Pacific Ethanol, Inc.
Form 10-Q
August 18, 2006

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**U. S. SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended **June 30, 2006**

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to _______

Commission File Number: **0-21467**

**PACIFIC ETHANOL, INC.**
(Name of small business issuer as specified in its charter)

| **Delaware** | **41-2170618** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**5711 N. West Avenue**
**Fresno, California 93711**
(Address of principal executive offices)

**(559) 435-1771**
(Registrant's telephone number, including Area Code)

**Not applicable.**
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check 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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. Check one:

Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o  No x

As of August 17, 2006, there were 37,224,236 shares of Pacific Ethanol, Inc. common stock, $.001 par value per share, outstanding.

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## PART I
## FINANCIAL INFORMATION


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## PART I - FINANCIAL INFORMATION

**ITEM 1. FINANCIAL STATEMENTS.**

## PACIFIC ETHANOL, INC.
## CONSOLIDATED BALANCE SHEETS
## AS OF JUNE 30, 2006 AND DECEMBER 31, 2005

| ASSETS | June 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| **Current Assets:** | | |
| Cash and cash equivalents | $ 139,994,795 | $ 4,521,111 |
| Restricted cash | 893,878 | — |
| Investments in marketable securities | — | 2,750,000 |
| Accounts receivable (including $661,839 and $937,713 as of June 30, 2006 and December 31, 2005, respectively, from related parties) | 12,764,801 | 4,947,538 |
| Notes receivable - related party | — | 135,995 |
| Inventories | 2,973,345 | 362,972 |
| Prepaid expenses | 321,422 | 626,575 |
| Prepaid inventory | 649,030 | 1,349,427 |
| Derivative instruments | 1,770,282 | — |
| Other current assets | 1,560,872 | 86,054 |
| Total current assets | 160,928,425 | 14,779,672 |
| **Property and Equipment, net** | 52,049,443 | 23,208,248 |
| **Restricted cash for plant construction and acquisitions** | 60,175,169 | — |
| **Goodwill** | 2,565,750 | 2,565,750 |
| **Intangible assets, net** | 7,215,839 | 7,568,723 |
| **Other assets** | 227,803 | 62,419 |
| **Total Assets** | $ 283,162,429 | $ 48,184,812 |

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**
**CONSOLIDATED BALANCE SHEETS**
**AS OF JUNE 30, 2006 AND DECEMBER 31, 2005**

| LIABILITIES AND STOCKHOLDERS' EQUITY | June 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| **Current Liabilities:** | | |
| Current portion - related party note payable | $ 2,123,978 | $ 1,200,000 |
| Accounts payable - trade | 10,894,201 | 4,755,235 |
| Accounts payable - related party | 4,660,049 | 6,411,618 |
| Accrued retention - related party | 2,510,794 | 1,450,500 |
| Accrued payroll | 279,672 | 433,887 |
| Other accrued liabilities | 3,829,163 | 3,422,565 |
| Total current liabilities | 24,297,857 | 17,673,805 |
| **Related-Party Notes Payable, Net of Current Portion** | — | 1,995,576 |
| Total Liabilities | 24,297,857 | 19,669,381 |
| **Commitments and Contingencies (Note 7)** | | |
| **Stockholders' Equity:** | | |
| Preferred stock, $0.001 par value; 10,000,000 shares authorized: | | |
| Series A Cumulative Redeemable Convertible Preferred Stock, 5,250,000 and 0 shares issued and outstanding and aggregate liquidation preference of $84,897,534 and $0 as of June 30, 2006 and December 31, 2005, respectively | 5,250 | — |
| Common stock, $0.001 par value; 100,000,000 shares authorized, 37,223,236 and 28,874,442 shares issued and outstanding as of June 30, 2006 and December 31, 2005, respectively | 37,223 | 28,874 |
| Additional paid-in capital | 358,356,147 | 43,697,486 |
| Unvested consulting expense | (1,048,014) | (1,625,964) |
| Accumulated other comprehensive income | 790,602 | — |
| Due from stockholders | (600) | (600) |
| Accumulated deficit | (99,276,036) | (13,584,365) |
| Total stockholders' equity | 258,864,572 | 28,515,431 |
| **Total Liabilities and Stockholders' Equity** | $ 283,162,429 | $ 48,184,812 |

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2006 AND 2005**
**(UNAUDITED)**

| | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|---|---|
| Net sales (including $2,722,864, $8,584,749, $1,496,178 and $1,849,236 for the three and six months ended June 30, 2006 and 2005, respectively, to a related party) | $ 46,461,077 | $ 22,814,433 | $ 84,700,244 | $ 25,116,430 |
| Cost of goods sold | 43,153,457 | 22,662,908 | 79,067,377 | 24,917,278 |
| Gross profit | 3,307,620 | 151,525 | 5,632,867 | 199,152 |
| Operating expenses: | | | | |
| Selling, general and administrative expenses | 4,758,996 | 2,393,071 | 7,743,080 | 3,136,304 |
| Services rendered in connection with feasibility study | — | — | — | 852,250 |
| Loss from operations | (1,451,376) | (2,241,546) | (2,110,213) | (3,789,402) |
| Other income (expense), net | 1,277,479 | 18,294 | 1,329,257 | (89,559) |
| Income (loss) before provision for income taxes | (173,897) | (2,223,252) | (780,956) | (3,878,961) |
| Provision for income taxes | 8,476 | 3,200 | 13,181 | 4,800 |
| Net loss | $ (182,373) | $ (2,226,452) | $ (794,137) | $ (3,883,761) |
| Preferred stock dividends | $ (897,534) | $ — | $ (897,534) | $ — |
| Deemed dividend on preferred stock | (84,000,000) | — | (84,000,000) | — |
| Loss available to common stockholders | $ (85,079,907) | $ (2,226,452) | $ (85,691,671) | $ (3,883,761) |
| Weighted average shares outstanding | 33,214,606 | 27,977,127 | 31,410,920 | 21,415,102 |
| | $ (2.56) | $ (0.08) | $ (2.73) | $ (0.18) |

Basic and diluted loss per common share

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**
**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2006 AND 2005**
**(UNAUDITED)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net loss | $ (182,373) | $ (2,226,452) | $ (794,137) | $ (3,883,761) |
| Other comprehensive income, net of tax: | | | | |
| Cash flow hedges: | | | | |
| Net change in the fair value of derivatives, net of tax | 116,394 | — | 790,602 | — |
| Comprehensive loss | $ (65,979) | $ (2,226,452) | $ (3,535) | $ (3,883,761) |

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**
**FOR THE SIX MONTHS ENDED JUNE 30, 2006**
**(UNAUDITED)**

| | Preferred Stock | | Common Stock | | Additional Paid-In | Unvested Consulting | Other Comprehensive | Due From | Accumulated | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Stock | Amount | Capital | Expense | Income | Stockholders | Deficit | T |
| **Balances,** December 31, 2005 | — | $ — | 28,874,442 | $ 28,874 | $ 43,697,486 | $ (1,625,964) | $ — | $ (600) | $ (13,584,365) | $ 28, |
| Issuance of preferred stock, net of offering costs of $1,433,266 | 5,250,000 | 5,250 | — | — | 82,561,484 | — | — | — | — | 82, |
| Deemed dividend on preferred stock | — | — | — | — | 84,000,000 | — | — | — | (84,000,000) | |
| Preferred stock dividend | — | — | — | — | — | — | — | — | (897,534) | ( |
| Issuance of common stock for private investment in public equity, net of issuance costs of $7,380,711 | — | — | 5,496,583 | 5,497 | 137,613,652 | — | — | — | — | 137, |
| Compensation expense related to issuance of warrants for consulting services | — | — | — | — | — | 577,950 | — | — | — | |
| Stock issued for exercise of warrants for cash | — | — | 2,518,358 | 2,518 | 8,556,480 | — | — | — | — | 8, |
| Stock issued for cashless exercise of warrants | — | — | 150,353 | 150 | (150) | — | — | — | — | |
| Compensation expense for options issued to employees and directors | — | — | — | — | 624,304 | — | — | — | — | |
| | — | — | 183,500 | 184 | 1,302,891 | — | — | — | — | 1, |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Stock issued for exercise of stock options for cash | | | | | | | | | | |
| Other comprehensive income from cash flow hedges | — | — | — | — | — | — | 790,602 | — | — | |
| Net loss | — | — | — | — | — | — | — | — | (794,137) | ( |
| **Balances,** June 30, 2006 | 5,250,000 | $ 5,250 | 37,223,236 | $ 37,223 | $ 358,356,147 | $ (1,048,014) | $ 790,602 | $ (600) | $ (99,276,036) | $ 258, |

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**FOR THE SIX MONTHS ENDED JUNE 30, 2006 AND 2005**
**(UNAUDITED)**

| | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|
| **Operating Activities:** | | |
| Net loss | $ (794,137) | $ (3,883,761) |
| Adjustments to reconcile net loss to cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 419,940 | 40,457 |
| Amortization of debt issuance costs | 175,933 | 235,334 |
| Amortization of debt discount | 128,404 | 120,268 |
| Non-cash compensation expense | 624,304 | 883,250 |
| Non-cash consulting expense | 577,950 | 460,386 |
| Non-cash services rendered in connection with feasibility study | — | 702,250 |
| Non-cash gain on derivatives | (462,680) | — |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (7,817,263) | 407,923 |
| Note receivable, related party | 135,995 | — |
| Inventories | (2,610,373) | (530,395) |
| Prepaid expenses and other assets | (320,722) | (667,081) |
| Prepaid inventory | 700,397 | 307,562 |
| Increase in restricted cash | (893,878) | — |
| Increase in derivative assets | (517,000) | — |
| Accounts payable and accrued expenses | 5,493,815 | 224,519 |
| Accounts payable and accrued retention, related party | (691,275) | 854,029 |
| Net cash used in operating activities | (5,850,590) | (845,259) |
| **Investing Activities:** | | |
| Additions to property, plant and equipment | (28,908,251) | (2,845,742) |
| Proceeds from sale of available-for-sale investment | 2,750,000 | — |
| Increase in restricted cash designated for construction projects and acquisitions | (60,175,169) | — |
| Net cash acquired in acquisition of Kinergy, ReEnergy and Accessity | — | 1,146,854 |
| Costs associated with share exchange transaction | — | (307,808) |
| Net cash used in investing activities | (86,333,420) | (2,006,696) |
| **Financing Activities:** | | |
| Proceeds from sale of common stock, net | 137,619,149 | 18,879,749 |
| Proceeds from sale of preferred stock, net | 82,566,734 | — |
| Proceeds from exercise of warrants and stock options | 9,862,073 | 332,503 |
| Payments on borrowings, related party | (1,200,002) | — |
| Receipt of stockholder receivable | — | 67,500 |
| Cash paid for debt issuance costs | (1,190,260) | — |
| Net cash provided by financing activities | 227,702,694 | 19,279,752 |
| Net increase (decrease) in cash and cash equivalents | 135,473,684 | 16,427,797 |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents at beginning of period | | 4,521,111 | | 42 |
| Cash and cash equivalents at end of period | $ | 139,994,795 | $ | 16,427,839 |

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**
**FOR THE SIX MONTHS ENDED JUNE 30, 2006 AND 2005**
**(UNAUDITED)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2006 | 2005 |
| Supplemental Information: | | |
| Cash paid for interest | $ 184,782 | $ 386,854 |
| Cash paid for taxes | $ 13,181 | $ 5,600 |
| Non-Cash Financing and Investing activities: | | |
| Increase in fair value of derivative instruments | $ 790,602 | $ — |
| Deemed dividend on preferred stock | $ 84,000,000 | $ — |
| Conversion of debt to equity | $ — | $ 1,245,000 |
| Issuance of warrants for consulting services | $ — | $ 2,139,000 |
| Issuance of warrants for employee compensation | $ — | $ 883,250 |
| Purchase of ReEnergy with stock | $ — | $ 316,250 |
| Shares contributed by stockholder in purchase of ReEnergy | $ — | $ 506,000 |
| Shares contributed by stockholder in purchase of Kinergy | $ — | $ 1,012,000 |
| Stock returned as payment for stock option exercise | $ — | $ 1,195,314 |
| Purchase of Kinergy with stock | $ — | $ 9,803,750 |

See accompanying notes to consolidated financial statements.

**PACIFIC ETHANOL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**(UNAUDITED)**

1. **Organization and Share Exchange Transaction**:

On March 23, 2005, Pacific Ethanol, Inc., a Delaware corporation, (the "Company") completed a share exchange transaction ("Share Exchange Transaction"), with the shareholders of Pacific Ethanol California, Inc. ("PEI California") and the holders of the membership interests of each of Kinergy Marketing, LLC ("Kinergy") and ReEnergy, LLC ("ReEnergy"), pursuant to which the Company acquired all of the issued and outstanding shares of capital stock of PEI California and all of the outstanding membership interests of each of Kinergy and ReEnergy. Immediately prior to the consummation of the Share Exchange Transaction, the Company's predecessor, Accessity Corp., a New York corporation ("Accessity"), reincorporated in the State of Delaware under the name "Pacific Ethanol, Inc." through a merger of Accessity with and into its then-wholly-owned Delaware subsidiary named Pacific Ethanol, Inc., which was formed for the sole purpose of effecting the reincorporation (the "Reincorporation Merger"). In connection with the Reincorporation Merger, the shareholders of Accessity became stockholders of the Company and the Company succeeded to the rights, properties, and assets and assumed the liabilities of Accessity.

The Share Exchange Transaction has been accounted for as a reverse acquisition whereby PEI California is deemed to be the accounting acquiror. The Company has consolidated the results of PEI California, Kinergy, and ReEnergy beginning March 23, 2005, the date of the Share Exchange Transaction. Accordingly, the Company's results of operations for the three months ended June 30, 2005 consist of the operations of PEI California, Kinergy and ReEnergy for that entire period; and the Company's results of operations for the six months ended June 30, 2005 consist of the operations of PEI California for that entire period and the operations of Kinergy and ReEnergy from March 23, 2005 through June 30, 2005.

In connection with the Share Exchange Transaction, the Company issued an aggregate of 20,610,987 shares of common stock to the shareholders of PEI California, 3,875,000 shares of common stock to the limited liability company member of Kinergy and an aggregate of 125,000 shares of common stock to the limited liability company members of ReEnergy.

On March 23, 2005, prior to the consummation of the Share Exchange Transaction, PEI California issued to 63 accredited investors in a private offering an aggregate of 7,000,000 shares of common stock at a purchase price of $3.00 per share, two-year investor warrants to purchase 1,400,000 shares of common stock at an exercise price of $3.00 per share and two-year investor warrants to purchase 700,000 shares of common stock at an exercise price of $5.00 per share, for total gross proceeds of approximately $21,000,000. PEI California paid cash placement agent fees and expenses of approximately $1,850,400 and issued five-year placement agent warrants to purchase 678,000 shares of common stock at an exercise price of $3.00 per share in connection with the offering. Additional costs related to the financing include legal, accounting and consulting fees that totaled approximately $274,415.

2. **Summary of Significant Accounting Policies**:

*Basis of Presentation* - The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and reflect all adjustments, consisting solely of normal recurring adjustments, needed to fairly present the financial results for these interim periods. These financial statements include some amounts that are based on management's best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. The results of the operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the entire year.

The Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company and the accompanying unaudited interim consolidated financial statements should be read in conjunction with the financial statements for the years ended December 31, 2005 and 2004 and notes thereto in the Company's annual report on Form 10-KSB for the year ended December 31, 2005, filed with the Securities and Exchange Commission ("SEC") on April 14, 2006.

*Concentrations of Credit Risk* - Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. Concentrations of credit risk (whether on- or off-balance sheet) that arise from financial instruments exist for groups of customers or counterparties when they have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions described below.

Financial instruments that subject the Company to credit risk consist of cash balances maintained in excess of federal depository insurance limits and accounts receivable, which have no collateral or security. The accounts maintained by the Company at the financial institution are insured by the Federal Deposit Insurance Corporation (FDIC) up to $100,000. At June 30, 2006, the uninsured balance was $201,155,393 and at December 31, 2005 the uninsured balance was $4,048,476. The Company has not experienced any losses in such accounts and believes that it is not exposed to any significant risk of loss on cash.

During the three and six months ended June 30, 2006 and 2005, the Company had sales to gasoline refining and distribution companies representing 10% or more of total sales as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Customer A | 14% | 19% | 18% | 18% |
| Customer B | 15% | 11% | 13% | 11% |
| Customer C | 13% | 9% | 11% | 9% |
| Customer D (related party) | 6% | 7% | 10% | 7% |

As of June 30, 2006, the Company had receivables of approximately $5,253,148 from these customers, representing 41% of total accounts receivable.

During the three and six months ended June 30, 2006 and 2005, the Company had purchases from ethanol suppliers representing 10% or more of total purchases as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Vendor A | 27% | 11% | 28% | 11% |
| Vendor B | 22% | 21% | 23% | 21% |
| Vendor C | 15% | 22% | 15% | 21% |
| Vendor D | 10% | — | 6% | — |
| Vendor E | 4% | 26% | 2% | 26% |

Restricted Cash - The current restricted cash balance at June 30, 2006 of $893,878 is the balance of deposits held at the Company’s trade broker in connection with trading instruments entered into as part of the Company’s hedging strategy.

The long-term restricted cash balance at June 30, 2006 of $60,175,169 is the remaining balance of the $80.0 million in cash received in connection with the issuance of 5,250,000 shares of the Company’s Series A Cumulative Redeemable Convertible Preferred Stock (“Series A Preferred Stock”) which will be disbursed in accordance with a Deposit Agreement between the Company and Comerica Bank. (See Note 6). The Deposit Agreement provides for a restricted cash account into which $80.0 million of the aggregate purchase price for the Series A Preferred Stock has been deposited. The Company may not withdraw funds from the restricted cash account except in accordance with the terms of the Deposit Agreement. Under the Deposit Agreement, the Company may, with certain prescribed limitations, requisition funds from the restricted cash account for the payment of construction costs in connection with the construction of ethanol production facilities. Of the $80.0 million deposited into the restricted cash account, $20.0 million has been advanced to the Company for use in the construction of its Madera County ethanol plant.

*Inventories* - Inventories consist of bulk ethanol fuel and is valued at the lower-of-cost-or-market, cost being determined on a first-in, first-out basis. Shipping and handling costs are classified as a component of cost of goods sold in the accompanying Consolidated Statements of Operations.

*Derivative Instruments and Hedging Activities* - In 2006 the Company implemented a policy to minimize its exposure to commodity price risk associated with certain anticipated commodity purchases and sales and interest rate risk associated with anticipated corporate borrowings by using derivative instruments. The Company accounts for its derivative transactions in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted. Derivative transactions, which can include forward contracts and futures positions on the New York Mercantile Exchange ("NYMEX") and interest rate caps are recorded on the balance sheet as assets and liabilities based on the derivative's fair value. Changes in the fair value of the derivative contracts are recognized currently in earnings unless specific hedge accounting criteria are met. If derivatives meet those criteria, effective gains and losses are deferred in other comprehensive income and later recorded together with the hedged item in earnings. For derivatives designated as a hedge, the Company formally documents the hedge and assesses the effectiveness with associated transactions. The Company has designated and documented contracts for the physical delivery of commodity products to and from counterparties as normal purchases and normal sales.

*Impairment of Long-Lived Assets* - The Company evaluates impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Asset*. The Company assesses the impairment of long-lived assets, including property and equipment and purchased intangibles subject to amortization, which are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The asset impairment review assesses the fair value of the assets based on the future cash flows the assets are expected to generate. An impairment loss is recognized when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from the disposition of the asset (if any) are less than the related asset's carrying amount. Impairment losses are measured as the amount by which the carrying amounts of the assets exceed their fair values. Estimates of future cash flows are judgments based on management's experience and knowledge of the Company's operations and the industries in which the Company operates. These estimates can be significantly affected by future changes in market conditions, the economic environment, and capital spending decisions of the Company's customers and inflation.

The Company believes the future cash flows to be received from its long-lived assets will exceed the assets' carrying values, and, accordingly, the Company has not recognized any impairment losses through June 30, 2006.

*Goodwill* - Goodwill represents the excess of cost of an acquired entity over the net of the amounts assigned to net assets acquired and liabilities assumed. The Company accounts for its goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, which requires an annual review for impairment or more frequently if impairment indicators arise. This review would include the determination of each reporting unit's fair value using market multiples and discounted cash flow modeling. The Company has adopted SFAS No. 142 guidelines for annual review of impairment of goodwill and performed its annual review of impairment in March 2006. The Company has not recognized any impairment losses through June 30, 2006.

*Stock-Based Compensation* - In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (Revised 2004), *Share-Based Payments* ("SFAS No. 123R"). SFAS No. 123R requires a public entity to measure the cost of employee services received in exchange for the award of equity instruments based on the fair value of the award at the date of grant. The expense is to be recognized over the period during which an employee is required to provide services in exchange for the award. SFAS No. 123R is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005 and accordingly the Company adopted this standard on January 1 , 2006.

SFAS No. 123R provides for two transition methods. The "modified prospective" method requires that share-based compensation expense be recorded for any employee options granted after the adoption date and for the unvested portion of any employee options outstanding as of the adoption date. The "modified retrospective" method requires that, beginning in the first quarter of 2006, all prior periods presented be restated to reflect the impact of share-based compensation expense consistent with the proforma disclosures previously required under SFAS No. 123. The Company has elected to use the "modified prospective" in adopting this standard.

Prior to January 1, 2006, the Company had adopted SFAS No. 123, *Accounting for Stock-Based Compensation*. As provided for by SFAS No. 123, the Company had elected to continue to account for its stock-based compensation programs according to the provisions of Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"). Accordingly, compensation expense had been recognized to the extent of employee or director services rendered based on the intrinsic value of stock options granted under the plan. The Company accounts for common stock, stock options, and warrants granted to non-employees based on the fair market value of the instrument, using the Black-Scholes option pricing model based on assumptions for expected stock price volatility, term of the option, risk-free interest rate and expected dividend yield at the grant date.

For all awards granted prior to January 1, 2006, the unearned deferred fair value of stock-based compensation was recognized as an expense on a straight-line basis over the remaining requisite service period, ranging from six months to three years. The Company's financial results for prior periods have not been restated. The adoption of SFAS No. 123R had no effect on net loss for the three and six months ended June 30, 2006 for stock-based compensation cost related to employee stock options. The unrecognized compensation cost related to non-vested share-based compensation arrangements for all employee stock options outstanding at June 30, 2006, as measured at the date of grant, was approximately $2,757,150.

Effective with the adoption of SFAS No. 123R, stock-based compensation expense related to the Company's share-based compensation arrangements attributable to employees is being recorded as a component of general and administrative expense in accordance with the guidance of Staff Accounting Bulletin ("SAB") No. 107, Topic 14, paragraph F, *Classification of Compensation Expense Associated with Share-Based Payment Arrangements* ("SAB 107").

Stock-based compensation expense related to employee and non-employee stock options recognized in the operating results for the three and six months ended June 30, 2006 and 2005 were as follow:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Employees — included in general and administrative | $ 312,152 | $ 651,000 | $ 624,304 | $ 883,250 |
| Non-employees — included in general and administrative | 288,975 | 267,375 | 577,950 | 460,386 |
| Total stock-based compensation expense | $ 601,127 | $ 918,375 | $ 1,202,254 | $ 1,343,636 |

The estimated fair value of employee options granted was determined in accordance with SFAS No. 123R on the date of grant using the Black-Scholes option valuation model with the following weighted-average assumptions . As no options were granted during the six months ended June 30, 2006 the following assumptions remain the same: risk free interest rate of 3.9% to 4.5%; dividend yield 0%; volatility 53.6% to 55.0% and expected life of 5.5 to 10 years. The risk-free interest rate assumption is based upon observed interest rates appropriate for the expected term of the stock options. The expected volatility is based on the historical volatility of the Company's common stock and based on management's forecasts. The Company has not paid any dividends on its common stock since its inception and does not anticipate paying dividends on its common stock in the foreseeable future. The computation of the expected option term is based on expectations regarding future exercises of options which generally vest over 5.5 to 10 years.

SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Based on historical experience, the Company estimated future unvested option forfeitures at 0% as of June 30, 2006 and incorporated this rate in estimated fair value of employee option grants.

The Company's determination of fair value is affected by the Company's common stock price as well as the assumptions discussed above that require judgment. No options were granted during the six months ended June 30, 2006. A summary of the status of Company's stock option plans as of June 30, 2006 and of changes in options outstanding under the Company's plans during the six months ended June 30, 2006 is as follows:

| | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding at January 1, 2006 | 927,500 | $ 7.53 |
| Granted | — | $ — |
| Exercised | (183,500) | $ 7.10 |
| Terminated | (3,000) | $ 5.50 |
| Outstanding at June 30, 2006 | 741,000 | $ 7.64 |
| Options exercisable at June 30, 2006 | 76,000 | $ 5.95 |

The weighted average remaining term of all options outstanding decreased from 9.61 years at December 31, 2005 to 9.11 years at June 30, 2006. At June 30, 2006 the Company had 665,000 stock options outstanding under its 2004 Stock Option Plan, and 76,000 stock options outstanding under its Amended 1995 Incentive Stock Plan.

SFAS No. 123R requires that cash flows resulting from tax deductions in excess of the cumulative compensation cost recognized for options exercised (excess tax benefits) be classified as cash inflows from financing activities and cash outflows from operating activities. Due to the Company's accumulated deficit position, no tax benefits have been recognized in the cash flow statement.

Had compensation cost for stock options granted to employees and directors prior to January 1, 2006 been determined based upon the fair value at the grant date for awards, consistent with the methodology prescribed under SFAS No. 123, the Company's net loss for the three and six months ended June 30, 2005 would not have changed.

*Revenue Recognition* - The Company derives revenue primarily from sales of ethanol. The Company's net sales are based upon written agreements or purchase orders that identify the amount of ethanol to be purchased and the purchase price. Shipments are made to customers, either, directly from suppliers or from the Company's inventory to the customers by truck or rail. Ethanol that is shipped by rail originates primarily in the Midwest and takes from 10 to 14 days from date of shipment to be delivered to the customer or to various terminals in the Western United States. For local deliveries, the product is shipped by truck and delivered the same day as shipment.

In accordance with SAB No. 104, *Revenue Recognition*, and the related Emerging Issues Task Force ("EITF") Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*, revenues on the sale of ethanol that are shipped from the Company's stock of inventory are recognized when the ethanol has been delivered to the customer, provided that appropriate signed documentation of the arrangement, such as a signed contract, purchase order or letter of agreement, has been received, the fee is fixed or determinable and collectibility is reasonably assured.

Also, in accordance with EITF Issue No. 99-19, revenue from direct shipments of third-party ethanol sales are recognized upon delivery, and recorded at the gross amount when the Company is responsible for fulfillment of the customer order, has latitude in pricing, incurs credit risk on the receivable and has discretion in the selection of the supplier. Shipping and handling costs are included in cost of goods sold.

In addition, the Company has entered into certain contracts under which the supplier is responsible for fulfillment of the customer order, the supplier has approval of pricing terms, credit risk is shared between the Company and the supplier and the Company does not have discretion in the selection of the supplier. Under these contracts, the Company pays the supplier the gross payments received by the Company from third parties for sales of ethanol less certain transaction costs and a fixed fee. (See Note 7.) In accordance with EITF Issue No. 99-19, revenues under these contracts are recorded net as the Company is deemed to be an agent. In the three and six months ending June 30, 2006 and 2005 an immaterial amount of service revenue was recorded.

<u>*Income (Loss) Per Common Share*</u> - The Company computes income (loss) per common share in accordance with the provisions of SFAS No. 128, *Earnings Per Share* ("SFAS No. 128"). SFAS No. 128 requires companies with complex capital structures to present basic and diluted earnings per share. Basic earnings (loss) per share are computed on the basis of the weighted average number of shares of common stock outstanding during the period. Preferred dividends are deducted from net income and have been considered in the calculation of income (loss) available to common stockholders in computing basic earnings (loss) per share. Diluted earnings per share is equal to basic earnings per share, but presents the dilutive effect on a per share basis of potential common shares (e.g., convertible preferred stock, stock options, etc.) as if they had been converted. Potential dilutive common shares that have an anti-dilutive effect (e.g., those that increase income per share or decrease loss per share) are excluded from diluted earnings per share. The following securities are excluded in the calculation of diluted shares outstanding as their effects would be anti-dilutive for the periods ended June 30, 2006 and 2005, as follows:

| | 2006 | 2005 |
|---|---|---|
| Stock options and warrants | 3,705,548 | 954,587 |
| Convertible preferred stock | 10,500,000 | — |
| Total | 14,205,548 | 954,587 |

*Reclassifications* - Certain prior year amounts have been reclassified to conform to the current presentation. Such reclassification had no effect on net loss.

3. **Property And Equipment**:

Property and equipment consisted of the following:

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Land | $ 515,298 | $ 515,298 |
| Facilities | 4,234,703 | 4,234,703 |
| Equipment and vehicles | 373,520 | 373,520 |
| Office furniture, fixtures and equipment | 553,847 | 378,149 |
| | 5,677,368 | 5,501,670 |
| Accumulated depreciation | (277,432) | (210,675) |
| | 5,399,936 | 5,290,995 |
| Construction in progress | 46,649,507 | 17,917,253 |
| | $ 52,049,443 | $ 23,208,248 |

As of June 30, 2006 and December 31, 2005, the Company had incurred costs of $38,440,841 and $17,917,253, respectively, under its Amended and Restated Phase 1 Design-Build Agreement and its Phase 2 Design-Build Agreement both dated November 2, 2005 with W.M. Lyles Co., a subsidiary of Lyles Diversified, Inc. (“LDI”), a former stockholder of the Company, which has been included in construction in progress at June 30, 2006 and December 31, 2005, respectively. Included in this amount is a total of $2,032,042 and $1,306,499, respectively, related to the construction management fee of W.M. Lyles Co., of which $130,518 and $195,901 had not been paid at June 30, 2006 and December 31, 2005, respectively.

As of June 30, 2006 and December 31, 2005, the Company had accounts payable due to W.M. Lyles Co. of $4,630,747 and $6,411,618, respectively, related to the construction in progress of an ethanol plant. As of June 30, 2006 and December 31, 2005, the Company had accrued retention due to W.M. Lyles Co. of $2,510,794 and $1,450,500, respectively, related to the construction in progress of an ethanol plant. Included in construction in progress at June 30, 2006 and December 31, 2005 is capitalized interest of $739,756 and $343,793, respectively.

The Madera ethanol production facility is estimated to have a construction cost of approximately $64.1 million as follows: site work ($1.7 million); building and concrete ($10.9 million); site utilities ($1.1 million); equipment and tanks ($21.1 million); piping ($5.7 million); electrical ($3.7 million); and engineering, general conditions and other ($19.9 million). In addition to the construction cost, the Madera project will require up to $11.2 million in additional funds for capital raising expenses, start-up inventory and working capital for a total project cost of up to approximately $75.3 million. The Company had previously estimated a total project cost of approximately $65.5 million.

Other construction in progress consists of engineering, site design, permitting, and other development costs related to preparation for the construction of additional ethanol production facilities.

As of June 30, 2006 and December 31, 2005, property and equipment totaling $4,114,391 had not been placed in service. Depreciation expense was $66,834 for the six months ended June 30, 2006 and $85,250 for the year ended December 31, 2005.

4. **Accrued Liabilities**:

Accrued liabilities as of June 30, 2006 and December 31, 2005 consisted of the following:

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Fire damage restoration in progress | $ 2,012,686 | $ 3,157,969 |
| Insurance policy premium financing | — | 209,469 |
| Preferred Stock Dividend Payable | 897,534 | — |
| Other accrued liabilities | 918,943 | 55,127 |
| Total accrued liabilities | $ 3,829,163 | $ 3,422,565 |

5. **Debt**:

*Related Party Notes Payable* - In connection with the acquisition of the grain facility in March 2003, on June 16, 2003 PEI California entered into a Term Loan Agreement (the “Loan Agreement”) with LDI whereby LDI loaned PEI California $5,100,000. On April 13, 2006, Pacific Ethanol Madera, LLC (“PEI Madera”), a second-tier subsidiary of the Company, and LDI entered into an Amended and Restated Loan Agreement (the “Amended and Restated Loan Agreement”) whereby the Loan Agreement was assigned by the Company to PEI Madera. The Amended and Restated Loan Agreement currently carries a variable interest rate based on *The Wall Street Journal* Prime Rate (8.25% as of June 30, 2006) plus 2%. Principal payments are due annually in three equal installments beginning June 20, 2006 and ending June 20, 2008. The amounts owing under the Amended and Restated Loan Agreement are collateralized by a lien created by a deed of trust on the grain facility, which deed of trust is subject and subordinate to the lien created by a deed of trust in favor of the lender under the construction loan with Hudson United Capital and Comerica Bank described below. The Amended and Restated Loan Agreement is described in further detail in the Company’s Form 10-KSB for the year ended December 31, 2005.

*Debt Financing* - On April 13, 2006, PEI Madera entered into a Construction and Term Loan Agreement dated April 10, 2006 (the "Construction Loan") with Comerica Bank ("Comerica") and Hudson United Capital ("Hudson") for a debt financing (the "Debt Financing"), from Hudson and Comerica (collectively, the "Lender"), in the aggregate amount of up to $34.0 million. The Debt Financing may be used by the Company as part of the total financing necessary for the completion of the Company's ethanol production facility in Madera County, California (the "Project"). The Company incurred related debt issuance costs of $1,190,260, and is amortizing such costs over the term of the loan.

The Company has contributed assets to PEI Madera having a value of approximately $13.9 million (the "Contributed Assets"). The Company is responsible for arranging cash equity (the "Contributed Amount") in an amount that, when combined with the Contributed Assets would be equal to no less than the difference between the Debt Financing amount of $34.0 million and the total Project Cost. The Contributed Amount was initially approximately $31.5 million and has been satisfied through the application of $17.7 million of Cascade's investment in the Company's Series A Preferred Stock.

The Debt Financing will initially be in the form the Construction Loan that will mature on or before the Final Completion Date, after which the Debt Financing will be converted to a term loan (the "Term Loan"), that will mature on the seventh anniversary of the closing of the Term Loan. On the Term Loan Conversion Date the Company is required to pay a fee of 1% of the borrowed amount upon conversion of the Construction Loan to the Term Loan. If the Construction Loan were to go unused, the last day in which the debt could be used is October 10, 2007. If the conversion does not occur and PEI Madera elects to repay the Construction Loan, then PEI Madera must pay a termination fee equal to 5.00% of the amount of the Construction Loan. The closing of the Term Loan is expected to be the Final Completion Date. The Construction Loan interest rate will float at a rate equal to the 30-day London Inter Bank Offered Rate ("LIBOR"), plus 3.75%. PEI Madera will be required to pay the Construction Loan interest monthly during the term of the Construction Loan. The Term Loan interest rate will float at a rate equal to the 90-day LIBOR plus 4.00%. PEI Madera will be required to purchase interest rate protection in the form of a LIBOR rate cap of no more than 5.50% from a provider on terms and conditions reasonably acceptable to Lender, and in an amount covering no less than 70% of the principal outstanding on any loan payment date commencing on the closing date through the fifth anniversary of the Term Loan. (See note 8.) Loan repayments on the Term Loan are to be due quarterly in arrears for a total of 28 payments beginning on the closing of the Term Loan and ending on its maturity date. The loan amortization for the Project will be established on the closing of the Term Loan based upon the operating cash projected to be available to PEI Madera from the Project as determined by closing pro forma projections. The Debt Financing will be the only indebtedness permitted on the Project. The Debt Financing will be senior to all obligations of the Project and PEI Madera other than direct Project operating expenses and expenses incurred in the ordinary course of business. All direct and out-of-pocket expenses of the Company or the Company's direct and indirect subsidiaries will be reimbursed only after the repayment of the Debt Financing obligations.

The Term Loan amount will be the lesser of (i) $34.0 Million, (ii) 52.25% of the total Project Cost as of the Term Loan Conversion Date, and (iii) an amount equal to the present value (discounted at an interest rate of 9.5% per annum) of 43.67% of the operating cash distributable to and received by PEI Madera supported by the closing pro forma projections, from the closing of Term Loan through the seventh anniversary of such closing.

The Debt Financing is secured by: (i) a perfected first priority security interest in all of the assets of PEI Madera, including inventories and all right title and interest in all tangible and intangible assets of the Project; (ii) a perfected first priority security interest in the Project's grain facility, including all of PEI Madera's and the Company's and its affiliates' right title and interest in all tangible and intangible assets of the Project's grain facility; (iii) a pledge of 100% of the ownership interest in PEI Madera; (iv) a pledge of the PEI Madera's ownership interest in the Project; (v) an assignment of all revenues produced by the Project and PEI Madera; (vi) the pledge and assignment of the material Project documents, to the extent assignable; (vii) all contractual cash flows associated with such agreements; and (viii) any other collateral security as Lender may reasonably request. In addition, the Construction Loan is secured by a completion bond provided by W.M. Lyles Co.

As of June 30, 2006, the Company was in compliance with all bank covenants under the Debt Financing and no borrowings under the Debt Financing were outstanding.

6. **Stockholders' Equity**:

*Preferred Stock* - The Company has 10,000,000 shares of preferred stock authorized, of which 7,000,000 have been designated as Series A Preferred Stock. As of June 30, 2006, 5,250,000 shares of Series A Preferred Stock were issued and outstanding.

On April 13, 2006, the Company issued to Cascade Investment, L.L.C. ("Cascade"), 5,250,000 shares of Series A Preferred Stock at a price of $16.00 per share, for an aggregate purchase price of $84.0 million. The Company is entitled to use $4.0 million of the proceeds for general working capital and must use the remaining $80.0 million for the construction or acquisition of one or more ethanol production facilities in accordance with the terms of a Deposit Agreement.

Under the Certificate of Designations, Powers, Preferences and Rights of the Series A Cumulative Redeemable Convertible Preferred Stock (the "Certificate of Designations"), the Series A Preferred Stock ranks senior in liquidation and dividend preferences to the Company's common stock. Holders of Series A Preferred Stock are entitled to quarterly cumulative dividends payable in arrears in cash in an amount equal to 5% per annum of the purchase price per share of the Series A Preferred Stock; however, such dividends may, at the Company's option, be paid in additional shares of Series A Preferred Stock based on the value of the purchase price per share of the Series A Preferred Stock.

The holders of the Series A Preferred Stock have conversion rights initially equivalent to two shares of common stock for each share of Series A Preferred Stock. The conversion ratio is subject to customary antidilution adjustments, including in the event that the Company issues equity securities at a price equivalent to less than $8.00 per share, including derivative securities convertible into equity securities (on an as-converted or as-exercised basis). Certain specified issuances will not result in antidilution adjustments. The shares of Series A Preferred Stock are also subject to forced conversion upon the occurrence of a transaction that would result in an internal rate of return to the holders of the Series A Preferred Stock of 25% or more. Accrued but unpaid dividends on the Series A Preferred Stock are to be paid in cash upon any conversion of the Series A Preferred Stock.

The holders of Series A Preferred Stock have a liquidation preference over the holders of the Company's common stock equivalent to the purchase price per share of the Series A Preferred Stock plus any accrued and unpaid dividends on the Series A Preferred Stock. A liquidation will be deemed to occur upon the happening of customary events, including transfer of all or substantially all of the Company's capital stock or assets or a merger, consolidation, share exchange, reorganization or other transaction or series of related transaction, unless holders of 66 2/3% of the Series A Preferred Stock vote affirmatively in favor of or otherwise consent to such transaction.

Upon the occurrence of a Redemption Event (as defined below), the Series A Preferred Stock will be subject to redemption, at the option of the holders of 66 2/3% of the then outstanding shares of Series A Preferred Stock. The redemption price for shares of Series A Preferred Stock subject to redemption will be equal to the Series A Preferred Stock issue price per share plus any accrued but unpaid dividends plus an amount sufficient to yield an Internal Rate of Return of 5.00%, payable in immediately available funds. A Redemption Event is defined as (i) the Company withdrawing or utilizing funds from the restricted cash account in violation of the terms of the Deposit Agreement, (ii) the Company publicly disclosing an intent not to build or acquire additional ethanol production facilities for an indefinite period or for a period of at least two years from the time of the announcement, (iii) the Company failing to withdraw funds from the restricted cash account for a period of two years, or (iv) amounts remaining in the restricted cash account after December 31, 2009.

In connection with the issuance of the Series A Preferred Stock, the Company entered into a Registration Rights and Stockholders Agreement (the “Rights Agreement”) with Cascade. The Rights Agreement is to be effective until the holders of the Series A Preferred Stock, and their affiliates, as a group, own less than 10% of the Series A Preferred Stock issued under the purchase agreement with Cascade, including common stock into which such Series A Preferred Stock has been converted (the “Termination Date”). The Rights Agreement provides that holders of a majority of the Series A Preferred Stock, including common stock into which the Series A Preferred Stock has been converted, may demand and cause the Company, at any time after April 13, 2007, to register on their behalf the shares of common stock issued, issuable or that may be issuable upon conversion of the Series A Preferred Stock (the “Registrable Securities”). Following such demand, the Company is required to notify any other holders of the Series A Preferred Stock or Registrable Securities of the Company’s intent to file a registration statement and, to the extent requested by such holders, include them in the related registration statement. The Company is required to keep such registration statement effective until such time as all of the Registrable Securities are sold or until such holders may avail themselves of Rule 144(k) under the Securities Act of 1933, which requires, among other things, a minimum two-year holding period and requires that any holder availing itself of Rule 144(k) not be an affiliate of the Company. The holders are entitled to three demand registrations on Form S-1 and unlimited demand registrations on Form S-3; however, the Company is not obligated to effect more than two demand registrations on Form S-3 in any 12-month period.

In addition to the demand registration rights afforded the holders under the Rights Agreement, the holders are entitled to “piggyback” registration rights. These rights entitle the holders who so elect to be included in registration statements to be filed by the Company with respect to other registrations of equity securities. The holders are entitled to unlimited “piggyback” registration rights.

The Rights Agreement also provides for the initial appointment of two persons designated by Cascade to the Company’s Board of Directors, and the appointment of one of such persons as the Chairman of the Compensation Committee of the Board of Directors. Following the Termination Date, Cascade is required to cause its director designees, and all other designees, to resign from all applicable committees and boards of directors, effective as of the Termination Date.

Deemed Dividend on Preferred Stock

In accordance with EITF 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*, and EITF 00-27, *Application of Issue No. 98-5 to Certain Convertible Instruments*, the Series A Preferred Stock is considered to have an embedded beneficial conversion feature because the conversion price was less than the fair value of the Company's common stock at the issuance date. The Company has recorded a deemed dividend on preferred stock in its financial statements for the three and six months ended June 30, 2006. This non-cash dividend is to reflect the implied economic value to the preferred stockholder of being able to convert its shares into common stock at a price which is in excess of the fair value of the Series A Preferred Stock. The fair value allocated to the Series A Preferred Stock together with the original conversion terms were used to calculate the value of the deemed dividend on the Series A Preferred Stock of $84 million at the date of issuance. The fair value was calculated using the difference between the agreed-upon conversion price of the Series A Preferred Stock into shares of common stock of $8.00 per share and the fair market value of the Company's common stock of $29.27 on the date of issuance of the Series A Preferred Stock. The fair value allocated to the Series A Preferred Stock was in excess of the gross proceeds received of $84 million in connection with the sale of the Series A Preferred Stock; however, the deemed dividend on the Series A Preferred Stock is limited to the gross proceeds received of $84 million. This amount has been charged to accumulated deficit with the offsetting credit to additional paid-in-capital. The Company has treated the deemed dividend on preferred stock as a reconciling item on the Consolidated Statements of Operations to adjust its reported net loss, together with any preferred stock dividends recorded during the applicable period, to "loss available to common stockholders."

Likely Embedded Derivative

Under the provisions of SFAS No. 133, the Series A Preferred Stock's redemption feature is likely a derivative instrument that requires bifurcation from the host contract. SFAS No. 133 requires all derivative instruments to be measured at fair value. However, because the underlying events that would cause the redemption feature to be exercisable (i.e., redemption events) are not probable of occurrence in the foreseeable future, the Company believes that the fair value of the embedded derivative was *de minimis* at the date of issuance of the Series A Preferred Stock. The Company will continue to evaluate the redemption feature and the probability of the occurrence of the redemption events at each reporting period to determine if a fair value should be ascribed to such embedded derivative and recorded in the Company's financial statements.

*Common Stock* - The Company has 100,000,000 shares of common stock authorized. As of June 30, 2006, 37,223,236 shares of common stock were issued and outstanding.

On May 31, 2006 (the "Closing Date"), the Company issued to 45 accredited investors an aggregate of 5,496,583 shares of common stock at a price of $26.38 per share, for an aggregate purchase price of $145.0 million in cash. The Company intends to use the net proceeds of approximately $138.0 million, net of capital raising fees and expenses, for construction of additional ethanol plants and working capital.

The Company also issued to the investors warrants to purchase an aggregate of 2,748,297 shares of common stock at an exercise price of $31.55 per share. The warrants are exercisable on or after a date that is the later of (i) six months from the Closing Date and (ii) the effective date of the related registration statement, through and including the date that is the later of (a) nine months from the Closing Date and (b) thirty days after the effective date of the related registration statement.

The Company was obligated under a Securities Purchase Agreement (the "Purchase Agreement") related to the above private offering to file, by June 30, 2006, a registration statement with the SEC, registering for resale shares of common stock, and shares of common stock underlying the warrants, issued in connection with the private offering. The Company filed the registration statement with the SEC on June 23, 2006. The Company's registration obligations also require, that it cause the registration statement to be declared effective on the date, which is the earliest of (i) if the registration statement does not become subject to review by the SEC, (a) ninety days after the Closing Date, or (b) five trading days after the Company receives notification from the SEC that the registration statement will not become subject to review and the Company fails to request to accelerate the effectiveness of the registration statement, or (ii) if the registration statement becomes subject to review by the SEC, one hundred twenty days after the Closing Date. The registration statement was declared effective by the SEC on July 10, 2006.

The Company has evaluated the classification of common stock and warrants issued in the private offering in accordance with EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* and EITF D-98, *Classification and Measurement of Redeemable Securities*. The Company has determined, based on a valuation performed by an independent appraiser that the maximum potential liquidated damages are less than the difference in fair value between registered and unregistered shares of the Company's stock and, therefore, has classified the common stock and warrants as equity.

The Company paid cash placement agent fees of approximately $7.25 million to the exclusive placement agent in connection with the private offering, and has agreed to pay up to an additional approximately $3.90 million in the event that all warrants are exercised in full by the investors.



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*Warrants* - The following table summarizes warrant activity for the six months ended June 30, 2006 and the year ended December 31, 2005:

| | Number of Shares | Price per Share | Weighted Average Exercise Price |
|---|---|---|---|
| Balance at December 31, 2005 | 2,904,818 | $ 0.0001 - 5.00 | $ 3.26 |
| Warrants granted | 2,748,297 | 31.55 | 31.55 |
| Warrants exercised | (2,688,567) | 0.0001 - 5.00 | 3.38 |
| Balance at June 30, 2006 | 2,964,548 | $ 0.0001 - 31.55 | $ 29.39 |

The weighted average remaining contractual life and weighted average exercise price of all warrants outstanding and of warrants exercisable as of June 30, 2006 were as follows:

| | Warrants Outstanding | | | Warrants Exercisable | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted-Average Exercise Price | Number Exercisable | Weighted-Average Exercise Price |
| $0.0001 | 86,251 | 2.74 | $0.0001 | — | $ — |
| $3.00 | 86,000 | 0.73 | $3.00 | 86,000 | $3.00 |
| $5.00 | 44,000 | 0.73 | $5.00 | 44,000 | $5.00 |
| $31.55 | 2,748,297 | 0.67 | $31.55 | — | $ — |
| | 2,964,548 | | | 130,000 | |

7. **Commitments and Contingencies**:

*Purchase Commitments* - During the six months ended June 30, 2006, the Company entered into purchase contracts with its major suppliers to acquire certain quantities of ethanol, corn, and denaturant.

As of June 30, 2006, the outstanding balance on fixed price contracts for the purchase of ethanol was $88,057,151. As of June 30, 2006, the Company also had purchase contracts for 56.2 million gallons of ethanol where the purchase price will be determined by the market price at the transaction date.

As of June 30, 2006, the outstanding balance on fixed price contracts for the purchase of corn was $4,304,300. As of June 30, 2006, the outstanding balance on fixed price purchase contracts for the purchase of denaturant was $859,200.

Sales Commitments - During the six months ended June 30, 2006, the Company entered into sales contracts with its major customers to sell certain quantities of ethanol and denaturant.

As of June 30, 2006, the outstanding balance on fixed price contracts for the sale of ethanol was $131,635,928. As of June 30, 2006, the Company also had sales contracts for 70.9 million gallons of ethanol where the sales price will be determined by the market price at the transaction date.

As of June 30, 2006, the outstanding balance on fixed price sales contracts for the sale of denaturant was $1,139,324.

Ethanol Purchase and Marketing Agreement - On March 4, 2005, Kinergy entered into an Ethanol Purchase and Marketing Agreement with the owner of an ethanol production facility. The agreement was amended in April 2006. The agreement is effective for two years with automatic renewals for additional one-year periods. Kinergy has the exclusive right to market and sell all of the ethanol from the facility. Pursuant to the terms of the agreement, the purchase price of the ethanol may be negotiated monthly between Kinergy and the owner of the ethanol production facility without regard to the price at which Kinergy will re-sell the ethanol to its customers or Kinergy may pay the owner the gross payments received by Kinergy from third parties for forward sales of ethanol less certain transaction costs and fees and retain a 1.0% marketing fee calculated after deducting these costs and expenses. During the six months ended June 30, 2006, purchases of ethanol from this facility were based on a blend of monthly negotiated prices, contract period fixed prices, and index-based prices based on a weekly NYMEX average.

Ethanol Marketing Agreement - On August 31, 2005, Kinergy entered into an Ethanol Marketing Agreement with the owner of an ethanol production facility. The agreement is effective for three years with automatic renewals for additional one-year periods thereafter. Kinergy has the exclusive right to market and sell all of the ethanol from the facility. Kinergy is to pay the owner the gross payments received by Kinergy from third parties for forward sales of ethanol less certain transaction costs and fees. Kinergy may also deduct and retain an amount equal to 1.0% of the difference between the gross payments received by Kinergy and the transaction costs and fees. On August 9, 2006, Kinergy entered into an amendment and restatement of the Ethanol Marketing Agreement, which among other things, allows the Company to make direct purchases from the owner of the ethanol production facility. See revenue recognition discussed in Note 2.

Litigation - General - The Company is subject to legal proceedings, claims and litigation arising in the ordinary course of business. While the amounts claimed may be substantial, the ultimate liability cannot presently be determined because of considerable uncertainties that exist. Therefore, it is possible that the outcome of those legal proceedings, claims and litigation could adversely affect the Company’s quarterly or annual operating results or cash flows when resolved in a future period. However, based on facts currently available, management believes such matters will not adversely affect the Company’s financial position, results of operations or cash flows.

*Litigation - Barry Spiegel* - On December 23, 2005, Barry J. Spiegel, a stockholder of the Company and former director of Accessity, filed a complaint in the Circuit Court of the 17th Judicial District in and for Broward County, Florida (Case No. 05018512) (the "Spiegel Action"), against Barry Siegel, Philip Kart, Kenneth Friedman and Bruce Udell (collectively, the "Defendants"). Messrs. Siegel, Udell and Friedman are former directors of Accessity and the Company. Mr. Kart is a former executive officer of Accessity and the Company. The Spiegel Action relates to the Share Exchange Transaction and purports to state five counts against the Defendants: (i) breach of fiduciary duty, (ii) violation of Florida's Deceptive and Unfair Trade Practices Act, (iii) conspiracy to defraud, (iv) fraud, and (v) violation of Florida Securities and Investor Protection Act. Mr. Spiegel is seeking $22.0 million in damages. On March 8, 2006, Defendants filed a motion to dismiss the Spiegel Action, which remains pending. No discovery has been taken. The Company has agreed with Messrs. Friedman, Siegel, Kart and Udell to advance the costs of defense in connection with the Spiegel Action. Under applicable provisions of Delaware law, the Company may be responsible to indemnify each of the Defendants in connection with the Spiegel Action.

*Litigation - Gerald Zutler* - In January 2003, DriverShield CRM Corp., or DriverShield, then a wholly-owned subsidiary of the Company's predecessor, Accessity, was served with a complaint filed by Mr. Gerald Zutler, its former President and Chief Operating Officer, alleging, among other things, that DriverShield breached his employment contract, that there was fraudulent concealment of DriverShield's intention to terminate its employment agreement with Mr. Zutler, and discrimination on the basis of age and aiding and abetting violation of the New York State Human Rights Law. The complaint was filed in the Supreme Court of the State of New York, County of Nassau, Index No.: 654/03. Mr. Zutler sought damages of approximately $2.2 million, plus punitive damages and reasonable attorneys' fees. On July 20, 2006, the Company settled Mr. Zutler's claims in full and subsequently made a settlement payment to Mr. Zutler in the amount of $515,000, of which $150,000 was covered by DriverShield's insurance carrier.

Litigation - Mercator - In 2003, Accessity filed a lawsuit seeking damages in excess of $100 million against: (i) Presidion Corporation, f/k/a MediaBus Networks, Inc., Presidion's parent corporation, (ii) Presidion's investment bankers, Mercator Group, LLC, or Mercator, and various related and affiliated parties and (iii) Taurus Global LLC, or Taurus, (collectively referred to as the "Mercator Action"), alleging that these parties committed a number of wrongful acts, including, but not limited to tortuously interfering in a transaction between Accessity and Presidion Solutions Inc. In 2004, Accessity dismissed this lawsuit without prejudice, which was filed in Florida state court. The Company recently refiled this action in the State of California, for a similar amount, as the Company believes that this is the proper jurisdiction. On August 18, 2005, the court stayed the action and ordered the parties to arbitration. The parties agreed to mediate the matter. Mediation took place on December 9, 2005 and was not successful. On December 5, 2005, the Company filed a Demand for Arbitration with the American Arbitration Association. On April 6, 2006, a single arbitrator was appointed. Arbitration hearings have been scheduled to commence in March 2007. The share exchange agreement relating to the Share Exchange Transaction provides that following full and final settlement or other final resolution of the Mercator Action, after deduction of all fees and expenses incurred by the law firm representing the Company in this action and payment of the 25% contingency fee to the law firm, shareholders of record of Accessity on the date immediately preceding the closing date of the Share Exchange Transaction will receive two-thirds and the Company will retain the remaining one-third of the net proceeds from any Mercator Action recovery.

Employment Agreements - On June 26, 2006, the Company entered into Executive Employment Agreements with each of John T. Miller, its Chief Operating Officer, and Christopher W. Wright, its Vice President, General Counsel and Secretary, that each provide for a one-year term and automatic one-year renewals thereafter, unless the executive or the Company provides written notice to the other at least 90 days prior to the expiration of the then-current term. Each executive is to receive a base salary of $185,000 per year and is entitled to receive a cash bonus not to exceed 50% of his base salary. Each executive is entitled to $92,500 for six months of severance pay effective throughout the entire term of his agreement and is also entitled to reimbursement of his costs associated with his relocation to the location of the Company's corporate headquarters. Each executive is also to be issued an aggregate of 54,000 shares of the Company's common stock pursuant to a restricted stock or restricted stock unit award under an incentive plan to be instituted by the Company that will vest as to 13,500 shares immediately and as to an additional 10,125 shares on each of the first, second, third and fourth anniversaries of the initial grant. The award is subject to stockholder approval of the related incentive plan. The incentive plan is to include terms comparable to those contained in the Company's existing 2004 Stock Option Plan providing for accelerated vesting in connection with a change in control of the Company.

8. **Derivatives**:

The business and activities of the Company expose it to a variety of market risks, including risks related to changes in commodity prices and interest rates. These financial exposures are monitored and managed by the Company as an integral part of its risk management program. This program recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effects that market volatility could have on operating results. The Company accounts for its use of derivatives related to its hedging activities pursuant to SFAS No. 133, in which the Company recognizes all of its derivative instruments in its statement of financial position as either assets or liabilities, depending on the rights or obligations under the contracts. The Company has designated and documented contracts for the physical delivery of commodity products to and from counterparties as normal purchases and normal sales. Derivative instruments are measured at fair value, pursuant to the definition found in SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. Changes in the derivative's fair value are recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's effective gains and losses to be deferred in other comprehensive income and later recorded together with the gains and losses to offset related results on the hedged item in earnings. Companies must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

*Commodity Risk* - *Cash Flow Hedges* - As part of its risk management strategy, the Company uses derivative instruments to protect cash flows from fluctuations caused by volatility in commodity prices out up to eighteen months. These hedging activities are conducted to protect product margin to reduce the potentially adverse effects that market volatility could have on operating results by minimizing the Company's exposure to price volatility on ethanol sale and purchase commitments where the price is to be set at a future date and/or if the contract specifies a floating or "index-based" price for ethanol that is based on either the NYMEX price of gasoline or the Chicago Board of Trade price of ethanol. In addition, the Company hedges anticipated sales of ethanol to minimize the Company's exposure to the potentially adverse effects of price volatility. These derivatives are designated and documented as SFAS No. 133 cash flow hedges and effectiveness is evaluated by assessing the probability of the anticipated transactions and regressing commodity futures prices against the Company's purchase and sales prices. Ineffectiveness, which is defined as the degree to which the derivative does not offset the underlying exposure, is recognized immediately in earnings. In the three and six months ending June 30, 2006 and 2005 an immaterial amount of ineffectiveness was recorded in cost of goods sold. In the three and six months ending June 30, 2006 $188,244 and $194,940 was recorded in other income, respectively. In the three and six months ending June 30, 2005 no amount of ineffectiveness was recorded to other income. Amounts remaining in other comprehensive income will be reclassified to earnings upon the recognition of the related purchase or sale. The notional balance of these derivatives as of June 30, 2006 and 2005 were $37,186,884 and $0, respectively.

_Commodity Risk_ - _Non-Designated Hedges_ - Occasionally the Company executes basis swaps to fix the cost of forecasted corn purchases. As of June 30, 2006, the Company had purchased and sold corn futures that will settle in November 2006, giving the Company the right to purchase 860,000 bushels of corn at $0.0225 per bushel and sell 430,000 bushels of corn at $0.07 per bushel.

_Interest Rate Risk_ - As part of the Company's interest rate risk management strategy, the Company uses derivative instruments to minimize significant unanticipated earnings fluctuations that may arise from rising variable interest rate cost associated with existing and anticipated borrowings. To meet these objectives the Company purchased interest rate caps on the three-month LIBOR. The capitalization rate for a notional balance ranging from $0 to $22,705,473 is 5.50% per annum. The capitalization rate for a notional balance ranging from $0 to 9,730,917 is 6.00% per annum. These derivatives are designated and documented as SFAS No. 133 cash flow hedges and effectiveness is evaluated by assessing the probability of anticipated interest expense and regressing the historical value of the caps against the historical value in the existing and anticipated debt. Ineffectiveness, reflecting the degree to which the derivative does not offset the underlying exposure, is recognized immediately in earnings. During the three and six months ending June 30, 2006 and 2005, an immaterial amount of ineffectiveness was recorded in interest expense. Amounts remaining in other comprehensive income will be reclassified to earnings upon the recognition of the hedged interest expense.

The Company marked its derivative instruments to fair value at each period end, except for those derivative contracts which qualified for the normal purchase and sale exemption pursuant to SFAS No. 133. According to the Company's designation of the derivative, changes in the fair value of derivatives are reflected in earnings or other comprehensive income.

_Other Comprehensive Income_

| | Commodity Derivatives Gains/(Loss)* | Interest Rate Derivatives Gains/(Loss)* |
|---|---|---|
| Beginning balance, December 31, 2005 | $ — | $ — |
| Net changes | 1,711,851 | 13,588 |
| Amount reclassified to revenue | (718,360) | — |
| Amount reclassified to cost of goods sold | (12,297) | — |
| Amount reclassified to interest expense | — | (9,240) |
| Amount reclassified to other income | (194,940) | — |
| Ending balance, June 30, 2006 | $ 786,254 | $ 4,348 |

*Calculated on a pretax basis

9. **Related Party Transactions:**

*Related Customer* - On January 14, 2006, the Company entered into a 6-month sales contract with a contract period beginning April 1, 2006 through September 30, 2006 for 2,100,000 gallons of fuel grade ethanol to be delivered ratably at approximately 350,000 gallons per month at varying prices based on delivery destinations in California. On June 13, 2006, the Company entered into an additional 6-month sales contract with a contract period beginning October 1, 2006 through March 31, 2007 for 6,300,000 gallons of fuel grade ethanol to be delivered ratably at approximately 1,050,000 gallons per month at varying prices based on delivery destinations in California, Nevada, and Arizona. During the six months ended June 30, 2006, sales to Southern Counties Oil Co. totaled $8,584,749 and accounts receivable from Southern Counties Oil Co. at June 30, 2006 totaled $659,585.

10. **Subsequent Events**:

*Termination of Amended 1995 Stock Incentive Plan* - On July 19, 2006, the Company terminated its Amended 1995 Stock Incentive Plan, except to the extent of currently issued and outstanding options under the plan.

*Payoff of LDI Term Loan* - On July 21, 2006, the Company paid off the balance of the LDI term loan in the amount of $2,413,479, including interest in the amount of $13,479.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis should be read in conjunction with our consolidated financial statements and notes to consolidated financial statements included elsewhere in this report. This report and our consolidated financial statements and notes to consolidated financial statements contain forward-looking statements, which generally include the plans and objectives of management for future operations, including plans and objectives relating to our future economic performance and our current beliefs regarding revenues we might generate and profits we might earn if we are successful in implementing our business strategies. The forward-looking statements and associated risks may include, relate to or be qualified by other important factors, including, without limitation:

- fluctuations in the market price of ethanol;
- the projected growth or contraction in the ethanol market in which we operate;
- our business strategy for expanding, maintaining or contracting our presence in this market;
- our ability to obtain the necessary financing to complete construction of our planned ethanol production facilities other than our facility in Madera County, California;
- anticipated trends in our financial condition and results of operations; and
- our ability to distinguish ourselves from our current and future competitors.

We do not undertake to update, revise or correct any forward-looking statements.

Any of the factors described above or in the "Risk Factors" section below could cause our financial results, including our net income or loss or growth in net income or loss to differ materially from prior results, which in turn could, among other things, cause the price of our common stock to fluctuate substantially.

**Overview**

Our primary goal is to become a leader in the production, marketing and sale of ethanol and other renewable fuels in the Western United States.

We are currently engaged in the business of marketing and selling ethanol in the Western United States. Through our wholly owned subsidiary, Kinergy Marketing, LLC, or Kinergy, we provide transportation, storage and delivery of ethanol through third-party service providers. We sell ethanol primarily in California, Nevada, Arizona, Washington and Oregon and have extensive customer relationships throughout the Western United States and extensive supplier relationships throughout the Western and Midwestern United States. We do not currently produce any ethanol that we sell. Until we commence the production of ethanol, we expect that our operations will consist primarily of the marketing and sale of ethanol produced by third-parties. We anticipate that our net sales will grow in the long-term as demand for ethanol increases and as a result of our marketing agreements with third-party ethanol producers.

We believe that we have a competitive advantage due to the market niche that we have developed by supplying ethanol to customers in several major metropolitan and rural markets in California and other Western states. We also believe that the experience of our management over the past two decades and our ethanol marketing and sales operations conducted over the past five years have enabled us to establish valuable relationships in the ethanol marketing industry and understand the business of marketing ethanol.

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Through Pacific Ethanol Madera, LLC, or PEI Madera, a second-tier subsidiary of our wholly-owned subsidiary, Pacific Ethanol California, Inc., or PEI California, we are constructing an ethanol production facility in Madera County, California. In April 2006, we secured all the necessary financing to complete construction of this facility. In May 2006, we commenced construction of our second ethanol production facility, located in Boardman, Oregon, which when completed is expected to produce at least 35 million gallons of ethanol per year. We are currently in advanced stages of development of three other ethanol facilities in two Western states. We also intend to construct or otherwise acquire additional ethanol production facilities as financing resources and business prospects make the construction or acquisition of these facilities advisable. In May 2006, we secured $138 million of additional financing to further fund our expansion plans.

Currently, ethanol represents only up to 3% of the total annual gasoline demand in the United States. We believe that the ethanol industry has substantial potential for growth to reach what we estimate is an achievable level of at least 10% of the total annual gasoline demand in the United States. An increase in the demand for ethanol from California's current level of 5.7%, or approximately 950 million gallons per year, to at least 10%, of total annual gasoline demand would result in demand for approximately 700 million additional gallons of ethanol, representing an increase in annual demand in California of approximately 75% and an increase in annual demand in the entire United States of approximately 18%.

We have two principal methods of marketing and selling ethanol: direct sales and inventory sales. The first method of marketing and selling ethanol involves direct sales through which suppliers deliver ethanol directly via rail to our customers. For direct sales, we typically match ethanol purchase and sale contracts of like quantities and delivery periods. These direct sales typically involve selection of a customer after the ethanol is purchased and fulfillment of the purchase terms to that customer. Our second method of selling ethanol involves truck deliveries from inventory purchased in advance. For inventory sales, as with direct sales, we select a particular customer and fulfill the terms of sale to that customer from our inventory. However, a time lag may result from inventory transit and turnover times. As a result, in some cases we may supply ethanol under new inventory sales contracts from existing inventory, and in some cases we may supply from currently acquired inventory. In either case, these transactions involve some price risks resulting from potential fluctuations in the market price of ethanol.

Management seeks to optimize transitions to new inventory sales contracts and reduce the effects in the case of declining ethanol prices by managing inventory as carefully as possible to decrease inventory levels in anticipation of declining ethanol prices. In addition, management seeks to increase inventory levels in anticipation of rising ethanol prices. Because we decrease inventory levels in anticipation of declining ethanol prices and increase inventory levels in anticipation of rising ethanol prices, we are subject to the risk of ethanol prices moving in unanticipated directions, which could result in declining or even negative gross profit margins over certain periods of time. However, this also enables us, in some cases, to benefit from above-normal gross profit margins.

Over the past few years, the market price of ethanol has experienced significant fluctuations. For example, our average sales price of ethanol declined by approximately 25% from our 2004 average sales price per gallon in five months from January 2005 through May 2005 and reversed this decline and increased to approximately 55% above our 2004 average sales price per gallon in four months from June 2005 through September 2005; and from September through December 2005, our average sales price of ethanol trended downward, but reversed its trend in the first six months of 2006 by rising approximately 31% above our 2005 average sales price per gallon.

We believe that the market price of ethanol will, for the foreseeable future, continue to experience significant fluctuations which may cause our future results of operations to fluctuate significantly. As a result, our historical results of operations may not be predictive of our future results of operations.

Historically, Kinergy's gross profit margins have averaged between 2.0% and 4.4%. Gross profit margins above this historical average range generally result when we are able to correctly anticipate and benefit from holding a net long position (i.e., volume on purchase contracts, together with inventory, exceeds volume on sales contracts) while ethanol prices are rising, or holding a net short position (i.e., volume on sales contracts exceeds volume on purchase contracts and inventory) while ethanol prices are declining. Gross profit margins below the historical average range generally result when a net long or short position is held and there is a sustained adverse movement in market prices.

Our future gross margins will primarily depend on the confluence of four key factors: (i) the degree of competition in the ethanol market, which may reduce margins; (ii) the proportion of direct sale arrangements, which typically result in lower gross profit margins, to our inventory sales, which typically result in higher gross profit margins; (iii) the volatility of the market price of ethanol; and (iv) management's ability to anticipate trends in the market price of ethanol and our ability to implement and hold the appropriate net long or net short positions. Given the difficulty associated with forecasting any of these factors, we are unable to estimate our future gross profit margins.

If we are able to complete our ethanol production facilities in Madera County and Boardman and commence producing ethanol, we expect our gross profit margins for ethanol that we produce to be substantially higher than our gross profit margins for our direct and inventory sales of ethanol produced by third parties. However, any gross profits that we realize from the production of ethanol will be highly dependent upon the prevailing market price of ethanol at the time of sale. Moreover, in light of the recent and expected future volatility in the price of ethanol, we are now, and expect for the foreseeable future to be, unable to estimate our gross profit margins resulting from the sale of ethanol that we may produce.

Our gross profit margin increased from 0.7% in the second quarter of 2005 to 7.0% in the second quarter of 2006. Our gross profit margins increased from 0.8% in the first six months of 2005 to 6.6% in the first six months of 2006. Our lower gross profit margins in the second quarter and for the first six months of 2005 as compared to the same periods in 2006 resulted primarily from the transition from inventory sales contracts ending in the first quarter of 2005 to new inventory sales contracts beginning in the second quarter of 2005 during a period of rapidly declining market prices. Because of the time lag in delivering ethanol under new inventory sales contracts, we sold ethanol under these contracts from existing inventory that was purchased at levels higher than the prevailing market price at the time of sale. The increase in our gross profit margins in the second quarter and for the first six months of 2006 as compared to the same periods in 2005 is generally reflective of opportunistic buying and selling during a period of rapidly increasing market prices. We established and maintained net long ethanol positions going during much of the first and second quarters of 2006. The decision to maintain net long ethanol positions was based on a confluence of factors, including management's expectation of increased prices of gasoline and petroleum and the continued phase-out of MTBE blending which we believed would result in a significant increase in demand for blending ethanol with gasoline.

**Share Exchange Transaction**

On March 23, 2005, we completed a share exchange transaction, or Share Exchange Transaction, with the shareholders of PEI California, and the holders of the membership interests of each of Kinergy and ReEnergy, LLC, or ReEnergy, pursuant to which we acquired all of the issued and outstanding shares of capital stock of PEI California and all of the outstanding membership interests of each of Kinergy and ReEnergy. Immediately prior to the consummation of the Share Exchange Transaction, our predecessor, Accessity Corp., or Accessity, reincorporated in the State of Delaware under the name “Pacific Ethanol, Inc.” through a merger of Accessity with and into its then-wholly-owned Delaware subsidiary named Pacific Ethanol, Inc., which was formed for the purpose of effecting the reincorporation, or Reincorporation Merger. We are the surviving entity resulting from the Reincorporation Merger and Kinergy, PEI California and ReEnergy are three of our wholly-owned subsidiaries.

The Share Exchange Transaction has been accounted for as a reverse acquisition whereby PEI California is deemed to be the accounting acquiror. We have consolidated the results of PEI California, Kinergy, and ReEnergy beginning March 23, 2005, the date of the Share Exchange Transaction. Accordingly, our results of operations for the three months ended June 30, 2005 consist of the operations of PEI California, Kinergy and ReEnergy for that entire period; and our results of operations for the six months ended June 30, 2005 consist of the operations of PEI California for that entire period and the operations of Kinergy and ReEnergy from March 23, 2005 through June 30, 2005. Our results of operations for the three and six months ended June 30, 2006 consist of our operations and the operations of all of our wholly-owned subsidiaries, including PEI California, Kinergy and ReEnergy for that entire period.

In connection with the Share Exchange Transaction, we issued an aggregate of 20,610,987 shares of common stock to the shareholders of PEI California, 3,875,000 shares of common stock to the limited liability company member of Kinergy and an aggregate of 125,000 shares of common stock to the limited liability company members of ReEnergy. In addition, holders of options and warrants to acquire an aggregate of 3,157,587 shares of common stock of PEI California were, following the consummation of the Share Exchange Transaction, deemed to hold warrants to acquire an equal number of our shares of common stock. Also, a holder of a promissory note, a portion of which was convertible into an aggregate of 664,879 shares of common stock of PEI California was, following the consummation of the Share Exchange Transaction, entitled to convert the note into an equal number of shares of our common stock.

On March 23, 2005, prior to the consummation of the Share Exchange Transaction, PEI California issued to 63 accredited investors in a private offering an aggregate of 7,000,000 shares of common stock at a purchase price of $3.00 per share, two-year investor warrants to purchase 1,400,000 shares of common stock at an exercise price of $3.00 per share and two-year investor warrants to purchase 700,000 shares of common stock at an exercise price of $5.00 per share, for total gross proceeds of approximately $21,000,000. PEI California paid cash placement agent fees and expenses of approximately $1,850,400 and issued five-year placement agent warrants to purchase 678,000 shares of common stock at an exercise price of $3.00 per share in connection with the offering. Additional costs related to the financing include legal, accounting and consulting fees that totaled approximately $274,415.

**Preferred Stock Financing**

*General*

On April 13, 2006, we issued to one investor, Cascade Investment, L.L.C., or Cascade, 5,250,000 shares of our Series A Cumulative Redeemable Convertible Preferred Stock, or Series A Preferred Stock, at a price of $16.00 per share, for an aggregate purchase price of $84.0 million. Of the $84.0 million aggregate purchase price, $4.0 million was paid to us at closing and $80.0 million was deposited into a restricted cash account and will be disbursed in accordance with the Deposit Agreement described below. We are entitled to use the initial $4.0 million of proceeds for general working capital purposes and must use the remaining $80.0 million for the construction or acquisition of one or more ethanol production facilities in accordance with the terms of the Deposit Agreement.

*Certificate of Designations*

The Certificate of Designations, Powers, Preferences and Rights of the Series A Cumulative Redeemable Convertible Preferred Stock, or Certificate of Designations, provides for 7,000,000 shares of preferred stock to be designated as Series A Cumulative Redeemable Convertible Preferred Stock. The Series A Preferred Stock ranks senior in liquidation and dividend preferences to our common stock. Holders of Series A Preferred Stock are entitled to quarterly cumulative dividends payable in arrears in cash in an amount equal to 5% of the purchase price per share of the Series A Preferred Stock; however, such dividends may, at our option, be paid in additional shares of Series A Preferred Stock based on the value of the purchase price per share of the Series A Preferred Stock. The holders of Series A Preferred Stock have a liquidation preference over the holders of our common stock equivalent to the purchase price per share of the Series A Preferred Stock plus any accrued and unpaid dividends on the Series A Preferred Stock. A liquidation will be deemed to occur upon the happening of customary events, including transfer of all or substantially all of our capital stock or assets or a merger, consolidation, share exchange, reorganization or other transaction or series of related transaction, unless holders of 66 2/3% of the Series A Preferred Stock vote affirmatively in favor of or otherwise consent to such transaction.

The holders of the Series A Preferred Stock have conversion rights initially equivalent to two shares of common stock for each share of Series A Preferred Stock. The conversion ratio is subject to customary antidilution adjustments. In addition, antidilution adjustments are to occur in the event that we issue equity securities at a price equivalent to less than $8.00 per share, including derivative securities convertible into equity securities (on an as-converted or as-exercised basis). Certain specified issuances will not result in antidilution adjustments. The shares of Series A Preferred Stock are also subject to forced conversion upon the occurrence of a transaction that would result in an internal rate of return to the holders of the Series A Preferred Stock of 25% or more. Accrued but unpaid dividends on the Series A Preferred Stock are to be paid in cash upon any conversion of the Series A Preferred Stock.

The holders of Series A Preferred Stock vote together as a single class with the holders of our common stock on all actions to be taken by our stockholders. Each share of Series A Preferred Stock entitles the holder to the number of votes equal to the number of shares of our common stock into which each share of Series A Preferred Stock is convertible. However, the number of votes for each share of Series A Preferred Stock may not exceed the number of shares of common stock into which each share of Series A Preferred Stock would be convertible if the applicable conversion price were $8.99. The holders of Series A Preferred Stock are afforded numerous customary protective provisions with respect to certain actions that may only be approved by holders of a majority of the shares of Series A Preferred Stock. The holders of the Series A Preferred Stock are also afforded preemptive rights with respect to certain securities offered by us and are entitled to certain redemption rights.

The holders of Series A Preferred Stock have a liquidation preference over the holders of the our common stock equivalent to the purchase price per share of the Series A Preferred Stock plus any accrued and unpaid dividends on the Series A Preferred Stock. A liquidation will be deemed to occur upon the happening of customary events, including transfer of all or substantially all of our capital stock or assets or a merger, consolidation, share exchange, reorganization or other transaction or series of related transaction, unless holders of 66 2/3% of the Series A Preferred Stock vote affirmatively in favor of or otherwise consent to such transaction.

Upon the occurrence of a Redemption Event (as defined below), the Series A Preferred Stock will be subject to redemption, at the option of the holders of 66 2/3% of the then outstanding shares of Series A Preferred Stock. The redemption price for shares of Series A Preferred Stock subject to redemption will be equal to the Series A Preferred Stock issue price per share plus any accrued but unpaid dividends plus an amount sufficient to yield an Internal Rate of Return of 5.00%, payable in immediately available funds. A Redemption Event is defined as (i) we withdraw or utilize funds from the restricted cash account in violation of the terms of the Deposit Agreement, (ii) we publicly disclose an intent not to build or acquire additional ethanol production facilities for an indefinite period or for a period of at least two years from the time of the announcement, (iii) we fail to withdraw funds from the restricted cash account for a period of two years, or (iv) amounts remain in the restricted cash account after December 31, 2009.

*Deposit Agreement*

The Deposit Agreement between us and Comerica Bank provides for a restricted cash account into which $80.0 million of the aggregate purchase price for the Series A Preferred Stock has been deposited. We may not withdraw funds from the restricted cash account except in accordance with the terms of the Deposit Agreement. Under the Deposit Agreement, we may, with certain prescribed limitations, requisition funds from the restricted cash account for the payment of costs in connection with the construction or acquisition of ethanol production facilities. Of the $80.0 million deposited into the restricted cash account, $20.0 million has been advanced to us for use in the construction of our Madera County ethanol plant.

*Registration Rights and Stockholders Agreement*

In connection with the issuance of the Series A Preferred Stock, we entered into a Registration Rights and Stockholders Agreement, or Rights Agreement, with Cascade. The Rights Agreement is to be effective until the holders of the Series A Preferred Stock, and their affiliates, as a group, own less than 10% of the Series A Preferred Stock issued under the purchase agreement with Cascade, including common stock into which such Series A Preferred Stock has been converted, or Termination Date. The Rights Agreement provides that holders of a majority of the Series A Preferred Stock, including common stock into which the Series A Preferred Stock has been converted, may demand and cause us, at any time after April 13, 2007, to register on their behalf the shares of common stock issued, issuable or that may be issuable upon conversion of the Series A Preferred Stock, or Registrable Securities. Following such demand, we are required to notify any other holders of the Series A Preferred Stock or Registrable Securities of our intent to file a registration statement and, to the extent requested by such holders, include them in the related registration statement. We are required to keep such registration statement effective until such time as all of the Registrable Securities are sold or until such holders may avail themselves of Rule 144(k), which requires, among other things, a minimum two-year holding period and requires that any holder availing itself of Rule 144(k) not be an affiliate of Pacific Ethanol. The holders are entitled to three demand registrations on Form S-1 and unlimited demand registrations on Form S-3; however, we are not obligated to effect more than two demand registrations on Form S-3 in any 12-month period.

In addition to the demand registration rights afforded the holders under the Rights Agreement, the holders are entitled to "piggyback" registration rights. These rights entitle the holders who so elect to be included in registration statements to be filed by us with respect to other registrations of equity securities. The holders are entitled to unlimited "piggyback" registration rights.

The Rights Agreement provides for the initial appointment of two persons designated by Cascade to our Board of Directors, and the appointment of one of such persons as the Chairman of the Compensation Committee of the Board of Directors. Following the Termination Date, Cascade is required to cause its director designees, and all other designees, to resign from all applicable committees and boards of directors, effective as of the Termination Date.

**Common Stock Financing**

On May 31, 2006, we issued to 45 investors an aggregate of 5,496,583 shares of our common stock at a price of $26.38 per share, for an aggregate purchase price of $145.0 million in cash. Net proceeds from this private offering totaled approximately $138.0 million. We also issued to the investors warrants to purchase an aggregate of 2,748,297 shares of our common stock at an exercise price of $31.55 per share. The warrants are exercisable from time to time on or after a date that is the later of (a) six months following May 31, 2006, and (b) the effective date of a registration statement covering the resale of the shares of common stock underlying the warrants, through and including the date that is the later of (i) nine months following May 31, 2006 and (ii) thirty days after the effective date of a registration statement covering the resale of the shares of common stock underlying the warrants. The warrants contain both cash and cashless exercise provisions; however, the cashless exercise provisions contained in the warrants are only applicable in the event that a registration statement covering the resale of the shares of common stock underlying the warrants is not effective or no current prospectus is available for the resale of the shares underlying the warrants on an exercise date after the date that a registration statement covering the resale of the shares of common stock underlying the warrants is to be effective.

We were obligated under a Securities Purchase Agreement, or Purchase Agreement, related to the above private offering to file, by June 30, 2006, a registration statement with the Securities and Exchange Commission, or the Commission, registering for resale shares of common stock, and shares of common stock underlying warrants, issued in connection with the private offering. We filed the registration statement with the Commission on June 23, 2006. Our registration obligations also require, that we cause the registration statement to be declared effective on the date, or Required Effectiveness Date, which is the earliest of (i) if the registration statement does not become subject to review by the Commission, (a) ninety days after the closing date of the private offering, or (b) five trading days after we receive notification from the Commission that the registration statement will not become subject to review and we fail to request to accelerate the effectiveness of the registration statement, or (ii) if the registration statement becomes subject to review by the Commission, one hundred twenty days after the closing date of the private offering. The registration statement was declared effective by the Commission on July 10, 2006.

If we were unable to meet these obligations or if we are unable to maintain the effectiveness of the registration in accordance with the requirements of the Purchase Agreement, then an event of default will have occurred or may occur, as the case may be, and upon the occurrence of such event and upon every monthly anniversary thereafter until such event is cured, we will be required to pay to each investor in the private offering, as partial relief for the damages suffered by each investor, which will not be exclusive of any other remedies available under the Purchase Agreement, liquidated damages, and not as a penalty, of an amount equal to 1% of the amount paid by the investor for the shares of common stock still owned by the investor on the date of the event. The maximum aggregate amount of such damages payable to any investor, when aggregated with all such payments paid to all investors, is 10% of the aggregate purchase price for the shares of common stock.

The Purchase Agreement also provides for customary piggy-back registration rights to which the investors are entitled in the event that there is no effective registration statement covering all of the shares of common stock, including the shares of common stock underlying the warrants, whereby the investors can cause us to register such shares for resale in connection with our filing of a registration statement with the Commission to register shares in another offering. The Purchase Agreement also contains customary representations and warranties, covenants and limitations.

We paid cash placement agent fees of approximately $7.25 million to the exclusive placement agent in connection with the private offering, and we have agreed to pay up to an additional approximately $3.90 million in the event that all warrants are exercised in full by the investors.

**Debt Financing**

*Overview*

On April 13, 2006, PEI Madera entered into a Construction and Term Loan Agreement, or Construction Loan, with Hudson United Capital, or Hudson, and Comerica Bank, or Comerica. This debt financing, or Debt Financing, is in the aggregate amount of up to approximately $34.0 million and may provide a portion of the total financing necessary for the completion of our ethanol production facility in Madera County, or Project.

We have contributed assets to PEI Madera having a value of approximately $13.9 million (the “Contributed Assets”). We are responsible for arranging cash equity (the “Contributed Amount”) in an amount that, when combined with the Contributed Assets would be equal to no less than the difference between the Debt Financing amount of $34.0 million and the total Project Cost. The Contributed Amount was approximately $31.5 million and has been satisfied through the application of $17.7 million of Cascade’s investment in our Series A Preferred Stock.

*Construction Loan and Term Loan*

The Debt Financing will initially be in the form of a construction loan, or Construction Loan, that will mature on or before the Final Completion Date, after which the Debt Financing will be converted to a term loan, or Term Loan, that will mature on the seventh anniversary of the closing of the Term Loan. If the conversion does not occur and PEI Madera elects to repay the Construction Loan, then PEI Madera must pay a termination fee equal to 5.00% of the amount of the Construction Loan. The closing of the Term Loan is expected to be the Final Completion Date. The Construction Loan interest rate will float at a rate equal to the 30-day London Inter Bank Offered Rate, or LIBOR, plus 3.75%. PEI Madera will be required to pay the Construction Loan interest monthly during the term of the Construction Loan. The Term Loan interest rate will float at a rate equal to the 90-day LIBOR plus 4.00%. PEI Madera will be required to purchase interest rate protection in the form of a LIBOR rate cap of no more than 5.50% from a provider on terms and conditions reasonably acceptable to Lender, and in an amount covering no less than 70% of the principal outstanding on any loan payment date commencing on the first draw down date through the fifth anniversary of the Term Loan. Loan repayments on the Term Loan are to be due quarterly in arrears for a total of 28 payments beginning on the closing of the Term Loan and ending on its maturity date. The loan amortization for the Project will be established on the closing of the Term Loan based upon the operating cash projected to be available to PEI Madera from the Project as determined by closing pro forma projections. The Debt Financing will be the only secured indebtedness permitted on the Project. The Debt Financing will be senior to all obligations of the Project and PEI Madera other than direct Project operating expenses and expenses incurred in the ordinary course of business. All direct and out-of-pocket expenses of Pacific Ethanol or our direct and indirect subsidiaries will be reimbursed only after the repayment of the Debt Financing obligations.

The Term Loan amount is to be the lesser of (i) $34.0 Million, (ii) 52.25% of the total Project cost as of the Term Loan Conversion Date, and (iii) an amount equal to the present value (discounted at an interest rate of 9.5% per annum) of 43.67% of the operating cash distributable to and received by PEI Madera supported by the closing pro forma projections, from the closing of Term Loan through the seventh anniversary of such closing.

*Lender’s Security Interest*

The Debt Financing is secured by: (i) a perfected first priority security interest in all of the assets of PEI Madera, including inventories and all right title and interest in all tangible and intangible assets of the Project; (ii) a perfected first priority security interest in the Project’s grain facility, including all of PEI Madera’s and Pacific Ethanol’s and its affiliates’ right title and interest in all tangible and intangible assets of the Project’s grain facility; (iii) a pledge of 100% of the ownership interest in PEI Madera; (iv) a pledge of the PEI Madera’s ownership interest in the Project; (v) an assignment of all revenues produced by the Project and PEI Madera; (vi) the pledge and assignment of the material Project documents, to the extent assignable; (vii) all contractual cash flows associated with such agreements; and (viii) any other collateral security as Lender may reasonably request. In addition, the Construction Loan is secured by a completion bond provided by W.M. Lyles Co.

**Critical Accounting Policies**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of net sales and expenses for each period. The following represents a summary of our critical accounting policies, defined as those policies that we believe are the most important to the portrayal of our financial condition and results of operations and that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

*Revenue Recognition*

We derive revenue primarily from sales of ethanol. Our net sales are based upon written agreements or purchase orders that identify the amount of ethanol to be purchased and the purchase price. Shipments are made to customers, either, directly from suppliers or from our inventory to our customers by truck or rail. Ethanol that is shipped by rail originates primarily in the Midwest and takes from 10 to 14 days from date of shipment to be delivered to the customer or to one of four terminals in California and Oregon. For local deliveries the product is shipped by truck and delivered the same day as shipment. Revenue is recognized upon delivery of ethanol to a customer's designated ethanol tank in accordance with Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition*, and the related Emerging Issues Task Force ("EITF") Issue No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*.

Revenues on the sale of ethanol, which is shipped from our stock of inventory, are recognized when the ethanol has been delivered to the customer, provided that appropriate signed documentation of the arrangement, such as a signed contract, purchase order or letter of agreement, has been received and collectibility is reasonably assured.

In accordance with EITF Issue No. 99-19, revenue from direct third-party ethanol sales are recognized upon delivery, and recorded at the gross amount when we are responsible for fulfillment of the customer order, have latitude in pricing, incur credit risk on the receivable and have discretion in the selection of the supplier.  Shipping and handling costs are included in cost of goods sold.

*Inventories*

Inventories consist of fuel ethanol and is valued at the lower of cost or market, cost being determined on a first-in, first-out basis. Shipping, handling and storage costs are classified as a component of cost of goods sold. Title to ethanol transfers from the producer to us when the ethanol passes through the inlet flange of our receiving tank.

*Intangibles, Including Goodwill*

We evaluate impairment of long-lived assets in accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* We assess the impairment of long-lived assets, including property and equipment and purchased intangibles subject to amortization, which are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The asset impairment review assesses the fair value of the assets based on the future cash flows the assets are expected to generate. An impairment loss is recognized when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from the disposition of the asset (if any) are less than the related asset's carrying amount. Impairment losses are measured as the amount by which the carrying amounts of the assets exceed their fair values. Estimates of future cash flows are judgments based on management's experience and knowledge of our operations and the industries in which we operate. These estimates can be significantly affected by future changes in market conditions, the economic environment, and capital spending decisions of our customers and inflation.

We believe the future cash flows to be received from its long-lived assets will exceed the assets' carrying value, and, accordingly, we have not recognized any impairment losses through June 30, 2006.

Goodwill represents the excess of cost of an acquired entity over the net of the amounts assigned to net assets acquired and liabilities assumed. We account for our goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, which requires an annual review for impairment or more frequently if impairment indicators arise. This review would include the determination of each reporting unit's fair value using market multiples and discounted cash flow modeling. We have adopted SFAS No. 142 guidelines for annual review of impairment of goodwill and have performed our annual review of impairment and accordingly, we have not recognized any impairment losses through June 30, 2006.

*Stock-Based Compensation*

During the first quarter of 2006, effective as of the beginning of the year, we adopted the fair value method of accounting for employee stock compensation cost pursuant to SFAS No. 123 (Revised 2004), *Share-Based Payments* ("SFAS No. 123R"). Prior to that date, we used the intrinsic value method under Accounting Policy Board ("APB") Opinion No. 25 to recognize compensation cost. Under the method of accounting for the change to the fair value method, compensation cost recognized in 2006 is the same amount that would have been recognized if the fair value method would have been used for all awards granted. The effects on net income and earnings per share had the fair value method been applied to all outstanding and unvested awards in each period are reflected in Note 1 of the financial statements.

Our assumptions made for purposes of estimating the fair value of our stock options, as well as a summary of the activity under our stock option plan are included in Note 1 of the financial statements.

We account for the stock options granted to non-employees in accordance with EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* and SFAS No. 123R.

*Derivative Instruments and Hedging Activities*

Our business and activities expose us to a variety of market risks, including risks related to changes in commodity prices and interest rates. We monitor and manage these financial exposures as an integral part of our risk management program. This program recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effects that market volatility could have on operating results. We account for our use of derivatives related to our hedging activities pursuant to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in which we recognize all of our derivative instruments in our statement of financial position as either assets or liabilities, depending on the rights or obligations under the contracts. We have designated and documented contracts for the physical delivery of commodity products to and from counterparties as normal purchases and normal sales. Derivative instruments are measured at fair value, pursuant to the definition found in SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. Changes in the derivative's fair value are recognized currently in earnings unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's effective gains and losses to be deferred in other comprehensive income and later recorded together with the gains and losses to offset related results on the hedged item in the income statement. Companies must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

The estimated fair values of our derivatives were as follows as of June 30, 2006 and December 31, 2005:

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Commodity futures | $ 1,235,182 | $ — |
| Commodity options | 4,512 | — |
| Interest rate options | 530,588 | — |
| Total | $ 1,770,282 | $ — |

**Results of Operations**

The tables presented below, which compare our results of operations from one period to another, present the results for each period, the change in those results from one period to another in both dollars and percentage change, and the results for each period as a percentage of net sales. The columns present the following:

- The first two data columns in the tables show the absolute results for each period presented.
- The columns entitled "Dollar Variance" and "Percentage Variance" show the change in results, both in dollars and percentages. These two columns show favorable changes as a positive and unfavorable changes as negative. For example, when our net sales increase from one period to the next, that change is shown as a positive number in both columns. Conversely, when expenses increase from one period to the next, that change is shown as a negative in both columns.
- The last two columns in the tables show the results for each period as a percentage of net sales.

***Three Months Ended June 30, 2006 Compared to the Three Months Ended June 30, 2005***

| | Three Months Ended June 30, | | Dollar Variance Favorable (Unfavorable) | Percentage Variance Favorable (Unfavorable) | Results as a Percentage of Net Sales for the Three Months Ended June 30, | |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | | | 2006 | 2005 |
| Net sales | $ 46,461,077 | $ 22,814,433 | $ 23,646,644 | 103.6% | 100.0% | 100.0% |
| Cost of sales | 43,153,457 | 22,662,908 | 20,490,549 | 90.4 | 92.9 | 99.3 |
| Gross profit | 3,307,620 | 151,525 | 3,156,095 | 2,082.9 | 7.1 | 0.7 |
| Selling, general and administrative expenses | 4,758,996 | 2,393,071 | 2,365,925 | 98.9 | 10.2 | 10.5 |
| Loss from operations | (1,451,376) | (2,241,546) | 790,170 | 35.3 | (3.1) | (9.8) |
| Total other income (expense) | 1,277,479 | 18,294 | 1,259,185 | 6,883.0 | 2.7 | 0.1 |
| Loss from operations before income taxes | (173,897) | (2,223,252) | 2,049,355 | 92.2 | (0.4) | (9.7) |
| Provision for income taxes | 8,476 | 3,200 | 5,276 | 164.9 | 0.0 | 0.0 |
| Net loss | $ (182,373) | | | | | |