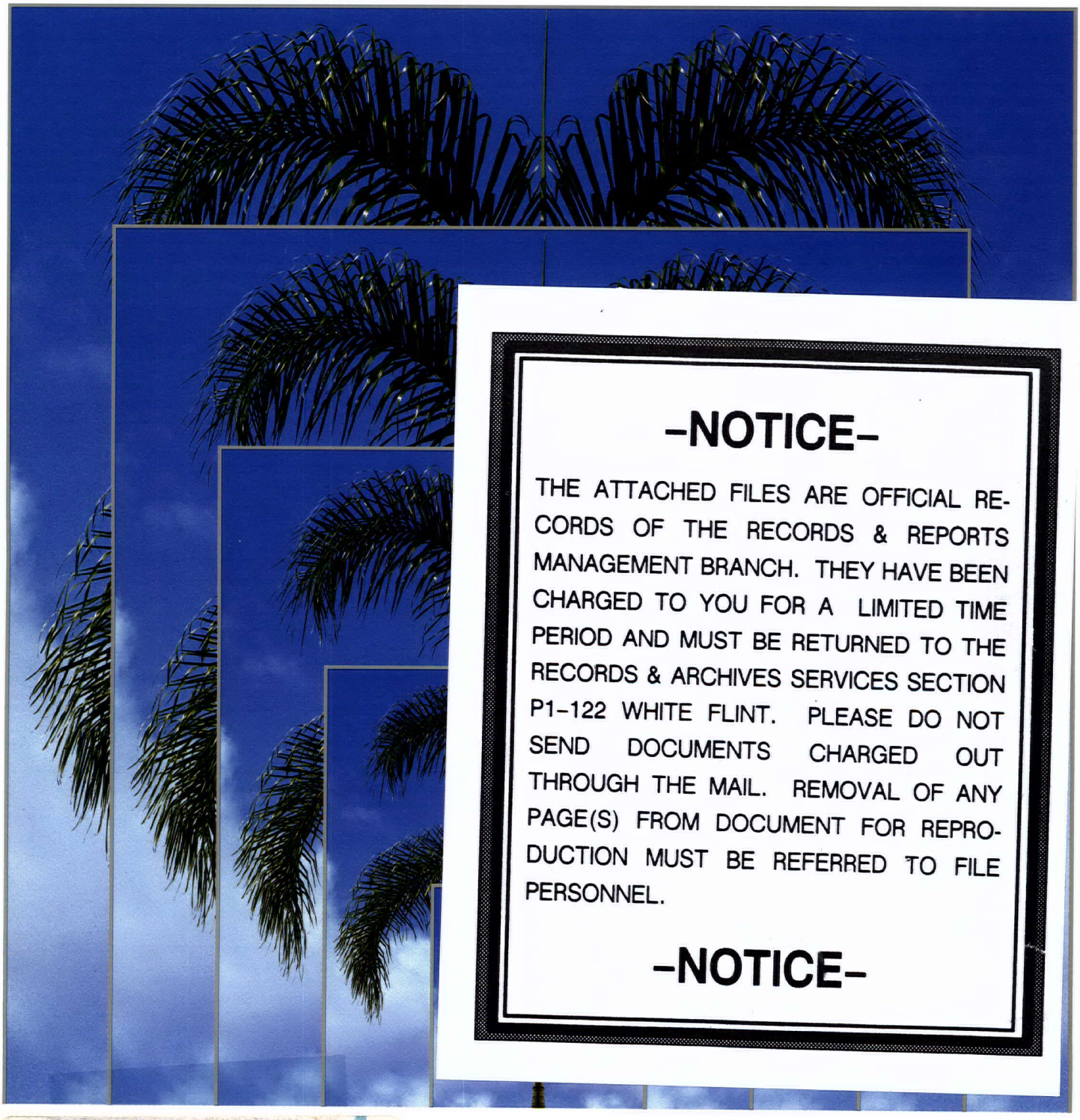
1987
Annual Report

San Diego
Gas & Electric

Pacific
Diversified
Capital

Managing Growth: That's Our Special Challenge

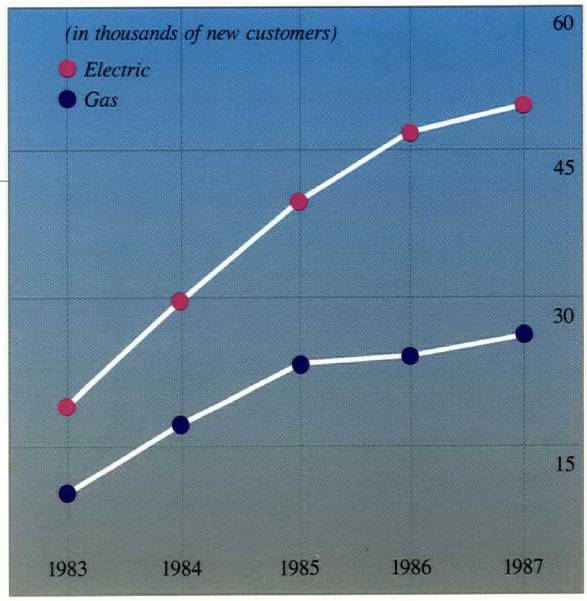


The Year in Review

1987

High Customer Growth Rate — A Nice Problem to Have

San Diego, America's seventh largest city, keeps growing rapidly. SDG&E's electric customer growth rate has been one of the highest in the nation for the last several years and it was 5.3 percent in 1987. It's a "nice problem" to have, says Chairman Thomas A. Page (page 2).



Nuclear Plant Among the Best In the Nation

Unit 2 at San Onofre Nuclear Generating Station qualified for a $400,000 incentive award because of its superior performance during part of 1986 and 1987. The two other units at the plant are performing well above the national average, too. SDG&E owns 20 percent of San Onofre (page 6).

Nuclear plant operators at San Onofre undergo continual training with the control room simulator.

Energy Use Establishes Record

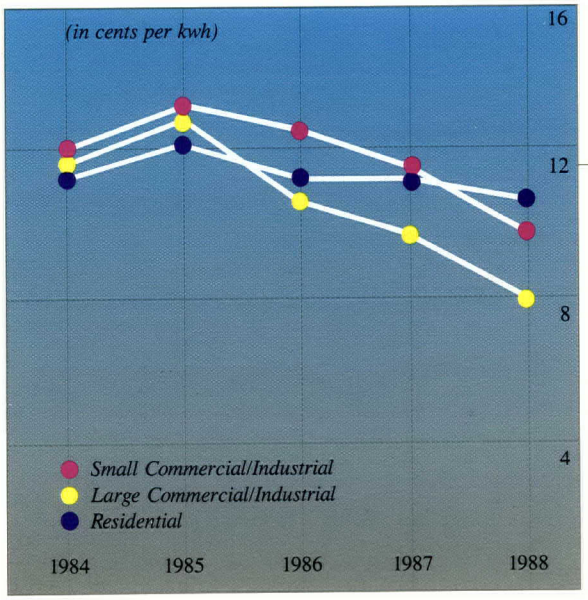
Unusually cold weather in the service area in December 1987 caused record demand for natural gas and electricity. On December 16, a new peak demand for electricity was set at 2,378 megawatts, up from the former record of 2,376 megawatts that was reached on August 19, 1986. In San Diego, it's unusual to establish peak demand records in the winter. They more often occur in summer. It didn't happen in 1987 because the summer was unseasonably cool.

Total Return Declines Slightly

SDG&E was just shy of its goal of being in the top 25 percent of the industry in total return in 1987. Stock price appreciation and dividends are the components of total return, measured over a five-year period (page 38).

Purchased Power Contracts Criticized

Two contracts for purchasing coal-fueled power were the subject of extensive hearings in 1987. The Division of Ratepayer Advocates of the California Public Utilities Commission proposed $285 million in disallowances. A decision is expected in 1988 (page 12).



Lower Prices Helping SDG&E Reach Goal

Lowering prices, and having them match the costs of providing service to each group of customers, is a primary company goal. Prices declined again in 1987, especially for commercial and industrial customers. In recent years, that group has been subsidizing residential customers' prices. The company is working to make them equitable. There were more decreases on January 1, 1988.

Mountain forest fires in October knocked out power to 1,000 rural customers. While the fires still burned nearby, SDG&E's highly skilled repairmen set up new poles in difficult conditions.

Employees' Ideas Saving Money
As of the end of 1987, employees' ideas are helping the company save more than $2 million annually. An additional incentive program to help cut costs began in 1988 (page 5).

Dividends Go Up Again in 1987
In February 1987, for the 11th year in a row, SDG&E increased its shareholders' dividend, to an annual rate of $2.50 per share.

Subsidiary Acquires Another Company

Pacific Diversified Capital, SDG&E's nonutility subsidiary, bought Wahlco, Inc. of Santa Ana, California in 1987. Wahlco manufactures flue gas conditioning systems that are sold around the world, primarily to electric utilities for their coal-fueled generating plants. A map showing the diversified facilities is on page 36.

Wahlco employees inspect pumps at an air pollution control facility installed by Wahlco at a southwestern electric generating plant.

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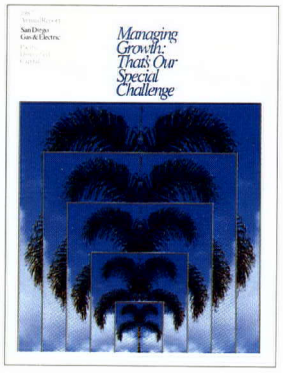
Managing Growth: That's Our Special Challenge

Company Description
San Diego Gas & Electric is an energy management company. It operates a gas and electric utility that serves more than 2.5 million people in Southern California. Through its subsidiary, Pacific Diversified Capital, it owns four companies in other industries. (More on pages 34–37.)



Palm trees, seen throughout Southern California, are impressive. Some grow to great heights. The company's growth is the focus of this annual report and the palm is symbolic of that growth.

To Our Shareholders:

It's an educational experience to look over what's been written in past annual reports. I recently re-read our 1978 Annual Report, since that was the year I joined San Diego Gas & Electric. The statistics in it weren't attractive: our annual dividend rate was only $1.40 per share; revenues were $479 million; the bond rating was a weak BBB; and we were purchasing only 20 percent of our energy and burning expensive OPEC-priced oil and natural gas for most of the rest of our energy.

Beyond these statistics, which I was determined to improve, the report discussed the genesis of ideas that have helped SDG&E to regain its financial strength and resource viability. Some of these were:

- Our initial plans for a financial recovery were stated. In 1979, the initial plan developed into our five-year goals. These were sent to our shareholders and we asked them to monitor our progress. We've met all those goals and have had an A+ bond rating from Standard & Poor's Corporation since 1984 and Aa3 from Moody's Investors Service since 1985.
- Our need to diversify fuel resources and our general plans to do so were outlined. We later set some specific goals and those have been met. Today we're purchasing nearly 40 percent of our energy. And we're only using small amounts of oil today.
- The concept of an energy management company was introduced. Since then, by our plan, we have evolved into an aggressively competitive, forward-looking company.

Without question, I believe the discipline of setting goals, publishing them and being held accountable by customers and investors to achieve them in subsequent years, has contributed greatly to your company's overall success.

"We have fewer officers and employees now."

Looking back almost inevitably gives rise to the question, "What would you do differently if you had the chance?" Well, in answer, we would have done things quicker. We could have shortened the time frame of our recovery plans and been faster to resolve organizational issues.

We have fewer officers and employees now and clear thinking is required to keep pace with events. We only have time to spend on things that really matter.

Among the things that matter greatly to us are the company's continued financial health and its attractiveness as an investment. Earnings are one part of that picture.

In 1987, our earnings declined to $3.28 per share from $3.42 per share in 1986. There were a couple of reasons for that decline but one is the most significant. In 1986, we had a one-time gain from the sale of our remaining interest in Energy Factors, Inc. That added 25 cents per share to 1986 earnings.

In 1987, there were two unrelated factors that affected earnings and about cancelled out each other. In connection with the Tax Reform Act of 1986, the company changed its method of recording revenue from when customers are billed to when the energy is delivered. This accounting change gave us a one-time increase of 32 cents per share in the first quarter.

Later in the year, the California Public Utilities Commission, in a series of decisions, disallowed $53 million in construction costs for units 2 and 3 at San Onofre Nuclear Generating Station. This resulted in a reduction of 39 cents per share in earnings. Future earnings will also be reduced as a result of this decision, though the annual amounts will be much smaller.

Looking at the national and California trends of declining allowed rates of return on equity, it's going to be increasingly difficult for utilities to show earnings growth. SDG&E's authorized rate of return in 1987 was 13.9 percent and in 1988 it's 12.75 percent.

Financial Highlights

(In Thousands of Dollars Except Per Share Amounts)

	1987	1986	Percent Change
Operating revenues	**$1,904,228**	$1,634,211	+16.5
Operating expenses	**$1,642,449**	$1,351,861	+21.5
Net income (before preferred dividend requirements)	**$ 196,803**	$ 213,196	− 7.7
Earnings applicable to common shares	**$ 183,058**	$ 190,771	− 4.0
Average common shares outstanding (thousands)	**55,849**	55,830	—
Common stock shareholders (at December 31)	**72,086**	73,771	− 2.3
Earnings per common share	**$ 3.28**	$ 3.42	− 4.1
Dividends declared per common share	**$ 2.50**	$ 2.345	+ 6.6
Retail energy sales			
Electric (billions of kilowatt-hours)	**11.92**	11.36	+ 4.9
Gas (millions of therms)	**554**	490	+13.1

"Our earnings were . . . 90 percent cash."

We also assess our financial condition in terms of the percentage of our earnings that are cash and the percentage of our dividends that come from cash earnings. By these measures, our financial health is very, very strong.

- In 1987, our earnings were more than 90 percent cash. By comparison, the recent industry average has been about 70 percent cash earnings.
- For the 11th year in a row, we increased the dividend, raising the annual rate to $2.50 per share. Because of our strong cash flow, we're paying those dividends with our own cash, not borrowing as we had to do a few years ago.

Another thing has been changing, and that's the payout ratio, or the proportion of our earnings paid out in dividends. In 1987, we paid out about 76 percent of our earnings to you, up from 69 percent. This percentage will continue to go up, because there will be continued competitive need to increase our dividend. Our strong cash flow and high quality of earnings strongly support this change.

"The success of Pacific Diversified Capital is very important to us."

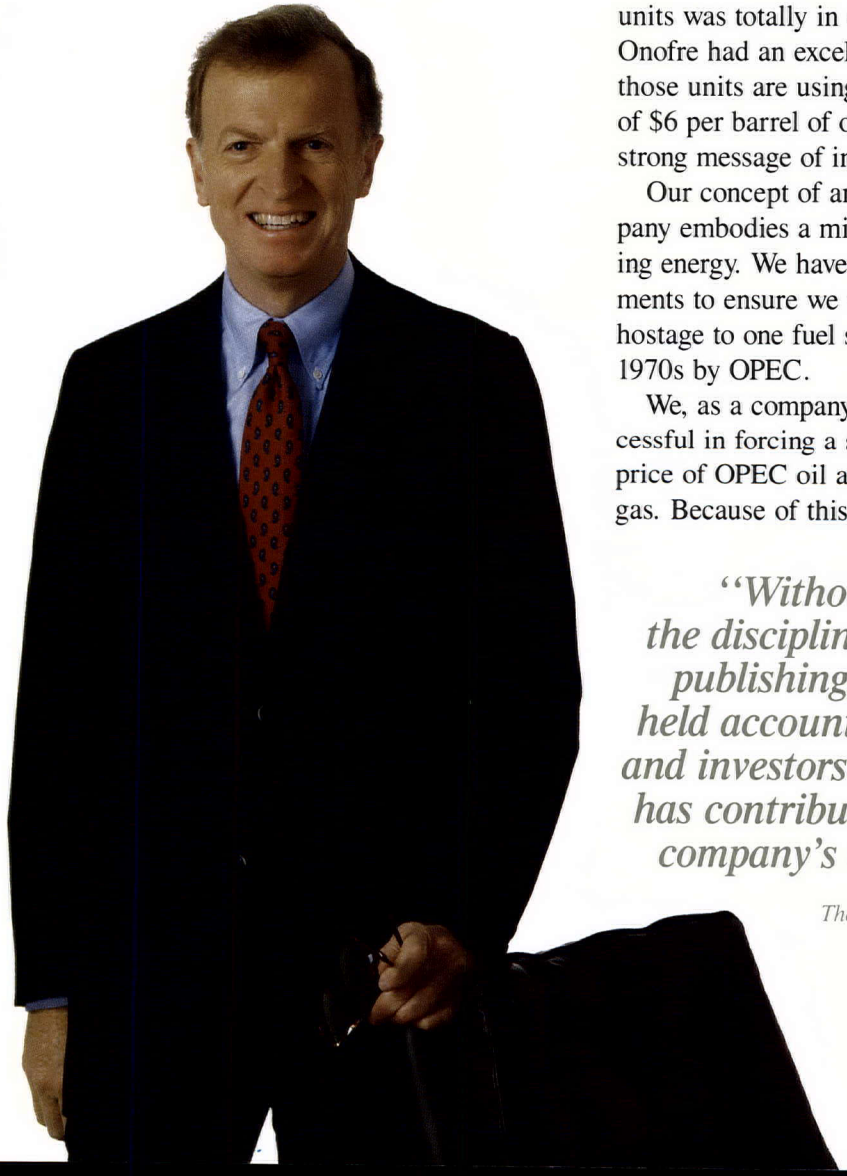
Because it's going to be increasingly difficult to get incremental earnings from utility operations, two years ago we activated a nonutility subsidiary, Pacific Diversified Capital, to purchase and develop other companies. We've bought four companies since then. In 1987 we saw the start up costs of this activity and the company didn't produce any earnings. I'm not satisfied with that and 1988 will be the year we start to show positive results.

"San Onofre had an excellent record."

Maintaining energy diversity, like financial health, continues to be one of our company's continuing goals. The three units at San Onofre are key to that program and it's gratifying that as of 1987 our 20 percent share of the three nuclear units was totally in our rate structure. San Onofre had an excellent record in 1987. And those units are using fuel that costs an equivalent of $6 per barrel of oil. In addition, that sends a strong message of independence to OPEC.

Our concept of an energy management company embodies a mix of generating and purchasing energy. We have made purchase commitments to ensure we would never again be held hostage to one fuel source, as we were in the 1970s by OPEC.

We, as a company and as a nation, were successful in forcing a substantial reduction in the price of OPEC oil and, as an offshoot, natural gas. Because of this, some of our longer-term



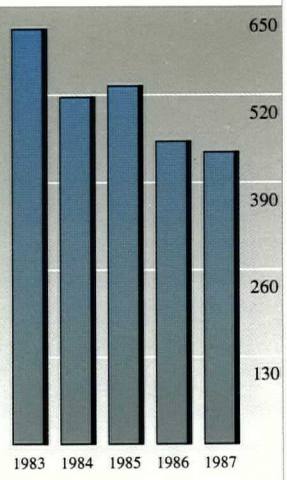
"Without question... the discipline of setting goals, publishing them and being held accountable by customers and investors to achieve them... has contributed greatly to your company's overall success."

Thomas A. Page

Electric Fuel and Purchased Power Costs

(in millions of dollars)

Power plant natural gas prices were lower again in 1987. Very little fuel oil was burned during the year.



purchased power commitments for coal-fueled energy now appear to be comparatively high cost. They are being questioned, in retrospect, by the California Public Utilities Commission.

I hope the commission, when it reviews the issues in 1988, will reject its Division of Ratepayer Advocates' penalty recommendations, which are based on a short-term view of the contracts' value. Rather, we have asked the commission to understand that it's the long-term reliability and price stability of our system that is important. That's where we're coming from in our resource planning.

"These are, comparatively, nice problems."

This annual report is about the challenges of growth. That means several things: our rapid utility customer growth, the need to have increased sales growth at lower cost and our push to find earnings growth through diversification.

We are fortunate to be located in a growing, vital community and to be dealing with *those* problems compared with being in a depressed community or being a utility with a major nuclear plant problem. I would much rather be dealing with the kinds of management challenges we have. These are, comparatively, nice problems.

"This business is not at all like it used to be."

While looking back 10 years has been an interesting exercise for me personally, shareholders prefer to hear about the future. Well, we can't see ahead 10 years, but there are some forces at work now that we can identify that are likely to affect your company within the next decade.

- *Competition*. This business is not at all like it used to be. It's become competitive, and this will be a way of life in the future. We are seeing utilities competing for market share with nonregulated companies, for territory with neighboring utilities and for access to transmission lines with more distant ones.
- *Regulatory process*. We sure hope it can be simplified. We would like to see pieces of the energy supply system operate more like the free enterprise system.
- *Diversification*. For the industry, as for SDG&E, it's definitely a way of producing needed earnings growth. We are moving slowly. That's because we would rather be successful than dramatic in our diversification effort.
- *Holding company*. In 1986, we decided not to form one because of several unacceptable conditions that the CPUC attached to its approval. We're still considering the issue, and it appears that we will have the opportunity to revisit this in 1988.

"We are ultimately responsible to you."

Looking ahead is the responsibility of many people at your company. SDG&E and PDC both have strategic plans and these put us in a frame of mind to be able to deal with the future. They help us recognize that change is a way of life.

Along with the strategic plan, we have articulated our corporate principles and values. Among them is the recognition that we are ultimately responsible to you, our shareholders.

We've specifically stated that we will work toward maximizing shareholder value and that we will keep you informed of current activities and future plans. And we intend to continue to set, publish and achieve tough goals.

Thomas A. Page
Chairman, President and
Chief Executive Officer

February 8, 1988

San Diego Gas & Electric

"To find ways to cut costs, we are drawing upon our greatest strength, the talented people who are employed in the corporation."

Thomas A. Page, Chairman

Performance Improvement Program

SDG&E has a Performance Improvement Program that's helping the company cut controllable costs and, thus, the company is reducing the price of its energy products.

The initial step in the program, called The 10% Solution, was taken in 1986 when the company began encouraging individual employees to contribute their ideas on ways to cut costs. Employees whose ideas are accepted earn 10 percent of the anticipated first year's savings for their ideas. By the end of 1987, suggestions from hundreds of employees that will save customers nearly $2 million annually had been approved and are being implemented.

Another step, called Gain Sharing, was introduced in 1987. This will reward all employees for working together and achieving certain company goals, beginning in 1988.

The plan was designed in part by 200 employees who agreed upon three major goals. These are:

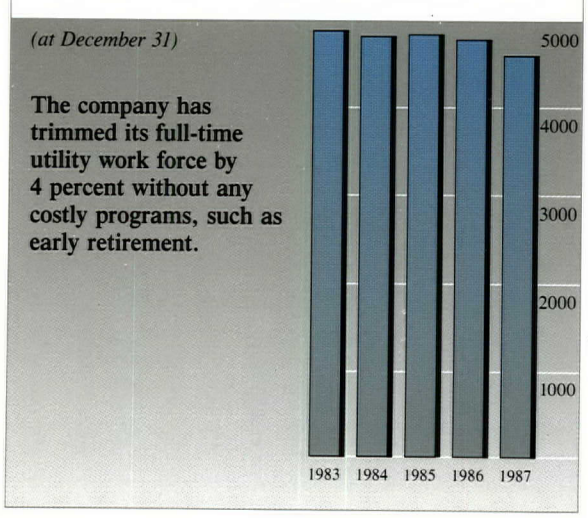
- Reduce the operating and maintenance part of the company's budget. The reductions will provide basic funding for Gain Sharing.
- Achieve a strategic goal of an 80 to 85 percent customer satisfaction level by 1990, as measured by the customer service monitoring system. If each year's customer service goal is exceeded, then the basic Gain Sharing fund will be increased by up to 20 percent. If goals are not met, the fund will be decreased by up to 20 percent.
- Meet the capital cost portion of the budget. If the company exceeds the capital budget by more than 3 percent, then the Gain Sharing fund will be reduced by 20 percent for that year.

"We've been identified as a high-cost producer of energy," says Chairman Thomas A. Page. "That's unacceptable to us. To find ways to cut costs, we are drawing upon our greatest strength, the talented people who are employed in the corporation.

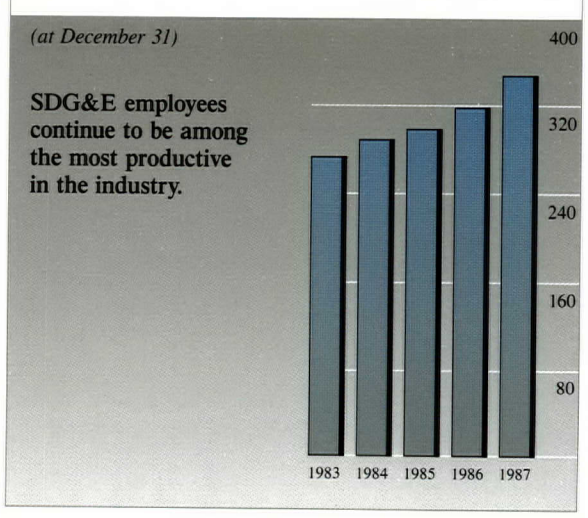
"With the Performance Improvement Program and other incentive programs for management we're placing much more emphasis on pay for performance.

"Another way we are controlling our costs is by gradually decreasing the number of full-time utility employees. We've been doing this for several years now, without using any costly programs that other companies have used to achieve employment reductions. As a result of this effort, in the last five years we've reduced the number of employees by about 300."

Total Number of Employees



Utility Customers Served Per Employee



An interview with Jack E. Thomas, Executive Vice President and Chief Operating Officer

San Diego Gas & Electric has one of the fastest electric customer growth rates in the industry. In 1987, the rate was 5.3 percent compared with the industry growth rate of about 2 percent. Is growth desirable to the company?

Yes, growth really is advantageous. We're encouraging growth, primarily in ways that will lead to increasing the use of our existing facilities. If we could attract customers that use energy 24 hours a day, that's the most advantageous for us.

Growth is going to continue. I serve on the City of San Diego's Growth Management Task Force, and the issue is not whether we are "for" or "against" growth. The issue is how to cope with the inevitable growth in a satisfactory way. At SDG&E, we're trying to stimulate certain kinds of industry to come to the area. For example, companies that produce a product, like Kyocera or Sanyo, are the targets of our development efforts.

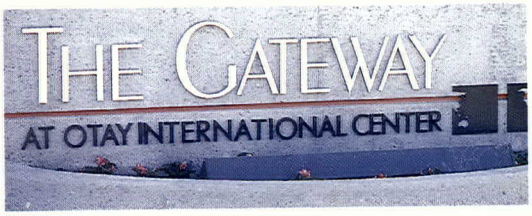
What's the company doing to encourage preferred types of customers to come to the service area?

In 1987, we began providing a spectrum of information and services to companies that are considering relocating in San Diego. We're working very closely with the San Diego Economic Development Corporation and many local chambers of commerce to attract new companies and help those that are in San Diego grow and prosper. This should encourage new job formation and assure job preservation for San Diegans.

The growth in retail electric sales in 1987 was nearly 5 percent in SDG&E's service area, and the national average is about 4 percent, according to recent figures. What's the forecast for 1988 for SDG&E?

Our forecast shows that retail electric sales should grow between 5 and 6 percent in 1988. So ours is a healthy sales growth rate.

For the last six or seven years, it's been a primary company goal to diversify energy sources so the



Along the USA side of the international border with Mexico, farmland is being transformed into business parks and warehousing facilities. A growing trade is attracting manufacturers from several countries, including Japan. They are taking advantage of lower labor costs in Mexico and tax incentives in the United States by putting parts of their business on each side of the border.

company wouldn't be dependent upon foreign oil. Were any new sources added in 1987 and will any be added in 1988?
No. Our resource picture is in very good order for the next several years. We expect to cover our growing base demand needs over the next five years in several ways. We're going to purchase additional base capacity when it makes economic sense; we could acquire ownership in existing or new coal-fueled generating facilities in Arizona or New Mexico and we may take our Silver Gate power plant out of mothballs.

As long as natural gas prices continue to be relatively low, restarting Silver Gate is a superb solution for us. It's fully depreciated and we can use it to meet peak demand requirements at very low cost. However, we are keeping our minds open to other possibilities. An even less costly alternative, perhaps, could be purchasing peak capacity during maximum demand times from a utility that has excess generating capacity—and there are many that do.

The development of our own power plant site at Blythe, California, maybe with a group of companies as owners, is some years away. But we really don't anticipate being the project manager for developing a large generating facility at Blythe or elsewhere.

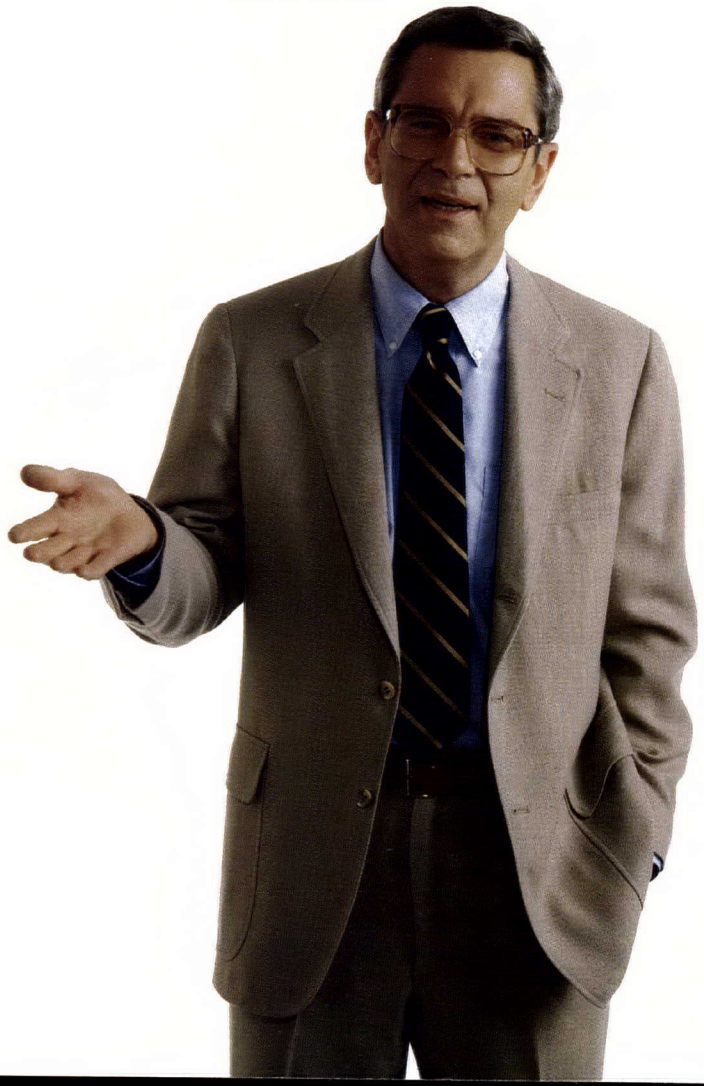
The company successfully developed the Southwest Powerlink transmission line on its own, which was a major project in the early 1980s. Why not be the project manager of a major power plant construction project sometime in the future?
The era of adding very large power plant units is gone. A single large generation unit of 400 to 800 megawatts requires an enormous capital investment and, consequently, enormous risk. We think utilities, including SDG&E, will make commitments in smaller capital packages to match their need for capacity as it occurs. Plant modules with between 100 and 400 megawatts of capacity that can be added on over a period of years are easier to finance and less risky to build.

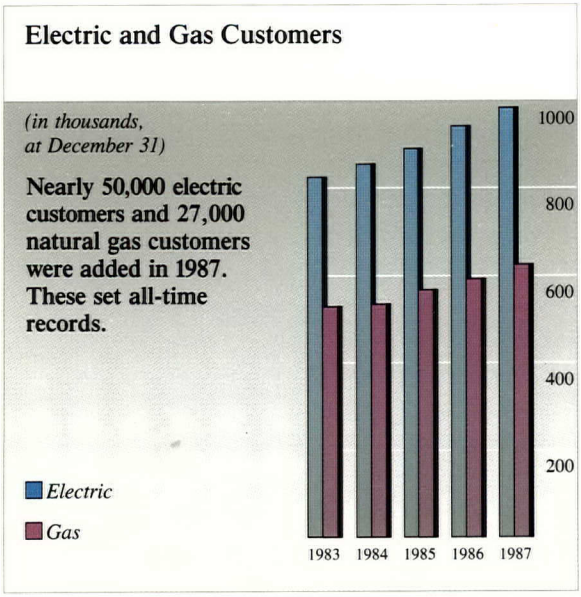
SDG&E's stepped-up marketing programs to commercial and industrial customers seem to conflict with the company's desire to postpone investment in new generating capacity. Is it a conflict?
I don't think it is. Clearly, we want to increase sales and use of our facilities. We have ample generating capacity today and if we add more sales we don't necessarily have to add new capacity. We have an average system usage of about 57 percent and we intend to improve that. So, we've been developing pricing mechanisms to stimulate the use of energy at other than peak demand times. We're also encouraging gas air conditioning and thermal energy storage, with financial incentives to install them for the same reason.

Ten years ago, SDG&E had 40 different conservation programs, part of the nationwide effort to reduce dependence on expensive foreign oil. In 1988, SDG&E has almost no programs left. Why?
Primarily because they are no longer cost effective. California got way ahead of the rest of the country in conservation programs in the 1970s and early 1980s. There were huge sums of money spent on them in California. For example,

"Growth is going to continue.... We're trying to stimulate certain kinds of industry to come to the area."

Jack E. Thomas





we've insulated most of the older homes in San Diego. To continue programs that are not cost effective would cause our prices to go up.

Also, sales are very important to us today. Our use per residential customer continues to be very low because of the climate and the conservation measures of the past. By using our system more efficiently we can provide energy at lower cost and, consequently, it's good for our customers and our shareholders.

There's been a great deal of talk in the industry about "growth in competition." What specifically does this mean for SDG&E?

SDG&E has become less like a monopoly and more like a competitive company in the last several years. I think 1987 was kind of a banner year in that regard. Many more commercial and industrial customers were planning to leave our system to produce their own energy through cogeneration. Our aggressive programs to reduce commercial and industrial prices in 1987, with the objective of having prices based on the costs of serving these customers, successfully mitigated that. As a result, we've been able to preserve most of our sales and retain most of our market share.

"San Onofre has become one of the best performing nuclear plants in the nation."

How has the pricing change affected the company's negotiations with its largest customer, the Navy, which in 1986 announced it was contemplating building its own power plants?

Our bill to the Navy a couple of years ago was $110 million. With the general 1987 price reductions, it declined to about $77 million. In 1988, we estimate the Navy's bill will be about $70 million, as a result of more commercial and industrial price reductions. At that level, it's much less economical for the Navy to build its own plants and we expect to keep it as a customer.

Price reductions to all customers have been under way for several years now. What has the company done to cut its costs to achieve this?

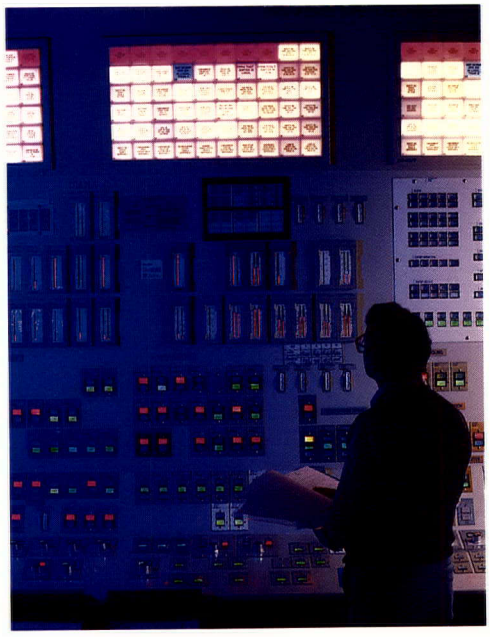
We've reduced our cost of debt, trimmed our operating and maintenance costs, and reduced our fuel and purchased power costs. That effort is continuing in 1988, too.

What was the additional savings to customers from recalling higher-cost debt and preferred stock in 1987?

We retired more than $60 million in higher-cost preferred stock, which will mean an annual savings of up to $2.2 million every year to our customers beginning in 1988. By recalling higher-cost debt and preferred stock—and we've been doing that since 1983—we've reduced our financing costs by more than $8 million annually. That's only one part of the savings. With our ability to use tax-exempt debt, rather than taxable bonds that most utilities rely on, in the last five years we've saved more than $20 million annually. Those are significant savings.

One of the company's past cost-cutting efforts was to trim the overall salary and benefit costs. Are any more cuts sought in this area?

We're continuing to cut operating and maintenance costs in many ways. One of these is reducing the number of employees. As a result of this, plus the growth in the number of customers, we continue to have one of the highest customer-to-employee ratios in the industry. It was 350-to-1 in 1987, and we expect this to increase again in 1988 to 364-to-1. This is one of the best mea-



Plant operators at San Onofre Nuclear Generating Station are trained and tested in emergency response methods in a control room simulator, which has instruments and panels identical to the plant's control rooms.

sures of our growth in productivity that I can think of.

In 1986, SDG&E made news around the USA for its aggressive spot-market purchases of natural gas and fuel oil for its power plants. What was the situation in 1987 and what's the outlook for 1988?
In 1987, we purchased about half of our natural gas needs on the spot market. I anticipate that we will continue to do so in 1988. By the way, we burned very little fuel oil in 1987 for one simple reason, natural gas was cheaper.

How many different suppliers of natural gas does the company have?
We take bids typically from about 30 suppliers and we end up buying from five or six low bidders, but the sources are from all over the Southwest and Canada and they're different from time to time. That's quite a change from just two years ago. For about 50 years, until 1986, we had one supplier.

SDG&E closed its Heber geothermal plant in 1987 and put it up for sale. Was that, in part, a result of the general cost-cutting efforts?
The Heber plant was a research and development project. It was successful and provided reliable energy. However, the costs of production at the level the plant was being operated were too high. Chevron and Unocal, the owners of the geothermal field, weren't willing to make the additional investments to increase the well capacity and provide the additional hot water resource needed by the plant on a schedule that met our needs. We have sued them because they did not meet their contractual commitment.

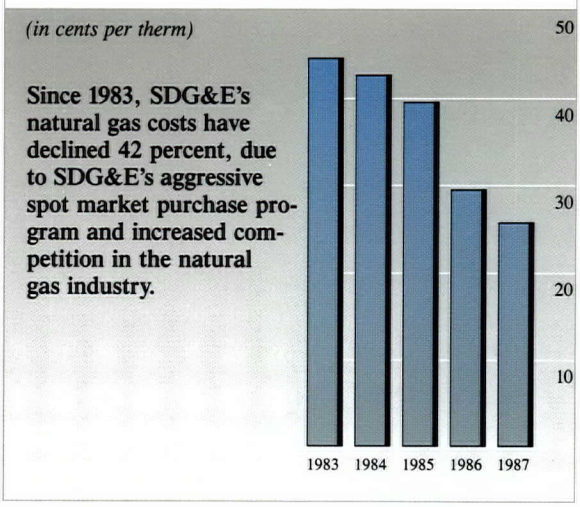
Has a buyer for the plant been found?
We've received six bids for the plant and a decision will be made in 1988.

What does the closing of the plant mean financially to shareholders?
SDG&E's customers funded 31 percent of the plant. The majority of the funding came from the U.S. Department of Energy, the Electric Power Research Institute and several other private and public organizations. The benefits of the sale will go to the contributors.

The electric utility industry has had a problem with polychlorinated biphenyls, or PCBs. What has SDG&E done about eliminating them?
The company has had a very good record on PCB removal. We were one of the early companies to eliminate PCB capacitors on most of our system. In 1988 we're proceeding with programs that will eliminate additional PCBs from our system.

In 1987, we established a separate environmental department because, frankly, we intend to give a lot more attention to environmental issues in the years ahead.

Average Cost of Purchased Gas



Since 1983, SDG&E's natural gas costs have declined 42 percent, due to SDG&E's aggressive spot market purchase program and increased competition in the natural gas industry.

Several years ago, the three units at San Onofre Nuclear Generating Station were able to operate at only about 60 percent of their capacity, in part because of lengthy refueling cycles, modifications required by the Nuclear Regulatory Commission and some unscheduled maintenance outages. SDG&E, which owns 20 percent of the plant, and Southern California Edison, the majority owner and operator, agreed in 1986 to take certain measures to improve the plant's performance. Was this achieved in 1987?
San Onofre performed marvelously in 1987. Unit 2 went through a refueling at the end of 1987 but for about a year and a half operated at an 82 percent performance level. That's very important, because the California Public Utilities Commission gives an economic incentive award for a performance level above 80 percent. We expect to collect an award of about $400,000. That's almost half a penny a share. The other units are performing very well, too.

How does San Onofre's performance compare with nuclear plants nationally?
Very, very well. San Onofre has become one of the best performing nuclear generating plants in the nation. Its overall 1987 capacity factor, which is a measure of operating performance, was 73 percent. That's compared with the industry average of about 60 percent. Furthermore, it achieved the second largest production of nuclear-generated electricity among the nation's nuclear power stations. ▣

Utility Operations Terminology

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

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

Refueling outage
Nuclear generating plants must be shut down at scheduled intervals to replace the uranium rods that provide the energy. For San Onofre's three units, these shutdowns, or refueling outages, occur every 18 months to two years. Units are out of service for about two to three months for refueling on a rotating basis.

Thermal energy storage
A compressor freezes water in a storage reservoir at night, using electrical energy when demand and prices are lower. The ice is used to cool the building during the daytime hours.

Pacific Diversified Capital

An interview with Richard Korpan, President and Chief Executive Officer of Pacific Diversified Capital

Pacific Diversified Capital was established specifically to increase the company's earnings. How are you going about this?

We're attempting to find companies that have earnings growth potential. We look specifically for companies where we think that ownership by Pacific Diversified Capital will, over time, give them an opportunity to increase earnings.

What are your specific earnings growth goals?

Our stated long-term goal is that we intend to produce 10 percent of the income of the total corporation in 1991 and 25 percent in 1996. Another way to look at it is based on return on equity. Once we have a solid base of companies we would expect to earn at least the same return as the utility is authorized to earn.

This is a new operation, however. We need time to let PDC's partnership with our subsidiaries mature. It would be unrealistic to assume that we would show large earnings growth in our first couple of years of existence. But we will need to grow rapidly after that.

Many companies have diversified but their financial results did not improve. Understandably, investors are concerned about the perceived increased risk. Today, would you invest in a utility if you knew it was going to diversify?

There isn't a simple answer. I think, generally, that diversification is a difficult thing to do for people with a background in a regulated industry. But I think it can be done successfully. I would invest in a company that has the right philosophical approach, the right management, a business plan and a sensible strategic plan for diversification.

What is PDC's philosophical approach?

We said we intended to start small, that we were going to invest primarily in companies we knew something about and could add value to by being associated with them. The companies we want must be doing business with or providing a product or a service to the utility industry or its marketplace. The other category is real estate development. That's what we set out to do and that's really what we have done.

In this annual report, there is very little detailed financial information about PDC. Why?

The results are not significant enough compared with the size of the entire corporation to justify separate accounting treatment yet. I would hope that in two or three years we will be large enough to justify more detailed information being shown.

Are you satisfied with your subsidiaries' results for 1987? Were all of them profitable?

To be successful we can never be satisfied with our results. They could always be better. From that standpoint, I would say we are not satisfied with the 1987 results, but when we buy a company, we expect that it's going to take a while before the company starts to produce the required level of profits. In fact, when we assess a company, we look at a projected five-year return on equity. Two of the subsidiaries were profitable in 1987 and two were not. Looking at each individual company, and the marketplaces

"To be successful we can never be satisfied with our results."

Richard Korpan

they faced during the year, I think that each one can, and will, do better in 1988.

How did the petroleum products marketing company, Mock Resources, Inc., fare in 1987? What's the outlook for its industry in 1988?
Mock Resources made a profit in 1987 but it was operating in a difficult marketplace. Because of the increase in oil prices, brought about by OPEC, oil was less desirable compared with natural gas for many of Mock's industrial customers. That's the reason why Mock is developing its natural gas business, but that business' size isn't sufficient enough yet to make up for the setback in the oil business.

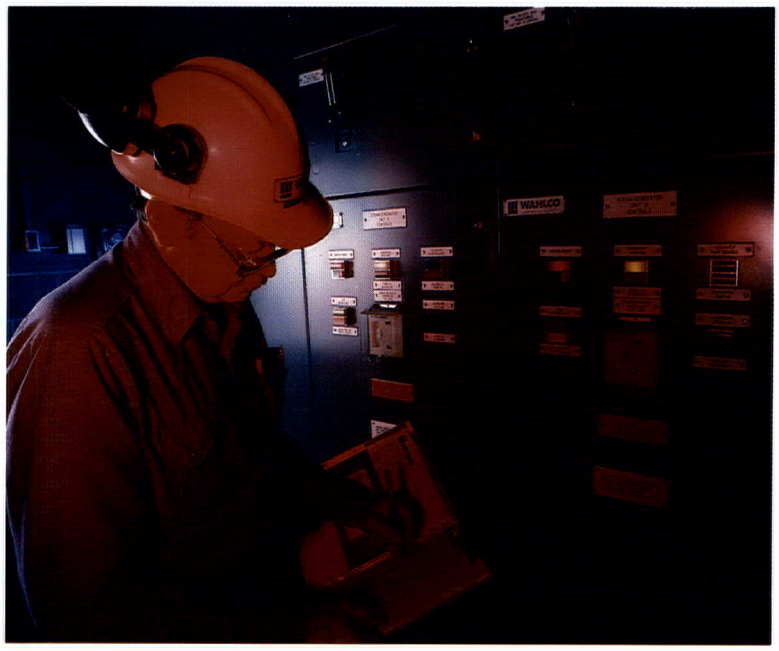
The outlook for Mock in 1988 is favorable. We're looking at several potential expansions of the business that would make its results less impacted by fluctuations in oil prices. Mock is adding some key personnel, moving into new markets and looking at acquisition opportunities. I expect 1988 to be a very busy year for Mock.

Phase One Development has received a lot of publicity in San Diego because of its involvement in the redevelopment of the city's historic oceanfront site, Belmont Park. Has the controversy increased the risk of success of the project?
The controversy made it difficult to develop the project but I don't feel that it's increased the risk of success of Belmont Park. That risk is past us now and Belmont Park will open in 1988.

I think we would always like to be able to avoid controversial projects, but the nature of the development business in California is that it's very difficult to avoid public concern. From time to time, projects will be controversial. That's part of doing business as a developer in this state.

The Colorado Springs commercial real estate market, where Phase One has a branch operation, has generally not been a good market during the last few years. Will that office remain open?
We think, long term, that Colorado Springs is an attractive market. We have a high concentration of projects there and we've recently increased our marketing effort. At the end of 1987, the leasing was going very well and we're optimistic that the area will make a good recovery.

We will be considering opportunities to expand into similar types of communities to broaden our base so we won't be impacted as adversely by a slowdown in any one area.



A control panel installed at a Wahlco facility, which has been leased to a southwestern utility for controlling air pollution at a coal-fueled generating plant. Wahlco employees operate the facility.

Integrated Information Systems, the smallest of your subsidiaries, is really a start-up operation because the computerized mapping field is so new. Would you acquire another start-up company?
We intend to have no more than one start-up company at a time. Integrated Information Systems is well-positioned in a developing market with tremendous potential but we have learned that start ups take a considerable amount of management time. Until IIS is out of the start-up phase, we wouldn't be interested in another new start-up situation.

In 1986, PDC bought three companies but in 1987 it acquired only one. Why the slowdown in acquisition?
There was no intentional slowdown. We have very stiff criteria for acquisitions and we found only one that met our criteria in 1987. Also, in 1986, there was a tax law change at year-end and many companies were for sale that year.

What are your acquisition plans generally for 1988?
We would like to see some expansion, possibly through acquisitions, of each of the businesses we already own. In addition, we would like to make another stand-alone acquisition. ▣

Financial Review

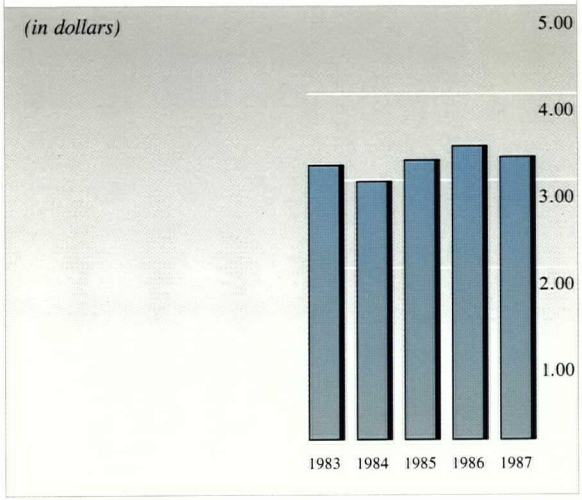
Results of Operations

Earnings

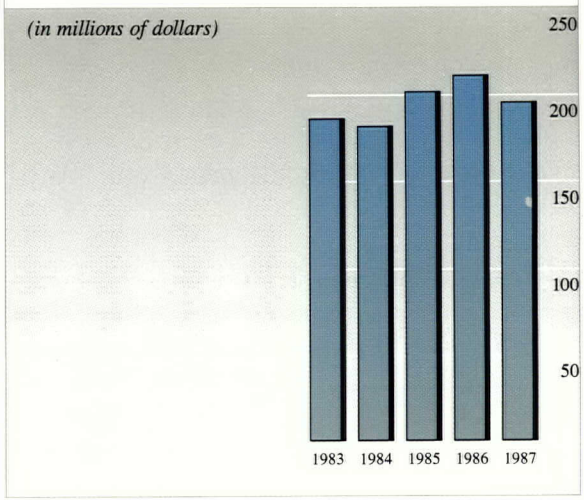
Earnings of $3.28 per share in 1987 reflect two significant events as well as the continuing financial strength of the company. One event was the long-awaited completion of the California Public Utilities Commission review of the costs for constructing the San Onofre nuclear power plant. The other event was the recognition of unbilled revenues for the first time. Both events are discussed below and in the notes to the consolidated financial statements. Their effects on earnings, one negative, the other positive, largely offset each other. They left earnings at about the same level had neither occurred.

1986 earnings per share and net income were higher than 1987 and 1985 amounts because in 1986 the company gained $14 million, or 25 cents per share, from the sale of its investment in Energy Factors, Inc.

Earnings Per Share



Net Income



San Onofre Nuclear Generating Station

In 1986, the California Public Utilities Commission voted to disallow $69 million of the company's $1.1 billion share of the San Onofre construction costs. The company petitioned for a rehearing. In 1987, the commission reheard the case and reduced the disallowance to $53 million.

The disallowance reduced 1986 net income by $5 million, or 8 cents per share, and 1987 income by $22 million, or 39 cents per share. In addition, the disallowance will require the company to write off the disallowed plant costs in 1988 by restating 1986 earnings. The complex accounting effects of the disallowance are explained further in Note 7 of the notes to consolidated financial statements.

Unbilled Revenues

Before January 1, 1987, the company recorded revenues from the sale of gas and electricity when it read customers' meters and billed customers for service. In 1987, the company began recording revenue based on the date the gas and electricity are delivered to customers. This change increased net income $18 million, or 32 cents per share, in the first quarter of 1987. It is discussed in Note 2 of the notes to consolidated financial statements.

Southwest Powerlink

An important regulatory contingency is discussed in Note 7 of the notes to consolidated financial statements. The CPUC is almost finished evaluating the cost of power transported

Six-Year Summary

(In Millions of Dollars Except Per Share Amounts)						
For the Years Ended December 31	**1987**	**1986**	**1985**	**1984**	**1983**	**1982**
Operating revenues	**$1,904.2**	$1,634.2	$1,738.7	$1,620.7	$1,530.2	$1,430.9
Operating income	**261.8**	282.4	287.9	251.6	174.2	169.9
Income before cumulative effect of change in accounting principle	**179.1**	213.2	202.7	183.5	187.4	157.3
Net income (before preferred dividend requirements)	**196.8**	213.2	202.7	183.5	187.4	157.3
Earnings per common share before cumulative effect of change in accounting principle	**2.96**	3.42	3.25	3.01	3.20	2.90
Earnings per common share	**3.28**	3.42	3.25	3.01	3.20	2.90
Dividends declared per common share	**2.50**	2.345	2.205	2.065	1.925	1.785
Funds provided by operations	**368.4**	434.5	418.1	390.9	276.5	199.2
Additions to utility plant (excluding allowance for funds used during construction)	**208.8**	254.7	257.5	219.9	312.5	271.7
At December 31						
Total assets	**3,601.2**	3,458.9	3,332.6	3,197.6	3,082.5	2,636.9
Long-term debt and preferred stock subject to mandatory redemption (excludes current portion)	**1,388.4**	1,333.2	1,354.1	1,391.0	1,338.9	1,115.2

The Six-Year Summary should be read in conjunction with the financial statements, notes to financial statements and statistical data contained elsewhere in this report.

Quarterly Financial Data (Unaudited)

(In Thousands Except Per Share Amounts)				
Quarter Ended	**March 31**	**June 30**	**September 30**	**December 31**
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
1987				
Operating revenues	$443,010	$455,569	$475,457	$530,192
Operating expenses	388,418	391,657	403,339	459,035
Operating income	54,592	63,912	72,118	71,157
Other income	6,160	5,413	3,534	4,954
Net interest charges	25,156	25,588	25,814	26,152
Income before cumulative effect of change in accounting principle	35,596	43,737	49,838	49,959
Cumulative effect of change in accounting principle	17,673	—	—	—
Net income (before preferred dividend requirements)	53,269	43,737	49,838	49,959
Preferred dividend requirements	3,936	3,707	3,048	3,054
Earnings applicable to common shares	$ 49,333	$ 40,030	$ 46,790	$ 46,905
Average common shares outstanding	55,848	55,848	55,848	55,854
Earnings per common share before cumulative effect of change in accounting principle	$ 0.56	$ 0.72	$ 0.84	$ 0.84
Earnings per common share	$ 0.88	$ 0.72	$ 0.84	$ 0.84

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

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

over the Southwest Powerlink transmission line. The company expects the commission to issue its decision in the first half of 1988. An unfavorable commission decision could materially affect earnings and cash provided by utility operations.

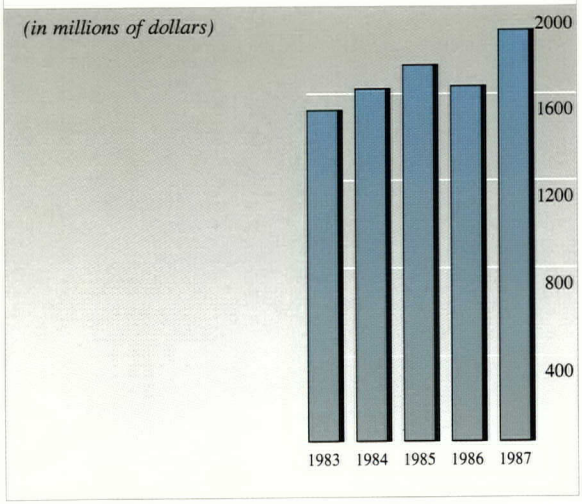
Revenues

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

Base prices compensate the company for operating and maintenance costs, taxes and depreciation and provide a return on capital. Base prices 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 was eliminated in 1987.

Revenues



During 1987 and 1988, a transition arrangement limits the change's potential impact on the company's earnings. The commission also is considering elimination of the balancing account for electric sales to the largest commercial and industrial customers.

In 1988, base prices will replace the balancing account for original San Onofre construction costs. Until the commission has reviewed those costs, the company will continue to use the balancing account for additions to San Onofre after it started operations.

Gas and electric operating revenues for 1987 were down 5 percent from 1986. About one-third of the decrease is due to lower fuel costs. The remainder largely is due to the San Onofre write-off discussed in Note 7 of the notes to consolidated financial statements.

Revenues also decreased due to a lower authorized margin. The margin is lower because authorized return on equity decreased from 15 percent in 1986 to 13.9 percent in 1987. Also, margin is lower because less revenue is required to cover the lower tax expense since the Tax Reform Act of 1986 lowered tax rates from 46 percent in 1986 to 40 percent in 1987. An increase in the authorized equity to debt ratio partly offset the lower authorized return on equity. The net effect of these changes was a reduction of net income by about $5 million, or 10 cents per share.

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.

Electric sales volume increased 6 percent in 1987, reflecting customer growth. In 1986, volume increased only .5 percent. While customers increased in 1986, average usage declined due to mild weather. Gas sales volume decreased 7 percent in 1986 due to mild weather but increased 17 percent in 1987 due to cold weather.

Revenues from diversified operations arise from subsidiaries of Pacific Diversified Capital Company, a company subsidiary. Most of these revenues and the gas and oil for resale to other customers arise from Mock Resources, Inc., one of these subsidiaries, which was acquired during the fourth quarter of 1986. Mock purchases the gas and oil and sells them at a small margin.

Costs

The total cost of electric fuel and purchased power decreased in 1987 and 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 aggressive program of spot-market gas purchases.

The cost of gas purchased for resale in 1987 decreased because of lower prices. The cost of gas purchased for resale decreased in 1986 because of lower sales volume, due to milder weather, and lower prices.

Other operating costs increased $19 million in 1986 due to the Heber geothermal plant's becoming operational, increased insurance costs and the operating costs of the new subsidiaries described below.

Taxes on operating income decreased in 1987 because the Tax Reform Act of 1986 lowered corporate tax rates and because operating income was lower.

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, changed only slightly in 1987 but increased in 1986 due to the increase in the amount of construction trust funds. 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.

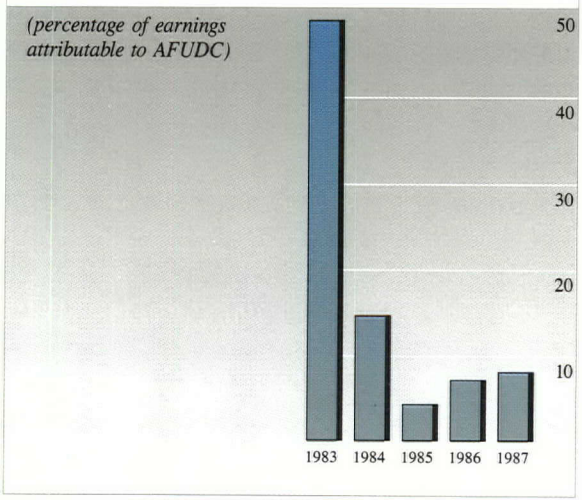
Interest charges are net of interest income on construction funds temporarily invested by the trustee. In 1987 and 1986, construction funds increased while debt reductions and the use of low-interest, tax-exempt financings increased. This resulted in a decrease in interest charges. The company's embedded cost of debt decreased from 10.1 percent in 1985, to 9.6 percent in 1986 and to 9.4 percent in 1987.

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 and 1987 is still held by a trustee for use in 1988.

A good measure of liquidity provided by operations is the percentage of earnings that arises from the allowance for funds used during construction. Since this type of earnings does not provide cash in the short-term, utilities prefer it to be a small percentage of earnings. The company's success in this area is shown in the following chart.

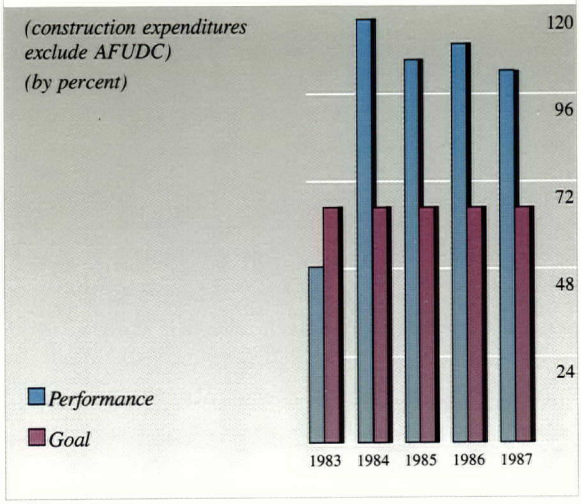
Quality of Earnings



The percentage of funds for construction that the company can generate internally is another

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.

Maintain Internal Generation of Construction Expenditures (at 65 percent or more)

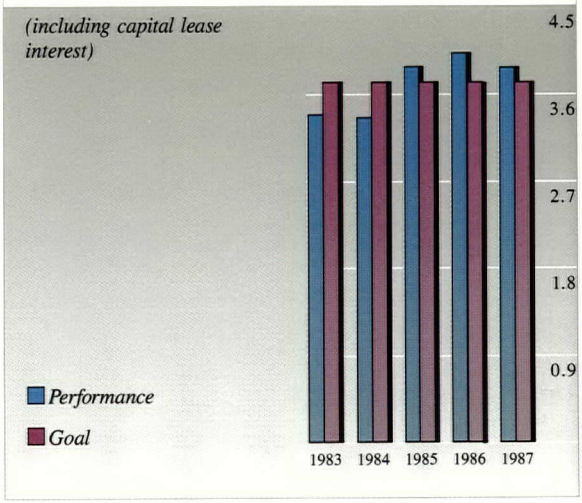


The company's capital structure is one factor that has enabled it to obtain long-term financing at attractive rates. The following table shows the percentages of capital represented by common equity, preferred stock and long-term debt.

	1983	1984	1985	1986	**1987**	Goal
Common equity	37%	40%	43%	44%	**45%**	45-48%
Preferred stock	9	9	8	7	**6**	5-7
Debt and leases	54	51	49	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 following chart shows the company's results.

Maintain 3.75X Pretax Interest Coverage



Construction expenditures, excluding nuclear fuel, are expected to total $225 million in 1988, up 14 percent from $197 million in 1987. 1988 construction is expected to be funded from the use of the construction trust funds arising from issuances of industrial development bonds and internal generation. And, in spite of the uncertainty associated with the Southwest Powerlink, management believes ample external sources of long-term and short-term financing will continue to be available if a need or an opportunity arises. Nevertheless, regulatory disallowances associated with the Southwest Powerlink may reduce cash flow from operations. The San Onofre disallowance will reduce cash flow from operations by about $13 million in 1988 and by slightly smaller amounts in future years.

The Future

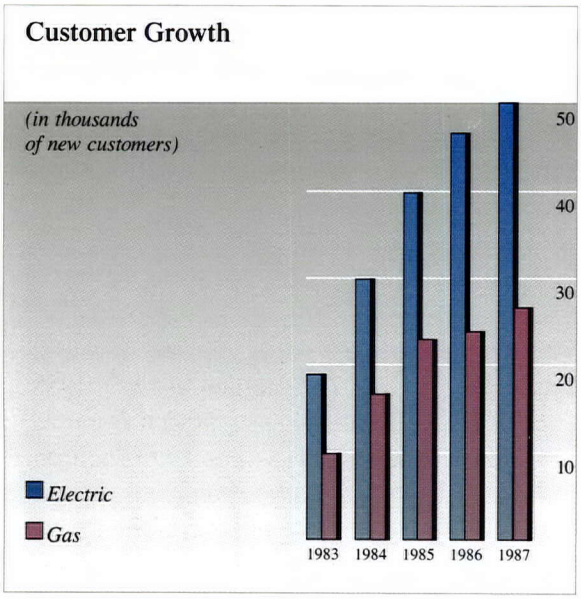
Several trends and factors are expected to affect future operating results and liquidity.

- San Diego's population is growing at a rapid rate, resulting in increasing sales. However, the rate of sales growth may 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.
- Competition and partial deregulation have begun.
- The company is diversifying.

A short description of each of these follows.

Population Growth

The company's rate of new customer additions has been and continues to be well above the national average. For 1986 and 1987, the rate exceeded 5 percent for electric and 4 percent for gas. The company expects the rate of growth to remain high. Over the last five years, electric and gas customer growth has averaged approximately 4 percent.



Rate of Return

The decline in inflation and interest rates has led to lower authorized rates of return on equity. The CPUC authorized a rate of return on equity of 13.9 percent in 1987, which was down from 15 percent in 1986 and 16 percent in 1985. For 1988, the commission lowered the rate of return on equity to 12.75 percent.

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 prices. 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 act has not significantly affected the company's net income because electric and gas prices are adjusted for the tax changes. However, it has reduced cash provided by operations because investment credits have been eliminated and the benefits of depreciation deductions have been reduced. The lower tax rates reduce tax expense and revenue by equal amounts, but do not affect cash flow.

Competition and Partial Deregulation

The electric and natural gas utility industry is facing competition and partial deregulation. 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 cost recovery risk to the company.

As of January 1, 1988, the company's electricity prices averaged 9.7 cents per kwh. While still higher than many other utilities, the company's average electricity prices have decreased 24 percent since 1985. The company continues to pursue goals to lower prices and restructure the way customers pay for electric service to reflect the company's costs better. Because of this, the company expects its prices to be more competitive with the alternative sources of electricity available to its customers.

Substantial progress toward the goals of lowering and restructuring electricity prices was made in 1987. In addition to reducing its costs which are passed on to customers, the company obtained approval from the CPUC to revise the price structure for its largest commercial and industrial customers. More fixed costs are recovered now through fixed price components rather than in variable costs. In addition, standby charges were revised to approximate more closely the cost of providing standby service to self-generators.

The CPUC also approved reallocation of costs to customer classes to reflect the actual costs of serving each class better. In the past, price increases were placed disproportionately on large electricity users in an effort to minimize price increases to residential customers. This resulted

in commercial and industrial customers' paying a price higher than the actual cost to serve them. This differential has been reduced greatly as a larger portion of price decreases has been passed on to commercial and industrial customers. These changes are expected to reduce the amount of bypass of the company's electric system. The CPUC's new price structure policies, however, do not allow residential prices to decrease as quickly or as much as those for commercial and industrial customers.

Almost one-tenth of the company's electric sales is to the federal government, principally to the U.S. Navy. As part of a national program, the Navy has studied its utility costs and considered leaving the company's electrical system. The changes described above have reduced the prices charged to the Navy and should significantly reduce the likelihood of the Navy's leaving the company's system.

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 lowered the total cost of natural gas purchases greatly. Previously, all gas came from Southern California Gas. SDG&E's retail customers that meet certain criteria may purchase gas and pay SDG&E a transmission fee. The California commission also has restructured the price-setting mechanisms for natural gas sales to certain large customers.

Diversification

One corporate strategy to improve financial performance is to diversify. During 1986 and 1987, Pacific Diversified Capital acquired four companies. In addition, SDG&E is reviewing a reapplication to the California commission for the formation of a holding company to facilitate diversification.

In November 1987, PDC acquired Wahlco, Inc., a manufacturer of air pollution control equipment. Its customers are primarily electric utility coal-fueled generating plants.

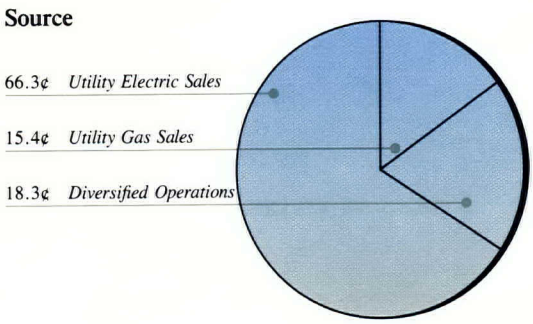
In October 1986, PDC acquired Computing Solutions, Inc., a computerized mapping company. The new acquisition was merged into Integrated Information Systems, Inc., the subsidiary formed in 1985 to operate in the same field. In October 1986, PDC acquired Phase One Development, Inc., a real estate development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

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

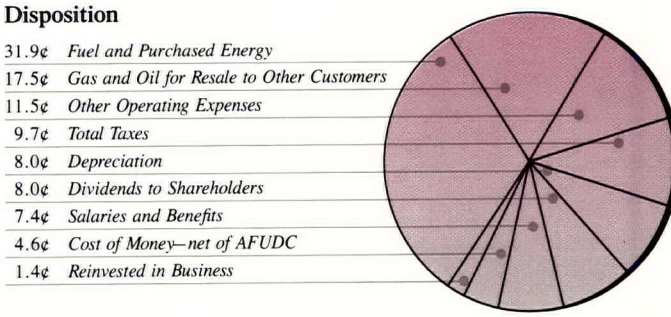
A full year of Mock Resources' revenues for the first time made a significant change in the source and disposition of the revenue dollar compared with earlier years. Mock is a marketer of petroleum products and natural gas.

1987 Revenue Dollar

Source



Disposition



Statements of Consolidated Income

(In Thousands Except Per Share Amounts)

For the Years Ended December 31		1987	1986	1985
Operating Revenues				
Electric	a	**$1,261,312**	$1,333,479	$1,395,655
Gas		**293,859**	299,202	343,047
Diversified operations	b	**349,057**	1,530	—
Total operating revenues		**1,904,228**	1,634,211	1,738,702
Operating Expenses				
Electric fuel and purchased power		**437,842**	456,402	535,968
Gas for resale to utility customers		**170,303**	175,286	223,407
Gas and oil for resale to other customers	b	**336,632**	—	—
Maintenance		**66,041**	73,502	74,484
Depreciation and amortization		**151,655**	140,732	132,506
Property and other taxes		**40,479**	37,714	35,179
Other		**288,476**	282,378	257,573
Income taxes (Note 6)	c	**151,021**	185,847	191,718
Total operating expenses		**1,642,449**	1,351,861	1,450,835
Operating Income		**261,779**	282,350	287,867
Other Income and (Deductions)				
Allowance for other funds used during construction		**14,816**	13,035	5,772
Taxes on nonoperating income (Note 6)		**7,161**	(4,534)	(972)
Other—net		**(1,916)**	34,296	23,269
Total other income		**20,061**	42,797	28,069
Income Before Interest Charges and Cumulative Effect of Change in Accounting Principle		**281,840**	325,147	315,936
Interest Charges				
Long-term debt		**90,529**	95,364	104,449
Short-term debt and other		**12,109**	17,468	11,065
Allowance for borrowed funds used during construction		**72**	(881)	(2,300)
Net interest charges		**102,710**	111,951	113,214
Income Before Cumulative Effect of Change in Accounting Principle		**179,130**	213,196	202,722
Cumulative effect of change in accounting principle (Note 2)	d	**17,673**	—	—
Net Income (before preferred dividend requirements)		**196,803**	213,196	202,722
Preferred Dividend Requirements		**13,745**	22,425	23,797
Earnings Applicable to Common Shares		**$ 183,058**	$ 190,771	$ 178,925
Average Common Shares Outstanding		**55,849**	55,830	55,125
Earnings Per Common Share				
Before cumulative effect of change in accounting principle		**$ 2.96**	$ 3.42	$ 3.25
Cumulative effect of change in accounting principle		**.32**	—	—
Net earnings	e	**$ 3.28**	$ 3.42	$ 3.25
Dividends Declared Per Common Share		**$ 2.50**	$ 2.345	$ 2.205

See notes to consolidated financial statements.

Excerpts from the Financial Review

a. Electric operating revenues decreased in 1987 primarily because of a decline in fuel costs and a construction cost disallowance for San Onofre Nuclear Generating Station units 2 and 3.

b. This relates primarily to Mock Resources, Inc., a nonutility subsidiary acquired at the end of 1986 by Pacific Diversified Capital.

c. Taxes declined due to the lower rates in the Tax Reform Act of 1986 and lower operating income.

d. In connection with the Tax Reform Act of 1986, the company changed the timing of when it records revenue. This resulted in a one-time boost to earnings.

e. Earnings in 1987 declined in comparison with those in 1986 because 1986 earnings included 25 cents per share from the sale of an investment in Energy Factors, Inc. by Pacific Diversified Capital.

Consolidated Balance Sheets

(In Thousands of Dollars)

Balance at December 31		1987	1986
Assets			
Utility plant—at original cost			
In service		**$3,907,208**	$3,696,637
Construction work in progress		**144,316**	150,329
Accumulated depreciation		**(1,134,617)**	(982,605)
Utility plant—net (Note 3)	a	**2,916,907**	2,864,361
Investments and other property		**81,436**	48,425
Construction funds held by trustee (Note 8)	b	**130,946**	137,152
Current assets			
Cash and temporary investments		**84,178**	70,409
Receivables		**189,020**	127,101
Inventories		**48,862**	66,046
Regulatory balancing accounts undercollected—net		**—**	24,039
Other		**14,351**	12,153
Total current assets		**336,411**	299,748
Goodwill	c	**38,722**	5,542
Deferred charges and other assets		**96,818**	103,704
Total		**$3,601,240**	$3,458,932
Capitalization and Liabilities			
Capitalization (see Statements of Capital Stock and Long-Term Debt)			
Common equity	d	**$1,243,343**	$1,205,819
Preferred stock	e	**156,307**	179,743
Long-term debt (Note 3)		**1,204,587**	1,193,922
Total capitalization		**2,604,237**	2,579,484
Current liabilities			
Long-term debt redeemable within one year (Note 3)		**115,000**	88,000
Current portion of long-term debt (Note 3)		**35,445**	54,144
Accounts payable		**179,961**	111,439
Dividends payable		**37,971**	37,529
Interest, taxes and other accruals		**74,325**	112,704
Regulatory balancing accounts overcollected—net		**58,883**	—
Other		**32,106**	46,358
Total current liabilities		**533,691**	450,174
Customer advances for construction		**65,692**	55,636
Accumulated deferred income taxes—net (Note 6)		**186,935**	173,609
Accumulated deferred investment tax credits (Note 6)		**159,897**	159,245
Deferred credits and other liabilities		**50,788**	40,784
Contingencies and commitments (Notes 7 and 8)		**—**	—
Total		**$3,601,240**	$3,458,932

See notes to consolidated financial statements.

Excerpts from the Financial Review

a. Although the company spent more than $200 million on capital additions in 1987, there was no large single project. Rather, the money was spent primarily on adding new customers and improving the distribution and transmission system.

b. Funds raised from the issuance of tax-exempt bonds in 1986 and 1987 will serve as a source of funds in 1988.

c. The increase resulted from the acquistion of Wahlco, Inc., by Pacific Diversified Capital in November 1987.

d. With the increase in common equity to 45 percent of total capitalization in 1987, the company achieved its capital structure goal.

e. The company retired two series of preferred stock as well as 90 percent of a third series. It also issued a lower-cost series. These events reduced preferred stock to 6 percent of total capitalization.

Statements of Consolidated Sources of Funds for Construction

(In Thousands of Dollars)

For the Years Ended December 31		1987	1986	1985
Funds Provided by Operations				
Income before cumulative effect of change in accounting principle		**$179,130**	$213,196	$202,722
Non-cash items in net income				
Depreciation and amortization		**178,433**	163,146	151,129
Deferred income taxes and investment tax credits—net	a	**9,236**	70,933	69,829
Allowance for funds used during construction	b	**(14,744)**	(13,916)	(8,072)
Other—net		**(1,301)**	1,145	2,468
Funds provided before cumulative effect of change in accounting principle		**350,754**	434,504	418,076
Cumulative effect of change in accounting principle		**17,673**	—	—
Funds provided by operations		**368,427**	434,504	418,076
Dividends		**(153,163)**	(153,106)	(145,713)
Funds reinvested	c	**215,264**	281,398	272,363
Funds Provided (Used) by Long-Term Financing				
Sale of preference stock		**44,473**	—	—
Sale of common stock		**124**	125	43,070
Issuance of long-term debt	d	**68,182**	122,392	131,227
Retirement of long-term financing		**(155,030)**	(189,164)	(201,810)
Addition to capital lease obligations		**12,025**	12,020	16,295
Funds used by long-term financing		**(30,226)**	(54,627)	(11,218)
Other Funds Provided (Used)				
Acquisition of Wahlco, Inc.				
Goodwill		**(33,229)**	—	—
Other		**(7,688)**	—	—
Regulatory balancing accounts—net	e	**82,922**	(29,073)	27,500
Investments and other property		**(8,311)**	3,933	(5,215)
Construction funds held by trustee		**6,206**	(88,214)	(25,448)
Cash and temporary investments		**(3,586)**	81,822	(5,183)
Receivables		**(58,625)**	7,733	1,806
Inventories		**17,184**	5,940	12,980
Accounts payable		**66,755**	(26,706)	26,222
Interest, taxes and other accruals		**(38,565)**	28,403	(11,004)
Other—net		**659**	44,059	(25,289)
Other funds provided (used)		**23,722**	27,897	(3,631)
Total additions to utility plant (excluding allowance for funds used during construction)		**$208,760**	$254,668	$257,514

See notes to consolidated financial statements.

Excerpts from the Financial Review

a. The Tax Reform Act of 1986 is causing the deferred taxes to decline substantially. This first affected the company in 1987, reducing cash provided by operations.

b. For the third year in a row, the allowance for funds used during construction remained very low. As a result, SDG&E has a higher quality of earnings than the industry average.

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

d. The embedded cost of debt decreased again in 1987 due to the retirement of two series of higher-cost debt issues, the maturing of half of a third series and the issuance of one series of lower-cost, tax-exempt industrial development bonds.

e. The company uses balancing accounts for fuel costs, San Onofre ownership costs, and differences between actual and estimated costs and sales volumes. In 1988, the San Onofre costs are being transferred to base prices.

Statements of Consolidated Changes in Capital Stock and Retained Earnings

(In Thousands of Dollars)

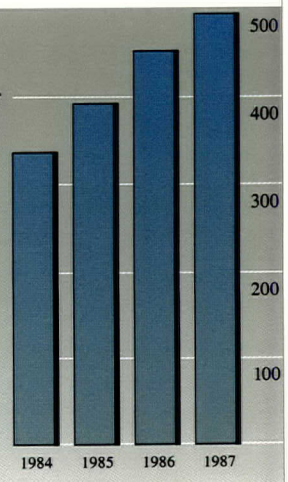
For the Years Ended December 31, 1985, 1986 and 1987	Preferred Stock: Not Subject to Mandatory Redemption	Preferred Stock: Subject to Mandatory Redemption	Common Stock	Premium on Capital Stock	Retained Earnings
Balance, December 31, 1984	$161,000	$60,500	$270,318	$446,964	$335,623
Net income					202,722
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
Net income					196,803
Common stock sold (24,780 shares)			124		
Preferred stock sold (450,000 shares)		45,000		(527)	
Preferred stock retired (1,384,360 shares)	(41,000)	(22,436)		(5,713)	
Current sinking fund requirement		(5,000)			
Dividends declared					
Preferred stock					(13,528)
Common stock					(139,635)
Balance, December 31, 1987	$ 87,493	$68,814	$279,363	$467,618	$496,362

See notes to consolidated financial statements.

Retained Earnings

(in millions of dollars, at December 31)

Lower earnings and higher dividends in 1987 resulted in a smaller increase in retained earnings.



Statements of Consolidated Capital Stock

(In Thousands of Dollars Except Voluntary Redemption Price)

Balance at December 31		1987	1986
Common Equity			
Common stock, without par value, authorized 170,000,000 shares, outstanding: 1987, 55,872,602 shares; 1986, 55,847,822 shares		$ 279,363	$ 279,239
Premium on capital stock		467,618	473,858
Retained earnings		496,362	452,722
Total common equity		$1,243,343	$1,205,819
Preferred Stock	Voluntary Redemption Price		
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, 374,650 shares outstanding	20.25	7,493	7,493
Without par value*			
$9.84 Series, 1986, 160,000 shares outstanding	—	—	16,000
$7.80 Series, 200,000 shares outstanding	101.00	20,000	20,000
$7.20 Series, 150,000 shares outstanding	101.00	15,000	15,000
$2.68 Series, 1986, 1,000,000 shares outstanding	—	—	25,000
$2.475 Series, 1,000,000 shares outstanding	29.15	25,000	25,000
Total not subject to mandatory redemption		$87,493	$128,493
Subject to mandatory redemption			
Without par value*			
$8.25 Series, 1987, 95,000 shares; 1986, 105,000 shares outstanding	$104.675	$ 9,500	$ 10,500
$9.125 Series, 1987, 160,000 shares; 1986, 200,000 shares outstanding	105.021	16,000	20,000
$15.44 Series, 1987, 25,640 shares; 1986, 250,000 shares outstanding	110.29	2,564	25,000
$7.05 Series, 1987, 450,000 shares outstanding	107.05	45,000	—
Current sinking fund requirement		(4,250)	(4,250)
Total subject to mandatory redemption		$68,814	$ 51,250

*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*	1987	1986
First mortgage bonds (Note 3)		
4⅞% Series G, due October 1, 1987	$ —	$ 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
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	**10,868**	11,268
16.70% Series W, due November 3, 1987 and 1988	**20,000**	40,000
16.65% Series X, due September 1, 1986 and 1987	—	10,000
16.65% Series Y, due September 1, 1986 and 1987	—	7,500
12⅞% Series Z, due July 15, 2013	**8,069**	8,069
10% Series AA, due June 1, 2018	**150,000**	150,000
10% Series BB, due September 1, 2018	**150,000**	150,000
4.90% 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
4.70% Series FF, due December 1, 2007	**35,000**	35,000
7⅝% Series GG, due July 1, 2021	**44,250**	44,250
7⅜% Series HH, due December 1, 2021	**81,350**	81,350
8¾% Series II, due March 1, 2023	**25,000**	—
Total	**1,054,537**	1,079,437
Capitalized leases		
Nuclear fuel	**92,811**	108,549
Generating facility	**101,534**	105,098
Other	**20,775**	18,108
Total	**215,120**	231,755
Other long-term debt	**101,922**	41,695
Unamortized discount on long-term debt	**(16,547)**	(16,821)
Long-term debt redeemable within one year (Note 3)	**(115,000)**	(88,000)
Current portion of long-term debt (Note 3)	**(35,445)**	(54,144)
Total	**$1,204,587**	$1,193,922

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	**1987**	**1986**	**1985**
Operating Revenues*	**$1,904,228**	$1,634,211	$1,738,702
Operating Income			
Electric operations	**$ 241,777**	$ 258,581	$ 261,199
Gas operations	**21,734**	24,940	26,668
Diversified operations	**(1,732)**	(1,171)	—
Total	**$ 261,779**	$ 282,350	$ 287,867
Depreciation and Amortization			
Electric operations	**$ 156,248**	$ 145,492	$ 136,571
Gas operations	**19,288**	17,345	14,558
Diversified operations	**2,897**	309	—
Total	**$ 178,433**	$ 163,146	$ 151,129
Utility Plant Additions**			
Electric operations	**$ 171,616**	$ 202,436	$ 221,764
Gas operations	**37,144**	52,232	35,750
Total	**$ 208,760**	$ 254,668	$ 257,514
Identifiable Assets			
Utility plant—net			
Electric operations	**$2,660,408**	$2,616,392	$2,549,596
Gas operations	**256,499**	247,969	218,618
Total	**2,916,907**	2,864,361	2,768,214
Inventories			
Electric operations	**46,735**	60,988	68,005
Gas operations	**2,127**	5,058	3,981
Total	**48,862**	66,046	71,986
Other identifiable assets			
Electric operations	**276,285**	252,773	204,098
Gas operations	**74,842**	96,236	31,809
Diversified operations	**143,719**	59,666	—
Total	**494,846**	408,675	235,907
Other Assets	**140,625**	119,850	256,426
Total Assets	**$3,601,240**	$3,458,932	$3,332,533

*The detail to operating revenues is provided on the Statements of Consolidated Income on page 19. The gas operating revenues shown therein include $18 million in 1987, $27 million in 1986 and $38 million in 1985 representing the gross margin on sales to the electric segment. These margins arise from intersegment sales of $137 million in 1987, $100 million in 1986 and $208 million in 1985 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.

Notes to Consolidated Financial Statements

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 utility plant: 4.12 percent in 1987 and 1986 and 4.08 percent in 1985.

Inventories

Inventories include $36 million of materials and supplies ($46 million in 1986) and $13 million of fuel oil ($20 million in 1986). Materials and supplies are valued at average cost and fuel oil is valued by the last-in first-out, or LIFO, method.

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 from utility customers consist of deliveries to customers and the changes in regulatory balancing accounts. Prior to 1987, these revenues were based on meters read on a cycle basis throughout each month. As described in Note 2, this method was changed in 1987. 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 prices. The CPUC reviews the reasonableness of the amounts in these accounts.

The CPUC also ordered the use of a balancing account to record the ownership costs, such as depreciation and an investment return, for San Onofre nuclear units 2 and 3 pending resolution of the issue discussed in Note 7. That balancing account currently is being phased out by a transfer to general rates.

Goodwill

Goodwill arose from the acquisition of certain businesses by Pacific Diversified Capital Company, an SDG&E subsidiary. It is being amortized on a straight-line basis over 20 to 40 years.

Other

Certain prior year amounts have been reclassified for comparability.

In 1987 and 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. SDG&E would become a subsidiary of the holding company and common stock shareholders of SDG&E 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 SDG&E. The company is continuing to reevaluate its alternatives, including reapplication to the commission for conditions that are acceptable to the company.

See Note 5 regarding employee benefit plans, Note 6 regarding accounting for income taxes and Note 8 regarding accounting for leases.

The Consolidated Balance Sheet at December 31, 1986 has been restated to add $232 million to net utility plant and to long-term debt in order to capitalize certain leases previously accounted for as operating leases. The Statements of Consolidated Sources of Funds for Construction and of Consolidated Long-Term Debt and the Schedules of Consolidated Financial Information by Segments of Business also have been restated to effect this change.

2 Change in Accounting Principle

Prior to January 1, 1987, the company recorded revenues from the sale of electricity and natural gas when it billed customers for service after it read their meters. This practice was common in the utility industry and the Internal Revenue Service accepted it for calculating taxable income.

Since meters are read once a month on a cycle basis, at any month end there has been up to one month's unbilled service for each customer, depending upon the date of the customer's meter reading. On the average, unbilled service approximated one-half of a month's deliveries at month end. Since this was generally consistent from month to month, the total revenue recorded in any year approximated the total deliveries for the year.

The Tax Reform Act of 1986 made the unrecorded deliveries subject to federal income tax effective January 1, 1987. Also as of January 1, 1987, the company made a similar change in its accounting policy for the financial statements. The cumulative effect of the change increased first quarter revenue by $32 million and net income by $18 million, or $.32 per share.

Since the $32 million has been building up over many years, applying the new accounting policy to prior years would not significantly affect previously recorded revenues or net income. Therefore, the pro-forma effects on prior years are not presented. Similarly, adoption of the new policy will not significantly affect revenues or net income for future periods.

3 Long-Term Debt

Due dates of long-term obligations are shown on the Statements of Consolidated Long-Term Debt on page 24. Excluding capital leases, which are described in Note 8, combined aggregate maturities and sinking fund requirements of long-term debt are $29 million for 1988, $26 million for 1989, $41 million for 1990, $13 million for 1991 and $14 million for 1992.

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, 1988 for the Series FF bonds and September 1, 1988 for the Series CC and Series DD bonds.

4 Facilities Under Joint Ownership

The Southwest Powerlink transmission line and the San Onofre nuclear power plant are jointly owned with other utilities. The company's interests at December 31, 1987 were:

(In Millions of Dollars)

Project	Southwest Powerlink	San Onofre
Ownership interest (%)	89	20
Utility plant in service	$209	$1,172
Accumulated depreciation	$ 24	$ 187
Construction work in progress	$ 0	$ 21

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 currently is estimated to be $170 million. These costs are expected to be recovered in rates over the estimated lives of the plants. In December 1987, the company began placing in an externally managed trust fund the amounts collected in rates.

5

Employee Benefit Plans

The company-funded pension plan covers substantially all employees. Benefits are related to the employees' compensation. Plan assets consist primarily of common stocks, annuity contracts, U.S. government securities and bonds.

At December 31, 1986, the company reported that as of the latest benefit information date, July 1, 1986, the plan had assets of $287 million and accumulated plan benefits of $173 million. The benefit amount was based upon an 8 percent discount rate and included $149 million that was vested.

In 1987, the company adopted Statement of Financial Accounting Standards No. 87. This had no effect on the pension expense for 1987. The company continues to fund the plan based on the aggregate cost actuarial method.

Net pension cost for 1987 consists of the following (in thousands):

Cost related to current service	$ 14,413
Interest on projected benefit obligation	20,878
Return on plan assets	(9,854)
Other	(14,650)
Total cost	$ 10,787

The plan's funded status at December 31, 1987 is as follows (in thousands):

Plan assets at fair value	$297,438
Projected benefit obligation (including $194,978 at current compensation levels of which $178,296 is vested)	285,818
Excess of plan assets over projected benefit obligation	11,620
Unrecognized effect of accounting change	(3,209)
Unrecognized actuarial gains and losses	(8,411)
Amount recognized as an asset	$ —

The projected benefit obligation assumes an 8 percent actuarial discount rate and a 6 percent average annual salary increase. The expected long-term rate of return on plan assets is 8.5 percent.

Eligible employees may make a contribution of 1 to 11 percent of their base pay to the company's Savings Plan for investment in mutual funds or in common stock of the company. The company contributes up to 3 percent of a participant's base compensation for investment in the company's common stock.

The company contributed approximately $14 million in 1987, $16 million in 1986 and $15 million in 1985 to these plans.

The company partially provides health and life insurance benefits to retired employees. The benefits paid and expensed amounted to $3 million in 1987 and $2 million in 1986 and in 1985.

The company has a long-term incentive stock compensation plan, which provides for aggregate awards of up to 1,350,000 shares of common stock over a 10-year period ending in 1996. The company issued approximately 25,000 shares of stock to officers for $5 per share in 1986 and in 1987. These shares were issued subject to buy-back if certain corporate goals are not met.

6 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, 1987, the cumulative net amounts of timing differences for which deferred taxes have not been provided were approximately $420 million for federal purposes and $630 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.

In December, the Financial Accounting Standards Board issued a new rule that will make a major change in the way tax expense is computed in future years. Deferred taxes shown in the income statement are essentially taxes on current year income that will be paid in future years. Under prior rules, deferred taxes are computed using current tax rates even if these taxes are expected to be higher or lower when they are paid in future years. The new rule will change that. Also, when tax rates change, like they did under the Tax Reform Act of 1986, the new rule requires an adjustment of deferred taxes. Prior rules do not permit it.

This new rule, which must be applied by 1989, is not expected to affect the company's profits or net worth significantly because most tax increases or reductions are borne by customers. However, deferred taxes on the balance sheet will increase by a substantial, but not yet quantified, amount and a new regulatory asset will be reported for the estimated amount collectible from customers.

Components of Income Tax Expense

(In Thousands of Dollars)	1987	1986	1985
Current federal income tax	**$145,679**	$ 87,231	$112,340
Current state franchise tax	**39,300**	28,060	36,166
Total current taxes	**184,979**	115,291	148,506
Deferred—federal and state taxes			
Regulatory balancing accounts—net	**(43,767)**	15,935	(14,010)
Construction projects	**(22,106)**	2,703	(19,277)
Tax over book depreciation	**38,985**	41,564	37,553
Nuclear fuel financing	**(2,009)**	(2,693)	3,211
Capitalized nuclear revenue	**626**	706	9,104
Call premium on refunded debt	**(821)**	5,862	7,785
State franchise tax	**(876)**	828	(3,678)
Unbilled revenue	**7,050**	—	—
Other—net	**(5,451)**	5,170	6,150
Total deferred taxes	**(28,369)**	70,075	26,838
Deferred investment tax credits—net	**2,161**	5,015	17,346
Total income tax expense	**$158,771**	$190,381	$192,690

Total Tax Expense as Reported in the Statements of Consolidated Income

(In Thousands of Dollars)	1987	1986	1985
Operating expenses	**$151,021**	$185,847	$191,718
Taxes on nonoperating income	**(7,161)**	4,534	972
Cumulative effect of change in accounting principle	**14,911**	—	—
Total	**$158,771**	$190,381	$192,690

Reconciliation of Statutory Federal Income Tax Rate to Effective Rate

(In Thousands of Dollars)	1987	1986	1985
Income before federal income taxes	**$326,595**	$369,803	$365,013
Statutory federal income tax rate	**40.0%**	46.0%	46.0%
Construction costs capitalized	**(1.0)**	(2.0)	(5.3)
Depreciation	**4.4**	3.1	2.9
Allowance for funds used during construction	**(1.7)**	(1.5)	(0.7)
Other—net	**(2.6)**	(3.2)	1.6
Effective federal income tax rate	**39.1%**	42.4%	44.5%

7

Contingencies Concerning San Onofre and the Southwest Powerlink

San Onofre Nuclear Generating Station units 2 and 3

The California Public Utilities Commission finished evaluating the construction costs for San Onofre units 2 and 3 in 1987, except as explained below. They disallowed $53 million of the company's share of the costs. The disallowance results in lower revenues and net income over the 30-year life of the plant. It reduced net income by $5 million in 1986 and $22 million in 1987. The annual reduction of net income will decline from $7 million in 1988 to zero over the remaining 26-year life of the units. The 1987 reduction was so much larger than future annual amounts will be because it included reductions related to 1983 through 1986 revenues.

In 1988, the company will restate its 1986 financial statements for the disallowance because of a new rule of the Financial Accounting Standards Board. The new rule requires reducing the plant value on the balance sheet by the amount of the disallowance and causes a further reduction of 1986 income. Accordingly, financial statements for the first quarter of 1988 will reflect a reduction of $30 million to $50 million in 1986 net income and in retained earnings at December 31, 1986. The exact amount depends upon two matters. The commission has not yet decided how much of the disallowed costs were AFUDC. The amount of AFUDC affects the income tax benefit arising from the disallowance. In addition, the Financial Accounting Standards Board's new rule on accounting for income taxes would affect the income tax rate applicable to the disallowance if the company adopts the new rule for 1986.

Southwest Powerlink

The company's 1986 General Rate Case decision by the California Public Utilities Commission ordered SDG&E to establish a five-year balancing account for the difference between the cost of energy received over the company's Southwest Powerlink transmission line and avoided cost.

In June 1986, the commission granted the company's request for a rehearing of this portion of the decision. During the hearings, the CPUC's Division of Ratepayer Advocates proposed disallowances aggregating $285 million in connection with power purchases over the transmission line. The Division of Ratepayer Advocates also recommended a balancing account, that would not earn interest, for allowed costs in excess of avoided costs.

The commission could decide to retain its original balancing account mechanism, adopt some or all of the division's recommendations, adopt a different disallowance mechanism or uphold the company's position that there should be no disallowance or balancing account mechanism. A decision is expected in the first half of 1988. 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.

8 Other Contingencies and Commitments

Nuclear insurance

Public liability claims that could arise from a nuclear incident are limited by the Price-Anderson Act to a maximum amount of $720 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 1987. The remaining $560 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 $3 million in the event of a nuclear incident involving any of the licensed reactors in the United States, if the amount of the loss exceeds $160 million.

The Price-Anderson Act expired in 1987 but, until it is replaced, its limits will remain in effect for the company and for other owners of existing nuclear facilities. The U.S. House of Representatives has passed a bill extending the act for 10 years. A Senate proposal to extend the act is still pending. The House bill would limit liability claims in the event of a nuclear incident such that the company's maximum retrospective adjustment would increase to $38 million. The act limits the retrospective premium adjustments to two incidents in any year, whereas the revised law may not have any such limit.

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 $895 million at December 31, 1987 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 $225 million, excluding nuclear fuel and AFUDC, is planned to be spent for utility plant construction in 1988. Construction funds held by a trustee (see the Consolidated Balance Sheets on page 20) 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. Utility plant includes $319 million at December 31, 1987 and $299 million at December 31, 1986 related to these leases. Utility plant—net and long-term debt include corresponding amounts of $215 million and $232 million. Prior to 1987, only a minor amount of these leases was accounted for as capital leases.

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

(In Millions of Dollars)	Capitalized Leases	Operating Leases
1988	$ 41	$11
1989	41	11
1990	41	11
1991	22	10
1992	12	8
Thereafter	144	—
Total future rental commitments	$301	$51

Rental payments totaled $54 million in 1987, $45 million in 1986 and $44 million in 1985.

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, 1987, the future minimum payments under the contracts were:

(In Millions of Dollars)	
1988	$ 223
1989	146
1990	107
1991	108
1992	111
Thereafter	1,334
Total minimum payments	$2,029

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 $229 million in 1987, $231 million in 1986 and $158 million in 1985.

Responsibility Report for the Financial Statements

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 discusses with the company's internal auditors and the independent public accountants the overall scope and specific plans for their respective audits. The committee also discusses the company's consolidated financial statements and the adequacy of the company's internal controls. The committee met twice during the fiscal year with the internal auditors and the independent public accountants, without management present, to discuss the results of their examinations, their evaluations of the company's internal controls, and the overall quality of the company's financial reporting. The internal auditors and the independent public accountants have full and free access to the 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.

Frank H. Ault
Controller

Auditors' Opinion

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

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

We have examined the consolidated financial statements of San Diego Gas & Electric Company and its subsidiaries (pages 19 to 31) for the years ended December 31, 1987, 1986 and 1985. 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.

In our report dated February 9, 1987, our opinion on the consolidated financial statements was qualified as being subject to the effects of such adjustments, if any, as might have been required had the outcome of the San Onofre matter been known. As discussed in Note 7 to the consolidated financial statements, during 1987 the uncertainty concerning the amounts of construction costs to be included in rate base was resolved. Accordingly, our present opinion on the 1986 and 1985 financial statements, as presented herein, is different from that expressed in our previous report.

As discussed in Note 7 to the consolidated financial statements, the California Public Utilities Commission is considering matters relating 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 1987 and 1986 consolidated financial statements had the outcome of the Southwest Powerlink matter been known, such consolidated financial statements present fairly the financial position of the company and its subsidiaries at December 31, 1987 and 1986 and the results of their operations and the sources of funds for construction for each of the three years in the period ended December 31, 1987, in conformity with generally accepted accounting principles consistently applied during the period except for the change, with which we concur, in 1987 in the method of accounting for unbilled revenues as described in Note 2 to the consolidated financial statements.

Deloitte Haskins & Sells January 22, 1988

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 A. Page, 54, a director since 1979, has been chairman of the board since 1983. He is president and chief executive officer of SDG&E. He also is the chairman of the board of Pacific Diversified Capital, an SDG&E subsidiary. Page is a certified public accountant and a licensed professional engineer with an extensive management background. He is chairman of the Pacific Coast Gas Association and a member of the board and former chairman of the San Diego Economic Development Corporation.

Clair W. Burgener

Clair Burgener, 66, 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 and is a director of San Diego Trust and Savings Bank, of TCS Enterprises and of Blue Shield of California.

Malin Burnham*

Malin Burnham, 60, a director since 1967, is chairman of John Burnham & Co., a mortgage loan, real estate and insurance firm. He is chairman of the board of First National Bank in San Diego and is a director of Businessmen's Assurance Co., of Cubic Corporation, of Gen-Probe, Inc., and of Pacific Diversified Capital. He also is chairman and a director of Burnham American Properties, Inc., and Burnham Pacific Properties, Inc. He serves as president of Sail America, which is organizing the USA's defense of the America's Cup.

Daniel W. Derbes*

Daniel Derbes, 57, 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 Signal Advanced Technology Group and executive vice president of The Signal Companies, Inc. Derbes also is a director of WD-40 and of Pacific Diversified Capital. He also is involved with many community organizations.

William D. McElroy

William McElroy, 71, a director since 1979, is a professor of biology and former chancellor of the University of California at San Diego. He is retiring from the board in April 1988.

Ralph R. Ocampo

Dr. Ralph Ocampo, 56, 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 is a director of the Mercy Hospital and Medical Center, of the San Diego chapter of the American Cancer Society and of the San Diego Community Foundation. He served as president of the Hispanic American University Foundation in 1986.

Charles R. Scott*

Charles Scott, 59, a director since 1983, has been president, chief executive officer and a director of Intermark, Inc. since 1970. He also is a director of the operating companies owned or controlled by Intermark, including Continental Graphic Corp., Mission West Properties, Pier 1 Imports, Ridgewood Properties, the Sunbelt Nursery Group, and the Triton Group, Ltd. He is a director of Pacific Diversified Capital. Scott has served on the board 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.

O. Morris Sievert*

Morris Sievert, 66, a director since 1976, was a corporate executive officer, primarily in the energy industry, for 30 years until he retired in 1987. He is president of O. Morris Sievert and Associates, general business consultants. He serves as a member of the board of directors of the Scripps Memorial Hospital Foundation and of Pacific Diversified Capital.

Fred C. Stalder

Fred Stalder, 67, 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 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.

Catherine Fitzgerald Wiggs

Catherine Fitzgerald Wiggs, 54, a director since 1979, is a management consultant in the fields of human resources and organizational effectiveness. 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 Stores, Inc., a division of Carter Hawley Hale Stores, Inc.

* Member of the executive committee

Committees of the Board

Audit

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

Executive

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

Executive Compensation

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

Finance

This committee 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 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.

Corporate Profile

San Diego Gas & Electric is an investor-owned energy management company founded in 1881. It has 4,612 full-time employees in its utility operations.

The electric operations division purchases, generates and distributes energy to about one million 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 about 2.5 million.

The systemwide electric customer growth rate was 5.3 percent in 1987, among the highest in the country. The company's northern districts had the highest growth rates, with two districts hooking up customers at a rate of 9.4 percent in 1987.

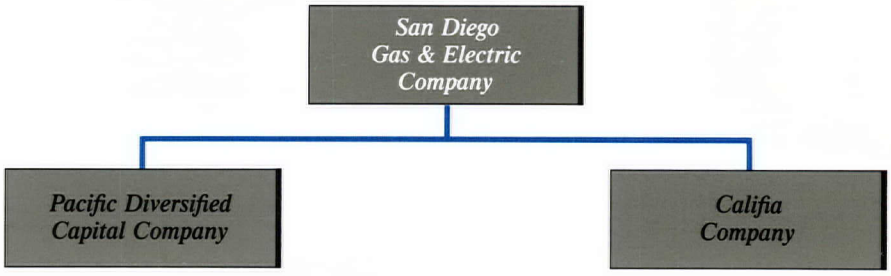
SDG&E's gas operations division purchases and distributes natural gas to more than 625,000 customers in San Diego County. The gas service area has been expanding, most recently eastward along the international border. The gas customer growth rate was 4.5 percent in 1987.

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; 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, a company used for general purposes, such as holding some real estate. (Additional information on PDC begins on page 36.) ▣

SDG&E Service Area

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 Moreno gas compressor station is located in Riverside County, 35 miles north of the San Diego County line.



Officers

Thomas A. Page, 54
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, 55
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.

Stephen L. Baum, 47
Senior Vice President and General Counsel

Stephen Baum was elected senior vice president in 1987 after serving as a vice president since 1985, when he joined SDG&E as vice president and general counsel. He formerly was senior vice president and general counsel for the Power Authority of the State of New York.

Gary D. Cotton, 47
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, 50
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, 40
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, 50
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, 61
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.

R. Lee Haney, 48
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.

James C. Holcombe, 42
Vice President—Resource Development

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, 56
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.

George A. F. Weida, 51
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.

Frank H. Ault, 43
Controller

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

Margot A. Kyd, 34
Treasurer

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

Delroy M. Richardson, 49
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.

Corporate Profile

Pacific Diversified Capital is SDG&E's independently operated holding company subsidiary. In 1986, it began acquiring and developing companies as part of the corporation's strategy to diversify into other businesses to achieve future earnings growth.

PDC's own strategic plan limits the types of businesses it will consider acquiring to:

- companies providing services and products to the utility industry or its marketplace
- real estate development opportunities in San Diego and a few other select locations

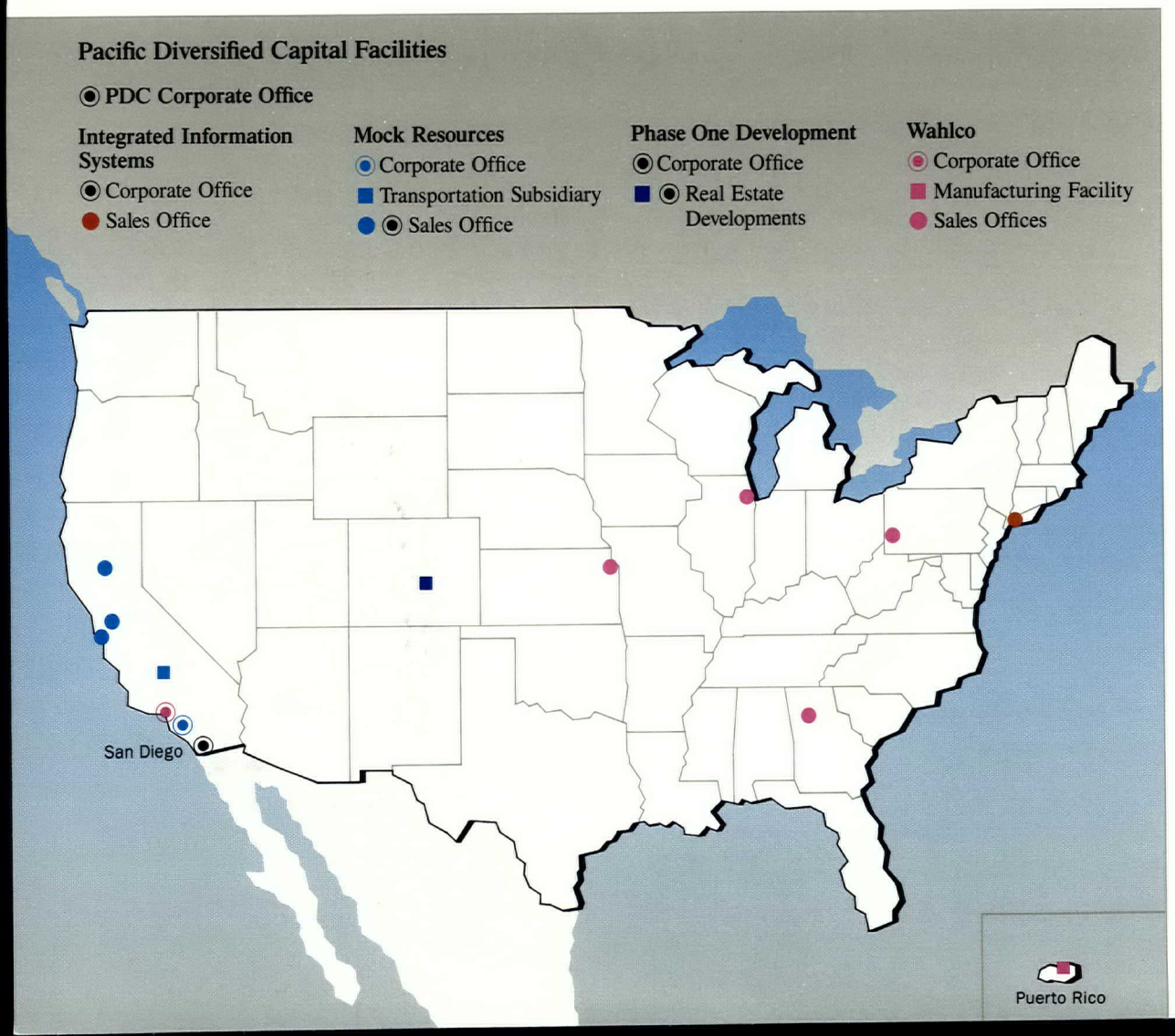
Using these guidelines, PDC acquired four companies by the end of 1987. Its most recent acquisition, Wahlco, Inc., of Santa Ana, California, was completed in October 1987. Wahlco is the leading domestic and international manufacturer of flue gas conditioning systems, which are used in air pollution control. Its customers primarily are electric utilities with coal-fueled generating plants.

Wahlco was founded in 1972. Its manufacturing facility is in Puerto Rico. It has regional sales offices in four U.S. cities and a worldwide network of manufacturers' representatives.

Wahlco's systems have been installed in more than 200 plants around the world. At the time of its acquisition, it had about $18 million in annual sales, $30 million in assets, and 100 employees.

In 1986, PDC acquired three other companies:

- Computing Solutions, Inc., of Port Chester, New York, a computerized mapping software company. It was merged into Integrated Information Systems of San Diego, an existing PDC subsidiary. The combined company provides services to the utility industry and to municipalities in the United States and several foreign countries.
- Mock Resources, Inc., of Irvine, California, PDC's largest revenue producer. It markets and



Pacific Diversified Capital has more than three hundred employees working in a dozen locations. Wahlco, Inc. has its manufacturing facility in San Juan, Puerto Rico. The company makes flue gas conditioners, which are used in many coal-fueled power plants for air pollution control.

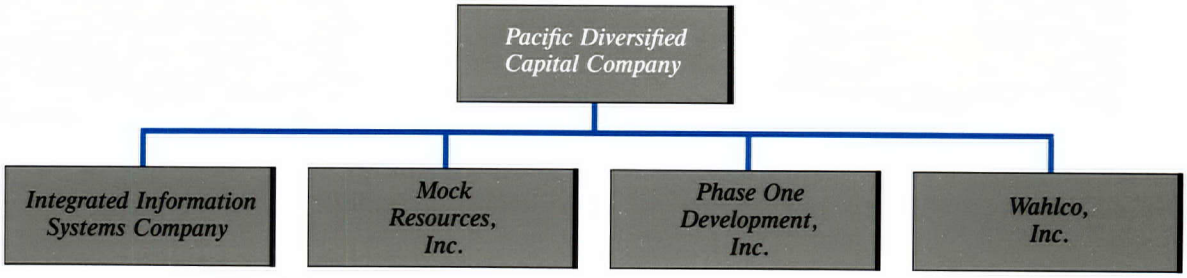
distributes natural gas and petroleum products in several western states. It has a transportation subsidiary based in Bakersfield, California and regional sales offices around the state.

- Phase One Development, Inc., a San Diego-based commercial real estate development company. It also has projects in Colorado Springs.

Pacific Diversified and its subsidiaries had 302 employees at December 31, 1987.

PDC's strategy has been, and continues to be, to diversify slowly and deliberately. Acquisition candidates must have certain characteristics, especially excellent top management that will stay with the company after it is acquired. Other important criteria that candidates must meet are good sales and financial performance records, low debt ratios and a leading position in their own industries.

PDC intends to acquire 8 to 12 companies by 1996 in order to achieve its earnings goal of generating 25 percent of the corporation's total earnings by that year. ▣



Officers

Pacific Diversified Capital Company

Richard Korpan, 46
President and
Chief Executive Officer

Henry N. Huta, 40
Vice President and
Chief Financial Officer

Computerized mapping

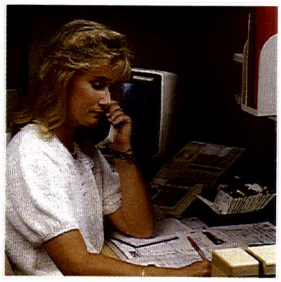
Integrated Information Systems Company

C. Christopher Fecher, 41
President and
Chief Executive Officer

Thomas E. Anderson, 38
Vice President and
General Manager

Charles Kogan, 50
Vice President

Michael J. Shaughnessy, 36
Vice President—Marketing and Business Development



Fuels broker

Mock Resources, Inc.

Brian Mock, 41
President and
Chief Executive Officer

Christopher P. Kunzi, 37
Executive Vice President

L. Keith McNair, 39
Vice President—
Natural Gas and
Business Development

L. Craig Smith, 33
Chief Financial Officer

Joyce O. Duval, 56
Treasurer

Oceanfront mall

Phase One Development, Inc.

Steven L. Davis, 44
President

G. Eric Gossett, 45
Executive Vice President—
Construction and Finance

Gary Hollenbeck, 38
Executive Vice President—
Marketing/Asset Management

James M. Justus, 42
Vice President and Manager—
Colorado Springs

Air pollution control equipment

Wahlco, Inc.

Robert R. Wahler, 61
President

John H. McDonald, 55
Executive Vice President—
Operations and Secretary

Howard E. Sandler, 46
Executive Vice President—
Administration, Assistant
Secretary and General
Counsel

"We're providing a very competitive rate of return and at the same time we continue to provide a . . . safe investment."

An interview with R. Lee Haney, Vice President and Chief Financial Officer

What makes SDG&E an attractive investment for investors, compared with other utilities?

We're a financially healthy company. A significant portion of the industry is not able to say that. In addition, our board of directors has a commitment to maintaining dividend growth, and our stock yield is at an attractive level.

At the end of 1987, our overall return dropped a bit, and we ended up in the top 27 percent. While it is going to be more difficult for us to be in the top 25 percent in the future, that continues to be our goal.

The most important thing to investors is the return that they are getting from an investment balanced by its relative risk. Well, we're providing a very competitive rate of return and at the same time we continue to provide a relatively safe investment.

Lee Haney (right), and Kiichi Suzuki, president and director of Nikko Securities International, at a meeting in New York.

In last year's annual report, it was stated that the company wanted to increase the number of its institutional shareholders. Were we able to do so in 1987?

No, we weren't. The flight from utilities to the other stocks in the market, particularly during the bull market period, resulted in a decline in institutional stock ownership to about 23 percent at the end of 1987 from 25 percent at the end of 1986. However, the number of institutions that held our stock remained steady at about 150.

Their interest in utility stocks is very dependent upon the market in general and upon interest rates in particular. We're considered by some to be a bond substitute and interest rates are low so I would expect that more institutions would buy utility stocks in 1988, particularly the higher quality stocks, of which we are one. We are continuing to update large institutions that don't hold our stock about our company's results. That includes Japanese businessmen in New York who purchase stocks on U.S. exchanges.

In 1987, you met with many institutional investors in Japan. Why has SDG&E been trying to attract Japanese investors?

We began making presentations to the Japanese investors several years ago because Japan has become a capital exporting nation. They can no longer plow back all their earnings into their own economy. We were considering listing our stock on the Tokyo exchange, but I'm not convinced this is the time for us to do that.

How many meetings with the financial community did SDG&E hold in 1987?

We held 22 group financial analyst meetings and nearly 50 other meetings with individuals.

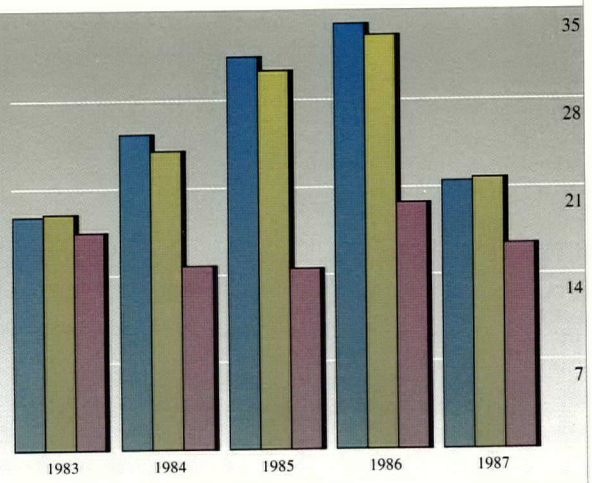
Have we set any new financial goals for 1988?

No. We are continuing to focus our attention on our current goals. ▣

Total Annual Return to Shareholders

(by percent)

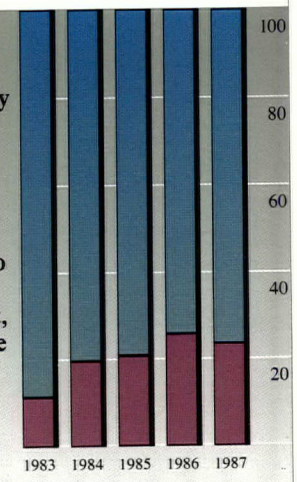
Stock price appreciation and dividends are the components of average annual total return, measured over a five-year period. The company's goal is to remain in the top 25 percent of the industry. It barely missed its goal in 1987.



Investor Profile

(by percent, at December 31)

In the bull market of early 1987, institutional investors decreased utility stockholdings generally. Although institutional ownership of SDG&E's common stock declined to about 23 percent in 1987 from a high of 25 percent, it is still more than double five years ago.



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 $7.05, $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 First Interstate Trust Company of New York
2 Broadway, 29th Floor
New York, New York 10004
(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 1988, the meeting is at 11 a.m., April 26 in the auditorium of the Electric Building, 101 Ash Street, San Diego, California.

Shareholder Profile

There were 72,086 common stock shareholders of record and 5,735 preferred and preference stock shareholders as of December 31, 1987. There are thousands of other individual shareholders whose accounts are held by securities dealers and nominees.

Common stock shareholders:

Joint accounts	24,318
Women	21,860
Men	15,394
Fiduciaries	9,463
Securities dealers, nominees, other	1,051

Location:

United States, except California	36,664
California, except SDG&E service area	21,453
SDG&E service area	13,767
Foreign countries	202

Shares owned:

1-99 shares	14,117
100-300	39,867
301-500	8,874
501-1000	6,191
1001 or more shares	3,037

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.

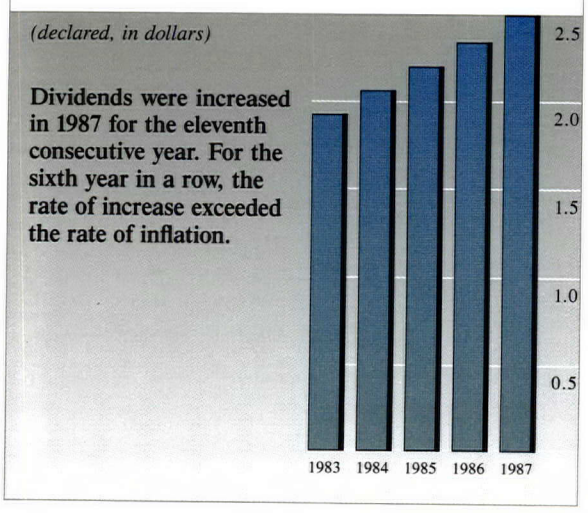
Book value per share
The total value of common equity divided by the number of shares of common stock outstanding.

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.

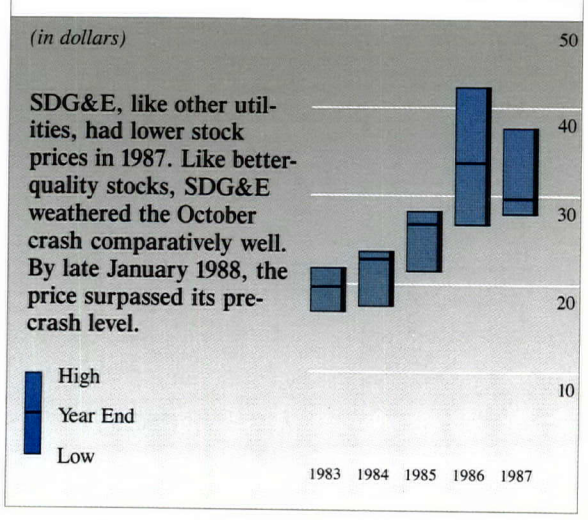
Internal generation of funds
The funds produced by the normal operations of the company for plant additions. It is usually expressed as a percentage of total expenditures for new construction.

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

Dividends Per Share



Common Stock Price Trend



Selected Financial Data

At December 31	1987	1986	1985	1984	1983	1982
Current assets*	**$ 336.4**	$ 299.7	$ 366.2	$ 393.8	$ 267.3	$ 303.9
Current liabilities*	**$ 533.7**	$ 450.2	$ 404.8	$ 352.2	$ 429.7	$ 443.6
Working capital*	**$ (197.3)**	$ (150.5)	$ (38.6)	$ 41.6	$ (162.4)	$ (139.7)
Working capital ratio	**.6**	.7	.9	1.1	.6	.7
Long-term debt*	**$ 1,204.6**	$ 1,193.9	$ 1,208.6	$ 1,277.5	$ 1,275.4	$ 1,007.2
Common shares outstanding	**55,872,602**	55,847,822	55,822,762	54,063,592	51,693,662	48,266,144
Book value per common share	**$ 22.25**	$ 21.59	$ 20.65	$ 19.48	$ 18.52	$ 16.94
Price/Earnings ratio	**9.1**	9.9	8.3	7.6	6.1	5.9
For Year Ended December 31						
Capital expenditures*/**	**$ 208.8**	$ 254.7	$ 257.5	$ 219.9	$ 312.5	$ 271.7
Pretax income/revenue	**18.7%**	24.7%	22.7%	19.8%	18.7%	15.3%
Return on equity	**15.0%**	16.0%	16.2%	15.8%	18.2%	17.5%
Effective federal tax rate	**39.1%**	42.4%	44.5%	38.7%	31.2%	24.0%
Earnings per common share	**$ 3.28†**	$ 3.42	$ 3.25	$ 3.01	$ 3.20	$ 2.90
Dividend payout ratio (declared)	**76.3%**	68.6%	68.1%	68.8%	60.7%	62.4%
Price range of common shares	**$37⅞–$28¼**	$42½–$26¾	$28⅜–$21½	$23¾–$17⅝	$22–$17	$17⅞–$11¾

*In millions of dollars.

**Excluding allowance for funds used during construction.

†Including $0.32 for cumulative effect of change in accounting principle.

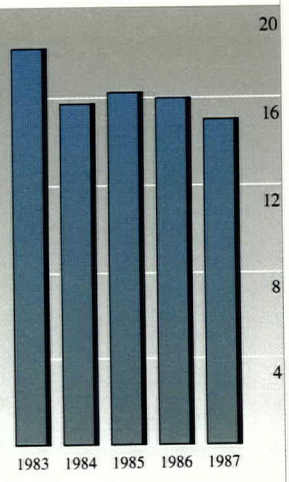
Quarterly Common Stock Data

	1987				1986			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Market price								
High	37⅞	35¼	35	33¾	34¼	36¾	42½	37⅝
Low	34	30⅝	31½	28¼	26¾	31⅜	34⅜	33¾
Dividends declared	62.5¢	62.5¢	62.5¢	62.5¢	56¢	59.5¢	59.5¢	59.5¢

Financial Return on Equity

(weighted average)
(by percent)

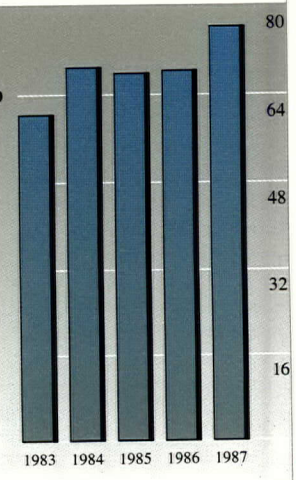
Financial return on equity is measured by earnings applicable to common shares divided by average common equity. The company's authorized rate of return was decreased again by the California Public Utilities Commission to 13.9 percent in 1987 and to 12.75 percent in 1988.



Dividend Payout Ratio

(by percent)

The dividend payout ratio increased in 1987. It is expected to continue to go up.



Compound Annual Growth Rate 5 Years (%)	1981	1980	1979	1978	1977	Compound Annual Growth Rate 10 Years (%)
2.1	$ 302.4	$ 308.8	$ 218.9	$ 180.2	$ 171.3	**7.0**
3.8	$ 453.4	$ 382.3	$ 307.0	$ 216.0	$ 224.5	**9.0**
—	$ (151.0)	$ (73.5)	$ (88.1)	$ (35.8)	$ (53.2)	—
—	.7	.8	.7	.8	.8	—
3.6	$ 925.0	$ 918.5	$ 813.8	$ 610.5	$ 602.9	**7.2**
3.0	41,499,034	36,469,483	31,188,237	27,592,809	22,648,992	**9.4**
5.6	$ 16.20	$ 16.06	$ 17.35	$ 17.41	$ 17.36	**2.5**
—	5.3	11.6	7.3	7.3	6.7	—
(5.1)	$ 216.3	$ 188.6	$ 339.4	$ 206.3	$ 214.8	**(0.3)**
—	10.2%	4.5%	10.0%	11.6%	11.0%	—
—	14.5%	6.0%	10.4%	11.4%	13.4%	—
—	4.7%	(13.1)%	4.3%	3.9%	(2.3)%	—
2.5	$ 2.34	$ 1.01	$ 1.80	$ 2.02	$ 2.32	**3.5**
—	71.1%	156.8%	83.1%	71.5%	55.9%	—
—	$14–$11	$15¼–$10	$15⅞–$12¾	$16⅜–$14¼	$16–$13¾	—

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.

Annual Report

Inquiries about this annual report should be directed to: Lynn Taylor, Investor Communications, Post Office Box 1831, San Diego, California 92112.

Publications

The Corporate Profile and Statistical Report for 1977-1987 (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: Our Strategies (explains the company's strategic direction).

For Information by Phone:

Shareholder inquiries 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 at the bottom of your SDG&E bill.

Executive Offices

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The estimated cost of the 1987 annual report to shareholders is 80 cents per copy.

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