PACIFIC GAS AND ELECTRIC COMPANY

PG&E's service to customers took on a new look in 1987 with the introduction of a new corporate visual identity: more progressive and innovative, yet warm and caring. And still "at your service" around the clock.

1987 ANNUAL REPORT

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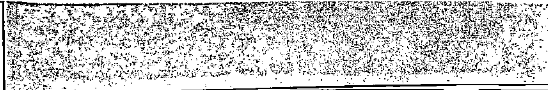
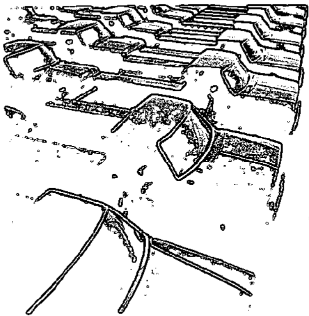


HIGHLIGHTS

	1987	1986	% Change
Operating Revenues	$ 7,185,701,000	$ 7,816,661,000	(8)
Operating Income	$ 1,261,701,000	$ 1,653,625,000	(24)
Net Income	$ 688,517,000	$ 1,081,223,000	(36)
Earnings Available for Common Stock	$ 577,735,000	$ 925,033,000	(38)
Earnings Per Common Share	$1.53	$2.60	(41)
Dividends Declared Per Common Share	$1.92	$1.90	1
Total Assets at Year-end	$21,733,652,000	$21,002,253,000	3
Funds Used for Construction	$ 1,328,775,000	$ 1,833,720,000	(28)
Sales of Electricity to Customers (KWH)	66,558,190,000	61,837,484,000	8
Sales of Gas to Customers (MCF)	424,722,000	405,893,000	5
Total Customers	7,197,000	7,013,000	3
Number of Shareholders	393,274	404,843	(3)
Number of Common Shares Outstanding	388,308,547	368,127,176	5
Number of Employees	27,300	29,200	(7)

In 1987, Operating Revenues were reduced by $717,100,000, Operating Income was reduced by $438,200,000 and Net Income and Earnings Available for Common Stock both were reduced by $485,900,000 ($1.29 per share) due to the change in recording revenues related to Diablo Canyon Nuclear Power Plant, and Net Income and Earnings Available for Common Stock were increased by $91,323,000 ($.24 per share) due to the change in method of accounting for unbilled revenues as discussed in Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations and in Notes to Consolidated Financial Statements.

PG&E today is one of the nation's largest investor-owned combined electric and gas utilities. Nearly 4.0 million electric customers and 3.2 million gas customers over 94,000 square miles of California rely on PG&E for warmth, light, and power. Now, markets outside the service territory are coming to value this reliable service. Symbol of that service is PG&E's new visual identity, which ensures that everything our customers see, from service trucks to stationery, reflects a dynamic, energetic, growing company.



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Cover: The Koll Company of Brisbane, California.

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LETTER TO SHAREHOLDERS

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JUL 26 1988
PACIFIC GAS & ELECTRIC CO.

PG&E is taking charge of its future - rapidly adapting to a more competitive marketplace. As we reduce costs and improve productivity, we're actively seeking new markets and increased revenues.

Success is the product of vision and action. The vision to see the forces at work around us and how they will shape the future, and action to provide value for our shareholders and customers now and in the years ahead.

PG&E is taking charge of its future. We recognize and understand the forces that are now reshaping the utility industry: new technologies, changing regulation and increased competition.

New Initiatives

We're pursuing a strategy that enables us to manage these changes, rather than allowing them to manage us. We are rapidly adapting to a more competitive marketplace. As we reduce costs and improve productivity, we're actively seeking new markets and increased revenues.

Our strategy calls for aggressive new marketing initiatives.

In December, PG&E announced plans to form a joint venture with Bechtel Power Corporation to develop non-utility electric generation projects nationwide. We'll be working with power purchasers, developers, and others to build, own and operate power plants in parts of the country where new energy supplies are needed.

Both PG&E and Bechtel have substantial experience in developing a wide range of power projects. We believe this experience, Bechtel's national marketing capability and PG&E's access to capital will make our joint venture a strong competitor in this new market.

PG&E is also determined to use its assets to build its financial strength and market position. The actions we're taking in our gas business make that clear.

A significant international event recently boosted the value of one of PG&E's prime assets–its extensive pipeline system linking gas-rich fields in Canada to gas-hungry customers in California. The new free trade agreement signed early this year by President Reagan and Prime Minister Mulroney will help assure the continued availability and competitiveness of Canadian gas. It builds on the pricing flexibility already provided by existing contracts negotiated by PG&E. And that will enhance our already strong gas supply position.

That's why we're seeking new markets in Southern California and evaluating the major expansion of our pipeline system needed to serve these markets.

In addition, our NGC Energy Company subsidiary is increasing its purchases of low-cost, high-value natural gas reserves within the 11 Western states. These reserves are in proven fields with ready access to major markets and should lead to increased revenues and earnings for PG&E in future years.

Expanding Markets

To build our business, we're also seeking opportunities to expand our markets. Last fall, we proposed to consolidate the electric operations of the Sacramento Municipal Utility District (SMUD) under PG&E's ownership and management.

Our proposal to the SMUD Board of Directors stressed the need for immediate joint efforts to negotiate the terms and conditions of consolidation. However, the SMUD Board decided not to enter into serious negotiation, and the company withdrew its proposal.

At the same time, PG&E has offered to serve as SMUD's primary wholesale power supplier. We have entered into a memorandum of understanding with SMUD that provides the basis for a 10-year power supply agreement between our two utilities. Under such an agreement, PG&E would supply SMUD with from 400,000 to 1,000,000 kilowatts of wholesale power annually to meet Sacramento's growing energy needs.

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PG&E is increasing its sales by attracting major new businesses to its service area. But as we expand, we remain committed to providing our residential and small commercial customers with high quality, affordable energy services.

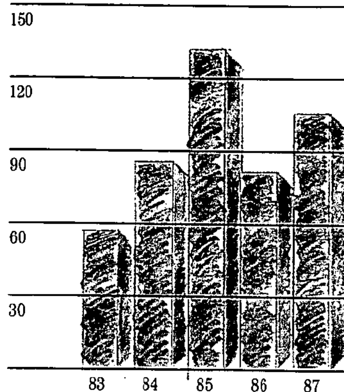
LETTER TO SHAREHOLDERS

And we are promoting expanded sales throughout our service area with a new-business development team. In 1987, this team helped convince major businesses to locate in our service territory–boosting the area's economic growth and increasing PG&E's sales. We're working to attract even more large firms to northern and central California this year.

But winning new markets and new customers isn't the only way to succeed–it's also essential to retain the valuable customers we already have.

In 1986, we estimated that a major portion of our commercial and industrial revenues could be vulnerable to our competitors. That was a powerful challenge and PG&E responded to it vigorously. We strengthened our marketing force, cut our costs and worked hard to retain or win back major customers by offering competitive rates and quality service.

That's crucial because markets are won by those who provide the best value–that combination of price and service quality desired by each customer. We understand this fundamental reality, and remain committed to controlling costs as we continue to improve the variety and quality of our customer service.



Controlling Costs

In 1987, PG&E built on its 1986 successes in controlling costs:

- We held our 1987 operating budget to 1986 levels, and we plan to do essentially the same with the 1988 operating budget.
- We reduced capital spending by roughly 28 percent.
- We reduced our workforce by roughly 2,000 positions, primarily through a voluntary early retirement program and normal attrition.
- We reduced our cost of capital by refinancing $457 million of high cost debt and preferred stock.

These cost-cutting measures, coupled with stable or declining oil and gas prices, have helped PG&E price its products to meet its competitors. Last year, we cut our industrial electric rates following similar reductions in 1986, and we held our industrial gas rates stable after reducing them by 24 percent in the previous year.

We're capitalizing on this progress by adopting a new internal organization that will help PG&E focus directly on its markets. The company has been reorganized into five market-responsive business units that began operating on January 1, 1988: Electric Supply, Gas Supply, Distribution, Engineering and Construction Services, and Non-Utility Business.

This business unit structure will make it easier for managers to identify costs, know their customers, understand the competition and respond to rapid technological and regulatory change.

But as PG&E expands into new markets and reorganizes, it remains focused on its core market, on small commercial and residential customers. We're committed to providing them with value–with high quality service and a reliable, affordable supply of energy.

Taken together, the interwoven initiatives we've launched are paying off. Cost-cutting and reorganization are honing the company's competitive

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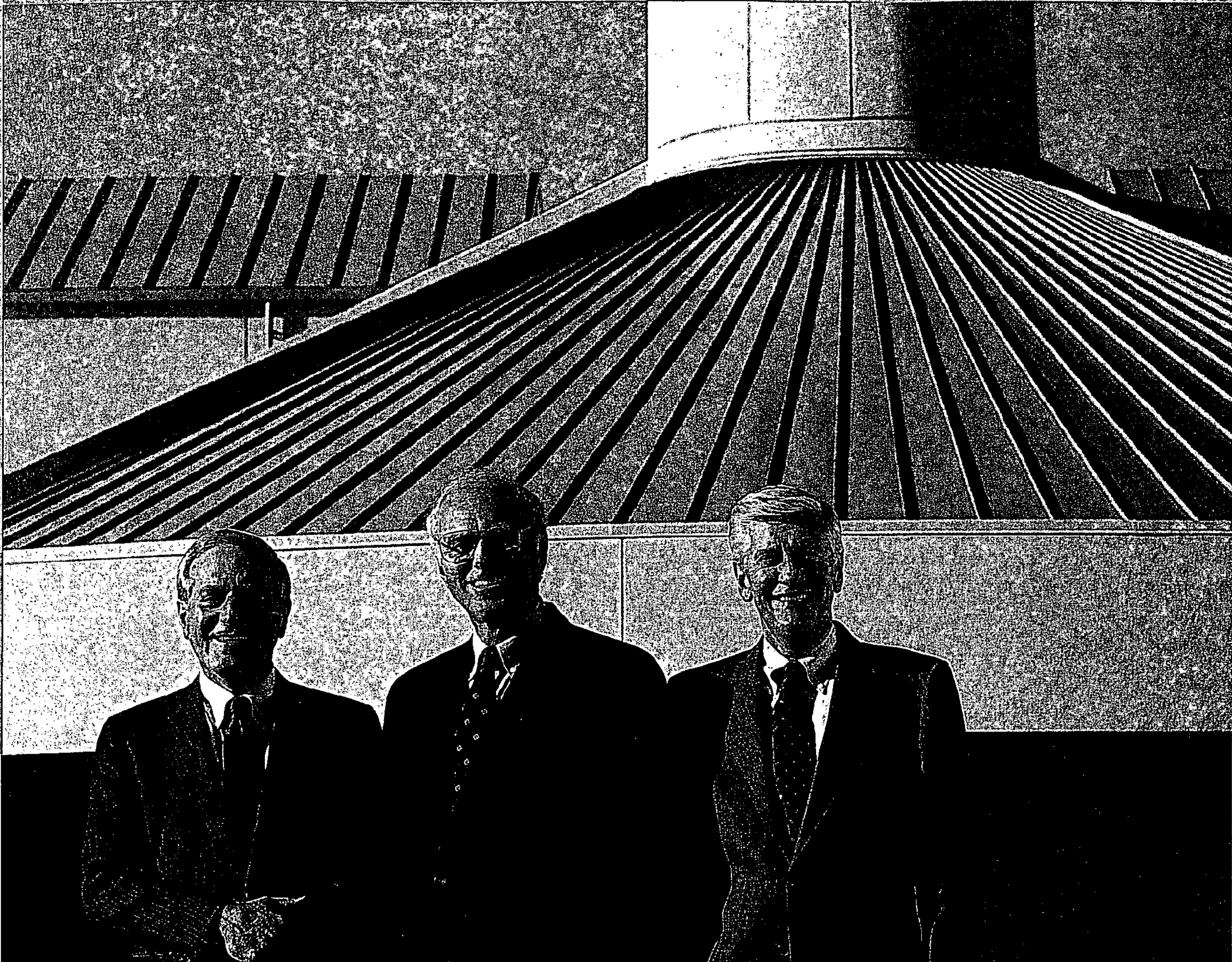

A clear vision of corporate direction will enable PG&E to succeed in a rapidly changing business environment. Shown at PG&E's new Learning Center in San Ramon, President George A. Maneatis (left), Chairman and Chief Executive Officer Richard A. Clarke and Vice Chairman and Chief Financial Officer Stanley T. Skinner share that vision.

Our initiatives are paying off - producing a leaner, more efficient and more flexible PG&E. We remain committed to increasing the company's financial strength and its value to shareholders.

LETTER TO SHAREHOLDERS

edge - producing a leaner, more efficient and more flexible PG&E.

Our sales figures for last year showed that. Total electric sales for 1987 were 7.6 percent higher than they were in 1986 and total gas deliveries (sales plus transport) were up 31 percent. And we've already reduced by more than 50 percent the major portion of our revenues we once estimated could be at risk by 1990.

We're well on the way to becoming a utility of the 1990s - entrepreneurial, forward-looking and able to react quickly to changing circumstances. To become that utility, we are managing an immediate and continuing challenge - the Diablo Canyon rate case.

Both units of the Diablo Canyon Nuclear Power Plant ran superbly in 1987, producing needed electricity for the people of northern and central California. But the interim rates we're now collecting represent only about half the total costs of owning and operating the plant.

That's why we are working to bring the Diablo rate case to a fair and timely conclusion. We've made progress in the past year.

Evidence from a wide range of experts demonstrates clearly that the decisions PG&E made in building the Diablo Canyon plant were prudent. Their testimony has already shown glaring weaknesses in the disallowance recommendation made by the California Public Utilities Commission's Division of Ratepayer Advocates. We believe that we have presented a strong case for recovering our investment in Diablo Canyon.

However, faced with persistent delays in recovering Diablo Canyon's costs, we are attempting to negotiate a final settlement of the case with the Attorney General of the State of California and the CPUC Division of Ratepayer Advocates.

Earnings

In addition, we have adopted a conservative accounting approach which better positions the company for the ultimate rate case decision. We changed the way we record revenues for the plant so that effective January 1, 1987, essentially only cash revenues for the plant are now included in the company's income. This change reduced PG&E's reported earnings for the year but it did not affect our cash position.

Our reported earnings for 1987 were down substantially from the previous year; $1.53 per share for 1987, compared to $2.60 in 1986. But our cash flow remained adequate to cover the current annual dividend at $1.92 per share.

PG&E is on course to increase its financial strength and to succeed in today's highly competitive energy markets. PG&E is reshaping itself for the future. But our strategy is firmly anchored in the company's traditional values - competitive returns for our shareholders, high quality service for all our customers, commitment to the well-being of the communities in which we do business, and a well-trained, highly motivated and fairly treated employee team.

PG&E remains a strong, vigorous company serving a dynamic economy, and I am confident that we have the dedicated workforce, resources and strategy we need to manage change and to prosper in the decade ahead.

Richard A. Clarke
Chairman of the Board
and Chief Executive Officer

February 5, 1988

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ADAPTING TO A CHANGING WORLD

PG&E faces growing competition in its commercial and industrial electric markets. We're working to meet our competitors with aggressive marketing and competitively priced, high quality service.

It used to seem so simple. PG&E generated its own electric power, bought natural gas and sent both on down the line to its customers – to customers without real alternatives. Strict regulation acted as a partial substitute for the lack of marketplace competition. But all that is changing.

Today, PG&E faces growing competition in its commercial and industrial markets. Technological advances and changing regulations have made it economic for large customers to generate their own power. Major gas users can buy gas directly from producers and call on utilities like PG&E to deliver it. All these changes are being driven by American industry's increasing need to cut manufacturing costs to compete both overseas and here at home.

Electric Competition

Cogeneration remains the major practical alternative to PG&E-supplied electricity. Many of our industrial and commercial customers can build cogeneration plants which produce electricity and use the waste heat to produce steam. In addition to the loss of these customers, PG&E is forced by current regulation to buy their excess power – whether or not it is needed. Through 1987, in PG&E's service territory, 112 operational cogeneration projects displaced 617,000 kilowatts of PG&E electric load. We expect this competitive challenge to intensify, and we are working to meet it through a combination of aggressive marketing and competitively priced, high quality service.

We also face increasing competition for the expanding wholesale power market. PG&E is responding vigorously to this competition, selling bulk power to several cities in Southern California.

Gas Business Competition

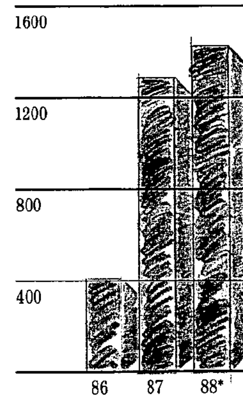
This competition for commercial and industrial electric markets is mirrored in PG&E's gas business.

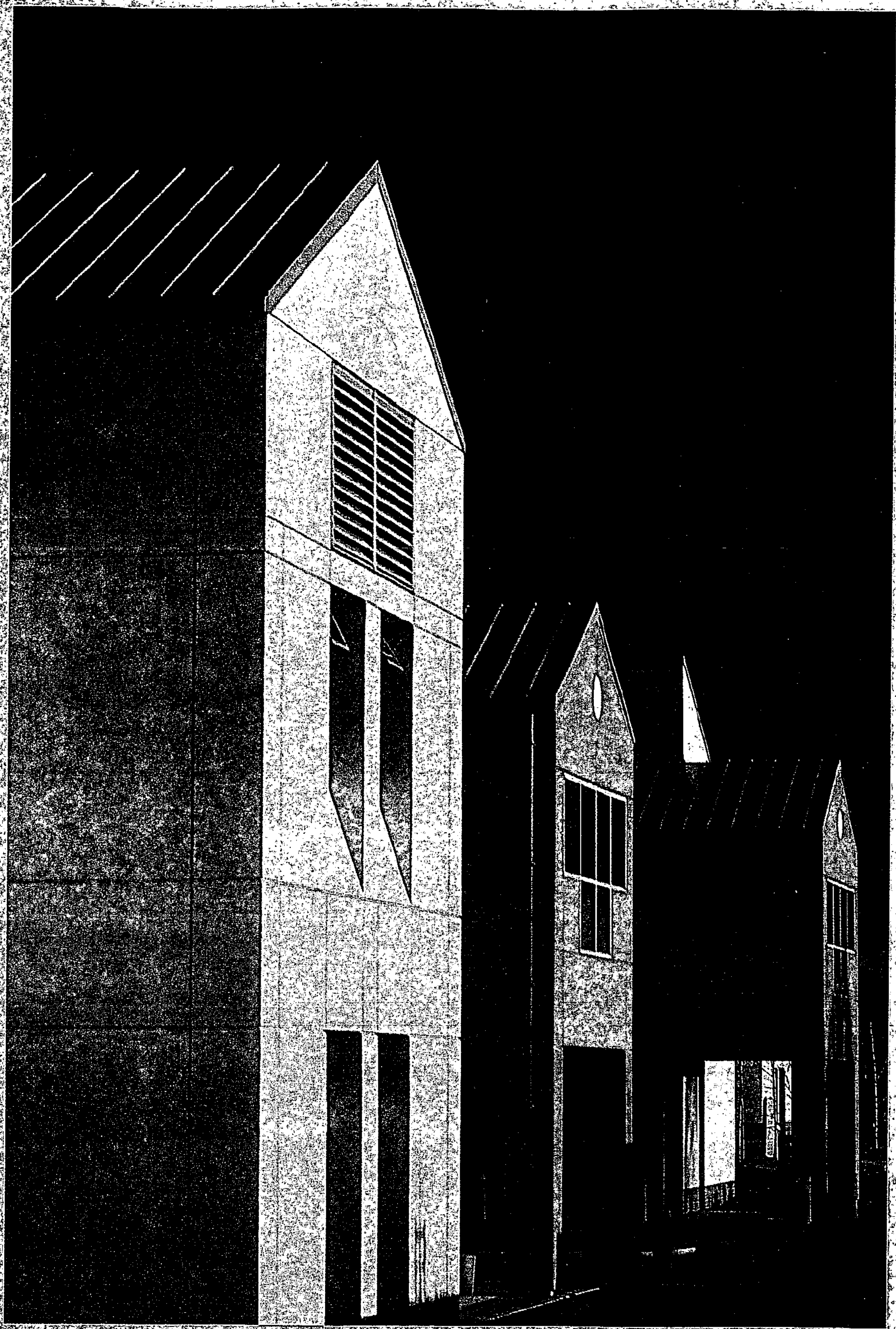
Not long ago, the company's gas supply managers faced a comparatively straightforward task: they bought gas from suppliers, moved the gas through our pipeline system, and then resold it to our customers.

The gas supply business today is dramatically different and infinitely more complex. Partial price deregulation in 1985 spurred production, producing a huge gas supply "bubble." At the same time, the Federal Energy Regulatory Commission moved to open interstate pipelines to private, retail gas buyers, and the California Public Utilities Commission took similar steps within the state. Many commercial and industrial customers now buy this low-priced gas directly – relying on PG&E only for transportation. They have more freedom to wheel and deal, and we must wheel and deal with them.

The company also faces rigorous competition from other pipelines. Several firms have proposed building a new interstate pipeline to serve the lucrative enhanced oil recovery (EOR) market in Kern County – a market now served by PG&E and Southern California Gas Company. We expect this market to be one of the largest in the nation. In 1987, PG&E transported up to 150 million cubic feet of gas per day for EOR use by Southern California Gas Company's customers – and sold another 90 million cubic feet a day for EOR use by its own customers.

PG&E's gas business must also compete with alternate fuels. Most





The new PG&E Learning Center at San Ramon began operations in 1987. It provides both technical training and management development for company employees. Courses at the Learning Center improve employees' skills, sharpen management practices and sensitize everyone to the needs of the marketplace.

The company's reorganization into five business units and a Corporate Center will help managers monitor their customers and costs better. The new organization strengthens our ability to find new revenue opportunities.

of our major industrial gas customers can burn oil, petroleum coke, coal or other fuels. As a result, customers routinely weigh our natural gas prices and transport fees against the prices for these alternatives–and if they're not competitive, we lose the business.

What's the bottom line for PG&E in the midst of all this increased competition? In 1986, we estimated that a major portion of our commercial and industrial revenues could be at risk by 1990–if we failed to take effective action to meet our competitors.

Managing Change

But PG&E is not sitting idly by. The company is aggressively pursuing a market-driven strategy to succeed in the competitive, cost-conscious business environment of the late 1980s and 1990s. The strategy embraces many interconnected corporate actions to cut costs, increase flexibility and boost revenues.

As a first step, PG&E streamlined its distribution operations in 1986 by reorganizing them into six regions–shifting decision-making authority back to the managers closest to the company's customers. Next, we instituted stringent cost controls to keep our prices competitive. The company's 1987 and 1988 budgets have been held close to 1986 levels–despite an anticipated 250,000 new customers and cumulative 7.3 percent inflation. Capital spending was cut from around $1.8 billion in 1986 to roughly $1.3 billion last year, and we intend to keep pushing capital budgets down.

PG&E is now taking the next logical step in this market-driven strategy. We have reorganized the company into five business units aimed at the primary markets we now serve: Electric Supply, Gas Supply, Distribution, Engineering and Construction Services, and Non-Utility Business. Managers in these units will be able to monitor their costs and customers better, and they will be given added authority, responsibility and accountability for results. By finding new revenue opportunities in some markets to offset lower returns in others, the new organization should also make it easier to earn a full rate of return in the highly competitive markets of the 1990s.

Finally, bolstered by corporate cost-cutting and a more efficient structure, PG&E is actively pursuing new business opportunities to boost its revenues. All of these business initiatives build on the company's existing strengths and expertise.

Corporate Center

As PG&E moves into the 1990s organized into flexible, market-wise business units, a Corporate Center will bind these units together as a single, strong company.

Made up of senior management and backed by an array of company-wide essential services, the Corporate Center will ensure that the results produced by each business unit increase the company's overall financial strength. It will provide strategic direction and will allocate PG&E's resources in the most efficient and most profitable manner. In addition, it will make certain that the company shares a common vision and speaks with a single, clear voice.

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The potential size of the wholesale electric power market is enormous. And Electric Supply will aggressively market power and transmission services to utilities both inside and outside PG&E's service territory.

THE POWER OF CONNECTIONS

PG&E's Electric Supply business unit controls 100-plus power plants and more than 4,000 miles of high-voltage power lines. Backed by these formidable assets, it supplies electricity to the Distribution business unit to serve PG&E's retail electric customers. But Electric Supply also sells to another market–the fast-growing and intensely competitive wholesale electric power market. The potential size of this market is enormous, stretching across the western United States and from Canada down into Northern Mexico.

Emerging Market

Events during 1987 showed just how fast this market is emerging. For example, the Federal Energy Regulatory Commission (FERC) authorized a two-year experiment proposed by PG&E called the Western Systems Power Pool. This experiment creates a computer-assisted marketplace for spot power and transmission service. It works much like a commodities exchange–with prices updated daily.

Even the construction of electric generating stations is becoming competitive. In California, the Public Utilities Commission has established a bidding system that will put future generation proposed by PG&E in competition with the power supplied by independent generators who qualify under the Public Utility Regulatory Policies Act of 1978. These are known as qualifying facilities (QFs). Now FERC is exploring ways to open this competition to other utilities and independent power producers.

And there's already competition for existing wholesale power markets. Last year the Sacramento Municipal Utility District (SMUD) asked for bids on 400,000 kilowatts of wholesale power. It received nearly 50 bids offering a total of 6,500,000 kilowatts–more than 16 times the amount requested. PG&E is already competing in certain non-traditional markets–selling more than 39,000 kilowatts of power to Anaheim and other Southern California municipal utilities in 1987. And with other utilities bidding for its customers, Electric Supply will broaden its wholesale market by aggressively marketing power and transmission services to utilities both inside and outside PG&E's service territory.

PG&E's strategic position in the expanding wholesale power market is strong. Our extensive transmission system links us to low-cost energy suppliers in the Pacific Northwest and to growing markets in the Southwest. We also have one of the nation's most reliable mixes of energy resources. We produce power from a vast array of hydro, fossil fuel, nuclear, geothermal, wind, and solar generating plants.

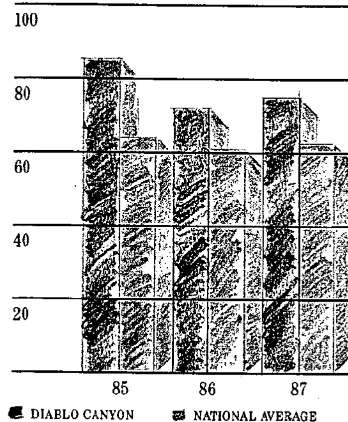
A Clear Mission

But competitive pricing, pure and simple, is the key to success in this emerging market. That is why PG&E's Electric Supply business unit is working hard to drive down the average and incremental cost of its electric production.

PG&E will also continue to play an active role in legislative and regulatory initiatives that could shape our future business environment.

As PG&E moves into a new era of competition, Electric Supply's mission is clear. It is committed to achieving solid, profitable results for the company and its shareholders.

NUCLEAR POWER PLANT PERFORMANCE
CAPACITY FACTOR PERCENTAGE



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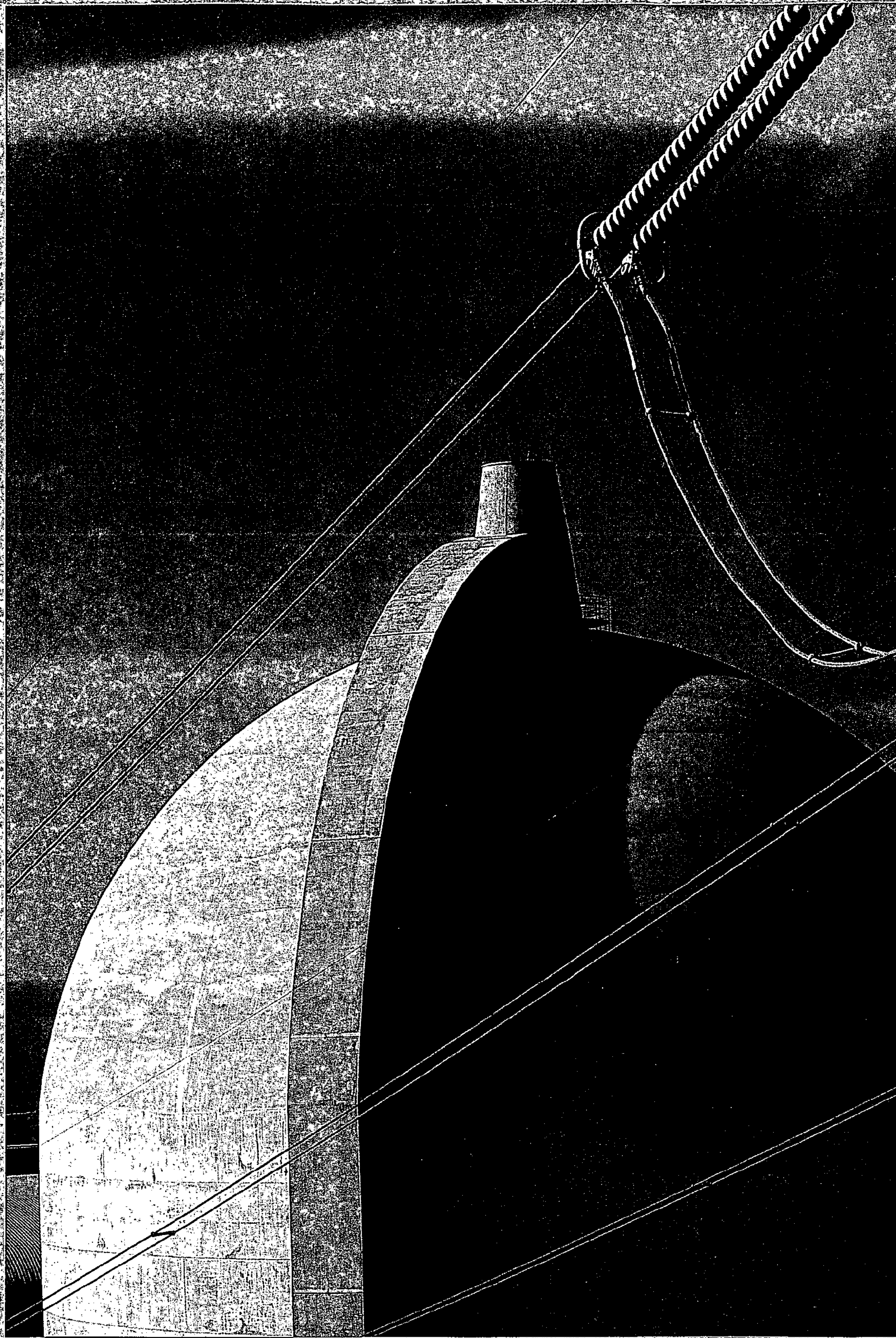


An interconnected transmission system and diversified generating resources – including Diablo Canyon's nuclear power – assure the company's future in the western electric market. PG&E can pursue bulk power sales opportunities, buy from outside its own system when the price is right, and contract for deliveries in the new regional spot market.

PG&E's integrated gas transmission system draws from Canada, the U.S. Southwest and California. With abundant underground storage capacity, illustrated here by the gas dehydrators at the McDonald Island storage facility, PG&E can transport and sell gas to customers in the western United States.

GAS SYSTEM FLEXIBILITY

Changing federal and state regulations have opened up new gas markets. PG&E gas has the reliable, committed supplies and the pipeline system needed to succeed in these new, more competitive markets.

As PG&E enters the 1990s, the Gas Supply business unit will operate a major interstate pipeline–connecting North America's largest gas supply sources to the continent's largest gas market. Gas Supply's 4,000 miles of pipeline and its storage fields give it an integrated transmission system running all the way from gas fields in Alberta, Canada to the Arizona-California border.

New Markets

Gas Supply's largest customers are PG&E's Distribution and Electric Supply business units. Both depend on Gas Supply for gas at prices that enable them to be competitive. In addition, changing federal and state regulations have opened up new markets in gas transport for enhanced oil recovery (EOR) customers and for off-system customers like other utilities.

Gas Supply's customers fit a common mold. They need low-cost gas to stay competitive in their own markets. They are big and they are concentrated–taking delivery of major volumes of gas at a limited number of points. Gas Supply is in a very strong position to meet these needs–and to respond to rapidly changing market conditions.

With gas supplies plentiful and prices low, the transportation business is booming–as pipelines compete to carry gas owned by others. Our pipeline system has the flexibility needed to transport large volumes of gas for others while still providing our core customers with the reliable, low-cost, total gas services they need. In 1987, PG&E transported 126.2 billion cubic feet of gas for customers–a 214 percent increase from our transport service in 1986.

PG&E is putting its strong market position to good use in California's vast enhanced oil recovery natural gas market. Oil producers inject large quantities of steam into the earth to help extract the heavy crude oil found in Kern County and elsewhere in the state. As these producers switch to natural gas to fire their steam-producing boilers, they are also creating a natural gas market that could eventually reach one billion cubic feet per day–roughly equal to two-thirds of PG&E's average daily gas sales in 1986.

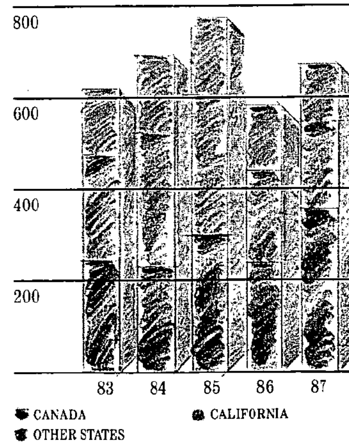
As the EOR market grows in the 1990s, PG&E's Gas Supply business unit will be ready to grow with it.

Gas Supply is also well prepared for other changes that could occur in the gas market. If expanded demand shrinks the existing gas supply "bubble," spot market prices will rise and customers will want the stability offered by long-term, dedicated supplies. PG&E stands ready to meet this need. We are the largest U.S. purchaser of natural gas from Canada and from northern California fields, and we negotiated vigorously in 1987 to win one-year price caps at very attractive levels for both these long-term supply sources. These reliable, committed supplies should help keep our prices down as gas supplies tighten. During a period of exceptionally cold weather last winter, they helped us provide emergency gas supplies to Southern California without curtailing service to our own retail gas customers.

Federal and state regulation of the gas industry is changing–shifting to greater reliance on market forces. PG&E must continue to play an active role in the legislative and regulatory debates that will shape the future course of the gas business.

However, with large, attractively priced supplies in Canada, California and the Southwest, and with an unparalleled pipeline system, Gas Supply has the flexibility and market position needed to succeed in the competitive gas and gas transport markets we face in the years ahead. Our task is to make that success a reality.

SOURCES OF GAS PURCHASED
BILLIONS OF CUBIC FEET



There is no substitute for knowing your customers, knowing your competitors, and being ready, willing and able to sell your products. PG&E's efforts to strengthen its marketing force began paying off in 1987.

DEPENDABLE ENERGY SERVICE

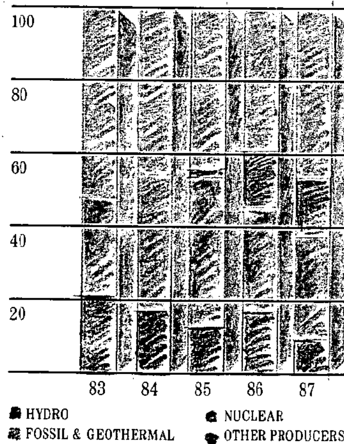
The Distribution business unit mans the front lines in PG&E's retail markets. Distribution does everything from hooking up new residential customers to marketing the company's services against competitors eyeing its commercial, industrial and agricultural customers.

Meeting the Competition

PG&E began preparing this front-line team for the competitive markets of the 1990s back in 1986. We reorganized 13 divisions into six streamlined operating regions. This cut costs and increased efficiency–all while maintaining our commitment to service and reliability. In 1987, PG&E once again achieved an exceptionally high electric service reliability factor of 99.96 percent.

PG&E ENERGY RESOURCES

PERCENTAGE OF TOTAL AREA LOAD



At the same time, we strengthened the company's marketing efforts, giving managers in the field more marketing representatives to learn customer needs–and meet them. In an increasingly competitive business environment, there is no substitute for knowing your customers, knowing your competitors, and being ready, willing and able to sell your products. Our efforts began paying off in 1987.

A powerful combination of cost-cutting measures and competitive pricing reduced potential revenue losses and increased our sales. Specifically, in 1987, PG&E:

- ☐ Held its industrial electric rates 17.5 percent lower than in 1986.
- ☐ Won California Public Utilities Commission approval for six negotiated electric rate agreements that retained 65,000 kilowatts of load. In addition, in December we signed a crucial, five-year contract for continued electric service to Chevron's Richmond, California oil refinery. Under this agreement, Chevron will defer construction of its own 100,000-kilowatt cogeneration plant.
- ☐ Convinced customers to defer an additional 205,000 kilowatts of planned cogeneration projects. We did this by marketing increased value–competitive rates, quality service and conservation.
- ☐ Used flexible pricing and supply options to gain or retain gas sales of 582 million therms and $69.6 million in revenues.

Sales figures for the year reflected these marketing successes. Total electric sales for 1987 were up 7.6 percent, and total gas deliveries (sales plus transport) were 31 percent higher than they were in 1986.

Thanks to our redoubled efforts to cut costs and market and price our products more competitively, PG&E has already managed to reduce by 50 percent the substantial revenues we once estimated could be at risk by 1990.

Good Progress

That's good progress, but more is needed–and more is being done. As PG&E's markets become increasingly segmented, the company is developing a more advanced system for determining incremental costs and overheads in these new market segments. This will help Distribution's managers allocate their resources more wisely, control costs more efficiently, and evaluate their markets more accurately.

As a first priority, the Distribution business unit will develop rate programs that better serve our markets and that balance PG&E's costs of service with prices that are competitive in today's markets. And that will enable us to provide extra value–a combination of competitive price and quality service–that customers demand and competitors can't match.

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PG&E service doesn't stop. When nature's meanest efforts bring down the wire, dedicated, experienced employees are dispatched to find the trouble and fix it, 'round the clock, fair weather or foul. That's a service strength that gives PG&E the edge on non-utility competitors.

Water flumes like this one winding through the Sierra at Pollock Pines are a big part of PG&E's hydroelectric system. And that system, in turn, is essential to providing low-cost electricity for customers. Engineering and Construction Services builds, maintains and improves PG&E facilities by offering competitively priced technical expertise.

BUILDING FOR THE FUTURE

PG&E depends on its ability to produce and move its products - electric power and natural gas - as efficiently and reliably as possible. Engineering and Construction Services helps the company provide safe and reliable energy to our customers.

The Engineering and Construction Services business unit has a crucial mission: to provide competitive engineering and construction services to the other business units. This organization also has a clear market focus - its largest market just happens to be inside PG&E.

Expertise in Action

Engineering and Construction Service's skilled personnel effectively designed and built the physical systems that are the heart of PG&E today - the company's fossil, geothermal, hydro, and nuclear power plants, and its electric and gas transmission and distribution systems. Their knowledge of these systems, their technical expertise and experience, and their long-range interest in PG&E's success put them in an excellent position to help the other business units meet their objectives.

PG&E's rapid response in emergency situations forms an important part of the increased value we can offer our customers in an increasingly competitive business environment. Our record is impressive. Construction crews have worked around the clock to repair damaged transmission lines, flooded substations, broken gas lines and damaged canals and tunnels. We will continue to support the company's customers by providing a trained workforce able to quickly and capably restore service under emergency conditions.

But superb emergency service isn't the only vital contribution this unit makes to the company. PG&E also depends on its ability to produce and move its products - electric power and natural gas - as efficiently and reliably as possible. Although the company's capital budget is being reduced, there is still a considerable amount of work involved in maintaining and improving PG&E's power plants, dams, transmission and distribution systems, and other facilities. Engineering and Construction Services personnel have the specialized skills to do the job, and they're now working on a number of essential projects:

- ☐ Installing high density fuel storage racks at Diablo Canyon to increase spent fuel storage capacity.
- ☐ Enhancing the computer facilities at PG&E's fossil power plants.
- ☐ Installing an Energy Management System that will boost the company's ability to get real-time data to and from its substations and power plants.
- ☐ Replacing aging gas transmission and distribution lines to enhance safety and reliability.
- ☐ Reviewing high temperature and pressure piping systems in older power plants for signs of potential failure.
- ☐ Completing major work at The Geysers power plant to retrofit additional pollution control systems, to increase efficiency with new control systems, and to design and construct an on-site waste management facility.
- ☐ Upgrading the Divide-Lompoc electric transmission line from 70,000 to 115,000 volts - increasing PG&E's ability to serve the Santa Maria area and giving us the capability to supply power to offshore oil platforms, a major new market.

Service and Success

Engineering and Construction Services is determined to provide the high quality support PG&E's other business units will need as they face increasing competition. The unit will help secure PG&E's edge in the safe and reliable supply of energy to its customers - and will do so at a competitive price.

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PURSUING NEW OPPORTUNITIES

Managing our utility businesses competitively, and prudently developing non-utility activities will increase PG&E's revenues and earnings– enhancing the company's value to its shareholders.

Non-utility businesses are ventures that are not regulated by government agencies in the traditional cost-of-service manner. Just as increasing competition and partial deregulation pose threats to PG&E's utility operations, they may also bring opportunities in the non-utility business sector. The Non-Utility Business unit will develop new businesses in areas where PG&E can add value and develop a competitive advantage.

Enhancing Value

The combination of managing its utility businesses competitively, and prudently developing non-utility activities will increase PG&E's revenues and earnings and will enhance the company's value to its shareholders.

In 1987, as part of its commitment to a sound, non-utility investment policy, PG&E consolidated nearly all its nonregulated oil and gas exploration and production activities into a single subsidiary – NGC Energy Company.

NGC Energy then launched a major expansion, acquiring substantial proven oil and gas reserves at an average cost of the equivalent of just 57 cents per thousand cubic feet. These acquisitions, together with purchases from other PG&E subsidiaries, more than quadrupled its reserves. As a result, NGC Energy now owns the equivalent of 117 billion cubic feet of low-cost, high-value reserves in the western United States. In fact, NGC Energy's reserves and production place it among the top 20 percent of oil and gas companies in the country.

PG&E's other unregulated subsidiaries include Angus Petroleum and JWP Land. Angus' operations focus on enhanced oil recovery in California. JWP Land develops real estate directly or on a joint venture basis with other developers in PG&E's service area in California. Both have been placed within the Non-Utility Business unit.

As it evaluates other opportunities, Non-Utility Business has established three criteria which new ventures must meet.

First, PG&E must be able to add value. New business ventures must be related to the company's existing strengths and expertise.

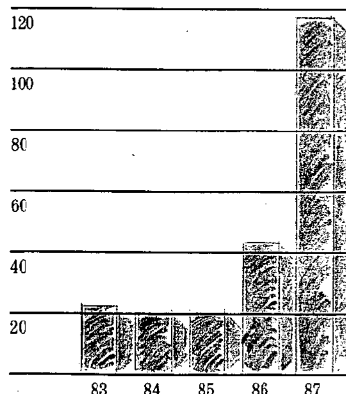
Second, the new ventures must offer the potential for making a significant contribution to PG&E's earnings. We do not plan to pursue a large number of small initiatives. Instead, we plan to focus upon and successfully develop a smaller number of major initiatives that could substantially boost our future earnings.

Finally, a non-utility investment must offer the potential for rates of return higher than those authorized by the California Public Utilities Commission for utility investments. And these returns must be commensurate with the risks involved in the proposed business venture.

New Venture

In December 1987, we took a major step forward in our efforts to expand PG&E's non-utility activities. The need for additional electric power is now apparent in several regions around the United States and this need is expected to grow in the 1990s.

Accordingly, PG&E and Bechtel Power Corporation are forming a joint venture to develop non-utility electric generation facilities nationwide. We believe the combination of our financial capabilities and power plant operating experience with one of the nation's leading engineering and construction firms will be able to capture a significant share of the expanding U.S. market for non-utility electric generation.



Oil and gas reserves, like this field in Utah, were brought under NGC Energy Company in 1987. Along with PG&E's other unregulated subsidiaries grouped in Non-Utility Business, NGC Energy offers a value-added, energy-related business opportunity.

SELECTED FINANCIAL INFORMATION

Pacific Gas and Electric Company

	1987	1986	1985	1984	1983
	In Thousands (except per share information)				
Operating Revenues	$ 7,185,701	$ 7,816,661	$ 8,430,981	$ 7,829,703	$ 6,646,699
Operating Income	$ 1,261,701	$ 1,653,625	$ 1,369,359	$ 1,103,388	$ 959,872
Net Income	$ 688,517	$ 1,081,223	$ 1,030,805	$ 974,892	$ 787,967
Earnings Per Common Share	$1.53	$2.60	$2.65	$2.62	$2.15
Dividends Declared Per Common Share	$1.92	$1.90	$1.81	$1.69	$1.58
Book Value Per Common Share at Year-end	$18.68	$19.06	$18.05	$17.18	$16.39
Market Price Per Common Share at Year-end	$16.25	$24.25	$20.00	$16.38	$14.88
Total Assets at Year-end	$21,733,652	$21,002,253	$19,098,003	$17,319,359	$14,717,357
Long-term Debt, Preferred Stock, and Capital Lease Obligations at Year-end	$ 9,521,984	$ 9,040,786	$ 9,187,957	$ 8,223,968	$ 7,055,825

In 1987, Operating Revenues were reduced by $717,100,000, Operating Income was reduced by $438,200,000 and Net Income was reduced by $485,900,000 ($1.29 per share) due to the change in recording revenues related to Diablo Canyon Nuclear Power Plant, and Net Income was increased by $91,323,000 ($.24 per share) due to the change in method of accounting for unbilled revenues as discussed in Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations and in Notes to Consolidated Financial Statements.

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

Pacific Gas and Electric Company

RESULTS OF OPERATIONS

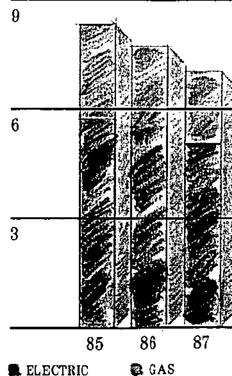
Revenues and Earnings Per Share

Earnings per common share of the Company in 1987 declined to $1.53 from $2.60 in 1986 and $2.65 in 1985. The 1987 earnings equal an 8.1% corporate return on weighted average common equity and an 8.9% return on utility rate base.

	1987	1986	1985
		In Thousands	
Earnings Available for Common Stock	$577,735	$925,033	$866,575
Weighted Average Number of Common Shares Outstanding	377,723	355,937	326,838

Revenues in 1987 decreased by $631 million from 1986. On March 31, 1987, the Company changed its recording of revenues relating to Diablo Canyon Nuclear Power Plant (Diablo Canyon), retroactive to January 1, 1987, essentially to reflect only the cash amounts actually received through interim rates approved by the California Public Utilities Commission (CPUC). Excluded from earnings before taxes and deferred are $717.1 million of revenues and $87.6 million of interest income in 1987. Included in revenues for 1987 is $504.8 million for recovery of a portion of operating expenses and an amount equal to the projected fuel costs saved because of Diablo Canyon Units 1 and 2. In 1986 and 1985, the corresponding amounts included in revenues were $1,199.7 million and $429.4 million, respectively. These revenues are subject to future adjustment or refund when the CPUC issues its decision on rate recovery, probably in 1989. Without additional interim rate relief, the deferral of revenues results in a significant decline in the reported earnings of the Company beginning in 1987, pending the final outcome of the Diablo Canyon rate proceedings.

CONSOLIDATED OPERATING REVENUES
DOLLARS (IN BILLIONS)



In 1987, the Company offered an early retirement plan to qualified employees. The plan cost, which is included in Administrative and General expenses, was approximately $87.1 million before taxes.

Before January 1, 1987, revenues were recognized as customers were billed throughout each month. To match revenues and expenses more closely, in January 1987 the Company began accruing revenues for service provided

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but unbilled at the end of each month. The cumulative effect of this accounting change as of January 1, 1987 increased net income by approximately $91.3 million, net of related income taxes of approximately $77 million. If this method had been used in prior years, consolidated net income, before the cumulative effect of the change for the periods prior to January 1, 1987, would not have been materially different.

In 1986, revenues decreased by $614.3 million from 1985. Lower fuel costs passed on to ratepayers through lower rates were offset partially by revenues related to Diablo Canyon Unit 1 which was in full commercial operation for all of 1986 compared to only eight months for 1985, and Diablo Canyon Unit 2 which began full commercial operation in March 1986.

In 1985, revenues increased $601.3 million over 1984 as Unit 1 began full commercial operation in May 1985.

Earnings Per Share Impact of Unusual Items:	**1987**	1986	1985
Diablo Canyon deferral	**$(1.29)**	$ –	$ –
Early retirement plan	**(.13)**	–	–
Unbilled revenues	**.24**	–	–
CPUC reduction in rate of return authorized on common equity	**(.06)**	(.14)	–
CPUC disallowance of energy project costs	–	–	(.14)
Adjustment of prior years' tax benefits	–	–	.13
Earnings per share impact	**$(1.24)**	$(.14)	$(.01)

Diablo Canyon Nuclear Power Plant

The Diablo Canyon Adjustment Account (DCAA) is used to accumulate the revenue requirement for expenses and return on rate base (11.44% in 1987 and 11.02% effective January 1, 1988) related to Units 1 and 2 for future recovery in rates. Current cash flows are not increased by the operation of the DCAA. However, the Company has been allowed to collect interim revenues to cover a portion of operation and maintenance expenses and an amount equal to the projected fuel costs saved.

Through December 31, 1986, the Company accrued $871.1 million in the DCAA as uncollected revenue subject to possible adjustment. Effective January 1, 1987, as discussed above, the Company deferred recognition of additional uncollected revenues. The Company took this action as a result of a number of factors, including uncertainty about the level of interim rate recovery and the length of time until the ultimate resolution of the Diablo Canyon rate proceedings. In 1987, the deferral resulted in a decrease in net income of $485.9 million.

Diablo Canyon revenues and interest income, which are subject to possible future adjustment and refund, and their effect on earnings per share are as follows:

	1987	1986*	1985*
	In Millions (except per share information)		
Revenue Requirement			
–for operating expenses	**$ 415.7**	$ 367.7	$125.0
–for interest	**218.3**	192.9	72.0
–for equity return and related taxes	**587.9**	639.1	232.4
Total Revenue Requirement	**1,221.9**	1,199.7	429.4
Interest Income on Receivable	**87.6**	31.3	3.3
Less Amount Recognized	**504.8**	1,231.0	432.7
Total Deferred	**$ 804.7**	$ –	$ –
Effect on earnings per share			
–Amount Recognized	**$ .73**	$ 1.69	$ .65
–Income Deferred	**$ 1.29**	$ –	$ –

*Changed to conform to 1987 presentation.

Inclusion of Diablo Canyon in rate base would improve the Company's cash flow significantly. The Company has applied to the CPUC for recovery of the costs of owning and operating Diablo Canyon. Under the current schedule, final rate recovery probably will not be authorized until 1989, after reasonableness hearings are completed. By the end of 1989, the total cumulative DCAA revenue requirement and interest will be approximately $5.8 billion. Of this total, an estimated $2.3 billion will be collected by the end of 1989, subject to refund, through interim rates, assuming continuation of the current level of interim rates.

As of December 31, 1987, $804.7 million has been excluded from revenues and interest income. As a result of this exclusion, a disallowance of the Diablo Canyon plant costs on December 31, 1987 of approximately $500 million would have had no effect on net income assuming that the Allowance for Funds Used During Construction (AFUDC) disallowed was in the same proportion as the AFUDC in the plant and that the disallowance would have applied equally to the two units. AFUDC is the cost of financing the construction of new facilities. Because AFUDC was recorded net of income taxes, there would be no additional tax benefit recognized if AFUDC were disallowed. As of December 31, 1987, AFUDC represented 35% of total Diablo Canyon plant costs.

Using the same assumptions as above, from January 1, 1987 to December 31, 1988, approximately $1.7 billion will be excluded from revenues and interest income, and a disallowance of the Diablo Canyon plant costs on December 31, 1988 of approximately $900 million would have no effect on net income.

Pending the outcome of the Diablo Canyon proceedings, from January 1, 1987 to December 31, 1989, approximately $2.6 billion will be excluded from revenues and interest income, assuming continuation of the current level of interim revenues. As a result of this exclusion, and using the same assumptions as above, a disallowance of the Diablo Canyon plant costs on December 31, 1989 of approximately $1.4 billion would have no additional effect in that year on net income, and for every $100 million of disallowed plant costs in excess of $1.4 billion, there would be a one-time reduction in net income of approximately $120 million, which would reflect a reduction of the plant costs and the related balancing account revenues already recognized.

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The CPUC will determine how much of the investment in Diablo Canyon ultimately will be permitted in rate base and recovered in rates. Because Diablo Canyon represents such a large portion of the Company's assets, if a disallowance of costs is significant, it could have a significant adverse impact on the Company's financial position. Annual interim revenues for 1988 of approximately $505 million (excluding $53.2 million in decommissioning costs) are sufficient only to provide for recovery of all Diablo Canyon operating expenses and the authorized rate of return on approximately $1.7 billion of the Diablo Canyon plant costs.

In August 1987, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 92, *Regulated Enterprises-Accounting for Phase-in Plans.* SFAS No. 92 specifies the accounting for phase-in plans and the capitalization of equity return and will be effective January 1, 1988. This statement would have prohibited the Company from capitalizing equity return relating to Diablo Canyon. Due to the Company's change in recording revenues relating to Diablo Canyon, which was effective January 1, 1987, application of SFAS No. 92 for Diablo Canyon would not have reduced earnings in the current year nor is it expected to do so in the future.

The California Supreme Court is reviewing the CPUC's interim decision that allowed the Company to retain the projected net fuel cost savings of approximately $334.2 million annually resulting from the operation of Unit 1 and to increase electric rates by $53.8 million annually for operation and maintenance expenses for Unit 1. If the decision is reversed and the Company is required to refund this revenue, earnings for 1988 could be reduced. The Court's ruling is expected in the future. (The uncertainties surrounding ultimate rate treatment of Diablo Canyon are discussed more fully in Note 10 to the consolidated financial statements.)

In January 1988, PG&E requested that non-investment expenses for Diablo Canyon for 1988 and the period since commercial operation be recovered in base rates. PG&E and the CPUC's Division of Ratepayer Advocates (DRA), formerly called the Public Staff Division, have agreed subsequently that the amounts for 1988 and for the prior periods are reasonable expenses. PG&E has proposed an increase in base rates of $202 million for the 1988 expenses, offset by a reduction of $54 million in interim revenues that is related to such expenses, and an additional increase of $140 million per year for two years to amortize the prior period expenses (including interest). The DRA has opposed any rate increase to recover such expenses and the matter has been set for a hearing. An increase in base rates, if allowed by the CPUC, would reflect a final determination of non-investment expenses and would not be subject to refund or further adjustment. Any increase in base rates, not offset by a decrease in interim rates, would increase earnings because PG&E records as income essentially only the cash amounts actually received from Diablo Canyon.

AFUDC

AFUDC declined for the fourth straight year in 1987, representing only .3% of net income, compared to 10.3% in 1986 and 33% in 1985. In 1987, AFUDC was reduced by $47.2 million, the amount recorded from 1983 through August 1987 for the income tax effect of the capitalization of construction-period interest under the Tax Equity and Fiscal Responsibility Act of 1982. The financial statement impact of this reduction is mitigated entirely by a corresponding reduction in income tax expense which is included in Other-Net in the consolidated income statement. AFUDC decreased in part due to commercial operation of Diablo Canyon Unit 1 in 1985 and Unit 2 in 1986 and in part due to shorter construction time for Company projects. AFUDC increases net income but does not contribute to cash flows until construction is completed and projects are included in rate base.

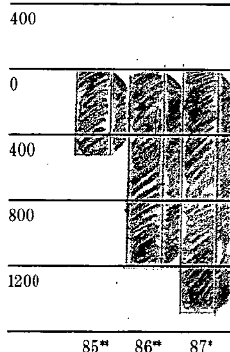
Ratemaking

Balancing accounts and major facility adjustment accounts authorized by the CPUC help maintain the Company's earnings stability. Energy-cost balancing accounts are used to accrue for future recovery all costs of gas and 91% of the costs of purchased power and fuels used to generate electricity.

Major facility adjustment accounts such as the DCAA are used to accrue for future recovery operating expenses and return on major generation projects from the time they become operational until the CPUC approves final rates.

Through 1987, sales-fluctuation balancing accounts reduced the impact on earnings of fluctuations in electric and gas sales. The CPUC based rates on estimated sales; differences between revenues based on these estimates and actual revenues are accumulated in the balancing accounts and are equalized by subsequent rate adjustments. In November 1987, the CPUC authorized such an electric revenue increase of $266.5 million effective January 1, 1988 to offset lower than forecasted sales.

BALANCING ACCOUNTS AT END OF YEAR
DOLLARS (IN MILLIONS)



*Net of deferred revenue of $805 million
**Includes Diablo Canyon Adjustment Account.

In 1986, the CPUC adopted a new regulatory framework to alter its policies to reflect the rapidly changing gas industry. This CPUC decision separated

gas customers into "core" and "non-core" classes. Core customers are those with few or no fuel alternatives to natural gas (such as most residential and smaller commercial customers). Non-core customers are those with fuel alternatives or the ability, because of size, to contract for their own gas supplies. The new framework allows the Company to negotiate with non-core customers for the price of gas and the cost of delivering that gas to the customer. While this new concept allows the Company greater flexibility in competing for some customers, in exchange, it loses some of the protection afforded previously by the gas balancing accounts. Under this new structure, which the CPUC authorized in December 1987, revenue requirements for core customers are anticipated to increase May 1, 1988 due to a forecasted decline in non-core gas sales and an undercollection in the gas balancing accounts. The new rates will be determined in May 1988.

The Attrition Rate Adjustment (ARA) compensates for changes in financial and operational expenses in years between general rate cases to adjust base rates for estimated future costs of doing business. As a result of strict cost control and the expected effect of the 1986 Tax Reform Act, the CPUC, in December 1987, authorized an electric revenue decrease of $117.4 million, effective January 1, 1988, and a gas revenue decrease of $16.9 million which will be deferred to May 1, 1988. The reductions also reflect a decrease from 11.44% to 11.02% in authorized return on rate base. This decrease is due to the lower embedded cost of debt and allowable return on common stock equity.

In 1987, revenues collected, subject to adjustment were reduced by approximately $85.3 million to reflect the estimated effect of the Tax Reform Act of 1986 (the Act), pending a review by the CPUC. In the fourth quarter of 1987, the CPUC administrative law judge issued a proposed decision which caused the Company to adjust the $85.3 million estimate to $66 million. The estimated effect of the Act also has been incorporated into the Company's request for an $86 million decrease for the 1988 ARA.

In 1986, the CPUC proposed eliminating sales-fluctuation balancing accounts and the ARA and changing the three-year general rate case cycle for electric utilities to two years. A final decision is expected in 1988. Proposed changes in sales-fluctuation and energy-balancing accounts would put PG&E's earnings at significantly more risk as sales and/or prices fluctuate, but also would create an opportunity for additional earnings. Changes in the ARA would increase the Company's risk from inflation between general rate cases.

The combination of balancing accounts and the nature of a cost-of-service regulated environment has helped to reduce the effects of inflation on the Company. Both the ARA and the energy-cost balancing accounts provided rate relief for the impact of inflation, helping to neutralize its effect on PG&E. Inclusion of new assets in rate base reduces the impact of replacing old facilities with more costly new ones.

These ratemaking procedures coupled with the Company's continuing efforts to control costs and increase productivity have resulted in strong earnings from utility operations other than Diablo Canyon.

LIQUIDITY AND CAPITAL RESOURCES

Diablo Canyon Nuclear Power Plant

As discussed in "Results of Operations," the Company changed its recording of revenues from Diablo Canyon, essentially to reflect the cash amounts actually received. This change has no effect on the cash flow of the Company and has had no effect on the current annual common stock dividend of $1.92 per share.

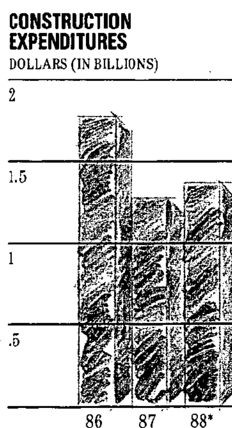
Helms Pumped Storage Project

The Helms project was placed in service in June 1984. At December 31, 1987, capitalized expenditures for Helms totaled approximately $960.6 million. Of this amount, $716 million was included in rate base and $21.7 million was disallowed and charged against 1985 earnings. Any portion of the remaining $222.9 million in costs will be subject to claims against third parties or included in rate requests. From the commercial operation date in 1984 through August 1985, $55.3 million has been placed in a balancing account pending future claims against third parties or rate requests. (See Note 10 to the consolidated financial statements.)

Construction Expenditures

In the future, the Company's construction projects will be smaller and take less time to build; carrying costs should be much less than in recent years. The need for new facilities will be reduced by signing long-term contracts to buy energy from others and by continuing to promote conservation. Projected 1988 expenditures of $1.4 billion for PG&E include reinforcing and expanding the transmission and distribution system and modernizing facilities and equipment. Expenditures for PG&E are expected to drop through 1990 from the approximately $1.3 billion and $1.8 billion spent in 1987 and 1986, respectively.

CONSTRUCTION EXPENDITURES
DOLLARS (IN BILLIONS)



*Projected

Other

The Company also will require capital to meet maturing debt and preferred stock issues.

	1988	1989	1990
		In Millions	
Maturing Debt and Preferred Stock (including Debt and Preferred Stock Sinking Fund Requirements)	$79	$125	$129

Capital is supplied by internally generated funds and by external financings. External funds from common stock and debt issued in 1987 supplied 75% of capital requirements for 1987. As major construction projects are placed into rate base and produce additional cash (beyond interim rate levels for Diablo Canyon), the Company's reliance on external financing should continue to decrease.

Proceeds from financings during 1987, 1986 and 1985, were as follows:

	1987	1986	1985
		In Millions	
Proceeds from Financings, Net of Refundings:			
Common Stock	**$416**	$ 679	$ 373
Long-term Debt	**567**	475	1,082
Total Proceeds	**$983**	$1,154	$1,455

Common stock financing has been accomplished through public offerings and the Company's dividend reinvestment and employee savings plans. Long-term debt has been sold in the United States and in European financial markets.

At December 31, 1987, the Company's common stock was selling at $16.25 per share, $2.43 below the book value of $18.68 per share. Sales of common stock below book value may be necessary in the future to provide capital for construction and other projects.

The Company's bond indenture permits issuance of mortgage bonds up to the amount approved by the Company's Board of Directors. At December 31, 1987, the Company had $6.8 billion outstanding in mortgage bonds and may issue up to $1.2 billion more, subject to indenture provisions on earnings coverage and property available as collateral. The CPUC also must approve such financings. (See Note 3 to the consolidated financial statements.)

The Company issues short-term debt-principally commercial paper-mainly for interim construction financing and for general working capital. Short-term debt also has helped fund fuel oil and gas inventories and unrecovered balances in balancing accounts. Such borrowing provides flexibility to meet capital needs and to schedule long-term debt issues.

At December 31, 1987, the Company had available credit facilities totaling $703.4 million, all of which were available at December 31, 1987. The Company also had short-term borrowings of $554 million at December 31, 1987. When balancing account revenues are undercollected, as in 1985, 1986, and 1987, the Company must borrow until the revenues, plus interest at the Company's commercial paper rate, are received. When revenues are overcollected, the Company uses the funds until they are refunded with interest.

PG&E seeks to maintain capitalization ratios comparable with those authorized for its utility operations in the most recent general rate case. In 1986 and 1987, the Company took advantage of lower interest rates by refinancing older, high-cost securities to reduce finance costs. The authorized and actual capitalization ratios for PG&E only, for 1987 and 1986 were:

	1987		1986	
	Authorized	Actual	Authorized	Actual
Common Stock	**44.5%**	**44.1%**	42.7%	44.8%
Preferred Stock	**9.0**	**7.3**	13.8	9.1
Long-term Debt	**46.5**	**48.6**	43.5	46.1
Total Capitalization	**100.0%**	**100.0%**	100.0%	100.0%

In December 1987, the FASB issued SFAS No. 96, *Accounting for Income Taxes,* which establishes new financial accounting and reporting standards for the effects of income taxes on the Company's activities.

The Company currently is evaluating the accounting, regulatory and financial implications of SFAS No. 96, which must be adopted by 1989. It is estimated that the adoption will require that both the assets and liabilities on the consolidated balance sheet be increased equally by two to three billion dollars. The impact, if any, on the consolidated income statement cannot be determined at this time.

Material Redacted

STATEMENT OF CONSOLIDATED INCOME

Pacific Gas and Electric Company

Years Ended December 31	1987	1986*	1985*
	In Thousands (except per share amounts)		
Operating Revenues			
Electric	$5,133,028	$5,567,438	$5,819,983
Gas	2,052,673	2,249,223	2,610,998
Total Operating Revenues	7,185,701	7,816,661	8,430,981
Operating Expenses			
Cost of Electric Energy	1,383,497	1,252,414	2,072,548
Cost of Gas	859,882	1,074,392	1,749,207
Transmission	175,534	148,788	148,479
Distribution	189,782	188,499	173,081
Customer Accounts and Services	283,965	339,583	357,189
Administrative and General	708,200	635,792	591,926
Other	263,585	333,038	302,326
Maintenance	341,118	352,230	312,531
Depreciation	875,208	693,675	535,654
Income Taxes	603,012	927,647	652,669
Property and Other Taxes	240,217	216,978	166,012
Total Operating Expenses	5,924,000	6,163,036	7,061,622
Operating Income	1,261,701	1,653,625	1,369,359
Other Income and (Income Deductions)			
Allowance for Equity Funds Used During Construction	2,564	69,164	247,367
Interest Income	99,011	120,431	132,985
Disallowed Project Costs	(8,689)	–	(58,882)
Other-Net	19,001	(37,760)	11,763
Total Other Income and (Income Deductions)	111,887	151,835	333,233
Income Before Interest Expense	1,373,588	1,805,460	1,702,592
Interest Expense			
Interest on Long-term Debt	698,233	707,975	709,258
Other Interest Charges	77,845	58,802	55,588
Allowance for Borrowed Funds Used During Construction	316	(42,540)	(93,059)
Net Interest Expense	776,394	724,237	671,787
Income Before Change in Recording Unbilled Revenues	597,194	1,081,223	1,030,805
Cumulative Effect as of January 1, 1987 of Accruing Unbilled Revenues, Net of Income Taxes of $77,045	91,323	–	–
Net Income	688,517	1,081,223	1,030,805
Preferred Dividend Requirement	110,782	156,190	164,230
Earnings Available for Common Stock	$ 577,735	$ 925,033	$ 866,575
Weighted Average Common Shares Outstanding	377,723	355,937	326,838
Earnings Per Common Share Before Change in Recording Unbilled Revenues	$1.29	$2.60	$2.65
Cumulative Effect as of January 1, 1987 of Accruing Unbilled Revenues	.24	–	–
Earnings Per Common Share	$1.53	$2.60	$2.65
Dividends Declared Per Common Share	$1.92	$1.90	$1.81

*Changed to conform to 1987 presentation.

The accompanying Notes to Consolidated Financial Statements are an integral part of this statement.

CONSOLIDATED BALANCE SHEET

Pacific Gas and Electric Company

December 31	1987	1986*
	In Thousands	
Assets		
Plant in Service (at original cost)		
Electric	$17,760,570	$16,659,173
Gas	3,594,959	3,335,255
Total Plant in Service	21,355,529	19,994,428
Accumulated Depreciation	(6,208,992)	(5,466,767)
Net Plant in Service	15,146,537	14,527,661
Construction Work in Progress	923,746	1,178,254
Nuclear Fuel and Other Capital Leases	381,376	434,303
Gas Exploration Costs	96,107	235,791
Advances to Gas Producers	334,767	367,426
Funds Held by Trustee	217,226	243,161
Investments	86,840	123,062
Customer Conservation Loans Receivable (net of current portion $24,142 in 1987; $33,697 in 1986)	40,045	60,935
Total	17,226,644	17,170,593
Current Assets		
Cash	8,632	5,618
Short-term Investments (at cost which approximates market)	136,925	112,586
Accounts Receivable		
Customers (including unbilled amounts of $311,604 in 1987)	962,922	556,648
Other	471,258	460,673
Allowance for Uncollectible Accounts	(8,340)	(8,951)
Regulatory Balancing Accounts Receivable	633,897	361,380
Inventories (Note 1)		
Fuel Oil	100,590	223,472
Gas Stored Underground	224,196	263,507
Materials and Supplies	168,246	165,223
Prepayments	34,925	31,754
Total Current Assets	2,733,251	2,171,910
Deferred Charges		
Diablo Canyon Balancing Accounts (net of deferred revenue and interest of $804,667 as of December 31, 1987)	871,144	871,144
Project Costs Pending Regulatory Action	16,970	16,970
Unamortized Project Costs	123,097	116,084
Workers' Compensation and Disability Claims Recoverable	91,900	93,500
Unamortized Debt Expense	47,218	37,459
Unamortized Loss Net of Gain on Reacquired Debt	305,461	303,049
Other–Net	317,967	221,544
Total Deferred Charges	1,773,757	1,659,750
Total Assets	$21,733,652	$21,002,253

*Changed to conform to 1987 presentation.

The accompanying Notes to Consolidated Financial Statements are an integral part of this statement.

Material Redacted

December 31	1987	1986*
	In Thousands	
Capitalization and Liabilities		
Capitalization		
Common Stock	**$ 1,941,543**	$ 1,840,636
Additional Paid-in Capital	**2,611,654**	2,319,344
Reinvested Earnings	**2,699,108**	2,855,748
Common Stock Equity	**7,252,305**	7,015,728
Preferred Stock Without Mandatory Redemption Provision	**1,010,195**	1,207,865
Preferred Stock With Mandatory Redemption Provision	**195,000**	225,285
Long-term Debt	**7,998,265**	7,255,956
Total Capitalization	**16,455,765**	15,704,834
Noncurrent Liabilities		
Capital Lease Obligations	**318,524**	351,680
Customer Advances for Construction	**159,907**	125,212
Workers' Compensation and Disability Claims	**91,900**	93,500
Customer Conservation Loans Payable	**59,300**	80,300
Other	**113,481**	34,352
Total Noncurrent Liabilities	**743,112**	685,044
Current Liabilities		
Short-term Borrowings	**554,024**	1,101,213
Accounts Payable		
Trade Creditors	**482,938**	459,255
Other	**244,180**	217,104
Accrued Taxes	**101,627**	49,834
Deferred Income Taxes - Current Portion	**275,245**	153,168
Long-term Debt - Current Portion	**71,620**	84,314
Capital Lease Obligations - Current Portion	**77,874**	89,892
Interest Payable	**75,228**	76,345
Dividends Payable	**186,001**	176,602
Amounts Due Customers	**77,983**	59,295
Other	**81,928**	76,962
Total Current Liabilities	**2,228,648**	2,543,984
Deferred Credits		
Deferred Investment Tax Credits	**553,481**	519,351
Deferred Income Taxes	**1,499,155**	1,517,194
Other	**253,491**	31,846
Total Deferred Credits	**2,306,127**	2,068,391
Contingencies (Note 10)		
Total Capitalization and Liabilities	**$21,733,652**	$21,002,253

STATEMENT OF CONSOLIDATED FUNDS USED FOR CONSTRUCTION

Pacific Gas and Electric Company

Years Ended December 31	1987	1986*	1985*
		In Thousands	
Funds From Operations			
Net Income	**$ 688,517**	$1,081,223	$1,030,805
Nonfund Items in Net Income			
Depreciation	**875,208**	693,675	535,654
Allowance for Equity Funds Used During Construction	**(2,564)**	(69,164)	(247,367)
Deferred Income Taxes	**48,381**	373,177	252,565
Regulatory Balancing Accounts			
Diablo Canyon	**–**	(713,405)	(157,739)
Other	**(272,517)**	17,151	37,252
Deferred Taxes Related to Regulatory Balancing Accounts	**124,451**	356,652	62,657
Disallowed Project Costs	**8,689**	–	58,882
Other-Net	**301,278**	121,299	188,120
Funds From Operations	**1,771,443**	1,860,608	1,760,829
Funds From Financings			
Common Stock Sold	**415,898**	536,299	373,458
Common Stock Issued for PGT Merger	**–**	143,159	–
Long-term Debt Issued	**1,085,131**	2,044,300	1,386,726
Funds Held by Trustee	**71,689**	(176,176)	(37,944)
Net Short-term Borrowings (Investments)	**(571,528)**	842,227	(269,299)
Total Funds From Financings	**1,001,190**	3,389,809	1,452,941
Funds From Changes in			
Accrued Taxes	**51,793**	20,186	(4,198)
Accounts Receivable	**(388,002)**	(20,534)	30,178
Accounts Payable	**44,776**	(77,442)	(50,792)
Other Working Capital (a)	**22,728**	(32,751)	(42,621)
Fuel Oil and Natural Gas Inventories	**35,183**	60,900	51,643
Other—Net	**305,172**	(54,308)	47,295
Conservation Loans to Customers	**11,333**	24,340	22,730
Total Other Funds	**82,983**	(79,609)	54,235
Total Funds Provided	**2,855,616**	5,170,808	3,268,005
Funds Used for Other Than Construction			
Preferred Stock Redeemed	**268,976**	243,242	7,500
Long-term Debt Matured or Redeemed	**317,359**	2,247,050	513,192
Long-term Debt Purchased for Sinking Fund	**72,205**	63,978	56,745
Dividends on Preferred and Common Stock	**849,865**	835,882	758,771
Customer Conservation Loans Funded	**21,000**	16,100	17,900
Total Funds Used for Other Than Construction	**1,529,405**	3,406,252	1,354,108
Construction Expenditures	**1,326,211**	1,764,556	1,913,897
Allowance for Equity Funds Used During Construction	**2,564**	69,164	247,367
Total Funds Used for Construction	**$1,328,775**	$1,833,720	$2,161,264

(a) Other Working Capital excludes changes in current portions of: long-term debt: 1987, ($12,694); 1986, ($10,359); 1985, ($148,123); conservation loans to customers: 1987, ($9,555); 1986, ($10,025); 1985, ($652); and capital lease obligations: 1987, ($12,018); 1986, $7,096; 1985, $23,145.

*Changed to conform to 1987 presentation.

The accompanying Notes to Consolidated Financial Statements are an integral part of this statement.

STATEMENT OF CONSOLIDATED COMMON STOCK EQUITY AND PREFERRED STOCK

Pacific Gas and Electric Company

	Common Stock	Additional Paid-in Capital	Reinvested Earnings	Common Stock Equity	Preferred Stock Without Mandatory Redemption Provision	Preferred Stock With Mandatory Redemption Provision
			In Thousands			
Balance, December 31, 1984	$1,584,542	$1,518,963	$2,340,041	$5,443,546	$1,427,451	$ 260,000
Net Income–1985			1,030,805	1,030,805		
Common Stock Sold (20,439,834 shares)	102,199	271,259		373,458		
Preferred Stock Redeemed (75,000 shares)						(7,500)
Cash Dividends Declared						
Preferred Stock			(164,342)	(164,342)		
Common Stock			(594,429)	(594,429)		
Foreign Currency Translation Adjustment			(1,563)	(1,563)		
Balance, December 31, 1985	1,686,741	1,790,222	2,610,512	6,087,475	1,427,451	252,500
Net Income–1986			1,081,223	1,081,223		
Common Stock Sold (23,519,364 shares)	117,597	418,702		536,299		
Common Stock Issued for PGT Merger (7,259,530 shares)	36,298	106,861		143,159		
Preferred Stock Redeemed (9,055,557 shares)		3,559		3,559	(219,586)	(27,215)
Cash Dividends Declared						
Preferred Stock			(156,190)	(156,190)		
Common Stock			(679,692)	(679,692)		
Foreign Currency Translation Adjustment			(105)	(105)		
Balance, December 31, 1986	1,840,636	2,319,344	2,855,748	7,015,728	1,207,865	225,285
Net Income–1987			**688,517**	**688,517**		
Common Stock Sold (20,181,371 shares)	**100,907**	**314,991**		**415,898**		
Preferred Stock Redeemed (8,209,650 shares)		**(22,681)**		**(22,681)**	**(197,670)**	**(30,285)**
Cash Dividends Declared						
Preferred Stock			**(120,992)**	**(120,992)**		
Common Stock			**(728,873)**	**(728,873)**		
Foreign Currency Translation Adjustment			**4,708**	**4,708**		
Balance, December 31, 1987	**$1,941,543**	**$2,611,654**	**$2,699,108**	**$7,252,305**	**$1,010,195**	**$ 195,000**

The accompanying Notes to Consolidated Financial Statements are an integral part of this statement.

Material Redacted

STATEMENT OF CONSOLIDATED CAPITALIZATION

Pacific Gas and Electric Company

December 31	1987		1986*	
	In Thousands (except percentages)			
Common Stock, Par Value $5 Per Share (authorized 800,000,000 shares, issued and outstanding at December 31, 1987: 388,308,547; 1986: 368,127,176)	**$ 1,941,543**		$ 1,840,636	
Additional Paid-in Capital	**2,611,654**		2,319,344	
Reinvested Earnings	**2,699,108**		2,855,748	
Common Stock Equity	**7,252,305**	**44%**	7,015,728	44%
Preferred Stock Without Mandatory Redemption Provision Par Value $25 Per Share (authorized 75,000,000 shares)				
Nonredeemable				
5% to 6%–5,785,000 shares outstanding	**144,621**		144,621	
Redeemable				
4.36% to 8.2%–13,534,000 shares outstanding	**338,373**		338,373	
9% to 10.46%–21,088,000 shares outstanding	**527,201**		527,201	
12.8% to 17.38%–7,907,000 shares outstanding at December 31, 1986	**—**		197,670	
	1,010,195		1,207,865	
Preferred Stock With Mandatory Redemption Provision Par Value $100 Per Share (authorized 10,000,000 shares) 9% to 14.75%–1,950,000 and 2,253,000 shares outstanding	**195,000**		225,285	
Total Preferred Stock	**1,205,195**	**7%**	1,433,150	9%
Pacific Gas and Electric Company				
First and Refunding Mortgage Bonds				
Maturity / **Interest Rates**				
1987–1992 3.375% to 15.375%	**151,292**		228,456	
1993–2016 4.25% to 8.125%	**1,632,527**		1,633,527	
1996–2020 8.2% to 8.875%	**1,709,984**		1,099,984	
1993–2020 9.0% to 10.0%	**1,893,750**		1,404,750	
1993–2022 10.125% to 14.0%	**1,444,195**		1,581,786	
Principal Amounts Outstanding	**6,831,748**		5,948,503	
Unamortized Discount Net of Premium	**(103,008)**		(91,859)	
Total Mortgage Bonds	**6,728,740**		5,856,644	
Unsecured Debentures, 5.25% to 12.0%, due 1994–2000	**223,650**		223,650	
Pollution Control Loan Agreements, variable rates, due 2008–2016	**925,000**		925,000	
Other Long-term Debt	**36,134**		40,263	
Total PG&E Long-term Debt	**7,913,524**		7,045,557	
Pacific Gas and Electric Finance Company N.V.				
Guaranteed Debentures, 12.0% to 15.5% due 1989–1991	**75,000**		180,000	
Pacific Gas Transmission Company Bank Term Loans	**51,991**		63,106	
Natural Gas Corporation of California Bank Term Loans	**29,370**		51,607	
Total Long-term Debt of PG&E and Subsidiaries	**8,069,885**	**49%**	7,340,270	47%
Less Long-term Debt – Current Portion				
PG&E	**42,760**		60,237	
Subsidiary Companies	**28,860**		24,077	
Total Long-term Debt – Current Portion	**71,620**		84,314	
Long-term Debt in Total Capitalization	**7,998,265**		7,255,956	
Total Capitalization	**$16,455,765**		$15,704,834	

*Changed to conform to 1987 presentation.

The accompanying Notes to Consolidated Financial Statements are an integral part of this statement.

SCHEDULE OF CONSOLIDATED SEGMENT INFORMATION

Pacific Gas and Electric Company

Years Ended December 31	Electric	Gas	Intersegment Eliminations	Total
		In Thousands		
1987				
Operating Revenues	$ 5,133,028	$ 2,052,673		$ 7,185,701
Intersegment Revenues (a)	7,724	631,981	$ (639,705)	—
Total Operating Revenues	5,140,752	2,684,654	(639,705)	7,185,701
Depreciation	674,135	201,073	—	875,208
Income Taxes (b)	444,607	158,405	—	603,012
Other Operating Expenses (b)	3,007,856	2,077,629	(639,705)	4,445,780
Total Operating Expenses	4,126,598	2,437,107	(639,705)	5,924,000
Operating Income	$ 1,014,154	$ 247,547	$ —	$ 1,261,701
Funds Used for Construction (c)	$ 948,080	$ 380,695		$ 1,328,775
Net Plant in Service and Construction Work in Progress (c)	$13,900,331	$ 2,169,952		$16,070,283
Other Identifiable Assets	$ 2,974,335	$ 1,595,127		4,569,462
Corporate Assets				1,093,907
Total Assets				$21,733,652
1986				
Operating Revenues	$ 5,567,438	$ 2,249,223		$ 7,816,661
Intersegment Revenues (a)	7,817	515,293	$ (523,110)	–
Total Operating Revenues	5,575,255	2,764,516	(523,110)	7,816,661
Depreciation	550,205	143,470	–	693,675
Income Taxes (b)	745,397	182,250	–	927,647
Other Operating Expenses (b)	2,910,313	2,154,511	(523,110)	4,541,714
Total Operating Expenses	4,205,915	2,480,231	(523,110)	6,163,036
Operating Income	$ 1,369,340	$ 284,285	$ –	$ 1,653,625
Funds Used for Construction (c)	$ 1,502,105	$ 331,615		$ 1,833,720
Net Plant in Service and Construction Work in Progress (c)	$13,689,094	$ 2,016,821		$15,705,915
Other Identifiable Assets	$ 2,607,302	$ 1,565,655		4,172,957
Corporate Assets				1,123,381
Total Assets				$21,002,253
1985				
Operating Revenues	$ 5,819,983	$ 2,610,998		$ 8,430,981
Intersegment Revenues (a)	8,190	1,351,806	$ (1,359,996)	–
Total Operating Revenues	5,828,173	3,962,804	(1,359,996)	8,430,981
Depreciation	399,825	135,829	–	535,654
Income Taxes (b)	463,415	189,254	–	652,669
Other Operating Expenses (b)	3,909,483	3,323,812	(1,359,996)	5,873,299
Total Operating Expenses	4,772,723	3,648,895	(1,359,996)	7,061,622
Operating Income	$ 1,055,450	$ 313,909	$ –	$ 1,369,359
Funds Used for Construction (c)	$ 1,784,784	$ 376,480		$ 2,161,264
Net Plant in Service and Construction Work in Progress (c)	$12,827,123	$ 1,875,483		$14,702,606
Other Identifiable Assets	$ 2,141,339	$ 1,514,890		3,656,229
Corporate Assets				739,168
Total Assets				$19,098,003

(a) Intersegment Electric and Gas Revenues are accounted for at tariff rates prescribed by the CPUC.
(b) Income Taxes and general corporate expenses are allocated in accordance with the FERC Uniform System of Accounts and requirements of the CPUC.
(c) Includes allocation of common utility plant.

The accompanying Notes to Consolidated Financial Statements are an integral part of this schedule.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pacific Gas and Electric Company

For the Years Ended December 31, 1987, 1986 and 1985

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Accounting Records

The accounting records of Pacific Gas and Electric Company (PG&E) are kept in accordance with the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) and adopted by the California Public Utilities Commission (CPUC).

Principles of Consolidation

The consolidated financial statements include PG&E and its wholly-owned and majority-owned subsidiaries (the Company). All significant intercompany transactions are eliminated.

Major subsidiaries are: Pacific Gas Transmission Company (PGT) - transports and sells natural gas outside California; Pacific Gas and Electric Finance Company N.V. (Finance), organized in Netherlands Antilles - borrows funds outside the U.S. and lends them to PG&E and subsidiaries; Alberta and Southern Gas Co. Ltd. (A&S) - buys gas in Canada and arranges transport to the U.S. border; NGC Energy Company (Energy) - performs oil and gas exploration and production; Pacific Conservation Services Company (PCSC) - made loans to PG&E residential customers for conservation and weatherization.

Alberta Natural Gas Company Ltd (ANG), PGT's largest subsidiary, owns and operates a pipeline in Canada, which transports natural gas for A&S to the U.S. border, and a plant which removes hydrocarbons from the gas stream. ANG owns 100% of ANGUS Chemical Company (ANGUS) which produces and sells nitroparaffins. ANGUS has facilities in the U.S. and Europe.

The investment in ANG, a less than 50%-owned subsidiary, is accounted for in accordance with the equity method of accounting.

Revenues

Revenues include billings to customers, accrued unbilled revenues and changes in regulatory balancing accounts.

Before January 1, 1987, revenues were recognized when customers were billed on a cycle basis. Beginning in 1987, the Company began accruing revenues for service provided but unbilled at the end of each month to match revenues and expenses more closely. If this accounting method had been used in prior years, consolidated net income before the cumulative effect of the change for the periods prior to January 1, 1987, would not have been materially different.

By CPUC order, the Company has established balancing accounts for electric energy costs, sales and major plant additions, and gas costs and sales. Operating revenues include changes in these accounts for amounts authorized by the CPUC to be deferred for future recovery from or repayment to customers. These accounts kept changes in sales, cost of sales of electricity and gas, and regulatory lag related to returns on major plant additions from affecting the Company's earnings significantly.

On March 31, 1987, the Company changed its recording of operating revenues relating to Diablo Canyon, retroactive to January 1, 1987, essentially to reflect only the cash amounts actually received through interim rates approved by the CPUC. The Company took this action as a result of a number of factors, including uncertainty about the level of interim rate recovery and the length of time until the ultimate resolution of the Diablo Canyon rate proceedings.

Utility Plant

The costs of additions to plant, including replacements of property retired, are capitalized. Until an addition is placed in service, its costs - including labor, material and similar items and indirect charges for such items as engineering, supervision, and transportation - are accumulated in construction work in progress. Such costs also include AFUDC at rates conforming to FERC requirements. AFUDC is the cost of financing the construction of new facilities. Costs of depreciable plant retired are eliminated from plant in service accounts, and such costs plus removal expenses less salvage are charged to accumulated depreciation. Costs of repairing property and replacing minor items of property are included in maintenance expense in the consolidated income statement.

Depreciation

Depreciation of plant in service is computed for financial statement purposes on a straight-line basis based on the remaining estimated useful life of the related asset. For federal income tax purposes, the Company generally uses the most liberal depreciation methods allowed by the Internal Revenue Code.

Income Taxes

PG&E files a consolidated federal income tax return with those subsidiaries in which its ownership is 80% or more. For financial reporting purposes, income taxes are allocated to PG&E and its subsidiaries on a separate tax return basis.

Income tax expense includes the current income tax liability resulting from operations during the year, plus deferred income taxes on most of the major timing differences between financial statement and income tax reporting, to the extent permitted for ratemaking purposes. These timing differences are shown in the deferred tax section of Note 8 to the consolidated financial statements.

Although the tax effects of most major timing differences are deferred, the tax effects of certain differences are recorded currently. These timing differences, for which flow-through accounting is utilized, include certain capitalized overheads, percentage repair allowances, excess depreciation for state tax purposes, and removal costs and federal tax depreciation on property acquired prior to 1981.

Prior to 1982, when the CPUC authorized that certain deferred income taxes be included in the determination of utility rates, PG&E used flow-through accounting for most timing differences. Consequently, timing differences exist for which PG&E has not provided deferred income taxes. The cumulative net amount of the timing differences for

Material Redacted

which deferred income taxes have not been provided at December 31, 1987 is approximately $2.5 billion for federal purposes and $3.1 billion for state purposes, the tax effects of which are expected to be recovered through rates in the future.

Debt, Premium, Discount, and Related Expenses

Long-term debt premium or discount and related expenses are amortized over the lives of each debt issue. The gain or loss on reacquired mortgage bonds is amortized over the remaining life of each reacquired bond, consistent with ratemaking.

Gas Exploration Costs

Under the regulated gas exploration program, the majority of gas exploration costs before 1987 were capitalized under a modified "full-cost" method of accounting, as authorized by the CPUC. Unsuccessful project costs, current operating costs, and the financing costs of regulated gas exploration were recovered through balancing accounts and therefore did not affect the Company's income. The CPUC terminated regulated gas exploration in 1985, but liquidation costs are being recovered through the existing balancing accounts over a 60-month period effective September 1987. The successful efforts method of accounting is used to determine the profits and losses on the continuing unregulated oil and gas exploration, development and production program.

Workers' Compensation and Disability Claims

Workers' compensation and disability claims are recorded in noncurrent liabilities in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation.* The corresponding amount to be recovered through future rates is shown as a deferred charge.

Nonearning Assets

Certain project costs are being amortized over a period set by the CPUC while other project costs are pending regulatory action. These costs are not in rate base and, therefore, are not earning a return on PG&E's investment. These projects are discussed further in Note 10 to the consolidated financial statements.

Inventories

Inventories are valued at average cost except for low sulfur fuel oil, which constitutes the major portion of the fuel oil inventory. Effective January 1, 1987, the Company reduced the carrying value of its low sulfur fuel oil inventory from average cost to then current market value. The reduction is being amortized and recovered through rates, as approved by the CPUC, over twenty-four months beginning in January 1987. PG&E also changed its method of valuing low sulfur fuel oil to a last-in, first-out (LIFO) cost, effective January 1987. Fuel oil other than low sulfur fuel oil is carried at average cost.

NOTE 2: PREFERRED STOCK

The nonredeemable Preferred Stock Without Mandatory Redemption Provision (issued at $25 par) consists of a 5%, a 5.5%, and a 6% series, which have rights to annual dividends per share of $1.25, $1.375, and $1.50, respectively.

The redeemable Preferred Stock Without Mandatory Redemption Provision (issued at $25 par) is subject to redemption, in whole or in part, if the Company pays the redemption price plus accumulated and unpaid dividends to the redemption date. The redemption premium per share declines in accordance with terms of the specific issue. Per share information is as follows:

Series	Annual Dividend	Redemption Price
4.36% to 8.2%	$1.09 to $2.05	$25.75 to $28.75
9% to 10.46%	$2.25 to $2.615	$25.85 to $29.25

The Preferred Stock With Mandatory Redemption Provision (issued at $100 par) consists of a 9% and a 10.17% series, each of which is entitled to a sinking fund providing for the retirement of stock outstanding at $100 per share plus accumulated and unpaid dividends. The total redemption cost, excluding any accumulated and unpaid dividends, for 1988 is $7.5 million, and for each of the years 1989 through 1992, is $12.6 million.

In addition to the sinking fund retirements, the 9% series, and after August 14, 1993, the 10.17% series, may be redeemed at PG&E's option for $100 per share plus accumulated and unpaid dividends and a redemption premium. At December 31, 1987, the redemption premium for the 9% series was $6.00 per share.

During 1987, PG&E redeemed for $269 million a portion of its preferred stock having a par value of $228 million at a net loss of $29.5 million. The series redeemed ranged from 9% to 17.38%. In 1986, PG&E redeemed preferred stock at a gain of $11.2 million. These net gains and losses realized from reacquiring the preferred stock include adjustments for premiums and issuance costs. The gains and losses are recorded in deferred charges and will be amortized consistent with ratemaking.

Preferred stock dividends are cumulative. All shares of preferred stock have equal preference in dividend and liquidation rights; however, different classes and series of stock have different dividend and liquidation payments. Upon liquidation or dissolution of PG&E, holders of the preferred stock would receive the par value of such shares plus all accumulated and unpaid dividends.

NOTE 3: LONG-TERM DEBT

Mortgage Bonds

The First and Refunding Mortgage Bonds of PG&E are issued in series, bear annual interest from 3.375% to 14.0% and mature from February 15, 1988 to August 1, 2020. Additional bonds may be issued up to a maximum total outstanding of $8 billion, assuming compliance with indenture convenants for earnings coverage and property available as security. The indenture requires that net earnings not including depreciation and interest be at least equal to 1.75 times the annual interest

charges on PG&E's mortgage bonds outstanding. The Board of Directors of PG&E may increase the amount authorized, subject to CPUC approval. All real properties and substantially all personal properties are subject to the lien of the indenture. Stock representing PG&E's investments in subsidiaries is pledged as collateral for PG&E bonds.

PG&E is required by the indenture to make semi-annual sinking fund payments on February 1 and August 1 of each year for the retirement of the bonds. The payments equal 1/2 of 1% of the aggregate bonded indebtedness outstanding on the preceding November 30 and May 31, respectively. Bonds of any series may be used to satisfy this requirement. In addition, holders of Series 84D Bonds maturing on November 1, 2017 have an option to redeem their bonds on June 1, 1995.

During 1987, PG&E issued $750 million in First and Refunding Mortgage Bonds, Series 87A through 87C with interest rates ranging from 8.5% to 10.0% and with maturity dates from February 1, 2020 to August 1, 2020. Proceeds from these bonds were applied to construction expenditures and to the redemption, repayment or retirement of indebtedness or preferred stock outstanding. Of the $750 million of bonds issued, $253.9 million of proceeds was used to redeem 8.1 million shares of Redeemable Preferred Stock ranging from 12.8% to 17.38% with a par value of $213 million. A total of $139 million of bonds outstanding with interest rates ranging from 12.375% to 15.375% was redeemed at a loss of $9.3 million, which will be amortized over the remaining life of the bonds redeemed.

Debentures and Unsecured Debt

PG&E has loans from an agency of the State of California to finance air and water pollution control, and sewage and solid waste disposal facilities. In December 1987, PG&E borrowed $265 million at 8.875% and $50 million at 8.75% to mature on January 1, 2010 and January 1, 2007, respectively, to finance new facilities. In June 1987, PG&E borrowed $45 million at 8.2% to mature on December 1, 2018 to redeem previously issued bonds. The above loans are secured by PG&E's First and Refunding Mortgage Bonds. PG&E has additional loans with the agency totaling $925 million with annual average interest rates ranging from 4.4% to 4.6% during 1987 and maturities from November 1, 2008 to December 1, 2016. Interest rates on the $925 million in loans are variable and may float on a daily, weekly or term basis or may be converted to a fixed rate at PG&E's option. Such loans are subject to redemption by the holder on demand under certain circumstances. The Company's obligations for such demands are secured by irrevocable letters of credit terminating in 1993 and 1994, unless extended.

PG&E issued 5.25% Debentures in 1985 for 150 million Swiss francs due November 1, 1995. As with the 7.0% Debentures described below, the Company has a foreign currency exchange agreement. This results in an effective interest rate of 10.81% and a PG&E liability of $67.4 million.

PG&E issued $75 million in debentures at 12.0% in 1985, maturing January 9, 2000. These debentures may be redeemed at PG&E's option at any time on or after January 9, 1997 and at the holder's option on January 9, 1992.

In 1984, PG&E issued 7.0% Debentures for 20 billion yen due September 12, 1994. To protect the Company from future fluctuations in the exchange rate, principal and interest payments due in yen are covered by a currency exchange agreement that secures the exchange rate over the term of the debentures resulting in an effective interest rate of approximately 12.0%. The transaction results in a PG&E liability of $81.25 million.

Long-term Debt of Subsidiaries

Finance's $75 million of Guaranteed Debentures due October 15, 1991 are unsecured and unsubordinated, do not have sinking fund requirements and are unconditionally guaranteed by PG&E. The debentures may be redeemed at Finance's option at specific times and prices. During 1987, debentures for $45 million and $60 million with interest rates of 15.5% and 14.75% and due dates of 1989 and 1990, respectively, were redeemed.

PGT's bank term loans are to be repaid in five annual payments through 1992. The effective interest rate on the amount outstanding at December 31, 1987 was 8.66%. This interest rate is subject to redetermination under the credit agreement.

NGC has a term loan requiring repayment in equal quarterly installments through May 1, 1990. The loan is secured by pipe and tubular goods held in inventory. The interest rate on the loan is based on the prime interest rate or the certificate of deposit rate at the option of NGC. At December 31, 1987, $12.5 million is outstanding at an effective interest rate of 9.25%.

NGC also has a term loan requiring quarterly payments of $.8 million until December 31, 1989, plus a payment of $1 million on December 31, 1989. In November 1987, this loan was increased by $9.6 million to repay the remaining balance on the $20.6 million loan mentioned below. The additional $9.6 million is due on February 1, 1988. The loan is secured by a negative pledge on certain producing properties. The interest rate on the loan is based on the prime interest rate. At December 31, 1987, $16.9 million is outstanding at an effective interest rate of 9.25%.

During 1987, NGC repaid a note for $20.6 million with a fixed interest rate of 14.82% and secured by certain gas properties.

Repayment Schedule

For the years 1988 through 1992, the Company's combined aggregate amount of debt maturing and sinking fund requirements, as of December 31, 1987 are $71.6 million, $112.8 million, $116.3 million, $205.7 million, and $104.4 million, respectively.

NOTE 4: SHORT-TERM BORROWINGS

PG&E has credit facilities with 24 banks to support the sale of commercial paper and for other corporate purposes. These credit facilities are renewed annually for a three-year period and total $640 million, all of which was available on December 31, 1987. The facilities require compliance with certain covenants, the most restrictive of which require that the Company maintain a positive balance in its reinvested earnings account. PG&E made no borrowings against these facilities,

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but for a brief period during the year, the Company borrowed directly from one of these banks using a separate money market facility. The usual maturity for commercial paper is 10 to 90 days.

A&S maintains a $35 million (Canadian) line of credit with a bank to support the sale of commercial paper for take-or-pay payments on gas contracts. PG&E has executed guarantees not to exceed $350 million on commercial paper and a bank line of credit. (See Note 9 to the consolidated financial statements.) A&S also maintains lines of credit with four banks totaling $25 million (Canadian) for operations. As of December 31, 1987, A&S had no significant borrowings outstanding against either of these lines of credit.

PGT redeemed all commercial paper outstanding and cancelled all lines of credit as of December 3, 1987.

PG&E also has an agreement with Pacific Energy Trust (PET) which permits borrowing of an amount up to the difference between $400 million and PET's investment in nuclear fuel with a maximum of $160 million. PG&E had no borrowings outstanding under this agreement.

The Company pays fees to the banks for credit facilities and other banking services.

Short-term borrowings and their interest rates were as follows:

December 31	1987	1986
	In Thousands (except percentages)	
Balance of Short-term Borrowings		
Commercial Paper	**$554,023**	$1,098,212
Other	**$ 1**	$ 3,001
Weighted Average Interest Rate		
Commercial Paper	**8.3%**	7.0%
Other	**9.8%**	8.5%

NOTE 5: CUSTOMER CONSERVATION LOAN PROGRAM

Pursuant to a CPUC decision, the Company terminated its Zero Interest Program (ZIP) offering loans to residential customers on December 31, 1986. These interest-free loans financed the installation of several conservation measures and require repayment over a specified time, not exceeding 100 months.

Pacific Conservation Services Company (PCSC) was formed as a wholly-owned subsidiary to assume responsibility for the customer conservation loan program. Although the ZIP has ended, operating and debt service expenses continue to be incurred and are recovered through the Conservation Financing Adjustment (CFA) tariffs. PCSC has contracted with PG&E to administer the loans.

These loans were funded by a revolving line of credit with ten banks. The line of credit ended on June 30, 1987, and the remaining balance was converted to a term loan with a final maturity of December 31, 1994. Interest is based on PCSC's choice of a floating rate determined in accordance with the agreement or a fixed rate based on average certificate of deposit or Eurodollar rates. The agreement has various covenants and conditions, including the continuing existence of the CFA tariffs. On December 31, 1987, the balance outstanding is $59.3 million at an average interest rate of 9.0%.

NOTE 6: LEASES

Nuclear Fuel

PG&E leases nuclear fuel from PET for use at the Diablo Canyon Nuclear Power Plant (Diablo Canyon). Two capital leases, with substantially the same terms, were entered into with PET in 1981 and 1984 to meet Diablo Canyon's fuel requirements. The first lease expires in 2030 and the second in 1989.

PET's total investment in nuclear fuel is limited to $600 million. (See Note 4 for short-term borrowing information related to PET.) If the nuclear fuel leases are terminated, PG&E must reimburse PET for all costs of nuclear fuel ownership.

Under these leases, PG&E owns the spent nuclear fuel. PG&E has a contract with the United States Department of Energy for its disposal.

The lease payments are based on the cost of the nuclear fuel burned plus the daily finance charges on PET's in-core net investment during the period. The daily finance charges on the in-core fuel are paid even when Diablo Canyon is not producing electric energy.

During pre-commercial operation, lease payments were capitalized as part of the cost of the plant. After commercial operation, lease payments and spent nuclear fuel disposal costs are charged to nuclear fuel expense and recovered through balancing accounts. Diablo Canyon Units 1 and 2 went into commercial operation in May 1985 and March 1986, respectively. The nuclear fuel lease payments capitalized and nuclear fuel lease expenses for Units 1 and 2 were as follows:

	1987	1986	1985
		In Thousands	
Nuclear Fuel Lease Payments Capitalized	**$ -**	$ 5,308	$16,591
Interest Portion of Payments	**$ -**	$ 1,918	$ 5,581
Nuclear Fuel Lease Expense	**$110,130**	$95,481	$42,797
Interest Portion of Expense	**$ 11,027**	$ 9,584	$ 5,311

These leases have been recorded on the consolidated balance sheet as an asset in the line item, Nuclear Fuel and Other Capital Leases. The related noncurrent obligation has been recorded in Capital Lease Obligations in the Noncurrent Liabilities section. The asset balances were as follows:

December 31	1987	1986
	In Thousands	
Nuclear Fuel	**$ 536,355**	$ 521,543
Accumulated Amortization	**(166,423)**	(103,718)
Net	**$ 369,932**	$ 417,825

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pacific Gas and Electric Company

Other Leases

The Company has various arrangements to lease real property and equipment. The leases are accounted for as operating and capital leases in accordance with SFAS Nos. 13 and 71. Annual lease expenses are not material.

NOTE 7: RETIREMENT PLAN AND POST RETIREMENT BENEFITS

Retirement Plan

The Company provides a defined benefit retirement plan covering substantially all employees. The retirement benefits are based on years of service and the employee's base salary. The Company's funding policy is to contribute each year no more than the maximum amount that can be deducted for federal income tax purposes and not less than the minimum required contribution under the Employee Retirement Income Security Act of 1974. The cost of this plan charged to expense and utility plant was $188 million ($87 million of which was the cost of the early retirement plan), $107 million and $97 million in 1987, 1986 and 1985, respectively. In 1986 and 1985, these amounts include amortization of past service cost.

The 1986 actuarial present value of accumulated plan benefits, using a discount rate of 7.0%, was $1,645 million ($1,574 million vested). The net assets available for benefits were $1,867 million, based upon market value as of January 1, 1986. Actuarial present values were based on historic pay.

Effective January 1, 1987, the Company adopted SFAS No. 87, *Employers' Accounting for Pensions.* The statement requires use of the projected unit credit actuarial method for the calculation of pension expense. The projected benefit obligation as of January 1, 1987 was determined using a weighted-average discount rate of 7.5%, weighted-average expected long-term rate of return on plan assets of 8.0% and a rate of increase in future compensation levels of 6.5%. In prior years, the Company used the entry age normal actuarial method. The adoption of this statement had no significant impact on earnings. Pension expense for prior years was not restated.

The following table sets forth the plan's funded status:

December 31	1987
	In Thousands
Actuarial present value of accumulated plan benefits	
Vested	$1,581,618
Nonvested	65,901
Total actuarial present value of accumulated plan benefits	1,647,519
Effect of projected future salary increases	738,732
Actuarial present value of projected benefit obligation for service rendered to date	2,386,251
Plan assets at fair value – primarily listed common stocks, U.S. government and agency securities, and real estate	2,205,153
Projected benefit obligation in excess of plan assets	181,098
Unrecognized net gain from past experience different from that assumed and effects of changes in assumptions	84,802
Unrecognized net obligation	(197,661)
Net pension liability	$ 68,239

Net pension cost included the following:

	1987
	In Thousands
Service cost – benefits earned during the period	$ 92,812
Interest cost on projected benefit obligation	184,774
Actual return on plan assets	(89,046)
Net amortization and deferral	(87,235)
Net periodic pension cost	101,305
Cost of early retirement benefits	87,052
Total pension cost	$188,357

As of December 31, 1987, the weighted-average discount rate and rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation were 8.5% and 7.5%, respectively.

Beginning January 1, 1988, pension benefits for management employees are based on final average pay. This change in the pension benefit formula did not affect the Company's compliance with the requirements of SFAS No. 87. With respect to nonmanagement employees, the Company historically has amended the retirement plan every two to three years so that pension benefits are based on the most current salaries. Subject to collective bargaining, the Company intends to continue amending the plan in the future so that pension benefits will be based upon the most current salary levels. Thus, future amendments to the plan for nonmanagement employees have been anticipated and are reflected in the projected benefit obligation and pension expense.

Early Retirement Plan

In January 1987, PG&E offered an early retirement plan to certain employees who had reached age 50 and had at least 15 years of service with PG&E. The present value of the expense of the early retirement plan in 1987 was $87 million, which will be funded over the next ten years. The $87 million is included in total pension cost.

Life Insurance

Life insurance benefits for substantially all retired employees are provided by the Company. The Group Life Insurance benefit is available to all retirees. This benefit is provided through an insurance company whose premiums are based on total claims paid in the prior year. The Post Retirement Life Insurance Plan, which is available to certain management employees, uses the same actuarial methods and assumptions as the funding for the Retirement Plan. The annual contribution is the normal cost plus the amortization of the unfunded actuarial liability. The cost of providing both the Group Life and the Post Retirement Life benefits is charged to expense and utility plant and totaled $2.2 million, $2.3 million and $3.8 million for 1987, 1986 and 1985, respectively.

Medical Benefits

The Company also provides certain medical benefits for substantially all retired employees. The benefits are provided or administered by medical care providers whose costs are based on benefits paid during each year. The cost of providing these benefits for retirees cannot be separated from the cost for active employees. The medical costs and the number of retired and active employees are as follows:

	1987	1986	1985
Medical Costs	**$87,000,000**	$80,000,000	$61,000,000
Retired Employees	**8,400**	7,300	7,000
Active Employees	**28,900**	30,700	30,200

NOTE 8: INCOME TAXES

Income before tax expense for the years 1987, 1986 and 1985 was $1,320,991,000, $2,033,141,000 and $1,643,914,000, respectively.

Income tax expense is included in the consolidated financial statements as follows:

	1987	1986	1985
		In Thousands	
Included in operating expenses	**$603,012**	$927,647	$652,669
Included in other income-net	**(47,583)**	24,271	(39,560)
Included in accounting change	**77,045**	–	–
Total Income Tax Expense	**$632,474**	$951,918	$613,109

The detail of income tax expense is:

	1987	1986*	1985*
		In Thousands	
Current Taxes			
Federal	**$313,144**	$132,444	$113,867
State and other	**111,835**	75,268	84,909
Total Current Taxes	**424,979**	207,712	198,776
Deferred Taxes			
Federal			
Changes in regulatory balancing accounts	**80,077**	289,759	50,905
Depreciation	**202,880**	259,782	227,756
Loss on reacquired debt	**(1,545)**	134,089	14,135
Fuel oil inventory	**(30,982)**	–	–
Contributions in aid of construction	**(30,379)**	–	–
Capitalized interest	**(31,247)**	–	–
Unbilled revenues	**31,611**	–	–
Early retirement incentive	**(30,079)**	–	–
Other-net	**(21,044)**	(36,976)	(12,366)
State	**3,540**	82,911	28,580
Total Deferred Taxes	**172,832**	729,565	309,010
Investment tax credits-net	**34,663**	14,641	105,323
Total Income Tax Expense	**$632,474**	$951,918	$613,109

*Changed to conform to 1987 presentation.

The reasons for the difference between the statutory federal income tax rate and the Company's effective tax rate are as follows:

	1987	1986*	1985*
Federal income tax rate	**40.0%**	46.0%	46.0%
Increases (reductions) from:			
Allowance for equity and borrowed funds used during construction	**(.1)**	(2.5)	(9.5)
Investment tax credits	**(2.1)**	(2.8)	(2.3)
State income tax (net of federal benefit)	**5.3**	4.2	3.7
Financial statement depreciation in excess of tax depreciation	**9.2**	6.0	4.8
Adjust prior years	**(2.8)**	–	(2.6)
Other-net	**(1.6)**	(4.1)	(2.8)
Effective tax rate	**47.9%**	46.8%	37.3%

*Changed to conform to 1987 presentation.

In December 1987, the Financial Accounting Standards Board (FASB) issued SFAS No. 96, *Accounting for Income Taxes*, which establishes new financial accounting and reporting standards for the effects of income taxes on the Company's activities.

The Company currently is evaluating the accounting, regulatory and financial implications of SFAS No. 96, which must be adopted by 1989. It is estimated that the adoption will require that both the assets and liabilities on the consolidated balance sheet be increased equally by two to three billion dollars. The impact, if any, on the consolidated income statement cannot be determined at this time.

NOTE 9: COMMITMENTS

Funds Used for Construction

Funds to be used for utility construction during 1988, including AFUDC, are estimated at $1.4 billion.

Natural Gas Take-or-Pay Payments

The Company's gas purchasing subsidiary has contracted to make take-or-pay payments to Canadian natural gas producers if it does not take certain quantities of natural gas during a contract year. The contracts permit make-up of the prepaid gas and provide for reimbursement of take-or-pay payments if make-up of the gas prior to the expiration of the contracts is not possible. Total advances by A&S to producers as of December 31, 1987 are $333 million. Advances unreimbursed by A&S's gas customers are financed by short-term borrowings. PG&E has executed guarantees to assume liabilities not to exceed $350 million on commercial paper and a standby bank line of credit for A&S to cover take-or-pay borrowings.

During 1981 and 1982, A&S negotiated a reduction in take-or-pay liabilities under its contracts through June 30, 1984 with Canadian gas producers. For the contract years beginning on July 1, 1984 and thereafter, A&S has negotiated additional take-or-pay reductions. Most

of the producers have signed the amended contracts. Negotiations with a few remaining producers are continuing. Additional payments under any contracts not amended would result in additional Advances to Gas Producers. Such additional amounts could aggregate approximately $99 million through the contract year ended June 30, 1987, none of which was recorded as of December 31, 1987.

Stock Option Plan

In 1986, the Company's Board of Directors and the shareholders approved a Stock Option Plan (the Plan) granting nonqualified stock options with associated stock appreciation rights (SARs) and dividend equivalents to key management employees of the Company.

A total of 1.5 million shares of the Company's $5 par value common stock has been authorized for award under the Plan. Common stock may be obtained from either authorized but unissued shares or from shares that have been purchased on the open market by PG&E. Costs associated with awards will not be recoverable in rates.

During 1987, 40 employees were granted stock options on 91,500 shares under the Plan with an option price of $26.625, the market value on the date of grant. The options may be exercised during a period of up to ten years and one day, and vesting of the right to exercise the option is as follows: (a) up to one-third may be exercised in the second year following the year the options are granted; (b) up to two-thirds may be exercised in the third year following the year the options are granted and (c) all the options may be exercised in the fourth year following the year the options are granted. Options also become vested and exercisable upon retirement or death.

As of December 31, 1987, stock options on 14,900 shares were vested. No options or SARs have been exercised. Dividend equivalents accrued as of December 31, 1987 are not material.

In January 1988, 36 employees were granted stock options on 85,150 shares under the Plan with an option price of $16.75, the market value on the date of grant.

Western Area Power Administration Energy Agreement

The Company has an agreement with the United States Western Area Power Administration (WAPA) to purchase energy from WAPA and resell the energy to WAPA upon WAPA's request. Energy purchased prior to 1967 must be resold to WAPA at a fixed contract price that is substantially below the Company's current cost of production. Since 1967, the energy under contract has been purchased by the Company from WAPA at favorable prices based on WAPA's cost of generation. That energy must be sold back to WAPA at a price equal to the Company's current thermal production cost at the time of delivery to WAPA less the Company's savings that resulted from the purchases at the lower WAPA prices.

The contract will expire on January 1, 2005. As of December 31, 1987, the Company's total cost to return the amount of energy currently available to WAPA is approximately $518 million, assuming WAPA requests the return of all the energy prior to the contract's expiration date, which the Company believes is highly unlikely. Most of that cost, however, is a return of the benefits the Company received through its purchases from WAPA since 1967 (due to the pricing mechanism described above), which were passed on to ratepayers at that time. The total cost of the energy resold to WAPA would be included in the Energy Cost Adjustment Clause (ECAC) balancing account and is expected to be recovered from ratepayers.

Merger of Pacific Gas Transmission Company

In 1986, the Company issued 7,259,530 shares of its common stock valued at $143 million to increase to 100% its ownership of Pacific Gas Transmission Company. This amount includes goodwill of $39 million which is being amortized over 8 years on a straight-line basis. As of December 31, 1987, $9.1 million has been amortized.

Qualifying Facilities

Under the Public Utility Regulatory Policy Act of 1978 (PURPA), the Company is required to purchase energy and capacity produced by Qualifying Facilities (QFs). The CPUC established a series of contracts which set the applicable terms, conditions, and price options.

Under the contracts, sellers receive payments for the energy delivered at a calculated rate equal to the Company's own marginal costs for constructing new facilities or purchasing power, or at forecasted rates negotiated in the individual contract. The total cost of the QF purchase payments are included in the ECAC balancing account and are recoverable from ratepayers.

Approximately $360 million was paid to QFs for 6,718 million kwh of energy and associated capacity in 1987.

NOTE 10: CONTINGENCIES

Diablo Canyon Nuclear Power Plant

The Diablo Canyon Nuclear Power Plant (Diablo Canyon) consists of two units, each providing approximately 1.1 million kilowatts of capacity to the Company's electric system. Diablo Canyon experienced significant delays and substantial cost increases during its construction period, which began in 1968. The units began commercial operation in May 1985 and March 1986, respectively.

The construction costs for Diablo Canyon, including additional capital costs incurred during the twelve months following commercial operation, are approximately $5.8 billion. This amount, net of accumulated depreciation, represented approximately 25% of the Company's total assets and 35% of net Plant in Service as of December 31, 1987. Under traditional ratemaking principles, all investment in new facilities such as Diablo Canyon is subject to review by the CPUC to determine whether such costs were incurred reasonably and will be allowed recovery in rates. The Company has filed with the CPUC for recovery of the costs of owning and operating Diablo Canyon. Under the current schedule, final rate recovery probably will not be authorized until 1989, after reasonableness hearings are completed.

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Pending the final outcome of this proceeding, the CPUC has granted PG&E interim rate recovery for Unit 1, subject to refund, to cover a portion of operation and maintenance expenses and an amount equal to the projected fuel costs saved. The CPUC also has approved a stipulation for Unit 2 to allow the Company to collect revenues equal to the projected fuel costs saved. The Company is collecting these interim revenues, subject to refund, to recover a portion of the revenue requirement for Diablo Canyon. In March 1987, the Company changed its recording of operating revenues relating to Diablo Canyon, retroactive to January 1, 1987, essentially to reflect only the cash amounts actually received through interim rates approved by the CPUC. Diablo Canyon revenues and interest, which are subject to possible future adjustment and refund are as follows:

	1987	1986*	1985*
		In Millions	
Revenue Requirement			
–for operating expenses	**$ 415.7**	$ 367.7	$125.0
–for interest	**218.3**	192.9	72.0
–for equity return and related taxes	**587.9**	639.1	232.4
Total Revenue Requirement	**$1,221.9**	$1,199.7	$429.4
Interest Income on Receivable	**87.6**	31.3	3.3
Less Amount Recognized	**504.8**	1,231.0	432.7
Total Deferred	**$ 804.7**	$ –	$ –

*Changed to conform to 1987 presentation.

The Company is collecting approximately $505 million annually (excluding $53.2 million in decommissioning costs), subject to refund or adjustment. The Company had requested interim rate relief of $800 million annually for Diablo Canyon. In October 1987, the CPUC denied any additional interim rate relief. Further interim rate recovery would have mitigated the impact on earnings which resulted from the change in recording revenues. PG&E was authorized to implement target capacity factor ranges of 55% to 75% for Unit 1 and Unit 2. The shareholders and ratepayers will share a portion of any fuel savings if the units exceed the 75% capacity factor and a portion of the additional fuel costs if the units fall below the 55% capacity factor. Within the performance range of 55% to 75%, no savings or penalty will result. While applicable to each fuel cycle, the target capacity factor will be based on a capacity factor for a three-fuel-cycle period (approximately 15 months per fuel cycle), currently expected to begin in 1988.

The California Supreme Court is reviewing the CPUC's interim decision that allowed the Company to retain an amount equal to the estimated net fuel cost savings of approximately $334.2 million annually resulting from the operation of Unit 1 and to increase electric rates by $53.8 million annually to recover the operation and maintenance expenses for Unit 1. If the decision is reversed and the Company is required to refund a portion of this revenue, earnings in the year of the disallowance could be reduced. A Supreme Court decision is expected in the future.

In May 1987, the CPUC's Division of Ratepayer Advocates (DRA), formerly called the Public Staff Division, released its report to the CPUC in which it recommended that the Company recover only $1.15 billion of the $5.5 billion cost of Diablo Canyon at the date of commercial operation and that $4.4 billion of the plant costs be disallowed. The DRA contended, among other things, that (i) the Company did not conduct adequate geoseismic studies which would have disclosed the existence of the Hosgri earthquake fault at the time of initial design of Diablo Canyon, (ii) from 1972 through 1976, the Company failed to conduct studies to evaluate fully the Hosgri fault's significance and to redesign the plant to withstand the earthquake potential of the Hosgri fault until ordered to do so by the Nuclear Regulatory Commission (NRC) in 1976, and (iii) the Company's quality assurance program was not adequate to prevent a series of major design errors in the plant, including the "mirror image" problem, which resulted in the suspension of the plant's low-power operating license in 1981. The DRA concluded that, as a result, operation of Diablo Canyon was delayed beyond 1976 unreasonably and recommended that substantially all costs incurred after 1976 (except approximately $360 million for certain plant upgrades required by the NRC) be disallowed.

The DRA is a consumer advocacy branch of the CPUC staff and its recommendation is not a CPUC decision. The CPUC can accept all, part or none of the DRA's recommendation. The Company strongly disagrees with the DRA's contentions and will pursue vigorously recovery of the cost of the Diablo Canyon plant during public hearings before the CPUC currently scheduled through early 1989.

In 1986, following a recommendation by the administrative law judge (ALJ) of no disallowance, the CPUC disallowed $345 million of the $4.5 billion cost of the San Onofre Nuclear Generating Station Units 2 and 3 owned by southern California utilities. In its decision, the CPUC used a "critical path method" to evaluate the reasonableness of the plant's costs and disallowed expenses associated with unreasonable delays. In July 1987, the CPUC reduced the disallowance to $265 million.

In December 1987, the CPUC ruled on three motions filed by the California Attorney General (AG) in the Diablo Canyon reasonableness review. The CPUC agreed to exclude evidence on the financial impact of a disallowance from the reasonableness phase. The CPUC supported essentially the same high standard of care adopted in the San Onofre Nuclear Generating Station case. The CPUC also denied the AG's motion to disallow the costs incurred during the suspension of the plant's low-power operating license from 1981 to 1984, estimated by the DRA to exceed $2.5 billion. The CPUC concluded that noncompliance with the NRC's regulations does not necessarily establish that any of the costs were unreasonable for ratemaking purposes, but has allowed the parties to file briefs on the issue.

As of December 31, 1987, $804.7 million has been excluded from revenues and interest income. As a result of this exclusion, a disallowance of the Diablo Canyon plant costs on December 31, 1987 of approximately $500 million would have had no effect on net income

assuming that the AFUDC disallowed was in the same proportion as the AFUDC in the plant and that the disallowance would have applied equally to the two units. AFUDC is the cost of financing the construction of new facilities. Because AFUDC was recorded net of income taxes, there would be no additional tax benefit if AFUDC is disallowed. As of December 31, 1987, AFUDC represented 35% of total Diablo Canyon plant costs. Using the same assumptions, if the disallowance were to exceed $500 million, there would be a one-time reduction in net income, which would reflect a reduction of the plant costs and the related balancing account revenues already recognized.

In view of the foregoing, it appears reasonable to expect that the CPUC will disallow some portion of the Diablo Canyon costs and the related balancing account revenues. Because Diablo Canyon represents such a large portion of the Company's assets, if a disallowance of costs is significant, it could have a significant adverse impact on the Company's financial position. However, the Company currently is unable to estimate the amount of such disallowance or predict whether such disallowance would have a significant adverse impact on its financial position or results of operations.

The CPUC also is considering an alternative ratemaking concept for Diablo Canyon which would provide revenues based primarily on the amount of electricity generated by the plant, rather than on more traditional cost-based ratemaking concepts. The Company currently is evaluating the accounting, income tax, and financial implications of this alternative concept.

In March 1987, the CPUC granted the Company a $53.2 million annual rate increase to provide for the future costs of decommissioning Diablo Canyon. This rate increase is based on the most recent estimate of the decommissioning cost of $578.6 million (computed in 1985 dollars) which includes a contingency factor of 50% for expected changes in regulatory requirements and waste disposal cost increases. As required by the Department of Energy, the cost of one-tenth of one cent per kwh generated is included in nuclear fuel expense for the future storage and disposal costs of spent fuel. The cost of nuclear fuel is recovered through the ECAC. As of December 31, 1987, approximately $37.4 million has been deposited into an external trust fund to be used exclusively for the decommissioning of the plant for the benefit of the ratepayers and the general public and is included in Funds Held by Trustee in the consolidated balance sheet. Funds may not be released from the trust fund until authorized by the CPUC.

In August 1987, the FASB issued SFAS No. 92, *Regulated Enterprises–Accounting for Phase-in Plans.* SFAS No: 92 specifies the accounting for phase-in plans and the capitalization of equity return and will be effective January 1, 1988. This statement would have prohibited the Company from capitalizing equity return related to Diablo Canyon. Due to the Company's change in recording revenues relating to Diablo Canyon, which was effective January 1, 1987, application of SFAS No. 92 for Diablo Canyon would not have reduced earnings in the current year nor is it expected to do so in the future.

Helms Pumped Storage Project

The Helms Pumped Storage Project (Helms), which was delayed due to a water conduit rupture in 1982 and various start-up problems, became commercially operable in 1984.

The total cost of the project is $960.6 million, of which $716 million has been included in rate base and $21.7 million has been disallowed by the CPUC. The remaining $222.9 million in costs may be recovered through litigation or future ratemaking applications. (This matter is included in the Nonearning Assets section of this note.)

The CPUC has indicated that PG&E will bear a heavy burden of proof in establishing the reasonableness of these costs. In addition, if PG&E seeks to recover in rates the costs related to the water conduit rupture, the CPUC intends to consider an offset to revenues to reflect lost or deferred capacity benefits due to the delay in commercial operation.

Notwithstanding the above, the Company believes that all Helms costs not recovered through claims and litigation should be recoverable through ratemaking and that any costs disallowed by the CPUC would not have a significant impact on its financial position or results of operations.

In its 1985 Helms rate case decision, the CPUC declined to include in rates the revenues accrued during the time Helms was out of service due to the replacement of certain generator parts. These revenues, with interest accrued through December 31, 1987, amount to $55.3 million. PG&E will be allowed to file a separate application for recovery of this amount after claims against third parties are resolved.

The Company believes that any revenues disallowed by the CPUC would not have a significant impact on the Company's financial position or results of operations.

Humboldt Bay Nuclear Power Plant

In 1983, PG&E elected to decommission the Humboldt Bay Nuclear Power Plant Unit No. 3 (Unit 3). In 1985, the CPUC disallowed $22.6 million of AFUDC and $14.5 million of direct costs and permitted recovery through rates of approximately $44.3 million of the $84 million net investment in Unit 3. The disallowances were charged against income. The decisions permit recovery over a four-year period with no rate base treatment for the unamortized balance. (This matter is included in the Nonearning Assets section of this note.)

In 1985, the CPUC authorized PG&E to recover the estimated $9.7 million of costs associated with the Company's custodial safe storage plan which the CPUC found reasonable.

In June 1987, the CPUC directed the Company to collect additional revenues which, after tax, will be deposited in an external trust fund to provide for the future funding of decommissioning costs. The amount of the revenues collected is computed based upon tax deductibility of a portion of contributions to the fund. The tax qualifying portion is approximately 50% of the total decommissioning cost. The most recent estimate of the decommissioning cost is $58 million (computed in 1986 dollars) which includes a contingency factor of 25% for expected changes in regulatory requirements and waste disposal cost increases.

Material Redacted

Collection of these revenues began July 1987, subject to refund or adjustment, pending further commission review of the current decommissioning study for Humboldt, due to be completed shortly. In its ruling, the CPUC authorized the total amount requested by the Company to be recovered over a four-year amortization period. As of December 31, 1987, approximately $8.3 million has been deposited into the external trust funds to be used exclusively for the decommissioning of the plant for the benefit of the ratepayers and the general public and is included in Funds Held by Trustee in the consolidated balance sheet.

The authorized revenue requirements were $14.3 million for July 1987 through December 1987; will be $26.9 million in 1988, 1989 and 1990; and $13.4 million from January 1991 through June 1991.

Nonearning Assets

PG&E has several assets which are not earning a return on investment currently, but for which some rate recovery has been authorized. Project costs currently not earning a return on investment include:

December 31	1987	1986
	In Millions	
Helms Pumped Storage Project	**$222.9**	$218.1
Humboldt Bay Nuclear Power Plant	**20.1**	34.0
Liquefied Natural Gas Project	**37.6**	56.7
Ten Section Field	**18.4**	26.5
Feasibility Study and RD&D Project Costs	**—**	18.5
Total	**$299.0**	$353.8

Of the $299 million of nonearning assets above, PG&E has been granted rate recovery of $56.5 million. Accordingly, the Company has amortized and recovered $50.9 million during the twelve months ended December 31, 1987.

In 1984, the CPUC disallowed $46.6 million of AFUDC for the Liquefied Natural Gas (LNG) Project, and the Company provided a reserve against its investment for that amount. Included in the LNG costs are $19.6 million in losses on tangible assets sold and remaining assets to be sold. During 1987, PG&E and its partner in the LNG Project completed a plan for the disposition of the remaining assets. In December 1987, the CPUC authorized recovery of $6 million through rates for the costs associated with their plan. As of December 31, 1987, approximately $18 million of the LNG costs included in the $37.6 million above remain to be amortized. The four-year amortization period began in 1985. Steps to conclude the affairs of this abandoned project are continuing.

PG&E requested recovery in the 1987 General Rate Case for the costs of the Ten Section Field. In December 1986, the CPUC granted rate recovery of those costs over a four-year period beginning in 1987.

In December 1987, the Company adopted SFAS No. 90, *Regulated Enterprises-Accounting for Abandonments and Disallowances of Plant Costs.* SFAS No. 90 requires that disallowed costs be recognized as losses and that abandoned assets being recovered in rates but earning less than a full rate of return be recorded at their present value. The assets listed above, which were granted rate recovery but are not earning a rate of return, have been reduced to their present value to reflect this change. The effect of this change on the Company's financial position and results of operations was not significant.

Nuclear Insurance

PG&E is a member of Nuclear Mutual Limited (NML) and Nuclear Electric Insurance Limited (NEIL I and II). In the event of property damage to a nuclear plant of a member utility or increased cost of replacement power due to prolonged accidental outage of a member utility's reactor unit, PG&E may be subject to maximum assessments of $60 million (property damage) or $8.6 million (replacement power), respectively, in each case per policy period, if losses exceed premiums, reserves, and other NML, NEIL I or NEIL II resources. With respect to property damage at Diablo Canyon, the NML coverage is limited to $500 million and the NEIL II coverage provides an additional $775 million in excess of that provided by NML.

The maximum public liability for claims resulting from any nuclear incident is limited to $720 million per incident under provisions of the Price-Anderson Act. In the event there is a nuclear incident involving any of the nation's licensed reactors, PG&E is subject to a retrospective assessment of up to $5 million per incident for each of its two licensed reactors with an aggregate assessment per calendar year of $10 million per reactor with payments in excess deferred to the next calendar year. The expiration of the Price-Anderson Act on August 1, 1987 did not affect currently licensed facilities, although legislation currently is pending in Congress that, if passed, would set the retrospective limit to approximately $63 million per reactor per incident.

Sacramento Municipal Utility District (SMUD)

PG&E has a contract with SMUD to purchase surplus energy and capacity from the Rancho Seco Nuclear Power Plant (Rancho Seco), which ceased operations in December 1985. As a result of the shutdown, PG&E stopped accruing a liability and paying SMUD for surplus capacity effective December 1985. The total of the suspended payments and adjustments from December 1, 1985 to January 1, 1987 is approximately $35.5 million excluding interest. SMUD offset this amount against amounts it owed to PG&E for energy deliveries in 1986.

Under an agreement between the parties, for 1987 transactions, PG&E is paying into an escrow account, but not expensing, an amount SMUD claims it is owed for surplus capacity, and SMUD is paying to PG&E, and PG&E is accruing as revenue, the full amount owed PG&E for energy deliveries. The amount paid into escrow as of December 31, 1987 is $8.6 million. PG&E also has submitted a claim requesting SMUD return $27.5 million in payments made for the period January 1, 1985 through November 30, 1985 for capacity not received during that period.

The matter has been submitted to the FERC for resolution. The FERC has concluded its hearings and has not issued a decision yet. If the FERC denies recovery from SMUD, the Company would expect to apply to the CPUC for and expects to receive recovery of these amounts from ratepayers.

As part of a long-term power supply arrangement, PG&E and SMUD have tentatively agreed to settle all disputes under their existing contract by the payment by SMUD of $75 million (including the amounts in escrow), amortized over four years. The agreement is subject to approval by the SMUD Board.

In September 1987, the Company sent a letter to SMUD suggesting

Material Redacted

that consideration be given to a combination of the SMUD and PG&E operations in the Sacramento area. There was no formal response from SMUD. Under the Company's proposal, PG&E would acquire all of SMUD's properties and facilities; close permanently the 900 megawatt Rancho Seco nuclear facility and arrange for its decommissioning; stabilize electric rates to the SMUD customers for an agreed upon period of time and offer job security for current full-time SMUD employees. The amounts in dispute, as discussed above, would be resolved in connection with the combination. On January 14, 1988, PG&E withdrew its proposal due to SMUD's failure to give it serious consideration.

Litigation—Geothermal Steam Contracts
In January 1987, two lawsuits were filed against the Company relating to the sale of geothermal steam to the Company for use in the generation of electricity at the Company's The Geysers Geothermal Power Plant (The Geysers). In total, the lawsuits claim damages in excess of $120 million for breach of contract, improper calculation of the steam price and inadequate operation of The Geysers.

The Company has filed a cross-complaint against the plantiffs, requesting damages in excess of $20 million for breach of contract, negligent misrepresentation, breach of covenant of good faith and fair dealing, and negligence.

The Company plans to defend these lawsuits vigorously and believes that the ultimate outcome of this matter will not have a significant impact on its financial position or results of operations.

FERC—Hydroelectric Licensing
In October 1986, the Electric Consumers Protection Act was enacted by the U.S. Congress, eliminating any preference for governmentally-run utilities in the relicensing of hydroelectric projects. Certain of these governmentally-run utilities had challenged the Company's relicensing of three hydroelectric projects with expired licenses.

The new law will require the Company to pay to these challengers a "reasonable" settlement consisting of their costs incurred to pursue the licenses and a potential further amount ranging from 0% to 100% of the Company's remaining net investment of between $124.5 million and $126 million in the projects as of October 22, 1985. The Company expects to recover in rates any costs incurred.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS
Pacific Gas and Electric Company

To the Shareholders and the Board of Directors
of Pacific Gas and Electric Company:

We have examined the consolidated balance sheet and statement of consolidated capitalization of Pacific Gas and Electric Company (a California corporation) and subsidiaries as of December 31, 1987 and 1986, and the related statements of consolidated income, funds used for construction, common stock equity and preferred stock, and the schedule of consolidated segment information for each of the three years in the period ended December 31, 1987. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed more fully in Note 10 to the financial statements, the Diablo Canyon Nuclear Power Plant experienced significant delays and substantial cost increases. In connection with the California Public Utilities Commission (CPUC) review of interim rates for Unit 1 and a stipulation for Unit 2, the Company has recorded through December 31, 1986, the revenues for operating expenses and a return on rate base and recognized as a deferred asset the amounts not allowed in current rates. Effective January 1, 1987, the Company has recorded revenues reflecting essentially cash amounts received through interim rates for both units. The allowed interim rates, accrued revenues and deferred asset are subject to adjustment or refund pending the CPUC reasonableness review of plant costs. In view of the events discussed in Note 10, the Company believes it appears reasonable to expect that the CPUC will disallow rate recovery of some portion of the Diablo Canyon plant costs and the related revenues. The Company is currently unable to estimate the amount of such disallowance or predict whether such disallowance of the Diablo Canyon plant costs and related revenues and deferred asset would have a significant adverse impact on its financial position and results of operations.

In our opinion, subject to the effects of such adjustments as might have been required had the outcome of the uncertainties referred to in the preceding paragraph been known, the consolidated financial statements and schedule of consolidated segment information referred to above present fairly the financial position of Pacific Gas and Electric Company and subsidiaries as of December 31, 1987 and 1986, and the results of its operations and funds used for construction for each of the three years in the period ended December 31, 1987 in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of accounting for unbilled revenues as described in Note 1 to the consolidated financial statements, were applied on a consistent basis.

ARTHUR ANDERSEN & CO.

San Francisco, California
February 5, 1988

RESPONSIBILITY FOR FINANCIAL STATEMENTS

Pacific Gas and Electric Company

The responsibility for the integrity of the financial information included in this annual report rests with management. Such information has been prepared in accordance with generally accepted accounting principles appropriate in the circumstances, and is based on the Company's best estimates and judgements after giving consideration to materiality.

PG&E maintains systems of internal accounting controls supported by formal policies and procedures which are communicated throughout the Company. These controls are adequate to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce the records necessary for the preparation of financial information. There are limits inherent in all systems of internal control, based on the recognition that the costs of such systems should not exceed the benefits to be derived. The Company believes its systems provide this appropriate balance. In addition, the Company's internal auditors perform audits and evaluate the adequacy of and the adherence to these controls, policies and procedures.

Arthur Andersen & Co., the Company's independent public accountants, review and evaluate the Company's internal accounting control systems to the extent they consider necessary in order to support their opinion on the consolidated financial statements. Their auditors' report, which is qualified with respect to Diablo Canyon matters discussed above, contains an independent informed judgement as to the fairness of the Company's reported results of operations and financial position.

In a further attempt to assure objectivity and remove bias, the financial data contained in this report have been reviewed by the audit committee of the board of directors. The audit committee is composed of five outside directors who meet regularly with management, the corporate internal auditors and Arthur Andersen & Co., jointly and separately, to review internal accounting controls and auditing and financial reporting matters.

The Company maintains high standards in selecting, training and developing personnel to ensure that management's objectives of maintaining strong, effective internal controls and unbiased, uniform reporting standards are attained. The Company believes its policies and procedures provide reasonable assurance that operations are conducted in conformity with applicable laws and with its commitment to a high standard of business conduct.

QUARTERLY CONSOLIDATED FINANCIAL DATA (Unaudited)

Pacific Gas and Electric Company

Quarterly financial data for the four quarters of 1987 and 1986 are shown in the table below. Due to the seasonal nature of the utility business, operating revenues, operating income, and net income are not generated evenly by quarter during the year.

The Company's common stock is traded on the New York, Pacific, London, Amsterdam, Basel and Zurich Stock Exchanges. The approximate number of common stockholders of record as of December 31, 1987 was 304,000. Dividends are paid on a quarterly basis, and there are no material restrictions on the present ability of the Company to pay dividends. Despite the change in recording operating revenues for Diablo Canyon discussed in Note 10 to the consolidated financial statements, the Company's cash flow from operations is adequate to cover the current annual dividend.

	4th	3rd	2nd	1st
	In Thousands (except per share amounts)			
1987				
Operating Revenues	**$1,830,920**	**$1,827,919**	**$1,774,712**	**$1,752,150**
Operating Income	**$ 327,313**	**$ 364,706**	**$ 323,475**	**$ 246,207**
Income Before Change in Recording Unbilled Revenues	**$ 148,897**	**$ 204,539**	**$ 153,462**	**$ 90,296**
Net Income	**$ 148,897**	**$ 204,539**	**$ 153,462**	**$ 181,619**
Earnings Per Common Share Before Change in Recording Unbilled Revenues	**$ .32**	**$ .47**	**$ .33**	**$ .17**
Earnings Per Common Share	**$ .32**	**$ .47**	**$ .33**	**$ .42**
Dividends Declared Per Common Share	**$ .48**	**$ .48**	**$ .48**	**$ .48**
Common Stock Price Per Share				
High	**$ 19.88**	**$ 20.88**	**$ 22.75**	**$ 27.88**
Low	**$ 15.00**	**$ 18.13**	**$ 19.13**	**$ 23.88**
1986				
Operating Revenues	$1,927,405	$2,000,896	$1,876,724	$2,011,636
Operating Income	$ 396,699	$ 461,897	$ 419,415	$ 375,614
Net Income	$ 235,998	$ 299,578	$ 265,339	$ 280,308
Earnings Per Common Share	$ .54	$ .73	$ .63	$ .70
Dividends Declared Per Common Share	$ .48	$ .48	$ .48	$ .46
Common Stock Price Per Share				
High	$ 26.13	$ 27.50	$ 23.38	$ 23.63
Low	$ 23.38	$ 22.25	$ 21.00	$ 18.75

In the first quarter of 1987 the Company recognized the cost of the early retirement plan of approximately $87.1 million before taxes.

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PG&E COMPARATIVE STATISTICS (Unaudited)

Pacific Gas and Electric Company

Years Ended December 31	1987	1986	1985
Electric Statistics			
Net Area Output (Millions of KWH)	**88,444**	84,633	85,398
Net Area Output - Percent			
Hydroelectric Plants	**10.2%**	17.4%	13.3%
Thermal Electric Plants (excluding Nuclear)	**38.2**	28.7	40.2
Nuclear Plants	**15.8**	14.5	7.6
Other Producers	**35.8**	39.4	38.9
Total	**100.0%**	100.0%	100.0%
Area Capability - MW (at annual peak)			
Hydroelectric Plants (adverse conditions)	**3,938**	3,875	3,913
Thermal Electric Plants (excluding Nuclear)	**9,070**	10,250	10,012
Nuclear Plants	**2,164**	1,073	–
Other Producers (adverse conditions)	**6,554**	6,978	6,866
Total	**21,726**	22,176	20,791
Net Area Peak Demand - MW	**16,202**	15,439	16,507
Reserves Capacity Margin at Peak - Percent	**19.3%**	25.7%	11.6%
Annual Load Factor - Percent	**62.3%**	62.6%	59.1%
Average Annual Residential Consumption - KWH	**6,489**	6,343	6,533
Average Residential Revenue Per KWH	**7.80¢**	7.82¢	7.88¢
Average Annual Residential Bill	**$506.26**	$496.28	$514.57
Total Customers (end of year)	**3,951,474**	3,854,787	3,760,521
Plant Investment Per Customer	**$3,565**	$3,592	$3,407
Customers Per Mile of Distribution Line	**40.0**	39.5	38.8
Gas Statistics			
Gas Purchased for U.S. Operations (Thousands of MCF)	**681,421**	586,135	778,318
Source of Gas Purchased - Percent			
From California	**18.3%**	24.4%	21.9%
From Other States	**27.7**	33.7	39.3
From Canada	**54.0**	41.9	38.8
Total	**100.0%**	100.0%	100.0%
Average Cost of Gas Purchased Per MCF (U.S. Operations)			
From California	**$1.71**	$2.20	$2.88
From Other States	**$2.16**	$2.58	$3.61
From Canada	**$1.87**	$2.26	$3.14
Average	**$1.92**	$2.36	$3.27
Peak Day Sendout - MMCF	**3,530**	3,107	3,603
Average Annual Residential Consumption - MCF	**66.0**	64.6	75.1
Average Residential Revenue Per MCF	**$4.55**	$4.75	$5.38
Average Annual Residential Bill	**$300.48**	$306.93	$404.15
Total Customers (end of year)	**3,245,051**	3,158,426	3,082,935
Plant Investment Per Customer	**$631**	$595	$555
Customers Per Mile of Distribution Main	**100.3**	99.8	98.9
Miscellaneous Statistics			
Customers Served Per Employee	**264**	240	231
Depreciation and Amortization as a Percent of Average Depreciable Plant			
Electric	**3.6%**	3.5%	3.6%
Gas	**5.7%**	4.2%	4.3%
PG&E Composite (includes Common Utility Plant)	**4.0%**	3.8%	3.8%

Material Redacted

1984	1983	1982	1981	1980	1979	1978	1977
84,227	78,879	78,399	80,606	76,747	77,511	74,538	72,255
17.9%	22.9%	19.9%	13.2%	17.3%	15.3%	18.1%	8.4%
36.8	28.9	31.7	48.8	46.0	53.6	44.9	65.5
.3	–	–	–	–	–	–	–
45.0	48.2	48.4	38.0	36.7	31.1	37.0	26.1
100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
3,723	2,658	2,518	2,517	2,491	2,485	2,491	2,435
8,926	8,923	8,699	8,815	8,694	8,629	8,311	8,304
–	–	–	–	–	–	–	–
7,561	7,617	6,673	8,732	7,180	7,307	6,320	5,933
20,210	19,198	17,890	20,064	18,365	18,421	17,122	16,672
16,225	15,156	13,907	15,542	15,336	15,065	14,948	13,815
6.2%	8.8%	9.6%	5.9%	9.0%	12.1%	8.4%	10.6%
59.1%	59.4%	64.4%	59.2%	57.0%	58.7%	56.9%	59.7%
6,557	6,386	6,252	6,489	6,535	6,811	6,553	6,408
6.75¢	6.03¢	7.33¢	5.77¢	5.16¢	3.54¢	3.93¢	3.81¢
$442.88	$385.18	$458.46	$374.21	$337.43	$240.88	$257.66	$243.86
3,686,179	3,594,124	3,545,923	3,515,099	3,447,739	3,365,950	3,270,302	3,179,362
$3,157	$2,847	$2,554	$2,310	$2,199	$2,032	$1,869	$1,755
38.3	39.4	39.1	39.2	39.1	38.9	38.5	38.1
690,455	621,539	698,166	835,684	781,643	843,381	711,052	817,745
24.0%	23.1%	18.2%	19.5%	16.0%	16.8%	16.4%	16.1%
42.4	36.9	45.4	49.2	43.7	37.0	35.1	36.2
33.6	40.0	36.4	31.3	40.3	46.2	48.5	47.7
100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
$3.60	$3.40	$3.09	$2.60	$2.16	$1.74	$1.59	$1.12
$3.98	$4.02	$3.54	$2.57	$2.30	$1.79	$1.35	$1.10
$4.21	$4.49	$5.14	$4.86	$4.34	$2.61	$2.22	$2.00
$3.96	$4.07	$4.04	$3.29	$3.10	$2.16	$1.81	$1.53
3,205	3,025	3,133	3,144	3,275	3,398	3,244	3,186
69.6	73.0	78.3	72.7	81.6	90.4	86.9	90.5
$5.43	$4.84	$4.39	$3.91	$3.70	$2.37	$1.97	$1.85
$377.94	$353.42	$344.07	$284.20	$301.67	$214.17	$170.97	$167.45
3,020,803	2,948,950	2,914,977	2,897,455	2,858,129	2,805,471	2,738,767	2,674,890
$500	$471	$474	$475	$467	$450	$441	$441
98.4	97.2	96.8	96.9	97.0	97.2	97.4	97.2
236	240	249	241	229	230	228	230
3.7%	3.5%	3.5%	3.3%	3.3%	3.1%	3.0%	3.0%
4.3%	4.2%	4.2%	3.5%	3.5%	3.1%	3.1%	3.1%
3.9%	3.7%	3.7%	3.4%	3.4%	3.2%	3.1%	3.1%

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CONSOLIDATED REVENUES AND SALES (Unaudited)

Pacific Gas and Electric Company

Years Ended December 31	1987	1986*	1985*
Electric Department			
Revenues			
Residential	$ 1,711,031	$ 1,639,108	$ 1,659,401
Commercial	1,955,721	1,918,093	1,952,531
Industrial (1000 KW demand or over)	980,773	1,184,217	1,381,346
Agricultural Power	239,204	220,462	287,226
Public Street and Highway Lighting	40,803	45,149	46,997
Other Electric Utilities	122,349	63,915	93,473
Miscellaneous	77,102	73,839	92,737
Other	3,492	3,504	5,305
Regulatory Balancing Accounts	2,553	419,151	300,967
Total Electric Revenues	$ 5,133,028	$ 5,567,438	$ 5,819,983
Sales - KWH			
Residential	21,932,544	20,949,230	21,067,234
Commercial	22,621,071	21,286,100	21,452,853
Industrial (1000 KW demand or over)	16,061,922	15,972,091	17,042,349
Agricultural Power	3,154,373	2,560,390	3,252,215
Public Street and Highway Lighting	341,909	344,276	336,736
Other Electric Utilities	2,446,371	725,397	1,576,215
Total Electric Sales to Customers	66,558,190	61,837,484	64,727,602
Gas Department			
Revenues			
Residential	$ 901,326	$ 899,039	$ 1,156,002
Commercial	435,618	435,351	562,590
Industrial	299,870	437,677	800,651
Other Gas Utilities	88,861	28,962	38,322
Miscellaneous	1,073	976	6,069
Regulatory Balancing Accounts	119,848	220,840	(233,064)
Subsidiary Companies (U.S. and Canada)	136,922	207,883	280,428
Gas Transport	69,155	18,495	–
Total Gas Revenues	$ 2,052,673	$ 2,249,223	$ 2,610,998
Sales - MCF			
Residential	197,882	189,120	214,935
Commercial	80,144	78,087	89,415
Industrial	99,719	128,854	178,407
Other Gas Utilities	46,977	9,832	9,247
Total Gas Sales to Customers	424,722	405,893	492,004
PG&E Use (primarily electric generation)	239,815	153,566	263,017
Subsidiary Companies (U.S. and Canada)	46,229	56,027	62,184
Total	710,766	615,486	817,205

*Changed to conform to 1987 presentation.

Material Redacted

1984*	1983*	1982*	1981*	1980*	1979*	1978*	1977*
		In Thousands					
$ 1,400,148	$ 1,192,997	$ 1,401,267	$ 1,128,851	$ 998,130	$ 693,368	$ 720,112	$ 661,502
1,580,192	1,326,406	1,530,542	1,233,564	1,067,198	752,359	852,265	789,401
1,105,750	914,786	1,078,493	860,577	699,073	461,653	531,593	498,462
239,644	157,528	235,164	241,221	212,770	142,727	149,986	212,649
41,970	48,320	53,224	41,498	38,225	30,491	34,179	33,501
99,350	129,992	172,819	117,791	71,926	67,740	69,855	103,890
116,050	40,350	56,256	70,094	58,568	50,111	43,584	42,075
7,113	7,890	8,008	7,313	5,336	4,115	3,814	3,664
567,948	87,545	(687,171)	204,964	(223,385)	261,281	(308,455)	9,989
$ 5,158,165	$ 3,905,814	$ 3,848,602	$ 3,905,873	$ 2,927,841	$ 2,463,845	$ 2,096,933	$ 2,355,133
20,730,060	19,778,553	19,107,415	19,575,283	19,329,190	19,605,541	18,314,721	17,383,011
20,626,467	19,259,758	18,662,382	18,722,954	18,283,154	17,891,820	17,166,973	16,771,232
16,108,571	14,986,722	15,843,646	16,401,293	14,801,260	15,253,371	14,815,289	14,354,359
3,309,155	2,304,205	2,922,541	3,890,088	3,540,022	3,715,026	3,120,644	5,113,726
329,378	339,823	365,119	401,930	431,564	455,445	485,725	491,558
2,230,163	3,341,984	3,544,563	2,676,998	1,906,465	2,807,249	2,232,563	3,957,141
63,333,794	60,011,045	60,445,666	61,668,546	58,291,655	59,728,452	56,135,915	58,071,027
$ 1,058,995	$ 972,150	$ 935,996	$ 764,468	$ 799,307	$ 555,017	$ 432,865	$ 414,087
596,107	651,332	681,520	607,417	626,611	406,497	346,229	365,623
732,875	648,832	712,341	794,786	708,259	499,242	340,546	366,293
37,410	39,202	52,589	158,433	148,074	85,867	18,384	14,349
3,686	5,469	8,835	2,290	(6,560)	7,128	4,315	4,773
(107,521)	91,820	149,817	(276,749)	(133,807)	176,354	193,960	(19,477)
349,986	332,080	395,395	238,057	189,174	170,519	136,141	128,749
–	–	–	–	–	–	–	–
$ 2,671,538	$ 2,740,885	$ 2,936,493	$ 2,288,702	$ 2,331,058	$ 1,900,624	$ 1,472,440	$ 1,274,397
195,092	200,774	213,031	195,631	216,184	234,295	220,076	223,732
90,027	109,637	124,622	128,758	146,827	143,707	144,162	163,828
137,178	114,310	132,789	171,769	161,060	186,165	138,975	162,529
8,281	8,532	12,021	35,135	34,821	36,013	9,926	7,810
430,578	433,253	482,463	531,293	558,892	600,180	513,139	557,899
242,985	170,773	201,219	280,990	202,964	216,062	125,636	217,272
61,400	69,417	96,330	73,166	72,608	77,411	64,633	65,515
734,963	673,443	780,012	885,449	834,464	893,653	703,408	840,686

Material Redacted

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DIRECTORS AND OFFICERS

Pacific Gas and Electric Company

BOARD OF DIRECTORS

Richard A. Clarke
Chairman of the Board and Chief Executive Officer, Pacific Gas and Electric Company

Harry M. Conger
Chairman of the Board and Chief Executive Officer, Homestake Mining Company

Lewis S. Eaton
Chairman of Guarantee Savings and Loan Association

Ira Michael Heyman
Chancellor, University of California, Berkeley

Robert B. Hoover[1]
Former Chairman of the Board, and Chief Executive Officer, The Pacific Lumber Company

Melvin B. Lane
Chairman of the Board, Lane Publishing Company (*Sunset* Magazine)

Leslie L. Luttgens
San Francisco Bay Area community leader

Richard B. Madden
Chairman of the Board, President, and Chief Executive Officer, Potlatch Corporation (diversified forest products)

Peter A. Magowan
Chairman of the Board and Chief Executive Officer, Safeway Stores, Incorporated

George A. Maneatis
President, Pacific Gas and Electric Company

Mary S. Metz
President, Mills College

Frederick W. Mielke, Jr.
Former Chairman of the Board and Chief Executive Officer, Pacific Gas and Electric Company

William F. Miller
President and Chief Executive Officer, SRI International (research and consulting)

John B. M. Place
Former Chairman of the Board and Chief Executive Officer, Crocker National Corporation and Crocker National Bank

Carl E. Reichardt
Chairman of the Board and Chief Executive Officer, Wells Fargo & Company and Wells Fargo Bank, N.A.

Wilson C. Riles
President, Wilson Riles and Associates, Inc. (educational development and consulting)

Stanley T. Skinner
Vice Chairman of the Board, Pacific Gas and Electric Company

PERMANENT COMMITTEES OF THE BOARD OF DIRECTORS[2]

Executive Committee
Within limits, may exercise powers and perform duties of the Board.

Richard A. Clarke (Chairman)
Lewis S. Eaton
Leslie L. Luttgens
Richard B. Madden
Peter A. Magowan
George A. Maneatis

Audit Committee
Reviews financial statements and internal accounting and control procedures with independent public accountants.

Lewis S. Eaton (Chairman)
Ira Michael Heyman
Peter A. Magowan
Mary S. Metz
Wilson C. Riles

Finance Committee
Recommends long-range financial policies and objectives and actions required to achieve those objectives.

Richard A. Clarke (Chairman)
Richard B. Madden
William F. Miller
John B. M. Place
Carl E. Reichardt
Stanley T. Skinner

Compensation and Management Development Committee
Recommends compensation and employee benefit policies and practices. Reviews planning for executive development and succession.

Leslie L. Luttgens (Chairman)
Harry M. Conger
Melvin B. Lane
Richard B. Madden
William F. Miller
John B. M. Place

Advisory Nominating Committee
Recommends candidates for nomination as directors.

Richard A. Clarke (Chairman)
Harry M. Conger
Leslie L. Luttgens
Peter A. Magowan
Frederick W. Mielke, Jr.
John B. M. Place

1. Retires April 20, 1988

2. Membership effective February 17, 1988

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OFFICERS

Richard A. Clarke[1]
Chairman of the Board
and Chief Executive Officer

Stanley T. Skinner[1]
Vice Chairman of the Board

George A. Maneatis[1]
President

Ellis B. Langley, Jr.[1]
Executive Vice President and
General Manager, Distribution
Business Unit

John A. Sproul[1]
Executive Vice President and
General Manager, Gas Supply
Business Unit

Mason Willrich[1]
Executive Vice President

Donald A. Brand[1]
Senior Vice President and General
Manager, Engineering and
Construction Business Unit

Gregory M. Rueger[1]
Senior Vice President and General
Manager, Electric Supply
Business Unit

Norman L. Bryan
Vice President
Redwood Region

George F. Clifton, Jr.
Vice President
East Bay Region

Russell H. Cunningham
Vice President
Human Resources

John C. Danielsen
Vice President
Computer Systems and Services

Richard A. Draeger
Vice President
General Services

Gene G. Elam
Vice President and
Comptroller

Daniel E. Gibson
Vice President
Fuel Resources

Robert D. Glynn, Jr.
Vice President
Power Generation

Howard V. Golub
Vice President and
General Counsel

Leland M. Gustafson
Vice President
Golden Gate Region

Robert J. Haywood
Vice President
Power Contracts

Jess R. Herrera
Vice President
General Construction

Thomas W. High
Vice President and
Corporate Secretary

Grant N. Horne
Vice President
Corporate Communications

John C. Keyser
Vice President
Marketing and
Customer Services

John E. Koehn
Vice President
Community and
Governmental Relations

Jack LaRue
Vice President
Sacramento Valley Region

C. Robert Martin
Vice President
San Joaquin Valley Region

Jackalyne Pfannenstiel
Vice President
Corporate Planning

Grant N. Radford
Vice President
Mission Trail Region

Virgil G. Rose
Vice President
Gas and Electric
Technical Services

James D. Shiffer
Vice President
Nuclear Power Generation

Gordon R. Smith
Vice President
Finance and Rates

James B. Stoutamore
Vice President
Gas Supply Operations

William H. Wallace
Vice President
Engineering

Jack F. Jenkins-Stark
Treasurer

Brian L. McGrath
Assistant Secretary

Kathleen Rueger
Assistant Secretary

Julia B. York
Assistant Treasurer

Donald E. Fissell
President
NGC Energy Company

Stephen P. Reynolds
President and Chief Executive
Officer, Pacific Gas
Transmission Company

1. Member Management
Committee

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SHAREHOLDER INFORMATION

Pacific Gas and Electric Company

SHAREHOLDER SERVICES OFFICE

77 Beale Street, Room 1580
San Francisco, CA 94106
(800) 367-7731

DIVIDEND PAYMENT DATES 1988

Common Stock	Preferred Stock
January 15	February 15
April 15	May 15
July 15	August 15
October 15	November 15

STOCK HELD IN BROKERAGE ACCOUNTS ("STREET NAME")

When you purchase your stock and the stock is held for you by the broker, it is listed with the Company in the broker's name, or "street name." PG&E does not know the identity of individual shareholders who hold their stock in this manner - we simply know that a broker holds a certain number of shares which may be for any number of customers.

If you hold your stock in street name, you are not eligible to participate in PG&E's Dividend Reinvestment Plan. Also, you receive all dividend payments, annual and quarterly reports, and proxy materials through your broker. Therefore, if you are receiving unwanted duplicate mailings, you should contact your broker, not PG&E, to eliminate the duplications.

ADDRESS CHANGE

You should advise the Shareholder Services office in writing immediately of any change in address. Please include the old address and the new address. If possible, also enclose a copy of a recent mailing label.

REPLACEMENT OF DIVIDEND CHECKS

If you do not receive your dividend check within five business days after the payment date, or if a check is lost or destroyed, you should notify the Shareholder Services office so that payment may be stopped on the check and a replacement issued.

DIVIDEND REINVESTMENT PLAN

You may automatically reinvest your dividends from common and preferred stock in new shares of PG&E common stock through the Company's Dividend Reinvestment and Common Stock Purchase Plan. Through an "optional cash investment" feature, Plan participants also may purchase additional shares of common stock, subject to limitations set forth in the Plan prospectus.

If you hold certificates in your own name (rather than through a broker) you may obtain the Plan prospectus and enrollment form by contacting the Shareholder Services office. However, if your certificates are held by a broker (in "street name"), then you are not eligible to participate in the Dividend Reinvestment Plan.

LOST OR STOLEN CERTIFICATES

If your stock certificate is lost, stolen, burned or in some other way destroyed, you should notify the Shareholder Services office in writing immediately.

SHAREHOLDER HANDBOOK

PG&E has prepared a helpful shareholder's handbook providing information on the Company's shareholder services, stock certificates, and stock transfer systems. Copies are available from the Shareholder Services office.

MULTIPLE DIVIDEND CHECKS AND DUPLICATE MAILINGS

Some shareholders hold their stock on our records in similar but different names (e.g. Robert A. Johnson and R. A. Johnson). When this occurs, the law requires that we create a separate account for each name. Even though the mailing addresses are the same, we are required to mail separate dividend checks and annual and quarterly reports to each account.

How to Consolidate Accounts

If you want to consolidate your separate accounts into one account, you should contact the Shareholder Services office to obtain the necessary forms and instructions. When accounts are consolidated, it may be necessary to reissue the stock certificates.

How to Eliminate Duplicate Mailings

If you want to maintain more than one account but eliminate additional mailings of annual and quarterly reports, you may do so by sending the labels (or a copy of the labels) from a Company mailing to the Shareholder Services office, indicating the names you wish to keep on the mailing list for annual and quarterly reports and the names you wish to delete. This will only affect these mailings; dividend checks and proxy materials will continue to be sent to each account.

10-K REPORT

If you would like a copy of the Company's 1987 Form 10-K Report to the Securities and Exchange Commission, please contact the Shareholder Services office.

STOCK EXCHANGE LISTINGS

PG&E's common stock is traded on the New York, Pacific, London, Basel, Zürich, and Amsterdam stock exchanges. The official New York Stock Exchange symbol is "PCG" but the Company's common stock usually is listed in the newspaper under "PacGE."

The Company has 21 issues of preferred stock, most of which are listed on the American Stock Exchange and the Pacific Stock Exchange.

Issue		Newspaper symbol
First Preferred, Cumulative, Par Value $25 Per Share		
Redeemable:		
10.46%		PGEpfS
10.28%		PGEpfW
10.18%		PGEpfT
9.48%		PGEpfR
9.30%		PGEpfV
9.28%		PGEpfJ
9.00%		PGEpfL
8.20%		PGEpfP
8.16%		PGEpfK
8.00%		PGEpfO
7.84%		PGEpfM
5.00%		PGEpfD
5.00%	Series A	PGEpfE
4.80%		PGEpfG
4.50%		PGEpfH
4.36%		PGEpfI
Non-Redeemable:		
6.00%		PGEpfA
5.50%		PGEpfB
5.00%		PGEpfC
$100 First Preferred, Cumulative, Par Value $100 Per Share		
10.17%		Unlisted
9.00%		Unlisted

ANNUAL MEETING OF SHAREHOLDERS

Date: April 20, 1988
Time: 2:00 p.m.
Location:
Masonic Auditorium
1111 California Street
San Francisco, California

A notice of the meeting, proxy statement, and proxy form are being mailed with this annual report on or about March 1, 1988 to all shareholders of record.

A report on the annual meeting will be included in PG&E's first quarter report, mailed to shareholders of record in early May.

SHAREHOLDER SERVICES

If you have questions about your account or need copies of the Company's publications, please write to the Transfer Agent at the address shown below or call (800) 367-7731.

If you have general questions about PG&E or information contained in the annual or quarterly reports, please write to the Office of the Corporate Secretary at the address shown below or call (415) 973-2880.

Security analysts, portfolio managers or other representatives of the investment community should write to the Director of Investor Relations at the address shown below or call (415) 972-3007.

Vice President and Corporate Secretary
Thomas W. High
77 Beale Street, Room 3212
San Francisco, CA 94106

Transfer Agent
Daniel T. Lamey
Shareholder Services
77 Beale Street, Room 1580
San Francisco, CA 94106

Director of Investor Relations
Gabriel B. Togneri
77 Beale Street, Room 835
San Francisco, CA 94106

Registrar of Stock
First Interstate Bank of California
345 California Street
San Francisco, CA 94104

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Pacific Gas and Electric Company®
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San Francisco, CA 94106