

SIMPLY STATED.



Sempra Energy™

**IN 2000 WE MET
OR EXCEEDED EVERY
GOAL WE SET.**

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Based in San Diego, California, **SEMPRA ENERGY** is a Fortune 500 corporation with 12,000 employees, serving the largest customer base of any energy services company in the United States. The Sempra Energy group of companies provides an integrated package of energy-related products and services. Sempra Energy common shares trade on the New York Stock Exchange under the symbol "SRE." The company's Web site address is www.sempra.com.

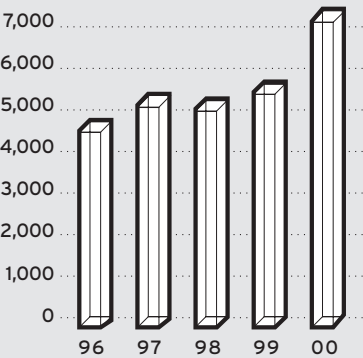
FINANCIAL HIGHLIGHTS

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

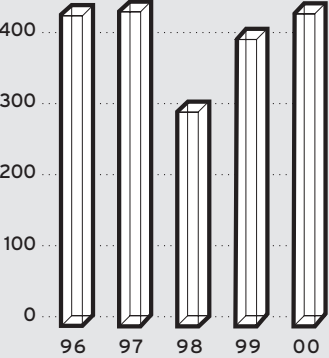
	2000	1999	Change
CONSOLIDATED FINANCIAL DATA			
Revenues and Other Income	\$ 7,143	\$ 5,410	32.0%
Net Income	\$ 429	\$ 394	8.9%
Net Income Per Share of Common Stock:			
Basic and Diluted	\$ 2.06	\$ 1.66	24.1%
Diluted, Excluding Business Combination Costs	\$ 2.06	\$ 1.72	19.8%
Weighted Average Number of			
Common Shares Outstanding (diluted, in millions)	208.3	237.6	-12.3%
Total Assets	\$15,612	\$ 11,124	40.3%
Common Dividends Declared Per Share	\$ 1.00	\$ 1.56	-35.9%
Dividend Payout Ratio	48.5%	94.0%	-48.4%
Debt to Total Capitalization	59.2%	50.4%	17.5%
Book Value Per Share	\$ 12.35	\$ 12.58	-1.8%
STATISTICS			
Natural Gas Throughput ^(a) (in billions of cubic feet)	1,131	1,004	12.6%
Average Cost of Natural Gas Purchased ^(a) (per thousand cubic feet)	\$ 3.51	\$ 2.33	50.6%
Electric Energy On-System Sales ^(a) (in billions of kilowatt hours)	18.4	17.9	2.8%
Average Cost of Electric Energy ^(a) (per kilowatt hour)	8.37¢	3.26¢	157%
Number of Customers ^(a) (in millions of meters served)			
Natural Gas	5.8	5.7	1.8%
Electricity	1.2	1.2	–
Return on Common Equity			
Sempra Energy	15.7%	13.4%	17.2%
SoCalGas	16.0%	15.2%	5.3%
SDG&E	12.2%	15.8%	-22.8%
Number of Employees ^(b)	11,232	11,248	-0.1%

(a) California utilities.
(b) Excludes contract and part-time employees.

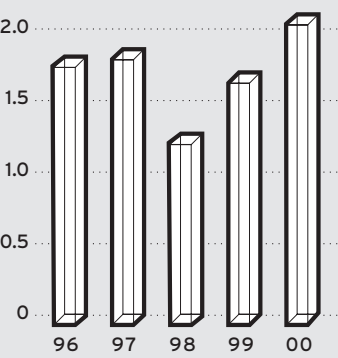
OPERATING REVENUES
(dollars in millions)



NET INCOME
(dollars in millions)



EARNINGS PER SHARE
(dollars)



FELLOW SHAREHOLDERS

2000 was a strong year for Sempra Energy. During the course of the past 12 months, we have seen tangible results from three years of effort to develop a diversified energy services company outside of our two regulated California utilities.

We exceeded our financial goals for the year, increasing overall earnings per share by approximately 20 percent – surpassing our three-year-average target of 8- to 10-percent annual growth. We returned a dividend consistent with our mix of delivery and growth businesses. Amidst the turmoil of California’s energy crisis, we even maintained strong investment-grade credit ratings – no small achievement.

2000 was the year in which our intellectual capital began to bear fruit; a year in which the company accomplished what it set out to do.

We expanded our wholesale energy trading and retail energy marketing businesses and developed generation assets to support them. We continued pursuing new opportunities both in the United States and abroad. We also assumed a leadership role with respect to the ongoing energy crisis in our home state. I will address this important issue in greater detail later in this report.



STEPHEN L. BAUM CHAIRMAN, PRESIDENT & CHIEF EXECUTIVE OFFICER

**We stated that we
would realize one-third
of earnings from our
unregulated businesses
by 2003.**


EXPANDING OUR HORIZONS When Sempra Energy was formed in 1998, our vision was to become a new kind of energy company – able to deliver integrated products and services demanded by today’s customers and an evolving energy marketplace. To accomplish this, our unregulated businesses, under the Sempra Energy Global Enterprises umbrella, work hand-in-hand to leverage our strengths in the retail marketplace to deliver the most value.

Today, I am pleased to report that this strategy is succeeding, with 18 percent of our earnings last year coming from unregulated businesses. We are on track toward meeting our goal of deriving one-third of our earnings from these businesses by the end of 2003.

Led by the success of Sempra Energy Trading, our newer businesses expanded in 2000. Our wholesale trading operation is a key driver of Sempra Energy’s retail strategy, providing the trading, hedging and risk-management capabilities necessary to execute complex energy transactions. It provides sophisticated solutions that few others in the industry can match.

Sempra Energy Resources also enables our retail strategy, through the acquisition and development of generation. Its power production gives Sempra Energy a natural hedge against unanticipated and severe fluctuations in market prices and demand – and the assurance that we can follow through on our commitments. This generation also provides a strong profit potential in volatile energy markets.

Sempra Energy Solutions, our retail energy services business, provides an integrated suite of energy products and services to commercial and industrial customers in the four regions of the United States with the highest energy demand.



SEMPRA ENERGY'S GROUP OF UNREGULATED BUSINESSES COMPRISES A WIDE SPECTRUM OF DISCIPLINES WITHIN THE ENERGY MARKETPLACE, INCLUDING WHOLESALE ENERGY COMMODITY TRADING, ELECTRIC GENERATION, COMMERCIAL AND INDUSTRIAL ENERGY SERVICES, INTERNATIONAL OPERATIONS, INFORMATION MANAGEMENT AND COMMUNICATIONS TECHNOLOGIES.

Over the course of the past year, our unregulated businesses increased to 18 percent of earnings from one percent, putting us well ahead of our four-year growth target.



“IN 2000, WE WITNESSED THE STAGGERING PACE OF CHANGE, CHALLENGE AND OPPORTUNITY IN THE ENERGY MARKETS SEMPRA ENERGY TARGETS. WE ARE PROUD TO SAY WE HAVE RESPONDED SUCCESSFULLY.”

– Donald E. Felsing (right), Group President, Sempra Energy Global Enterprises. Pictured with Darcel L. Hulse, Senior Vice President, Sempra Energy.

Sempra Energy International, together with its Mexican partner, Próxima Gas, S.A. de C.V., expanded its Mexican gas distribution properties in Mexicali, Chihuahua and La Laguna-Durango and this year will commence construction of a major natural gas pipeline across northern Baja California. Sempra Energy International will continue to balance its portfolio of companies among existing businesses with continued high growth potential in Argentina, Chile and Peru. The company also continues to develop new gas distribution projects in Mexico and Canada that are beginning to demonstrate their overall potential.

Finally, with information technology a central element for developing new and innovative products and services, Sempra Energy’s technology ventures are providing more information, more control and more solutions to increasingly sophisticated customers.

I invite you to read on for a more detailed explanation of our operational successes.

We stated that our trading operations would achieve net income of \$15 million and expand in key world markets.

POWERING GROWTH The emerging competitive energy market favors the kind of business that can apply strong intellectual assets to complex problems. Indeed, the largely entrepreneurial activity of energy-commodity trading requires just the right mix of customer-relationship building, energy experience and financial expertise.

With more than 1,200 customers, including virtually every major oil and natural gas company in North America and Europe, Sempra Energy Trading has become one of the industry's leaders.

In 2000, in addition to realizing net income of \$155 million, our trading business reached two important operational milestones. First, Sempra Energy Trading significantly expanded in Europe, opening three new offices to complement its existing natural gas and power-trading activities in London, Norway and Germany. It established a crude oil and refined petroleum products trading business in Geneva, and took advantage of Spain's evolving electricity market by opening operations in Madrid. The company also expanded to Singapore, focusing on the petroleum and refined petroleum product markets.

Second, Sempra Energy Trading built a stronger presence in power trading worldwide. This was due, in part, to the volatility in global energy markets. The company now maintains a round-the-clock power-trading operation.



ACTING AS A CRITICAL LINK IN THE MARKETPLACE BETWEEN TOP ENERGY PRODUCERS AND USERS, SEMPRA ENERGY TRADING PROVIDES COMPETITIVELY PRICED NATURAL GAS, ELECTRICITY, CRUDE OIL AND PETROLEUM PRODUCTS TO A BROAD RANGE OF CUSTOMERS WORLDWIDE.

In 2000, Sempra Energy Trading netted \$155 million, more than eight times its 1999 earnings.



“OUR ABILITY TO SUCCEED IS BASED ON CREATIVITY, PERSISTENCE AND A STAUNCH COMMITMENT TO MEETING OUR CUSTOMERS' RISK-MANAGEMENT NEEDS.”

– David A. Messer (left), **President, Sempra Energy Trading**. Pictured with **Jacqueline Mitchell**, **Managing Director, Sempra Energy Trading**.

None of these achievements would have been possible without the company’s customer-driven approach and its disciplined emphasis on quality and profitability rather than quantity. Sempra Energy Trading focuses its operation and takes pride in the fact that it has a value-at-risk (VaR) index that is among the lowest in the industry – meaning that the company has few equals in maintaining a low-risk trading portfolio.

Sempra Energy Trading continues to develop. It is looking to expand its activities into new areas – including the trading of liquified natural gas, where it already has significant expertise. With the volatility of the energy markets not expected to change materially in the near term, Sempra Energy Trading should continue to enjoy healthy earnings in 2001.

We stated that we would develop or acquire generation to support our overall growth strategy.

THE NEXT GENERATION As the energy market evolves, many commercial and industrial customers demand direct access to generation. Sempra Energy Resources is building a comprehensive generation business around this demand, supporting the activities of Sempra Energy's retail marketing and wholesale trading operations.

Just one year ago, Sempra Energy Resources had one plant under construction and several others on the drawing board. Today, its 500-megawatt (MW) El Dorado Energy plant near Las Vegas – a joint venture with Reliant Energy – is operating, while three other projects in the Southwestern United States have successfully completed their major permitting requirements.

This activity is significant, especially in light of the severe power shortages in the Western United States and rapid growth in Northern Mexico. Sempra Energy Resources' goal is to be part of the solution to the region's energy problems, providing critically needed new investment in increasing the power supply.

The company expects to break ground later this spring on the 1,200MW Mesquite Power plant in Arizona and the 550MW Elk Hills Power plant near Bakersfield, California. Also, Sempra Energy Resources will break ground on a 600MW facility in Mexicali, Mexico, later this year. The Mexicali plant will be able to supply power to both sides of the border, and is being built to meet California's strict air-quality standards.



IN SUPPORT OF THE SEMPRA ENERGY GROUP OF COMPANIES, SEMPRA ENERGY RESOURCES IS CHARTERED WITH ACQUIRING, DEVELOPING AND OPERATING A NEW BREED OF POWER PLANTS THAT UTILIZE THE LATEST TECHNOLOGIES TO PROVIDE CLEAN, EFFICIENT GENERATION.

In 2000, Sempra Energy Resources brought online one of a new breed of U.S. merchant power plants, and advanced three additional projects toward the construction phase.



“WITH STRONG MARKET GROWTH, ACCESS TO MULTIPLE MARKETS, AND FUEL AND TRANSMISSION COST ADVANTAGES, WE ARE WELL POSITIONED TO BE AMONG THE MOST COMPETITIVE GENERATORS OF ELECTRICITY.”

– Michael R. Niggli, President, Sempra Energy Resources

These new power plants employ state-of-the-art technology at least 30 percent more efficient than that used in today’s aging plants, many of which are unable to keep up with rising electric demand and more rigid air-quality standards. The new plants have other, distinct advantages as well. Mesquite Power is ideally situated next to the Palo Verde hub and switchyard, offering direct access to the voracious Arizona and California power markets. And, because the Elk Hills project is a joint venture with Occidental Petroleum, it offers Sempra Energy Resources the significant financial advantage of being able to use “on-site” natural gas without being subject to normal border-delivery charges for gas.

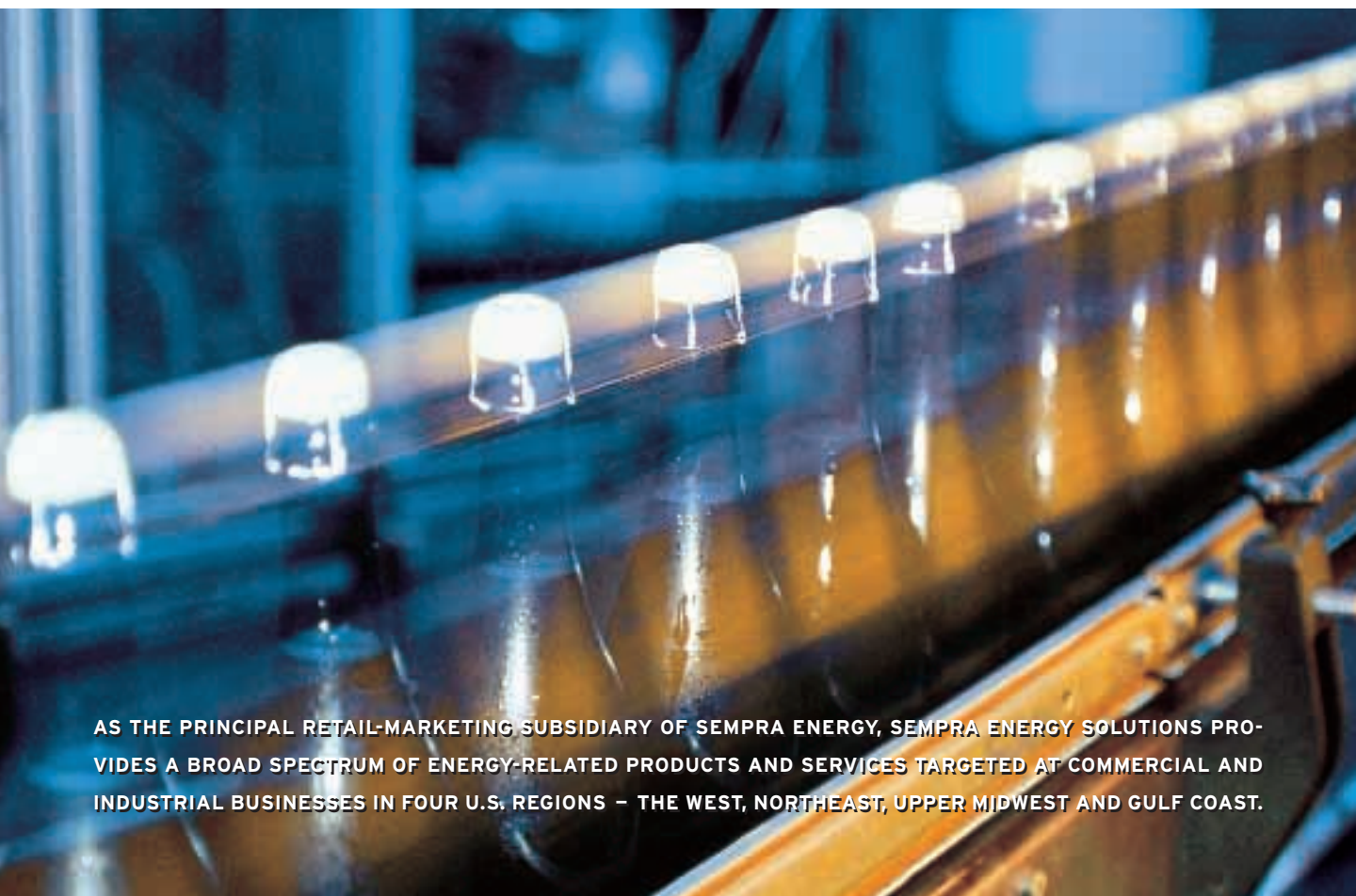
Sempra Energy Resources has been successful in rapidly transforming itself from a small start-up operation two years ago into what will be a supplier of almost 4,000 new megawatts of electricity by the end of 2004.

We stated that our retail energy services business targeting regional commercial and industrial markets would show dramatic revenue growth.

SOLUTIONS OF CHOICE In 2000, Sempra Energy Solutions made great strides in delivering new integrated, packaged and outsourced solutions to the commercial and industrial marketplace – from generation solutions for power-intensive Internet data centers to cost-saving energy-usage plans for computer chip manufacturers. In the process, the group met and surpassed its stated financial targets for the year.

Unlike the energy environment of just 12 months ago, in which customers wished to lock in lower prices before those prices began to rise, today's environment places a higher demand on new, money-saving systems. Sempra Energy Solutions – by providing both supply-side services that can generate greater revenue and demand-side consulting that can lower costs – is building a reputation for delivering answers to its customers' precise needs.

In 2000, Sempra Energy Solutions signed several key contracts, including a \$31 million deal with TrizecHahn. Sempra Energy Solutions will own, operate and provide energy services for the new \$567 million Hollywood & Highland entertainment and retail destination being developed in Los Angeles by TrizecHahn. At the State University of New York at Stony Brook, Sempra Energy Solutions is optimizing the university's energy system, which serves 7.5 million square feet.



AS THE PRINCIPAL RETAIL-MARKETING SUBSIDIARY OF SEMPRA ENERGY, SEMPRA ENERGY SOLUTIONS PROVIDES A BROAD SPECTRUM OF ENERGY-RELATED PRODUCTS AND SERVICES TARGETED AT COMMERCIAL AND INDUSTRIAL BUSINESSES IN FOUR U.S. REGIONS – THE WEST, NORTHEAST, UPPER MIDWEST AND GULF COAST.

In 2000, Sempra Energy Solutions' revenues more than doubled to \$380 million over 1999 – fast growth that defined it as an energy partner, not just a provider.



“OUR APPROACH IS SIMPLE: WHERE WE HAVE REGIONAL STRENGTH AND TARGETED INDUSTRY EXPERTISE, WE GIVE OUR CUSTOMERS GREATER CONTROL OF COMMODITY PRICING AND ENERGY INFRASTRUCTURE.”

– Robert N. Dickerman (right), **President, Sempra Energy Solutions**. Pictured with **Erbin B. Keith** (left) and **Gary Hessenauer**, both **Senior Vice Presidents of Sempra Energy Solutions**.

Last year, we agreed to sell our 72.5-percent stake in mass-market retailer Energy America to Centrica, plc for \$56 million. Energy America sells electricity or natural gas to nearly 400,000 residential and small-business customers in five states. This transaction, which was completed in January of this year, has enabled us to unlock additional value for shareholders, boosting 2001 earnings by a projected 10 cents per share.

Looking ahead, Sempra Energy Solutions will continue to pursue an ambitious agenda. Within the next three years, it aims to be one of the top energy service companies in the commercial and industrial market, reaching \$2 billion in revenue. To accomplish this, it will continue to expand its sales organization and marketing efforts to grow in target industry segments.

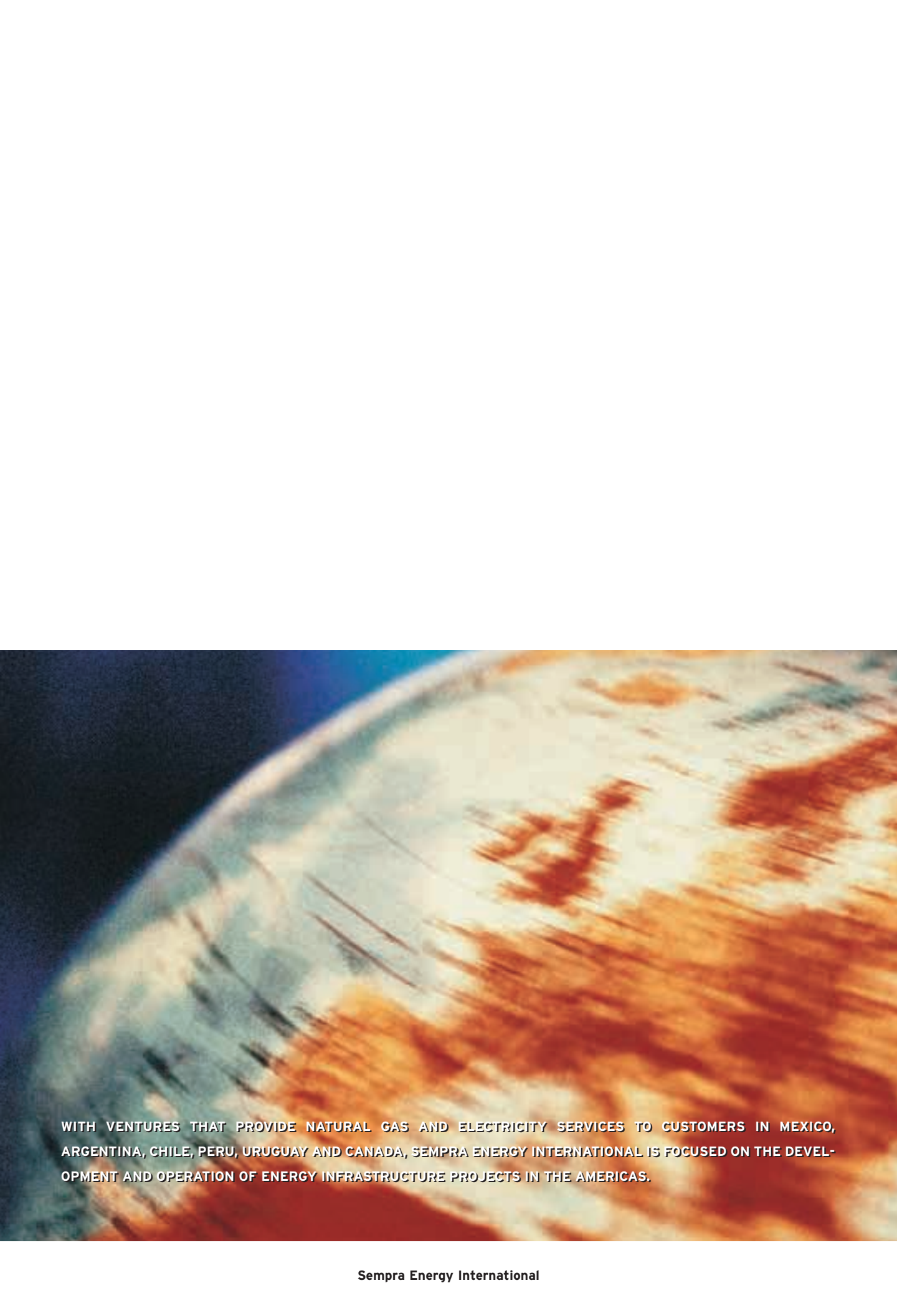
We stated that net income from international operations would reach \$25 million and that we would expand distribution systems located in high-growth markets.

REACHING OUT In 2000, Sempra Energy International expanded its business in regions across borders where it has traditional strengths. A focus on opportunities in the Americas – particularly Northern Mexico and the Southern Cone – has resulted in major new businesses in those areas.

Among the initiatives that have boosted earnings is the acquisition of an additional equity interest in the Camuzzi Gas companies in Argentina, as well as increased revenues from the Chilquinta Energía electric distribution utility in Chile, which Sempra Energy International jointly acquired in mid-1999 with PSEG Global.

Further, what was just a vision last year – the Bajanorte Pipeline – has received regulatory approval in Mexico to proceed and is now one of Sempra Energy International's most important projects. When completed in November 2002, this pipeline will extend 135 miles across the northern Baja California peninsula, carrying as much as 500 million cubic feet of natural gas each day to fuel new power plants in the region – including Sempra Energy Resources' newly announced 600MW facility in Mexicali – that will feed energy-hungry economies on both sides of the border. With Northern Mexico among the fastest growing regions in the world, we foresee significant further opportunity in this area.

In October, through its Sempra Atlantic Gas unit, Sempra Energy International broke ground on its Nova Scotia natural gas distribution system. This project will bring gas to 18 counties of the province, serving potentially 300,000 households by 2008.



WITH VENTURES THAT PROVIDE NATURAL GAS AND ELECTRICITY SERVICES TO CUSTOMERS IN MEXICO, ARGENTINA, CHILE, PERU, URUGUAY AND CANADA, SEMPRA ENERGY INTERNATIONAL IS FOCUSED ON THE DEVELOPMENT AND OPERATION OF ENERGY INFRASTRUCTURE PROJECTS IN THE AMERICAS.

In 2000, Sempra Energy International earned \$33 million – a near 16-fold increase over 1999 – and dramatically extended our global reach.



“WE HAVE EXPANDED FROM FOUR BUSINESSES IN TWO COUNTRIES IN 1998 TO 13 PROJECTS IN SEVEN COUNTRIES IN 2000 WITH \$1.2 BILLION IN ASSETS – TODAY SERVING NEARLY 2.6 MILLION CUSTOMERS.”

– Dennis V. Arriola (left), **Regional President, South American Operations, Sempra Energy International.**
Pictured with **George S. Liparidis**, **Regional President, North American Operations, Sempra Energy International.**

Given its knowledge of these contiguous geographies and cultures, Sempra Energy International chose to focus its efforts largely on the Americas, rather than in far-flung corners of the world. Indeed, its familiarity with doing business in the Americas aids in partnering with regional governments to develop successful businesses.

Moving forward in 2001, Sempra Energy International’s goals are to grow its existing businesses, capture adjacent opportunities and, where appropriate, cross-sell other energy-related and communications services from the Sempra Energy companies.

We stated that we would invest in new technologies to develop next-generation products, enhance core business operations and create incremental earnings.

CONNECTING TO SUCCESS Sempra Communications was formed in 2000 to provide information solutions through partnerships with leading technology companies. In April 2000, the group's unique mix of energy expertise and information-technology experience led Aerie Networks to select Sempra Communications as a partner in its 12-member joint venture to build a new high-bandwidth, 20,000-mile, nationwide broadband network.

In June 2000, Sempra Communications was granted authority to provide competitive local exchange telephony services in California, allowing the company to explore a variety of new, telecommunications-based business ventures. In addition, over the past year, Sempra Communications contributed its expertise in support of Sempra Energy Solutions' systems design projects for the burgeoning data-center and Web-hosting markets. These "information warehouses," which store equipment and data for the ever-increasing Internet and e-business needs of large corporations, pose unique challenges for the safe, secure transmission of power and information.

Also in the information management arena, our Soliance joint venture is creating Web-based information technology systems for small- and mid-sized natural gas and electric utilities adapting to deregulated markets nationwide. The company offers rapid delivery, lower up-front capital costs and fixed-price, fixed-time solutions in the Application Services Provider marketplace.

The background of the slide is an abstract composition of light. It features several bright green light trails that originate from the bottom right and fan out towards the top left. Interspersed among these are smaller, out-of-focus red and orange circular bokeh lights. The overall effect is one of dynamic energy and technological connectivity.

IN CONJUNCTION WITH OTHER SEMPRA ENERGY COMPANIES AND PARTNERS, SEMPRA COMMUNICATIONS PROVIDES INFRASTRUCTURE EXPERTISE TO BUSINESSES BUILDING THE NEXT GENERATION OF COMMUNICATIONS NETWORKS.

In 2000, Sempra Communications became a partner in one of the most ambitious telecom ventures in the industry.



“SUCCESSFUL PARTNERING IN NEW TECHNOLOGY VENTURES TAKES EXPERIENCE, ASSETS AND A DISCIPLINED APPROACH TO INVESTING – THESE ARE THE QUALITIES BY WHICH WE JUDGE OUR SUCCESS.”

– Michael W. Allman, President, Sempra Communications

Soliance secured important contracts in 2000, including agreements with City Public Service, the municipally owned gas and electric utility serving San Antonio, Texas, as well as with Sempra Atlantic Gas, Centrica, plc and Energy America. Additionally, Soliance was recognized last year for the excellence of its operations by AMR Research, a leading industry research firm.

We continue to identify more high-technology opportunities, leveraging our valuable intellectual capital and entrepreneurial drive to secure strong investments in promising early-stage businesses.

SPECIAL FOCUS:

THE ENERGY CRISIS AND OUR CALIFORNIA UTILITIES

We stated that our utilities would deliver safe, reliable service – even in what proved to be a very challenging environment.

MANAGING IN CRISIS I would like to address the key issues in this crisis, as well as the solid performance of our two utilities, Southern California Gas Company (SoCalGas) and San Diego Gas & Electric (SDG&E).

First, some history is in order. In July 1999, the California Public Utilities Commission determined SDG&E had completed the recovery of its stranded costs under California's 1996 electric restructuring law. This meant that the rate freeze was lifted for SDG&E customers in San Diego and southern Orange counties. When the wholesale price of power spiked last summer, SDG&E customers were the first in the country to feel the full brunt of the volatile wholesale electricity market.

Amidst the hardship and turmoil the energy crisis caused SDG&E's customers, its employees never lost sight of their commitment to providing safe and reliable energy-delivery service. In a year of undeniable challenge, both SDG&E and SoCalGas met or exceeded their goals for service and reliability. I am extremely proud of these accomplishments.

In fact, 2000 was a landmark year for SoCalGas in the face of unprecedented demand and rising natural gas costs. It became the first U.S. utility to connect its 5 millionth meter, set a record for gas throughput and changed its entire operation to deliver more gas to fuel California's power plants as they struggled to keep pace with California's electricity needs.

At the heart of the dysfunctional electric market is an imbalance of supply and demand. In California, no major



"WE MUST RECOGNIZE THAT AT THE CORE OF OUR ENERGY PROBLEMS IS A CRITICAL SHORTAGE OF REASONABLY PRICED POWER TO MEET TODAY'S DEMANDS. ANY 'FIX' THAT DOES NOT ADDRESS THE LACK OF SUPPLY WILL FAIL."

– Edwin A. Guiles, Group President, Regulated Business Units. Pictured with Debra L. Reed, President of SDG&E.

new power plants have been brought online in the past decade, a period during which the state's electric demands have grown 14.5 percent, according to the California Energy Commission. Energy demand in neighboring states has grown even faster, resulting in those states no longer having excess power to export.

Consumers have a critical role to play as well. While supply is a problem, all of us need to conserve. Technology advances also can help curb demand – real-time electric metering would provide accurate price signals and encourage efficient energy use.

Californians must begin to see the true cost of electricity. When energy prices soared last summer, the state set a new retail rate cap for SDG&E customers at 6.5 cents per kilowatt-hour. These charges that consumers see are one-third or less of the *actual* wholesale price SDG&E paid for the electricity. At the end of January 2001, this "undercollected" balance reached \$605 million. SDG&E has a legislative guarantee that it will be able to recover its prudently incurred power costs after the rate cap ends in 2002 or 2003.

In February, a new state law was enacted giving California's Department of Water Resources authority to buy power on behalf of SDG&E, PG&E and Southern California Edison. This change should keep SDG&E's undercollection from expanding, as long as the state continues to procure enough energy to meet SDG&E's full power needs.

At this critical juncture, our focus should be on two questions: What will reduce demand for power? What will increase power supplies? This problem will be solved only by addressing these fundamental questions.

We stated that the year 2000 would be just the beginning.

Despite its challenges, 2000 has been a successful year on many different levels. In addition to the milestones already mentioned in this report, we are equally proud of the ways in which we have enriched our corporate culture.

The corporation becomes stronger by building a workforce and a network of suppliers that reflect the diversity of the communities in which we operate. To that end, we were extremely pleased to have been recognized in 2000 for our successful corporate diversity programs.

In July 2000, we earned the No. 4 spot on *Fortune* magazine's list of "America's 50 Best Companies for Minorities," marking the company's third consecutive year among the top five of this prestigious grouping. The ranking was based on Sempra Energy's efforts in 15 different categories, including hiring, promoting and retaining people of ethnic diversity, as well as outreach to minority suppliers and charitable contributions.

In September, we were awarded the U.S. Department of Labor's Office of Federal Contract Compliance Programs' prestigious EVE (Exemplary Voluntary Efforts) Award for the quality of our affirmative action programs. This award is given to just a handful of U.S. organizations each year.

Satisfied though we may be with the year just past, there is still much work to do. As we look ahead, Sempra Energy will continue to set realistic goals – and meet them.

On behalf of the Board of Directors, I would like to thank you for your continued support.

Sincerely,

A handwritten signature in black ink, appearing to read "S. Baum", with a long, sweeping horizontal line extending to the right.

STEPHEN L. BAUM Chairman, President & Chief Executive Officer

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

INTRODUCTION

This section includes management's discussion and analysis of operating results from 1998 through 2000, and provides information about the capital resources, liquidity and financial performance of Sempra Energy and its subsidiaries (together referred to as "the company"). This section also focuses on the major factors expected to influence future operating results and discusses investment and financing plans. It should be read in conjunction with the consolidated financial statements included in this Annual Report.

The company is a California-based Fortune 500 energy services company whose principal subsidiaries are San Diego Gas & Electric (SDG&E), which provides electric and natural gas service in San Diego County and southern Orange County, and Southern California Gas Company (SoCalGas), the nation's largest natural gas distribution utility, serving 5 million meters throughout most of Southern California and part of central California. Together, the two utilities serve approximately 7 million meters. In addition, Sempra Energy owns and operates other regulated and unregulated subsidiaries. Sempra Energy Trading (SET) is engaged in the wholesale trading and marketing of natural gas, power and petroleum. Sempra Energy International (SEI) develops, operates and invests in energy-infrastructure systems and power-generation facilities outside the United States. Sempra Energy Resources (SER) develops power plants and natural gas storage, production and transportation facilities within the United States. Sempra Energy Financial (SEF) invests in limited partnerships, which own 1,300 affordable-housing properties throughout the United States. Through other subsidiaries, the company owns and operates centralized heating and cooling for large building complexes, and is involved in domestic energy-utility operations and other energy-related products and services.

The uncertainties shaping California's electric industry and business environment significantly affect the company's operations. A flawed electric-industry restructuring plan, electricity supply/demand imbalances, and legislative and regulatory responses, including a temporary rate ceiling on the cost of electricity that SDG&E can pass on to its small-usage customers on a current basis, have materially and adversely affected the timing of revenue collections by SDG&E and related cash flows. These, together with concerns with California utility regulation generally and increased electricity cost undercollections, have significantly impaired the company's access to the capital markets and ability to obtain financing on commercially reasonable terms. In addition, supply/demand imbalances are affecting the price of natural gas in California more than in the rest of the country because of California's dependence on natural gas fired electric generation due to air-quality considerations. These recent developments are continuing to change rapidly. Information as of March 7, 2001, the date this report was prepared, is found herein, primarily under "California Utility Operations" and "Factors Influencing Future Performance" and in Note 14 of the notes to Consolidated Financial Statements.

BUSINESS-COMBINATION COSTS

Sempra Energy was formed to serve as a holding company for Pacific Enterprises (PE), the parent corporation of SoCalGas, and Enova Corporation (Enova), the parent corporation of SDG&E, in connection with a business combination that became effective on June 26, 1998 (the PE/Enova business combination). In connection with the PE/Enova business combination, the holders of common stock of PE and Enova became the holders of the company's common stock. The preferred stock of PE remained outstanding. The combination was a tax-free transaction. Expenses incurred in connection with the PE/Enova business combination were \$70 million, aftertax, for the year ended December 31, 1998. No significant expenses were incurred subsequently.

On February 22, 1999, the company and KN Energy, Inc. (KN) announced that their respective boards of directors had approved the company's acquisition of KN. On June 21, 1999, the company terminated its agreement to acquire KN. Expenses incurred in connection with the KN transaction were \$11 million, aftertax, all in the year ended December 31, 1999.

In January 1998, PE and Enova jointly acquired CES/Way International, Inc. (CES/Way), which was subsequently renamed Sempra Energy Services. Expenses incurred in connection with the CES/Way acquisition were \$15 million, aftertax, all in the year ended December 31, 1998.

The costs of the transactions discussed above and similar, smaller transactions consist primarily of employee-related costs, and investment banking, legal, regulatory and consulting fees. See Note 1 of the notes to Consolidated Financial Statements for additional information.

CAPITAL RESOURCES AND LIQUIDITY

The company's California utility operations have historically been a major source of liquidity. However, higher electric-commodity prices and the inability of SDG&E to bill its small-usage customers on a current basis for the full purchase cost of electricity due to legislative actions, have resulted in a significant decrease in cash flow available from SDG&E's operating activities in 2000. SDG&E had incurred costs in excess of amounts which it can bill its customers on a current basis, or "undercollected costs," of \$447 million at December 31, 2000, and \$605 million at January 31, 2001. California recently enacted legislation authorizing the California Department of Water Resources (DWR) to purchase electricity for resale to all California investor-owned utility retail end-use customers (including customers of SDG&E), that is intended to halt or substantially slow the growth of cost undercollections by SDG&E and other California Investor-Owned Utilities (IOUs). Consequently, SDG&E believes that its continued accumulation of undercollected costs will depend primarily upon the effects of this legislation and other legislative and regulatory developments. For additional discussion, see "California Utility Operations" herein and Note 14 of the notes to Consolidated Financial Statements.

Additional working capital and other requirements for the California utilities are met primarily through the issuance of long-term debt. Cash requirements at the utilities primarily consist of capital expenditures for utility plant. The company's nonutility cash requirements include additional investments in SET, SEI, SER and other ventures. These requirements are met through the issuance of short-term and long-term debt by the company or its subsidiaries, as well as from cash flow generated from growing nonutility operations. Due to the factors described herein and in Note 14 of the notes to Consolidated Financial Statements regarding high electricity costs, and the company's inability to bill its small-usage customers on a current basis for the full cost of electricity purchases, management is unable to determine whether the sources of funding described above are sufficient to provide for all of the capital expenditures it otherwise would intend to make, after funding its basic liquidity needs, as described below.

Continued purchases by the DWR for resale to SDG&E's customers of substantially all of the electricity that would otherwise be purchased by SDG&E (as further discussed under "California Utility Operations" herein) or dramatic decreases in wholesale electricity prices, favorable action by the CPUC on SDG&E's electric-rate-surcharge application discussed below and SDG&E's access to the capital markets are required to manage and finance SDG&E's cost undercollections and provide adequate liquidity.

Other company subsidiaries have significant receivables from the other IOUs and from the California Power Exchange (PX) and the Independent System Operator (ISO), which are described under "California Utility Operations." The collection of these receivables may depend on satisfactory resolution of the financial difficulties being experienced by those IOUs as a result of the California electric-industry problem discussed above. In addition, the company's ability to fund its subsidiaries' capital expenditure program and liquidity requirements is significantly affected by the company's credit ratings and related ability to obtain financing on commercially reasonable terms.

CASH FLOWS FROM OPERATING ACTIVITIES

The decrease in cash flows from operating activities in 2000 was primarily due to increased net trading assets, SDG&E's refunds to customers for surplus rate-reduction-bond proceeds, SDG&E's cost undercollections related to high electric-commodity prices and energy charges in excess of the 6.5 cents/kWh ceiling in accordance with AB 265 (see "California Utility Operations" below and Note 14 of the notes to Consolidated Financial Statements) and increased accounts receivable. These factors were partially offset by higher overcollected regulatory balancing accounts at SoCalGas, increased accounts payable and lower income tax payments. The increases in accounts receivable and accounts payable were primarily due to higher sales volumes and higher prices for natural gas and purchased power.

The decrease in cash flows from operating activities in 1999 was primarily due to the completion of the recovery of SDG&E's stranded costs in 1999 and to reduced revenues (both the result of the sale of SDG&E's fossil power plants and combustion turbines in the second quarter of 1999) and a return to ratepayers of the previously overcollected regulatory balancing accounts of SoCalGas. This decrease was partially offset by the absence of business-combination expenses and lower income tax payments in 1999. See additional discussion on the sale of the power plants in Note 14 of the notes to Consolidated Financial Statements.

CASH FLOWS FROM INVESTING ACTIVITIES

For 2000, cash flows from investing activities included capital expenditures for utility plant and investments in South America.

For 1999, cash flows from investing activities included proceeds from the sale of SDG&E's two fossil power plants and combustion turbines. The South Bay Power Plant was sold to the San Diego Unified Port District for \$110 million. The Encina Power Plant and 17 combustion-turbine generators were sold to Dynegy, Inc. and NRG Energy, Inc. for \$356 million.

CAPITAL EXPENDITURES Capital expenditures were \$170 million higher in 2000 compared to 1999 due to investments in gas distribution facilities in the eastern United States, Canada and Mexico, expenditures for gas turbines, and improvements to SDG&E's electric distribution system and to the California utilities' gas systems.

Capital expenditures were \$151 million higher in 1999 compared with 1998 due to investments in gas distribution facilities in Mexico, a gas system expansion at SDG&E and improvements to SDG&E's electric distribution system.

Capital expenditures in 2001 are expected to be comparable to those of 2000. They will include, among other things, capital expenditures for new power plant construction by SER and utility plant improvements. Capital expenditures for power plant construction are intended to be financed by debt issuances. The California utilities' capital expenditures are intended to be financed primarily by operations and debt issuances. SDG&E's capital expenditures are dependent on SDG&E's ability to recover its electricity costs, including the balancing account undercollections referred to above.

SER plans expenditures of up to \$1.9 billion over the next five years related to new power plant construction.

INVESTMENTS During the three years ended December 31, 2000, the company made various investments and entered into several joint ventures. These include, among others, SEI's additional investment in two Argentinean natural gas utility holding companies (*Sodigas Pampeana S.A.* and *Sodigas Sur S.A.*) of \$147 million in October 2000. In August 2000, Sempra Energy Solutions (SES) purchased Connectiv Thermal Systems' 50-percent interests in both Atlantic-Pacific Las Vegas and Atlantic-Pacific Glendale for \$40 million, thereby acquiring full ownership of these companies. In September 2000, the company acquired a majority interest in Atlantic Electric and Gas in the United Kingdom for \$8 million and, in July 1998, purchased a subsidiary of Consolidated Natural Gas for \$36 million.

In June 1999, SEI and PSEG Global (PSEG) jointly purchased 90 percent of *Chilquinta Energía S.A. (Energía)* at a total cost of \$840 million. With the January 2000 joint purchase of an additional 9.75 percent, the companies jointly and equally hold 99.98 percent of *Energía*. In September 1999, the company and PSEG completed their acquisition of 47.5 percent of *Luz del Sur S.A.A.* SEI's share of the transaction was \$108 million. This acquisition, combined with the interest already owned through *Energía*, increased the companies' total joint and equal ownership to 84.5 percent of *Luz del Sur S.A.A.*

Sempra Energy's level of investments in the next few years may vary substantially and will depend on the availability of financing and business opportunities that are expected to provide desirable rates of return.

See further discussion of international operations in "International Operations" below and further discussion of investing activities in Note 3 of the notes to Consolidated Financial Statements.

CASH FLOWS FROM FINANCING ACTIVITIES

Net cash was provided by financing activities in 2000 compared to being used in 1999, due to the issuance of long-term and short-term debt in 2000 (excluding that related to the repurchase of common stock), and lower common stock dividends.

Net cash used in financing activities decreased in 1999 from 1998 levels primarily due to lower long-term and short-term debt repayments, greater long-term and short-term debt issuances and the repurchase of preferred stock in 1998.

LONG-TERM AND SHORT-TERM DEBT In 2000, the company issued \$500 million of long-term notes and \$200 million of mandatorily redeemable trust preferred securities to finance the repurchase of 36.1 million shares of its outstanding common stock. The company issued an additional \$300 million of long-term notes during 2000 to reduce short-term debt. The increase in short-term debt primarily represents borrowings through Sempra Energy Global Enterprises (Global), a holding company for many of the company's subsidiaries, to finance the construction of gas distribution systems by SEI; and borrowings by SET to finance increased trading activities. Repayments on long-term debt in 2000 included \$10 million of first-mortgage bonds, \$65 million of rate-reduction bonds and \$51 million of unsecured debt. In addition, during December 2000, \$60 million of variable-rate industrial development bonds were put back by the holders and subsequently remarketed in February 2001 at a 7.0 percent fixed interest rate. Between January 24 and February 5, 2001, the company drew down substantially all (\$1.3 billion) of its available credit facilities.

In 1999, repayments on long-term debt included \$28 million of first-mortgage bonds, \$66 million of rate-reduction bonds and \$82 million of unsecured notes. The long-term debt issued in 1999 related primarily to the purchase of *Energía*. See additional discussion in Note 3 of the notes to Consolidated Financial Statements. The increase in short-term debt primarily represents borrowing through Global to finance a portion of SEI's acquisitions.

In 1998, cash was used for the repayment of \$247 million of first-mortgage bonds and \$66 million of rate-reduction bonds. Short-term debt repayments included repayment of \$94 million of debt issued to finance SoCalGas' Comprehensive Settlement as discussed in Note 14 of the notes to Consolidated Financial Statements.

STOCK PURCHASES AND REDEMPTIONS As noted above, the company repurchased 36.1 million shares of its common stock at a price of \$20.00 per share in 2000. In March 2000, the company's board of directors authorized the optional expenditure of up to \$100 million to repurchase additional shares of common stock from time to time in the open market or in privately negotiated transactions. Through December 31, 2000, the company acquired 162,000 shares under this authorization (all in July 2000). In 1998 the company repurchased \$1 million of common stock. There were no common stock repurchases in 1999.

On February 2, 1998, SoCalGas redeemed all outstanding shares of its 7.75% Series Preferred Stock at a cost of \$25.09 per share, or \$75 million including accrued dividends.

DIVIDENDS Dividends paid on common stock amounted to \$244 million in 2000, compared to \$368 million in 1999 and \$325 million in 1998. The decrease in 2000 is due to a reduction in the quarterly dividend to \$0.25 per share (\$1.00 annualized rate) from its previous level of \$0.39 per share (\$1.56 annualized rate) and the previously mentioned stock repurchase. The increase in 1999 was the result of the company's paying dividends on its common stock at the rate previously paid by Enova, which, on an equivalent-share basis, is higher than the rate previously paid by PE.

The payment of future dividends and the amount thereof are within the discretion of the company's board of directors. The California Public Utilities Commission's (CPUC) regulation of the California utilities' capital structure limits to \$924 million the portion of the company's December 31, 2000, retained earnings that is available for dividends.

CAPITALIZATION Total capitalization at December 31, 2000, was \$7.1 billion. The debt-to-capitalization ratio was 59 percent at December 31, 2000. Significant changes in capitalization during 2000 include the increase in long-term debt and the issuance of mandatorily redeemable trust preferred securities to repurchase common stock.

CASH AND CASH EQUIVALENTS Cash and cash equivalents were \$637 million at December 31, 2000. This cash is available for investment in domestic and international projects consistent with the company's strategic direction, the retirement of debt, the repurchase of common stock, the payment of dividends and other corporate purposes. However, as discussed above, funds available for these purposes may be limited by SDG&E's ability to recover from its customers on a current basis the full amount of the high electricity prices.

If the impacts of the high electricity costs and the company's inability to bill customers for these costs on a current basis are favorably resolved, the company anticipates that operating cash required in 2001 for common stock dividends and debt payments will be provided by cash generated from operating activities and existing cash balances. Cash required for capital expenditures will be provided by cash generated both from operating activities and from long-term and short-term debt issuances.

In addition to cash generated from ongoing operations, the company has credit agreements that permit short-term borrowings of up to \$2.2 billion, of which \$566 million is outstanding at December 31, 2000, and/or support its commercial paper. These agreements expire at various dates through 2002. Because of the ramifications of the high electric costs (as discussed in Notes 4 and 14 of the notes to Consolidated Financial Statements), between January 24 and February 5, 2001, the company drew down substantially all (\$1.3 billion) of its available credit facilities.

In December 2000, Sempra Energy and certain affiliates filed shelf registrations for public offerings of up to \$2.3 billion of certain securities guaranteed by Sempra Energy. As yet, no debt securities have been issued under these registration statements. For additional information see Notes 5 and 14 of the notes to Consolidated Financial Statements.

RESULTS OF OPERATIONS

SEASONALITY SDG&E's electric sales volume generally is higher in the summer due to air-conditioning demands. Both California utilities' natural gas sales volumes generally are higher in the winter due to heating demands, although that difference is lessening as the use of natural gas to fuel electric generation increases. Sales volumes of the company's South American affiliates are also affected by seasonality, but the timing of its increases and decreases is opposite of those in California since the seasons are reversed in the Southern Hemisphere.

2000 COMPARED TO 1999 Net income for 2000 increased to \$429 million, or \$2.06 per share of common stock, from \$394 million, or \$1.66 per share of common stock, in 1999.

The \$35 million increase in net income was primarily due to higher earnings achieved by SET and, to a lesser extent, SEI and SER. This increase was partially offset by lower income generated from the California utility operations and higher interest expense. The lower income at the California utilities resulted primarily from the \$50 million pretax write off described in Note 14 of the notes to Consolidated Financial Statements. See additional discussion in "California Utility Operations," "International Operations," "Trading Operations" and "Other Operations" below.

For the fourth quarter of 2000, net income was \$95 million, or \$0.47 per share of common stock, compared with \$105 million, or \$0.44 per share of common stock, for the fourth quarter of 1999. The decrease in earnings was primarily attributable to increased interest costs and income taxes, partially offset by higher earnings from the company's trading and generation operations. The increase in earnings per share was due to the decrease in weighted-average shares for the fourth quarter of 2000 in comparison to the corresponding period in 1999, partially offset by the lower net income.

In 2000, book value per share decreased to \$12.35 from \$12.58 in 1999, due to the repurchase of 36.1 million shares of common stock in February 2000, at a price higher than book value.

1999 COMPARED TO 1998 Net income for 1999 increased to \$394 million, or \$1.66 per share of common stock, from \$294 million, or \$1.24 per share of common stock, in 1998.

The increase was primarily attributable to higher net income at the California utilities as a result of the business-combination costs in 1998, and increased earnings from SET and, to a lesser extent, from SEF and SER.

In 1999, book value per share increased to \$12.58 from \$12.29 in 1998, primarily due to the settlement of quasi-reorganization issues. See additional discussion in Note 2 of the notes to Consolidated Financial Statements.

CALIFORNIA UTILITY OPERATIONS

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

SoCalGas and SDG&E are regulated by the CPUC. It is the responsibility of the CPUC to determine that utilities operate in the best interests of their customers and have the opportunity to earn a reasonable return on investment. In 1996, California enacted legislation restructuring California's investor-owned electric utility industry. The legislation and related decisions of the CPUC were intended to stimulate competition and reduce electric rates. The PX served as a wholesale power pool and the ISO scheduled power transactions and access to the transmission system.

A flawed electric-industry restructuring plan, electricity supply/demand imbalances, and legislative and regulatory responses, including the rate ceiling as described in "Factors Influencing Future Performance" below, have materially and adversely affected the timing of revenue collections by the company and related cash flows. Additional legislation passed in early 2001, as well as future legislation and regulatory actions concerning California's energy crisis, could have a significant impact on SDG&E's future operations, liquidity and financial results.

The natural gas industry experienced an initial phase of restructuring during the 1980s by deregulating natural gas sales to noncore customers. The CPUC currently is studying the issue of restructuring for sales to core customers and, as mentioned above, supply/demand imbalances are affecting the price of natural gas in California more than in the rest of the country because of California's dependence on natural gas fired electric generation due to air-quality considerations.

In connection with restructuring of the electric and natural gas industries, SDG&E and SoCalGas received approval from the CPUC for Performance-Based Ratemaking (PBR). Under PBR, income potential is tied to achieving or exceeding specific performance and productivity measures, rather than to expanding utility plant in a market where a utility already has a highly developed infrastructure.

See additional discussion of these situations under "Factors Influencing Future Performance" and in Note 14 of the notes to Consolidated Financial Statements.

The tables below summarize the California utilities' natural gas and electric volumes and revenues by customer class for the years ended December 31, 2000, 1999 and 1998.

GAS SALES, TRANSPORTATION & EXCHANGE

(Dollars in millions, volumes in billion cubic feet)		Gas Sales		Transportation & Exchange		Total
	Throughput	Revenue	Throughput	Revenue	Throughput	Revenue
2000:						
Residential	284	\$ 2,446	3	\$ 13	287	\$ 2,459
Commercial and industrial	107	760	339	225	446	985
Utility electric generation	–	–	373	130	373	130
Wholesale	–	–	25	18	25	18
	391	\$ 3,206	740	\$ 386	1,131	3,592
Balancing accounts and other						(287)
Total						\$ 3,305
1999:						
Residential	313	\$ 2,091	3	\$ 10	316	\$ 2,101
Commercial and industrial	105	560	324	243	429	803
Utility electric generation	18	7*	218	83	236	90
Wholesale	–	–	23	11	23	11
	436	\$2,658	568	\$347	1,004	3,005
Balancing accounts and other						(94)
Total						\$ 2,911
1998:						
Residential	304	\$2,234	3	\$ 11	307	\$2,245
Commercial and industrial	102	571	329	277	431	848
Utility electric generation	57	9*	139	66	196	75
Wholesale	–	–	28	7	28	7
	463	\$ 2,814	499	\$ 361	962	3,175
Balancing accounts and other						(423)
Total						\$2,752

*This consists of the interdepartmental margin on SDG&E’s sales to its power plants prior to their sale in 1999.

ELECTRIC SALES

	2000		1999		1998	
(Dollars in millions, volumes in million kWhs)	Volumes	Revenue	Volumes	Revenue	Volumes	Revenue
Residential	6,304	\$ 730	6,327	\$ 663	6,282	\$ 637
Commercial	6,123	747	6,284	592	6,821	643
Industrial	2,614	310	2,034	154	3,097	233
Direct access	3,308	99	3,212	118	964	44
Street and highway lighting	74	7	73	7	85	8
Off-system sales	899	59	383	10	706	15
	19,322	1,952	18,313	1,544	17,955	1,580
Balancing accounts and other		232		274		285
Total	19,322	\$2,184	18,313	\$1,818	17,955	\$1,865

2000 COMPARED TO 1999 Natural gas revenues increased from \$2.9 billion in 1999 to \$3.3 billion in 2000, primarily due to higher prices for natural gas in 2000 (see discussion of balancing accounts in Note 2 of the notes to Consolidated Financial Statements) and higher utility electric generation (UEG) revenues. The increase in UEG revenues was due to higher demand for electricity in 2000 and the sale of SDG&E's fossil fuel generating plants in the second quarter of 1999. Prior to the plant sale, SDG&E's natural gas revenues from these plants consisted of the margin from the sales. Subsequent to the plant sale, SDG&E gas revenues consist of the price of the natural gas transportation service since the sales now are to unrelated parties. In addition, the generating plants receiving gas transportation from the California utilities are operating at higher capacities than previously, as discussed below.

Electric revenues increased from \$1.8 billion in 1999 to \$2.2 billion in 2000. The increase was primarily due to higher sales to industrial customers and the effect of higher electric-commodity costs, partially offset by the \$50 million pretax charge at SDG&E for a potential regulatory disallowance related to the acquisition of wholesale power in the deregulated California market, and the decrease in base electric rates (the noncommodity portion) from the completion of stranded cost recovery. For 2000, SDG&E's electric revenues included an undercollection of \$447 million as a result of the 6.5-cent rate cap. In January 2001, SDG&E filed with the CPUC for a temporary electric surcharge to reduce the growing undercollection of electric-commodity costs. SDG&E is unable to predict the amount, if any, of the request that the CPUC would grant, or when it would issue a decision. The CPUC has deferred this proceeding pending resolution of the broader issues related to the state-wide high costs. Additional information concerning electric rates is described in "Factors Influencing Future Performance" below and in Note 14 of the notes to Consolidated Financial Statements.

The cost of natural gas distributed increased from \$1.2 billion in 1999 to \$1.6 billion in 2000. The increase was largely due to higher prices for natural gas. Prices for natural gas have increased due to the increased use of natural gas to fuel electric generation, colder winter weather, and population growth in California. Under the current regulatory framework, changes in core-market natural gas prices do not affect net income, since the actual commodity cost of natural gas for core customers is included in customer rates on a substantially current basis.

The cost of electric fuel and purchased power increased from \$0.5 billion in 1999 to \$1.3 billion in 2000. The increase was primarily due to the higher cost of electricity from the PX that has resulted from higher demand for electricity, and the shortage of power plants in California, higher prices for natural gas used to generate electricity (as described above), the sale of SDG&E's fossil fuel generating plants and warmer weather in California. Additional information concerning the recent supply/demand conditions is provided in Note 14 of the notes to Consolidated Financial Statements. Under the current regulatory framework, changes in on-system prices normally do not affect net income. See the discussions of balancing accounts and electric revenues in Note 2 of the notes to Consolidated Financial Statements.

PX/ISO power revenues have been netted against purchased-power expense. In September 2000, as a result of high electricity costs the CPUC authorized SDG&E to purchase up to 1,900 megawatts of power directly from third-party suppliers under both short-term contracts and long-term contracts. Subsequent to December 31, 2000, the state of California authorized the DWR to purchase all of SDG&E's power requirements not covered by its own generation or by existing contracts. These and related events are discussed more fully in Note 14 of the notes to Consolidated Financial Statements.

Depreciation and amortization expense decreased from \$0.8 billion in 1999 to \$0.5 billion in 2000 and operating expenses decreased from \$1.2 billion in 1999 to \$1.1 billion in 2000. The decreases were primarily due to the 1999 sale of SDG&E's fossil fuel generating plants.

1999 COMPARED TO 1998 Natural gas revenues increased from \$2.8 billion in 1998 to \$2.9 billion in 1999. The increase was primarily due to lower overcollections in 1999 and higher UEG revenues, partially offset by a decrease in residential, commercial and industrial revenues. The increase in UEG revenues was primarily due to the sale of SDG&E's fossil fuel generating plants in the second quarter of 1999, as explained above.

Electric revenues decreased from \$1.9 billion in 1998 to \$1.8 billion in 1999. The decrease was primarily due to a temporary decrease in base electric rates following the completion of SDG&E's stranded cost recovery as noted above and as more fully described in Note 14 of the notes to Consolidated Financial Statements.

The company's cost of natural gas distributed increased from \$1.0 billion in 1998 to \$1.2 billion in 1999. The increase was largely due to an increase in the average price of natural gas purchased.

Depreciation and amortization expense decreased from \$0.9 billion in 1998 to \$0.8 billion in 1999. The decrease was primarily due to the mid-1999 completion of the accelerated recovery of generation assets.

Operating expenses decreased from \$1.3 billion in 1998 to \$1.2 billion in 1999. The decrease was primarily due to the \$117 million of business-combination costs in 1998.

TRADING OPERATIONS

SET, a leading natural gas, petroleum and power marketing firm headquartered in Stamford, Connecticut, was acquired on December 31, 1997. In addition to the transactions described below in "Market Risk," SET also enters into long-term structured transactions, such as the one supporting the SEI agreement referred to below in "International Operations." For the year ended December 31, 2000, SET recorded net income of \$155 million compared to net income of \$19 million in 1999. The increase in net income in 2000 compared to 1999 was primarily due to increased volatility in the U.S. natural gas and electric power markets, and higher trading volumes. In addition, European crude oil contributed significantly to SET's 2000 earnings. In 1998, a net loss of \$13 million was recorded. The improvement in net income in 1999 compared to 1998 is due to greater penetration of all customer segments, resulting in higher volumes traded.

INTERNATIONAL OPERATIONS

SEI was formed in June 1998 to develop, operate and invest in energy-infrastructure systems and power-generation facilities outside the United States. SEI now has interests in natural gas and/or electric transmission and distribution projects in Argentina, Canada, Chile, Mexico, Peru and Uruguay, and is pursuing other projects in Latin America.

In February 2001, SEI announced plans to construct a \$350 million, 600-megawatt power plant near Mexicali, Mexico. Construction of the project, named *Termoeléctrica de Mexicali*, is expected to begin in mid-2001, with completion anticipated by mid-2003.

As noted above in "Investments," SEI increased its investment in *Sodigas Pampeana S.A.* and *Sodigas Sur S.A.* in 2000 and 1998. These natural gas distribution companies serve 1.3 million customers in central and southern Argentina, respectively, and have a combined sendout of 650 million cubic feet per day. See further discussion at Note 3 of the notes to Consolidated Financial Statements.

In June 2000, SEI, PG&E Corporation and *Proxima Gas S.A de C.V.* announced an agreement to construct a \$230 million, 215-mile natural gas pipeline which will extend from Arizona to the Rosarito Pipeline south of Tijuana. The pipeline will have the capacity to transport 500 million cubic feet per day of natural gas. Construction of the pipeline is anticipated to begin in early 2002. Agreements have been signed for more than half of the capacity on the pipeline, with natural gas expected to begin flowing by September 2002.

As previously discussed, during 1999 and 2000 SEI and PSEG jointly purchased *Energía* and 84.5 percent of *Luz del Sur S.A.A.* See Note 3 of the Notes to Consolidated Financial Statements for a discussion of the acquisitions of *Energía* and *Luz del Sur S.A.A.*

In December 1999, Sempra Atlantic Gas (SAG), a subsidiary of SEI, was awarded a 25-year franchise by the provincial government of Nova Scotia to build and operate a natural gas distribution system in Nova Scotia. SAG has invested \$23 million and plans to invest \$700 million to \$800 million over the next seven years to build the system, which will make natural gas available to 78 percent of the 350,000 households in Nova Scotia. Construction of the system began in the fourth quarter of 2000, with delivery of natural gas expected to begin in the second quarter of 2001.

SEI owns 60 percent of *Distribuidora de Gas Natural de Mexicali, S. de R.L. de C.V.* (DGN-Mexicali), that holds the first license awarded to a private company to build and operate a natural gas distribution system in Mexico. It plans to invest up to \$25 million to provide service to 25,000 customers during the first five years of operation.

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

In May 1999, SEI was awarded a 30-year license to build and operate a natural gas distribution system in the *La Laguna-Durango* zone in north-central Mexico. SEI plans to invest over \$40 million in the project during the first five years of operation.

In August 1998, SEI was awarded a 10-year agreement by the Mexican Federal Electric Commission to provide a complete energy-supply package for a power plant in Rosarito, Baja California through a joint venture. As noted above, SET acted as the trading company for the supply of natural gas. The contract includes provisions for delivery of up to 300 million cubic feet per day of natural gas, the related transportation services in the U.S., and construction of a 23-mile pipeline from the U.S.-Mexico border to the plant. Construction of the pipeline was completed in mid-2000 at a cost of \$38 million, and SEI began supplying gas to the Rosarito Power Plant in July 2000. The pipeline will also serve as a link for a natural gas distribution system in Tijuana, Baja California, between San Diego and Rosarito.

Net income for international operations in 2000 was \$33 million compared to net income of \$2 million and a net loss of \$4 million for 1999 and 1998, respectively. The increase in net income for 2000 was primarily due to the first full year of results from *Luz del Sur S.A.A.* and *Energía*, and improved operating results at *Sodigas Pampeana S.A.* and *Sodigas Sur S.A.* The increase in net income for 1999 was primarily due to income from *Energía*, and lower operating costs and increased sales (as a result of colder weather) in Argentina.

OTHER OPERATIONS

SER develops power plants for the competitive market, as well as owning natural gas storage, production and transportation assets. SER is planning to develop 5,000 to 10,000 megawatts of generation within the next decade in the Southwest, the Northeast, the Gulf States and the Midwest. SER is a 50-percent partner in El Dorado Energy, a 500-megawatt power plant located near Las Vegas, Nevada, which began commercial operation in 2000. SER recorded net income of \$33 million, \$5 million and \$8 million in 2000, 1999 and 1998, respectively. The increase in net income for 2000 is primarily due to earnings from the El Dorado power plant.

SEF invests as a limited partner in affordable-housing properties and alternative-fuel projects. SEF's portfolio includes 1,300 properties throughout the United States. These investments are expected to provide income tax benefits (primarily from income tax credits) over 10-year periods. SEF recorded net income of \$28 million in both 2000 and 1999, and \$20 million in 1998. SEF's future investment policy is dependent on the company's future income tax position.

SES provides integrated energy-related products and services to commercial, industrial, government, institutional and consumer markets. SES recorded net losses of \$23 million, \$11 million and \$24 million in 2000, 1999 and 1998, respectively. These losses are primarily attributable to ongoing start-up costs.

OTHER INCOME, INTEREST EXPENSE AND INCOME TAXES

OTHER INCOME Other income, which primarily consists of interest income from short-term investments, equity earnings from unconsolidated subsidiaries and interest on regulatory balancing accounts, increased to \$106 million in 2000 from \$50 million in 1999. The increase was primarily due to improved equity earnings from unconsolidated subsidiaries of SER and SEI, and higher balancing-account interest. Other income increased in 1999 to \$50 million from \$15 million in 1998, primarily due to increased equity earnings from SEI's unconsolidated subsidiaries.

INTEREST EXPENSE Interest expense for 2000 increased to \$286 million in 2000 from \$229 million in 1999. The increase was primarily due to interest expense incurred on long-term debt issued in connection with the company's common stock repurchase, as described in Notes 5 and 12 of the notes to the Consolidated Financial Statements, and on short-term commercial paper borrowings made in 2000. Interest expense for 1999 increased to \$229 million from \$197 million

in 1998. This increase was primarily due to interest expense on the excess rate-reduction bond liability, as discussed in “Factors Influencing Future Performance” below.

INCOME TAXES Income tax expense was \$270 million, \$179 million and \$138 million for 2000, 1999 and 1998, respectively. The effective income tax rates were 38.6 percent, 31.2 percent and 31.9 percent for the same years. The increase in income tax expense for 2000 compared to 1999 was due to the increase in income before taxes combined with lower charitable contributions. (During 1999 SDG&E made a charitable contribution to the San Diego Unified Port District in connection with the sale of the South Bay generating plant.) The increase in income tax expense for 1999 compared to 1998 was due to the increase in income before taxes, partially offset by the charitable contribution to the San Diego Unified Port District. The effective income tax rates for 1998 and 1999 are not significantly different because the effect of leasing and other activities in 1998 was comparable to that of the 1999 charitable contribution.

FACTORS INFLUENCING FUTURE PERFORMANCE

Base results of the company in the near future will depend primarily on the results of the California utilities, while earnings growth and volatility will depend primarily on changes in the utility industry and activities at SEI, SET, SER and other businesses. The factors influencing future performance are summarized below.

ELECTRIC INDUSTRY RESTRUCTURING AND ELECTRIC RATES In 1996, California enacted legislation restructuring California’s investor-owned electric utility industry. The legislation and related decisions of the CPUC were intended to stimulate competition and reduce electric rates. During the transition period, utilities were allowed to charge frozen rates that were designed to be above current costs by amounts assumed to provide a reasonable opportunity to recover the above-market “stranded” costs of investments in electric generating assets. The rate freeze was to end for each utility when it completed recovery of its stranded costs, but no later than March 31, 2002. SDG&E completed recovery of its stranded costs in June 1999 and, with its rates no longer frozen, SDG&E’s overall rates were initially lower, but became subject to fluctuation with the actual cost of electricity purchases.

A number of factors, including supply/demand imbalances, resulted in abnormally high electric-commodity costs beginning in mid-2000 and continuing into 2001. During the second half of 2000, the average electric-commodity cost was 15.51 cents/kWh (compared to 4.15 cents/kWh in the second half of 1999). This caused SDG&E’s monthly customer bills to be substantially higher than normal. In response, legislation enacted in September 2000 imposed a ceiling of 6.5 cents/kWh on the cost of electricity that SDG&E may pass on to its small-usage customers on a current basis. Customers covered under the commodity rate ceiling generally include residential, small-commercial and lighting customers. The ceiling, which was retroactive to June 1, 2000, extends through December 31, 2002 (December 31, 2003 if deemed by the CPUC to be in the public interest). As a result of the ceiling, SDG&E is not able to pass through to its small-usage customers on a current basis the full purchase cost of electricity that it provides. The legislation provides for the future recovery of undercollections in a manner (not specified in the decision) intended to make SDG&E whole for the reasonable and prudent costs of procuring electricity. In the meantime, the amount paid for electricity in excess of the ceiling (the undercollected costs) is accumulated in an interest-bearing balancing account. The undercollection, included in Regulatory Assets on the Consolidated Balance Sheets, was \$447 million at December 31, 2000, and \$605 million at January 31, 2001, and is expected to increase to \$700 million in March 2001, and remain constant thereafter, except for interest, if the DWR continues to purchase SDG&E’s power requirements, as more fully described in “California Utility Operations” herein. The rate ceiling has materially and adversely affected SDG&E’s revenue collections and its related cash flows and liquidity. SDG&E has fully drawn upon substantially all of its short-term credit facilities. Its ability to access the capital markets and obtain additional financing has been substantially impaired by the financial distress being experienced by other California investor-owned utilities as well as by lender uncertainties concerning California utility regulation generally and the rapid growth of utility cost undercollections. Continued purchases by the DWR for resale to SDG&E’s customers of substantially all of the electricity that would otherwise be purchased by SDG&E or dramatic decreases in wholesale electricity prices, favorable action by the CPUC on SDG&E’s electric-rate-surge application and SDG&E’s access to the capital markets are required to manage and finance SDG&E’s cost undercollections and provide adequate liquidity.

Consequently, in January 2001, SDG&E filed an application with the CPUC requesting a temporary electric-rate surcharge of 2.3 cents/kWh, subject to refund, beginning March 1, 2001. The surcharge is intended to provide SDG&E with continued

access to financing on commercially reasonable terms by managing the growth of SDG&E's undercollected power costs. The CPUC has deferred this proceeding, pending resolution of the broader issues related to the statewide high costs. In response to the situation facing the California IOUs, the state of California passed legislation to permit its governor to negotiate with the IOUs to acquire their transmission assets. SDG&E has been having discussions with representatives of the governor concerning the possibility of such a transaction and what its terms might be. There is no assurance that these discussions will result in a sale of the transmission assets. SDG&E would consider entering into such a transaction only if the sales price and conditions of the sale and of future operating arrangements are reasonable.

See additional discussion in Note 14 of the notes to Consolidated Financial Statements.

NATURAL GAS RESTRUCTURING AND GAS RATES The natural gas industry experienced an initial phase of restructuring during the 1980s by deregulating natural gas sales to noncore customers. In January 1998, the CPUC released a staff report initiating a proceeding to assess the current market and regulatory framework for California's natural gas industry. The general goals of the plan are to consider reforms to the current regulatory framework, emphasizing market-oriented policies benefiting California's natural gas consumers. A CPUC decision is expected in 2001.

In October 1999, the state of California enacted a law that requires natural gas utilities to provide "bundled basic gas service" (including transmission, storage, distribution, purchasing, revenue-cycle services and after-meter services) to all core customers, unless the customer chooses to purchase gas from a nonutility provider. The law prohibits the CPUC from unbundling distribution-related gas services (including meter reading and billing) and after-meter services (including leak investigation, inspecting customer piping and appliances, pilot relighting and carbon monoxide investigation) for most customers. The objective is to preserve both customer safety and customer choice.

Supply/demand imbalances have increased the price of natural gas in California more than in the rest of the country because of California's dependence on natural gas fired electric generation due to air-quality considerations. The average price of natural gas at the California/Arizona (CA/AZ) border was \$6.25/mmbtu in 2000, compared with \$2.33/mmbtu in 1999. On December 11, 2000, the average spot-market price at the CA/AZ border reached a record high of \$56.91/mmbtu. Underlying the high natural gas prices are several factors, including the increase in natural gas usage for electric generation, colder winter weather and reduced natural gas supply resulting from historically low storage levels, lower gas production and a major pipeline rupture. In December 2000, SDG&E and SoCalGas filed separately with the Federal Energy Regulatory Commission (FERC) for a reinstitution of price caps on short-term interstate capacity to the CA/AZ border and between the interstate pipelines and California's local distribution companies, effective until March 31, 2001. The FERC responded by issuing extensive data requests, but has not otherwise acted on the requests.

A recent lawsuit, which seeks class-action certification, alleges that Sempra Energy, SoCalGas, SDG&E and El Paso Energy Corp. acted to drive up the price of natural gas for Californians by agreeing to stop a pipeline project that would have brought new and cheaper natural gas supplies into California. Sempra Energy believes the allegations are without merit.

ELECTRIC-GENERATION ASSETS El Dorado Energy (El Dorado), of which SER is a 50-percent partner, began commercial operations in May 2000 at its 500-megawatt power plant near Las Vegas, Nevada, generating energy to serve 350,000 households as discussed in "Other Operations" above. Its proximity to existing natural gas pipelines and electric transmission lines allows El Dorado to actively compete in the deregulated electric-generation market.

In December 2000, SER obtained approvals from the appropriate state agencies to construct the Elk Hills Power Project and the Mesquite Power Plant. The Elk Hills Power Project is a 550-megawatt power plant project near Bakersfield, California, in which SER will have a 50-percent interest. It is scheduled to begin construction in the second quarter of 2001 and to be operating in 2002. The plant is expected to generate energy to serve 350,000 households. The Mesquite Power Plant is a 1,200-megawatt project located near Phoenix, Arizona, which is scheduled to begin construction in the second quarter of 2001 and to be operating in 2003. The plant is expected to generate energy to serve 700,000 households.

Construction of the *Termoeléctrica de Mexicali* power plant is expected to begin in mid-2001, with completion anticipated by mid-2003. The 600-megawatt power plant will be located near Mexicali, Mexico.

See additional discussion of these projects in Note 3 of the notes to Consolidated Financial Statements.

INVESTMENTS AND JOINT VENTURES As discussed in “International Operations” above, the company has various investments, joint ventures and projects that will impact the company’s future performance. These include, among other things, SEI’s increased investment in two Argentinean natural gas utility holding companies (*Sodigas Pampeana S.A.* and *Sodigas Sur S.A.*), SEI’s investment in *Energía* and *Luz del Sur S.A.A.*, construction of the Baja California pipelines, SEI’s investments in several natural gas distribution systems in Mexico, the franchise awarded to SAG to build and operate a natural gas distribution system in Nova Scotia, and the investment in Atlantic Electric and Gas in the United Kingdom. See additional discussion of these investments, joint ventures and projects in Note 3 of the notes to Consolidated Financial Statements.

PERFORMANCE-BASED REGULATION (PBR) To promote efficient operations and improved productivity and to move away from reasonableness reviews and potential disallowances, the CPUC has been directing utilities to use PBR. PBR has replaced the general rate case and certain other regulatory proceedings for both SoCalGas and SDG&E. Under PBR, regulators require future income potential to be tied to achieving or exceeding specific performance and productivity goals, as well as cost reductions, rather than by relying solely on expanding utility plant in a market where a utility already has a highly developed infrastructure. See additional discussion of PBR in “California Utility Operations” above and in Note 14 of the notes to Consolidated Financial Statements.

ALLOWED RATE OF RETURN For 2001, SoCalGas is authorized to earn a rate of return on rate base of 9.49 percent and a rate of return on common equity of 11.6 percent, the same as in 2000 and 1999. SDG&E is authorized to earn a rate of return on rate base of 8.75 percent and a rate of return on common equity of 10.6 percent, compared to 9.35 percent and 11.6 percent, respectively, prior to July 1, 1999. Either utility can earn more than the authorized rate by controlling costs below approved levels or by achieving favorable results in certain areas, such as incentive mechanisms. In addition, earnings are affected by changes in sales volumes, except for the majority of SoCalGas’ core sales.

MANAGEMENT CONTROL OF EXPENSES AND INVESTMENT In the past, management has been able to control operating expenses and investment within the amounts authorized to be collected in rates. However, that effort is now increasing. Due to the ever-increasing financial pressures experienced by SDG&E in the current electric-industry environment, in January 2001 SDG&E launched a cash-conservation plan, which includes sales of nonessential property, containment of new hiring, reduction of outside contractors, and deferral of information system and construction projects that do not affect the core reliability of service to customers. While the company is not planning employee layoffs at this time, all expenses and activities not directly tied to the maintenance of essential services and safety will continue to be scrutinized and deferred if possible.

ENVIRONMENTAL MATTERS

The company’s operations are subject to federal, state and local environmental laws and regulations governing such things as hazardous wastes, air and water quality, land use, solid-waste disposal, and the protection of wildlife.

Most of the environmental issues faced by the company occur at the California utilities. Utility capital costs to comply with environmental requirements are generally recovered through the depreciation components of customer rates. The utilities’ customers generally are responsible for 90 percent of the noncapital costs associated with hazardous substances and the normal operating costs associated with safeguarding air and water quality, disposing properly of solid waste, and protecting endangered species and other wildlife. Therefore, the likelihood of the company’s financial position or results of operations being adversely affected in a significant manner is remote.

The environmental issues currently facing the company or resolved during the latest three-year period include investigation and remediation of the California utilities’ manufactured-gas sites (21 completed as of December 31, 2000, and 24 to be completed), asbestos and other cleanup at SDG&E’s former fossil fuel power plants (all sold in 1999 and actual or estimated cleanup costs included in the transactions), cleanup of third-party waste-disposal sites used by the company, which has been identified as a Potentially Responsible Party (investigations and remediations are continuing), and mitigation of damage to the marine environment caused by the cooling-water discharge from the San Onofre Nuclear Generating Station (the requirements for enhanced fish protection, a 150-acre artificial reef and restoration of 150 acres of coastal wetlands are in process).

MARKET RISK

The company's policy is to use derivative financial instruments to reduce its exposure to fluctuations in interest rates, foreign-currency exchange rates and energy prices. The company also uses and trades derivative financial instruments in its energy trading and marketing activities. Transactions involving these financial instruments are with credit-worthy firms and major exchanges. The use of these instruments exposes the company to market and credit risks which, at times, may be concentrated with certain counterparties.

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

The California utilities periodically enter into interest-rate swap and cap agreements to moderate exposure to interest-rate changes and to lower the overall cost of borrowing. These swap and cap agreements generally remain off the balance sheet since they involve the exchange of fixed-rate and variable-rate interest payments without the exchange of the underlying principal amounts. The related gains or losses are reflected in the income statement as part of interest expense. The company would be exposed to interest-rate fluctuations on the underlying debt should other parties to the agreement not perform. See the "Interest-Rate Risk" section below for additional information regarding the company's use of interest-rate swap and cap agreements.

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

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

Along with other tools, the company uses Value at Risk (VaR) to measure its exposure to market risk. VaR is an estimate of the potential loss on a position or portfolio of positions over a specified holding period, based on normal market conditions and within a given statistical confidence level. The company has adopted the variance/covariance methodology in its calculation of VaR, and uses a 95-percent confidence level. Holding periods are specific to the types of positions being measured, and are determined based on the size of the position or portfolios, market liquidity, purpose and other factors. Historical volatilities and correlations between instruments and positions are used in the calculation. As of December 31, 2000, the VaR on the company's fixed-rate long-term debt and SET's portfolio were \$314 million and \$7.3 million, respectively, as more fully discussed below.

The following discussion of the company's primary market-risk exposures as of December 31, 2000, includes a discussion of how these exposures are managed.

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

At December 31, 2000, the notional amount of interest-rate swap transactions associated with the regulated operations totaled \$45 million. See Note 10 of the notes to Consolidated Financial Statements for further information regarding this swap transaction.

The VaR on the company's fixed-rate long-term debt is estimated at approximately \$314 million as of December 31, 2000, assuming a one-year holding period.

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

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

Market risk of SET's portfolio is measured using a variety of methods, including VaR. SET computes the VaR of its portfolio based on the risk incurred in a one-day holding period. As of December 31, 2000, the diversified VaR of SET's portfolio was \$7.3 million, compared to \$2.6 million at December 31, 1999. The increased VaR results from the increased volatility and activity in the market in 2000 compared to 1999.

SDG&E AND SOCALGAS The California utilities may, at times, be exposed to limited market risk in their natural gas purchase, sale and storage activities as a result of activities under SDG&E's gas PBR or SoCalGas' Gas Cost Incentive Mechanism. They manage their risk within the parameters of the company's market-risk management and trading framework. As of December 31, 2000, the total VaR of the California utilities' natural gas positions was not material.

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

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

Almost all of the California utilities' accounts receivable and significant portions of the accounts receivable of the company's other subsidiaries are with customers located in California and, therefore, potentially affected by the high costs of electricity and natural gas in California, as described above in "Factors Influencing Future Performance" and in Note 14 of the notes to Consolidated Financial Statements.

FOREIGN-CURRENCY-RATE RISK Foreign-currency-rate risk exists by the nature of the company's global operations. The company has investments in entities whose functional currency is not the U.S. dollar, which exposes the company to foreign-exchange movements, primarily in Latin American currencies. When appropriate, the company may attempt to limit its exposure to changing foreign-exchange rates through both operational and financial market actions. These actions may include entering into forward, option and swap contracts to hedge existing exposures, firm commitments and anticipated transactions. As of December 31, 2000, the company had not entered into any such arrangements.

NEW ACCOUNTING STANDARDS

Effective January 1, 2001, the company adopted Statement of Financial Accounting Standards (SFAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." As amended, SFAS 133 requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position, measure those instruments at fair value and recognize changes in the fair value of derivatives in earnings in the period of change unless the derivative qualifies as an effective hedge that offsets certain exposures.

The adoption of this new standard on January 1, 2001, did not have a material impact on the company's earnings. However, \$1.1 billion in current assets, \$1.1 billion in noncurrent assets, \$6 million in current liabilities, and \$238 million in noncurrent liabilities were recorded as of January 1, 2001, in the Consolidated Balance Sheet as fixed-priced contracts and other derivatives. Due to the regulatory environment in which SoCalGas and SDG&E operate, regulatory assets and liabilities were established to the extent that derivative gains and losses are recoverable or payable through future rates. As such, \$1.1 billion in current regulatory liabilities, \$1.1 billion in noncurrent regulatory liabilities, \$5 million in current regulatory assets, and \$238 million in noncurrent regulatory assets were recorded as of January 1, 2001, in the Consolidated Balance Sheet. The ongoing effects will depend on future market conditions and the company's hedging activities.

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 101 – Revenue Recognition. SABs are not rules issued by the SEC. Rather, they represent interpretations and practices followed by SEC staff in administering the disclosure requirements of the federal securities laws. SAB 101 provides guidance on the recognition, presentation and disclosure of revenue in financial statements; it does not change the existing rules on revenue recognition. SAB 101 sets forth the basic criteria that must be met before revenue should be recorded. Implementation of SAB 101 was required by the fourth quarter of 2000 and had no effect on the company's consolidated financial statements.

INFORMATION REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains statements that are not historical fact and constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding SDG&E's ability to finance undercollected costs on reasonable terms and retain its financial strength, estimates of future accumulated undercollected costs, and plans to obtain future financing. The words "estimates," "believes," "expects," "anticipates," "plans," "intends," "may," "would" and "should" or similar expressions, or discussions of strategy or of plans are intended to identify forward-looking statements. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Future results may differ materially from those expressed in these forward-looking statements.

Forward-looking statements are necessarily based upon various assumptions involving judgments with respect to the future and other risks, including, among others, local, regional, national and international economic, competitive, political, legislative and regulatory conditions; actions by the CPUC, the California Legislature, the DWR and the FERC; the financial condition of other investor-owned utilities; inflation rates and interest rates; energy markets, including the timing and extent of changes in commodity prices; weather conditions; business, regulatory and legal decisions; the pace of deregulation of retail natural gas and electricity delivery; the timing and success of business-development efforts; and other uncertainties, all of which are difficult to predict and many of which are beyond the control of the company. Readers are cautioned not to rely unduly on any forward-looking statements and are urged to review and consider carefully the risks, uncertainties and other factors which affect the company's business described in this Annual Report and other reports filed by the company from time to time with the SEC.

FIVE-YEAR SUMMARY

At December 31 or for the years ended December 31

(Dollars in millions except

per-share amounts)

	2000	1999	1998	1997	1996
REVENUES AND OTHER INCOME					
California utility revenues:					
Gas	\$ 3,305	\$ 2,911	\$ 2,752	\$ 2,964	\$ 2,710
Electric	2,184	1,818	1,865	1,769	1,591
Other operating revenues	1,548	631	364	336	195
Other income	106	50	15	39	24
Total	\$ 7,143	\$ 5,410	\$ 4,996	\$ 5,108	\$ 4,520
Income before interest and income taxes	\$ 985	\$ 802	\$ 629	\$ 927	\$ 927
Net income	\$ 429	\$ 394	\$ 294	\$ 432	\$ 427
Net income per common share:					
Basic	\$ 2.06	\$ 1.66	\$ 1.24	\$ 1.83	\$ 1.77
Diluted	\$ 2.06	\$ 1.66	\$ 1.24	\$ 1.82	\$ 1.77
Dividends declared per common share	\$ 1.00	\$ 1.56	\$ 1.56	\$ 1.27	\$ 1.24
Pretax income/revenue	9.9%	10.7%	8.7%	14.5%	16.2%
Return on common equity	15.7%	13.4%	10.0%	14.7%	14.9%
Effective income tax rate	38.6%	31.2%	31.9%	41.1%	41.3%
Dividend payout ratio:					
Basic	48.5%	94.0%	125.8%	69.4%	70.1%
Diluted	48.5%	94.0%	125.8%	69.8%	70.1%
Price range of common shares	\$24 ⁷ / ₈ -\$16 ³ / ₁₆	\$26-\$17 ¹ / ₈	\$29 ⁵ / ₁₆ -\$23 ³ / ₄	*	*
AT DECEMBER 31					
Current assets	\$ 6,425	\$ 3,015	\$ 2,458	\$ 2,761	\$ 1,592
Total assets	\$ 15,612	\$ 11,124	\$ 10,456	\$ 10,756	\$ 9,762
Current liabilities	\$ 7,467	\$ 3,236	\$ 2,466	\$ 2,211	\$ 1,572
Long-term debt (excludes current portion)	\$ 3,268	\$ 2,902	\$ 2,795	\$ 3,175	\$ 2,704
Shareholders' equity	\$ 2,494	\$ 2,986	\$ 2,913	\$ 2,959	\$ 2,930
Common shares outstanding (in millions)	201.9	237.4	237.0	235.6	240.0
Book value per common share	\$ 12.35	\$ 12.58	\$ 12.29	\$ 12.56	\$ 12.21
Price/earnings ratio	11.3	10.5	20.5	*	*
Number of meters (in thousands):					
Natural gas	5,807	5,726	5,639	5,551	5,501
Electricity	1,238	1,218	1,192	1,178	1,164

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

STATEMENT OF MANAGEMENT'S RESPONSIBILITY FOR CONSOLIDATED FINANCIAL STATEMENTS

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

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

Management monitors the system of internal control for compliance through its own review and a strong internal auditing program, which independently assesses the effectiveness of the internal controls. In establishing and maintaining internal controls, the company must exercise judgment in determining whether the benefits derived justify the costs of such controls. Management believes that the company's system of internal control is adequate to provide assurance that the accompanying financial statements present fairly the company's financial position and results of operations.

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

The board of directors has an audit committee, composed of independent directors, to assist in fulfilling its oversight responsibilities for management's conduct of the company's financial reporting processes. The audit committee meets regularly to discuss financial reporting, internal controls and auditing matters with management, the company's internal auditors and independent auditors, and recommends to the board of directors any appropriate response to those discussions. The audit committee recommends for approval by the full board the appointment of the independent auditors. The independent auditors and the internal auditors periodically meet alone with the audit committee and have free access to the audit committee at any time.



Neal E. Schmale
Executive Vice President and
Chief Financial Officer



Frank H. Ault
Vice President and Controller

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of Sempra Energy:

We have audited the accompanying consolidated balance sheets of Sempra Energy and subsidiaries (the "company") as of December 31, 2000 and 1999, and the related statements of consolidated income, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Sempra Energy and subsidiaries as of December 31, 2000 and 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America.



San Diego, California

January 26, 2001 (February 27, 2001 as to Notes 3, 4, 5 and 14)

STATEMENTS OF CONSOLIDATED INCOME

For the years ended December 31

(Dollars in millions, except per-share amounts)

	2000	1999	1998
REVENUES AND OTHER INCOME			
California utility revenues:			
Natural gas	\$ 3,305	\$ 2,911	\$ 2,752
Electric	2,184	1,818	1,865
Other operating revenues	1,548	631	364
Other income	106	50	15
Total	7,143	5,410	4,996
EXPENSES			
Cost of natural gas distributed	1,599	1,164	954
Electric fuel and net purchased power	1,326	536	437
Operating expenses	2,464	1,837	1,853
Depreciation and amortization	563	879	929
Franchise payments and other taxes	180	181	182
Preferred dividends of subsidiaries	11	11	12
Trust preferred distributions by subsidiary	15	—	—
Total	6,158	4,608	4,367
Income before interest and income taxes	985	802	629
Interest	286	229	197
Income before income taxes	699	573	432
Income taxes	270	179	138
Net income	\$ 429	\$ 394	\$ 294
Weighted-average number of shares outstanding:			
Basic*	208,155	237,245	236,423
Diluted*	208,345	237,553	237,124
Net income per share of common stock (basic)	\$ 2.06	\$ 1.66	\$ 1.24
Net income per share of common stock (diluted)	\$ 2.06	\$ 1.66	\$ 1.24
Common dividends declared per share	\$ 1.00	\$ 1.56	\$ 1.56

*In thousands of shares

See notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

At December 31
(Dollars in millions)

	2000	1999
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 637	\$ 487
Accounts receivable – trade	994	428
Accounts and notes receivable – other	213	124
Income taxes receivable	24	144
Energy trading assets	4,083	1,539
Inventories	145	147
Other	329	146
Total current assets	6,425	3,015
Investments and other assets:		
Regulatory assets	1,174	549
Nuclear-decommissioning trusts	543	551
Investments	1,288	1,164
Other assets	456	451
Total investments and other assets	3,461	2,715
Property, plant and equipment:		
Property, plant and equipment	11,889	11,127
Less accumulated depreciation and amortization	(6,163)	(5,733)
Total property, plant and equipment – net	5,726	5,394
Total assets	\$15,612	\$ 11,124

See notes to Consolidated Financial Statements.

At December 31

(Dollars in millions)

	2000	1999
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Short-term debt	\$ 568	\$ 182
Accounts payable – trade	1,162	492
Accounts payable – other	117	54
Energy trading liabilities	3,619	1,365
Dividends and interest payable	124	154
Regulatory balancing accounts – net	830	346
Deferred income taxes	110	67
Current portion of long-term debt	368	155
Other	569	421
Total current liabilities	7,467	3,236
Long-term debt	3,268	2,902
Deferred credits and other liabilities:		
Customer advances for construction	56	72
Postretirement benefits other than pensions	152	147
Deferred income taxes	826	615
Deferred investment tax credits	101	106
Deferred credits and other liabilities	844	856
Total deferred credits and other liabilities	1,979	1,796
Preferred stock of subsidiaries	204	204
Mandatorily redeemable trust preferred securities	200	–
Commitments and contingent liabilities (Notes 3 and 13)		
SHAREHOLDERS' EQUITY		
Common stock	1,420	1,966
Retained earnings	1,162	1,101
Deferred compensation relating to ESOP	(39)	(42)
Accumulated other comprehensive income (loss)	(49)	(39)
Total shareholders' equity	2,494	2,986
Total liabilities and shareholders' equity	\$15,612	\$11,124

See notes to Consolidated Financial Statements.

STATEMENTS OF CONSOLIDATED CASH FLOWS

For the years ended December 31

(Dollars in millions)

	2000	1999	1998
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 429	\$ 394	\$ 294
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	563	879	929
Portion of depreciation arising from sales of generating plants	–	(303)	–
Application of balancing accounts to stranded costs	–	(66)	(86)
Deferred income taxes and investment tax credits	258	86	(229)
Equity in (income) losses of unconsolidated subsidiaries and joint ventures	(62)	5	19
Customer refunds paid	(628)	–	–
Other – net	(88)	(61)	(161)
Net change in other working capital components	410	254	557
Net cash provided by operating activities	882	1,188	1,323
CASH FLOWS FROM INVESTING ACTIVITIES			
Expenditures for property, plant and equipment	(759)	(589)	(438)
Investments and acquisitions of subsidiaries	(243)	(639)	(191)
Net proceeds from sales of generating plants	–	466	–
Other – net	78	(27)	(50)
Net cash used in investing activities	(924)	(789)	(679)
CASH FLOWS FROM FINANCING ACTIVITIES			
Common stock dividends	(244)	(368)	(325)
Repurchase of common stock	(725)	–	(1)
Sale of common stock	12	3	35
Issuance of trust preferred securities	200	–	–
Redemption of preferred stock	–	–	(75)
Issuances of long-term debt	813	160	75
Payment on long-term debt	(238)	(270)	(431)
Increase (decrease) in short-term debt – net	386	139	(311)
Other	(12)	–	(1)
Net cash provided by (used in) financing activities	192	(336)	(1,034)
Increase (decrease) in cash and cash equivalents	150	63	(390)
Cash and cash equivalents, January 1	487	424	814
Cash and cash equivalents, December 31	\$ 637	\$ 487	\$ 424

See notes to Consolidated Financial Statements.

For the years ended December 31
(Dollars in millions)

	2000	1999	1998
CHANGES IN OTHER WORKING CAPITAL COMPONENTS (Excluding cash and cash equivalents, short-term debt and long-term debt due within one year)			
Accounts and notes receivable	\$ (655)	\$ 188	\$ 90
Net trading assets	(290)	(73)	(71)
Income taxes	120	(171)	22
Regulatory balancing accounts	522	303	417
Other current assets	(181)	(23)	12
Accounts payable	733	25	77
Other current liabilities	161	5	10
Net change in other working capital components	\$ 410	\$254	\$557
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Interest payments, net of amounts capitalized	\$ 297	\$ 281	\$ 211
Income tax payments, net of refunds	\$ 104	\$ 168	\$366
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES			
Liabilities assumed for real estate investments	\$ -	\$ 34	\$ 36

See notes to Consolidated Financial Statements.

STATEMENTS OF CONSOLIDATED CHANGES IN SHAREHOLDERS' EQUITY

For the years ended				Deferred Compensation	Accumulated Other	Total
December 31, 2000, 1999 and 1998	Comprehensive	Common	Retained	Relating	Comprehensive	Shareholders'
(Dollars in millions)	Income	Stock	Earnings	to ESOP	Income (Loss)	Equity
Balance at December 31, 1997		\$1,849	\$1,157	\$ (47)	\$ -	\$ 2,959
Net income/comprehensive income	\$294		294			294
Common stock dividends declared			(376)			(376)
Sale of common stock		34				34
Repurchase of common stock		(1)				(1)
Long-term incentive plan		1				1
Common stock released from ESOP				2		2
Balance at December 31, 1998		1,883	1,075	(45)	-	2,913
Net income	\$394		394			394
Comprehensive income adjustment:						
Foreign-currency translation losses	(42)				(42)	(42)
Available-for-sale securities	10				10	10
Pension	(7)				(7)	(7)
Comprehensive income	\$355					
Common stock dividends declared			(368)			(368)
Quasi-reorganization adjustment (Note 2)		80				80
Sale of common stock		2				2
Long-term incentive plan		1				1
Common stock released from ESOP				3		3
Balance at December 31, 1999		1,966	1,101	(42)	(39)	2,986
Net income	\$429		429			429
Comprehensive income adjustment:						
Foreign-currency translation losses	(2)				(2)	(2)
Available-for-sale securities	(10)				(10)	(10)
Pension	2				2	2
Comprehensive income	\$ 419					
Common stock dividends declared			(201)			(201)
Sale of common stock		11				11
Repurchase of common stock		(558)	(167)			(725)
Long-term incentive plan		1				1
Common stock released from ESOP				3		3
Balance at December 31, 2000		\$1,420	\$1,162	\$ (39)	\$ (49)	\$2,494

See notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BUSINESS COMBINATION

Sempra Energy (the company) was formed as a holding company for Enova Corporation (Enova) and Pacific Enterprises (PE) in connection with a business combination of Enova and PE that was completed on June 26, 1998. As a result of the combination, each outstanding share of common stock of Enova was converted into one share of common stock of Sempra Energy, and each outstanding share of common stock of PE was converted into 1.5038 shares of common stock of Sempra Energy. The preferred stock and preference stock of the combining companies and their subsidiaries remained outstanding.

The Consolidated Financial Statements are those of the company and its subsidiaries and give effect to the business combination using the pooling-of-interests method and, therefore, are presented as if the companies were combined during all periods included therein.

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

EFFECTS OF REGULATION The accounting policies of the company's principal subsidiaries, San Diego Gas & Electric (SDG&E) and Southern California Gas Company (SoCalGas), conform with generally accepted accounting principles for regulated enterprises and reflect the policies of the California Public Utilities Commission (CPUC) and the Federal Energy Regulatory Commission (FERC).

SDG&E and SoCalGas prepare their financial statements in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation," under which a regulated utility records a regulatory asset if it is probable that, through the ratemaking process, the utility will recover that asset from customers. Regulatory liabilities represent future reductions in rates for amounts due to customers. To the extent that portions of the utility operations were to be no longer subject to SFAS No. 71, or recovery was to be no longer probable as a result of changes in regulation or the utility's competitive position, the related regulatory assets and liabilities would be written off. In addition, SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," affects utility plant and regulatory assets such that a loss must be recognized whenever a regulator excludes all or part of an asset's cost from rate base. The application of SFAS No. 121 continues to be evaluated in connection with industry restructuring. Information concerning regulatory assets and liabilities is described below in "Revenues and Regulatory Balancing Accounts" and industry restructuring is described in Note 14.

REVENUES AND REGULATORY BALANCING ACCOUNTS Revenues for the California utilities consist of deliveries to customers and the changes in regulatory balancing accounts. The amounts included in regulatory balancing accounts at December 31, 2000, represent net payables of \$463 million and \$367 million for SoCalGas and SDG&E, respectively. The corresponding amounts at December 31, 1999, were net payables of \$154 million and \$192 million for SoCalGas and SDG&E, respectively.

Prior to 1998, fluctuations in California utility earnings from changes in the costs of fuel oil, purchased energy and natural gas, and consumption levels for electricity and the majority of natural gas were eliminated by balancing accounts authorized by the CPUC. However, as a result of California's electric-restructuring law, previous overcollections recorded in SDG&E's applicable balancing accounts were applied to recovery of prior generation costs (as described in Note 14), and fluctuations in certain costs and consumption levels can now affect earnings from electric operations. In addition, fluctuations in certain costs and consumption levels can affect earnings from the California utilities' gas operations. Additional information on regulatory matters is included in Note 14.

Sempra Energy Trading (SET) derives a substantial portion of its revenue from market making and trading activities, as a principal, in natural gas, electricity, petroleum and petroleum products. It also earns trading profits as a dealer by structuring and executing transactions that permit its counterparties to manage their risk profiles, and takes positions in energy markets based on the expectation of future market conditions. These positions include options, forwards, futures and swaps. SET adjusts these derivatives to market each month with gains and losses recognized in earnings. See “Trading Instruments” below and Note 10 for additional information. Other subsidiaries recognize revenue on a mark-to-market basis, as energy is delivered to customers or as installations of customer projects progress.

REGULATORY ASSETS Regulatory assets include SDG&E’s undercollected electric-commodity costs accumulated due to the temporary rate ceiling imposed in mid-2000. Regulatory assets also include unrecovered premiums on early retirement of debt, postretirement benefit costs, deferred income taxes recoverable in rates and other expenditures that the utilities expect to recover in future rates. See Note 14 for additional information on the rate ceiling, industry restructuring and other regulatory matters.

TRADING INSTRUMENTS Trading assets and trading liabilities are recorded on a trade-date basis at fair value and include option premiums paid and received, and unrealized gains and losses from exchange-traded futures and options, over-the-counter (OTC) swaps, forwards, and options. Unrealized gains and losses on OTC transactions reflect amounts which would be received from or paid to a third party upon settlement of the contracts. Unrealized gains and losses on OTC transactions are reported separately as assets and liabilities unless a legal right of setoff exists under a master netting arrangement enforceable by law. Revenues are recognized on a trade-date basis and include realized gains and losses, and the net change in unrealized gains and losses.

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

INVENTORIES Included in inventories at December 31, 2000, were \$77 million of materials and supplies (\$67 million in 1999), and \$68 million of natural gas and fuel oil (\$80 million in 1999). Materials and supplies are generally valued at the lower of average cost or market; fuel oil and natural gas are valued by the last-in first-out method.

PROPERTY, PLANT AND EQUIPMENT This primarily represents the buildings, equipment and other facilities used by SoCalGas and SDG&E to provide natural gas and electric utility service.

The cost of utility plant includes labor, materials, contract services and related items, and an allowance for funds used during construction. The cost of retired depreciable utility plant, plus removal costs minus salvage value, is charged to accumulated depreciation. Information regarding electric industry restructuring and its effect on utility plant is included in Note 14. Utility plant balances by major functional categories at December 31, 2000, were: natural gas operations \$7.2 billion, electric distribution \$2.7 billion, electric transmission \$0.8 billion, and other electric \$0.4 billion. The corresponding amounts at December 31, 1999, were: natural gas operations \$7.1 billion, electric distribution \$2.5 billion, electric transmission \$0.7 billion, and other electric \$0.4 billion. Accumulated depreciation and decommissioning of natural gas and electric utility plant in service at December 31, 2000, were \$4.1 billion and \$2.0 billion, respectively, and at December 31, 1999, were \$3.8 billion and \$1.9 billion, respectively. Depreciation expense is based on the straight-line method over the useful lives of the assets or a shorter period prescribed by the CPUC. The provisions for depreciation as a percentage of average

depreciable utility plant (by major functional categories) in 2000, 1999 and 1998, respectively were: natural gas operations 4.29, 4.32, 4.32, electric distribution 4.67, 4.69, 4.49, electric transmission 3.21, 3.50, 3.31, and other electric 8.33, 8.21, 6.29. See Note 14 for discussion of the sale of generation facilities and industry restructuring. The remaining cost amounts (\$0.8 billion at December 31, 2000, and \$0.4 billion at December 31, 1999) consist of various items of property at other consolidated entities, with various depreciation rates depending on the nature of the items.

NUCLEAR-DECOMMISSIONING LIABILITY Deferred credits and other liabilities at December 31, 2000, and 1999, include \$162 million and \$165 million, respectively, of accumulated decommissioning costs associated with SDG&E's interest in San Onofre Nuclear Generating Station (SONGS) Unit 1, which was permanently shut down in 1992. Additional information on SONGS Unit 1 decommissioning costs is included in Note 6. The corresponding liability for Units 2 and 3 is included in accumulated depreciation and amortization.

FOREIGN CURRENCY TRANSLATION The assets and liabilities of the company's foreign operations are generally translated into U.S. dollars at current exchange rates, and revenues and expenses are translated at average exchange rates for the year. Resulting translation adjustments are reflected in a component of shareholders' equity ("accumulated other comprehensive income"). Foreign currency transaction gains and losses are included in consolidated net income.

COMPREHENSIVE INCOME Comprehensive income includes all changes, except those resulting from investments by owners and distributions to owners, in the equity of a business enterprise from transactions and other events including, as applicable, foreign-currency translation adjustments, minimum pension liability adjustments and unrealized gains and losses on marketable securities that are classified as available-for-sale. At December 31, 1999, the company had one such investment, which increased in value during 1999. In October 2000, this investment was sold. These changes are reflected in the Statement of Consolidated Changes in Shareholders' Equity.

QUASI-REORGANIZATION In 1993, PE divested its merchandising operations and most of its oil and gas exploration and production business. In connection with the divestitures, PE effected a quasi-reorganization for financial reporting purposes, effective December 31, 1992. Certain of the liabilities established in connection with the quasi-reorganization were favorably resolved in November 1999, including unitary tax issues. Excess reserves of \$80 million resulting from the favorable resolution of these issues were added to shareholders' equity at that time. Other liabilities established in connection with discontinued operations and the quasi-reorganization will be resolved in future years. Management believes the provisions established for these matters are adequate.

USE OF ESTIMATES IN THE PREPARATION OF THE FINANCIAL STATEMENTS The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS Cash equivalents are highly liquid investments with original maturities of three months or less at the date of purchase.

BASIS OF PRESENTATION Certain prior-year amounts have been reclassified to conform to the current year's presentation.

NEW ACCOUNTING STANDARDS Effective January 1, 2001, the company adopted Statement of Financial Accounting Standards (SFAS) No. 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." As amended, SFAS 133 requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position, measure those instruments at fair value and recognize changes in the fair value of derivatives in earnings in the period of change unless the derivative qualifies as an effective hedge that offsets certain exposure.

The adoption of this new standard on January 1, 2001, did not have a material impact on the company's earnings. However, \$1.1 billion in current assets, \$1.1 billion in noncurrent assets, \$6 million in current liabilities, and \$238 million in noncurrent liabilities were recorded as of January 1, 2001, in the Consolidated Balance Sheet as fixed-priced contracts and other derivatives. Due to the regulatory environment in which SoCalGas and SDG&E operate, regulatory assets and liabilities were established to the extent that derivative gains and losses are recoverable or payable through future rates. As such, \$1.1 billion in current regulatory liabilities, \$1.1 billion in noncurrent regulatory liabilities, \$5 million in current regulatory assets and \$238 million in noncurrent regulatory assets were recorded as of January 1, 2001, in the Consolidated Balance Sheet. The ongoing effects will depend on future market conditions and the company's hedging activities.

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) 101 – Revenue Recognition. SABs are not rules issued by the SEC. Rather, they represent interpretations and practices followed by SEC staff in administering the disclosure requirements of the federal securities laws. SAB 101 provides guidance on the recognition, presentation and disclosure of revenue in financial statements; it does not change the existing rules on revenue recognition. SAB 101 sets forth the basic criteria that must be met before revenue should be recorded. Implementation of SAB 101 was required by the fourth quarter of 2000 and had no effect on the company's consolidated financial statements.

NOTE 3. ACQUISITIONS AND JOINT VENTURES

SEMPRA ENERGY INTERNATIONAL (SEI) SEI is involved in several investments, joint ventures and projects. In October 2000, SEI increased its existing investment in two Argentinean natural gas utility holding companies (*Sodigas Pampeana S.A. and Sodigas Sur S.A.*) from 21.5 percent to 43 percent by purchasing an additional interest for \$147 million. In June 2000, SEI, PG&E Corporation and *Proxima Gas S.A. de C.V.* announced a joint agreement to construct a \$230 million, 215-mile natural gas pipeline which will extend from Arizona to the Rosarito Pipeline south of Tijuana.

In June 1999, SEI and PSEG Global (PSEG) each purchased a 50-percent interest in *Chilquinta Energía S.A. (Energía)*. SEI invested \$260 million for the purchase of stock and refinanced \$160 million of *Energía's* long-term debt outstanding. In September 1999, SEI and PSEG completed their acquisition of 47.5 percent of the outstanding shares of *Luz del Sur S.A.A.*, a Peruvian electric company. SEI's share of the transaction was \$108 million in cash. Combined with the 37 percent already owned through *Energía*, the companies' total joint ownership of *Luz del Sur S.A.A.* increased to 84.5 percent. In December 1999, Sempra Atlantic Gas (SAG), a subsidiary of SEI, was awarded a 25-year franchise by the provincial government of Nova Scotia to build and operate a natural gas distribution system in Nova Scotia. SAG invested \$23 million in 2000.

SEI and *Proxima Gas S.A. de C.V.*, partners in the Mexican companies *Distribuidora de Gas Natural (DGN) de Mexicali* and *Distribuidora de Gas Natural de Chihuahua*, are the licensees to build and operate natural gas distribution systems in Mexicali and Chihuahua. SEI owns interests of 60 and 95 percent in the *DGN-Mexicali* and *DGN-Chihuahua* projects, respectively. In addition, SEI was awarded a 30-year license to build and operate, through its subsidiary, *DGN de La Laguna Durango*, a natural gas distribution system in the La Laguna-Durango zone in north-central Mexico. Through 2000, *DGN-Mexicali*, *DGN-Chihuahua* and *DGN de La Laguna Durango* have invested \$18 million, \$38 million and \$18 million, respectively.

In August 1998, SEI was awarded a 10-year agreement by the Mexican Federal Electric Commission to provide a complete energy-supply package for a power plant in Rosarito, Baja California through a joint venture. SET acted as the trading company for the supply of natural gas. The contract includes provisions for delivery of up to 300 million cubic feet per day of natural gas, the related transportation services in the U.S., and construction of a 23-mile pipeline from the U.S.-Mexico border to the plant. Construction of the Rosarito pipeline was completed in mid-2000 at a cost of \$38 million.

In February 2001, SEI announced plans to construct a \$350 million, 600-megawatt power plant near Mexicali, Mexico. Construction is expected to begin in mid-2001, with completion anticipated by mid-2003.

SEMPRA ENERGY TRADING (SET) In April 2000, SET invested \$4 million in Utility.com, the world's first Internet utility company. In July 1998, SET purchased CNG Energy Services Corporation, a subsidiary of Pittsburgh-based Consolidated Natural Gas Company, for \$36 million.

SEMPRA ENERGY RESOURCES (SER) In December 2000, SER obtained approvals from the appropriate state agencies to construct the Elk Hills Power Project and the Mesquite Power Plant. The Elk Hills Power Project is a \$360 million, 550-megawatt power plant near Bakersfield, California. Mesquite Power is a \$630 million, 1200-megawatt project located near Phoenix, Arizona. In mid-2000, El Dorado Energy, a partnership between SER and Reliant Energy Power Generation, completed construction of a \$280 million, 500-megawatt merchant power plant near Las Vegas, Nevada.

SEMPRA ENERGY SOLUTIONS (SES) In August 2000, SES purchased Connectiv Thermal Systems' 50-percent interests in Atlantic-Pacific Las Vegas and Atlantic-Pacific Glendale for \$40 million, thereby acquiring full ownership of these companies. In January 1998, SES completed the acquisition of CES/Way International (renamed Sempra Energy Services in 1999).

NOTE 4. SHORT-TERM BORROWINGS

At December 31, 2000, SoCalGas had a \$200 million credit agreement, which was available to support commercial paper. At December 31, 2000, and 1999, SoCalGas' lines of credit were unused. On February 9, 2001, the agreement expired and was replaced on February 27, 2001, with a \$170 million, one-year agreement. This agreement bears interest at various rates based on market rates and SoCalGas' credit rating.

At December 31, 2000, SDG&E had \$285 million of bank lines available to support commercial paper and variable-rate long-term debt. The credit agreements expire at varying dates in mid-2001, but \$200 million of the then outstanding borrowings may be extended at SDG&E's option to a term maturity of an additional year. Any debt under the lines would bear interest at various rates based on market rates and SDG&E's credit rating. SDG&E's bank lines of credit were unused at both December 31, 2000, and 1999.

At December 31, 2000, Sempra Energy Global Enterprises (Global), formerly Sempra Energy Holdings, the intermediate holding company for many of the company's subsidiaries, had a \$1.2 billion credit agreement that expires in September 2001 and is extendable at Global's option for an additional year. Borrowings under the agreement bear interest at various rates based on market rates and the credit rating of Sempra Energy. Global's credit agreement is available to support commercial paper and variable-rate, long-term debt. Borrowings and the commercial paper are guaranteed by Sempra Energy. Global had \$401 million and \$182 million of commercial paper outstanding at December 31, 2000, and 1999, respectively.

Between January 24 and February 5, 2001, the company drew down substantially all (\$1.3 billion) of the above credit facilities.

SET has \$499 million in various uncommitted lines of credit that expire at varying dates in 2001 and bear interest at various rates based on market rates and the credit rating of SET. At December 31, 2000, SET had \$165 million in short-term borrowings outstanding.

NOTE 5. LONG-TERM DEBT

December 31 (Dollars in millions)

	2000	1999
LONG-TERM DEBT		
First-mortgage bonds		
7.625% June 15, 2002	\$ 28	\$ 28
6.875% August 15, 2002	100	100
5.75% November 15, 2003	100	100
6.8% June 1, 2015	14	14
5.9% June 1, 2018	68	68
5.9% September 1, 2018	93	93
6.1% and 6.4% September 1, 2018 and 2019	118	118
Variable rates September 1, 2020	58	58
5.85% June 1, 2021	60	60
8.75% October 1, 2021	150	150
8.5% April 1, 2022	10	10
7.375% March 1, 2023	100	100
7.5% June 15, 2023	125	125
6.875% November 1, 2025	175	175
Various rates December 1, 2027	165	225
9.625% April 15, 2020	–	10
Total	1,364	1,434
Rate-reduction bonds, various rates (payable annually through 2007)	461	526
Debt incurred to acquire limited partnerships, secured by real estate, at 6.8% to 9.0% payable annually through 2009	233	284
Notes payable, 6.95% and 7.95%, payable in 2005 and 2010	800	–
Various unsecured bonds at 5.67% to 6.38% or at variable rates (3.7% to 4.1% at December 31, 2000) payable from 2001 to 2028	467	495
Employee Stock Ownership Plan, at variable rates (6.80% at December 31, 2000) payable from 2001 to 2015	130	130
Variable rate debt (10.20% at December 31, 2000) payable from 2008 to 2011	160	160
Capitalized leases	37	43
Total	3,652	3,072
Less:		
Current portion of long-term debt	368	155
Unamortized discount on long-term debt	16	15
	384	170
Total	\$3,268	\$2,902

Excluding capital leases, which are described in Note 13, maturities of long-term debt are \$368 million in 2001, \$234 million in 2002, \$277 million in 2003, \$100 million in 2004, \$94 million in 2005 and \$2.5 billion thereafter. Although holders of variable-rate bonds may elect to redeem them prior to scheduled maturity, for purposes of determining the maturities listed above, since redeemed bonds are remarketed and are backed by long-term lines of credit, it is assumed the bonds will be held to maturity. SDG&E has CPUC authorization to issue an additional \$938 million in short-term or long-term debt (see discussion under “Recent Shelf Registrations” below) and SoCalGas has CPUC authorization to issue an additional \$455 million in long-term debt.

FIRST-MORTGAGE BONDS First-mortgage bonds are secured by a lien on substantially all utility plant. SDG&E and SoCalGas may issue additional first-mortgage bonds upon compliance with the provisions of their bond indentures, which permit, among other things, the issuance of an additional \$2.2 billion of first-mortgage bonds as of December 31, 2000, subject to CPUC authorization (see discussion under “Recent Shelf Registrations” below).

During May 2000, the company called \$10 million of first-mortgage bonds prior to scheduled maturity. During December 2000, \$60 million of variable-rate first-mortgage bonds were put back by the holders and subsequently remarketed on February 1, 2001, at a 7.0 percent fixed interest rate.

CALLABLE BONDS At the company's option, certain bonds may be called at a premium, including \$227 million of variable-rate bonds that are callable at various dates in 2001. Of the company's remaining callable bonds, \$195 million are callable in 2001, \$204 million in 2002 and \$621 million in 2003.

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

The sizes of the rate-reduction bond issuances were set so as to make the investor-owned utilities (IOUs) neutral as to the 10-percent rate reduction, and were based on a four-year period to recover stranded costs. Because SDG&E recovered its stranded costs in only 18 months (due to the greater-than-anticipated plant-sale proceeds), the bond sale proceeds were greater than needed. Accordingly, during the third quarter of 2000, SDG&E returned to its customers, via a combination of cash refunds and billing credits, \$388 million of surplus bond proceeds in accordance with a June 8, 2000 CPUC decision. The bonds and their repayment schedule are not affected by this refund.

UNSECURED DEBT Various long-term obligations totaling \$1.3 billion are unsecured at December 31, 2000. In February 2000, the company issued \$500 million of long-term 7.95 percent notes due in 2010 to partially finance the self-tender offer described in Note 12. In December 2000, the company issued an additional \$300 million in long-term 6.95 percent notes due in 2005 in order to reduce short-term debt. Unsecured bonds totaling \$124 million have variable-rate provisions. In July 2000, SoCalGas repaid \$30 million of 8.75 percent medium-term notes upon maturity.

RECENT SHELF REGISTRATIONS In December 2000, Sempra Energy and certain affiliates filed three shelf registrations. Sempra Energy, Global and other affiliates jointly filed a shelf registration for the public offering of up to \$1.0 billion of certain securities, guaranteed by Sempra Energy. SDG&E filed a shelf registration for the public offering of up to \$800 million of debt securities and requested CPUC authorization to incur additional indebtedness. On February 8, 2001, the CPUC approved SDG&E's financing application, but denied SDG&E authority to issue first-mortgage bonds beyond the \$138 million previously authorized. SDG&E has requested a rehearing of this denial. PE and Sempra Energy jointly filed a shelf registration for the public offering of up to \$500 million of debt securities of PE, guaranteed by Sempra Energy. Any securities under these shelf registrations are offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933. At December 31, 2000, no debt securities were issued under these registration statements.

DEBT OF EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) AND TRUST (TRUST) The Trust covers substantially all of SoCalGas' employees and is used to fund part of the retirement savings plan. The Trust was assumed by Sempra Energy on October 1, 1999, and participation in the ESOP was expanded to include employees of Sempra Energy and some of its unregulated affiliates effective January 1, 2000. In November 1999, the \$130 million ESOP debt was refinanced using 15-year notes with a variable interest rate (6.80% at December 31, 2000 and 6.59% at December 31, 1999). The notes are repriced weekly and are subject to buyback, at the holder's option, depending on market demand. Consequently, the notes are classified as "current portion of long-term debt" on the Consolidated Balance Sheets. Interest on ESOP debt amounted to \$9 million in 2000 and \$6 million in both 1999 and 1998. Dividends used for debt service amounted to \$3 million in 2000 and \$5 million in both 1999 and 1998.

INTEREST-RATE SWAPS SDG&E periodically enters into interest-rate swap and cap agreements to moderate its exposure to interest-rate changes and to lower its overall cost of borrowing. At December 31, 2000, SDG&E had such an agreement, maturing in 2002, with underlying debt of \$45 million.

NOTE 6. FACILITIES UNDER JOINT OWNERSHIP

SONGS and the Southwest Powerlink transmission line are owned jointly with other utilities. The company’s interests at December 31, 2000, are:

(Dollars in millions) Project	SONGS	Southwest Powerlink
Percentage ownership	20	88
Utility plant in service	\$63	\$217
Accumulated depreciation and amortization	\$32	\$ 119
Construction work in progress	\$ 5	\$ 2

The company’s share of operating expenses is included in the Statements of Consolidated Income. Participants in each project must provide their own financing. The amounts specified above for SONGS include nuclear production, transmission and other facilities. Certain substation equipment at SONGS is wholly owned by the company.

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

The company’s share of decommissioning costs for the SONGS units is estimated to be \$449 million in current dollars, based on a cost study completed in 1998. Cost studies are updated every three years and approved by the CPUC. Rate recovery of decommissioning costs is allowed until the time that the costs are fully recovered. The amount accrued each year, which is currently being collected in rates, is based on the amount allowed by regulators. This amount is considered sufficient to cover the company’s share of future decommissioning costs. Payments to the nuclear decommissioning trusts are expected to continue until SONGS is fully decommissioned, which is not expected to occur before 2022, or until sufficient funds have been collected.

Unit 1 was permanently shut down in 1992, and physical decommissioning began in January 2000. Several structures have been dismantled, and preparations have been made for major work to be performed in 2001 and beyond. That work will include dismantling, removal and disposal of all Unit 1 equipment and facilities (both nuclear and non-nuclear components), decontamination of the site and construction of an on-site storage facility for Unit 1 spent fuel. These activities are expected to be completed by 2008.

The amounts collected in rates are invested in externally managed trust funds. The securities held by the trust are considered available for sale and the trust is shown on the Consolidated Balance Sheets at market value. These values reflect unrealized gains of \$158 million and \$164 million at December 31, 2000, and 1999, respectively.

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

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

NOTE 7. INCOME TAXES

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

For the years ended December 31	2000	1999	1998
Statutory federal income tax rate	35.0%	35.0%	35.0%
Depreciation	6.7	7.0	7.5
State income taxes – net of federal income tax benefit	6.6	6.6	7.4
Tax credits	(13.0)	(14.9)	(12.9)
Charitable contribution of plant	–	(4.4)	–
Other – net	3.3	1.9	(5.1)
Effective income tax rate	38.6%	31.2%	31.9%

The components of income tax expense are as follows:

(Dollars in millions)	2000	1999	1998
CURRENT:			
Federal	\$ (8)	\$ 72	\$ 278
State	(5)	21	89
Foreign	25	–	–
Total	12	93	367
DEFERRED:			
Federal	207	79	(165)
State	57	15	(58)
Foreign	(1)	–	–
Total	263	94	(223)
DEFERRED INVESTMENT TAX CREDITS – NET	(5)	(8)	(6)
Total income tax expense	\$270	\$179	\$ 138

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

(Dollars in millions)	2000	1999
DEFERRED TAX LIABILITIES:		
Differences in financial and tax bases of utility plant	\$ 804	\$ 832
Balancing accounts and other regulatory assets	521	235
Partnership income	49	37
Other	276	118
Total deferred tax liabilities	1,650	1,222
DEFERRED TAX ASSETS:		
Investment tax credits	71	74
General business tax credit carryforward	113	46
Comprehensive Settlement (see Note 14)	26	42
Postretirement benefits	39	69
Other deferred liabilities	143	98
Restructuring costs	51	51
Other	271	160
Total deferred tax assets	714	540
Net deferred income tax liability	\$ 936	\$ 682

The net liability is recorded on the Consolidated Balance Sheets at December 31 as follows:

(Dollars in millions)	2000	1999
Current liability	\$ 110	\$ 67
Noncurrent liability	826	615
Total	\$936	\$682

The general business tax credit carryforwards expire in 2019 and 2020.

The company has not provided for U.S. income taxes on foreign subsidiaries' undistributed earnings (\$104 million at December 31, 2000), which are expected to be reinvested indefinitely. It is not possible to predict the amount of U.S. income taxes that might be payable if these earnings are eventually repatriated.

NOTE 8. EMPLOYEE BENEFIT PLANS

The information presented below describes the plans of the company and its principal subsidiaries. In connection with the PE/Enova business combination described in Note 1, certain of these plans have been merged with similar plans or modified, and numerous participants have been transferred among plans of related entities. In connection with voluntary separations related to the business combination, the company recorded a \$66 million special termination benefit and a settlement gain of \$30 million in 1998.

During 2000, Sempra Energy and most of its subsidiaries participated in another voluntary separation program. As a result, the company recorded a \$56 million special termination benefit, a curtailment credit of \$2 million, and a settlement gain of \$26 million in 2000.

PENSION AND OTHER POSTRETIREMENT BENEFITS The company sponsors several qualified and nonqualified pension plans and other postretirement benefit plans for its employees. Effective March 1, 1999, the Pacific Enterprises Pension Plan merged with the Sempra Energy Cash Balance Plan.

The following tables provide a reconciliation of the changes in the plans' benefit obligations and the fair value of assets over the two years, and a statement of the funded status as of each year end:

	Pension Benefits		Other Postretirement Benefits	
(Dollars in millions)	2000	1999	2000	1999
WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31:				
Discount rate	7.25%(1)	7.75%	7.75%	7.75%
Expected return on plan assets	8.00%	8.00%	7.85%	7.85%
Rate of compensation increase	5.00%	5.00%	5.00%	5.00%
Cost trend of covered health care charges	-	-	7.50%(2)	7.75%(2)
CHANGE IN BENEFIT OBLIGATION:				
Net benefit obligation at January 1	\$ 1,962	\$2,080	\$555	\$ 563
Service cost	41	48	11	15
Interest cost	153	142	37	40
Plan participants' contributions	-	-	-	3
Actuarial (gain) loss	114	(147)	(37)	(44)
Curtailments	(7)	-	5	-
Settlements	2	-	-	-
Special termination benefits	54	-	2	-
Gross benefits paid	(292)	(161)	(22)	(22)
Net benefit obligation at December 31	2,027	1,962	551	555
CHANGE IN PLAN ASSETS:				
Fair value of plan assets at January 1	3,427	2,796	548	443
Actual return on plan assets	(247)	789	(25)	96
Employer contributions	22	3	14	28
Plan participants' contributions	-	-	-	3
Gross benefits paid	(292)	(161)	(22)	(22)
Fair value of plan assets at December 31	2,910	3,427	515	548
Funded status at December 31	883	1,465	(36)	(7)
Unrecognized net actuarial gain	(945)	(1,627)	(106)	(128)
Unrecognized prior service cost	55	66	(10)	(12)
Unrecognized net transition obligation	2	3	-	-
Net recorded liability at December 31	\$ (5)	\$ (93)	\$(152)	\$(147)

(1) Discount rate decreased from 7.75% to 7.25%, effective March 1, 2000.

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

The following table provides the amounts recognized on the Consolidated Balance Sheets at December 31:

	Pension Benefits		Other Postretirement Benefits	
(Dollars in millions)	2000	1999	2000	1999
Prepaid benefit cost	\$ 75	\$ 13	\$ -	\$ -
Accrued benefit cost	(80)	(106)	(152)	(147)
Additional minimum liability	(12)	(18)	-	-
Intangible asset	4	6	-	-
Accumulated other comprehensive income, pretax	8	12	-	-
Net recorded liability	\$ (5)	\$ (93)	\$(152)	\$(147)

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

	Pension Benefits			Other Postretirement Benefits		
For the years ended December 31	2000	1999	1998	2000	1999	1998
(Dollars in millions)						
Service cost	\$ 41	\$ 48	\$ 55	\$ 11	\$ 15	\$ 13
Interest cost	153	142	148	37	40	36
Expected return on assets	(239)	(206)	(196)	(37)	(32)	(24)
Amortization of:						
Transition obligation	1	1	1	11	11	11
Prior service cost	6	6	6	(2)	(1)	(1)
Actuarial (gain) loss	(55)	(31)	(23)	(8)	2	-
Special termination benefits	54	-	63	2	-	3
Curtailment credit	(2)	-	-	-	-	-
Settlement credit	(26)	-	(30)	-	-	-
Regulatory adjustment	18	17	-	26	15	-
Total net periodic benefit cost (income)	\$ (49)	\$ (23)	\$ 24	\$ 40	\$ 50	\$ 38

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percent change in assumed health care cost trend rates would have the following effects:

(Dollars in millions)	1% Increase	1% Decrease
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	\$ 8	\$ (7)
Effect on the health care component of the accumulated other postretirement benefit obligation	\$74	\$(69)

Except for one nonqualified retirement plan, all pension plans had plan assets in excess of accumulated benefit obligations. For that one plan the projected benefit obligation and accumulated benefit obligation were \$65 million and \$51 million, respectively, as of December 31, 2000, and \$67 million and \$62 million, respectively, as of December 31, 1999.

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

SAVINGS PLANS The company offers savings plans, administered by plan trustees, to all eligible employees. Eligibility to participate in the various employer plans ranges from one month to one year of completed service. Employees may contribute, subject to plan provisions, from one percent to 15 percent of their regular earnings. Employer contributions, after one year of completed service, are used to purchase shares of company stock. Employer contribution methods vary by plan, but generally the contribution is equal to 50 percent of the first 6 percent of eligible base salary contributed by employees. The employees' contributions, at the direction of the employees, are primarily invested in company stock, mutual funds, institutional trusts or guaranteed investment contracts. Employer contributions for the Sempra Energy and SoCalGas plans are partially funded by the employee stock ownership plan referred to below. Company contributions to the savings plans were \$15 million in 2000, \$14 million in 1999 and \$14 million in 1998. The fair value of company stock held by the savings plan was \$501 million at December 31, 2000, and \$391 million at December 31, 1999.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) All contributions to the Employee Stock Ownership Plan and Trust (Trust) are made by the company; there are no contributions made by the participants.

As the company makes contributions to the ESOP, the ESOP debt service is paid and shares are released in proportion to the total expected debt service. Compensation expense is charged and equity is credited for the market value of the shares released. Income tax deductions are allowed based on the cost of the shares. Dividends on unallocated shares are used to pay debt service and are applied against the liability. The Trust held 2.8 million and 2.9 million shares of Sempra Energy common stock, with fair values of \$65.5 million and \$51.1 million, at December 31, 2000, and 1999, respectively.

NOTE 9. STOCK-BASED COMPENSATION

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

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

In 1999 and 1998, 85,400 shares and 102,640 shares, respectively, of restricted company stock were awarded to officers. There were no new issues in 2000. Each award is subject to forfeiture after four years if certain corporate goals are not met. Holders of this stock have voting rights and receive dividends prior to the time the restrictions lapse if, and to the extent, dividends are paid on company stock. Compensation expense for the issuance of these restricted shares was approximately \$1 million in 2000, \$1 million in 1999 and \$2 million in 1998.

In 2000, 1999 and 1998 Sempra Energy granted to officers and 175 key employees 4,339,000, 3,442,400 and 3,635,800 stock options, respectively. The option price is equal to the market price of common stock at the date of grant. The grants, which vest over a one to four-year period, include options with and without performance-based dividend equivalents. The stock options expire in 10 years from the date of grant. Compensation expense (or reduction thereof) for the stock option grants (all associated with the options with dividend equivalents) and similar awards was \$14 million, (\$13 million) and \$12 million in 2000, 1999 and 1998, respectively.

Had compensation cost for the stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans, consistent with the method of SFAS No. 123, the company's net income (earnings per share) would have been \$378 million (\$1.59 per share) and \$285 million (\$1.20 per share) for 1999 and 1998, respectively. For 2000, the company's net income was not affected and remained at \$429 million (\$2.06 per share).

The plans permit the granting of dividend equivalents, which provide grantees the opportunity to receive some or all of the cash dividends that would have been paid on the shares since the grant date, depending on the degree, if any, by which certain corporate goals are met. For grants prior to July 1, 1998, payment of the dividend equivalents is also contingent upon exercise of the options and requires that the market value of the shares purchased exceeds the option price.

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

STOCK OPTION ACTIVITY

	Shares Under Option	Average Exercise Price	Options Exercisable at Year End
OPTIONS WITH DIVIDEND EQUIVALENTS			
December 31, 1997	2,486,217	\$ 18.51	1,513,545
Granted	2,131,803	\$ 25.23	
Exercised	(512,059)	\$ 17.12	
Cancelled	(509,301)	\$ 23.00	
December 31, 1998	3,596,660	\$ 22.06	1,387,523
Granted	1,451,100	\$ 21.00	
Exercised	(254,886)	\$ 17.32	
Cancelled	(99,677)	\$ 23.34	
December 31, 1999	4,693,197	\$ 21.96	1,844,079
Exercised	(399,875)	\$ 18.91	
Cancelled	(264,749)	\$ 23.39	
December 31, 2000	4,028,573	\$ 22.17	2,462,574
OPTIONS WITHOUT DIVIDEND EQUIVALENTS			
December 31, 1997	1,363,496	\$ 19.08	1,363,496
Granted	1,503,997	\$ 26.47	
Exercised	(596,629)	\$ 15.72	
Cancelled	(240,632)	\$ 29.78	
December 31, 1998	2,030,232	\$ 24.28	523,661
Granted	1,991,300	\$ 21.00	
Exercised	(12,781)	\$ 15.20	
Cancelled	(55,746)	\$ 23.25	
December 31, 1999	3,953,005	\$ 22.67	1,019,056
Granted	4,339,000	\$ 19.03	
Exercised	(329,313)	\$ 19.10	
Cancelled	(397,271)	\$ 25.07	
December 31, 2000	7,565,421	\$ 20.61	1,659,244

Additional information on options outstanding at December 31, 2000, is as follows:

Range of Exercise Prices	Number of Shares	Average Remaining Life	Average Exercise Price
Outstanding options			
\$12.80–\$16.12	422,959	3.40	\$ 15.10
\$16.79–\$21.00	8,203,611	8.34	\$ 19.72
\$24.10–\$27.92	2,967,424	6.83	\$ 25.91
	11,593,994	7.77	\$ 21.14
Exercisable options			
\$12.80–\$16.12	422,959		\$ 15.10
\$16.79–\$21.00	1,867,161		\$ 19.96
\$24.10–\$27.92	1,831,698		\$ 25.86
	4,121,818		\$ 22.08

The fair value of each option grant (including dividend equivalents where applicable) was estimated on the date of grant using the modified Black-Scholes option-pricing model. Weighted average fair values for options granted in 2000, 1999 and 1998 were \$3.07, \$4.24 and \$8.20, respectively.

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

	2000	1999	1998
Stock price volatility	20%	19%	16%
Risk-free rate of return	6.8%	5.5%	5.6%
Annual dividend yield*	5.4%	6.11%	5.27%
Expected life	6 Years	6 Years	6 Years

*The assumed yield for the options that include dividend equivalents is zero.

NOTE 10. FINANCIAL INSTRUMENTS

FAIR VALUE The fair values of the company’s financial instruments (cash, temporary investments, funds held in trust, notes receivable, investments in limited partnerships, dividends payable, short-term and long-term debt, customer deposits, mandatorily redeemable trust preferred securities, and preferred stock of subsidiaries) are not materially different from the carrying amounts, except for long-term debt, mandatorily redeemable trust preferred securities and preferred stock of subsidiaries. The carrying amounts and fair values of long-term debt were \$3.7 billion and \$3.6 billion, respectively, at December 31, 2000, and \$3.1 billion and \$3.0 billion, respectively, at December 31, 1999. Included in long-term debt are SDG&E’s rate-reduction bonds. The carrying amounts and fair values of the bonds were \$461 million and \$462 million, respectively, at December 31, 2000, and \$526 million and \$511 million, respectively, at December 31, 1999. The carrying amounts and fair values of mandatorily redeemable trust preferred securities, at December 31, 2000, were \$200 million and \$188 million, respectively. There were no issues of the mandatorily redeemable trust preferred securities at December 31, 1999. The carrying amounts and fair values of subsidiaries’ preferred stock were \$204 million and \$146 million, respectively, at December 31, 2000, and \$204 million and \$167 million, respectively, at December 31, 1999. The fair values of the long-term debt, preferred stock and mandatorily redeemable trust preferred securities were estimated based on quoted market prices for them or for similar issues. In addition, included in long-term debt were notes payable which had carrying amounts and fair values of \$237 million and \$188 million, respectively, at December 31, 2000. The fair values of these notes payable were estimated based on the present value of the future cash flows, discounted at rates available for similar notes with comparable maturities.

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

SWAP AGREEMENTS The company periodically enters into interest-rate swap and cap agreements to moderate exposure to interest-rate changes and to lower the overall cost of borrowing. These agreements generally remain off the balance sheet as they involve the exchange of fixed-rate and variable-rate interest payments without the exchange of the underlying principal amounts. The related gains or losses are reflected in the Statements of Consolidated Income as part of interest expense.

At December 31, 2000, and 1999, SDG&E had one interest-rate-swap agreement: a floating-to-fixed-rate swap associated with \$45 million of variable-rate bonds maturing in 2002. SDG&E expects to hold this financial instrument to its maturity. This swap agreement has effectively fixed the interest rate on the underlying variable-rate debt at 5.4 percent. SDG&E would be exposed to interest-rate fluctuations on the underlying debt should the counterparty to the agreement not perform. Such nonperformance is not anticipated. This agreement, if terminated, would result in an obligation of \$1.3 million at both December 31, 2000, and December 31, 1999. Additional information on this topic is included in Note 5.

ENERGY DERIVATIVES The company uses energy derivatives for price-risk management and trading purposes within certain limitations imposed by company policies and regulatory requirements. Information on derivative financial instruments of SoCalGas and SET is provided below. Other business units use energy derivatives to mitigate risk and better manage costs. These instruments include forward contracts, swaps, options and other contracts which have maturities ranging from 30 days to 12 months.

SOUTHERN CALIFORNIA GAS COMPANY SoCalGas is subject to price risk on its natural gas purchases if its cost exceeds a 2 percent tolerance band above the benchmark price. This is discussed further in Note 14. SoCalGas becomes subject to price risk when positions are incurred during the buying, selling and storage of natural gas. As a result of its Gas Cost Incentive Mechanism (GCIM), SoCalGas enters into a certain amount of gas futures contracts in the open market with the intent of reducing gas costs within the GCIM tolerance band. The CPUC has approved the use of gas futures for managing risk associated with the GCIM. At December 31, 2000, unrealized gains associated with these activities totaled \$72 million. These savings will be passed on to customers during the first quarter of 2001. At December 31, 1999, gains and/or losses from natural gas futures contracts were not material to the company's financial statements.

SEMPRA ENERGY TRADING SET derives a substantial portion of its revenue from market making and trading activities, as a principal, in natural gas, electricity, petroleum and petroleum products. It quotes bid and offer prices to other market makers and end users. It also earns trading profits as a dealer by structuring and executing transactions that permit its counterparties to manage their risk profiles. In addition, it takes positions in energy markets based on the expectation of future market conditions. These positions may be offset with similar positions or may be offset in exchange traded markets. These positions include options, forwards, futures and swaps. These financial instruments represent contracts with counterparties whereby payments are linked to or derived from energy market indices or on terms predetermined by the contract, which may or may not be financially settled by SET. For the year ended December 31, 2000, substantially all of SET's derivative transactions were held for trading and marketing purposes.

SET marks these derivatives to market each month, with gains and losses recognized in earnings. These instruments are included in the Consolidated Balance Sheets as energy trading assets or liabilities. Certain instruments, such as swaps, are entered into and closed out within the same month. Net gains and losses on these derivative transactions are included in revenue and other income in the Statements of Consolidated Income.

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

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

SET's credit risk from financial instruments as of December 31, 2000, is represented by the positive fair value of financial instruments after consideration of collateral. Credit risk disclosures, however, relate to the net losses that would be recognized if all counterparties completely failed to perform their obligations. Options written do not expose SET to credit risk. Exchange-traded futures and options are not deemed to have significant credit exposure as the exchanges guarantee that every contract will be properly settled on a daily basis.

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

Counterparty credit quality:	Futures, forward and swap contracts	Purchased options	Total
AAA	\$ 22	\$ 9	\$ 31
AA	344	7	351
A	1,008	221	1,229
BBB	995	124	1,119
Below investment grade	299	112	411
Exchanges	491	6	497
Total	\$3,159	\$479	\$3,638

Financial instruments with maturities or repricing characteristics of 180 days or less, including cash and cash equivalents, are considered short-term and, therefore, the carrying values of these financial instruments approximate their fair values. SET's commodities owned, trading assets and trading liabilities are carried at fair value. Accordingly, SET has determined that all of its financial instruments are recorded at fair value.

Based on quarterly observations, the average fair values during 2000, for trading assets and trading liabilities which are considered financial instruments with off-balance-sheet risk, approximate \$2.5 billion and \$2.2 billion, respectively.

The carrying value of trading assets and trading liabilities approximates the following:

December 31 (Dollars in millions)	2000	1999
ENERGY TRADING ASSETS		
Unrealized gains on swaps and forwards	\$2,647	\$1,244
Due from trading counterparties	684	63
OTC commodity options purchased	653	108
Due from commodity clearing organization and clearing brokers	99	124
Total	\$4,083	\$1,539
ENERGY TRADING LIABILITIES		
Unrealized losses on swaps and forwards	\$2,590	\$ 1,210
OTC commodity options written	612	73
Due to trading counterparties	417	82
Total	\$ 3,619	\$1,365

Notional amounts do not necessarily represent the amounts exchanged by parties to the financial instruments and do not measure SET's exposure to credit or market risks. The notional or contractual amounts are used to summarize the

volume of financial instruments, but do not reflect the extent to which positions may offset one another. Accordingly, SET is exposed to much smaller amounts.

The notional amounts of SET’s financial instruments at December 31, 2000, were:

(Dollars in millions)	Total
Forwards and commodity swaps	\$45,656
Options written	13,799
Options purchased	13,496
Futures and exchange options	3,117
Total	\$76,068

NOTE 11. PREFERRED STOCK OF SUBSIDIARIES

PACIFIC ENTERPRISES

December 31 (Dollars in millions except call price)	Call Price	2000	1999
Cumulative preferred without par value:			
\$4.75 Dividend, 200,000 shares authorized and outstanding	\$100.00	\$20	\$20
\$4.50 Dividend, 300,000 shares authorized and outstanding	\$100.00	30	30
\$4.40 Dividend, 100,000 shares authorized and outstanding	\$ 101.50	10	10
\$4.36 Dividend, 200,000 shares authorized and outstanding	\$ 101.00	20	20
\$4.75 Dividend, 253 shares authorized and outstanding	\$ 101.00	-	-
Total		\$80	\$80

All or any part of every series of presently outstanding PE preferred stock is subject to redemption at PE’s option at any time upon not less than 30 days’ notice, at the applicable redemption price for each series, together with the accrued and accumulated dividends to the date of redemption. All series have one vote per share and cumulative preferences as to dividends. PE is authorized to issue 10,000,000 shares of Preferred Stock and 5,000,000 shares of Class A Preferred Stock. No shares of Class A Preferred Stock are outstanding.

SOCALGAS

December 31 (Dollars in millions)	2000	1999
Not subject to mandatory redemption:		
\$25 par value, authorized 1,000,000 shares		
6% Series, 28,134 shares outstanding	\$ 1	\$ 1
6% Series A, 783,032 shares outstanding	19	19
Without par value, authorized 10,000,000 shares	-	-
Total	\$20	\$20

None of SoCalGas’ series of preferred stock is callable. All series have one vote per share and cumulative preferences as to dividends. On February 2, 1998, SoCalGas redeemed all outstanding shares of 7.75% Series Preferred Stock at a price per share of \$25 plus accrued dividends. The total cost to SoCalGas was approximately \$75.3 million.

SDG&E

December 31, (Dollars in millions except call price)

	Call Price	2000	1999
Not subject to mandatory redemption			
\$20 par value, authorized 1,375,000 shares:			
5% Series, 375,000 shares outstanding	\$24.00	\$ 8	\$ 8
4.50% Series, 300,000 shares outstanding	\$ 21.20	6	6
4.40% Series, 325,000 shares outstanding	\$ 21.00	7	7
4.60% Series, 373,770 shares outstanding	\$20.25	7	7
Without par value:			
\$1.70 Series, 1,400,000 shares outstanding	\$25.85	35	35
\$1.82 Series, 640,000 shares outstanding	\$26.00	16	16
Total not subject to mandatory redemption		\$79	\$79
Subject to mandatory redemption			
Without par value: \$1.7625 Series, 1,000,000 shares outstanding	\$25.00	\$25	\$25

All series of SDG&E's preferred stock have cumulative preferences as to dividends. The \$20 par value preferred stock has two votes per share on matters being voted upon by shareholders of SDG&E and a liquidation value at par, whereas the no-par-value preferred stock is nonvoting and has a liquidation value of \$25 per share. SDG&E is authorized to issue 10,000,000 shares of no-par-value preferred stock (both subject to and not subject to mandatory redemption). All series are currently callable except for the \$1.70 and \$1.7625 series (callable in 2003). The \$1.7625 Series has a sinking fund requirement to redeem 50,000 shares per year from 2003 to 2007; the remaining 750,000 shares must be redeemed in 2008.

MANDATORILY REDEEMABLE TRUST PREFERRED SECURITIES

On February 23, 2000, a wholly owned subsidiary trust of the company issued 8,000,000 shares of preferred stock in the form of 8.90-percent Cumulative Quarterly Income Preferred Securities, Series A (QUIPS). The QUIPS have cumulative preferences as to distributions, are nonvoting and have a par and liquidation value of \$25 per share. Cash dividends are paid quarterly and the QUIPS mature on February 23, 2030, subject to extension to a date not later than February 23, 2049, and shortening to a date not earlier than February 23, 2015. The QUIPS are subject to mandatory redemption and the company has guaranteed payments to the extent that the trust does not have funds available to make distributions. The QUIPS are callable on or after February 23, 2005 and there are no sinking fund provisions. The QUIPS are reflected as "Mandatorily redeemable trust preferred securities" on the company's Consolidated Balance Sheets and cash dividend payments are shown as "Trust preferred distributions by subsidiary" on the company's Statements of Consolidated Income. Proceeds of this issuance, together with \$500 million of long-term 7.95% notes due 2010 (see Note 5), were used to finance substantially all of the tender offer referred to in Note 12.

NOTE 12. SHAREHOLDERS' EQUITY AND EARNINGS PER SHARE

The only difference between basic and diluted earnings per share is the effect of common stock options. For 2000, 1999 and 1998, the effect of dilutive options was equivalent to an additional 190,000; 308,000; and 701,000 shares, respectively. This had no effect on earnings per share.

This calculation excludes options covering 6.6 million shares for 2000, and 3.3 million shares for 1999 and 1998 for which the exercise price was greater than the shares' market price.

The company is authorized to issue 750,000,000 shares of no-par-value common stock and 50,000,000 shares of Preferred Stock. Excluding shares held by the ESOP, there were 201,927,524 shares of common stock outstanding at December 31, 2000, compared to 237,408,051 shares at December 31, 1999.

TENDER OFFER On February 25, 2000, the company completed a self-tender offer, purchasing 36.1 million shares of its outstanding common stock at \$20 per share. In March 2000, the company's board of directors authorized the optional expenditure of up to \$100 million to repurchase additional shares of common stock from time to time in the open market or

in privately negotiated transactions. Through December 31, 2000, the company acquired 162,000 shares under this authorization (all in July 2000). In 1998 the company repurchased \$1 million of common stock. There were no common stock repurchases in 1999.

NOTE 13. COMMITMENTS AND CONTINGENCIES

NATURAL GAS CONTRACTS The company buys natural gas under short-term and long-term contracts. Short-term purchases are from various Southwest U.S. and Canadian suppliers and are primarily based on monthly spot-market prices. SoCalGas and SDG&E transport gas under long-term firm pipeline capacity agreements that provide for annual reservation charges. SoCalGas and SDG&E recover such fixed charges in rates.

SoCalGas has commitments for firm pipeline capacity under contracts with pipeline companies that expire at various dates through 2006. In 1998, SoCalGas restructured its long-term commodity contracts with suppliers of California off-shore and Canadian gas. These contracts expire at the end of 2003. SDG&E has long-term natural gas transportation contracts with various interstate pipelines which expire on various dates between 2007 and 2023.

SDG&E had been involved in negotiations and litigation with four Canadian suppliers concerning contract terms and prices related to long-term natural gas supply contracts. In 1999, SDG&E settled with the last of the four suppliers, terminating the contract. SDG&E continues to purchase natural gas from one of the suppliers under terms of the settlement agreement. SDG&E purchases natural gas on a spot basis to fill its additional long-term pipeline capacity. SDG&E intends to continue using the long-term pipeline capacity in other ways as well, including the transport of replacement natural gas and the release of a portion of this capacity to third parties.

In connection with the new natural gas franchise for Nova Scotia, the company plans to build and operate a natural gas system providing service to 78 percent of the 350,000 households in Nova Scotia. Construction began in October 2000. Total capital expenditures are estimated to be \$700 million to \$800 million over the next seven years. See Note 3 for additional information.

At December 31, 2000, the future minimum payments under natural gas contracts were:

(Dollars in millions)	Storage and Transportation	Natural Gas
2001	\$ 192	\$ 1,376
2002	188	394
2003	191	279
2004	195	—
2005	190	—
Thereafter	249	—
Total minimum payments	\$1,205	\$2,049

Total payments under the contracts were \$1.6 billion in 2000, and \$1.3 billion in 1999 and 1998.

PURCHASED-POWER CONTRACTS SDG&E buys electric power under several long-term contracts. The contracts expire on various dates between 2001 and 2025. Prior to the electric-rate ceiling described in Note 14, the above-market cost of contracts was recovered from virtually all of SDG&E's customers. In general, the market value of these contracts was recovered by bidding them into the California Power Exchange (PX) and receiving revenue from the PX for bids accepted. As of January 1, 2001, SDG&E no longer bid those contracts into the PX in compliance with a FERC order prohibiting sales to the PX. Since then those contracts have been used to serve customers. In late 2000, SDG&E entered into additional contracts to serve customers instead of buying all of its power from the PX. On January 17, 2001, the California Assembly passed a bill (AB 1) to allow the California Department of Water Resources (DWR) to purchase power under long-term contracts for the benefit of California consumers. For additional discussion of this matter see Note 14.

At December 31, 2000, the estimated future minimum payments under the long-term contracts were:

(Dollars in millions)	
2001	\$ 320
2002	223
2003	211
2004	162
2005	164
Thereafter	2,295
Total minimum payments	\$3,375

The payments represent capacity charges and minimum energy purchases. SDG&E is required to pay additional amounts for actual purchases of energy that exceed the minimum energy commitments. Total payments under the contracts were \$257 million in 2000, \$251 million in 1999 and \$293 million in 1998.

LEASES The company has leases (primarily operating) on real and personal property expiring at various dates from 2001 to 2040. Certain leases on office facilities contain escalation clauses requiring annual increases in rent ranging from 2 percent to 6 percent. The rentals payable under these leases are determined on both fixed and percentage bases, and most leases contain extension options which are exercisable by the company. The company also has long-term capital leases for its nuclear fuel and real property. Property, plant and equipment includes \$92 million at December 31, 2000, and \$83 million at December 31, 1999, related to these leases. The associated accumulated amortization is \$55 million and \$39 million, respectively.

At December 31, 2000, the minimum rental commitments payable in future years under all noncancellable leases were:

(Dollars in millions)	Operating	Capitalized
	Leases	Leases
2001	\$ 61	\$26
2002	61	6
2003	77	3
2004	124	3
2005	105	2
Thereafter	285	3
Total future rental commitment	\$713	43
Imputed interest (6% to 15%)		(6)
Net commitment		\$37

During 2000, SER entered into agreements with a lessor to facilitate the development and leasing of several power-generation projects. The lessor has an aggregate financing commitment from investors of \$1.05 billion. SER, as construction agent for the lessor, is responsible for completing construction by specified completion dates. Upon completion of an individual project, SER is required to make lease payments to the lessor in an amount sufficient to provide a return to the investors. In 2005, SER has the option to extend the lease at fair market value, purchase the project at a fixed amount, or act as remarketing agent for the lessor to sell the project. If SER elects the remarketing option, it may be required to pay the lessor up to 85 percent of the project cost if the proceeds from remarketing are deficient to repay the investors.

Rent expense totaled \$102 million in 2000, \$108 million in 1999 and \$105 million in 1998.

In connection with the quasi-reorganization described in Note 2, PE established reserves of \$102 million to fair value operating leases related to its headquarters and other leases at December 31, 1992. The remaining amount of these reserves was \$56 million at December 31, 2000. These leases are included in the above table.

OTHER COMMITMENTS AND CONTINGENCIES At December 31, 2000, the company had commitments of approximately \$450 million for the development of power plant sites and the purchase of the related gas turbines.

At December 31, 2000, commitments for other capital expenditures were approximately \$44 million.

ENVIRONMENTAL ISSUES The company's operations are subject to federal, state and local environmental laws and regulations governing hazardous wastes, air and water quality, land use, solid waste disposal and the protection of wildlife. Significant costs are incurred to operate the facilities in compliance with these laws and regulations and these costs generally have been recovered in customer rates.

In 1994, the CPUC approved the Hazardous Waste Collaborative Memorandum account allowing utilities to recover their hazardous waste costs, including those related to Superfund sites or similar sites requiring cleanup. Recovery of 90 percent of cleanup costs and related third-party litigation costs and 70 percent of the related insurance-litigation expenses is permitted. In addition, the company has the opportunity to retain a percentage of any insurance recoveries to offset the 10 percent of costs not recovered in rates. Environmental liabilities that may arise are recorded when remedial efforts are probable and the costs can be estimated.

The company's capital expenditures to comply with environmental laws and regulations were \$4 million in 2000, \$2 million in 1999 and \$1 million in 1998. The increase in 2000 is due to the installation of emission-control equipment on SDG&E's Rainbow compressor facility and the increase in activity at SEI and SAG. Compliance with these regulations over the next five years is not expected to be significant. The company has been associated with various sites, which may require remediation under federal, state or local environmental laws. The company is unable to determine fully the extent of its responsibility for remediation of these sites until assessments are completed. Furthermore, the number of others that also may be responsible, and their ability to share in the cost of the cleanup, is not known.

The environmental issues currently facing the company or resolved during the latest three-year period include investigation and remediation of the California utilities' manufactured-gas sites (21 completed as of December 31, 2000, and 24 to be completed), asbestos and other cleanup at SDG&E's former fossil-fueled power plants (all sold in 1999 and actual or estimated cleanup costs included in the transactions), cleanup of third-party waste-disposal sites used by the company, which has been identified as a Potentially Responsible Party (investigations and remediations are continuing), and mitigation of damage to the marine environment caused by the cooling-water discharge from the San Onofre Nuclear Generating Station (the requirements for enhanced fish protection, a 150-acre artificial reef and restoration of 150 acres of coastal wetlands are in process).

As discussed in Note 14, restructuring of the California electric utility industry has changed the way utility rates are set and costs are recovered. In 1998, the CPUC modified the Hazardous Waste Collaborative mechanism by providing that electric-generation-related cleanup costs be included in transition-cost recovery. The effect of this decision is that SDG&E's costs of compliance with environmental regulations may not be fully recoverable.

NUCLEAR INSURANCE SDG&E and the co-owners of SONGS have purchased primary insurance of \$200 million, the maximum amount available, for public-liability claims. An additional \$9.3 billion of coverage is provided by secondary financial protection required by the Nuclear Regulatory Commission and provides for loss sharing among utilities owning nuclear reactors if a costly accident occurs. SDG&E could be assessed retrospective premium adjustments of up to \$36 million in the event of a nuclear incident involving any of the licensed, commercial reactors in the United States, if the amount of the loss exceeds \$200 million. In the event the public-liability limit stated above is insufficient, the Price-Anderson Act provides for Congress to enact further revenue-raising measures to pay claims, which could include an additional assessment on all licensed reactor operators.

Insurance coverage is provided for up to \$2.8 billion of property damage and decontamination liability. Coverage is also provided for the cost of replacement power, which includes indemnity payments for up to three years, after a waiting period of 12 weeks. Coverage is provided primarily through mutual insurance companies owned by utilities with nuclear facilities. If losses at any of the nuclear facilities covered by the risk-sharing arrangements were to exceed the accumulated funds available from these insurance programs, SDG&E could be assessed retrospective premium adjustments of up to \$4 million.

DEPARTMENT OF ENERGY DECOMMISSIONING The Energy Policy Act of 1992 established a fund for the decontamination and decommissioning of the Department of Energy (DOE) nuclear fuel enrichment facilities. Utilities which have used DOE enrichment services are being assessed a total of \$2.3 billion, subject to adjustment for inflation, over a 15-year period ending in 2006. Each utility's share is based on its share of enrichment services purchased from the DOE through 1992. SDG&E's annual assessment is approximately \$1 million. This assessment is recovered through SONGS revenue.

DEPARTMENT OF ENERGY NUCLEAR FUEL DISPOSAL The Nuclear Waste Policy Act of 1982 made the DOE responsible for the disposal of spent nuclear fuel. However, it is uncertain when the DOE will begin accepting spent nuclear fuel from SONGS. Continued delays by the DOE can lead to increased cost of disposal, which could be significant. If this occurs and the company is unable to recover the increased costs from the federal government or from its customers, the company's profitability from SONGS would be adversely affected.

LITIGATION A recent lawsuit, which seeks class-action certification, alleges that Sempra Energy, SoCalGas, SDG&E and El Paso Energy Corp. acted to drive up the price of natural gas for Californians by agreeing to stop a pipeline project that would have brought new and cheaper natural gas supplies into California. The company believes the allegations are without merit.

Various recent lawsuits, which seek class-action certification and which are expected to be consolidated, allege that company subsidiaries unlawfully manipulated the electric-energy market. The company believes the allegations are without merit.

Except for the matters referred to above, neither the company nor its subsidiaries are party to, nor is their property the subject of, any material pending legal proceedings other than routine litigation incidental to their businesses. Management believes that these matters will not have a material adverse effect on the company's results of operations, financial condition or liquidity.

ELECTRIC DISTRIBUTION SYSTEM CONVERSION Under a CPUC-mandated program and through franchise agreements with various cities, SDG&E is committed, in varying amounts, to converting overhead distribution facilities to underground. As of December 31, 2000, the aggregate unexpended amount of this commitment was approximately \$100 million. Capital expenditures for underground conversions were \$26 million in 2000, \$20 million in 1999 and \$17 million in 1998.

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

Supply/demand imbalances have caused a significant increase in the price of electricity and, although there is currently a temporary ceiling on the cost of electricity that SDG&E may pass on to its customers, once SDG&E is able to pass on these costs, the company may experience an increase in customer credit risk. Additional information on this issue is discussed in Note 14.

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

NOTE 14. REGULATORY MATTERS

ELECTRIC INDUSTRY RESTRUCTURING In 1996, California enacted legislation (AB 1890) restructuring California's investor-owned electric utility industry. The legislation and related decisions of the CPUC were intended to stimulate competition and reduce electric rates.

As part of the framework for a competitive electric-generation market, the legislation established the PX. The PX served as a wholesale power pool to which the California IOUs were required to sell all of their power supply (including owned generation and purchased-power contracts) and, except to the extent otherwise authorized by the CPUC, from which they were required to buy all of the electricity needed to serve their retail consumers. The PX also purchased power from nonutility generators through an auction process intended to establish competitive market prices for the power that it sells to the IOUs.

The restructuring legislation also established a rate freeze on amounts that the IOUs could charge their customers. The rate freeze was designed to generate revenue levels assumed to be sufficient to provide the IOUs with a reasonable opportunity to recover, by December 31, 2001, their costs of generation and purchased power that are fixed and unavoidable and included in customer rates. Certain costs such as those related to purchased-power contracts (including those with qualifying facilities) may be recovered beyond December 31, 2001. The rate freeze was to end as to each utility when it completed recovery of the costs, but in no event later than March 31, 2002.

In June 1999, SDG&E completed the recovery of its stranded costs, other than the future above-market portion of its purchased-power contracts that were in effect at December 31, 1995, and SONGS costs, both of which will continue to be collected in rates. Recovery of the other costs was effected by, among other things, the sale of SDG&E's fossil power plants and combustion turbines during the quarter ended June 30, 1999. Therefore, SDG&E is no longer subject to the rate freeze imposed by AB 1890.

With the rate freeze no longer applicable, SDG&E lowered its base rates (the portion of its rates not attributable to electric-commodity costs) and began to pass through to its customers, without markup, the cost of electricity purchased from the PX. SDG&E's overall rates were lower than during the rate freeze, but they also became subject to fluctuation with the actual cost of electricity purchases.

A number of factors, including supply/demand imbalances, resulted in abnormally high electric-commodity prices beginning in mid-2000, which caused SDG&E's monthly customer bills to be substantially higher than normal. These conditions and the resultant abnormally high electric-commodity prices continued into 2001. During the second half of 2000, the average electric-commodity cost was 15.51 cents/kWh (compared to 4.15 cents/kWh in the second half of 1999). In December 2000, the average was 17.91 cents/kWh (compared to 3.73 cents/kWh in December 1999).

These higher prices were initially passed through to SDG&E's customers and resulted in customer bills that in most cases were double or triple those from the prior year. This resulted in legislative and regulatory responses.

California Assembly Bill 265 (AB 265), enacted in September 2000, imposes a ceiling of 6.5 cents/kWh on the cost of the electric commodity that SDG&E may pass on to its small-usage customers on a current basis. Customers covered under the commodity rate ceiling generally include residential, small-commercial and lighting customers. This is a "floating cap" that can float downward as prices decrease, but cannot exceed actual commodity costs without the permission of the CPUC. The ceiling, retroactive to June 1, 2000, extends through December 31, 2002, and may be extended through December 31, 2003, if the CPUC determines that it is in the public interest to do so. The legislation also provides for the future recovery of undercollections (the cost of electricity purchased by SDG&E that cannot be passed on to customers on a current basis) resulting from the reasonable and prudent costs of procuring the commodity. In accordance with AB 265, the CPUC is examining the prudence and reasonableness of SDG&E's procurement of wholesale energy on behalf of its customers for the period July 1999 through August 2000. A decision is expected in the third quarter of 2001. Based upon historical experience with the CPUC, SDG&E recorded a \$50 million pretax charge during the third quarter of 2000 related to the recent legislative and regulatory actions associated with power acquisition costs.

SDG&E accumulates the amount that it pays for electricity in excess of the ceiling rate (the undercollected costs) in an interest-bearing balancing account. SDG&E expects to amortize these amounts, together with interest, in rates charged to customers following the end of the ceiling period. Due to their long-term nature, these undercollected costs are classified as a noncurrent regulatory asset on the company's Consolidated Balance Sheets. The undercollection was \$447 million at December 31, 2000 and \$605 million at January 31, 2001. The rate ceiling materially and adversely affects the timing of SDG&E's revenue collections and related cash flows. The rate at which the undercollected costs accumulate will depend

primarily upon the effects of the recently enacted AB 1 discussed under “Purchased Power Contracts” in Note 13 and below under “Recent State of California Actions,” and other legislative and regulatory developments, wholesale prices for electric power and, to a lesser extent, variations in the volume of electricity used by SDG&E’s customers (which is significantly affected by seasonal and other temperature variations) and the availability, price and use of longer-term fixed-price purchase contracts. Because of these and many other factors, the amount of undercollected costs that will accumulate in future periods cannot be estimated with any reasonable certainty. However, as discussed below under “Recent State of California Actions,” AB1 could end material growth in SDG&E’s cost undercollections.

The rate ceiling has materially and adversely affected SDG&E’s revenue collections and its related cash flows and liquidity. SDG&E has fully drawn upon substantially all of its short-term credit facilities. Its ability to access the capital markets and obtain additional financing has been substantially impaired by the financial distress being experienced by other California IOUs as well as by lender uncertainties concerning California utility regulation generally and the rapid growth of utility cost undercollections.

On January 24, 2001, SDG&E filed an application with the CPUC requesting a temporary 2.3 cents/kWh electric-rate surcharge, subject to refund, beginning March 1, 2001. The surcharge is intended to provide SDG&E with continued access to financing on commercially reasonable terms by managing the growth of SDG&E’s undercollected power costs and to provide for the amortization of the undercollections in customer rates. SDG&E’s application also renews a previous request that the CPUC freeze the commodity rate SDG&E can charge its customers at 6.5 cents/kWh instead of using that rate as a ceiling. SDG&E is unable to predict the amount, if any, of the request that the CPUC would grant, or when it would issue a decision. The CPUC has deferred this proceeding pending resolution of the broader issues related to the state-wide high costs.

FERC ACTIONS On November 1, 2000, the FERC reported its findings from its formal investigation of the electric rates and structure of the ISO/PX, as well as of market-based sellers in the California market. The investigation found no specific abuse of market power by individual generators and determined that constraints within the market structure, such as hedging restrictions imposed by the CPUC, and a long-term shortage of power in the state, resulted in the high electric-commodity prices. Federal regulators proposed several remedies to fix California’s flawed market, but stated that past profits from generators and traders could not be ordered refunded to customers. The FERC did state that the high short-term energy rates during the summer of 2000 were “unjust and unreasonable” and left the door open to future customer refunds should specific instances of market abuses be uncovered. The report proposed various remedies and on December 15, 2000, the FERC issued an order adopting these remedies. Among other things, the order allows the California IOUs to buy and sell power outside the PX to afford the IOUs more favorable pricing, to replace the ISO/PX stakeholder governing boards with independent boards, and to require market buyers to schedule 95 percent of their transactions in the day-ahead markets to reduce the over-reliance on the real-time market to meet supply.

The order fails to require sellers to enter into forward contracts at reasonable prices, fails to provide an effective price cap and does not address issues associated with retroactive refund and retroactive remedial authority issues. The IOUs have requested a rehearing, which is pending, of the FERC’s decision based on insufficiency of remedies for the wholesale electric market situation.

In connection with reaction to the FERC order, the PX suspended its trading operations on January 31, 2001.

PX/ISO BILLINGS Although it has experienced substantial undercollections of its costs of purchasing electricity for its customers, SDG&E has nonetheless remained current in paying for its electricity purchases as well as its other payment obligations. However, on February 9, 2001, SDG&E received a “charge-back” billing of \$29 million relating to a default by another California utility in paying for power purchased by the other utility from the Independent System Operator (ISO) that schedules power transactions and access to the transmission system. SDG&E believes the charge-back is improper under applicable tariffs. SDG&E and other recipients of the charge-back billings have obtained an order preventing their collection pending the outcome of litigation contesting the charges.

SDG&E may receive additional charge-back billings in respect to defaults in electricity purchase payments by other California IOUs in paying for electricity purchased from the ISO and the PX. It also expects that it may receive billings for its own purchases of electricity from the PX that do not reflect proper compliance by the PX with wholesale price caps ordered

by the FERC. These billings are expected to cease in March 2001, since SDG&E is no longer selling electricity to the PX. SDG&E will contest all such billings to the extent that it believes they are inconsistent with applicable tariffs and orders.

RECENT STATE OF CALIFORNIA ACTIONS Federal and California officials met with power generators, marketers and utility representatives several times in January 2001 to try to end California's power crisis. The parties conceptually agreed that, among other things, the state of California would buy electricity through long-term contracts at reduced rates, which it would resell to consumers. In order to implement these plans, the California Legislature passed AB 1, signed by the governor on February 1, 2001, to allow the DWR to purchase power via long-term contracts for resale to consumers. The bill authorizes the DWR to enter into long-term contracts of up to 10 years to purchase power and to sell it to consumers at not more than the acquisition costs. This authority ends on December 31, 2002. Repayment will come from utility customers' monthly bills. The bill also authorizes funds from the state's general fund for immediate power purchases and authorizes the DWR to issue up to \$10 billion in revenue bonds to purchase power. Ratepayers will pay off these advances and bonds over time. The law also encourages energy conservation by prohibiting higher rates for customers that do not exceed 130 percent of a baseline allotment for energy consumption and setting penalties for businesses that don't reduce their outside lighting. The first state power auction was held in January 2001. In early February 2001, the DWR announced agreements on contracts totaling about 5,000 megawatts and ranging from three years to 10 years. The state is expected to purchase about one-third of the electricity used by the IOUs' customers. Also in early February 2001, the CPUC approved emergency regulations for delivery and payment mechanisms for the sale of electricity procured by the DWR. In an interim agreement between the DWR and SDG&E, effective February 7, 2001, the DWR is purchasing the entire portion of the power used by SDG&E customers that is not provided by SONGS or SDG&E's existing contracts.

SDG&E believes that the DWR's purchase of all of SDG&E's power needs would end material growth in SDG&E's cost undercollections. To the extent that the DWR does not purchase all of SDG&E's power needs, SDG&E may be required to begin again making purchases and to purchase any shortfall at market prices for resale to its customers at SDG&E's ceiling rate (which remains unchanged by the legislation) with any related undercollection continuing to increase SDG&E's total undercollected costs.

The California Legislature continues to remain in emergency session to address the California energy crisis. Various legislative and other proposals that would significantly affect the structure of California's electric industry, the rates that SDG&E and other IOUs may charge their customers and the ability of the utilities to purchase electricity for their customers, and to finance and recover undercollected costs have been advanced. Among these proposals is that of the Governor that would, among other things, have the state of California purchase the IOUs' transmission systems for amounts at least equal to their net book value to provide the IOUs with funds to mitigate the situation. SDG&E has been having discussions with representatives of the governor concerning the possibility of such a transaction and what its terms might be. There is no assurance that these discussions will result in a sale of the transmission assets. SDG&E would consider entering into such a transaction only if the sales price and conditions of the sale and of future operating arrangements are reasonable.

CREDIT RATINGS Although the credit ratings of the company and SDG&E have not changed, California regulatory uncertainties have led the major credit-rating agencies to change their rating outlooks on most of the company's and SDG&E's securities to negative.

SDG&E LIQUIDITY AND CAPITAL RESOURCES The rate ceiling has materially and adversely affected SDG&E's revenue collections and its related cash flows and liquidity. SDG&E has fully drawn upon substantially all of its short-term credit facilities. Its ability to access the capital markets and obtain additional financing has been substantially impaired by the financial distress being experienced by other California IOUs as well as by lender uncertainties concerning California utility regulation generally and the rapid growth of utility cost undercollections.

Continued purchases by the DWR for resale to SDG&E's customers of substantially all of the electricity that would otherwise be purchased by SDG&E or dramatic decreases in wholesale electricity prices, favorable action by the CPUC on SDG&E's electric-rate-surcharge application and SDG&E's access to the capital markets are required to manage and finance SDG&E's cost undercollections and provide adequate liquidity.

EFFECT ON OTHER SUBSIDIARIES Other company subsidiaries have significant receivables from the other IOUs and from the PX/ISO. The collection of these receivables could be dependent on satisfactory resolution of the financial diffi-

culties being experienced by those IOUs as a result of the California electric-industry problem discussed above. In addition, the company's ability to fund its subsidiaries' capital expenditure program and liquidity requirements are significantly affected by the company's credit ratings and related ability to obtain financing on commercially reasonable terms. Also see "Natural Gas" below.

NATURAL GAS Supply/demand imbalances are affecting the price of natural gas in California more than in the rest of the country because of California's dependence on natural gas fired electric generation due to air-quality considerations. The average price of natural gas at the California/Arizona (CA/AZ) border was \$6.25/mmbtu in 2000, compared with \$2.33/mmbtu in 1999. On December 11, 2000, the average spot cash gas price at the CA/AZ border reached a record high of \$56.91/mmbtu. Underlying the high natural gas prices are several factors, including the increase in natural gas throughput for electric generation (a 40-percent increase in Southern California compared to 1999), colder winter weather and reduced natural gas supply resulting from historically low storage levels, lower natural gas production and a major pipeline rupture. In December 2000, SDG&E and SoCalGas filed separately with the FERC for a reinstitution of price caps on short-term interstate capacity to the CA/AZ border and between the interstate pipelines and California's local distribution companies, effective until March 31, 2001. The California utilities requested that, if the price of natural gas sold into California exceeds 150 percent of the national average, the price should be capped at that level, plus FERC-imposed transportation costs. The FERC responded by issuing extensive data requests, but has not otherwise acted on the requests.

On January 18, 2001, Pacific Gas and Electric Company (PG&E) filed an emergency application with the CPUC requesting that SoCalGas be ordered to purchase natural gas or supply available natural gas to meet PG&E's core procurement needs. Some of PG&E's suppliers are declining to sell natural gas to PG&E due to its poor credit rating. Although SoCalGas has agreed to supply a limited amount of natural gas to PG&E through March 31, 2001 (secured by PG&E customer receivables), it is still urging rejection of the request which, if approved, could severely jeopardize SoCalGas' ability to serve its own customers because of cash flow considerations.

RESTRUCTURING OF ELECTRIC DISTRIBUTION Thus far, the CPUC's electric industry restructuring has been confined to generation. Transmission and distribution have remained subject to traditional cost-of-service regulation. However, the CPUC is exploring the possibility of opening up electric distribution to competition. A CPUC staff report on this issue was submitted to the CPUC in July 2000, with dissenting opinions recommending against changing electric distribution regulation at this time due to the current state of electric industry restructuring. A proposed decision is expected in mid-2001.

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

In July 1999, after hearings, the CPUC issued a decision stating which natural gas regulatory changes it found most promising, encouraging parties to submit settlements addressing those changes, and providing for further hearings if necessary.

In October 1999, the state of California enacted a law (AB 1421) which requires that natural gas utilities provide "bundled basic gas service" (including transmission, storage, distribution, purchasing, revenue-cycle services and after-meter services) to all core customers, unless the customer chooses to purchase natural gas from a nonutility provider. The law prohibits the CPUC from unbundling most distribution-related natural gas services (including meter reading) and after-meter services (including leak investigation, inspecting customer piping and appliances, pilot relighting and carbon monoxide investigation) for core customers. The objective is to preserve both customer safety and customer choice.

Between late 1999 and April 2000, several conflicting settlement proposals were filed by various groups of parties that addressed the changes the CPUC found promising in July 1999. The principal issues in dispute included: whether firm, tradable rights to capacity on SoCalGas' major gas transmission lines should be created, with SoCalGas at risk for market demand for the recovery of the cost of these facilities; the extent to which SoCalGas' storage services should be further unbundled and SoCalGas be put at greater risk for recovery of storage costs; the manner in which interstate pipeline capacity held by SoCalGas to serve core markets should be allocated to core customers who purchase gas from energy

service providers other than SoCalGas; and the recovery of the utilities' costs to implement whatever regulatory changes are adopted. Additional proposals included improving the access of energy service providers to sell natural gas supply to core customers of SoCalGas and SDG&E.

Certain parties contend that the restructuring process is an appropriate venue for addressing whether SoCalGas should refund retroactively to September 1999 the cost in rates of ownership and operation of one of SoCalGas' storage fields. SoCalGas actively opposes this proposal and the propriety of this venue for its resolution. In November 2000, these parties entered into a settlement with SoCalGas in a related CPUC proceeding that provides for no retroactive refund of the cost in rates of this field. This settlement is pending CPUC approval.

Hearings in the restructuring case were held in mid-2000 and a Proposed Decision (PD) was released in November 2000. A CPUC decision is expected in 2001. The PD does not recommend adoption of shareholder absorption of stranded interstate pipeline costs or retroactive refund of any amount related to the storage field. The PD recommends some, but not all, of the changes proposed by the California utilities. If adopted, the PD is not expected to have a negative earnings impact on the California utilities.

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

The utilities' PBR mechanisms are in effect through December 31, 2002, at which time the mechanisms will be updated. That update will include, among other things, a reexamination of the companies' reasonable costs of operation in 2003 to be allowed in rates. Key elements of the current mechanisms include an annual indexing mechanism that adjusts rates by the inflation rate less a productivity factor and other adjustments to accommodate major unanticipated events, a sharing mechanism with customers that applies to earnings that exceed the authorized rate of return on rate base, rate refunds to customers if service quality deteriorates or awards if service quality exceeds set standards, and a change in authorized rate of return and customer rates if interest rates change by more than a specified amount. The SoCalGas rate change is triggered if the 12-month trailing average of actual market interest rates increases or decreases by more than 150 basis points and is forecasted to continue to vary by at least 150 basis points for the next year. The SDG&E rate change is triggered by a six-month trailing average and a 100-basis-point change in interest rates. If this occurs, there would be an automatic adjustment of rates for the change in the cost of capital according to a formula which applies a percentage of the change to various capital components.

COMPREHENSIVE SETTLEMENT OF NATURAL GAS REGULATORY ISSUES In July 1994, the CPUC approved a comprehensive settlement for SoCalGas (Comprehensive Settlement) of a number of regulatory issues, including rate recovery of a significant portion of the restructuring costs associated with certain long-term gas-supply contracts. In addition to the supply issues, the Comprehensive Settlement addressed the following other regulatory issues:

****Noncore revenues were governed by the Comprehensive Settlement through July 31, 1999. This treatment was replaced by the 1999 Biennial Cost Allocation Proceeding (BCAP), which went into effect on June 1, 2000. The CPUC's decision on the 1999 BCAP allows balancing account treatment for 75 percent of noncore revenues.**

****The Gas Cost Incentive Mechanism (GCIM) for evaluating SoCalGas' natural gas purchases substantially replaced the previous process of reasonableness reviews. GCIM compares SoCalGas' cost of natural gas with a benchmark level, which is the average price of 30-day firm spot supplies in the basins in which SoCalGas purchases natural gas. The mechanism permits full recovery of all costs within a tolerance band above the benchmark price and refunds all savings within a tolerance band below the benchmark price. The costs or savings outside the tolerance band are shared equally between customers and shareholders. The CPUC approved the use of natural gas futures for managing risk associated with the GCIM. SoCalGas enters into natural gas futures contracts in the open market on a limited basis to mitigate risk and better manage natural gas costs.**

In 1998 the CPUC approved GCIM-related shareholder awards to SoCalGas totaling \$13 million. On June 8, 2000, the CPUC approved an \$8 million award for the year ended March 31, 1999, and deferred its decision regarding extending the GCIM beyond March 31, 2000 until an evaluation is performed by its staff. On January 4, 2001, the CPUC's Energy Division issued its evaluation report recommending the continuation of the GCIM with modifications. A CPUC decision is expected by September 2001.

In June 2000, SoCalGas filed its annual GCIM application with the CPUC, requesting an award of \$10 million for the year ended March 31, 2000. On October 30, 2000, the CPUC's Office of Ratepayer Advocates recommended approval of the award and the extension of the GCIM beyond March 31, 2000, with certain modifications to the tolerance band and benchmark price. A CPUC decision is expected by September 2001.

BIENNIAL COST ALLOCATION PROCEEDING On November 4, 1999, the CPUC revised its previous decision on SoCalGas' 1996 BCAP, shifting \$88 million of pipeline surcharges from the pipeline capacity relinquishments to noncore customers. The noncore customer rate impact of the decision is mitigated by overcollections in the regulatory accounts and is reflected in the rates adopted in the final 1999 BCAP decision.

On April 20, 2000, the CPUC issued a decision on the 1999 BCAP, adopting overall decreases in natural gas revenues of \$210 million for SoCalGas and \$37 million for SDG&E for transportation rates effective June 1, 2000. For SoCalGas, there is a return to 75/25 (customer/shareholder) balancing account treatment for noncore transportation revenues, excluding certain transactions. In addition, unbundled noncore storage revenues are balanced 50/50 between customers and shareholders. Since the decreases reflect anticipated changes in corresponding costs, they have no effect on net income.

COST OF CAPITAL For 2001, SoCalGas is authorized to earn a rate of return on common equity (ROE) of 11.6 percent and a 9.49 percent return on rate base (ROR), the same as in 2000 and 1999, unless interest-rate changes are large enough to trigger an automatic adjustment as discussed above under "Performance-Based Regulation." For SDG&E, electric industry restructuring has changed the method of calculating the utility's annual cost of capital. In June 1999, the CPUC adopted a 10.6 percent ROE and an 8.75 percent ROR for SDG&E's electric distribution and natural gas businesses. These rates remain in effect for 2000 and 2001. The electric-transmission cost of capital is determined under a separate FERC proceeding. SDG&E is required by its last cost of capital proceeding to file an application on or before May 8, 2001, proposing revisions to its authorized ROE, ROR and capital structure, to be in effect for 2002. The application will, among other things, consider the recent and ongoing financial impacts on SDG&E of electric industry restructuring.

INTEGRATION OF CORE GAS PURCHASE FUNCTIONS On January 11, 2001, SoCalGas and SDG&E filed an application with the CPUC to integrate their natural gas purchasing departments. The filing calls for a single natural gas acquisition group to purchase natural gas for the two utilities' core gas customers by using their pooled gas portfolio assets. These assets include storage, interstate capacity and natural gas supply contracts. The two utilities would charge their core customers the same natural gas commodity rate from the diversified portfolio. The change would bring increased efficiency to the utilities' core gas purchase functions. The filing requests that this change be effective November 1, 2001. A CPUC decision is not expected until October 2001.

NOTE 15. SEGMENT INFORMATION

The company, primarily an energy services company, has three separately managed reportable segments comprised of SoCalGas, SDG&E and SET. The two utilities operate in essentially separate service territories under separate regulatory frameworks and rate structures set by the CPUC. SDG&E provides electric and natural gas service to San Diego and southern Orange counties. SoCalGas is a natural gas distribution utility, serving customers throughout most of Southern

California and part of central California. SET is based in Stamford, Connecticut, and is engaged in wholesale trading and marketing of natural gas, power and petroleum in the United States, Canada, Europe and Asia. The accounting policies of the segments are the same as those described in Note 2, and segment performance is evaluated by management based on reported net income. Intersegment transactions generally are recorded the same as sales or transactions with third parties. Utility transactions are primarily based on rates set by the CPUC and FERC.

For the years ended December 31 (Dollars in millions)	2000	1999	1998
OPERATING REVENUES			
Southern California Gas	\$2,854	\$2,569	\$2,427
San Diego Gas & Electric	2,671	2,207	2,249
Sempra Energy Trading	795	450	110
Intersegment revenues	(65)	(72)	(59)
All other	782	206	254
Total	\$7,037	\$5,360	\$4,981
INTEREST REVENUE			
Southern California Gas	\$ 27	\$ 16	\$ 4
San Diego Gas & Electric	51	40	31
Sempra Energy Trading	8	3	3
All other interest	(18)	(26)	2
Total interest	68	33	40
Sundry income (loss)	38	17	(25)
Total other income	\$ 106	\$ 50	\$ 15
DEPRECIATION AND AMORTIZATION			
Southern California Gas	\$ 263	\$ 260	\$ 254
San Diego Gas & Electric (See Note 14)	210	561	603
Sempra Energy Trading	32	29	25
All other	58	29	47
Total	\$ 563	\$ 879	\$ 929
INTEREST EXPENSE			
Southern California Gas	\$ 74	\$ 60	\$ 80
San Diego Gas & Electric	118	120	106
Sempra Energy Trading	18	15	5
All other	76	34	6
Total	\$ 286	\$ 229	\$ 197
INCOME TAX EXPENSE (BENEFIT)			
Southern California Gas	\$ 183	\$ 182	\$ 128
San Diego Gas & Electric	144	126	142
Sempra Energy Trading	63	(7)	(9)
All other	(120)	(122)	(123)
Total	\$ 270	\$ 179	\$ 138
NET INCOME			
Southern California Gas	\$ 206	\$ 200	\$ 158
San Diego Gas & Electric	145	193	185
Sempra Energy Trading	155	19	(13)
All other	(77)	(18)	(36)
Total	\$ 429	\$ 394	\$ 294

At December 31, or for the years then ended (Dollars in millions)

	2000	1999	1998
ASSETS			
Southern California Gas	\$ 4,116	\$3,452	\$ 3,834
San Diego Gas & Electric	4,734	4,366	4,257
Sempra Energy Trading	4,689	1,981	1,400
All other	2,073	1,325	965
Total	\$15,612	\$ 11,124	\$10,456
CAPITAL EXPENDITURES			
Southern California Gas	\$ 198	\$ 146	\$ 128
San Diego Gas & Electric	324	245	227
Sempra Energy Trading	22	26	-
All other	215	172	83
Total	\$ 759	\$ 589	\$ 438
GEOGRAPHIC INFORMATION			
Long-lived assets:			
United States	\$6,080	\$5,857	\$ 5,849
Latin America	911	701	140
Canada	23	-	-
Total	\$ 7,014	\$6,558	\$ 5,989
OPERATING REVENUES			
United States	\$ 6,700	\$5,280	\$ 4,974
Latin America	154	16	7
Europe	158	62	-
Canada	14	2	-
Asia	11	-	-
Total	\$ 7,037	\$5,360	\$ 4,981

QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarter ended (Dollars in millions except per-share amounts)	March 31	June 30	September 30	December 31
2000				
Revenues and other income	\$ 1,460	\$ 1,530	\$ 1,832	\$ 2,321
Operating expenses	1,206	1,295	1,605	2,053
Income before interest and income taxes	\$ 254	\$ 235	\$ 227	\$ 268
Net income	\$ 113	\$ 110	\$ 110	\$ 95
Average common shares outstanding (diluted)	228.4	201.5	201.5	202.7
Net income per common share (diluted)	\$ 0.49	\$ 0.55	\$ 0.55	\$ 0.47
1999				
Revenues and other income	\$ 1,186	\$ 1,512	\$ 1,246	\$ 1,466
Operating expenses	966	1,375	998	1,269
Income before interest and income taxes	\$ 220	\$ 137	\$ 248	\$ 197
Net income	\$ 99	\$ 82	\$ 108	\$ 105
Average common shares outstanding (diluted)	237.4	237.5	237.8	237.6
Net income per common share (diluted)	\$ 0.42	\$ 0.35	\$ 0.45	\$ 0.44

The sum of the quarterly amounts does not necessarily equal the annual total due to rounding. Reclassifications have been made to certain of the amounts since they were presented in the Quarterly Reports on Form 10-Q.

QUARTERLY COMMON STOCK DATA (UNAUDITED)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2000				
Market price				
High	\$ 19 ¹ / ₄	\$ 19 ¹ / ₄	\$21	\$24 ⁷ / ₈
Low	16 ¹ / ₄	16 ³ / ₁₆	17	19 ³ / ₈
Dividends				
Declared	\$0.25	\$ 0.25	\$ 0.25	\$0.25
1999				
Market price				
High	\$26	\$24 ⁷ / ₈	\$23 ³ / ₁₆	\$ 21 ³ / ₄
Low	19 ¹ / ₈	18 ¹ / ₂	20	17 ¹ / ₈
Dividends				
Declared	\$0.39	\$ 0.39	\$ 0.39	\$0.39

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