in millions of dollars)

Many smaller construction projects contributed to the growth in assets. ▶

Results of Operations

Earnings

The increase in net income and earnings per share in 1986 reflects the sale of the investment in Energy Factors, Inc. The gain on the sale net of taxes was $14 million, or 25 cents per share. The gain was offset partly by a reserve of $5 million net of taxes, or 8 cents per share, for the California Public Utilities Commission's partial disallowance of construction costs for San Onofre Nuclear Generating Station units 2 and 3.

Financial return on equity declined slightly from 16.2 percent in 1985 to 16.0 percent in 1986. This occurred because average common equity grew at a slightly higher rate than the increase in net income.

Two important regulatory contingencies are discussed in Note 6 to the financial statements. In December 1986, the company petitioned the commission to rehear its recent decision to disallow part of the costs to construct San Onofre. In addition, the commission is evaluating the cost of power purchased from other sources and transported over the Southwest Powerlink. Unfavorable commission decisions in these cases could materially affect the company's earnings and the cash provided by utility operations.

The company's independent auditors qualified their opinion relating to the company's audited financial statements for the year ended December 31, 1986 because of these uncertainties. The same qualification relating to San Onofre appeared in the auditors' opinion covering the company's financial statements for the years ended December 31, 1985 and 1984.

Revenues

The California Public Utilities Commission controls the company's rates, and thereby its revenues, generally by two mechanisms – base rates and balancing accounts.

Base rates compensate the company for operating and maintenance costs, taxes and depreciation and provide a return on capital. Base rates are set in a general rate case every three years. Between rate cases, the commission makes adjustments for inflation, system growth and rate of return. The current three-year cycle started in 1986.

The company uses balancing accounts for fuel costs, both electric and gas, and for San Onofre ownership costs, consisting primarily of depreciation and a return on capital. The commission sets balancing account rates based on estimated costs. Differences between actual and estimated costs are accumulated in the balancing accounts. Periodically, the company adjusts rates to amortize the balances. The company also uses balancing accounts to compensate for the differences between actual and estimated sales volumes. However, the account for gas sales to certain large customers will be eliminated in 1987. For two years, a transition arrangement will limit the change's potential impact on the company's earnings. The commission is also considering elimination of the balancing account for electric sales. The company expects base rates to replace the balancing account for San Onofre ownership costs in 1988.

Gas and electric operating revenues for 1986 were down 6 percent from 1985. The $106 million decrease was due primarily to the $128 million decrease in fuel costs. However, because of the balancing account process described above, the decrease had no impact on operating income.

Electric sales volume increased 5 percent in 1985 reflecting customer growth. In 1986, volume increased only .5 percent. While customers increased in 1986, average usage declined. Gas sales volume increased 17 percent in 1985, due to cold weather, but decreased 7 percent in 1986 due to milder weather.

Changes in electric revenues are due to the following:

(Millions of Dollars)

For the Years Ended December 31	**1986**	1985
Authorized margin	**$(10)**	$ 67
Fuel cost	**(73)**	13
Other	**21**	23
Net increase (decrease)	**$(62)**	$103

Changes in gas revenues are due to the following:

(Millions of Dollars)

For the Years Ended December 31	**1986**	1985
Authorized margin	**$ (2)**	$ 6
Fuel cost	**(48)**	10
Other	**6**	(1)
Net increase (decrease)	**$(44)**	$15

Costs

The total cost of electric fuel and purchased power decreased in 1986 because lower prices more than offset the increase in sales volume. The lower prices primarily resulted from the general decline in world oil and gas prices and the company's aggresive program of spot-market purchases. However, the total cost increased in 1985 because increases in sales volume more than offset the decreases in fuel prices.

The cost of gas purchased for resale decreased in 1986 because of lower sales volume, due to milder weather, and lower prices. In 1985, volume increased and prices decreased.

Other operating costs increased $19 million in 1986 due to the Heber geothermal plant becoming operational, increased insurance costs and the operating costs of the new subsidiaries described below. In 1985, other operating costs decreased $7 million primarily because of the non-recurrence of 1984 start-up costs for the Southwest Powerlink and San Onofre units 2 and 3 and development costs for the Heber plant.

Taxes on operating income basically were unchanged in 1986 after increasing substantially in 1985 due primarily to increased operating income.

The company earns an allowance for funds used during construction on the construction funds held by a trustee as well as on construction in progress. The total allowance for construction funds, both debt and equity, increased in 1986 due to the increase in the amount of construction trust funds. The total allowance had decreased in 1985 due to completion in 1984 of the Southwest Powerlink and San Onofre units 2 and 3. The allowance is not a current source of cash but will result in increased future cash flows as its amortization is included in rates.

Other income in 1986 includes the $21 million pretax gain from the sale of the investment in Energy Factors, Inc. The 1985 total was up significantly from 1984 due to an increase in temporary investments.

Interest charges are net of interest income on construction funds temporarily invested by the trustee. These interest charges increased in 1985 because construction trust funds declined. However, in 1986 construction funds increased while debt reductions and the use of low-interest, tax-exempt financings increased. This resulted in a decrease in interest charges. The company's embedded cost of debt decreased from 10.5 percent in 1984 to 10.1 percent in 1985 and to 9.6 percent in 1986.

Liquidity and Capital Resources

Utility operations are a major source of liquidity for the company. Since 1984, tax-exempt industrial development bonds and pollution control bonds have been the major external sources of liquidity. Funds from operations and tax-exempt bonds have been more than adequate to cover construction of utility plant, payment of dividends, and maturing long-term debt. In fact, a large part of the proceeds from bonds issued in 1986 is still held by a trustee awaiting its use in 1987.

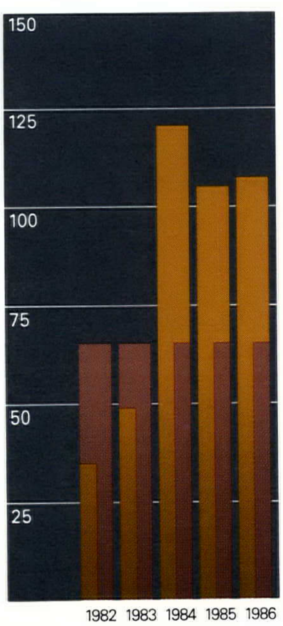
The percentage of funds for construction that the company can generate internally is a good measure of liquidity provided by operations. The company's goal is to exceed 65 percent. The following chart shows the company's success in achieving that goal.

The company's capital structure is one factor that has enabled it to obtain long-term financing at attractive rates. The following table shows the percentages of capital represented by common equity, preferred stock and long-term debt. It also shows the targets toward which the company intends to progress.

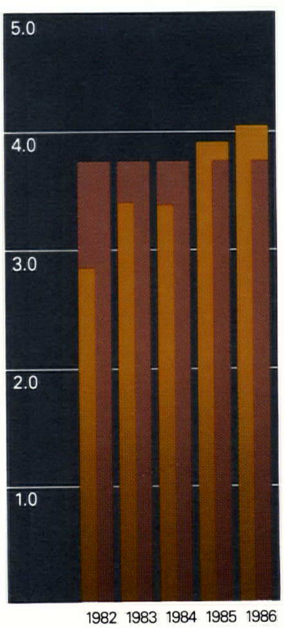
	1982	1983	1984	1985	1986	Goal
Common equity	36%	37%	40%	43%	44%	45-48%
Preferred stock	12	9	9	8	7	5-7
Debt and leases	52	54	51	49	49	46-49
Total	100%	100%	100%	100%	100%	100%

Another measure of the company's ability to obtain financing is pretax interest coverage. The company's goal is to exceed 3.75. The chart shows the company's results.

Maintain Internal Generation of Construction Expenditures (at 65 percent or more)
(construction expenditures exclude AFUDC)
(by percent)
■ Performance
■ Goal



Maintain 3.75X Pretax Interest Coverage
(including capital lease interest)
■ Performance
■ Goal



Controlling the level of construction expenditures is one method the company uses to meet its financial goals. Power plant construction has been minimized by increasing the percentage of power purchased from others. As the chart shows, the company has been recently successful in keeping construction expenditures below 10 percent of capitalization.

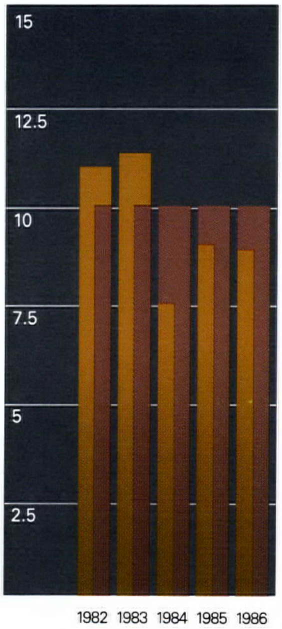
Limit Construction Expenditures to 10 Percent of Capitalization

(construction expenditures exclude AFUDC)

(capitalization includes capital leases and short-term debt)

Performance

10 percent limit



Funds generated internally plus the drawdown of the construction trust funds discussed above are expected to be more than adequate to fund 1987 construction. And, in spite of the uncertainties associated with the Southwest Powerlink and San Onofre contingencies, management believes ample external sources of long-term financing will continue to be available if a need or an opportunity arises. Nevertheless, regulatory disallowances associated with the Southwest Powerlink or San Onofre may reduce liquidity from operations.

Construction expenditures are expected to total $196 million in 1987, down 19 percent from $243 million in 1986. Planned 1987 expenditures are less than 1986 expenditures due to non-recurring activity in 1986, primarily at San Onofre and the newly expanded Moreno natural gas compressor facility.

The sale of Pacific Diversified Capital's investment in Energy Factors, Inc. provided $22 million in cash net of taxes in 1986. Pacific Diversified uses that cash, plus cash accumulated in prior years, to invest in the existing subsidiaries and to acquire new subsidiaries.

The Future

Several trends and factors are expected to affect future operating results and liquidity.

- San Diego's population is growing at a rapid rate, resulting in increasing sales. However, the rate of sales growth will be reduced somewhat by additional cogeneration.
- Declines in interest and inflation rates are resulting in lower authorized rates of return.
- The Tax Reform Act of 1986 has lowered tax rates, eliminated investment tax credits and reduced the benefit of depreciation deductions.
- Partial deregulation has begun.
- The company is diversifying.

A short description of each of these follows. In addition, the outcome of the commission's evaluations of San Onofre construction costs and power received over the Southwest Powerlink may affect results of operations and liquidity. These contingencies were discussed above.

Population Growth: The company's rate of new customer additions has been and continues to be well above the national average. For 1985, the rate was almost five percent and for 1986 it exceeded five percent. The company expects the rate of growth to remain high.

Cogeneration: Cogeneration is the simultaneous generation of steam and electricity from one fuel, usually oil or natural gas. Cogenerators may use both the steam and the electricity, use one and sell the other, or sell both. Largely because of the way the commission has allocated costs among the company's classes of customers and structured rates, cogeneration can sometimes produce electricity and steam at a cost lower than the comparable cost of purchasing energy from the company. Increases in customer electric rates could result if major customers elect to install and operate cogeneration facilities in the company's service area. Since a large share of the company's costs are fixed, the company would have to allocate a greater proportion of the costs to those users who remain customers.

The U.S. Navy is the company's largest customer, accounting for almost one-tenth of total sales. The Navy is considering using cogeneration to meet a large percentage of its electric requirements. The company's efforts to retain the Navy's business have included discussions of recent reductions in the company's rates after the Navy study began and changes in rate structure to allocate a lower share of costs to customers like the Navy.

Since the company sells both gas and electricity, the effects of cogeneration on its operations are greater if the cogenerator burns oil, purchased from another supplier, rather than gas, purchased from SDG&E. Since many of the cogenerators in the company's service territory are equipped to burn either fuel, the choice will depend primarily on the fuels' relative prices. Regulatory changes described below are expected to keep gas competitive with oil.

Rates of Return: The decline in inflation and interest rates has led to lower authorized rates of return on rate base and equity. The commission authorized a rate of return on equity of 15 percent in 1986, which is down from 16 percent in 1985 and 1984. For 1987, the commission lowered the rate to 13.9 percent. However, on behalf of the U.S. Navy, the Federal Executive Agencies has challenged that rate. The company cannot predict whether the 13.9 percent rate will be changed.

Other than being a factor in determining the authorized rate of return, inflation does not generally affect income. Increases in operating costs due to inflation are normally recovered through base rates. Changes in fuel and purchased power prices do not affect income because these costs are recovered in the balancing accounts.

Tax Reform Act of 1986: The new tax law is not expected to have a significant effect on the company's net income because electric and gas rates will be adjusted for the tax changes. However, it will reduce cash provided by operations because investment credits have been eliminated and the benefits of depreciation deductions have been reduced.

Partial Deregulation: The company is preparing for potential deregulation in both its electric and natural gas business segments. Deregulation could result in increased volatility in electricity prices. In the future, customers may be able to purchase power from other sources and transmit it over the company's transmission lines. This could result in higher rates to remaining customers and increased risk of cost recovery to the company.

Rates that subsidize residential and other low-volume customers to the detriment of large-volume customers encourage cogeneration and other forms of competition. As noted above, this can lead ultimately to higher rates for customers who do not have access to cogeneration or other alternative sources. Therefore, the company recently has asked for, and received, from regulators changes in rate structure to relate the various rate classes more closely with the cost of providing service to them. The company will continue to seek additional changes. Such changes will enhance the company's competitive position and reduce imbalances in rates.

The company is taking advantage of the deregulation of the natural gas industry. In 1985, the Federal Energy Regulatory Commission provided for open access to interstate gas transmission pipelines. The company is buying a substantial portion of its natural gas from suppliers in Texas and Oklahoma at relatively low spot-market prices. Southern California Gas Company transports that gas for a fee. This arrangement has greatly lowered the total cost of natural gas purchases. Previously, all gas came from Southern California Gas. SDG&E's retail customers that meet certain criteria may also purchase gas and pay SDG&E a transmission fee. The California commission has also restructured the rate-setting mechanisms for natural gas sales to certain large customers, as described above.

Diversification: One corporate strategy to improve financial performance is to diversify. During 1986, Pacific Diversified Capital acquired three companies. In addition, SDG&E is reviewing a reapplication to the California commission for the formation of a holding company to facilitate diversification.

In October 1986, Pacific Diversified acquired Computing Solutions, Inc., a computerized mapping company. The new acquisition was merged into Integrated Information Systems, Inc., the subsidiary formed in 1985 to operate in the same field. In October 1986, Pacific Diversified acquired Phase One Development, Inc., a real estate development firm, whose operations were combined with an existing real estate subsidiary. The real estate subsidiary then changed its name to Phase One Development, Inc. In December 1986, Pacific Diversified acquired 51 percent of Mock Resources, Inc., a seller of petroleum-based fuels and recent entrant into the newly deregulated business of selling natural gas to industrial users.

Pacific Diversified intends to continue this program of diversification, acquiring other companies whose operations relate to fields in which the company is active already.

Because of the diversification in 1986 and its expected continuation, the company's financial statements for 1986 are consolidated to include all subsidiaries, since acquisition, where applicable. This change has little effect, particularly because the acquisitions were late in the year. The company has not restated prior financial statements because the diversified activity was not significant to the financial statements in the past.

(In Thousands Except Per Share Amounts)

For the Years Ended December 31		1986	1985	1984
Operating Revenues				
Electric		**$1,333,479**	$1,395,655	$1,292,839
Gas		**299,202**	343,047	327,862
Other		**1,530**	–	–
Total operating revenues	a	**1,634,211**	1,738,702	1,620,701
Operating Expenses				
Electric fuel and purchased power	b	**456,402**	535,968	521,621
Gas purchased for resale	c	**175,286**	223,407	213,813
Transmission, distribution and storage		**49,935**	40,263	43,725
Franchise payments		**30,952**	34,443	30,961
Other operating	d	**201,491**	182,867	190,359
Maintenance		**73,502**	74,484	73,164
Depreciation and amortization		**140,732**	132,506	115,200
Property and other taxes		**37,714**	35,179	32,088
Income taxes (Note 5)		**185,847**	191,718	148,220
Total operating expenses		**1,351,861**	1,450,835	1,369,151
Operating Income		**282,350**	287,867	251,550
Other Income and (Deductions)				
Allowance for other funds used during construction		**13,035**	5,772	19,241
Taxes on nonoperating income (Note 5)		**(4,534)**	(972)	10,656
Other–net	e	**34,296**	23,269	9,296
Total other income		**42,797**	28,069	39,193
Income Before Interest Charges		**325,147**	315,936	290,743
Interest Charges				
Long-term debt		**95,364**	104,449	100,391
Short-term debt and other		**17,468**	11,065	10,987
Allowance for borrowed funds used during construction		**(881)**	(2,300)	(4,102)
Net interest charges		**111,951**	113,214	107,276
Net Income (before preferred dividend requirements)		**213,196**	202,722	183,467
Preferred Dividend Requirements		**22,425**	23,797	24,172
Earnings Applicable to Common Shares		**$ 190,771**	$ 178,925	$ 159,295
Average Common Shares Outstanding		**55,830**	55,125	52,868
Earnings Per Common Share		**$ 3.42**	$ 3.25	$ 3.01
Dividends Declared Per Common Share		**$ 2.345**	$ 2.205	$ 2.065

See notes to consolidated financial statements.

Excerpts from the Financial Review

a. Operating revenues for 1986 were down 6 percent, primarily due to the decrease in fuel costs. However, because of balancing accounts, the decrease had no impact on operating income.

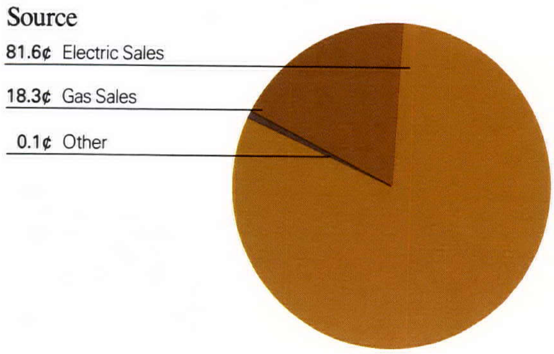
b. The total cost of electric fuel and purchased power decreased in 1986 because lower prices more than offset the increase in sales volume.

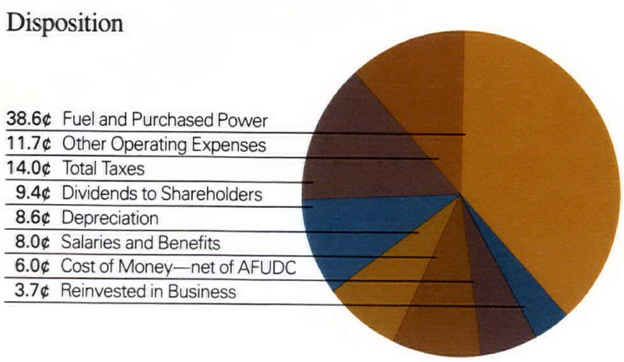
c. The cost of gas purchased for resale decreased in 1986 because of lower sales volume, due to milder weather, and lower prices.

d. The $19 million increase was due to the Heber geothermal plant's becoming operational, increased insurance costs and the operating costs of new subsidiaries.

e. In 1986, this includes the $21 million pretax gain from Pacific Diversified Capital's sale of its investment in Energy Factors, Inc.

1986 Revenue Dollar





In 1986, the fuel and purchased power component declined again, to 38.6 cents of every revenue dollar compared with 43.7 cents in 1985.

Consolidated Balance Sheets

(In Thousands of Dollars)

Balance at December 31		1986	1985
Assets			
Utility plant—at original cost			
In service			
Electric		$3,003,555	$2,790,158
Gas		384,884	347,317
Common		65,838	46,743
Total plant in service		3,454,277	3,184,218
Plant held for future use		767	1,009
Construction work in progress		93,348	117,336
Total utility plant	a	3,548,392	3,302,563
Accumulated depreciation		(915,786)	(780,920)
Utility plant—net (Note 2)		2,632,606	2,521,643
Investments and other property		53,967	57,953
Construction funds held by trustee (Note 7)		137,152	48,938
Current assets			
Cash and temporary investments		70,409	152,231
Receivables (less allowance for doubtful accounts: 1986, $1,298; 1985, $1,311)			
Customer		110,026	122,661
Other		17,075	12,173
Materials and supplies—at average cost		45,591	41,336
Fuel inventory—at average cost	b	20,455	30,650
Regulatory balancing accounts undercollected—net		24,039	—
Other		12,153	7,180
Total current assets		299,748	366,231
Deferred charges and other assets		103,704	91,197
Total	c	$3,227,177	$3,085,962
Capitalization and Liabilities			
Capitalization (see Statements of Capital Stock and Long-Term Debt)			
Common equity		$1,205,819	$1,152,984
Preferred stock			
Not subject to mandatory redemption	d	128,493	161,000
Subject to mandatory redemption	d	51,250	57,500
Long-term debt (Note 2)		966,128	967,067
Total capitalization		2,351,690	2,338,551
Current Liabilities			
Long-term debt redeemable within one year (Note 2)		88,000	88,000
Current portion of long-term debt (Note 2)		50,183	17,980
Accounts payable		111,439	138,145
Dividends payable		37,529	37,183
Interest, taxes and other accruals		112,704	84,301
Regulatory balancing accounts overcollected—net		—	5,034
Other		46,358	29,051
Total current liabilities		446,213	399,694
Customer advances for construction		55,636	52,006
Accumulated deferred income taxes—net (Note 5)		173,609	107,941
Accumulated deferred investment tax credits (Note 5)		159,245	153,980
Deferred credits and other liabilities		40,784	33,790
Contingencies and commitments (Notes 6 and 7)		—	—
Total	c	$3,227,177	$3,085,962

See notes to consolidated financial statements.

Excerpts from the Financial Review

a. Construction expenditures in 1986 remained below 10 percent of capitalization. The expenditures were used for the San Onofre Nuclear Generating Station, the Moreno natural gas compressor facility and general upgrading and extension of other facilities to meet record customer growth.

b. An aggressive program of spot market purchases of fuel oil from suppliers in Singapore, Australia, Alaska and California led to a sharp decline in the average cost of fuel oil in inventory.

c. Because of diversification in 1986, the company's financial statements are consolidated. The assets and liabilities include those of all the subsidiaries of SDG&E and Pacific Diversified Capital.

d. Voluntary and sinking fund retirements of preferred stock helped to improve the capital structure in 1986. The company's new, tougher goal is to limit preferred stock to 5 percent to 7 percent of its capitalization.

Statements of Consolidated Sources of Funds for Construction

(In Thousands of Dollars)

For the Years Ended December 31		1986	1985	1984
Funds Provided by Operations				
Net income		**$213,196**	$202,722	$183,467
Non-cash items in net income				
Depreciation and amortization		**140,732**	132,506	115,200
Deferred income taxes and investment tax credits – net		**70,933**	69,829	90,922
Allowance for funds used during construction		**(13,916)**	(8,072)	(23,343)
Other – net		**1,145**	2,468	4,609
Funds provided by operations		**412,090**	399,453	370,855
Dividends		**(153,106)**	(145,713)	(133,556)
Funds reinvested	a	**258,984**	253,740	237,299
Funds Provided (Used) by Long-Term Financing				
Sale of common stock		**125**	43,070	45,387
Sale of first mortgage bonds	b	**122,392**	131,227	77,757
Retirement of long-term financing	b	**(166,750)**	(183,187)	(53,725)
Funds provided (used) by long-term financing		**(44,233)**	(8,890)	69,419
Other Funds Provided (Used)				
Regulatory balancing accounts – net	c	**(29,073)**	27,500	(1,144)
Investments and other property		**3,933**	(5,215)	(7,635)
Construction funds held by trustee		**(88,214)**	(25,448)	131,290
Cash and temporary investments		**81,822**	(5,183)	(142,171)
Receivables		**7,733**	1,806	(3,293)
Fuel inventory		**10,195**	10,991	34,447
Short-term borrowings		**–**	–	(85,000)
Accounts payable		**(26,706)**	26,222	(47,708)
Interest, taxes and other accruals		**28,403**	(11,004)	2,203
Other – net		**39,804**	(23,300)	10,068
Other funds provided (used)		**27,897**	(3,631)	(108,943)
Total additions to utility plant (excluding allowance for funds used during construction)		**$242,648**	$241,219	$197,775

See notes to consolidated financial statements.

Excerpts from the Financial Review

a. The company again surpassed its goal of financing more than 65 percent of its utility plant additions through operations.

b. Debt reductions and the increased use of low-interest, tax-exempt financings were largely responsible for the embedded cost of debt decreasing from 10.5 percent in 1984 to 10.1 percent in 1985 and to 9.6 percent in 1986.

c. The company uses balancing accounts for fuel costs, San Onofre ownership costs and differences between actual and estimated costs and sales volumes. Periodically, the company adjusts rates to amortize the balances.

Statements of Consolidated Changes in Capital Stock and Retained Earnings

(In Thousands of Dollars)

For the Years Ended December 31, 1984, 1985 and 1986	Preferred Stock: Not Subject to Mandatory Redemption	Preferred Stock: Subject to Mandatory Redemption	Common Stock	Premium on Capital Stock	Retained Earnings
Balance, December 31, 1983	$161,000	$63,500	$258,468	$413,427	$285,712
Net income					183,467
Common stock sold (2,369,930 shares)			11,850	33,537	
Current sinking fund requirement		(3,000)			
Dividends declared					
Preferred stock					(24,030)
Common stock					(109,526)
Balance, December 31, 1984	161,000	60,500	270,318	446,964	335,623
Net income					202,722
Common stock sold (1,759,170 shares)			8,796	34,274	
Current sinking fund requirement		(3,000)			
Dividends declared					
Preferred stock					(23,785)
Common stock					(121,928)
Balance, December 31, 1985	161,000	57,500	279,114	481,238	392,632
Net income					213,196
Common stock sold (25,060 shares)			125		
Preferred stock retired (1,300,350 shares)	(32,507)			(7,380)	
Current sinking fund requirement		(6,250)			
Dividends declared					
Preferred stock					(22,172)
Common stock					(130,934)
Balance, December 31, 1986	$128,493	$51,250	$279,239	$473,858	$452,722

See notes to consolidated financial statements.

(In Thousands of Dollars Except Voluntary Redemption Price)

Balance at December 31	Voluntary Redemption Price	1986	1985
Common Equity			
Common stock, $5 par value, authorized 80,000,000 shares, outstanding: 1986, 55,847,822 shares; 1985, 55,822,762 shares		$ 279,239	$ 279,114
Premium on capital stock		473,858	481,238
Retained earnings		452,722	392,632
Total common equity		$1,205,819	$1,152,984
Preferred Stock			
Not subject to mandatory redemption			
$20 par value, authorized 1,375,000 shares			
5% Series, 375,000 shares outstanding	$ 24.00	$ 7,500	$ 7,500
4½% Series, 300,000 shares outstanding	21.20	6,000	6,000
4.40% Series, 325,000 shares outstanding	21.00	6,500	6,500
4.60% Series, 1986, 374,650 shares; 1985, 375,000 shares outstanding	20.25	7,493	7,500
Without par value*			
$9.84 Series, 160,000 shares outstanding (redeemed January 1987)	101.00	16,000	16,000
$7.80 Series, 200,000 shares outstanding	101.00	20,000	20,000
$7.20 Series, 150,000 shares outstanding	102.50	15,000	15,000
$2.68 Series, 1,000,000 shares outstanding (redeemed January 1987)	28.50	25,000	25,000
$2.475 Series, 1,000,000 shares outstanding	29.15	25,000	25,000
$4.65 Series, 1985, 1,300,000 shares outstanding	–	–	32,500
Total not subject to mandatory redemption		$128,493	$161,000
Subject to mandatory redemption			
Without par value*			
$8.25 Series, 1986, 105,000 shares; 1985, 115,000 shares outstanding	104.95	$ 10,500	$ 11,500
$9.125 Series, 1986, 200,000 shares; 1985, 240,000 shares outstanding	113.50	20,000	24,000
$15.44 Series, 250,000 shares outstanding	115.44	25,000	25,000
Current sinking fund requirement		(4,250)	(3,000)
Total subject to mandatory redemption		$ 51,250	$ 57,500

*Authorized 10,000,000 shares total (both subject to and not subject to mandatory redemption).
See notes to consolidated financial statements.

Statements of Consolidated Long-Term Debt

(In Thousands of Dollars)

Balance at December 31	1986	1985
First mortgage bonds (Note 2)		
4⅞% Series G, due October 1, 1987	$ 12,000	$ 12,000
4⅝% Series H, due October 1, 1990	30,000	30,000
5½% Series I, due March 1, 1997	25,000	25,000
7% Series J, due December 1, 1998	35,000	35,000
8¾% Series K, due February 1, 2000	40,000	40,000
8% Series L, due September 1, 2001	45,000	45,000
8⅜% Series M, due January 15, 2004	75,000	75,000
10% Series P, due July 15, 2006	–	45,000
8¾% Series Q, due March 15, 2007	50,000	50,000
9¾% Series R, due May 1, 2008	50,000	50,000
5½% Series U-2, due September 1, 1994	11,268	11,668
17⅜% Series V, due July 15, 2011	–	16,714
16.70% Series W, due November 3, 1987 and 1988	40,000	40,000
16.65% Series X, due September 1, 1986 and 1987	10,000	20,000
16.65% Series Y, due September 1, 1986 and 1987	7,500	15,000
12⅞% Series Z, due July 15, 2013	8,069	39,769
10% Series AA, due June 1, 2018	150,000	150,000
10% Series BB, due September 1, 2018	150,000	150,000
5.25% Series CC, due May 1, 2008	53,000	53,000
8.50% Series DD, due December 1, 2008	27,000	27,000
9¼% Series EE, due September 1, 2020	100,000	100,000
4.75% Series FF, due December 1, 2007	35,000	35,000
7⅝% Series GG, due July 1, 2021	44,250	–
7⅜% Series HH, due December 1, 2021	81,350	–
Total	1,079,437	1,065,151
Other long-term debt		
Pollution control bonds, 6⅜% 1977 Series A, due April 1, 2007	9,575	9,575
Pollution control bonds, 7.20% 1979 Series A, due April 1, 2009	5,700	5,700
Sinking fund debentures, 4½%, due September 1, 1994	1,384	1,412
Other	25,036	7,256
Total	41,695	23,943
Unamortized discount on long-term debt	(16,821)	(16,047)
Long-term debt redeemable within one year (Note 2)	(88,000)	(88,000)
Current portion of long-term debt (Note 2)	(50,183)	(17,980)
Total	$ 966,128	$ 967,067

See notes to consolidated financial statements.

Schedules of Consolidated Financial Information by Segments of Business

(In Thousands of Dollars)

At December 31 or for the Years Then Ended	1986	1985	1984
Operating Revenues*	**$1,634,211**	$1,738,702	$1,620,701
Operating Income			
Electric operations	**$ 258,581**	$ 261,199	$ 224,156
Gas operations	**24,940**	26,668	27,394
Other	**(1,171)**		
Total	**$ 282,350**	$ 287,867	$ 251,550
Depreciation and Amortization			
Electric operations	**$ 123,078**	$ 117,948	$ 101,805
Gas operations	**17,345**	14,558	13,395
Other	**309**		
Total	**$ 140,732**	$ 132,506	$ 115,200
Utility Plant Additions**			
Electric operations	**$ 190,416**	$ 205,469	$ 174,753
Gas operations	**52,232**	35,750	23,022
Total	**$ 242,648**	$ 241,219	$ 197,775
Identifiable Assets			
Utility plant—net			
Electric operations	**$2,384,637**	$2,303,025	$2,197,292
Gas operations	**247,969**	218,618	195,736
Total	**2,632,606**	2,521,643	2,393,028
Materials and supplies			
Electric operations	**40,688**	37,614	39,580
Gas operations	**4,903**	3,722	3,745
Total	**45,591**	41,336	43,325
Fuel inventory			
Electric operations	**20,300**	30,391	40,606
Gas operations	**155**	259	1,035
Total	**20,455**	30,650	41,641
Other identifiable assets			
Electric operations	**252,773**	204,098	218,683
Gas operations	**96,236**	31,809	25,349
Other	**59,666**		
Total	**408,675**	235,907	244,032
Other Assets	**119,850**	256,426	228,669
Total Assets	**$3,227,177**	$3,085,962	$2,950,695

*The detail to operating revenues is provided on the Statements of Consolidated Income on page 19. The gas operating revenues shown thereon include $27 million in 1986, $38 million in 1985 and $47 million in 1984 representing the gross margin on sales to the electric segment. Those margins arise from intersegment sales of $100 million in 1986, $208 million in 1985 and $252 million in 1984 based on transfer pricing allowed by the California Public Utilities Commission in tariff rates.

**Excluding allowance for funds used during construction.

See notes to consolidated financial statements.

The company is an operating public utility engaged principally in the generation, purchase, distribution and sale of electrical energy and the purchase, distribution and sale of natural gas. Income taxes and corporate expenses are allocated to departments in accordance with regulatory accounting requirements.

1 Summary of Accounting Policies

Utility plant and depreciation

Utility plant represents the buildings, equipment and other facilities used to provide electric and gas service. The cost of utility plant includes labor, material, contract services and other related items and an allowance for funds used during construction. The cost of depreciable retired utility plant, plus removal expenses minus salvage value, is charged to accumulated depreciation.

Depreciation expense reflects the straight-line remaining useful life method. The provisions for depreciation approximated the following percentages of average depreciable plant: 4.12 percent in 1986, 4.08 percent in 1985 and 4.09 percent in 1984.

Allowance for funds used during construction

The allowance represents the cost of funds used to finance the construction of utility plant and is added to the cost of utility plant. AFUDC also increases income, partly as an offset to financing costs shown in the Statements of Consolidated Income, although it is not a current source of cash.

Revenues and regulatory balancing accounts

Revenues consist of billings to customers and the changes in regulatory balancing accounts. Billings to customers are based on meters read on a cycle basis throughout each month. Earnings fluctuations from changes in the costs of fuel oil, purchased energy and gas, and consumption levels for electricity and the majority of gas are eliminated by balancing accounts authorized by the California Public Utilities Commission. The balances of these accounts represent amounts that will be recovered from, or repaid to, customers by adjustments to future rates. The CPUC reviews the reasonableness of the amounts in these accounts.

The CPUC also has ordered the use of a balancing account to record the ownership costs, such as depreciation and a return on capital, for San Onofre units 2 and 3 until the issue discussed in Note 6 is resolved.

Other

Certain prior year amounts have been reclassified for comparability.

In 1986, the financial statements are consolidated to include the assets and operations of the subsidiaries. In prior years, the equity method was used.

In 1985, company shareholders approved a proposal that would result in the reorganization of the company into a holding company structure. The company would become a subsidiary of the holding company and common stock shareholders of the company would become the shareholders of the holding company. During 1986, the commission granted permission for the restructuring subject to certain conditions, several of which were unacceptable to the company. The company is reevaluating its alternatives, including reapplication to the commission for conditions that are acceptable to the company.

See Note 4 regarding employee benefit plans, Note 5 regarding accounting for income taxes and Note 7 regarding accounting for leases.

2 Long-Term Debt

Due dates of long-term obligations are shown on the Statements of Consolidated Long-Term Debt on page 22. Combined aggregate maturities and sinking fund requirements of long-term debt are $50 million for 1987, $24 million for 1988, $4 million for 1989, $33 million for 1990 and $2 million for 1991.

First mortgage bonds are secured by a lien on substantially all utility plant. Additional first mortgage bonds may be issued upon compliance with the provisions of the bond indenture.

Certain first mortgage bonds have variable interest rate provisions. Bondholders may elect to redeem their bonds at the interest adjustment dates. The next interest rate adjustment dates will be August 1, 1987 for the Series FF bonds, September 1, 1987 for the Series CC bonds and September 1, 1988 for the Series DD bonds.

3

Facilities Under Joint Ownership

The Southwest Powerlink transmission line and the San Onofre nuclear plant are jointly owned with other utilities. The company's interests at December 31, 1986 were:

(In Millions of Dollars)

Project	Southwest Powerlink	San Onofre
Ownership interest (%)	89	20
Utility plant in service	$209	$1,142
Accumulated depreciation	$ 16	$ 142
Construction work in progress	$ 0	$ 23

Each participant in the projects must provide its own financing.

The company's share of operating expenses is included in its Statements of Consolidated Income.

The company's share of future dismantling and decontamination costs for the San Onofre units is currently estimated to be $170 million. These costs are expected to be recovered in rates over the estimated lives of the plants. Procedures for rate recovery are to be established by the California Public Utilities Commission. These procedures will include placing the amounts collected in a trust fund as they are received.

4

Employee Benefit Plans

A non-contributory, funded pension plan is provided for substantially all employees. Pension costs are based on actuarial determinations and the pension plan is funded on the same basis. A non-contributory, unfunded pension plan for certain officers also is maintained. The accumulated plan benefits and net assets as of the latest benefit information date are presented below:

(In Millions of Dollars)

As of July 1	1986	1985
Actuarial present value of accumulated plan benefits		
Vested	**$149**	$135
Non-vested	**24**	21
Total	**$173**	$156
Net assets available for benefits	**$287**	$226

An 8 percent rate of return was used to determine the actuarial present value of accumulated plan benefits.

Eligible employees may make a contribution of 1 to 11 percent of their base pay to the company's Savings Plan. The company contributes up to 3 percent of a participant's base compensation. Company contributions are invested in the company's common stock. Employee contributions are invested, as the employees elect, in mutual funds or common stock of the company.

The company contributed approximately $16 million in 1986 and $15 million in 1985 and 1984 to these plans.

Employees may participate also in the Employee Stock Ownership Plan. The company's contribution to that plan is funded by tax credits.

The company provides health and life insurance benefits to all retired employees. The benefits paid and expensed amounted to $2 million in each of the years 1986, 1985 and 1984.

A long-term incentive stock compensation plan was approved by company shareholders in April 1986 and provides for aggregate awards of up to 1,350,000 shares of common stock over the 10-year period ending in 1996. In 1986, the company issued 25,060 shares of stock to officers for $5 per share. If certain corporate goals are not met over the next four years, the company will buy back the stock at $5 per share.

5

Income Taxes

Deferred income taxes arise from including income or deductions in the company's income tax returns in a year different from the year they are reported in the financial statements. However, deferred taxes are not provided for those timing differences that are reflected in customer rates. At December 31, 1986, the cumulative net amounts of timing differences for which deferred taxes have not been provided were approximately $445 million for federal purposes and $612 million for state purposes. In addition, current tax reductions arising from investment tax credits are deferred and recognized over the useful lives of the related property.

The Tax Reform Act of 1986 is not expected to have a significant effect on the net income of the company. However, the repeal of the investment tax credit and the changes in the depreciation rules will reduce cash provided by operations.

Components of Income Tax Expense

(In Thousands of Dollars)

	1986	1985	1984
Current federal income tax	**$ 87,231**	$112,340	$ 13,162
Current state franchise tax	**28,060**	36,166	25,894
Total current taxes	**115,291**	148,506	39,056
Deferred – federal and state taxes			
Regulatory balancing accounts – net	**15,935**	(14,010)	609
Construction projects	**2,703**	(19,277)	8,502
Tax over book depreciation	**41,564**	37,553	34,490
Nuclear fuel financing	**(2,693)**	3,211	(3,234)
Capitalized nuclear revenue	**706**	9,104	(3,303)
Call premium on refunded debt	**5,862**	7,785	(298)
State franchise tax	**828**	(3,678)	(4,514)
Other – net	**5,170**	6,150	(4,497)
Total deferred taxes	**70,075**	26,838	27,755
Deferred investment tax credits – net	**5,015**	17,346	70,753
Total income tax expense	**$190,381**	$192,690	$137,564

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

Reconciliation of Statutory Federal Income Tax Rate to Effective Rate

(In Thousands of Dollars)

	1986	1985	1984
Income before federal income taxes	**$369,803**	$365,013	$299,428
Statutory federal income tax rate	**46.0%**	46.0%	46.0%
Construction costs capitalized	**(2.0)**	(5.3)	(3.6)
Depreciation	**3.1**	2.9	2.3
Allowance for funds used during construction	**(1.5)**	(0.7)	(3.6)
Other – net	**(3.2)**	1.6	(2.4)
Effective federal income tax rate	**42.4%**	44.5%	38.7%

6

Contingencies Concerning San Onofre and the Southwest Powerlink

San Onofre Nuclear Generating Station Units 2 and 3

On November 10, 1986, the California Public Utilities Commission released its written decision on the prudency of construction costs for San Onofre nuclear units 2 and 3, owned by the company and Southern California Edison Company. Under the commission's decision, approximately $69 million of the costs incurred by the company in connection with the units' construction would be permanently excluded from rate base. Along with SCE, the company has filed an application for a rehearing of the commission's decision. Although the company is seeking a rehearing with respect to the entire amount of costs disallowed by the commission, the company did not actively challenge the disallowance of $12 million of such costs.

Because the company has been accruing revenue based on full recovery of construction costs, the revenue attributable to the disallowed costs recorded since the plants started operation would have to be reversed. Based on a disallowance of $69 million, such reversal would reduce the company's net income by $26 million after tax, or $.47 per share. Due to the $12 million of disallowed costs which the company did not actively challenge, the company recorded a charge against earnings of $5 million after tax, or $.08 per share, in the fourth quarter of 1986. Future write-offs, if any, related to the remaining $57 million of disallowed costs will be recorded if and when the company has determined that the ultimate disallowance of such costs is probable and the amount of such disallowance can be reasonably estimated.

In December 1986, the Financial Accounting Standards Board issued a rule requiring that the company write off the undepreciated balance of the construction costs disallowed. Implementation of the rule is not required until 1988. If the commission's decision is not modified, the write-off of the $69 million of disallowed costs would reduce the company's net income by an additional $50 million after tax, or $.90 per share. If only the $12 million portion of such costs which the company has not challenged actively is disallowed, such reduction in net income would be $8 million after tax, or $.15 per share.

The above amounts would be one-time charges against earnings. Continuing effects due to the $69 million exclusion from rate base initially would be approximately $7 million after tax per year, and would decline to zero over the remaining 27-year depreciable life of the units. If the amount of costs disallowed is limited to the $12 million which the company has not challenged actively, the continuing effect initially would be approximately $1 million per year and would decline to zero over 27 years.

Management cannot predict the outcome of this matter.

Southwest Powerlink

The company's 1986 General Rate Case decision by the California Public Utilities Commission ordered the company to establish a five-year balancing account for the difference between the cost of energy received over the company's Southwest Powerlink and avoided cost as established by the procedures set forth in the commission's decision. In June 1986, the commission granted the company's request for a rehearing of this portion of the decision. The company now expects a final decision in this matter in late 1987. In the meantime, in response to a commission request, the company has estimated the projected excess of the company's cost of energy received over the Southwest Powerlink over avoided costs from January 1986 through December 1988, when certain purchased power contracts expire, will be approximately $380 million, excluding interest.

In the rehearing, the commission could retain the balancing account mechanism, eliminate it or propose a different mechanism. Because of the uncertainty concerning the outcome of the rehearing and the nature of the process of estimating future power purchases and avoided costs, management cannot predict the ultimate outcome of this matter.

7

Other Contingencies and Commitments

Nuclear insurance

Public liability claims that could arise from a nuclear incident currently are limited by the Price-Anderson Act to a maximum amount of $690 million for each licensed nuclear facility. The company and the co-owners of the San Onofre units have purchased primary insurance of $160 million for this exposure, the maximum amount available in 1986. The remaining $530 million is provided by secondary financial protection required by the Nuclear Regulatory Commission. This secondary coverage provides for loss sharing among utilities owning nuclear reactors if a costly accident occurs. Under the agreement with the NRC, the company could be assessed retrospective premium adjustments of up to $6 million a year in the event of nuclear incidents involving any of the licensed reactors in the United States, if the amount of the loss exceeds $160 million.

The Price-Anderson Act is scheduled to expire in 1987 and Congress is considering several proposals to amend it. The proposals include substantial increases in the maximum claim. The company is unable to predict the effect on its potential liability.

In addition to public liability insurance, coverage is provided for property damage and replacement power costs at San Onofre. Primary property damage coverage is provided for losses of up to $500 million. Additional decontamination liability and excess property damage insurance coverage of $660 million at December 31, 1986 is provided. Replacement power insurance provides weekly indemnity payments for up to two years, commencing after a waiting period of 26 weeks. These three insurance coverages are provided primarily through mutual insurance companies owned by utilities with nuclear facilities. If losses at any of the nuclear facilities covered by the risk-sharing arrangements were to exceed the accumulated funds available for these insurance programs, the company could be assessed retrospective premium adjustments of up to $15 million per year.

Construction

Approximately $196 million, excluding AFUDC, is planned to be spent for utility plant construction in 1987. Construction funds held by a trustee (see Consolidated Balance Sheets, p.18) represent unspent proceeds from certain first mortgage bonds.

Leases

Nuclear fuel, an office building and a generating facility are financed by long-term capital leases. If they were included on the Consolidated Balance Sheets, both assets and liabilities would increase by $234 million at December 31, 1986 and $242 million at December 31, 1985. Generally accepted accounting principles require capitalization of these leases in 1987. Capitalizing these leases would not affect total expenses.

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

(In Millions of Dollars)	
1987	$ 46
1988	48
1989	45
1990	43
1991	36
Thereafter	168
Total future rental commitments	$386

Rent expense totaled $24 million in 1986, 1985 and 1984. In addition, nuclear fuel expense associated with the rental commitments amounted to $21 million in 1986, $20 million in 1985 and $23 million in 1984.

Purchased power contracts

The company buys electric power under several long-term contracts. The contracts expire on various dates between 1988 and 2013.

At December 31, 1986, the future minimum payments under the contracts were:

(In Millions of Dollars)	
1987	$ 203
1988	199
1989	156
1990	110
1991	111
Thereafter	1,506
Total minimum payments	$2,285

These payments are fixed charges. The company is required to pay additional amounts for actual deliveries of energy under the contracts.

Total payments, including energy payments, under the contracts were $231 million in 1986, $158 million in 1985 and $87 million in 1984.

8

Quarterly Financial Data (Unaudited)

These amounts are unaudited, but in the opinion of the company reflect all adjustments necessary for a fair presentation.

(In Thousands Except Per Share Amounts)

Quarter Ended	**March 31**	June 30	September 30	December 31
1985				
Operating revenues	**$447,300**	$403,503	$433,102	$454,797
Operating expenses	**371,667**	337,579	362,918	378,671
Operating income	**75,633**	65,924	70,184	76,126
Other income	**5,090**	6,548	6,194	10,237
Net interest charges	**29,840**	28,720	27,359	27,295
Net income (before preferred dividend requirements)	**50,883**	43,752	49,019	59,068
Preferred dividend requirements	**5,989**	5,963	5,923	5,922
Earnings applicable to common shares	**$ 44,894**	$ 37,789	$ 43,096	$ 53,146
Average common shares outstanding	**54,428**	54,952	55,383	55,721
Earnings per common share*	**$ 0.82**	$ 0.69	$ 0.78	$ 0.95
1986				
Operating revenues	**$433,750**	$399,238	$392,285	$408,938
Operating expenses	**360,285**	334,703	320,153	336,720
Operating income	**73,465**	64,535	72,132	72,218
Other income	**20,579**	7,294	5,685	9,239
Net interest charges	**27,307**	26,605	27,656	30,383
Net income (before preferred dividend requirements)	**66,737**	45,224	50,161	51,074
Preferred dividend requirements	**5,922**	5,890	5,811	4,802
Earnings applicable to common shares	**$ 60,815**	$ 39,334	$ 44,350	$ 46,272
Average common shares outstanding	**55,823**	55,823	55,826	55,848
Earnings per common share*	**$ 1.09**	$ 0.70	$ 0.79	$ 0.83

*Because these earnings are based on average common shares outstanding during the quarter, the sum of quarterly earnings per share does not equal annual earnings per share.

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

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

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

The company's independent public accountants, Deloitte Haskins & Sells, are engaged to examine the company's financial statements in accordance with generally accepted auditing standards for the purpose of expressing their opinion as to whether the company's financial statements are presented fairly in accordance with generally accepted accounting principles applied on a consistent basis.

The audit committee of the board of directors meets periodically with management, the independent public accountants and the internal auditors to ensure that each is carrying out its responsibilities, and to discuss auditing, financial reporting and internal control matters. The independent public accountants and the company's internal auditors have full and free access to the audit committee throughout the year.

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

FH Ault

Frank H. Ault
Controller

Auditors' Opinion

Deloitte Haskins & Sells
Certified Public Accountants
701 B Street
San Diego, California 92101

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

We have examined the consolidated financial statements and schedules of San Diego Gas & Electric Company and its subsidiaries (pages 17 to 29) for the years ended December 31, 1986, 1985 and 1984. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note 6 to the consolidated financial statements, the California Public Utilities Commission is considering matters relating to San Onofre Nuclear Generating Station units 2 and 3 and to the cost of energy received over the company's Southwest Powerlink. The outcome of these matters is uncertain at this time and could result in the reversal of revenues previously recorded.

In our opinion, subject to the effects of such adjustments, if any, as might have been required to the 1986, 1985 and 1984 consolidated financial statements had the outcome of the San Onofre matter been known and to the 1986 consolidated financial statements of such adjustments had the outcome of the Southwest Powerlink matter been known, such consolidated financial statements and schedules present fairly the financial position of the company and its subsidiaries at December 31, 1986 and 1985 and the results of their operations and the sources of funds for construction for each of three years in the period ended December 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

February 9, 1987

Deloitte Haskins + Sells

San Diego Gas & Electric is an investor-owned energy management company founded in 1881. It has 4,815 full-time employees.

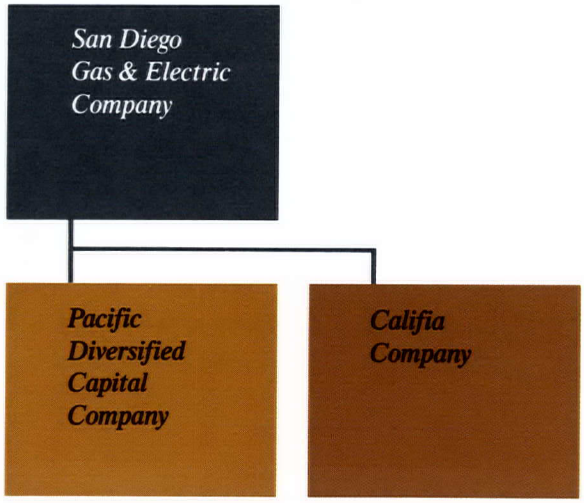
The electric operations division purchases, generates and distributes energy to 940,000 customers in San Diego County and the southwestern section of Orange County. The service area covers 4,100 square miles and has a population of more than two million.

The systemwide electric customer growth rate was 5.25 percent in 1986, among the highest in the country. The Orange County service area, which is the smallest in total number of customers, had a 9.7 percent growth rate, the highest in the company's system.

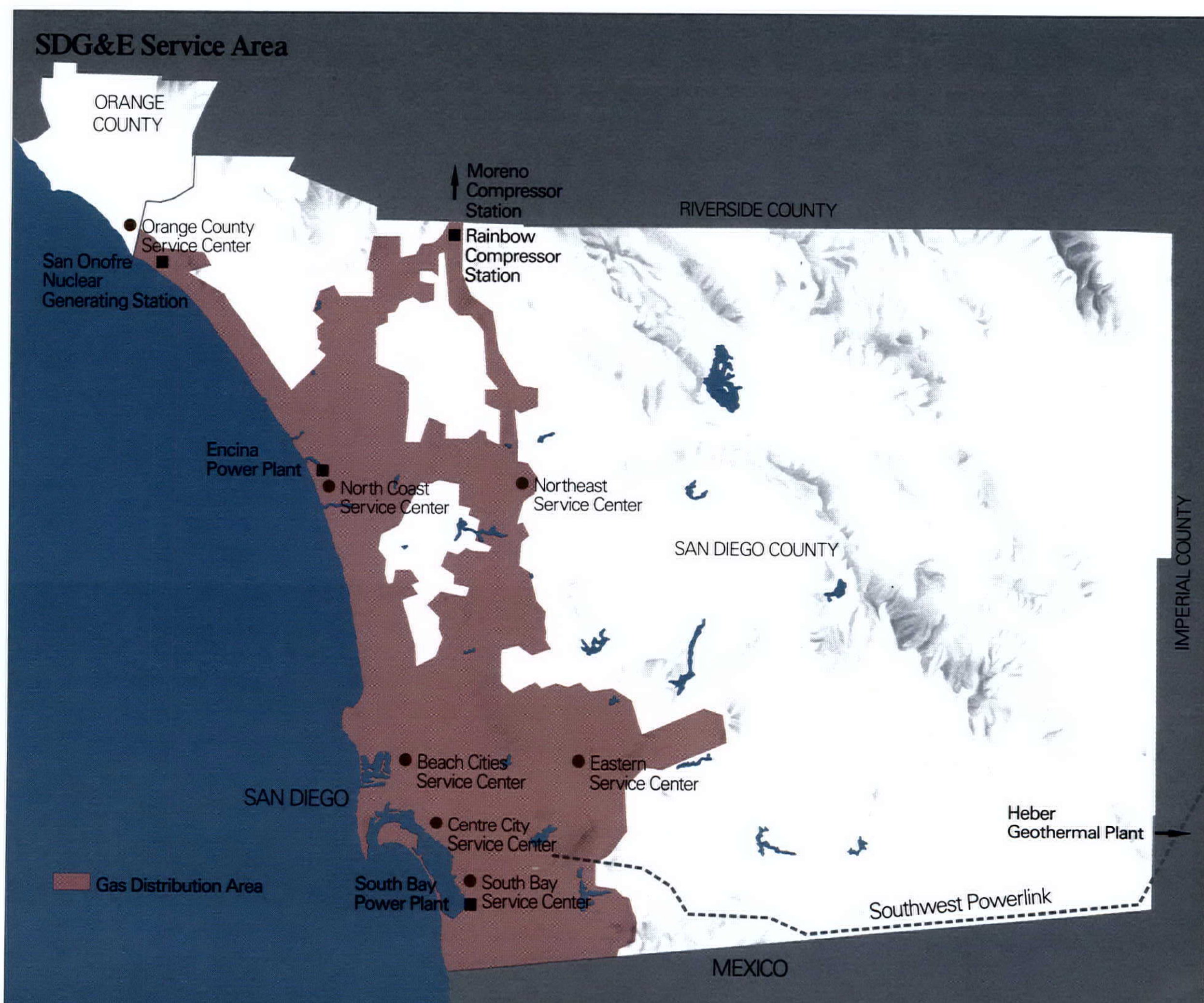
SDG&E's gas operations division purchases and distributes natural gas to 595,000 customers in San Diego County. The gas service area has been expanding, most recently eastward along the international border. The gas customer growth rate was 4.2 percent in 1986.

Among the company's major assets: a 20 percent interest in three nuclear units at the San Onofre Nuclear Generating Station in northwestern San Diego County; the Encina and South Bay power plants, which can burn either fuel oil or natural gas; the Southwest Powerlink 500,000-volt transmission line, which runs between San Diego and Phoenix; the Moreno and Rainbow gas compressor stations; and the natural gas pipeline system in SDG&E's gas service area. Seven service centers are located regionally in the service territory.

SDG&E has two subsidiaries: Pacific Diversified Capital, an independently operated holding company; and Califia Company, an inactive financing company. (Additional information on Pacific Diversified begins on page 36.)



SDG&E's electric service area covers all of San Diego County and the southwestern section of Orange County. The gas service area, which is gradually expanding, is shown in color. The newly expanded Moreno gas compressor station is located in Riverside County, 35 miles north of the San Diego county line.



Officers

Thomas A. Page, 53
Chairman, President and Chief Executive Officer

Thomas Page was elected chairman in 1983. He has been president and chief executive officer since 1981. He joined SDG&E in 1978 as a senior officer.

Jack E. Thomas, 54
Executive Vice President and Chief Operating Officer

Jack Thomas was elected executive vice president in 1985 and chief operating officer in 1986, after serving as a group vice president since 1980 and a vice president since 1972. He joined SDG&E as an engineer in 1957.

Operations Officers

Gary D. Cotton, 46
Senior Vice President – Engineering and Operations

Gary Cotton was elected senior vice president in 1985 after serving as a vice president since 1979. He was appointed to his current position in November 1986. Cotton joined SDG&E in 1975.

Alton T. Davis, 49
Senior Vice President – Customer Services

Alton Davis was elected senior vice president in 1985 after serving as a group vice president since 1981 and a vice president since 1976. He was appointed to his current position in November 1986. Davis joined SDG&E in 1968.

Donald E. Felsinger, 39
Vice President – Marketing

Donald Felsinger was elected a vice president in 1983 and was appointed to his current position in November 1986. Felsinger joined SDG&E in 1972.

Ronald K. Fuller, 49
Vice President – Governmental and Regulatory Services

Ronald Fuller was elected vice president of regulatory services in 1983. Governmental services was added to the division in 1984. He joined the company in 1974.

John E. Hamrick, 60
Vice President – Administrative Services

John Hamrick was elected a vice president in 1973 and named to his current position in November 1986. He joined the company in 1971.

James C. Holcombe, 41
Vice President – Fuel and Power Contracts

James Holcombe was elected a vice president in 1983 and named to his current position in April 1985. He joined the company in 1967.

Richard L. Manning, 55
Vice President – Public Relations

Richard Manning has been vice president – public relations since he joined SDG&E in 1981 from the Western Oil & Gas Association, where he was manager of public affairs.

Ronald W. Watkins, 45
Vice President – Information Services

Ronald Watkins, a vice president since 1979, was appointed to his current position in November 1986. He joined the company in 1967.

Financial Officers

R. Lee Haney, 47
Vice President – Finance and Chief Financial Officer

Lee Haney was elected a vice president in 1983 and appointed to his current position in April 1986. He joined SDG&E in 1972.

Frank H. Ault, 42
Controller

Frank Ault was elected controller in May 1986 after serving as director – internal auditing. Ault joined SDG&E in 1969.

Margot A. Kyd, 33
Treasurer

Margot Kyd was elected treasurer in April 1986 after serving as manager of financial services. Kyd joined SDG&E in 1980.

Staff Officers

Stephen L. Baum, 46
Vice President and General Counsel

Stephen Baum joined SDG&E as vice president and general counsel in 1985 from the Power Authority of the State of New York, where he was senior vice president and general counsel.

Delroy M. Richardson, 48
Secretary

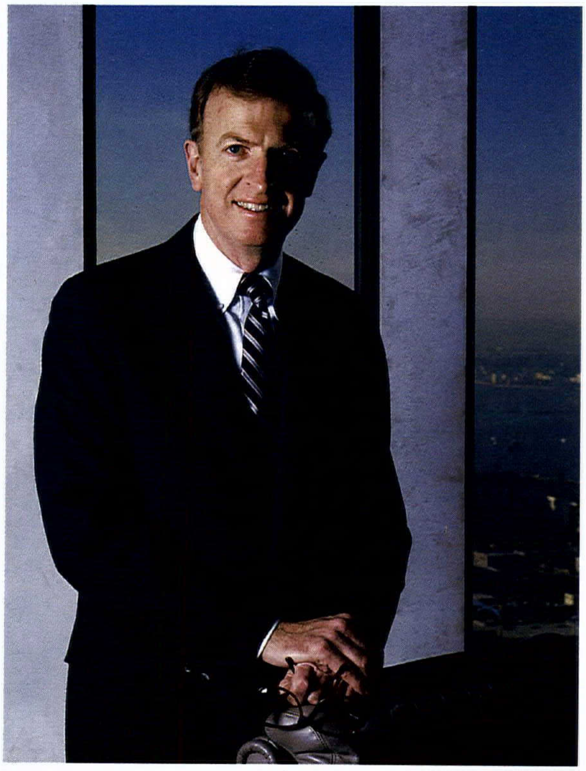
Delroy Richardson was elected secretary in December 1986 after serving as assistant secretary since 1983. He joined SDG&E as an attorney in 1971.

George A. F. Weida, 50
Vice President – Human Resources

George Weida joined SDG&E in 1983 as a vice president and was named head of the human resources division in 1984. Previously, he was head of human resources for other major U.S. corporations.

Board of Directors

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

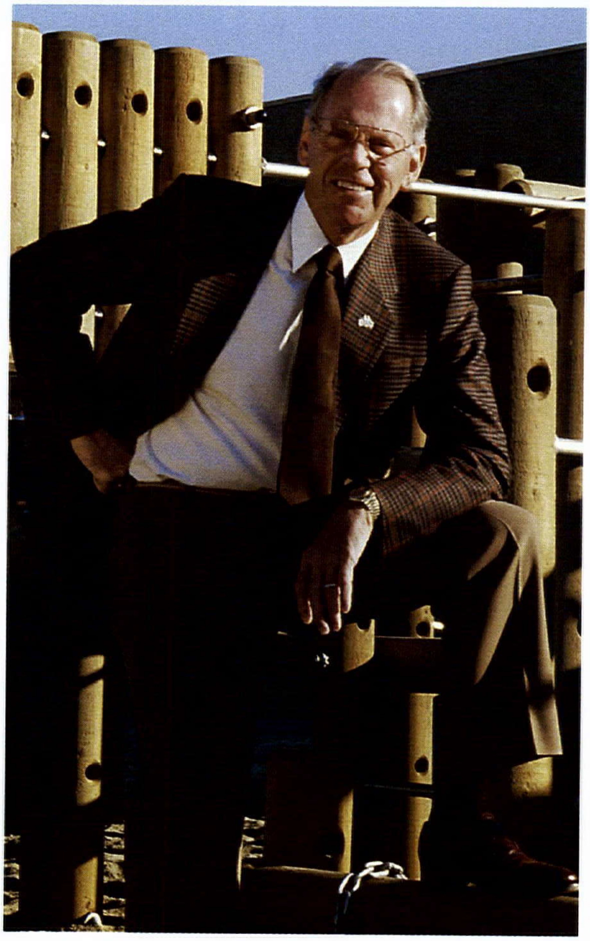


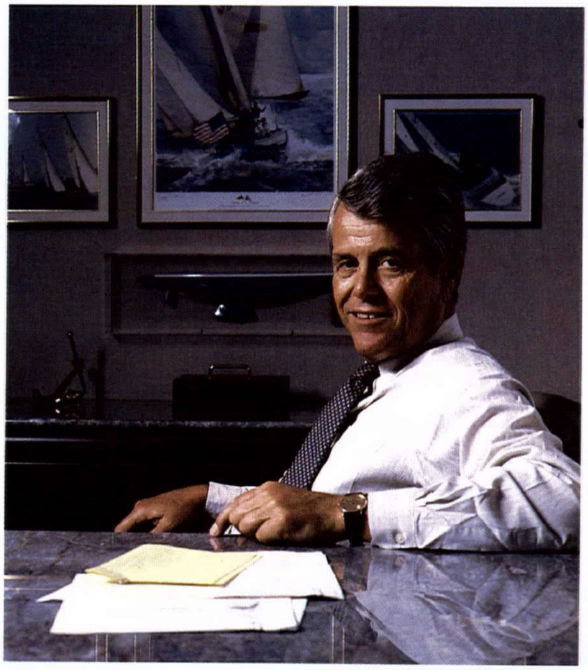
Thomas A. Page*
Thomas Page, 53, a director since 1979, has been chairman of the board since 1983. He is president and chief executive officer of SDG&E. Page is a certified public accountant and licensed professional engineer with an extensive management background. He currently is chairman of the San Diego Economic Development Corporation.

◄ In the corporate headquarters of SDG&E.

Clair W. Burgener
Clair Burgener, 65, a director since 1983, is president of Burgener Properties, Inc., a real estate and property development firm. Earlier, he served 24 years in elected public office. Burgener serves on the boards of several community service organizations. In 1972, a public school for the trainable mentally retarded in Oceanside, California was named for him, one of many honors he has received for his public service work.

With new playground ► equipment at the Burgener School, which was paid for and installed by SDG&E employees.





▲ In his office in the new corporate headquarters of John Burnham & Co. in downtown San Diego.

Malin Burnham*
Malin Burnham, 59, a director since 1967, is chairman of John Burnham & Co., an insurance, real estate and real estate finance firm. He is chairman of First National Bank located in San Diego and serves as a director of Cubic Corporation. A life-long sailor, Burnham is president of Sail America, San Diego's successful 1987 America's Cup challenger.

*Member of the executive committee

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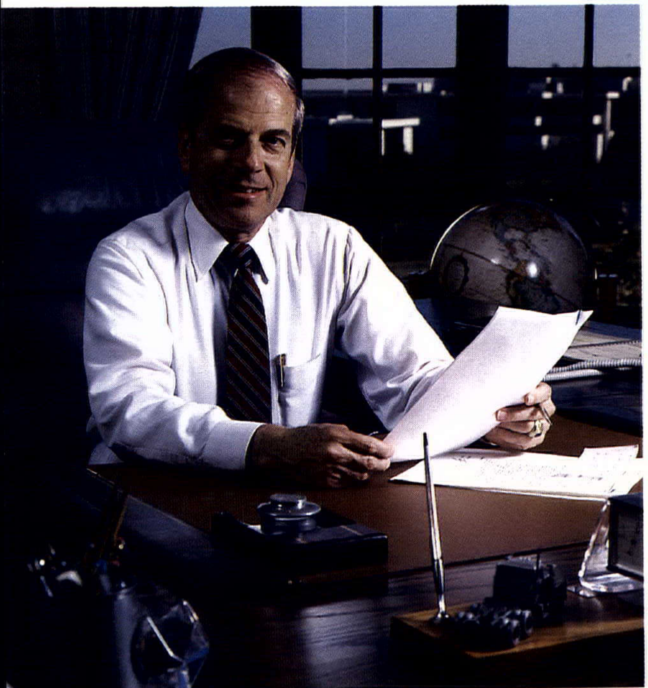


Daniel W. Derbes*
Daniel Derbes, 56, a director since 1983, has been president of Allied-Signal International Inc. and executive vice president of Allied-Signal Inc. since the company was formed in 1985. From 1983 to 1985 he was president of the Advanced Technology Group of The Signal Companies, Inc. Derbes is a director of The Garrett Corporation, Ampex Corporation and WD-40 Company. He also is involved with many community organizations.

◀ In the headquarters of Allied-Signal International.

▲ In front of the library on the campus of the University of California at San Diego.

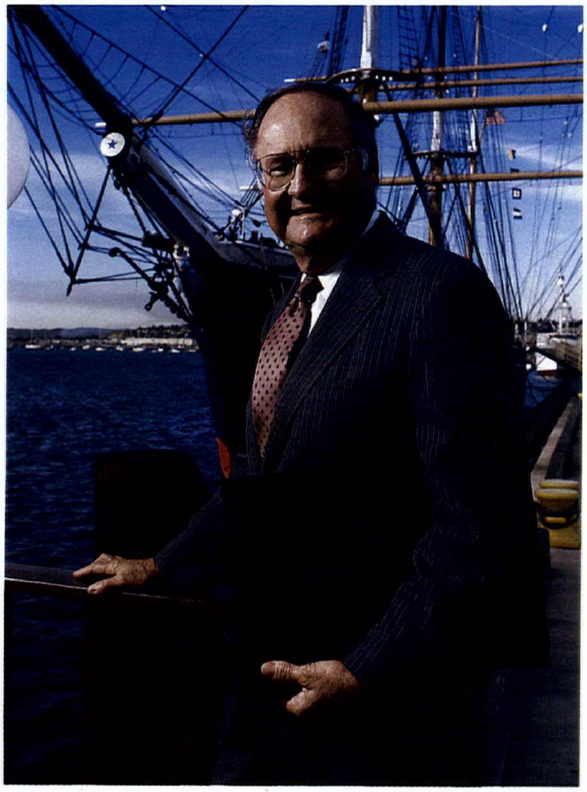
William D. McElroy
William McElroy, 70, a director since 1979, is a professor of biology and former chancellor of the University of California at San Diego. As a distinguished member of the country's scientific community, he has received many honorary degrees and awards. He is the author and editor of numerous scientific textbooks and articles.

Ralph R. Ocampo
Dr. Ralph Ocampo, 55, a director since 1983, is a physician and surgeon. He has been active throughout his career in many professional associations and in community activities. He currently is a director of the Mercy Hospital and Medical Center, the San Diego chapter of the American Cancer Society and the San Diego Community Foundation. He served as president of the Hispanic American University Foundation in 1986.

▲ In Mercy Hospital, San Diego.

Charles R. Scott*
Charles Scott, 58, a director since 1983, has been president and chief executive officer of Intermark, Inc. since 1970. Intermark owns and/or controls a diversified group of operating companies including Pier 1 Imports, Mission West Properties, The Triton Group, Ridgewood Properties and the Sunbelt Nursery Group. Scott has served on the boards of many civic, charitable and industrial organizations. In 1984, Scott was a national recipient of the Horatio Alger Award, one of several awards he has received.

In front of Intermark's ▶ headquarters in La Jolla.

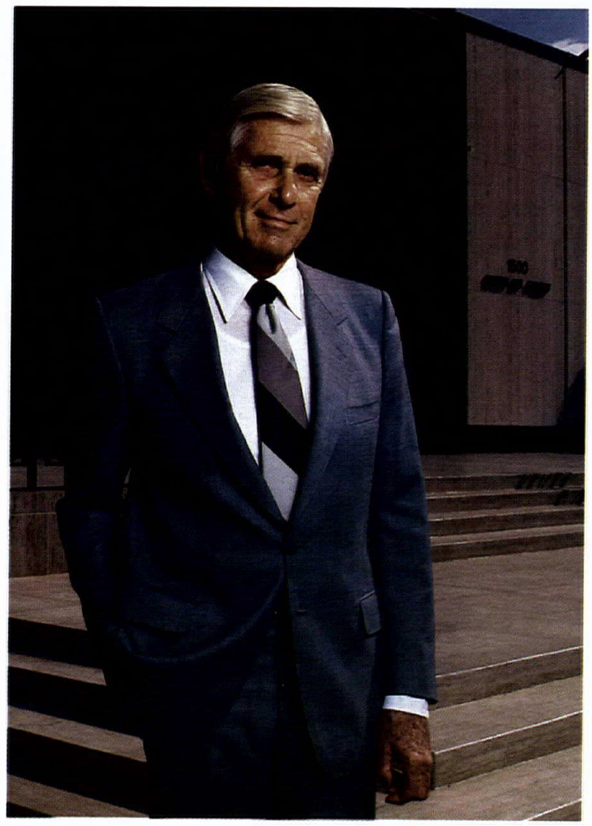


O. Morris Sievert*
Morris Sievert, 65, a director since 1976, was a corporate executive officer, primarily in the energy industry, from 1957 until his retirement in early 1987. Sievert currently is a private investor. He serves as a member of the board of directors of the Scripps Memorial Hospital Foundation and of San Diego's annual Holiday Bowl.

◄ Near the historic merchant vessel Star of India, a short walk from SDG&E's corporate offices.

Fred C. Stalder
Fred Stalder, 66, a member of the board since 1969, was chief executive officer of Central Federal Savings and Loan in San Diego from 1948 until his retirement in 1985. He currently is a private investor. Stalder has been involved with and has provided leadership to many San Diego area civic and cultural organizations for 40 years.

In front of the Timken Art Gallery, located in San Diego's Balboa Park. ▼



Catherine Fitzgerald Wiggs
Catherine Fitzgerald Wiggs, 53, a director since 1979, is a management advisor on organization structure and effectiveness and long range planning of human resources. In the nine years prior to establishing her own consulting business in 1986, she was executive vice president of human resources and a member of the executive committee for The Broadway Department Stores.

◄ Near The Broadway store in downtown San Diego's Horton Plaza.

Committees of the Board

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

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

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

Finance
This committee plans and counsels with management concerning the company's capital requirements, proposed financing programs and capital risk exposure analyses and reviews the general investment policy and investment performance for the Pension Plan and the Savings Plan.

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

*Member of the executive committee

Among Pacific Diversified Capital's stated goals is to have its earnings reach 10 percent of the total corporate earnings of SDG&E by 1991 and 25 percent by 1996 through mergers, acquisitions and investments in other companies.

PDC began working toward this goal in 1986. It sought candidates and many were reviewed during the year. While few fit the established profile, three companies did.

In October, PDC acquired the assets of Phase One Development, Inc., a San Diego-based commercial real estate development company.

Also in October, PDC acquired all the stock of Computing Solutions Inc., of Port Chester, New York, a computerized mapping software company. It was merged into Integrated Information Systems, a marketer of a computerized mapping service to the utility industry.

In December, PDC acquired a majority interest in Mock Resources, Inc., an Irvine, California-based marketer and distributor of natural gas and petroleum products. It has 130 employees.

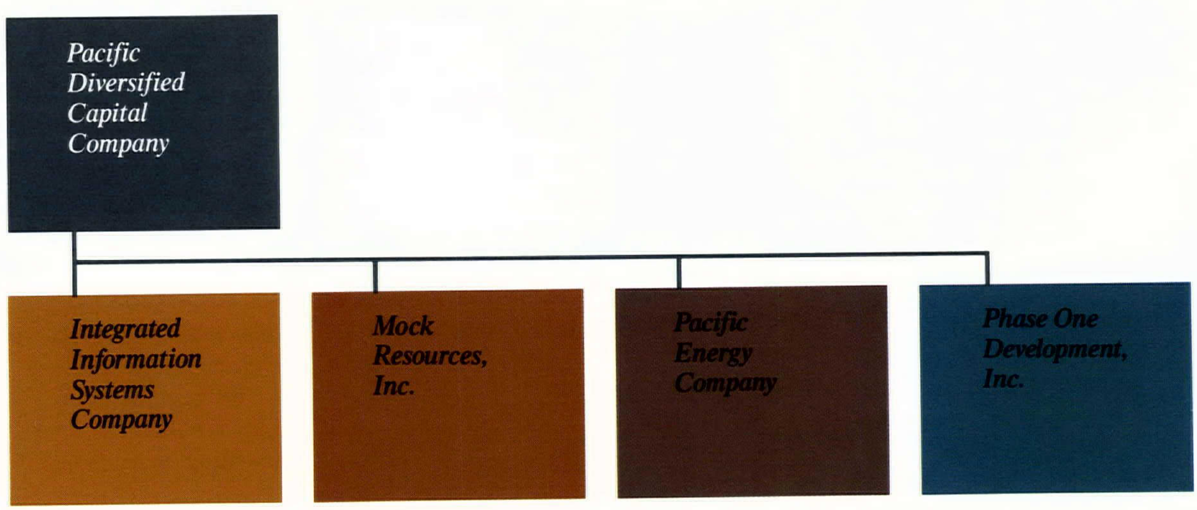
Richard Korpan, president and chief executive officer of PDC, says, "Companies often have more than one potential buyer and the process is something like a courtship. Many things must be considered. We're finding corporate executives are very responsive to being acquired by Pacific Diversified Capital because of our philosophy of keeping intact the management team of acquired companies.

"We still have a substantial amount of cash available for our 1987 acquisition program, but if we need to, we will do some debt financing. The acquisition rate in 1987, by design, will be slower.

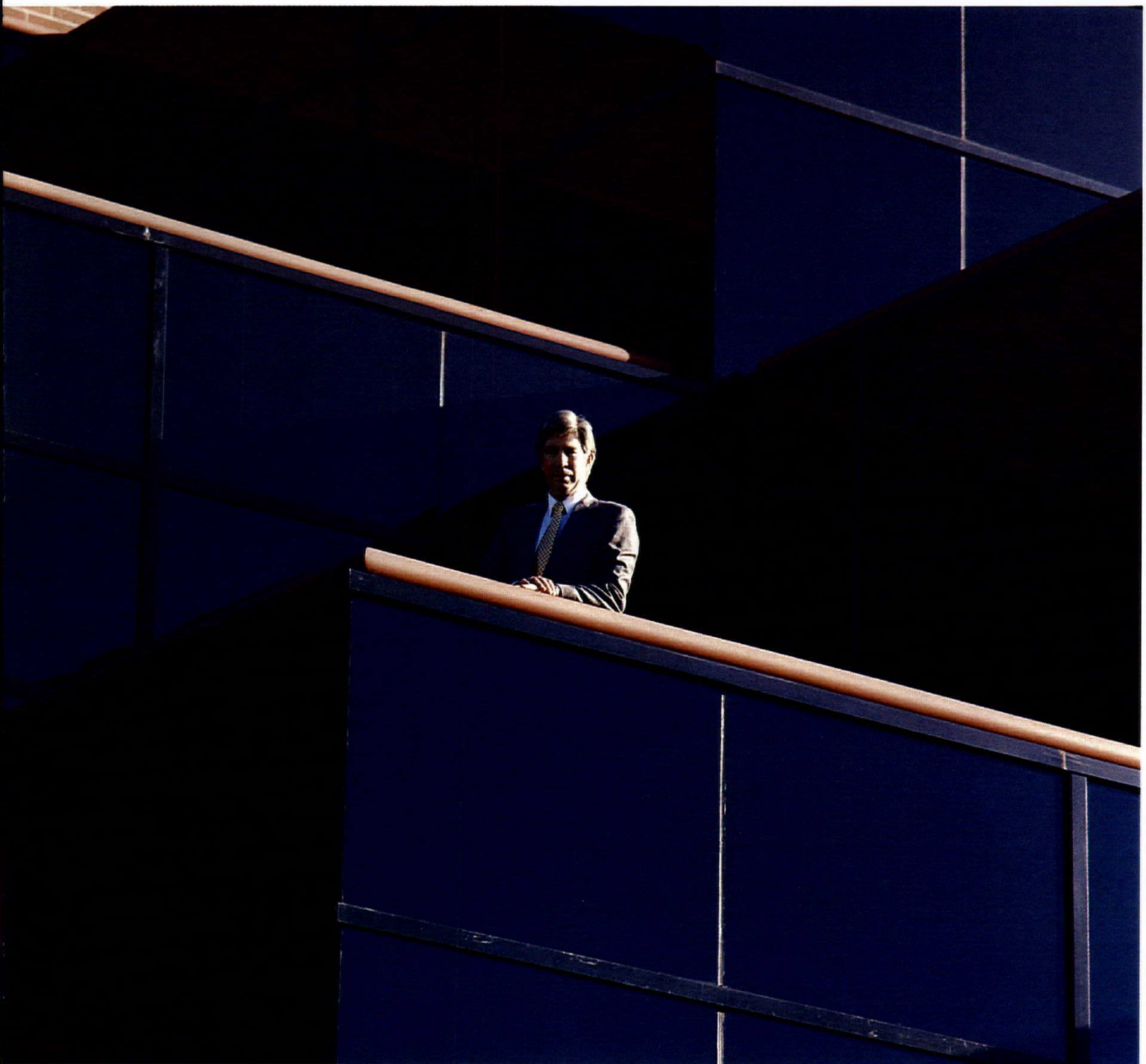
"In 1986, we did exactly what we said we were going to do. We said we would acquire two or three companies and we did. We said the acquired companies would be in three specified industries and they were. And we said we wanted management to remain with the acquired companies and they are.

"We are well aware that diversification is a difficult thing to do properly. Therefore, we will continue to follow our plan in a disciplined manner."

Richard Korpan (center), president and chief executive officer of Pacific Diversified Capital, formerly was SDG&E's chief financial officer. Henry Huta (right) joined PDC in 1986 as vice president and chief financial officer. He formerly held several senior management positions at Ducommun, Inc., where he helped formulate the company's strategic plan. Paul Rasmussen (left) is director of mergers and acquisitions. He formerly was manager of SDG&E's growth opportunities department. PDC's corporate staff totals six employees.



Officers



Retaining key management is an important element in PDC's acquisition strategy. Steven Davis, president and founder of Phase One Development, Inc., continues as the company's president. He's on a balcony of a Phase One commercial building in San Diego's Sorrento Valley Science Park.

Areas targeted for investment in PDC's strategic plan: real estate and products or services to utilities or their customers. Mock Resources, Inc. fit the latter profile and met other specific PDC acquisition standards. A majority interest in the company was acquired in December 1986.

Pacific Diversified Capital Company

Richard Korpan, 45
President and
Chief Executive Officer

Henry N. Huta, 39
Vice President and
Chief Financial Officer

Subsidiaries:

Integrated Information Systems Company

Chris Harlow, 42
President and
Chief Executive Officer

Thomas E. Anderson, 37
Vice President
and General Manager

Charles Kogan, 49
(Founder of Computing Solutions, Inc.)
Vice President

Michael J. Shaughnessy, 35
Vice President – Marketing
and Business Development

Mock Resources, Inc.

Brian Mock, 40
President

Christopher P. Kunzi, 36
Executive Vice President

Phase One Development, Inc.

Steven L. Davis, 42
President

G. Eric Gossett, 44
Executive Vice President – Construction and Finance

James M. Justice, 42
Vice President and
Manager – Colorado Springs

Lee Haney, vice president-finance, at an interview in New York City with Dan Tanz of Electric Utility Week. Interviews such as this one help introduce the company to potential investors and update present investors on SDG&E's activities. Haney participated in 50 such interviews, conducted in New York, Los Angeles and San Francisco as well as San Diego.

Telling how SDG&E sets goals and then works thoughtfully and carefully to achieve them is the subject of this Annual Report. Here's one final example.

In last year's Annual Report it was stated that the number of institutional shareholders had increased to 127 and that the company would like to have even more institutional interest in its stock, especially by portfolio managers, who control billion-dollar investment funds.

To achieve this, a two-pronged approach was planned. First, more meetings were scheduled with financial analysts and with current and potential institutional investors.

Second, SDG&E increased its financial media relations program. This helped the company to reach even more potential investors, including individuals, and to reinforce the contacts made at the meetings with institutional investors.

By year's end, 44 meetings with financial analysts and institutional investors had been held in 12 different cities. The company's financial executives were interviewed, in person or by phone, more than 200 times. In 1986, articles appeared in many major publications including Forbes, Business Week, Wall Street Journal, Los Angeles Times, San Diego Union and USA Today.

The important result of this concerted, well-planned effort was that the number of institutional investors had risen to about 150 by December 31. This represented an estimated 31 percent of the common stock ownership of the company.

"While there's a lot of competition for investment money, we have a very good story to tell," says Lee Haney, vice president-finance. "Our overall return to shareholders, in the top 19 percent of the utility industry, is appealing as is our focus on the need to improve the price of our stock. Financial professionals also have told us they like the strong goal orientation of our management team. They tell us this is not so in many other companies.

"In our meetings with fund managers and analysts, we discovered there is a preference for investing in companies with which they are familiar. In 1986, we concentrated on meeting people we had not met before. This year we will follow up with them and visit new cities to talk with other potential institutional investors."

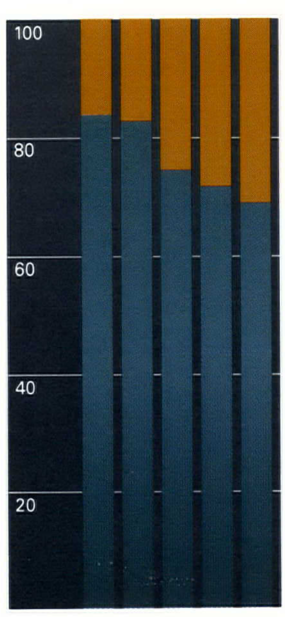
Investor Profile

(by percent)

Institutions

Individuals

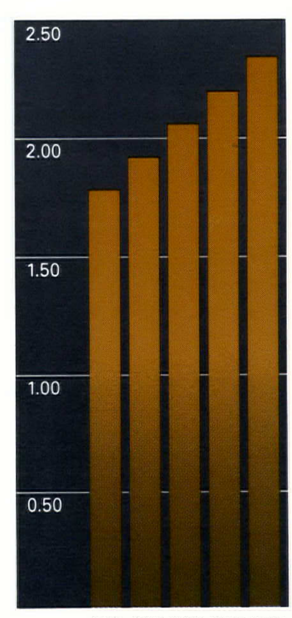
SDG&E's continuing effort to interest financial institutions in its stock has been successful.



Dividends Per Share

(declared, in dollars)

Dividends were increased in 1986 for the tenth consecutive year. For the fifth year in a row, the rate of increase exceeded the rate of inflation.



Finance and Operations Terminology

Allowance for funds used during construction
The net cost of funds used to finance construction. This cost is added to construction work in progress and credited to interest expense and other income.

Book value per share
The total value of common equity divided by the number of shares of common stock outstanding.

Cash flow
An indication of how much cash a company is able to generate in order to meet its debt payments, to invest in new equipment and other assets and to pay dividends.

Cogeneration
The production of thermal and electrical energy from one primary fuel. Commercial and industrial firms use waste heat from their own operations.

Internal generation of funds
The funds produced by the normal operations of the company for plant additions. It is usually expressed as a percentage of total expenditures for new construction.

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

Peak demand
The time, or season, when there is the greatest customer demand for energy. For SDG&E's electric operations division, this occurs during the day in the summer and for the gas operations division in the early morning in the winter.

Purchased power
Electric energy purchased from other sources. In 1986, this included coal, geothermal and hydropower, amounting to 43 percent of the system's total energy needs.

Stock Listing and Trading Information

Common stock: Ticker symbol is SDO. Listed on New York and Pacific stock exchanges. Newspaper listing is SDieGs.

Preferred and preference stocks: Ticker symbol SDO. Listed on the American and Pacific stock exchanges (except for the 4.60% preferred series and the $8.25, $9.125 and $15.44 preference series, which are not listed). Newspaper listing is SDgo.

Transfer Agents and Registrars Information

The transfer agent has primary responsibility for stock transfers and the cancellation and issuance of stock certificates. The agent should be contacted directly about these subjects.

Common stock transfer agents:

California First Bank
8155 Mercury Court
Post Office Box 2529
San Diego, California 92112
(619) 230-4487
(Also the registrar of common stock in San Diego)

First Interstate Bank of California
c/o Schroder Trust Company
One State Street
New York, New York 10015
(Also registrar of common stock in New York)

Preferred and preference stock transfer agents and registrar:

California First Bank
(listed above)

First Interstate Bank
(listed above)
(Preference series only except the $8.25 and $9.125 series)

Annual Meeting Information

The Annual Meeting of Shareholders is held on the fourth Tuesday in April. In 1987, the meeting will begin at 11 a.m., April 28 in the auditorium of the Electric Building, 101 Ash Street, San Diego, California.

Shareholder Profile

There were 73,771 common stock shareholders of record and 9,672 preferred and preference stock shareholders as of December 31, 1986. There are thousands of other individual shareholders whose accounts are held by the securities dealers and nominees.

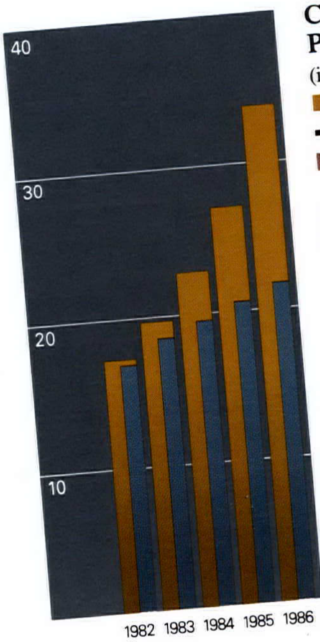
Common stock shareholders:	
Joint Accounts	25,390
Women	22,526
Men	15,781
Fiduciaries	8,998
Securities dealers, nominees, other	1,076

Location:	
United States, except California	37,542
California, except SDG&E service area	22,086
SDG&E service area	13,93
Foreign countries	20

Shares owned:	
1–99 shares	14,1
100–300	41,0
301–500	9,1
501–1000	6,3
1001 or more shares	3,0

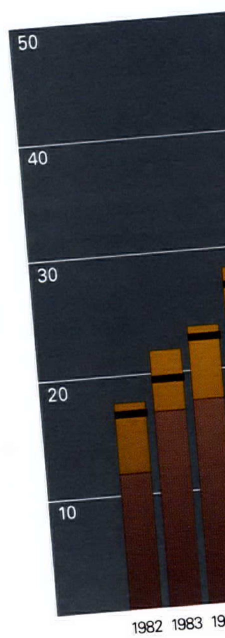
Common Stock Data
(in dollars, at December 31)
Market Price
Book Value

The price of a share of common stock closed the year at $33.875, giving the company a market price-to-book value ratio of 156 percent.



Common Stock Price Trend
(in dollars)
High
Year End
Low

A record high stock price of $42.50 was reached in September 1986. Favorable reports by several financial analysts and investment newsletters reflected the company's continuing financial improvements.



Selected Financial Data

At December 31	1986	1985	1984	1983	1982	1981
Current assets*	**$ 299.7**	$ 366.2	$ 393.8	$ 267.3	$ 303.9	$ 302.4
Current liabilities*	**$ 446.2**	$ 399.7	$ 348.0	$ 426.4	$ 440.5	$ 450.5
Working capital*	**$ (146.5)**	$ (33.5)	$ 45.8	$ (159.1)	$ (136.6)	$ (148.1)
Working capital ratio	**.7**	.9	1.1	.6	.7	.7
Long-term debt*	**$ 966.1**	$ 967.1	$ 1,034.8	$ 1,036.4	$ 785.1	$ 727.2
Common shares outstanding	**55,847,822**	55,822,762	54,063,592	51,693,662	48,266,144	41,499,034
Book value per common share	**$ 21.59**	$ 20.65	$ 19.48	$ 18.52	$ 16.94	$ 16.20
Price/Earnings ratio	**9.9**	8.3	7.6	6.1	5.9	5.3
For Year Ended December 31						
Capital expenditures*/**	**$ 242.6**	$ 241.2	$ 197.8	$ 292.0	$ 252.8	$ 209.7
Pre-tax income/revenue	**24.7%**	22.7%	19.8%	18.7%	15.3%	10.2%
Return on equity	**16.0%**	16.2%	15.8%	18.2%	17.5%	14.5%
Effective federal tax rate	**42.4%**	44.5%	38.7%	31.2%	24.0%	4.7%
Earnings per common share	**$ 3.42**	$ 3.25	$ 3.01	$ 3.20	$ 2.90	$ 2.34
Dividend payout ratio (declared)	**68.6%**	68.1%	68.8%	60.7%	62.4%	71.1%
Price range of common shares	**$42½–$26¾**	$28⅜–$21½	$23¾–$17⅝	$ 22–$17	$17⅞–$11¾	$ 14–$11

*In millions of dollars.

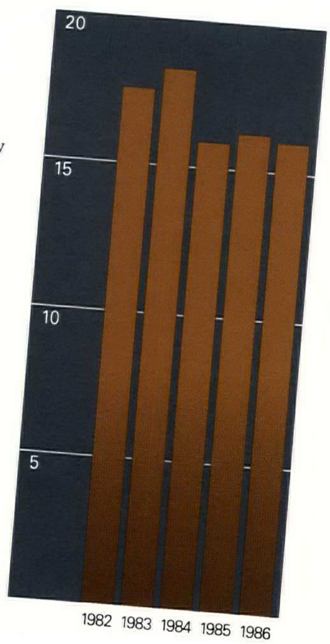
*Excluding allowance for funds used during construction.

Quarterly Common Stock Data

r Ended December 31	1986 First Quarter	1986 Second Quarter	1986 Third Quarter	1986 Fourth Quarter	1985 First Quarter	1985 Second Quarter	1985 Third Quarter	1985 Fourth Quarter
rket Price								
High	34¼	36¾	42½	37⅝	24	28⅜	27½	28¼
ow	26¾	31⅜	34⅜	33¾	21½	23⅞	24⅛	25
idends declared	56¢	59.5¢	59.5¢	59.5¢	52.5¢	56¢	56¢	56¢

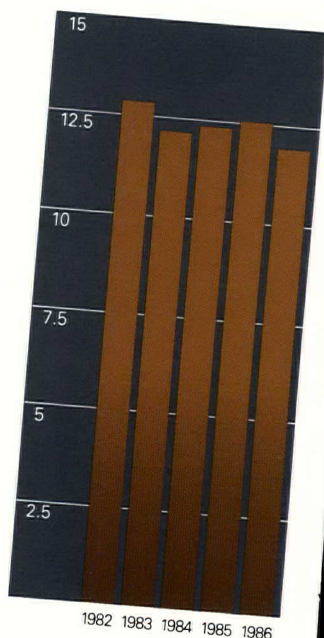
Financial Return on Equity
(weighted average)
(by percent)

Financial return on equity is measured by earnings applicable to common shares divided by average common equity. The company's authorized rate of return was decreased by the California Public Utilities Commission in 1986.



Financial Return on Rate Base
(weighted average)
(by percent)

Financial return on rate base is operating income divided by average rate base. In 1986, a lower authorized rate of return contributed to the decline.



Compound Annual Growth Rate 5 Years (%)	1980	1979	1978	1977	1976	Compound Annual Growth Rate 10 Years (%)
(0.2)	$ 308.8	$ 218.9	$ 180.2	$ 171.3	$ 128.5	8.8
(0.2)	$ 379.6	$ 304.5	$ 215.8	$ 224.3	$ 178.3	9.6
–	$ (70.8)	$ (85.6)	$ (35.6)	$ (53.0)	$ (49.8)	–
–	.8	.7	.8	.8	.7	–
5.8	$ 732.3	$ 640.1	$ 573.1	$ 572.6	$ 489.6	7.0
6.1	36,469,483	31,188,237	27,592,809	22,648,992	19,281,308	11.2
5.9	$ 16.06	$ 17.35	$ 17.41	$ 17.36	$ 16.72	2.6
–	11.6	7.3	7.3	6.7	6.8	–
3.0	$ 178.1	$ 200.1	$ 200.3	$ 205.5	$ 175.8	3.3
–	4.5%	10.0%	11.6%	11.0%	12.3%	–
–	6.0%	10.4%	11.4%	13.4%	12.7%	–
–	(13.1)%	4.3%	3.9%	(2.3)%	5.6%	–
7.9	$ 1.01	$ 1.80	$ 2.02	$ 2.32	$ 2.14	4.8
–	156.8%	83.1%	71.5%	55.9%	56.5%	–
–	$15¼–$10	$15⅞–$12¾	$16⅜–$14¼	$ 16–$13¾	$ 15–$11⅛	–

Other Information Available

Shareholders who wish to receive more written information about SDG&E should write to: Office of the Secretary, San Diego Gas & Electric, Post Office Box 1831, San Diego, California 92112, or call: (619) 696-2020.

Common Stock Investment Plan

A prospectus explains how SDG&E common stock shareholders can purchase additional shares, without paying brokerage fees, by investing all or a portion of their quarterly dividends on directly held shares. The plan also allows optional cash investments of as little as $25 per investment to a maximum of $5,000 per calendar quarter.

The Share Forum

Membership information for The Share Forum, an organization of SDG&E shareholders, is available. Members receive additional news about the company through meetings with management, tours of utility facilities and periodic mailings. There are nearly 10,000 members.

Publications

The Corporate Profile and Statistical Report for 1976-1986 (contains 11 years of financial data and information on California regulation).

Form 10-K (the Annual Report to the Securities and Exchange Commission).

Shareholder Information Handbook (answers many common questions asked by shareholders).

Toward 2000: New Strategies (outlines the company's strategic plan).

For Information by Phone:

Shareholder inquires about stock holdings:
From California (800) 826-5942
From outside California (800) 243-5454

Recorded corporate news and stock update:
From California (800) 443-SDGE
From outside California (800) 521-NEWS

Financial community inquiries:
Jennifer Lewis, Manager
Investor Relations (619) 696-4487

Utility customer inquiries on general energy subjects: (619) 239-SDGE

Utility customer inquiries on specific bill or service-related subjects: See the number listed at the bottom of your SDG&E bill.

Executive Offices

San Diego Gas & Electric
101 Ash Street
Post Office Box 1831
San Diego, California
92112
(619) 696-2000

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Post Office Box 1831
San Diego, California 92112