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PACIFIC ENTERPRISES INC
 Form 10-K
 March 21, 2002

SECURITIES AND EXCHANGE COMMISSION
 WASHINGTON, D.C. 20549
 FORM 10-K

(Mark One)

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the fiscal year ended December 31, 2001

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from to .

Commission File Number	Exact Name of Registrant as specified in its charter	State of Incorporation	IRS Employer Identification Number
1-40	PACIFIC ENTERPRISES	California	94-0743670
1-1402	SOUTHERN CALIFORNIA GAS COMPANY	California	95-1240705

555 WEST FIFTH STREET, LOS ANGELES, CALIFORNIA 90013

 (Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (213)244-1200

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of each class	Name of each exchange on which registered
Pacific Enterprises Preferred Stock: \$4.75 dividend; \$4.50 dividend; \$4.40 dividend; \$4.36 dividend	American and Pacific

Southern California Gas Co. Preferred Stock	Pacific
Southern California Gas Co. First Mortgage Bonds: Series Y, due 2021; Series Z, due 2002; Series BB, due 2023; Series DD, due 2023; Series EE, due 2025; Series FF, due 2003	New York

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

Pacific Enterprises	None
Southern California Gas Company	None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Exhibit Index on page 76. Glossary on page 79.

Aggregate market value of the voting stock held by non-affiliates of the registrant as of February 28, 2002:

Pacific Enterprises \$51.1 Million

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Southern California Gas Company

\$15.8 Million

Common Stock outstanding without par value as of February 28, 2002:

Pacific Enterprises Wholly owned by Sempra Energy

Southern California Gas Company Wholly owned by Pacific Enterprises

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Information Statement prepared for the May 2002 annual meeting of shareholders are incorporated by reference into Part III.

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This Annual Report contains statements that are not historical fact and constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. The words "estimates," "believes," "expects," "anticipates," "plans," "intends," "may," "would" and "should" or similar expressions, or discussions of strategy or of plans are intended to identify forward-looking statements. Forward-looking statements are not guarantees of performance. They involve risks, uncertainties and assumptions. Future results may differ materially from those

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expressed in these forward-looking statements.

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

ITEM 1. BUSINESS

Description of Business

Pacific Enterprises (PE or the company) is an energy services company whose only direct subsidiary is Southern California Gas Company (SoCalGas), the nation's largest natural gas distribution utility. A description of PE and SoCalGas is given in "Management's Discussion and Analysis of Financial Condition and Results of Operations" herein.

SoCalGas is PE's only subsidiary and PE itself has no operations. PE's financial position and operations consist of those of SoCalGas and some additional items attributable to PE's position as a holding company (e.g. cash, intercompany accounts, debt and equity.)

GOVERNMENT REGULATION

Local Regulation

SoCalGas has gas franchises with the 239 legal jurisdictions in its service territory. These franchises allow SoCalGas to locate facilities for the transmission and distribution of natural gas in the streets and other public places. Some franchises have fixed terms, such as that for the city of Los Angeles, which expires in 2012. Most of the franchises do not have fixed terms and continue indefinitely. The range of expiration dates for the franchises with definite terms is 2003 to 2048.

California Utility Regulation

The State of California Legislature, from time to time, passes laws that regulate SoCalGas' operations. For example, in 1999, the legislature enacted a law addressing natural gas industry restructuring.

The California Public Utilities Commission (CPUC), which consists of five commissioners appointed by the Governor of California for staggered six-year terms, regulates SoCalGas' rates and conditions of service, sales of securities, rate of return, rates of depreciation, uniform systems of accounts, examination of records, and long-term resource procurement. The CPUC also conducts various reviews of utility performance and conducts investigations into various matters, such as deregulation, competition and the environment, to determine its future policies.

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United States Utility Regulation

The Federal Energy Regulatory Commission (FERC) regulates the interstate sale and transportation of natural gas, the uniform systems of accounts and rates of depreciation.

Licenses and Permits

SoCalGas obtains a number of permits, authorizations and licenses in connection with the transmission and distribution of natural gas. They require periodic renewal, which results in continuing regulation by the granting agency.

Other regulatory matters are described in Note 12 of the notes to Consolidated Financial Statements, herein.

SOURCES OF REVENUE

Information on this topic is provided in Note 2 of the notes to Consolidated Financial Statements herein.

NATURAL GAS OPERATIONS

Utility Services

SoCalGas purchases, sells, distributes, stores and transports natural gas. It owns and operates a natural gas distribution, transmission and storage system that supplies natural gas to 5.1 million end-use customers throughout a 23,000-square-mile service territory from central California to the Mexican border. SoCalGas also transports gas to about 1,300 utility electric generation (UEG), wholesale, large commercial, industrial and off-system (outside the company's normal service territory) customers.

SoCalGas offers two basic utility services: sale of natural gas and transportation of natural gas. Natural gas service is also provided on a wholesale basis to the distribution systems of the City of Long Beach, Southwest Gas Corporation and San Diego Gas & Electric Company (SDG&E), an affiliated company.

Supplies of Natural Gas

SoCalGas buys natural gas under several short-term and long-term contracts. Short-term purchases are from various Southwest U.S. and Canadian gas suppliers, and are primarily based on monthly spot-market prices. SoCalGas transports gas under long-term firm pipeline capacity agreements that provide for annual reservation charges, which are recovered in rates. SoCalGas has commitments for firm pipeline capacity under contracts with pipeline companies that expire at various dates through 2006.

Most of the natural gas purchased and delivered by SoCalGas is produced outside of California. These supplies are delivered to SoCalGas' intrastate transmission system by interstate pipeline companies, primarily El Paso Natural Gas Company and Transwestern Natural Gas Company. These interstate companies provide transportation services for supplies purchased from other sources by SoCalGas or its transportation customers. The rates that interstate pipeline companies may charge for natural gas and transportation services are regulated by the FERC.

The following table shows the sources of natural gas deliveries from 1997 through 2001:

Years Ended December 31

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	2001	2000	1999	1998	1997
Purchases in billions of cubic feet					
Gas Purchases - Commodity Portion	367	360	391	374	329
Customer-owned and exchange receipts	837	755	637	637	614
Storage Withdrawal (Injection) - net	(27)	39	(6)	(28)	(3)
Company use and unaccounted For	(24)	(21)	(16)	(21)	(10)
Net Deliveries	1,153	1,133	1,006	962	930
Purchases in millions of dollars					
Commodity costs	\$1,997	\$1,243	\$ 916	\$ 774	\$ 849
Fixed charges*	128	128	147	174	250
Total Purchases	\$2,125	\$1,371	\$1,063	\$ 948	\$1,099
Average Commodity Cost of Purchases (dollars per thousand cubic feet)**	\$5.44	\$3.45	\$ 2.34	\$2.07	\$2.58

* Fixed charges primarily include pipeline demand charges, take or pay settlement costs and other direct-billed amounts allocated over the quantities delivered by the interstate pipelines serving SoCalGas.

** The average commodity cost of natural gas purchased excludes fixed charges.

Market-sensitive natural gas supplies (supplies purchased on the spot market as well as under longer-term contracts, ranging from one month to two years, based on spot prices) account for 100 percent of total natural gas volumes purchased by SoCalGas. The average price of natural gas at the California/Arizona (CA/AZ) border was \$7.27/mmbtu in 2001, compared with \$6.25/mmbtu in 2000, and \$2.33/mmbtu in 1999. Supply/demand imbalances and a number of other factors associated with California's energy crisis in late 2000 and early 2001 resulted in higher natural gas prices during that period. Prices for natural gas have subsequently decreased in the later part of 2001. As of December 31, 2001, the average spot cash price at the California/Arizona border was \$2.63/mmbtu.

During 2001, SoCalGas delivered 1,153 bcf of natural gas through its system. Approximately 69 percent of these deliveries were customer-owned natural gas for which SoCalGas provided transportation services. The remaining natural gas deliveries were purchased by SoCalGas and resold to customers. The company estimates that sufficient natural gas supplies will be available to meet the requirements of its customers for the next several years.

Customers

For regulatory purposes, customers are separated into core and noncore customers. Core customers are primarily residential and small commercial and industrial customers, without alternative fuel capability. Noncore customers consist primarily of utility electric generation (UEG), wholesale, large commercial, industrial and off-

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system (outside the company's normal service territory) customers. Of the 5.1 million meters in SoCalGas service territory, only 1,300 serve the noncore market.

Most core customers purchase natural gas directly from SoCalGas. Core customers are permitted to aggregate their natural gas requirement and, up to a limit of 10 percent of SoCalGas' core market, to purchase natural gas directly from brokers or producers. Beginning in 2002, the CPUC authorized the removal of the 10 percent limit. SoCalGas continues to be obligated to purchase reliable supplies of natural gas to serve the requirements of its core customers. SoCalGas and SDG&E recently filed an application with the CPUC to combine the two companies' core procurement portfolios. On March 6, 2002, a proposed decision was issued which, if approved, will allow SoCalGas and SDG&E to combine their core procurement portfolios. A final CPUC decision is expected in mid-2002.

Beginning in 2002, utility procurement services offered to noncore customers will be phased out. Noncore customers will have the option to either become core customers, and continue to receive utility procurement services, or remain noncore customers and purchase their natural gas from other sources, such as brokers or producers. Noncore customers will also have to make arrangements to deliver their purchases to SoCalGas' receipt points for delivery through the company's transmission and distribution system.

In 2001, approximately 87 percent of the CPUC-authorized natural gas margin was allocated to the core customers, with 13 percent allocated to the noncore customers.

Although revenues from transportation throughput is less than for natural gas sales, SoCalGas generally earns the same margin whether SoCalGas buys the gas and sells it to the customer or transports natural gas already owned by the customer.

SoCalGas also provides natural gas storage services for noncore and off-system customers on a bid and negotiated contract basis. The storage service program provides opportunities for customers to store natural gas on an "as available" basis, usually during the summer to reduce winter purchases when natural gas costs are generally higher. As of December 31, 2001, SoCalGas was storing approximately 35 bcf of customer-owned gas.

Demand for Natural Gas

Natural gas is a principal energy source for residential, commercial, industrial and UEG customers. Natural gas competes with electricity for residential and commercial cooking, water heating, space heating and clothes drying, and with other fuels for large industrial, commercial and UEG uses. Growth in the natural-gas markets is largely dependent upon the health and expansion of the southern California economy. SoCalGas added approximately 58,000 new customer meters in 2001 and 69,000 in 2000, representing growth rates of approximately 1.2 percent and 1.4 percent, respectively. SoCalGas expects its growth rate for 2002 will approximate that of 2001.

During 2001, 99 percent of residential energy customers in SoCalGas' service area used natural gas for water heating, 96 percent for space heating, 76 percent for cooking and 55 percent for clothes drying.

Demand for natural gas by noncore customers is very sensitive to the price of competing fuels. Although the number of noncore customers in 2001 was only 1,300, it accounted for approximately 9 percent of the authorized natural gas revenues and 69 percent of total natural gas volumes. External factors such as weather, the price of electricity, electric deregulation, the use of hydroelectric power, competing pipelines and general economic conditions can result in significant shifts in demand and market price. The demand for natural gas by large UEG customers is also greatly affected by the price and

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availability of electric power generated in other areas.

Effective March 31, 1998, electric industry restructuring gave California consumers the option of selecting their electric energy provider from a variety of local and out-of-state producers. As a result, natural gas demand for electric generation within southern California competes with electric power generated throughout the western United States. Although electric industry restructuring has no direct impact on SoCalGas' natural gas operations, future volumes of natural gas transported for electric generating plant customers may be significantly affected to the extent that regulatory changes divert electricity generation from SoCalGas' service area.

Other

Additional information concerning customer demand and other aspects of natural gas operations is provided under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Notes 11 and 12 of the notes to Consolidated Financial Statements herein.

RATES AND REGULATION

Natural Gas Industry Restructuring

The natural gas industry in California experienced an initial phase of restructuring during the 1980s. In December 2001 the CPUC issued a decision adopting provisions affecting the structure of the natural gas industry in California, some of which could introduce additional volatility into the earnings of SoCalGas and other market participants. Additional information on natural gas industry restructuring is provided in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 12 of the notes to Consolidated Financial Statements herein.

Balancing Accounts

In general, earnings fluctuations from changes in the costs of natural gas and consumption levels for the majority of natural gas are eliminated through balancing accounts authorized by the CPUC. Additional information on balancing accounts is provided in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 2 of the notes to Consolidated Financial Statements herein.

Biennial Cost Allocation Proceeding (BCAP)

Rates to recover the changes in the cost of natural gas transportation services are determined in the BCAP. The BCAP adjusts rates to reflect variances in customer demand from estimates previously used in establishing customer natural gas transportation rates. The mechanism substantially eliminates the effect on income of variances in market demand and natural gas transportation costs and is subject to the limitations of the Gas Cost Incentive Mechanism (GCIM) described below. Additional information on the BCAP is provided in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 12 of the notes to Consolidated Financial Statements herein.

Gas Cost Incentive Mechanism (GCIM)

The GCIM is a process SoCalGas uses to evaluate its natural gas purchases, substantially replacing the previous process of reasonableness reviews. Additional information on the GCIM is provided in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 12 of the notes to Consolidated Financial Statements herein.

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Cost of Capital

The authorized cost of capital is determined by an automatic adjustment mechanism based on changes in certain capital market indices. Additional information on the company's cost of capital is provided in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in Note 12 of the notes to Consolidated Financial Statements herein.

ENVIRONMENTAL MATTERS

Discussions about environmental issues affecting SoCalGas are included in "Management's Discussion and Analysis of Financial Condition and Results of Operations" herein. The following additional information should be read in conjunction with those discussions.

Hazardous Substances

In 1994, the CPUC approved the Hazardous Waste Collaborative Memorandum account, a mechanism that allows SoCalGas to recover in rates the costs associated with the cleanup of sites contaminated with hazardous waste. In general, SoCalGas is allowed to recover 90 percent of its cleanup costs and any related costs of litigation.

During the early 1900s, SoCalGas and its predecessors manufactured gas from coal or oil. The manufacturing sites often have become contaminated with the hazardous residual by-products of the process. SoCalGas has identified 42 former manufactured-gas plant sites at which it (together with other users as to 21 of these sites) may have cleanup obligations. As of December 31, 2001, 18 of these sites have been remediated, of which 14 have received certification from the California Environmental Protection Agency. Preliminary investigations, at a minimum, have been completed on 41 of the sites. At December 31, 2001, SoCalGas' estimated remaining investigation and remediation liability for all of these sites is \$54.5 million.

SoCalGas lawfully disposed of wastes at permitted facilities owned and operated by other entities. Operations at these facilities may result in actual or threatened risks to the environment or public health. Under California law, businesses that arrange for legal disposal of wastes at a permitted facility from which wastes are later released, or threaten to be released, can be held financially responsible for corrective actions at the facility.

SoCalGas has been named as a potentially responsible party (PRP) for two landfill sites and five industrial waste disposal sites, from which releases have occurred as described below.

Remedial actions and negotiations with other PRPs and the United States Environmental Protection Agency have been in progress since 1986 and 1993 for the two landfill sites. The company's share of costs to remediate these sites is estimated to be \$10.4 million (\$0.7 million for the first site and \$9.7 million for the second site). Of this, \$5.0 million has been spent since 1987 (\$140,000 in 2001) and the company recently signed a Consent Decree to settle and liquidate all remaining liabilities at the second site for \$5.7 million.

In the early 1990s, the company was notified of hazards at two industrial waste treatment facilities in the California communities of Fresno and Carson, where the company had disposed of wastes. During 2000, the company settled with the other PRPs at these sites for \$0.4 million and has no additional liability.

In December 1999, SoCalGas was notified that it is a PRP at a waste treatment facility in Bakersfield, California. SoCalGas is working with other PRPs in order to remove from the site certain liquid wastes that threaten to be released. SoCalGas has reserved \$0.8 million in contingent environmental liability for its share of site cleanup. Amounts expended to date are \$0.1 million, including \$11,000 in 2001.

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In March 2000, SoCalGas was notified it is a PRP at a former mercury recycling facility in Brisbane, California. Total potential liability is estimated at \$5,900. Settlement and payment to the State of California is expected by mid-2002. Also in March 2000, SoCalGas was sued in Federal District Court as a PRP in a waste oil disposal site in Los Angeles. Plaintiffs alleged that SoCalGas had transported various petroleum wastes to the site in the 1950s for recycling. SoCalGas settled with plaintiffs in December 2000 for \$0.2 million.

At December 31, 2001, SoCalGas' estimated remaining investigation and remediation liability related to hazardous waste sites, including the manufactured gas sites, was \$54.5 million, of which 90 percent is authorized to be recovered through the Hazardous Waste Collaborative mechanism. SoCalGas believes that any costs not ultimately recovered through rates, insurance or other means, will not have a material adverse effect on SoCalGas' results of operations or financial position.

Estimated liabilities for environmental remediation are recorded when amounts are probable and estimable. Amounts authorized to be recovered in rates under the Hazardous Waste Collaborative mechanism are recorded as a regulatory asset.

Air and Water Quality

California's air quality standards are more restrictive than federal standards. The transmission and distribution of natural gas require the operation of compressor stations, which are subject to increasingly stringent air-quality standards. Costs to comply with these standards are recovered in rates.

OTHER MATTERS

Research, Development and Demonstration (RD&D)

The SoCalGas RD&D portfolio is focused in five major areas: operations, utilization systems, power generation, public interest and transportation. Each of these activities provides benefits to customers and society by providing more cost-effective, efficient natural gas equipment with lower emissions, increased safety, and reduced environmental mitigation and other operating costs. The CPUC has authorized SoCalGas to recover its operating costs associated with RD&D. An annual average of \$7.5 million has been spent over the last three years.

Employees of Registrant

As of December 31, 2001, SoCalGas had 6,063 employees, compared to 5,853 at December 31, 2000.

Wages

Field, technical and most clerical employees at SoCalGas are represented by the Utility Workers' Union of America or the International Chemical Workers' Council. The collective bargaining agreement on wages, hours and working conditions remains in effect through March 31, 2002. Negotiations for a new agreement are currently in progress.

ITEM 2. PROPERTIES

Natural Gas Properties

At December 31, 2001, SoCalGas owned approximately 2,845 miles of transmission and storage pipeline, 45,620 miles of distribution pipeline and 44,868 miles of service piping. It also owned 10 transmission compressor stations and 6 underground storage reservoirs, with a combined working capacity of 121.1 billion cubic feet.

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Other Properties

SoCalGas has a 15-percent limited partnership interest in a 52-story office building in downtown Los Angeles. SoCalGas leases approximately half of the building through the year 2011. The lease has six separate five-year renewal options.

The company owns or leases other offices, operating and maintenance centers, shops, service facilities, and equipment necessary in the conduct of business.

ITEM 3. LEGAL PROCEEDINGS

Except for the matters described in Note 11 of the notes to Consolidated Financial Statements or referred to elsewhere in this Annual Report, neither the company nor its subsidiaries are party to, nor is their property the subject of, any material pending legal proceedings other than routine litigation incidental to their businesses.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

As a result of the formation of Sempra Energy as described in Note 1 of notes to Consolidated Financial Statements, all of the issued and outstanding common stock of PE is owned by Sempra Energy. The information required by Item 5 concerning dividends declared is included in the "Statements of Consolidated Changes in Shareholders' Equity" set forth in Item 8 of this Annual Report herein.

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in millions)

	At December 31, or for the years then ended				
	2001	2000	1999	1998	1997
Pacific Enterprises:					
Income Statement Data:					
Operating revenues	\$3,716	\$2,854	\$2,569	\$2,472	\$2,738
Operating income	\$ 269	\$ 263	\$ 271	\$ 218	\$ 259
Dividends on preferred stock	\$ 4	\$ 4	\$ 4	\$ 4	\$ 4
Earnings applicable to common shares	\$ 202	\$ 207	\$ 180	\$ 143	\$ 180
Balance Sheet Data:					
Total assets	\$4,191	\$4,756	\$4,110	\$4,571	\$4,977
Long-term debt	\$ 579	\$ 821	\$ 939	\$ 985	\$1,118
Short-term debt (a)	\$ 150	\$ 120	\$ 30	\$ 249	\$ 502
Shareholders' equity	\$1,574	\$1,526	\$1,426	\$1,547	\$1,469

(a) Includes long-term debt due within one year.

Since Pacific Enterprises is a wholly owned subsidiary of Sempra Energy, per share data has been omitted.

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	At December 31, or for the years then ended				
SoCalGas:	2001	2000	1999	1998	1997
Income Statement Data:					
Operating revenues	\$3,716	\$2,854	\$2,569	\$2,427	\$2,641
Operating income	\$ 273	\$ 266	\$ 268	\$ 238	\$ 318
Dividends on preferred Stock	\$ 1	\$ 1	\$ 1	\$ 1	\$ 7
Earnings applicable to					
Common shares	\$ 207	\$ 206	\$ 200	\$ 158	\$ 231
Balance Sheet Data:					
Total assets	\$3,762	\$4,128	\$3,452	\$3,834	\$4,205
Long-term debt	\$ 579	\$ 821	\$ 939	\$ 967	\$ 968
Short-term debt (a)	\$ 150	\$ 120	\$ 30	\$ 75	\$ 498
Shareholders' equity	\$1,327	\$1,309	\$1,310	\$1,382	\$1,467

(a) Includes long-term debt due within one year.

Since SoCalGas is a wholly owned subsidiary of Pacific Enterprises, per share data has been omitted.

This data should be read in conjunction with the Consolidated Financial Statements and notes to Consolidated Financial Statements contained herein.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS -- Pacific Enterprises and Southern California Gas Company

Introduction

This section includes management's discussion and analysis of operating results from 1999 through 2001, and provides information about the capital resources, liquidity and financial performance of Pacific Enterprises (PE) and Southern California Gas Company (SoCalGas). SoCalGas, PE or the two together are referred to as the company herein, the distinction being indicated by the context. It also focuses on the major factors expected to influence future operating results and discusses investment and financing plans. It should be read in conjunction with the Consolidated Financial Statements included in this Annual Report.

PE is a holding company whose only direct subsidiary is SoCalGas, the nation's largest natural gas distribution utility. SoCalGas owns and operates a natural gas distribution, transmission and storage system supplying natural gas throughout a 23,000-square mile service territory comprising most of southern California and part of central California. SoCalGas provides natural gas service to residential, commercial, industrial, electric generation and wholesale customers through 5 million meters in a service area with a population of 18 million.

Business Combination

Sempra Energy was formed as a holding company for PE and Enova Corporation (Enova), the parent corporation of San Diego Gas & Electric Company (SDG&E), in connection with a business combination that was completed on June 26, 1998 (the business combination). In connection with the business combination, the holders of common stock

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of PE and Enova became the holders of Sempra Energy's common stock.

As a result of the business combination, PE divided its nonutility subsidiaries to Sempra Energy during 1998 and early 1999. See Note 1 of the notes to the Consolidated Financial Statements for additional information.

Capital Resources And Liquidity

SoCalGas' operations have historically been a major source of liquidity. In addition, working capital requirements can be met through the issuance of short-term and long-term debt. Cash requirements primarily consist of capital expenditures for utility plant.

At December 31, 2001, the company had \$13 million in cash and \$620 million in unused, committed lines of credit (of which SoCalGas had \$120 million in unused lines of credit). Construction, investment and financing programs are continuously reviewed and revised in response to changes in competition, customer growth, inflation, customer rates, the cost of capital, and environmental and regulatory requirements. Management believes that cash flows from operations and from debt issuances are adequate to meet capital expenditure requirements and other commitments.

Cash Flows From Operating Activities

The decrease in cash flows from operating activities in 2001 compared to 2000 was the result of SoCalGas' balancing account activity. This included returns of prior overcollections and the temporary effects of higher-than-expected costs of natural gas and public purpose programs and lower-than-expected sales volumes. The increase in cash flows from operating activities in 2000 was primarily due to higher accounts payable and overcollected regulatory balancing accounts, partially offset by increased accounts receivable. The increases in accounts payable and accounts receivable were primarily due to higher prices for natural gas. The regulatory balancing account overcollections resulted from higher sales volume and the actual cost of gas being slightly lower than amounts being collected in rates on a current basis.

Cash Flows From Investing Activities

Cash flow used in investing activities decreased in 2001 due to loan repayments being made by Sempra Energy to the company in 2001 compared to loans being made to Sempra Energy in 2000, partially offset by an increase in capital expenditures for utility plant. Capital expenditures were \$294 million in 2001, compared to \$198 million and \$146 million in 2000 and in 1999, respectively. Increases in capital expenditures in 2001 and 2000 were primarily due to improvements to the gas distribution system and expansion of pipeline capacity to meet increased demand by electric generators and by commercial and industrial customers.

Over the next five years, the company expects to make capital expenditures of approximately \$2.0 billion. Capital expenditures in 2002 are expected to be comparable to those of 2001. They will be financed primarily by operations and debt issuances.

Construction, investment and financing programs are continuously reviewed and revised by the company in response to changes in economic conditions, competition, customer growth, inflation, customer rates, the cost of capital, and environmental and regulatory requirements.

Cash Flows From Financing Activities

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Net cash used in financing activities increased in 2001 compared to 2000 primarily due to the increase in long-term debt repayments and higher dividends paid by PE in 2001.

Net cash used in financing activities decreased in 2000 compared to 1999 primarily due to lower long-term debt repayments. For SoCalGas, the decrease was also attributable to lower dividends paid in 2000.

Long-Term and Short-Term Debt

In 2001, cash was used for the repayment of \$150 million of first-mortgage bonds and \$120 million of unsecured notes. PE had an offsetting increase of \$50 million in short-term debt.

Cash was used for the repayment of \$30 million of unsecured notes in 2000. In 1999, cash was used for the repayment of \$75 million of unsecured notes. PE also repaid \$43 million of short-term debt.

Dividends

Dividends paid to Sempra Energy amounted to \$190 million in 2001 and \$100 million in each of 2000 and 1999. Dividends paid by SoCalGas to PE amounted to \$190 million, \$200 million and \$278 million in 2001, 2000 and 1999, respectively.

The payment of future dividends and the amount thereof are within the discretion of the companies' boards of directors. The CPUC's regulation of SoCalGas' capital structure limits to \$280 million the portion of its December 31, 2001 retained earnings that is available for dividends to PE.

Capitalization

Total capitalization at December 31, 2001, was \$2.3 billion of which \$2.1 billion applied to SoCalGas. The debt-to-capitalization ratios were 32 percent and 35 percent at December 31, 2001 for PE and SoCalGas, respectively. Significant changes in capitalization during 2001 included dividends declared and repayment of long-term debt.

Cash and Cash Equivalents

Cash and cash equivalents are available for investment in projects consistent with the company's strategic direction, retirement of debt, payment of dividends and other corporate purposes.

In addition to cash generated from ongoing operations, PE has a credit agreement which permits short-term borrowings of up to \$500 million, and/or supports its commercial paper. This agreement expires in 2003. SoCalGas has a \$170 million line of credit which expires in 2002. These revolving lines of credit were unused at December 31, 2001 and 2000. At December 31, 2001, SoCalGas had \$50 million in short-term debt outstanding.

Commitments

The following is a summary of the company's contractual commitments at December 31, 2001 (in millions of dollars). Additional information concerning these commitments is provided above and in Notes 3, 4 and 11 of the notes to Consolidated Financial Statements.

Description	By Period				Total
	Less than 1 year	2-3 years	4-5 years	More than 5 years	

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SoCalGas:

Short-term debt	\$ 50	\$ --	\$ --	\$ --	\$ 50
Long-term debt	100	175	--	404	679
Natural gas contracts	614	504	262	--	1,380
Operating leases	30	61	61	172	324
Environmental commitments	12	22	21	--	55

Total	806	762	344	576	2,488
PE - operating leases	12	24	26	45	107

Total PE consolidated	\$ 818	\$ 786	\$ 370	\$ 621	\$2,595
	=====				

Results of Operations

To understand the operations and financial results of the company, it is important to understand the ratemaking procedures that SoCalGas follows.

SoCalGas is regulated by the CPUC. It is the responsibility of the CPUC to determine that utilities operate in the best interests of their customers and have the opportunity to earn a reasonable return on investment.

The natural gas industry experienced an initial phase of restructuring during the 1980s by deregulating natural gas sales to noncore customers. In December 2001, the CPUC issued a decision adopting several provisions that the company believes will make gas service more reliable, efficient and better tailored to the desires of customers. The CPUC is still considering the schedule for implementation of these regulatory changes, but it is expected that most of the changes will be implemented during 2002.

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

See additional discussions of natural gas-industry restructuring below under "Factors Influencing Future Performance" and in Note 12 of the notes to Consolidated Financial Statements.

The table below summarizes SoCalGas' natural gas volumes and revenues by customer class:

GAS SALES, TRANSPORTATION AND EXCHANGE

(Dollars in millions, volumes in billion cubic feet)

For the years ended December 31

	Gas Sales		Transportation & Exchange		Total	
	Volumes	Revenue	Volumes	Revenue	Volumes	Revenue
2001:						
Residential	263	\$2,336	2	\$ 6	265	\$2,342
Commercial and industrial	95	670	258	157	353	827
Electric generation plants	--	--	361	86	361	86

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Wholesale	--	--	174	36	174	36
	358	\$3,006	795	\$285	1,153	3,291
Balancing accounts and other						425
Total						\$3,716

2000:						
Residential	251	\$2,167	3	\$ 12	254	\$2,179
Commercial and industrial	86	621	317	209	403	830
Electric generation plants	--	--	310	106	310	106
Wholesale	--	--	166	54	166	54
	337	\$2,788	796	\$381	1,133	3,169
Balancing accounts and other						(315)
Total						\$2,854

1999:						
Residential	275	\$1,821	3	\$ 10	278	\$1,831
Commercial and industrial	84	452	306	229	390	681
Electric generation plants	--	--	188	77	188	77
Wholesale	--	--	150	57	150	57
	359	\$2,273	647	\$373	1,006	2,646
Balancing accounts and other						(77)
Total						\$2,569

2001 Compared to 2000

Net income for SoCalGas increased to \$208 million in 2001 compared to \$207 million in 2000 primarily due to higher gas volumes in 2001, offset by the gain on sale of SoCalGas' investment in Plug Power during 2000. In addition to the above factors, PE's net income included less interest income from affiliates in 2001. Net income for the fourth quarter of 2001 decreased compared to the fourth quarter of 2000 for both SoCalGas and PE. The decrease was primarily due to the sale of the investment in Plug Power during the fourth quarter of 2000.

Natural gas revenues increased from \$2.9 billion in 2000 to \$3.7 billion in 2001, and the cost of natural gas distributed increased from \$1.4 billion in 2000 to \$2.1 billion in 2001. These increases were due to higher average gas prices and higher volumes of gas sales in 2001. Under the current regulatory framework, changes in core-market natural gas prices (gas purchased for customers who are primarily residential and small commercial and industrial customers, without alternative fuel capability) do not affect net income, since current or future core customer rates generally recover the actual cost of natural gas on a substantially concurrent basis. See discussion of balancing accounts in Note 2 of the notes to Consolidated Financial Statements.

Other operating expenses increased in 2001 compared to 2000 due to higher costs for company-use fuel (as a result of higher gas prices), higher employee benefit expenses and operation costs covered by balancing accounts.

2000 Compared to 1999

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Net income for 2000 increased compared to net income in 1999. The increase was primarily due to higher non-core gas throughput, the gain on sale of SoCalGas' investment in Plug Power noted above, and lower operating and maintenance expenses. For the fourth quarter of 2000, net income for SoCalGas decreased compared to the fourth quarter of 1999. The decrease was primarily due to the favorable resolution of income tax issues in 1999, partially offset by higher non-core gas throughput and the sale of the investment in Plug Power. In addition to the above factors, net income for PE increased in the fourth quarter of 2000 due to higher expenses associated with other, former PE subsidiaries in 1999.

Natural gas revenues increased from \$2.6 billion in 1999 to \$2.9 billion in 2000, primarily due to higher prices for natural gas in 2000 and higher revenues from electric-generation customers. The increase in these revenues was due to higher demand for electricity in 2000 which increased prices and volumes.

The cost of natural gas distributed increased from \$1.0 billion in 1999 to \$1.4 billion in 2000. The increase was largely due to higher prices for natural gas. Prices for natural gas have increased due to the increased use of natural gas to fuel electric generation, colder winter weather and population growth in California.

Other operating expenses decreased in 2000 compared to 1999 primarily due to lower pension expense in 2000.

Other Income and Deductions, Interest Expense and Income Taxes

Other Income and Deductions

Other income and deductions consist primarily of interest income from short-term investments and interest income or expense from regulatory balancing accounts. This decreased in 2001 as compared to 2000 due to lower interest from affiliates, and due to the 2000 gain on the sale of SoCalGas' investment in Plug Power. Other income increased in 2000 compared to 1999 primarily due to higher interest earned on loans to affiliates, and also due to the gain recognized on the sale of Plug Power.

Interest Expense

Interest expense decreased in 2001 as compared to 2000 due to SoCalGas' repayments of \$270 million in long-term debt during the fourth quarter of 2001, and also due to lower interest expense to affiliates. Interest expense increased in 2000 as compared to 1999 primarily due to SoCalGas' 1999 reversal of previously accrued interest related to income-tax issues as a result of favorable income-tax rulings.

Income Taxes

Income tax expense decreased in 2001 as compared to 2000 due to lower income before taxes, and higher deductions related to capitalized costs. Income tax expense at PE increased in 2000 as compared to 1999 primarily due to an increase in income before taxes.

Factors Influencing Future Performance

Performance of PE in the near future will depend on the results of SoCalGas. The factors influencing SoCalGas' future performance are summarized below.

Natural Gas Restructuring and Gas Rates

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On December 11, 2001, the CPUC issued a decision adopting the following provisions affecting the structure of the natural gas industry in California, some of which could introduce additional volatility into the earnings of SoCalGas and other market participants: a system for shippers to hold firm, tradable rights to capacity on SoCalGas' major gas transmission lines with SoCalGas' shareholders at risk for whether market demand for these rights will cover the cost of these facilities; a further unbundling of SoCalGas' storage services, giving SoCalGas greater upward pricing flexibility (except for storage service for core customers) but with increased shareholder risk for whether market demand will cover storage costs; new balancing services including separate core and noncore balancing provisions; a reallocation among customer classes of the cost of interstate pipeline capacity held by SoCalGas and an unbundling of interstate capacity for gas marketers serving core customers; and the elimination of noncore customers' option to obtain gas supply service from SoCalGas. The CPUC is still considering the schedule for implementation of these regulatory changes, but it is expected that most of the changes will be implemented during 2002.

Allowed Rate of Return

SoCalGas is authorized to earn a rate of return on rate base (ROR) of 9.49 percent and a rate of return on common equity (ROE) of 11.6 percent, the same as in 2001 and 2000. These rates will continue to be effective until the next periodic review by the CPUC unless interest-rate changes are large enough to trigger an automatic adjustment prior thereto. SoCalGas can earn more than the authorized rate by controlling costs below approved levels or by achieving favorable results in certain areas, such as various incentive mechanisms. In addition, earnings are affected by changes in sales volumes, except for the majority of core sales.

Utility Integration

On September 20, 2001 the CPUC approved Sempra Energy's request to integrate the management teams of SoCalGas and SDG&E. The decision retains the separate identities of each utility and is not a merger. Instead, utility integration is a reorganization that consolidates senior management functions of the two utilities and returns to the utilities a significant portion of shared support services currently provided by Sempra Energy's centralized corporate center. Once implementation is completed, the integration is expected to result in more efficient and effective operations.

In a related development, a CPUC draft decision would allow SoCalGas and SDG&E to combine their natural gas procurement activities. The CPUC is scheduled to act on the draft decision at its April 4, 2002 meeting.

Environmental Matters

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

Utility capital costs to comply with environmental requirements are generally recovered through customer rates. Therefore, the likelihood of the company's financial position or results of operations being adversely affected in a significant manner is believed to be remote.

The environmental issues currently facing the company or resolved during the latest three-year period include investigation and

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remediation of its manufactured-gas sites and cleanup of third-party waste-disposal sites used by the company. See additional discussions of environmental issues in Note 11 of the notes to Consolidated Financial Statements.

Market Risk

Market risk is the risk of erosion of the company's cash flows, net income, asset values and equity due to adverse changes in prices for natural gas, and in interest rates.

The company's policy is to use derivative financial instruments to reduce its exposure to fluctuations in interest rates and natural gas prices. Transactions involving these financial instruments are with firms believed to be credit-worthy and major exchanges. The use of these instruments exposes the company to market and credit risks which, at times, may be concentrated with certain counterparties. There were no unusual concentrations at December 31, 2001 that would indicate an unacceptable level of risk.

SoCalGas uses energy derivatives to manage natural gas price risk associated with servicing its load requirements. In addition, SoCalGas makes limited use of natural gas derivatives for trading purposes. These instruments can include forward contracts, futures, swaps, options and other contracts. In the case of both price-risk management and trading activities, the use of derivative financial instruments by the company is subject to certain limitations imposed by company policy and regulatory requirements. See Note 8 of the notes to Consolidated Financial Statements for further information regarding the use of energy derivatives by the company.

Sempra Energy has adopted corporate-wide policies governing its market-risk management and trading activities. An Energy Risk Management Oversight Committee, consisting of senior officers, oversees company-wide energy risk management activities to ensure compliance with Sempra Energy's stated energy-risk management and trading policies. In addition, SoCalGas' risk-management committee monitors and controls energy-price risk management and trading activities independently from the employees responsible for creating or actively managing these risks.

Along with other tools, the company uses Value at Risk (VaR) to measure its exposure to market risk. VaR is an estimate of the potential loss on a position or portfolio of positions over a specified holding period, based on normal market conditions and within a given statistical confidence interval. The company has adopted the variance/covariance methodology in its calculation of VaR, and uses both the 95-percent and 99-percent confidence interval. Holding periods are specific to the types of positions being measured, and are determined based on the size of the position or portfolios, market liquidity, purpose and other factors. Historical volatilities and correlations between instruments and positions are used in the calculation. As of December 31, 2001, the VaR of SoCalGas' natural gas positions was not material.

The following discussion of the company's primary market-risk exposures as of December 31, 2001, includes further discussion of how these exposures are managed.

Commodity-Price Risk

Market risk related to physical commodities is based upon potential fluctuations in the prices and basis of natural gas. The company's market risk is impacted by changes in volatility and liquidity in the markets in which natural gas or related financial instruments are traded. The company is exposed, in varying degrees, to price risk in the natural gas markets. The company's policy is to manage this risk within a framework that considers the unique markets, and operating

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and regulatory environments.

SoCalGas' market risk exposure is limited due to CPUC-authorized rate recovery of natural gas purchase, sale and storage activity. However, at times it may be exposed to limited market risk as a result of activities under the Gas Cost Incentive Mechanism (GCIM), which is discussed in Note 12 of the notes to Consolidated Financial Statements. SoCalGas manages this risk within the parameters of the company's market-risk management and trading framework.

Interest-Rate Risk

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

At December 31, 2001, SoCalGas had \$508 million of fixed-rate debt and \$175 million of variable-rate debt. Interest on fixed-rate utility debt is fully recovered in rates on a historical cost basis and interest on variable-rate debt is provided for in rates on a forecasted basis. At December 31, 2001, SoCalGas' fixed-rate debt had a one-year VaR of \$96 million and SoCalGas variable-rate debt had a one-year VaR of \$1 million.

At December 31, 2001, the notional amount of interest-rate swap transactions totaled \$175 million. See Notes 4 and 8 of the notes to Consolidated Financial Statements for further information regarding these swap transactions.

Credit Risk

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

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

The company periodically enters into interest-rate swap agreements to moderate exposure to interest-rate changes and to lower the overall cost of borrowing. The company would be exposed to interest-rate fluctuations on the underlying debt should other parties to the agreement not perform.

Critical Accounting Policies

The company's most significant accounting policies are described in Note 2 of the notes to Consolidated Financial Statements. The most critical policies are Statement of Financial Accounting Standards (SFAS) 71 "Accounting for the Effects of Certain Types of Regulation,"

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and SFAS 133 and SFAS 138 "Accounting for Derivative Instruments and Hedging Activities" and "Accounting for Certain Derivative Instruments and Certain Hedging Activities," (see below). All of these policies are mandatory under generally accepted accounting principles and the regulations of the Securities and Exchange Commission. Each of these policies has a material effect on the timing of revenue and expense recognition for significant company operations.

In connection with the application of these and other accounting policies, the company makes estimates and judgments about various matters. The most significant of these involve the calculation of fair values, and the collectibility of regulatory and other assets. As discussed elsewhere herein, the company uses exchange quotations or other third-party pricing to estimate fair values whenever possible. When no such data is available, it uses internally developed models or other techniques. The assumed collectibility of regulatory assets considers legal and regulatory decisions involving the specific items or similar items. The assumed collectibility of other assets considers the nature of the item, the enforceability of contracts where applicable, the creditworthiness of other parties and other factors.

New Accounting Standards

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

The company utilizes derivative financial instruments to reduce its exposure to unfavorable changes in energy prices, which are subject to significant and often volatile fluctuation. Derivative financial instruments are comprised of futures, forwards, swaps, options and long-term delivery contracts. These contracts allow SoCalGas to predict with greater certainty the effective prices to be received and the prices to be charged to its customers.

Upon adoption of SFAS 133 on January 1, 2001, the company is classifying its forward contracts as follows:

Normal Purchase and Sales: These forward contracts are excluded from the requirements of SFAS No. 133. The realized gains and losses on these contracts are reflected in the income statement at the contract settlement date. The contracts that generally qualify as normal purchases and sales are long-term contracts that are settled by physical delivery.

Cash Flow Hedges: The unrealized gains and losses related to these forward contracts are included in accumulated other comprehensive income, a component of shareholders' equity, and reflected in the Statements of Consolidated Income when the corresponding hedged transaction is settled.

Gas Purchases and Sales: The unrealized gains and losses related to these forward contracts are reflected on the balance sheet as regulatory assets and liabilities, to the extent derivative gains and losses will be recoverable or payable in future rates.

If gains and losses at SoCalGas are not recoverable or payable through future rates, SoCalGas will apply hedge accounting if certain criteria are met. In instances where hedge accounting is applied to energy derivatives, cash flow hedge accounting is elected and, accordingly,

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changes in fair values of the derivatives are included in other comprehensive income and reflected in the Statements of Consolidated Income when the corresponding hedged transaction is settled. The effect on other comprehensive income for the year ended December 31, 2001 was not material. In instances where energy derivatives do not qualify for hedge accounting, gains and losses are recorded in the Statements of Consolidated Income.

The adoption of this new standard on January 1, 2001, did not impact the company's earnings. However, \$982 million in current assets, \$1.1 billion in noncurrent assets, and \$4 million in current liabilities were recorded as of January 1, 2001, in the Consolidated Balance Sheets as fixed-priced contracts and other derivatives. Due to the regulatory environment in which SoCalGas operates, regulatory assets and liabilities were established to the extent that derivative gains and losses are recoverable or payable through future rates. As such, \$982 million in current regulatory liabilities, \$1.1 billion in noncurrent regulatory liabilities, and \$4 million in current regulatory assets were recorded as of January 1, 2001, in the Consolidated Balance Sheets. See Note 8 of the notes to Consolidated Financial Statements for additional information on the effects of SFAS 133 on the financial statements at December 31, 2001. The ongoing effects will depend on future market conditions and the company's hedging activities.

In July 2001, the Financial Accounting Standards Board (FASB) issued three statements, SFAS 141 "Business Combinations," SFAS 142 "Goodwill and Other Intangible Assets" and SFAS 143 "Accounting for Asset Retirement Obligations." The first two are not presently relevant to the company.

SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived asset. It requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity increases the carrying amount of the related long-lived asset to reflect the future retirement cost. Over time, the liability is accreted to its present value and paid, and the capitalized cost is depreciated over the useful life of the related asset. SFAS 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. The company has not yet determined the effect of SFAS 143 on its Consolidated Balance Sheets, but has determined that it will not have a material impact on its Statements of Consolidated Income.

In August 2001, the FASB issued SFAS 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" that replaces SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS 144 applies to all long-lived assets, including discontinued operations. SFAS 144 requires that those long-lived assets classified as held for sale be measured at the lower of carrying amount or fair value less cost to sell. Discontinued operations will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. SFAS 144 also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. The provisions of SFAS 144 are effective for fiscal years beginning after December 15, 2001. The company has not yet determined the effect of SFAS 144 on its financial statements.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The information required by Item 7A is set forth under "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Market Risk."

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA - Pacific Enterprises

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of Pacific Enterprises:

We have audited the accompanying consolidated balance sheets of Pacific Enterprises and subsidiaries as of December 31, 2001 and 2000, and the related statements of consolidated income, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Pacific Enterprises and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

/S/ DELOITTE & TOUCHE LLP

San Diego, California
February 4, 2002 (March 5, 2002 as to Note 12)

PACIFIC ENTERPRISES AND SUBSIDIARIES STATEMENTS OF CONSOLIDATED INCOME Dollars in millions

Years ended December 31	2001	2000	1999
Operating Revenues	\$3,716	\$2,854	\$2,569
Operating Expenses			

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Cost of natural gas distributed	2,117	1,361	1,033
Other operating expenses	794	696	748
Depreciation	268	263	261
Income taxes	167	175	163
Other taxes and franchise payments	101	96	93
	-----	-----	-----
Total operating expenses	3,447	2,591	2,298
	-----	-----	-----
Operating Income	269	263	271
	-----	-----	-----
Other Income and (Deductions)			
Interest income	40	64	40
Regulatory interest	(19)	(12)	(14)
Allowance for equity funds used during construction	6	3	--
Taxes on non-operating income	(4)	(10)	(3)
Preferred dividends of subsidiaries	(1)	(1)	(1)
Other - net	1	3	(21)
	-----	-----	-----
Total	23	47	1
	-----	-----	-----
Interest Charges			
Long-term debt	63	68	82
Other	25	33	8
Allowance for borrowed funds used during construction	(2)	(2)	(2)
	-----	-----	-----
Total	86	99	88
	-----	-----	-----
Net Income	206	211	184
Preferred Dividend Requirements	4	4	4
	-----	-----	-----
Earnings Applicable to Common Shares	\$ 202	\$ 207	\$ 180
	=====	=====	=====

See notes to Consolidated Financial Statements.

PACIFIC ENTERPRISES AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
Dollars in millions

Balance at December 31	2001	2000
	-----	-----
ASSETS		
Property, plant and equipment	\$6,590	\$6,337
Accumulated depreciation	(3,793)	(3,571)
	-----	-----
Property, plant and equipment - net	2,797	2,766
	-----	-----
Current assets:		
Cash and cash equivalents	13	205
Accounts receivable - trade	415	589
Accounts receivable - other	14	83
Due from unconsolidated affiliates	--	214
Income taxes receivable	20	--
Deferred income taxes	33	43
Regulatory assets arising from fixed-price contracts and other derivatives	103	--
Other regulatory assets	--	24
Fixed-price contracts and other derivatives	59	--
Inventories	42	67

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Other	4	84
	-----	-----
Total current assets	703	1,309
	-----	-----
Other assets:		
Due from unconsolidated affiliates	409	617
Regulatory assets arising from fixed-price contracts and other derivatives	157	--
Other regulatory assets	--	12
Sundry	125	52
	-----	-----
Total other assets	691	681
	-----	-----
Total assets	\$4,191	\$4,756
	=====	=====

See notes to Consolidated Financial Statements.

PACIFIC ENTERPRISES AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
Dollars in millions

Balance at December 31	2001	2000
	-----	-----
CAPITALIZATION AND LIABILITIES		
Capitalization:		
Common Stock (600,000,000 shares authorized; 83,917,664 shares outstanding)	\$1,317	\$1,282
Retained earnings	177	165
Accumulated other comprehensive income (loss)	--	(1)
	-----	-----
Total common equity	1,494	1,446
Preferred stock	80	80
	-----	-----
Total shareholder's equity	1,574	1,526
Long-term debt	579	821
	-----	-----
Total capitalization	2,153	2,347
	-----	-----
Current liabilities:		
Short-term debt	50	--
Current portion of long-term debt	100	120
Accounts payable - trade	160	368
Accounts payable - other	81	43
Due to unconsolidated affiliates	168	365
Regulatory balancing accounts - net	85	465
Income taxes payable	--	50
Dividends and interest payable	31	28
Regulatory liabilities	18	--
Fixed-price contracts and other derivatives	103	--
Other	390	321
	-----	-----
Total current liabilities	1,186	1,760
	-----	-----

Deferred credits and other liabilities:

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Customer advances for construction	24	16
Post-retirement benefits other than pensions	88	97
Deferred income taxes	110	150
Deferred investment tax credits	50	53
Regulatory liabilities	86	--
Fixed-price contracts and other derivatives	162	--
Deferred credits and other liabilities	312	313
Preferred stock of subsidiary	20	20
	-----	-----
Total deferred credits and other liabilities	852	649
	-----	-----
Contingencies and commitments (Note 11)		
Total liabilities and shareholder's equity	\$4,191	\$4,756
	=====	=====

See notes to Consolidated Financial Statements.

PACIFIC ENTERPRISES AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CASH FLOWS
Dollars in millions

Years ended December 31	2001	2000	1999
	-----	-----	-----
Cash Flows from Operating Activities			
Net Income	\$ 206	\$ 211	\$ 184
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	268	263	261
Deferred income taxes and investment tax credits	24	5	135
(Increase) decrease in other assets	(12)	40	11
Increase (decrease) in other liabilities	32	(16)	33
Changes in working capital components:			
Accounts and notes receivable	244	(377)	158
Income taxes receivable/payable	(71)	84	(59)
Fixed-price contracts and other derivatives	16	--	--
Inventories	25	11	(18)
Other current assets	4	(75)	(2)
Accounts payable	(171)	191	(19)
Due to/from affiliates	5	35	(39)
Regulatory balancing accounts	(380)	309	36
Regulatory assets and liabilities	39	(2)	(2)
Other current liabilities	71	93	10
	-----	-----	-----
Net cash provided by operating activities	300	772	689
	-----	-----	-----
Cash Flows from Investing Activities			
Capital expenditures	(294)	(198)	(146)
Loans repaid by (paid to) affiliates	220	(267)	(336)
Other - net	--	21	(1)
	-----	-----	-----
Net cash used in investing activities	(74)	(444)	(483)
	-----	-----	-----
Cash Flows from Financing Activities			
Common dividends paid	(190)	(100)	(100)
Preferred dividends paid	(4)	(4)	(4)
Payments on long-term debt	(270)	(30)	(75)

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Increase (decrease) in short-term debt	50	--	(43)
Other	(4)	--	--
	-----	-----	-----
Net cash used in financing activities	(418)	(134)	(222)
	-----	-----	-----
Increase (decrease) in cash and cash equivalents	(192)	194	(16)
Cash and cash equivalents, January 1	205	11	27
	-----	-----	-----
Cash and cash equivalents, December 31	\$ 13	\$ 205	\$ 11
	=====	=====	=====
Supplemental Disclosure of Cash Flow Information:			
Interest payments, net of amounts capitalized	\$ 83	\$ 127	\$ 90
	=====	=====	=====
Income tax payments, net of refunds	\$ 209	\$ 99	\$ 92
	=====	=====	=====

See notes to Consolidated Financial Statements

PACIFIC ENTERPRISES AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CASH FLOWS (continued)
Dollars in millions

Years ended December 31	2001	2000	1999
	-----	-----	-----
Supplemental Schedule of Noncash Activities:			
Dividend of affiliates to Sempra Energy	\$ --	\$ --	\$ 417
	=====	=====	=====
Capital contribution from Sempra Energy	\$ --	\$ --	\$ 85
	=====	=====	=====

See notes to Consolidated Financial Statements.

PACIFIC ENTERPRISES AND SUBSIDIARIES
STATEMENTS OF CONSOLIDATED CHANGES IN SHAREHOLDERS' EQUITY
Years ended December 31, 2001, 2000 and 1999
Dollars in millions

	Comprehensive Income	Preferred Stock	Common Stock	Retained Earnings	Deferred Compensation Relating to ESOP	Accumulated Other Comprehensive Income (Loss)	To Sh Eq
Balance at December 31, 1998		\$ 80	\$1,117	\$395	\$ (45)		
Net income	\$184			184			
Other comprehensive income (loss):							
Available-for-sale securities	10					\$ 10	
Pension	(4)					(4)	

Comprehensive income	\$190						
Preferred stock dividends	=====						

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declared				(4)	
Common stock dividends					
declared				(100)	
Capital contribution		85			
Quasi-reorganization					
Adjustment (Note 2)		80			
Dividend of subsidiaries to					
Sempra Energy				(417)	
Transfer of ESOP to					
Sempra Energy					45

Balance at December 31, 1999	80	1,282	58	--	6
Net income	\$211		211		
Other comprehensive income (loss):					
Available-for-sale					
securities	(10)				(10)
Pension	3				3

Comprehensive income	\$204				
	=====				
Preferred stock dividends					
declared				(4)	
Common stock dividends					
declared				(100)	

Balance at December 31, 2000	80	1,282	165	--	(1)
Net income	\$206		206		
Other comprehensive income (loss):					
Other	1				1

Comprehensive income	\$207				
	=====				
Quasi-reorganization					
adjustment (Note 2)		35			
Preferred stock dividends					
declared				(4)	
Common stock dividends					
declared				(190)	

Balance at December 31, 2001	\$ 80	\$1,317	\$ 177	\$ --	\$ --
=====					

See notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BUSINESS COMBINATION

Sempra Energy was formed as a holding company for Pacific Enterprises (PE) the parent company of Southern California Gas Company (SoCalGas) and Enova Corporation (Enova), the parent company of San Diego Gas & Electric (SDG&E), in connection with a business combination that was completed on June 26, 1998. As a result of the combination, each outstanding share of common stock of Enova was converted into one share of common stock of Sempra Energy, and each outstanding share of common stock of PE was converted into 1.5038 shares of common stock of Sempra Energy.

As a result of the business combination, PE dividdended its nonutility subsidiaries to Sempra Energy during 1998 and early 1999. SoCalGas is now the sole direct subsidiary of PE.

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NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

As a subsidiary of Sempra Energy, the company receives certain services therefrom. Although it is charged its allocable share of the cost of such services, that cost is believed to be less than if the company had to provide those services itself.

Effects of Regulation

The accounting policies of the company conform with generally accepted accounting principles for regulated enterprises and reflect the policies of the California Public Utilities Commission (CPUC) and the Federal Energy Regulatory Commission (FERC).

The company prepares its financial statements in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, "Accounting for the Effects of Certain Types of Regulation," under which a regulated utility records a regulatory asset if it is probable that, through the ratemaking process, the utility will recover that asset from customers. Regulatory liabilities represent future reductions in rates for amounts due to customers. To the extent that portions of the utility operations cease to be subject to SFAS No. 71, or recovery is no longer probable as a result of changes in regulation or the utility's competitive position, the related regulatory assets and liabilities would be written off. In addition, SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," affects utility plant and regulatory assets such that a loss must be recognized whenever a regulator excludes all or part of an asset's cost from rate base. The application of SFAS No. 121 continues to be evaluated in connection with industry restructuring. Information concerning regulatory assets and liabilities is described below in "Revenues," "Regulatory Balancing Accounts" and "Regulatory Assets and Liabilities," and industry restructuring is described in Note 12.

Revenues

Revenues for SoCalGas are derived from deliveries of natural gas to customers and changes in related regulatory balancing accounts. Revenue for natural gas sales and services are generally recorded under the accrual method and these revenues are recognized upon delivery. Natural gas storage contract revenues are accrued on a monthly basis and reflect reservation, storage and injection charges in accordance with negotiated agreements, which have one-year to three-year terms. Operating revenue includes amounts for services rendered but unbilled (approximately one-half month's deliveries) at the end of each year.

Additional information concerning utility revenue recognition is discussed below under "Regulatory Balancing Accounts" and "Regulatory Assets and Liabilities."

Regulatory Balancing Accounts

The amounts included in regulatory balancing accounts represent net payables (overcollected balancing accounts less undercollected balancing accounts) of \$85 million and \$465 million at December 31, 2001 and 2000, respectively.

Balancing accounts provide a mechanism for charging utility customers the exact amount incurred for certain costs, primarily commodity costs. As a result, fluctuations in most costs and consumption levels do not affect earnings from SoCalGas' operations.

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Additional information on regulatory matters is included in Note 12.

Regulatory Assets and Liabilities

In accordance with the accounting principles of SFAS 71 for rate-regulated enterprises, the company records regulatory assets (which represent probable future revenues associated with certain costs that will be recovered from customers through the rate-making process) and regulatory liabilities (which represent probable future reductions in revenue associated with amounts that are to be credited to customers through the rate-making process). They are amortized over the periods in which the costs are recovered from or refunded to customers in regulatory revenues.

Regulatory assets (liabilities) as of December 31 consist of the following (dollars in millions):

	2001	2000
	-----	-----
SoCalGas		

Environmental remediation	\$ 55	\$ 58
Fixed-price contracts and other derivatives	257	--
Unamortized loss on retirement of debt - net	41	36
Deferred taxes recoverable in rates	(158)	(100)
Employee benefit costs	(132)	(60)
Other	5	6
	-----	-----
Total	68	(60)
PE		

Employee benefit costs	88	96
	-----	-----
Total PE consolidated	\$ 156	\$ 36
	=====	=====

Net regulatory assets are recorded on the Consolidated Balance Sheets at December 31 as follows (dollars in millions):

	2001	2000
	-----	-----
SoCalGas		

Current regulatory assets	\$ 103	\$ 24
Noncurrent regulatory assets	157	--
Current regulatory liabilities	(18)	--
Noncurrent regulatory liabilities	(174)	(84)
	-----	-----
Total	68	(60)
PE		

Noncurrent regulatory assets	88	96
	-----	-----
Total PE consolidated	\$ 156	\$ 36
	=====	=====

All assets earn a return or the cash has not yet been expended and the assets are offset by liabilities that do not incur a carrying cost.

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Allowance for Doubtful Accounts

The allowance for doubtful accounts was \$14 million, \$19 million and \$17 million at December 31, 2001, 2000, and 1999, respectively. The company recorded a provision for doubtful accounts of \$9 million, \$9 million and \$7 million in 2001, 2000 and 1999, respectively.

Inventories

At December 31, 2001, inventory included natural gas of \$34 million, and materials and supplies of \$8 million. The corresponding balances at December 31, 2000 were \$56 million and \$11 million, respectively. Natural gas is valued by the last-in first-out (LIFO) method. When the inventory is consumed, differences between this LIFO valuation and replacement cost will be reflected in customer rates. Materials and supplies are generally valued at the lower of average cost or market.

Due to/from Unconsolidated Affiliates

PE has promissory notes due from Sempra Energy and from Sempra Energy Global Enterprises (Global) which bear variable interest rates based on short-term commercial paper rates. These notes were \$268 million and \$138 million, respectively, at December 31, 2001 and were included in noncurrent assets under the caption "due from unconsolidated affiliates". The corresponding balances at December 31, 2000 were \$469 million and \$133 million, respectively. PE also had \$3 million and \$15 million due from other affiliates at December 31, 2001 and 2000, respectively.

SoCalGas had a promissory note receivable from Sempra Energy of \$214 million at December 31, 2000, included in current assets under the caption "due from unconsolidated affiliates." Sempra Energy paid this promissory note during 2001.

In addition, PE had intercompany payables due to various affiliates of \$168 million and \$365 million at December 31, 2001, and 2000, respectively, which are recorded as a current liability. These balances are due on demand. Of the \$168 million balance, \$24 million was recorded at SoCalGas.

Property, Plant and Equipment

Utility plant primarily represents the buildings, equipment and other facilities used by SoCalGas to provide natural gas service.

The cost of utility plant includes labor, materials, contract services and related items, and an allowance for funds used during construction (AFUDC). The cost of most retired depreciable utility plant, plus removal costs minus salvage value, is charged to accumulated depreciation. Accumulated depreciation was \$3.8 billion and \$3.6 billion at December 31, 2001 and 2000, respectively, which primarily reflects accumulated depreciation for natural gas utility plant at SoCalGas of \$3.7 billion and \$3.6 billion, respectively. Depreciation expense is based on the straight-line method over the useful lives of the assets, an average of 23 years in each of 2001, 2000 and 1999, or a shorter period prescribed by the CPUC. The provision for depreciation as a percentage of average depreciable utility plant was 4.33, 4.36 and 4.39 in 2001, 2000 and 1999, respectively. See Note 12 for discussion of industry restructuring. Maintenance costs are expensed as incurred.

AFUDC, which represents the cost of funds used to finance the construction of utility plant, is added to the cost of utility plant. AFUDC also increases income, partly as an offset to interest charges and partly as a component of other income, shown in the Statements of

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Consolidated Income, although it is not a current source of cash.

Long-Lived Assets

In accordance with SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," the company periodically evaluates whether events or circumstances have occurred that may affect the recoverability or the estimated useful lives of long-lived assets. Impairment occurs when the estimated future undiscounted cash flows exceed the carrying amount of the assets. If that comparison indicates that the assets' carrying value may be permanently impaired, such potential impairment is measured based on the difference between the carrying amount and the fair value of the assets based on quoted market prices or, if market prices are not available, on the estimated discounted cash flows. This calculation is performed at the lowest level for which separately identifiable cash flows exist. The effects of ratemaking procedures and SFAS 71 significantly reduce the likelihood of any impairment.

Comprehensive Income

Comprehensive income includes all changes, except those resulting from investments by owners and distributions to owners, in the equity of a business enterprise from transactions and other events, including, as applicable, foreign-currency translation adjustments, minimum pension liability adjustments, unrealized gains and losses on marketable securities that are classified as available-for-sale, and certain hedging activities. The components of other comprehensive income are shown in the Statements of Consolidated Changes in Shareholders' Equity.

Quasi-Reorganization

In 1993, PE divested its merchandising operations and most of its oil and gas exploration and production business. In connection with the divestitures, PE effected a quasi-reorganization for financial reporting purposes as of December 31, 1992. Certain of the liabilities established in connection with the quasi-reorganization, including various income-tax issues, have been favorably resolved. Excess liabilities of \$35 million and \$80 million resulting from the favorable resolution of these issues were restored to shareholders' equity in December 2001 and November 1999, respectively, but did not affect the calculation of net income. The remaining liabilities will be resolved in future years. Management believes the provisions established for these matters are adequate.

Use of Estimates in the Preparation of the Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results can differ significantly from those estimates.

Cash and Cash Equivalents

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

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Basis of Presentation

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

New Accounting Standards

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

The company utilizes derivative financial instruments to reduce its exposure to unfavorable changes in energy prices, which are subject to significant and often volatile fluctuation. Derivative financial instruments include futures, forwards, swaps, options and long-term delivery contracts. These contracts allow SoCalGas to predict with greater certainty the effective prices to be received and the prices to be charged to its customers.

Upon adoption of SFAS 133 on January 1, 2001, the company classifies its forward contracts as follows:

Normal Purchase and Sales: These forward contracts are excluded from the requirements of SFAS No. 133. The realized gains and losses on these contracts are reflected in the income statement at the contract settlement date. The contracts that generally qualify as normal purchases and sales are long-term contracts that are settled by physical delivery.

Cash Flow Hedges: The unrealized gains and losses related to these forward contracts are included in accumulated other comprehensive income, a component of shareholders' equity, but not reflected in the Statements of Consolidated Income until the corresponding hedged transaction is settled.

Gas Purchases and Sales: The unrealized gains and losses related to these forward contracts are reflected on the balance sheet as regulatory assets and liabilities, to the extent derivative gains and losses will be recoverable or payable in future rates.

If gains and losses at SoCalGas are not recoverable or payable through future rates, SoCalGas will apply hedge accounting if certain criteria are met.

In instances where hedge accounting is applied to energy derivatives, cash flow hedge accounting is elected and, accordingly, changes in fair values of the derivatives are included in other comprehensive income, but not reflected in the Statements of Consolidated Income until the corresponding hedged transaction is settled. The effect on other comprehensive income for the year ended December 31, 2001 was not material. In instances where energy derivatives do not qualify for hedge accounting, gains and losses are recorded in the Statements of Consolidated Income.

The adoption of this new standard on January 1, 2001, did not impact the company's earnings. However, \$982 million in current assets, \$1.1 billion in noncurrent assets, and \$4 million in current liabilities were recorded as of January 1, 2001, in the Consolidated

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Balance Sheets as fixed-priced contracts and other derivatives. Due to the regulatory environment in which SoCalGas operates, regulatory assets and liabilities were established to the extent that derivative gains and losses are recoverable or payable through future rates. As such, \$982 million in current regulatory liabilities, \$1.1 billion in noncurrent regulatory liabilities, and \$4 million in current regulatory assets were recorded in the Consolidated Balance Sheets as of January 1, 2001. See Note 8 for additional information on the effects of SFAS 133 on the financial statements at December 31, 2001. The ongoing effects will depend on future market conditions and the company's hedging activities.

In July 2001, the Financial Accounting Standards Board (FASB) issued three statements, SFAS 141 "Business Combinations," SFAS 142 "Goodwill and Other Intangible Assets" and SFAS 143 "Accounting for Asset Retirement Obligations." The first two are not presently relevant to the company.

SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived asset. It requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity increases the carrying amount of the related long-lived asset to reflect the future retirement cost. Over time, the liability is accreted to its present value and paid, and the capitalized cost is depreciated over the useful life of the related asset. SFAS 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. The company has not yet determined the effect of SFAS 143 on its Consolidated Balance Sheets, but has determined that it will not have a material impact on its Statements of Consolidated Income.

In August 2001, the FASB issued SFAS 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" that replaces SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS 144 applies to all long-lived assets, including discontinued operations. SFAS 144 requires that those long-lived assets be measured at the lower of carrying amount (cost less accumulated depreciation) or fair value less cost to sell. Discontinued operations will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. SFAS 144 also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. The provisions of SFAS 144 are effective for fiscal years beginning after December 15, 2001. The effect of adopting SFAS 144 is not expected to have a material impact on the company's financial statements.

NOTE 3. SHORT-TERM BORROWINGS

At December 31, 2001, PE had a \$500 million two-year revolving line of credit, guaranteed by Sempra Energy, for the purpose of providing loans to Sempra Energy Global Enterprises (Global). The revolving credit commitment expires in April 2003, at which time then outstanding borrowings may be converted into a two-year term loan. Borrowings would be subject to mandatory prepayment should PE's issuer credit rating cease to be at least BBB- by Standard & Poors (S&P), should SoCalGas' unsecured long-term credit ratings cease to be at least BBB by S&P and Baa2 by Moody's, should Sempra Energy's or

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SoCalGas' debt-to-total capitalization ratios (as defined in the agreement) exceed 65 percent, or should there be a change in law materially and adversely affecting the ability of SoCalGas to pay dividends or make distributions to PE. Borrowings would bear interest at rates varying with market rates and the amount of the outstanding borrowings. PE's line of credit was unused at December 31, 2001.

At December 31, 2001, SoCalGas had a \$170 million syndicated revolving line of credit, which is available to support commercial paper. Borrowings under the agreement, which expires on May 26, 2002, would bear interest at various rates based on market rates and SoCalGas' credit rating. The agreement requires SoCalGas to maintain a debt-to-total capitalization ratio (as defined in the agreement) of not to exceed 65 percent. At December 31, 2001, SoCalGas had \$50 million of commercial paper outstanding. The revolving line of credit was unused at December 31, 2001 and 2000.

The company's weighted average interest rate for short-term borrowings outstanding at December 31, 2001 was 2.04%.

NOTE 4. LONG-TERM DEBT

(Dollars in millions)	December 31,	
	2001	2000

First-mortgage bonds		
6.875% August 15, 2002	\$ 100	\$ 100
5.75% November 15, 2003	100	100
7.375% March 1, 2023	100	100
7.5% June 15, 2023	125	125
Variable rates November 1, 2025 (1.95% at December 31, 2001)	175	175
8.75% October 1, 2021	--	150
	-----	-----
	600	750

Unsecured long-term debt		
5.67% January 18, 2028	75	75
6.375% May 14, 2006	8	8
6.375% October 29, 2001	--	120
	-----	-----
	83	203

Total	683	953
Less:		
Current portion of long-term debt	100	120
Unamortized discount on long-term debt	-	12
Market value adjustment on Interest-rate swap	4	-
	-----	-----
Total	\$ 579	\$ 821

Maturities of long-term debt are \$100 million in 2002, \$175 million in 2003 and \$408 million after 2006.

First-mortgage Bonds

First-mortgage bonds are secured by a lien on utility plant. SoCalGas may issue additional first-mortgage bonds upon compliance with the

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provisions of its bond indentures, which require, among other things, the satisfaction of pro forma earnings-coverage tests on first-mortgage bond interest and the availability of sufficient mortgaged property to support the additional bonds. The most restrictive of these tests (the property test) would permit the issuance, subject to CPUC authorization, of an additional \$753 million of first-mortgage bonds as of December 31, 2001.

In November 2001, SoCalGas called its \$150 million 8.75 percent first-mortgage bonds at a premium of 3.59 percent.

On December 11, 2001, SoCalGas entered into an interest-rate swap which effectively exchanged the fixed rate on its \$175 million 6.875 percent first-mortgage bonds for a floating rate. Additional information is provided under "Interest-Rate Swaps" below.

Unsecured Long-term Debt

Various long-term obligations totaling \$83 million are unsecured at December 31, 2001. In October 2001, SoCalGas repaid \$120 million of 6.38 percent medium-term notes upon maturity.

Callable Bonds

At SoCalGas' option, certain fixed-rate bonds may be called at a premium, including \$400 million that are callable in 2003 and \$8 million in 2006.

Interest-Rate Swaps

SoCalGas periodically enters into interest-rate swap agreements to moderate its exposure to interest-rate changes and to lower its overall cost of borrowing. At December 31, 2001, the company had one such swap agreement. On December 11, 2001, SoCalGas executed a cancelable-call interest-rate swap, exchanging its fixed rate obligation of 6.875 percent on its \$175 million first-mortgage bonds for a floating rate of LIBOR plus 4 basis points. The transaction may be cancelled every 5 years by either party by payment of the mark-to-market value, or may be cancelled by the counterparty at any time the bonds are callable, by payment to SoCalGas of the applicable call premium on the bonds. The company believes the swap is fully effective in its purpose of converting the fixed rate stated in the debt to a floating rate and the swap meets the criteria for accounting under the short-cut method defined in SFAS no. 133 for fair value hedges of debt instruments. Accordingly, a market value adjustment to long-term debt of \$4 million was recorded at December 31, 2001 to reflect, without affecting net income or other comprehensive income, the favorable economic consequences (as measured at December 31, 2001) of having entered into the swap transaction. See additional discussion of interest rate swaps in Note 8.

Financial Covenants

SoCalGas' first-mortgage bond indentures require the satisfaction of certain bond interest coverage ratios and the availability of sufficient mortgaged property to issue additional first-mortgage bonds, but do not restrict other indebtedness. Note 3 discusses the financial covenants applicable to short-term debt.

NOTE 5. INCOME TAXES

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

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Years ended December 31	2001	2000	1999
Statutory federal income tax rate	35.0%	35.0%	35.0%
Depreciation	5.4	5.2	7.4
State income taxes - net of federal income tax benefit	6.9	6.9	7.3
Tax credits	(0.8)	(0.7)	(0.9)
Other - net	(1.1)	0.3	(1.4)
Effective income tax rate	45.4%	46.7%	47.4%

The components of income tax expense are as follows:

(Dollars in millions)	2001	2000	1999
Current:			
Federal	\$ 116	\$ 139	\$ 22
State	30	41	9
Total	146	180	31
Deferred:			
Federal	20	7	113
State	8	--	25
Total	28	7	138
Deferred investment tax credits - net	(3)	(2)	(3)
Total income tax expense	\$ 171	\$ 185	\$ 166

Federal and state income taxes are allocated between operating income and other income. PE is included in the consolidated tax return of Semptra Energy and is allocated income tax expense from Semptra Energy in an amount equal to that which would result from filing a separate return.

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

(Dollars in millions)	2001	2000
Deferred Tax Liabilities:		
Differences in financial and tax bases of utility plant	\$ 295	\$ 373
Regulatory balancing accounts	56	11
Regulatory assets	36	39
Other	49	11
Total deferred tax liabilities	436	434
Deferred Tax Assets:		
Investment tax credits	34	38
Postretirement benefits	36	39
Other deferred liabilities	174	143
Restructuring costs	42	43
Other	73	64

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Total deferred tax assets	359	327
Net deferred income tax liability	\$ 77	\$ 107

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

(Dollars in millions)	2001	2000
Current asset	\$ (33)	\$ (43)
Noncurrent liability	110	150
Total	\$ 77	\$ 107

NOTE 6. EMPLOYEE BENEFIT PLANS

Pension and Other Postretirement Benefits

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

During 2000, the company participated in a voluntary separation program. As a result, the company recorded a \$40 million special termination benefit.

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

(Dollars in millions)	Pension Benefits		Other Postretirement Benefits	
	2001	2000	2001	2000
Weighted-Average Assumptions				
as of December 31:				
Discount rate	7.25%	7.25%(1)	7.25%	7.25%
Expected return on plan assets	8.00%	8.00%	8.00%	8.00%
Rate of compensation increase	5.00%	5.00%	5.00%	5.00%
Cost trend of covered health care charges	--	--	7.25%(2)	7.50%(2)
Change in Benefit Obligation:				
Net benefit obligation at January 1	\$1,125	\$1,057	\$ 415	\$ 408
Service cost	25	23	9	8
Interest cost	78	84	32	28
Actuarial (gain) loss	(46)	79	23	(17)
Curtailments	--	(4)	--	4
Special termination benefits	--	34	--	2
Benefits paid	(71)	(148)	(22)	(18)
Net benefit obligation at December 31	1,111	1,125	457	415

Change in Plan Assets:

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Fair value of plan assets				
at January 1	1,682	1,971	434	463
Actual return on plan assets	(162)	(141)	(33)	(23)
Employer contributions	--	--	13	10
Transfer of assets (3)	3	--	--	2
Benefits paid	(71)	(148)	(22)	(18)

Fair value of plan assets				
at December 31	1,452	1,682	392	434

Plan assets net of benefit				
obligation at December 31	341	557	(65)	19
Unrecognized net actuarial gain	(322)	(591)	(23)	(116)
Unrecognized prior service cost	35	38	--	--
Unrecognized net transition				
obligation	2	2	--	--

Net recorded asset (liability)				
at December 31	\$ 56	\$ 6	\$ (88)	\$ (97)

- (1) Discount rate decreased from 7.75% to 7.25%, effective March 1, 2000.
(2) Decreasing to ultimate trend of 6.50% in 2004.
(3) To reflect transfer of plan assets and liability to Sempra Energy.

The following table provides the amounts recognized on the Consolidated Balance Sheets (under "sundry" and under "postretirement benefits other than pensions") at December 31:

(Dollars in millions)	Pension Benefits		Other Postretirement Benefits	
	2001	2000	2001	2000

Prepaid benefit cost	\$ 67	\$ 15	--	--
Accrued benefit cost	(11)	(9)	\$ (88)	\$ (97)
Additional minimum liability	(2)	(4)	--	--
Intangible asset	1	1	--	--
Accumulated other comprehensive income, pre-tax	1	3	--	--

Net recorded asset (liability)	\$ 56	\$ 6	\$ (88)	\$ (97)

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

(Dollars in millions)	Pension Benefits			Other Postretirement Benefits		
	2001	2000	1999	2001	2000	1999

For the years ended December 31						

Service cost	\$ 25	\$ 23	\$ 28	\$ 9	\$ 8	\$ 11
Interest cost	78	84	77	32	28	30

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Expected return on assets	(129)	(131)	(112)	(34)	(32)	(27)
Amortization of:						
Transition obligation	1	1	1	8	9	9
Prior service cost	3	4	4	--	--	--
Actuarial gain	(28)	(29)	(14)	(3)	(8)	--
Special termination benefits	--	33	--	--	7	--
Regulatory adjustment	51	18	17	29	28	24
Total net periodic benefit cost	\$ 1	\$ 3	\$ 1	\$ 41	\$ 40	\$ 47

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

(Dollars in millions)	1% Increase	1% Decrease
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	\$ 8	\$ (6)
Effect on the health care component of the accumulated other postretirement benefit obligation	\$76	\$ (60)

Except for one nonqualified, unfunded retirement plan, all pension plans had plan assets in excess of accumulated benefit obligations. For that one plan the projected benefit obligation and accumulated benefit obligation were \$13 million and \$12 million, respectively, as of December 31, 2001, and \$16 million and \$12 million, respectively, as of December 31, 2000.

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

Savings Plan

SoCalGas offers a savings plan, administered by plan trustees, to all eligible employees. Eligibility to participate in the plan is immediate for salary deferrals. Employees may contribute, subject to plan provisions, from one percent to 15 percent of their regular earnings. After one year of completed service, the company begins to make matching contributions. Employer contributions are equal to 50 percent of the first 6 percent of eligible base salary contributed by employees. Employer contributions are invested in Sempra Energy common stock (new issuances or market purchases) and must remain so invested until termination of employment. At the direction of the employees, the employee's contributions are invested in Sempra Energy stock, mutual funds, or institutional trusts. Employer contributions for the SoCalGas plan are partially funded by the Sempra Energy Employee Stock Ownership Plan and Trust (formerly the Pacific Enterprises Employee Stock Ownership Plan and Trust). Company contributions to the savings plan were \$7 million in 2001, \$5 million in 2000 and \$6 million in 1999.

NOTE 7. STOCK-BASED COMPENSATION

Sempra Energy has stock-based compensation plans intended to align

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employee and shareholder objectives related to Sempra Energy's long-term growth. The plans permit a wide variety of stock-based awards, including Sempra Energy non-qualified stock options, incentive stock options, restricted stock, stock appreciation rights, performance awards, stock payments and dividend equivalents.

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Gross profit (loss)	1,262,436	1,091,346	1,262,436	(913,
Operating costs:				
Operating expenses - Manager - related party		168,643	151,204	476,
Other selling, general and administrative expenses		118,100	117,524	
Total operating costs	286,743	268,728	939,588	982,395
Operating income (loss)	975,693	822,618	322,848	(1,895,
Other income:				
Interest income	3,559	5,183	9,895	18,930
Other income	52,346	18,829	101,655	38,890
Net income (loss) before income taxes		1,031,598	846,630	434,398
Income tax expense	(10,000)	-	(10,000)	-
Net income (loss)	\$ 1,021,598	\$ 846,630	\$ 424,398	\$ (1,837,817)
Net Income (Loss) Per Share				
Basic	\$ 0.12	\$ 0.10	\$ 0.05	\$ (0.21)
Diluted	\$ 0.12	\$ 0.10	\$ 0.05	\$ (0.21)
Weighted Average Number of Shares Outstanding				
Basic	8,802,242	8,832,301	8,803,605	8,803,104
Diluted	8,834,242	8,832,301	8,823,004	8,803,104

The accompanying notes are an integral part of these unaudited condensed financial statements.

SMG INDIUM RESOURCES LTD.
CONDENSED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

	Common Stock Shares	Value	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total Stockholders' Equity
Balance at December 31, 2012	8,832,301	\$ 8,833	\$ 40,106,728	\$ (11,427,369)	\$ (52,284)	\$ 28,635,908
Award of stock options to officer	-	-	4,900	-	-	4,900
Purchase of 6,720 shares of treasury stock	-	-	-	-	(16,420)	(16,420)
Return of capital distributions	-	-	(1,760,469)	-	-	(1,760,469)
Net income	-	-	-	424,398	-	424,398
Balance at September 30, 2013	8,832,301	\$ 8,833	\$ 38,351,159	\$ (11,002,971)	\$ (68,704)	\$ 27,288,317

The accompanying notes are an integral part of these unaudited condensed financial statements.

SMG INDIUM RESOURCES LTD.
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	For the Nine Months Ended September 30,	
	2013	2012
Cash flow from operating activities:		
Net income (loss)	\$ 424,398	\$ (1,837,817)
Adjustments to reconcile net income (loss) to net cash provided by (used in)		
operating activities:		
Write-downs of inventory - indium	-	913,242
Share-based compensation to officer	4,900	5,300
Depreciation	597	249
Changes in operating assets and liabilities:		
Increase in accounts receivable	(668,531)	-
Increase in prepaid expenses and other current assets	(31,219)	(21,857)
Decrease in cash and cash equivalents restricted for indium purchases	-	2,700,781
Decrease (increase) in inventory - indium	5,151,837	(6,157,539)
Increase in accounts payable and accrued expenses	74,816	57,293
Increase in unconditional sale and purchase agreement repurchase obligation	1,024,192	-
Net cash provided by (used in) operating activities	5,980,990	(4,340,348)
Cash flow from financing activities:		
Proceeds from private placement of common stock to a related party, net	-	7,497,500
Purchase of treasury shares	(16,420)	-
Return of capital distributions	(1,760,469)	-
Net cash (used in) provided by financing activities	(1,776,889)	7,497,500
Net increase in cash and cash equivalents	4,204,101	3,157,152
Cash and cash equivalents, at beginning of period	6,151,770	3,536,331
Cash and cash equivalents, at end of period	\$ 10,355,871	\$ 6,693,483

The accompanying notes are an integral part of these unaudited condensed financial statements.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 1 Organization and Nature of Business and Basis of Presentation

Organization and Nature of Business

SMG Indium Resources Ltd. (the "Company") is a corporation established pursuant to the laws of the State of Delaware on January 7, 2008. The Company operates in a single-segment business whose primary business purpose was to stockpile indium, a specialty metal that is being used as a raw material in a wide variety of consumer electronics manufacturing applications. The primary commercial application of indium is in coatings for the flat panel display industry and in the liquid crystal display ("LCD") industry on electronic devices such as television sets, computer monitors, cell phones and digital cameras. Indium is increasingly being used as a raw material in light emitting diodes ("LED") and in the solar energy industry. Its main use in solar energy applications is for high-efficiency photovoltaic cells in the form of thin-film photovoltaic. Other uses of indium are in electrical components, alloys and solders. At its discretion and based on market conditions, the Company leases, lends or sells some, or all, of its indium stockpile. The Company's common shares represent an indirect interest in the physical indium the Company owns.

The Company entered into a Management Services Agreement, as amended and restated on May 10, 2011 (the "MSA"), with a related party, Specialty Metals Group Advisors, LLC ("SMG Advisors" or the "Manager"). The primary responsibilities of the Manager are: (i) purchasing, lending, leasing and selling indium; (ii) submitting written reports to the Company's board of directors detailing the delivery and payment particulars regarding each purchase, lease, loan or sale of indium; (iii) arranging for the storage of indium; (iv) preparing a biweekly report on the net market value ("NMV"), as defined below; (v) preparing any regulatory filings or special reports to the Company's stockholders and board of directors; and (vi) managing the general business affairs of the Company. The MSA has an initial term of five years with options to renew upon mutual agreement between the parties. Pursuant to the terms of the MSA, the Company is required to pay the Manager a fee of 2 % per annum of the monthly NMV.

NMV is not a United States generally accepted accounting principles ("U.S. GAAP") measurement. It is an internally created formula used by the Company to monitor performance and to compute the management fee. NMV is determined by multiplying the number of kilograms of indium held by the Company by the last spot price for indium published by Metal Bulletin and posted on Bloomberg L.P. (Bloomberg L.P. is not regulated or government approved) for the month, plus cash and other Company assets, less any liabilities. At September 30, 2013 and December 31, 2012, the Company's management calculated the NMV of the Company to be approximately \$35.0 million and \$28.8 million, respectively. At September 30, 2013 and December 31, 2012, the excess of NMV at the indium spot price as of the respective dates (as published by Metal Bulletin PLC and posted on Bloomberg L.P.) over the historical net book value was approximately \$7.7 million and \$0.1 million, respectively.

The Company's business strategy has been to stockpile indium in order to achieve long-term appreciation in the value of its indium stockpile, and not to actively speculate with regard to short-term fluctuations in indium prices. There is no assurance that the price of indium or the value of the Company's securities will increase over time. Recently, the Company began selling a portion of its stockpile in response to market conditions.

Basis of Presentation

The accompanying interim unaudited condensed financial statements have been prepared in accordance with U.S. GAAP and with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission ("SEC"). Accordingly, these interim unaudited condensed financial statements do not include

all of the disclosures required by U.S. GAAP for complete financial statements. These interim unaudited condensed financial statements should be read in conjunction with the Company's audited financial statements included in the Company's 2012 Annual Report on Form 10-K, as filed with the SEC. In the opinion of management, the interim unaudited condensed financial statements included herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statement of the results for the interim periods presented. The condensed balance sheet at December 31, 2012 has been derived from the Company's 2012 audited balance sheet as of December 31, 2012 included in the Company's 2012 Annual Report on Form 10-K, as filed with the SEC. Operating results for the three months and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013 or any interim period.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 2 Summary of Significant Accounting Policies

Use of Estimates

The preparation of the financial statements and related disclosures in conformity with U.S. GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statement and the reported amounts of revenue and expenses during the reporting period. The most significant estimates relate to the valuation of indium inventory, share-based compensation, income tax, and income and revenue recognition. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid instruments with original maturities of 90 days or less at the time of purchase to be cash equivalents.

Inventory of the Metal Indium

The Company's inventory or "stockpile" of the metal indium is recorded at cost, including all associated costs of delivering the indium to the bonded storage warehouse on the date the Company takes delivery of the physical metal. The stockpile of the physical metal indium and the related repurchase right was classified as noncurrent as the Company's primary business purpose was to stockpile indium with the objective of achieving long-term appreciation in the value of indium. At June 30, 2013, approximately \$11.3 million of inventory-indium was reclassified to current assets due to the fact that during the next twelve months the Company intended to sell up to 50% of the indium stockpile to satisfy its cash requirements for its corporate initiatives based on prevailing market conditions. The Company began selling indium in July 2013 and at September 30, 2013, the balance in current indium-inventory was approximately \$6.2 million in the accompanying unaudited condensed balance sheet. The decrease resulted from sales of indium in the third quarter of 2013.

The stockpile of the physical metal indium is carried at the lower of cost or market with cost being determined on a specific-identification method and market being determined as the net realizable value based on the spot prices obtained from Metal Bulletin as posted on Bloomberg L.P., a real-time financial information services data platform. The Company charges against earnings an inventory write-down on an interim basis for the amount by which the spot price of indium is less than cost on a specific-identification basis. Increases or decreases in the spot price of the same lots of indium held in inventory in later interim periods within the fiscal year are recognized in such interim periods. Increases in value recognized on an interim basis do not exceed the previously recognized diminution in value within that fiscal year. Further, the Company periodically reviews the indium stockpile to determine if a loss should be recognized where the utility of indium has been impaired on an other-than-temporary basis. Where such impairment is viewed as other-than-temporary, the Company will charge against earnings the amount by which the fair value is less than the cost. Through December 31, 2012, certain lots of indium in inventory were adjusted to reflect a lower of cost or market write-down aggregating approximately \$5.9 million based on the spot price of indium of \$485 per kilogram at December 31, 2012. As a result, the cost basis of all lots in inventory for accounting purposes is \$485 or less per kilogram. The Company will not record any additional write-downs unless the spot price of indium falls below \$485 per kilogram. Further, inventory cannot be increased above its cost based on increases in the spot price of indium. During 2013, the spot price of indium has been above \$485 per kilogram and, accordingly, no lower of cost or market

adjustments to inventory were recorded during the three and nine months ended September 30, 2013.

Basic and Diluted Net Income (Loss) per Share

The Company presents both basic and diluted net income (loss) per share on the face of the statement of operations. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) gives effect to all potentially dilutive common shares outstanding during the period including stock options, warrants and unit purchase options, using the treasury-stock method. If anti-dilutive, the effect of potentially dilutive common shares is ignored. In computing diluted net income (loss) per share, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock option or warrants. For both the three and nine months ended September 30, 2013 and the three months ended September 30, 2012, potential shares of common stock that resulted from the assumed exercise of outstanding stock options, with exercise prices less than the average market price of the Company's common stock for the period, were calculated using the treasury stock method. All other potentially issuable shares of common stock have been excluded from the calculation because their effect would be antidilutive. For the nine months ended September 30, 2012, all potentially issuable shares from outstanding options, warrants and unit purchase options have been excluded from the computation of the diluted net loss since the effect would be anti-dilutive due to the net loss for the period.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 2 Summary of Significant Accounting Policies (continued)

Accounting for Direct Sales, Lending and Leasing Transactions

The stockpile of indium may be used from time to time for “direct sales,” “lending” or “leasing” transactions. Under a “direct sale” transaction, the Company records revenue when there is pervasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable and collectibility is reasonably assured. Cost of sales is recorded for the indium carrying value based on specific-identification method. Allowances, if any, are recorded based on management’s best estimate for uncollectible accounts. There is no right of return. The Company may also enter into a lending transaction. In indium lending transactions, the Company would exchange a specified tonnage and purity of indium for cash. Title and the risks and rewards of such indium ownership would pass to the purchaser/counterparty in the lending transaction. The Company would simultaneously enter into an agreement with such counterparty in which it would unconditionally commit to purchase and the counterparty would unconditionally commit to sell a specified tonnage and purity of indium that would be delivered to the Company at a fixed price and at a fixed future date in exchange for cash (the Unconditional Sale and Purchase Agreement or “USPA”). The USPA would also contain terms providing the counterparty with substantial disincentives (“penalty fees”) for nonperformance of the return of indium to the Company as a means to assure its future supply of indium. While the Company believes that this risk would be mitigated by the penalty fee features of the USPA, it is nonetheless a risk associated with a transaction of this type. The Company accounts for any USPA transaction on a combined basis (sale and purchase) and evaluates whether, and in what period, other income may be recognized based on the specific terms of any arrangements. The Company discloses unconditional purchase obligations under these arrangements and, if applicable, accrues any net losses on such unconditional purchase obligations. Further, the cost of inventory-indium under an open USPA is reported as “indium repurchase obligation” in the accompanying unaudited condensed balance sheet at September 30, 2013. Income arising from leasing transactions is reported as other income.

Income Taxes

Income taxes are accounted under the asset-and-liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and the respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The portion of any deferred tax asset for which it is more likely than not that a tax benefit will not be realized must then be offset by recording a valuation allowance. A valuation allowance has been established against all of the deferred tax assets, as it is more likely than not that these assets will not be realized given the Company’s history of operating losses. The Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. The Company will recognize potential interest and penalties related to income tax positions as a component of the provision for income taxes on the statements of operations in any future periods in which the Company must record a liability.

For the three and nine months ended September 30, 2013, the Company recorded \$10 thousand for Federal income taxes. The Company’s effective tax rate for the three and nine months ended September 30, 2013 was significantly

lower than the statutory rate due to its utilization of its net operating loss carryforwards, which offset the Company's taxable income, except for Federal alternative minimum taxes that are not offset by such operating losses. For the three months ended September 30, 2012, the Company did not record any income tax expense due to the fact that the Company expected to have a net operating loss for 2012. For the nine months ended September 30, 2012, the Company had a net loss resulting in a tax benefit that was fully offset by a valuation reserve.

Share-Based Payment Arrangements

The Company measures the cost of employee services received in exchange for an award of equity instruments (share-based payments or "SBP") based on the grant-date fair value of the award. That cost is recognized over the period during which an employee is required to provide service in exchange for the SBP award the requisite service period (vesting period). For SBP awards subject to conditions, compensation is not recognized until the performance condition is probable of occurrence. The grant-date fair value of share options is estimated using the Black-Scholes-Merton option-pricing model. Compensation expense for SBP awards granted to nonemployees is remeasured each period as the underlying options vest. The Company recorded non-cash charges for SBP of approximately \$2 thousand for both the three months ended September 30, 2013 and 2012 and \$5 thousand for both the nine months ended September 30, 2013 and 2012. The fair value of each option granted during the nine months ended September 30, 2013 and 2012 was estimated on the date of grant using the Black-Scholes-Merton option-pricing model with the weighted average assumptions in the following table:

SMG INDIUM RESOURCES LTD.
 NOTES TO CONDENSED FINANCIAL STATEMENTS
 (Unaudited)

Note 2 Summary of Significant Accounting Policies (continued)

Share-Based Payment Arrangements - (continued)

	Nine Months Ended September 30,			
	2013		2012	
Expected dividend yield	0	%	0	%
Expected option term (years)	5		5	
Expected volatility	11	%	17	%
Risk-free interest rate	0.75-1.38	%	0.72-1.02	%

The weighted average fair value at the date of grant for options granted during the nine months ended September 30, 2013 and 2012 was \$0.33 and \$0.53, respectively, per share. The expected term of options granted represents the period of time that options granted are expected to be outstanding. Because of the Company's limited trading history and trading volume, the expected volatility was calculated based on the five-year volatility of indium. The assumed discount rate was the default risk-free five-year interest rate provided by Bloomberg L.P.

Common Stock Purchase Contracts

The Company classifies as equity any common stock purchase contracts that: (i) require physical settlement or net-share settlement or give the Company a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement) and (ii) are indexed to the Company's common stock. The Company classifies as assets or liabilities any common stock purchase contracts that: (i) require net-cash settlement (including a requirement to net-cash settle the contract if an event occurs and that event is outside the control of the Company), (ii) give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement), or (iii) are not indexed to the Company's common stock. The Company assesses classification of its equity-classified contracts at each reporting date to determine whether a change in classification between assets and liabilities is required. The Company's outstanding common stock purchase contracts were accounted for as equity through September 30, 2013.

Concentration of Credit and Market Risk

The Company maintains cash deposits with banks that at times exceed applicable Federal Deposit Insurance Corporation limits. The Company reduces its exposure to credit risk by maintaining such deposits with high-quality financial institutions. The Company has not experienced any losses in such accounts. At September 30, 2013, the Company had cash on deposit of approximately \$10.1 million in excess of federally- insured limits of \$0.3 million.

The Company grants credit, without collateral, to specialty metals companies creating a credit risk with third parties that it sells, lends or leases indium. The Company seeks to reduce its credit risk by reviewing the third party's credit portfolio, and, when deemed necessary obtains third party guarantees. To reduce its market risks for changes in the price of indium, the USPA and lease agreements contain terms providing the third-party with disincentives ("penalty fees") for nonperformance of the return of indium to the Company.

Fair Value

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. For cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, and prepaid expenses, the carrying amount approximated the fair value because of the immediate or short-term nature of those instruments. For inventory, the carrying amount is based on lower of cost or market calculated on a specific-identification method with market being determined by the spot price of indium published by Metal Bulletin as posted on Bloomberg L.P. (a Level 2 fair value measurement).

Reclassifications

Certain reclassifications were made to the 2012 statement of operations to conform to the presentation in 2013.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 2 Summary of Significant Accounting Policies (continued)

Equipment

Equipment is stated at cost and depreciated on a straight-line basis over the estimated useful life of three years.

Recently Issued Accounting Pronouncements

Recently issued accounting pronouncements did not, or are not believed by management to, have a material effect on the Company's present or future financial statements.

Note 3 USPA and Leasing of Indium

In 2013 and 2012, the Company entered into USPAs where the Company sold indium at a fixed price and the buyers agreed to subsequently sell back to the Company the same quantity and purity of indium at a fixed price that was at a discount from the price per kilogram that the Company originally sold indium to the buyer. Any USPA is accounted for on a combined basis resulting in a gain as a result of the discount that is recorded in other income over the term of the agreement. At September 30, 2013, the Company has an unconditional obligation to repurchase indium in the fourth quarter of 2013 under a USPA, as amended. Accordingly, at September 30, 2013, the Company classified approximately \$0.9 million of indium covered by the USPA as "indium repurchase right" in long-term assets in the accompanying unaudited condensed balance sheet. Further, at September 30, 2013, cash and cash equivalents include approximately \$1.0 million received upon the sale of indium and a \$1.0 million current liability has been recorded in the accompanying unaudited condensed balance sheet for the amount payable under the USPA for the Company's unconditional obligation to buyback indium. During the second quarter of 2013, the Company entered into a lease agreement for a certain tonnage of indium that expires in 2013. There was no such transaction in 2012. At September 30, 2013, approximately \$2.4 million is included in inventory-indium in the accompanying unaudited condensed balance sheet representing the amount of leased indium.

During the three and nine months ended September 30, 2013, the Company recorded other income of approximately \$52 thousand and \$102 thousand, respectively, under USPA and lease transactions and during the three and nine months ended September 30, 2012, the Company recorded \$19 thousand and \$39 thousand, respectively, under USPAs.

Note 4 Stockholders' Equity

Common Stock

On January 5, 2012, the Company closed a private placement of an aggregate of 2.0 million shares of its common stock at \$3.75 per share to two accredited investors, Raging Capital Fund, LP and Raging Capital Fund (QP), LP, for aggregate net proceeds of \$7.5 million. In January 2013, substantially all of the assets of Raging Capital Fund, LP and Raging Capital Fund (QP), LP were transferred to Raging Capital Master Fund, Ltd. Raging Capital Management, LLC is the general partner of Raging Capital Master Fund, Ltd., and they are affiliated and controlled by William C. Martin, a member of the Company's board of directors and, through his control of RCM Indium, LLC, a member of the Manager, Specialty Metals Group Advisors LLC. Mr. Martin has been granted a demand registration right with respect to all shares of common stock acquired by Mr. Martin and his affiliates in private placement transactions with

the Company.

During 2013, the Company's board of directors approved two return of capital distributions, each in the amount of \$0.10 per common share. The payment dates were June 26, 2013 and September 25, 2013.

Equity Compensation Plan

The Company's board of directors adopted, and the Company's stockholders approved, the 2008 Equity Incentive Plan (the "Plan"). Under the Plan, the Company may grant incentive stock options, nonqualified stock options, restricted and unrestricted stock awards and other stock-based awards. Pursuant to the Plan, 1,000,000 shares of common stock are reserved for issuance. Options are granted with exercise prices equal to or greater than the fair value of the common stock. The terms of the options are approved by the Company's board of directors or one of its committees. Options granted to date have vested immediately and expire in five years. At September 30, 2013, there were 325,001 options available under the Plan for future grants.

SMG INDIUM RESOURCES LTD.
 NOTES TO CONDENSED FINANCIAL STATEMENTS
 (Unaudited)

Note 4 Stockholders' Equity (continued)***Stock Options***

Summary stock option information is as follows:

	Aggregate Number	Aggregate Exercise Price	Exercise Price Range	Weighted Average Exercise Price
Outstanding, December 31, 2012	659,999	\$ 3,151,593	\$ 2.52-7.50	\$ 4.78
Granted	15,000	39,400	2.45-2.85	\$ 2.63
Exercise	-	-	-	-
Cancelled or Forfeited	-	-	-	-
Outstanding, September 30, 2013	674,999	\$ 3,190,993	\$ 2.45-7.50	\$ 4.73

The weighted average grant-date fair value was \$0.33 and \$0.53 for options granted during the nine months ended September 30, 2013 and 2012, respectively. The weighted average remaining contractual life is 2.4 years for stock options outstanding at September 30, 2013.

Warrants

As of September 30, 2013, the Company has outstanding warrants exercisable for 6,993,701 shares of the Company's common stock including 240,000 warrants underlying a Unit Purchase Option ("UPO"), as described below, which has not yet been exercised, all at an exercise price of \$5.75 per share. Such warrants expire on May 4, 2016, except for 240,000 warrants underlying the UPO, which expire on May 4, 2015.

The warrants contain a call feature that permits the Company to redeem the warrants at a price of \$0.01 per warrant at any time after the warrants become exercisable, upon providing at least 30 days advance written notice of redemption, and if, and only if, the last sales price of the Company's common stock equals or exceeds \$8.00 per share for any 20 trading days within a 30-trading-day period ending three business days before the Company sends the notice of redemption. In addition, the Company may not redeem the warrants unless the warrants comprising the units and the shares of common stock underlying those warrants are covered by an effective registration statement from the beginning of the measurement period through the date scheduled for the redemption. If the foregoing conditions are satisfied and the Company calls the warrants for redemption, each warrant holder shall then be entitled to exercise their warrants prior to the date scheduled for redemption. The redemption provisions for the Company's warrants have been established at a price that is intended to avail to the warrant holders a premium in the market price as compared to the initial exercise price. There can be no assurance, however, that the price of the common stock will exceed either the redemption price of the warrants of \$8.00 or the warrant exercise price of \$5.75 after the Company calls the warrants for redemption.

The Company has outstanding a UPO previously issued to underwriters or their designees exercisable for 240,000 IPO units. The UPO allows the underwriters to purchase units at an exercise price of \$5.50 per share and expires in May 2015.

Stock Repurchase Program

In May 2013, the Company's board of directors authorized an increase in its stock repurchase program from \$1.0 million to \$3.0 million. Repurchases may occur from time to time in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares will be determined by the Company's Manager, based on its evaluation of market conditions, cash on hand, alternative investment opportunities and other factors. The authorization will stay in effect until December 31, 2014. The program does not obligate the Company to acquire any particular amount of stock, and purchases under the program may be commenced or suspended at any time, or from time to time, without prior notice. Further, the stock repurchase program may be modified, extended or terminated by the board of directors at any time. During the first nine months of 2013, the Company purchased 6,720 shares of its common stock and 1,900 warrants for an aggregate purchase price of \$16 thousand. From the inception of the stock repurchase program and through September 30, 2013, the Company has purchased 30,304 shares of its common stock and 4,400 warrants for an aggregate purchase price of approximately \$69 thousand.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 5 Net Income (Loss) Per Share

Per share data is based on the weighted average number of shares of the Company's common stock during the relevant period. Basic net income (loss) per share is calculated using the weighted average number of outstanding shares of common stock. Diluted net income (loss) per share computations, as calculated under the treasury stock method, include the weighted average number of shares of additional common stock issuable for stock options, warrants and unit purchase options. Diluted net income (loss) per share for all the periods presented does not include securities if their effect was anti-dilutive.

	For the Three Months Ended September 30,		For the Three Months Ended September 30,	
	2013	2012	2013	2012
	(in thousands, except per share amounts)			
Net income (loss)	\$ 1,022	\$ 847	\$ 424	\$ (1,838)
Basic Net Income (Loss) Per Share				
Weighted average basic common shares outstanding	8,802	8,832	8,804	8,803
Basic net income (loss) per share	\$ 0.12	\$ 0.10	\$ 0.05	\$ (0.21)
Diluted Net Income (Loss) per Share				
Weighted average basic common shares outstanding	8,802	8,832	8,804	8,803
Dilutive effect of stock options outstanding	32	-	19	-
Weighted average dilutive common shares	8,834	8,832	8,823	8,803
Diluted income (loss) per share	\$ 0.12	\$ 0.10	\$ 0.05	\$ (0.21)
Stock option and warrant shares excluded from the weighted average dilutive common shares because the effect would be antidilutive	7,874	7,874	7,889	7,874

Note 6 Related-Party Transactions

The members of SMG Advisors, and the positions they hold in the Company, are as follows: Ailon Z. Grushkin, President and Director; BRACK Advisors LLC, an entity controlled by Richard A. Biele, Chief Operating Officer and Director; Alan C. Benjamin, Chairman and Chief Executive Officer; and RCM Indium, LLC, an entity controlled by William C. Martin, Director. The members of SMG Advisors beneficially own an aggregate of 48% of the Company's outstanding common stock. SMG Advisors is managed by Ailon Z. Grushkin. The Manager's financial statements are not consolidated with those of the Company. Pursuant to the MSA, the Manager is responsible for: (i) purchasing, leasing, lending and selling indium; (ii) submitting written reports to the Company's board of directors detailing the

delivery and payment particulars regarding each purchase, lease, loan or sale; (iii) arranging for the storage of indium; (iv) preparing a report on the Company's NMV; (v) preparing any regulatory filing materials or special reports to the Company's stockholders and board of directors; and (vi) managing the general business and affairs of the Company.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 6 Related-Party Transactions (continued)

The MSA, as amended and restated in May 2011, has an initial term of five years, with options to renew the agreement on terms mutually acceptable to each party and may be terminated by either party upon 90 days prior written notice. The Company is responsible for paying all costs and expenses incurred in connection with the business, except those expressly assumed by the Manager. The Company pays the Manager a fee equal to 2% per annum, payable monthly, based on NMV, at the end of each month. Such Manager fees aggregated approximately \$0.2 million for both the three months ended September 30, 2013 and 2012 and approximately \$0.5 million for both the nine months ended September 30, 2013 and 2012.

The Company paid a relative of one of its officers to perform outsourced secretarial services for the Company \$5 thousand during both the three months ended September 30, 2013 and 2012 and \$15 thousand during both the nine months ended September 30, 2013 and 2012.

On January 5, 2012, the Company closed a private placement of an aggregate of 2.0 million shares of its common stock at \$3.75 per share to two accredited investors, Raging Capital Fund, LP and Raging Capital Fund (QP), LP, for aggregate net proceeds of \$7.5 million. In January 2013, substantially all of the assets of Raging Capital Fund, LP and Raging Capital Fund (QP), LP were transferred to Raging Capital Master Fund, Ltd. Raging Capital Management, LLC is the general partner of Raging Capital Master Fund, Ltd., and they are affiliated and controlled by William C. Martin, a member of the Company's board of directors and, through his control of RCM Indium, LLC, a member of the Manager, Specialty Metals Group Advisors LLC.

The Company believes that all related-party transactions were made on terms no less favorable to the Company than could have been obtained from unaffiliated parties. The Company does not engage in any transactions with its officers and directors involving purchasing, lending, or selling indium to or from the Company, except pursuant to the terms of the MSA.

Note 7 Commitments and Contingencies

Management Services Agreement

As described in note 6, the Company entered into the MSA, as amended and restated on May 10, 2011, with the Manager, a related party. The MSA has an initial term of five years with options to renew upon mutual agreement between the parties. The Company is required to pay the Manager a fee of 2% per annum of the monthly NMV, as previously defined, through May 2016.

Compensation

In June 2012, the Company entered into an arrangement with its chief financial officer ("CFO") that increased the annual base compensation from \$50 thousand to \$60 thousand to be paid quarterly. Further, the Company agreed to grant the CFO quarterly five-year options to acquire 5,000 shares (2,500 shares prior to September 2012) of common stock vesting at the date of grant and exercisable at the market value at the date of grant. The compensation committee of the board of directors has approved the payment of \$10 thousand per year to each of the nonexecutive board members and \$1 thousand to such directors for each meeting attended in person. The Company engages a relative of one of its officers to perform outsourced secretarial services for the Company at \$5 thousand per quarter.

The Company's board of directors has approved a contingent cash bonus award of \$0.1 million and a contingent award of 22,000 shares of restricted common stock to the Manager, a related party. The aforementioned award will be granted if the Company completes an additional equity offering raising a minimum of \$15 million in one single transaction of cash or a combination of cash and indium metal in lieu of cash. Further, the board of directors has approved an additional contingent cash bonus award of \$0.1 million and a contingent award of 22,000 shares of restricted common stock to the Manager, a related party, if the Company can successfully list its common stock on a major exchange. As of September 30, 2013, none of the aforementioned awards have been granted.

SMG INDIUM RESOURCES LTD.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited)

Note 8 Segment Information

The Company operates in a single-segment business whose primary business purpose was to stockpile indium, a specialty metal that is being used as a raw material in a wide variety of consumer electronics manufacturing applications. Umicore USA Inc., Vital Materials Co., Limited, Indium Corporation of America and Aim Specialty Materials each account for more than 10% of the Company's net sales.

Note 9 Subsequent Events

The Company evaluates events that have occurred after the balance sheet date but before the financial statements are issued. Based upon the evaluation, the Company did not identify any recognized or non-recognized subsequent events that have required adjustment or disclosure in the financial statements.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Cautionary Note Regarding Forward-Looking Statements

Unless otherwise indicated, the terms “SMG Indium,” “SMG,” the “Company,” “we,” “us,” and “our” refer to SMG Indium Resources Ltd. In this Quarterly Report on Form 10-Q, we may make certain forward-looking statements, including statements regarding our plans, strategies, objectives, expectations, intentions and resources that are made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995.

The statements contained in this Quarterly Report on Form 10-Q that are not historical fact are forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995), within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. Forward-looking statements may be identified by the use of forward-looking terminology such as “should,” “could,” “may,” “will,” “expect,” “believe,” “estimate,” “anticipate,” “intends,” “continue,” or similar terms or variations of those terms or the negative of those terms. These statements appear in a number of places in this Form 10-Q and include statements regarding the intent, belief or current expectations of SMG Indium Resources Ltd. Forward-looking statements are merely our current predictions of future events. Investors are cautioned that any such forward-looking statements are inherently uncertain, are not guaranties of future performance and involve risks and uncertainties. Actual results may differ materially from our predictions. There are a number of factors that could negatively affect our business and the value of our securities, including and not limited to indium price volatility from supply and demand factors, international export quotas that could affect the availability of indium and our ability to purchase or sell indium, lack of any internationally recognized exchanges for indium, limited number of potential suppliers of indium and potential customers who purchase or borrow indium, disruption of mining operations, technological obsolescence, substitution of other materials decreasing the demand for indium, regulatory requirements regarding indium, risks associated with international economic and political events, lack of operational liquidity, lack of investment liquidity, factors affecting our Net Market Value, and changes in interest rates. Such factors could materially affect our Company's future operating results and could cause actual events to differ materially from those described in forward-looking statements relating to our Company. Although we have sought to identify the most significant risks to our business, we cannot predict whether, or to what extent, any of such risks may be realized, nor is there any assurance that we have identified all possible issues that we might face. We assume no obligation to update our forward-looking statements to reflect new information or developments. We urge readers to carefully review and consider the various disclosures we make in this report and our other reports filed with the Securities and Exchange Commission (“SEC”) that attempt to advise interested parties of the risks, uncertainties and other factors that may affect our business including the risk factors disclosed herein in Part II under “Risk Factors” and in our 2012 Annual Report on Form 10-K, as filed with the SEC.

Overview

We were formed under the laws of the State of Delaware on January 7, 2008. On May 4, 2011, we amended our certificate of incorporation to provide for 40,000,000 shares of authorized common stock, par value \$0.001 per share and 1,000,000 shares of authorized preferred stock, par value \$0.001. In November 2012, our board of directors and stockholders approved an amendment to our certificate of incorporation to reduce our authorized shares of common stock to 25,000,000. We were formed to stockpile the specialty metal indium. From time to time, we lend, lease or sell indium, if management believes it is advantageous. Based on prevailing market conditions, we may sell up to \$6.2 million of our indium stockpile over the next 12 months to fund our cash requirements for our corporate initiatives. These corporate initiatives currently include funding our stock repurchase program and returning cash to shareholders via quarterly return of capital distributions.

Our Company

We were formed to stockpile the metal indium. Our strategy was to achieve long-term appreciation in the value of our indium stockpile, and not to actively speculate with regard to short-term fluctuations in indium prices. We planned to achieve long-term appreciation in the value of our indium stockpile primarily through price appreciation of the physical metal. Although the price of indium has increased in 2013 from the low of \$485 per kilogram at December 31, 2012 to \$695 per kilogram at September 30, 2013, it has declined substantially from its high in March 2005. It is our belief that the long-term industry prospects for indium are attractive, and over time, the price of the metal may continue to appreciate. However, there is no assurance that the price of indium or the value of the Company's securities will increase over time. To our knowledge, our stock is currently the only investment that allows potential stockholders to participate in any price appreciation of indium other than physical delivery of the metal itself. Our structure provides a simple and efficient mechanism by which a potential public stockholder may benefit from any appreciation in the price of indium. Our stockholders have the ability to effectively purchase an interest in indium in a manner that does not directly include the risks associated with ownership of companies that explore for, mine and process indium. Our common shares represent an indirect interest in the physical indium we own.

In August 2013, our board of directors authorized the Manager to sell up to 50% of our stockpile of indium held as of June 30, 2013. Through September 30, 2013, we had net sales of approximately \$6.4 million of indium at a gross profit of approximately \$1.3 million. At September 30, 2013, we have approximately \$6.2 million of indium available for sale, which is classified as a current asset. The remainder of indium inventory of approximately \$11.3 million is in long-term assets since the Company does not intend to sell such inventory over the next twelve months.

We physically store and insure our indium in third-party warehouses or storage facilities located in the United States, Canada, the Netherlands and/or the United Kingdom. Our Manager, Specialty Metals Group Advisors LLC, which is a related party, negotiates storage arrangements for our indium holdings and is required to use commercially reasonable efforts to ensure that the indium holdings have the benefit of insurance arrangements obtained on standard industry terms.

We utilize and expect to continue to utilize facilities that meet our requirements that are either (i) located closest in proximity to our indium suppliers in order to reduce transportation fees or (ii) located closest in proximity to our corporate headquarters or satellite offices in order to facilitate our ability to inspect our inventory and reduce future corporate expenses associated with travel. We believe there are numerous third-party storage facilities that provide more than adequate services that meet our criteria, which eliminates the need for hiring a custodian. As of September 30, 2013, we own approximately 36.3 metric tons (“mt”) of indium for an aggregate original cost (prior to any lower of cost or market adjustment) of approximately \$22.3 million or \$613 per kilogram. After the lower of cost or market adjustment, the carrying value of inventory is approximately \$17.5 million or \$483 per kilogram of which approximately \$14.2 million is currently stored in a secure insured bonded warehouse facility located in New York owned by Brink’s. The facility is visited at least once per year for inspection. Of the remaining indium, approximately \$2.4 million has been leased to a third party and approximately \$0.9 million was sold to a third party under an unconditional sale and purchase agreement (“USPA”). Under the terms of the USPA, as amended, we have an unconditional obligation to buy back that indium from the third party during the fourth quarter of 2013.

At September 30, 2013, we had cash and cash equivalents of approximately \$10.4 million \$1.0 million of which will be used in the fourth quarter of 2013 to satisfy our obligation under a USPA, as amended. Our expenses will be required to be satisfied by cash on hand. Our annual cash operating expenses, including management fees, are estimated to be approximately \$1.2 million. Further, our board of directors approved in 2013 a stock repurchase plan for up to \$3.0 million of our securities and we may return additional capital to our stockholders subject to prevailing market conditions. Although we currently have sufficient cash to satisfy our requirements over the twelve months, if needed to support continued return of capital distributions or repurchases of our securities, we plan to sell indium from our stockpile to cover our cash requirements.

At September 30, 2013, the spot price of indium was \$695 per kilogram, representing an increase of 43% from the spot price of \$485 per kilogram at December 31, 2012. The annual average price of indium decreased approximately 24% in 2012 from 2011 decreasing from \$696 per kilogram in 2011 to \$528 per kilogram in 2012. As a result of the decline in the price of indium since the closing of our Initial Public Offering (“IPO”) in May 2011 to December 31, 2012, our cost of indium has been reduced by lower of cost or market write-downs of certain lots of our indium stockpile aggregating approximately \$4.8 million at September 30, 2013. In addition, through September 30, 2013, our NMV per share has declined 13% since the closing of our IPO.

Critical Accounting Policies and Estimates

Use of Estimates

The preparation of financial statements and related disclosures in conformity with United States generally accepted accounting principles (“U.S. GAAP”) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Estimates are used for, but not limited to, valuation of indium inventories, income taxes, share-based compensation and revenue recognition. Management will base its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results could differ from these estimates under different assumptions or conditions.

Common Stock Purchase Contracts

We classify as equity any common stock purchase contracts that: (i) require physical settlement or net-share settlement or gives us a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement) and (ii) is index to our common stock. We classify as assets or liabilities any common stock purchase contracts that: (i) require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and that event is outside our control); (ii) give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement); or (iii) are not indexed to our common stock. We assess classification of our equity-classified contracts at each reporting date to determine whether a change in classification between assets and liabilities is required. Our outstanding common stock purchase contracts (warrants and unit purchase options) were accounted for as equity through September 30, 2013.

Share-Based Payment Arrangements

We measure the cost of services received in exchange for an award of equity instruments (share-based payments or “SBP”) based on the grant-date fair value of the award. That cost is recognized over the period during which a service is required to be provided in exchange for the SBP award the requisite service period (vesting period). For SBP awards subject to performance conditions compensation is not recognized until the performance condition is probable of occurrence. The grant-date fair value of share options is estimated using the Black-Scholes-Merton option-pricing model. Compensation expense for SBP awards granted to nonemployees is remeasured each period as the underlying options vest.

Inventory of the Metal Indium

Our inventory of the metal indium is recorded at cost including all associated costs of delivering the indium to the bonded storage warehouse on the date we take delivery of the physical metal. The stockpile of the physical metal indium and the related repurchase right was classified as noncurrent as our primary business purpose was to stockpile indium with the objective of achieving long-term appreciation in the value of indium. At June 30, 2013, approximately \$11.3 million of indium inventory was reclassified to current assets due to the fact that during the next twelve months the Company intended to sell up to 50% of the indium stockpile to satisfy its cash requirements for its corporate initiatives based on prevailing market conditions. The Company began selling indium in July 2013 and at September 30, 2013, the balance in current indium inventory is approximately \$6.2 million in the accompanying unaudited condensed balance sheet. The decrease resulted from sales of indium in the third quarter of 2013.

The stockpile of the physical metal indium is carried at the lower of cost or market with cost being determined on a specific-identification method and market being determined as the net realizable value based on the spot prices obtained from Metal Bulletin on Bloomberg L.P., a real-time financial information services data platform. We charge against earnings on an interim basis the amount by which the spot price of indium is less than cost on a specific-identification basis. Increases in the spot price of indium for the same lot of indium held in inventory in later interim periods within the fiscal year are recognized in the later interim period. Increases in value recognized on an interim basis do not exceed the previously recognized diminution in value within that fiscal year. However, it should be noted that there may not be a correlation between the spot price of indium as published by Metal Bulletin and posted on Bloomberg L.P. and the amount we may realize upon selling indium in the open market. Further, we periodically review the indium stockpile to determine if a loss should be recognized where the utility of indium has been impaired on an other-than-temporary basis. Where such impairment is viewed as something other than temporary, we will charge against earnings the amount by which the fair market value is less than the cost. Through December 31, 2012, certain lots of indium in inventory were adjusted to reflect a lower of cost or market write-down aggregating approximately \$5.9 million based on the spot price of indium of \$485 per kilogram at December 31, 2012. As a result, the cost basis of all lots in inventory for accounting purposes is \$485 or less per kilogram. We will not record any additional write-downs unless the spot price of indium falls below \$485 per kilogram and inventory cannot be increased above its cost based on increases in the spot price of indium. At September 30, 2013, June 30, 2013 and March 31, 2013, the spot price of indium was \$695, \$547.50 and \$555 per kilogram, respectively, and accordingly, no adjustments to inventory were recorded in 2013.

Income Taxes

Income taxes are accounted under the asset-and-liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and the respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The portion of any

deferred tax asset for which it is more likely than not that a tax benefit will not be realized must then be offset by recording a valuation allowance. A valuation allowance has been established against all of the deferred tax assets, as it is more likely than not that these assets will not be realized given our history of operating losses. We recognize the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. We will recognize potential interest and penalties related to income tax positions as a component of the provision for income taxes on the statements of operations in any future periods in which the Company must record a liability.

For the three and nine months ended September 30, 2013, the Company recorded \$10 thousand for Federal income taxes. The Company's effective tax rate for the three and nine months ended September 30, 2013 was significantly lower than the statutory rate due to its utilization of its net operating loss carryforwards, which offset the Company's taxable income, except for Federal alternative minimum taxes that are not offset by such operating losses. For the three months ended September 30, 2012, the Company did not record any income tax expense due to the fact that the Company expected to have a net operating loss for 2012. For the nine months ended September 30, 2012, the Company has a net loss resulting in a tax benefit that was fully offset by a valuation reserve.

Accounting for Direct Sales, Lending and Leasing Transactions

The stockpile of indium may be used from time to time for “direct sales,” “lending” or “lease” transactions. Under a “direct sale” transaction, the Company records revenue when there is pervasive evidence that an arrangement exists, delivery has occurred, the price is fixed and determinable and collectibility is reasonably assured. Cost of sales is recorded for the indium carrying value based on specific-identification method. Allowances, if any, are recorded based on management’s best estimate for uncollectible accounts. There is no right of return. We may also elect to enter into a lending transaction. In indium lending transactions, we would exchange a specified tonnage and purity of indium for cash. Title and the risks and rewards of such indium ownership would pass to the purchaser/counterparty in the lending transaction. We would simultaneously enter into an agreement with such counterparty in which it would unconditionally commit to purchase and the counterparty would unconditionally commit to sell a specified tonnage and purity of indium that would be delivered to us at a fixed price and at a fixed future date in exchange for cash (the USPA). The USPA would also contain terms providing the counterparty with substantial disincentives (“penalty fees”) for nonperformance of the return of indium to the Company as a means to assure our future supply of indium. While we believe that this risk would be mitigated by the penalty fee features of the USPA, it is nonetheless a risk associated with a transaction of this type. We account for any USPA transaction on a combined basis (sale and purchase) and evaluate whether, and in what period, other income may be recognized based on the specific terms of any arrangements. We disclose unconditional purchase obligations under these arrangements and, if applicable, accrue net losses on such unconditional purchase obligations. Further, the cost of inventory-indium under an open USPA, as amended, is reported as “indium repurchase obligation” in the accompanying unaudited condensed balance sheet at September 30, 2013. Income arising from leasing transactions is reported as other income.

Recently Issued Accounting Pronouncements

Recently issued accounting pronouncements did not, or are not believed by management to, have a material effect on the Company’s present or future financial statements.

Results of Operations

The results of operations for the three and nine months ended September 30, 2013 and 2012 are as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
Net sales	\$ 6,416,122	\$ -	\$ 6,416,122	\$ -
Cost of sales, including inventory-write down (recovery)	5,153,686	(1,091,346)	5,153,686	913,242
Gross profit (loss)	1,262,436	1,091,346	1,262,436	(913,242)
Operating costs:				
Operating expenses - Manager - related party	168,643	151,204	476,434	471,026
Other selling, general and administrative expenses	118,100	117,524	463,154	511,369
Total operating costs	286,743	268,728	939,588	982,395
Operating income (loss)	975,693	822,618	322,848	(1,895,637)
Other income:				
Interest income	3,559	5,183	9,895	18,930
Other income	52,346	18,829	101,655	38,890

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Net income (loss) before income taxes	1,031,598	846,630	434,398	(1,837,817)
Income tax expense	(10,000)	-	(10,000)	-
Net income (loss)	\$ 1,021,598	\$ 846,630	\$ 424,398	\$ (1,837,817)

Net Income (Loss) Per Share

Basic	\$ 0.12	\$ 0.10	\$ 0.05	\$ (0.21)
Diluted	\$ 0.12	\$ 0.10	\$ 0.05	\$ (0.21)

Weighted Average Number of Shares

Outstanding				
Basic	8,802,242	8,832,301	8,803,605	8,803,104
Diluted	8,834,242	8,832,301	8,823,004	8,803,104

Revenues

Subsequent to June 30, 2013, we began selling indium from our stockpile to generate cash to fund our corporate initiatives, including our share buyback program and any additional distributions to our stockholders that we may undertake in the future, based on prevailing market conditions. During the third quarter of 2013, we had net sales of approximately \$6.4 million of indium.

Three Months Ended September 30, 2013 Compared to September 30, 2012 Comparable Period

For the three months ended September 30, 2013, net sales were approximately \$6.4 million. There were no sales in the 2012 period as we did not begin selling indium until the third quarter of 2013. Previously we were stockpiling the metal indium. Cost of sales was approximately \$5.2 million resulting in gross profit of approximately \$1.2 million or 20% in the third quarter of 2013. The cost of sales, including inventory recovery of approximately \$1.1 million in the 2012 period was due to the fact that the spot price of indium at September 30, 2012 of \$535 per kilogram, as published by Metal Bulletin and posted on Bloomberg L.P., had recovered from the \$502.50 per kilogram, the price of indium at June 30, 2012. We charge against earnings on an interim basis the amount by which the spot price of indium is less than cost on a specific-identification basis. Increases in the spot price of indium for the same lot of indium held in inventory in later interim periods within the fiscal year are recognized in the later interim period. Accordingly in the third quarter of 2012, we recorded a write-up of inventory due to the recovery in the spot price of indium that quarter. There was no lower of cost or market adjustment in the 2013 period and we do not expect any additional write-downs unless the spot price of indium should fall below \$485 per kilogram, however, we cannot guarantee that any such write-downs will not occur.

For the three months ended September 30, 2013, total operating expenses were approximately \$287 thousand. For the comparable period in 2012, total operating costs were approximately \$269 thousand representing a 7% increase. The increase was due principally to an increase in the Manager fee as a result of an increase in NMV caused principally by the increase in the spot price of indium in the 2013 period. Other operating expenses were approximately the same in the third quarter of 2013 when compared to the comparable period in 2012. During the three-month period ended September 30, 2013, other income increased approximately \$34 thousand when compared to the third quarter in 2012 due to increased income recorded on indium USPA and lease transactions during the third quarter of 2013.

Income taxes of \$10 thousand was provided for in the third quarter of 2013 for the alternative minimum tax that is not offset by net operating losses based on our estimated tax rate.

Net income was approximately \$1.0 million for the three months ended September 30, 2013 (or \$0.12 per basic and diluted share) compared to a net income of approximately \$0.8 million (or \$0.10 per basic and diluted share) in the comparable period ended September 30, 2012. The increase of approximately \$0.2 million was due to higher gross profits in 2013. As described above, the net income in the third quarter of 2012 was due to approximately \$1.1 million in gross profits as a result of a lower of cost or market recovery of indium inventory offset in part by operating expenses. The basic weighted average number of common shares outstanding was 8,802,242 in the third quarter of 2013 compared to 8,832,301 in the third quarter of 2012. The decrease in shares in 2013 was due to the purchase of common shares under our repurchase program.

Nine Months Ended September 30, 2013 compared to September 30, 2012 Comparable Period

For the nine months ended September 30, 2013, net sales were approximately \$6.4 million. Cost of sales was approximately \$5.2 million resulting in gross profit of approximately \$1.2 million or 20%. There were no sales in the comparable period in 2012. Cost of sales, including inventory write-down of approximately \$0.9 million in the 2012 period was due to a lower of cost or market write-down of certain lots in indium inventory as a result of the decline in the spot price of indium from the price at the end of the 2011 for certain lots. The spot price of indium at September 30, 2012 was \$535 per kilogram, as published by Metal Bulletin and posted on Bloomberg L.P., compared to the \$570 per kilogram, the price of indium at December 31, 2011. There was no lower of cost or market adjustment in the 2013 period, and, we do not expect any adjustment unless the spot price of indium should fall below \$485 per kilogram, however, we cannot guarantee that any such write-downs will not occur.

For the nine months ended September 30, 2013, total operating costs were approximately \$940 thousand compared to approximately \$982 thousand in the comparable period in 2012 resulting in a decline of 4% for the nine months ended September 30, 2013. Manager expenses increased approximately \$5 thousand or 1% due to a increase in average NMV for the nine month period. Other selling, general and administrative expenses declined approximately \$48 thousand or 9% due principally to lower professional fees and the fact that there was no CFO bonus in 2013. Interest income decreased \$9 thousand when compared to the same period in 2012 principally as a result of lower cash available to invest. During the nine months ended September 30, 2013, there was approximately \$102 thousand in other income representing the aggregate income relating to indium USPA's and lease transactions compared to \$39 thousand in the 2012 period. The increase was primarily due to the lease transaction in the 2013 period. There was no lease transaction in the 2012 period.

Income taxes of \$10 thousand was provided for in the nine months ended September 30, 2013 for the alternative minimum tax that is not offset by net operating losses based on our estimated tax rate.

For the nine months ended September 30, 2013, we reported net income of approximately \$0.4 million (or \$0.05 per basic and diluted share) as compared with a net loss for the nine months ended September 30, 2012 of approximately (\$1.8) million (or (\$0.21) per basic and diluted share). The improvement in net income was due principally to the gross profit on net sales in 2013 and the fact that there was no write-down in inventory in the 2013 period. As mentioned above, the nine months ended September 30, 2012 included a \$0.9 million inventory write-down. The basic weighted average number of common shares outstanding was approximately the same in both periods at 8,803,605 in the nine months ended September 30, 2013 compared to 8,803,104 in the 2012 period.

Based on our current business plan, we expect that our normal annual cash operating expenses will approximate \$1.2 million annually. However, we expect our monthly expenses may increase or decrease with the change in our NMV. The monthly management fee payable to our Manager, a related party, is directly correlated to our NMV, which fluctuates primarily based on the price of indium. Furthermore, our monthly storage and insurance expense is directly correlated to the quantity of indium held in inventory and to the increase or decrease in the value of our indium stockpile.

GAAP vs. Non-GAAP Disclosure

We use the term NMV throughout this report when we discuss the value of our indium holdings. We define the term NMV, as used in this report, as the product of multiplying the number of kilograms of indium held by the Company at any given point by the spot price for indium as published by Metal Bulletin and posted on Bloomberg L.P., plus cash and other Company assets, less any liabilities. The use of the term NMV is a non-GAAP financial measurement.

A reconciliation of the Non-GAAP NMV to the GAAP historical net book value is as follows:

	September 30, 2013	December 31, 2012
U.S. GAAP net book value	\$ 27,288,317	\$ 28,635,908
Excess of the indium inventory at spot price over GAAP book value	7,719,873	122,689
NMV	\$ 35,008,190	\$ 28,758,597

The reasons we rely on NMV measurements are as follows:

it is a measurement of the true value of the Company's indium holdings at any given point and thus is a primary factor in evaluating the general liquidity of the Company should the Company ever decide to sell any or all of its indium holdings;

it provides the greatest transparency to our shareholders in evaluating how the Company is performing relative to the indium purchased by the Company when compared to the current market prices for indium as published by Metal Bulletin and posted on Bloomberg L.P.;

it is used internally to evaluate the performance of the Manager, a related party, who is entitled to a management fee based upon the NMV metric each month;

it provides additional disclosures about the value of our indium holdings and the potential impact that such value would have on our operating results on a true period-to-period basis in terms of the market value of such indium holdings;

it provides the most useful tool for shareholders and potential investors to evaluate how management has performed in terms of the indium purchased versus the NMV at any given point;

it more readily provides a market value metric that may be useful in analyzing trends or other market conditions that a historical cost presentation might not; and

it provides a meaningful liquidity measurement for the Company's indium stockpile.

No assurances can be given that the Company could liquidate its indium holdings at the market prices published by Metal Bulletin.

Liquidity and Capital Resources

Since our inception and through September 30, 2013, we have incurred an accumulated deficit of approximately \$11.0 million (including approximately \$2.4 million non-cash dividend to Class A common stockholders). Prior to the third quarter of 2013, we had no sales and we had not yet achieved profitability. Our strategy had been to achieve long-term appreciation in the value of our indium stockpile and not to actively speculate with regard to short-term fluctuations in indium prices. In the third quarter of 2013, we began selling indium as the spot price of indium began a recovery but

there is no assurance that the price of indium will continue to increase. We expect that we may sell up to \$6.2 million of our stockpile over the next year to fund corporate initiatives including funding our stock buyback program and returning capital to our stockholders, subject to prevailing market conditions. There is no assurance that there will be long-term appreciation in the price of indium. In fact, the price of indium had declined since the closing of our IPO in May 2011 until recently when the spot price began to recover. Historically, the fluctuations in these prices have been, and will continue to be, affected by numerous factors beyond our control. At November 8, 2013, the spot price of indium, as published by Metal Bulletin and posted on Bloomberg L.P., was \$670 per kilogram.

The purpose of our Company is to permit a simple and efficient mechanism by which an investor may benefit from appreciation in the price of indium. The value of our Company is designed to track and correspond with fluctuations in the price of indium. In theory, our stock price should correlate to increases or decreases in the value of our Company, which is directly tied to fluctuations in indium prices. However, at September 30, 2013, our stock traded at a 28% discount from our NMV at that date.

As of September 30, 2013, we have cash and cash equivalents of approximately \$10.4 million compared to cash and cash equivalents of approximately \$6.2 million at December 31, 2012. The increase of \$4.2 million is due to approximately \$6.0 million cash provided by operations in the first nine months of 2013, offset in part by approximately \$1.8 million in return of capital cash distributions to stockholders in that period. Our primary source of funds has been from the public and private sale of equity securities. At September 30, 2013, approximately \$1.0 million of cash was committed to pay the unconditional repurchase obligation for indium sold under a USPA. Therefore, we had approximately \$9.4 million available for general corporate purposes of which up to \$3.0 million may be used for repurchases of our securities under a program described below and approved by our board of directors in the second quarter of 2013. Further, we currently estimate our cash operating expenses to be approximately \$1.2 million annually. Our annual cash operating expenses include paying the annual related-party Manager's fee of \$0.6 million for the acquisition, storage, insuring and disposition of indium on our behalf and reviewing corporate, title, environmental, and financial documents and material agreements regarding the acquisition, storage, insuring and disposition of indium on our behalf. We also anticipate that we will incur annual cash expenses including: (i) storage and insurance for indium \$0.1 million; (ii) director and officer compensation expense \$0.1 million; (iii) director and officer liability insurance premiums \$0.1 million; and (iv) other general and administrative expenses including officer and director expenses and public company costs including legal and accounting fees \$0.3 million. We also declared a return of capital distribution to our stockholders of \$0.10 per share in both the second and third quarters of 2013 aggregating \$1.8 million and may continue to pay such distributions subject to our Manager's assessment of prevailing market conditions. We expect our monthly expenses to increase or decrease with the change in our NMV. The monthly management fee payable to our Manager is directly correlated to our NMV, which fluctuates primarily based on the price of indium. Furthermore, our monthly storage and insurance expense is directly correlated to the quantity of indium held in inventory and to the increase or decrease in the value of our indium stockpile.

We currently do not believe we will need to raise additional funds over the next 12 months in order to cover our cash needed to fund our corporative initiatives.

Although we are currently not a party to any agreement or letter of intent with respect to potential investments in, or acquisitions of businesses, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

In May 2013, the Company's board of directors authorized an increase from \$1.0 million to \$3.0 million for its stock repurchase program. The repurchases may occur from time to time in the open market or in privately negotiated transactions. The timing and amount of any repurchase of shares will be determined by the Company's Manager, based on its evaluation of market conditions, cash on hand, alternative investment opportunities and other factors. The authorization will stay in effect until December 31, 2014. The program does not obligate the Company to acquire any particular amount of stock and purchases under the program may be commenced or suspended at any time, or from time to time, without prior notice. Further, the stock repurchase program may be modified, extended or terminated by the board of directors at any time. Through September 30, 2013, we have purchased an aggregate of approximately \$69 thousand of our securities, representing 30,304 shares of our common stock and 4,400 warrants to acquire shares of our common stock.

Discussion of Cash Flows

The Company's cash flow activity was as follows:

	For the Nine Months Ended September 30,	
	2013	2012
Net cash provided by (used in) operating activities	\$ 5,980,990	\$ (4,340,348)
Net cash (used in) provided by financing activities	(1,776,889)	7,497,500
Net increase in cash and cash equivalents	\$ 4,204,101	\$ 3,157,152

Cash Flows from Operating Activities

Net cash and cash equivalents provided by operations during the first nine months of 2013 approximated \$6.0 million principally from cash received from sales of indium and USPA and lease transactions, offset in part by our cash operating expenses. Net cash and cash equivalents used in operating activities for the nine months ended September 30, 2012 was approximately \$4.3 million representing an increase of approximately \$10.3 million in cash provided by operating activities in the first nine months of 2013. The change in cash and cash equivalents provided by operating activities in 2013 was primarily due to cash sales in the nine months ended September 30, 2013, the effects of cash received under a USPA during the nine months ended September 30, 2013 plus the fact that indium purchases were higher in the 2012 period.

Cash Flows from Financing Activities

The net cash and cash equivalents used in financing activities in the first nine months of 2013 was approximately \$1.8 million for the return of capital distributions to stockholders and the purchase of treasury shares under our repurchase program. During the nine months ended September 30, 2012, net cash and cash equivalents provided by financing activities was due to net proceeds received from a 2012 private placement of approximately \$7.5 million in the first quarter of 2012. There was no financing in 2013.

Working Capital, Indium Inventory and Indium Purchase Commitments

At September 30, 2013, we had working capital of approximately \$15.9 million. This represented an increase of approximately \$9.9 million from the working capital of approximately \$6.0 million at December 31, 2012. The increase in working capital was primarily due to approximately \$6.2 million of inventory-indium in current assets in the third quarter of 2013 as a result of the fact that we intend to sell that indium over the next year, and increases in cash and accounts receivable as a result of sales in the third quarter of 2013 offset in part by the return of capital distributions to stockholders in the nine months ended September 30, 2013.

Our activity has been centered on stockpiling indium with the net proceeds received from the sale of our securities. At September 30, 2013, we had 36,329 kilograms of indium in inventory. As of September 30, 2013, our aggregate original cost basis (prior to any lower of cost or market write-down) for the indium was approximately \$22.3 million or approximately \$613 per kilogram. At September 30, 2013 and December 31, 2012, we had an aggregate of approximately \$4.8 million and \$5.9 million, respectively, in lower of cost or market write-downs as a result of the quoted price of indium at December 31, 2012 being less than the purchase price on certain lots resulting in a new cost basis of \$485 per kilogram for accounting purposes for the respective lots. The spot price of indium at September 30, 2013 was \$695 per kilogram. We do not expect any additional write-downs of indium unless the spot price falls below \$485 per kilogram. Further, under GAAP the indium inventory cannot be written up above costs as a result of the spot price being greater than the cost for accounting purposes.

During the second quarter of 2013, we entered into a lease agreement expiring at the end of 2013 for a certain tonnage of indium. Included in inventory-indium at September 30, 2013 is approximately \$2.4 million of indium covered by the lease agreement. Also, at September 30, 2013, we have an outstanding unconditional obligation to repurchase indium in the fourth quarter of 2013 that was sold under a USPA, entered into in May 2013 and as amended in October 2013. At September 30, 2013, we recorded a liability of approximately \$1.0 million for this obligation and the indium covered by this agreement has been classified as "indium repurchase right" in the unaudited condensed accompanying balance sheet at September 30, 2013.

Item 3. Qualitative and Quantitative Disclosures about Market Risk.

We are a smaller reporting company, and therefore, we are not required to provide information required by this item.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Financial Officer and Chief Executive Officer (Principal Executive Officer) and our President, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that

any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As of September 30, 2013, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in our periodic filings with the Securities and Exchange Commission within the required time period.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 1A. Risk Factors.

We are a smaller reporting company, and therefore, we are not required to provide information required by this item. We are providing the following information regarding changes that have occurred to previously disclosed risk factors from our Annual Report on Form 10-K for the year ended December 31, 2012. In addition to the other information set forth below and elsewhere in this report, you should carefully consider the factors discussed under the heading “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2012. The risks described in our Annual Report on Form 10-K and herein are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

The price of indium is volatile and affected by factors beyond our control which could negatively affect us as we lend, lease or sell indium.

From time to time, we may lend, lease or sell indium, if management believes market conditions warrant executing transactions. The price of indium is volatile, and historically, the fluctuations in these prices have been, and will continue to be, affected by numerous factors beyond our control, including, among others, the demand for products that utilize indium directly or as a key component. Based on prevailing market conditions, we may sell up to 50% of our indium stockpile held at June 30, 2013 over the next 12 months to fund our cash requirements for our corporate initiatives. Subsequent to June 30, 2013, we began selling indium and through September 30, 2013, we have net sales of indium of approximately \$6.4 million. There can be no assurance that we will be able to continue to sell indium at a profit nor can there be any assurance that the price of indium will not appreciate in value subsequent to our sale of such indium. The Company’s inability to sell indium at times and prices acceptable to us could have a material adverse effect on the share price of our common stock as well as our business, financial condition and results of operations.

We rely on a few customers for a large portion of our revenues.

Our top four customers generated approximately 97% of our net sales of indium for the nine months ended September 30, 2013. We didn’t commence selling indium from our stockpile to generate cash until subsequent to June 30, 2013. The amount of net sales generated by specific customers is likely to vary from year to year, and a major customer in one year may not purchase our products in a subsequent year. The loss of one of our large customers could have a material adverse effect on our business, results of operations and financial condition.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Issuer Purchases of Equity Securities

In May 2013, our board of directors authorized an increase in the amount of funds for repurchases of the Company’s outstanding shares of common stock from \$1.0 million to \$3.0 million. The program authorizes the Company’s Manager to repurchase shares in the open market or in private transactions from time to time, depending on market conditions and expires on December 31, 2014.

During the three months ended September 30, 2013, we repurchased \$3 thousand of our common stock under our stock repurchase program. The remaining authorized balance as of September 30, 2013 was approximately \$2.9

million. Stock repurchases were funded from working capital.

Month	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased under the Plans or Programs (in thousands)
July 1, 2013 – July 31, 2013	500	\$ 2.91	30,104	\$ 2,933
August 1, 2013 – August 31, 2013	200	2.95	30,304	\$ 2,933
September 1, 2013 – September 30, 2013	0	n/a	30,304	\$ 2,933
Total	700	\$ 2.92	30,304	\$ 2,933

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit No.	Description of Document
31.1*	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
31.2*	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
32.1*	Certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).*
32.2*	Certification pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350).*
101.ins**	XBRL Instance Document
101.xsd**	XBRL Taxonomy Extension Schema Document
101.cal**	XBRL Taxonomy Calculation Linkbase Document
101.def**	XBRL Taxonomy Definition Linkbase Document
101.lab**	XBRL Taxonomy Label Linkbase Document
101.pre**	XBRL Taxonomy Presentation Linkbase Document

* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

** Furnished. Not filed. Not incorporated by reference. Not subject to liability.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SMG Indium Resources Ltd.

(Registrant)

November 13, 2013
Date

/s/ Alan C. Benjamin
Alan C. Benjamin
Chief Executive Officer
(Principal Executive Officer)

November 13, 2013
Date

/s/ Mary E. Paetzold
Mary E. Paetzold
Chief Financial Officer
(Principal Financial and Accounting Officer)