

Pacific Ethanol, Inc.
Form 10-Q
August 05, 2016
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the quarterly period ended **June 30, 2016**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: **000-21467**

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

41-2170618
(I.R.S. Employer
Identification No.)

400 Capitol Mall, Suite 2060, Sacramento, California
(Address of principal executive offices)

95814
(zip code)

(916) 403-2123

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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

No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes

No

As of August 5, 2016, there were 39,617,328 shares of Pacific Ethanol, Inc. common stock, \$0.001 par value per share, and 3,540,132 shares of Pacific Ethanol, Inc. non-voting common stock, \$0.001 par value per share, outstanding.

	Page
PART I	
FINANCIAL INFORMATION	
ITEM 1.	FINANCIAL STATEMENTS. 1
	Consolidated Balance Sheets as of June 30, 2016 (unaudited) and December 31, 2015 1
	Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2016 and 2015 (unaudited) 3
	Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2016 and 2015 (unaudited) 4
	Notes to Consolidated Financial Statements (unaudited) 5
ITEM 2.	MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS. 17
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK. 28
ITEM 4.	CONTROLS AND PROCEDURES. 29
 PART II	
OTHER INFORMATION	
ITEM 1.	LEGAL PROCEEDINGS. 31
ITEM 1A.	RISK FACTORS. 31
ITEM 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS. 39
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES. 40
ITEM 4.	MINE SAFETY DISCLOSURES. 40
ITEM 5.	OTHER INFORMATION. 40
ITEM 6.	EXHIBITS. 40

SIGNATURES

41

EXHIBITS FILED WITH THIS REPORT

i

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

PACIFIC ETHANOL, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2016 (unaudited)	December 31, 2015 *
<u>ASSETS</u>		
Current Assets:		
Cash and cash equivalents	\$ 31,673	\$ 52,712
Accounts receivable, net (net of allowance for doubtful accounts of \$311 and \$25, respectively)	71,946	61,346
Inventories	65,928	60,820
Prepaid inventory	10,319	5,973
Income tax receivables	6,114	10,654
Derivative instruments	13,299	2,081
Other current assets	4,055	4,356
Total current assets	203,334	197,942
Property and equipment, net	454,775	464,960
Other Assets:		
Intangible assets, net	2,678	2,678
Other assets	4,933	9,100
Total other assets	7,611	11,778
Total Assets	\$ 665,720	\$ 674,680

* Amounts derived from the audited consolidated financial statements for the year ended December 31, 2015.

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
 CONSOLIDATED BALANCE SHEETS (CONTINUED)
 (in thousands, except par value and shares)

	June 30, 2016 (unaudited)	December 31, 2015 *
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Current Liabilities:		
Accounts payable – trade	\$ 23,844	\$ 30,520
Accrued liabilities	15,156	10,072
Current portion – capital leases	4,431	4,248
Current portion – long-term debt	–	17,003
Derivative instruments	12,166	1,848
Accrued PE Op Co. purchase	3,828	3,828
Other current liabilities	6,026	5,390
Total current liabilities	65,451	72,909
Long-term debt, net of current portion	215,041	203,861
Capital leases, net of current portion	1,921	4,183
Warrant liabilities at fair value	257	273
Deferred tax liabilities	1,174	1,174
Other liabilities	18,261	20,736
Total Liabilities	302,105	303,136
Commitments and Contingencies (Note 7)		
Stockholders' Equity:		
Pacific Ethanol, Inc. Stockholders' Equity:		
Preferred stock, \$0.001 par value; 10,000,000 shares authorized; Series A: 1,684,375 shares authorized; no shares issued and outstanding as of June 30, 2016 and December 31, 2015; Series B: 1,580,790 shares authorized; 926,942 shares issued and outstanding as of June 30, 2016 and December 31, 2015; liquidation preference of \$18,075 as of June 30, 2016	1	1
Common stock, \$0.001 par value; 300,000,000 shares authorized; 39,617,328 and 38,974,972 shares issued and outstanding as of June 30, 2016 and December 31, 2015, respectively	40	39
Non-voting common stock, \$0.001 par value; 3,553,000 shares authorized; 3,540,132 shares issued and outstanding as of June 30, 2016 and December 31, 2015	4	4
Additional paid-in capital	903,683	902,843
Accumulated other comprehensive income	1,040	1,040
Accumulated deficit	(541,153)	(532,383)
Total Stockholders' Equity	363,615	371,544
Total Liabilities and Stockholders' Equity	\$ 665,720	\$ 674,680

* Amounts derived from the audited consolidated financial statements for the year ended December 31, 2015.

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited, in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2016	2015	2016	2015
Net sales	\$422,860	\$227,621	\$765,233	\$433,797
Cost of goods sold	405,156	221,367	746,460	428,530
Gross profit	17,704	6,254	18,773	5,267
Selling, general and administrative expenses	6,148	3,993	14,465	8,898
Income (loss) from operations	11,556	2,261	4,308	(3,631)
Fair value adjustments and warrant inducements	(24)	384	16	211
Interest expense, net	(6,536)	(1,005)	(12,769)	(2,020)
Other income (expense), net	(155)	(58)	60	(187)
Income (loss) before provision for income taxes	4,841	1,582	(8,385)	(5,627)
Provision (benefit) for income taxes	(245)	530	(245)	(2,170)
Consolidated net income (loss)	5,086	1,052	(8,140)	(3,457)
Net (income) loss attributed to noncontrolling interests	–	(42)	–	87
Net income (loss) attributed to Pacific Ethanol, Inc.	\$5,086	\$1,010	\$(8,140)	\$(3,370)
Preferred stock dividends	\$(315)	\$(315)	\$(630)	\$(627)
Income allocated to participating securities	\$(71)	\$(18)	\$–	\$–
Income (loss) available to common stockholders	\$4,700	\$677	\$(8,770)	\$(3,997)
Net income (loss) per share, basic	\$0.11	\$0.03	\$(0.21)	\$(0.16)
Net income (loss) per share, diluted	\$0.11	\$0.03	\$(0.21)	\$(0.16)
Weighted-average shares outstanding, basic	42,191	24,268	42,121	24,589
Weighted-average shares outstanding, diluted	42,229	24,837	42,121	24,589

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited, in thousands)

	Six Months Ended June 30,	
	2016	2015
Operating Activities:		
Consolidated net loss	\$(8,140)	\$(3,457)
Adjustments to reconcile consolidated net loss to net cash provided by operating activities:		
Depreciation and amortization of intangibles	17,670	6,748
Interest expense added to term debt	9,451	–
Fair value adjustments	(16)	(211)
Amortization of debt discount	610	99
Amortization of deferred financing fees	75	121
Non-cash compensation	1,181	915
Loss (gain) on derivative instruments	(809)	477
Bad debt expense	286	3
Changes in operating assets and liabilities:		
Accounts receivable	(10,886)	6,018
Inventories	(5,108)	(321)
Prepaid expenses and other assets	4,909	(1,506)
Prepaid inventory	(4,346)	3,581
Accounts payable and accrued expenses	(3,771)	(1,100)
Net cash provided by operating activities	1,106	11,367
Investing Activities:		
Additions to property and equipment	(7,485)	(12,166)
Proceeds from cash collateralized letters of credit	4,010	–
Net cash used in investing activities	(3,475)	(12,166)
Financing Activities:		
Net proceeds from (payments on) Kinerget's line of credit	1,042	(8,974)
Principal payments on borrowings	(17,003)	–
Payments on capital leases	(2,079)	(2,790)
Proceeds from exercise of warrants	–	368
Preferred stock dividends paid	(630)	(627)
Net cash used in financing activities	(18,670)	(12,023)
Net decrease in cash and cash equivalents	(21,039)	(12,822)
Cash and cash equivalents at beginning of period	52,712	62,084
Cash and cash equivalents at end of period	\$31,673	\$49,262
Supplemental Cash Flow Information:		
Interest paid	\$2,595	\$1,911
Income tax refunds received	\$4,784	\$–
Noncash financing and investing activities:		
Reclass of warrant liability to equity upon warrant exercises	\$–	\$72

Edgar Filing: Pacific Ethanol, Inc. - Form 10-Q

Reclass of noncontrolling interests to APIC upon acquisitions of ownership positions in PE Op Co.	\$-	\$560
Accrued payment for ownership positions in PE Op Co.	\$-	\$3,828

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.

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

1. ORGANIZATION AND BASIS OF PRESENTATION.

Organization and Business – The consolidated financial statements include, for all periods presented, the accounts of Pacific Ethanol, Inc., a Delaware corporation (“Pacific Ethanol”), and its direct and indirect subsidiaries (collectively, the “Company”), including its wholly-owned subsidiaries, Kinergy Marketing LLC, an Oregon limited liability company (“Kinergy”), Pacific Ag. Products, LLC, a California limited liability company (“PAP”) and PE Op Co., a Delaware corporation (“PE Op Co.”).

The Company’s acquisition of Aventine Renewable Energy Holdings, Inc. (now, Pacific Ethanol Central, LLC, a Delaware limited liability company, “Aventine”) was consummated on July 1, 2015, and as a result, the Company’s accompanying consolidated financial statements include the results of Aventine only as of and for the three and six months ended June 30, 2016.

The Company is a leading producer and marketer of low-carbon renewable fuels in the United States. The Company’s four ethanol plants in the Western United States (together with their respective holding companies, the “Pacific Ethanol West Plants”) are located in close proximity to both feed and ethanol customers and thus enjoy unique advantages in efficiency, logistics and product pricing. These plants produce among the lowest-carbon ethanol produced in the United States due to low energy use in production.

With the addition of four Midwestern ethanol plants in July 2015 as a result of the Company’s acquisition of Aventine, the Company now has a combined ethanol production capacity of 515 million gallons per year, markets over 800 million gallons of ethanol, on an annualized basis, and produces over one million tons of co-products such as wet and dry distillers grains, wet and dry corn gluten feed, condensed distillers solubles, corn gluten meal, corn germ, distillers yeast and CO₂, on an annualized basis. The Company’s four ethanol plants in the Midwest (together with their respective holding companies, the “Pacific Ethanol Central Plants”) are located in the heart of the Corn Belt, benefit from low-cost and abundant feedstock production and allow for access to many additional domestic markets. In addition, the Company’s ability to load unit trains from these facilities in the Midwest allows for greater access to international markets.

Accounts Receivable and Allowance for Doubtful Accounts – Trade accounts receivable are presented at face value, net of the allowance for doubtful accounts. The Company sells ethanol to gasoline refining and distribution companies, sells distillers grains and other feed co-products to dairy operators and animal feedlots and sells corn oil to poultry and biodiesel customers generally without requiring collateral.

The Company maintains an allowance for doubtful accounts for balances that appear to have specific collection issues. The collection process is based on the age of the invoice and requires attempted contacts with the customer at specified intervals. If, after a specified number of days, the Company has been unsuccessful in its collection efforts, a bad debt allowance is recorded for the balance in question. Delinquent accounts receivable are charged against the allowance for doubtful accounts once uncollectibility has been determined. The factors considered in reaching this determination are the apparent financial condition of the customer and the Company's success in contacting and negotiating with the customer. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of ability to make payments, additional allowances may be required.

Of the accounts receivable balance, approximately \$63,330,000 and \$42,049,000 at June 30, 2016 and December 31, 2015, respectively, were used as collateral under Kinery's operating line of credit. The allowance for doubtful accounts was \$311,000 and \$25,000 as of June 30, 2016 and December 31, 2015, respectively. The Company recorded a bad debt expense of \$30,000 and \$286,000 for the three and six months ended June 30, 2016, respectively, and a bad debt expense of \$3,000 for the three and six months ended June 30, 2015. The Company does not have any off-balance sheet credit exposure related to its customers.

Provision for Income Taxes – The Company recognized a tax benefit of \$0.2 million for the three and six months ended June 30, 2016, as the Company has finalized certain of its tax returns. The Company recognized a provision of \$0.5 million and a benefit of \$2.2 million for the three and six months ended June 30, 2015, respectively, related to losses incurred in 2015 that were able to be carried back to a prior taxable year. For the three and six months ended June 30, 2016, the Company applied a valuation allowance against the amount of deferred tax losses from the periods. To the extent the Company believes it can utilize these losses, it will adjust its provision (benefit) for income taxes accordingly in future periods.

Financial Instruments – The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are reasonable estimates of their fair values because of the short maturity of these items. The Company recorded its warrants at fair value. The Company believes the carrying value of its long-term debt approximates fair value because the interest rates on these instruments are variable.

Reclassifications – Certain prior year amounts have been reclassified to conform to the current presentation. Such reclassification had no effect on the consolidated net loss reported in the consolidated statements of operations.

Recent Accounting Pronouncements – In February 2016, the Financial Accounting Standards Board (“FASB”) issued new guidance on accounting for leases. Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted cash flow basis; and (2) a “right of use” asset, which is an asset that represents the lessee’s right to use the specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged, with some minor exceptions. Lessees will no longer be provided with a source of off-balance sheet financing for other than short-term leases. The standard is effective for public companies for annual reporting periods beginning after December 15, 2019, and for interim periods beginning after December 15, 2020. Early adoption is permitted. The Company has several operating leases that may be impacted by this guidance. The Company is currently evaluating the impact of the adoption of this accounting standard on its consolidated results of operations and financial condition.

In May 2014, the FASB issued new guidance on the recognition of revenue. The guidance states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard was originally effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, but has been further deferred one year. The Company’s adoption begins with the first fiscal quarter of fiscal year 2018. In March and April 2016, the FASB issued further revenue recognition guidance amending principal vs. agent considerations whether an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The Company is currently evaluating the impact of the adoption of this accounting standard update on its consolidated results of operations and financial condition.

In September 2015, the FASB issued new guidance on simplifying the accounting for measurement-period adjustments. Under the new guidance, an acquirer must recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The guidance also requires acquirers to present separately on the face of the statement of operations or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The guidance is effective for fiscal years beginning after December 31, 2015, applied prospectively. Early adoption is permitted. The Company will adopt the guidance as to future acquisitions.

In April 2016, the FASB issued new guidance to reduce the complexity of certain aspects of accounting for employee share-based payment transactions. Currently, accruals of compensation costs are based on an estimated forfeiture rate. The new guidance allows an entity to make an entity-wide accounting policy election to either continue using an estimate of forfeitures or account for forfeitures only when they occur. The guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company is currently evaluating the impact of the guidance on its consolidated results of operations and financial condition.

In April 2015, the FASB issued new guidance on presentation of debt issuance costs. Historically, entities have presented debt issuance costs as an asset. Under the new guidance, effective for fiscal years beginning after December 31, 2015, debt issuance costs have been reclassified as a deduction to the carrying amount of the related debt balance. The guidance does not change any of the Company's other debt recognition or disclosure. On January 1, 2016, the Company adopted this guidance for all periods presented on the consolidated balance sheets. The impact of the adoption was a reclassification of other assets to long-term debt, net of current portion of \$386,000 and \$462,000 as of June 30, 2016 and December 31, 2015, respectively.

Basis of Presentation—Interim Financial Statements – The accompanying unaudited consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Results for interim periods should not be considered indicative of results for a full year. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. The accounting policies used in preparing these consolidated financial statements are the same as those described in Note 1 to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, except as noted herein. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair statement of the results for interim periods have been included. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates – The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are required as part of determining the fair value of warrants, allowance for doubtful accounts, net realizable value of inventory, estimated lives of property and equipment and intangibles, long-lived asset impairments, valuation allowances on deferred income taxes and the potential outcome of future tax consequences of events recognized in the Company's financial statements or tax returns and the valuation of assets acquired and liabilities assumed as a result of business combinations. Actual results and outcomes may materially differ from management's estimates and assumptions.

2. SEGMENTS.

The Company reports its financial and operating performance in two segments: (1) ethanol production, which includes the production and sale of ethanol and co-products, with all eight of the Company's production facilities aggregated, and (2) marketing and distribution, which includes marketing and merchant trading for Company-produced ethanol and co-products and third-party ethanol.

The following tables set forth certain financial data for the Company's operating segments (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net Sales				
Ethanol Production:				
Net sales to external customers	\$271,630	\$108,960	\$500,871	\$207,957
Intersegment net sales	260	85	523	85
Total production segment sales	271,890	109,045	501,394	208,042
Marketing and distribution:				
Net sales to external customers	151,230	118,661	264,362	225,840
Intersegment net sales	2,091	836	3,843	1,571
Total marketing and distribution net sales	153,321	119,497	268,205	227,411
Intersegment eliminations	(2,351)	(921)	(4,366)	(1,656)
Net sales as reported	\$422,860	\$227,621	\$765,233	\$433,797
Cost of goods sold:				
Ethanol production	\$260,237	\$105,623	\$496,246	\$207,160
Marketing and distribution	149,521	118,522	258,819	226,581
Intersegment eliminations	(4,602)	(2,778)	(8,605)	(5,211)
Cost of goods sold as reported	\$405,156	\$221,367	\$746,460	\$428,530
Income (loss) before provision for income taxes:				
Ethanol production	\$794	\$1,013	\$(16,330)	\$(4,199)
Marketing and distribution	2,209	(516)	6,178	(2,131)
Corporate activities	1,838	1,085	1,767	703
	\$4,841	\$1,582	\$(8,385)	\$(5,627)
Depreciation and amortization:				
Ethanol production	\$8,793	\$3,206	\$17,209	\$6,390
Marketing and distribution	—	15	3	142
Corporate activities	225	119	458	216
	\$9,018	\$3,340	\$17,670	\$6,748

Edgar Filing: Pacific Ethanol, Inc. - Form 10-Q

Interest expense:				
Ethanol production	\$6,180	\$922	\$12,080	\$1,844
Marketing and distribution	356	83	689	176
Corporate activities	—	—	—	—
	\$6,536	\$1,005	\$12,769	\$2,020

The following table sets forth the Company's total assets by operating segment (in thousands):

	June 30, 2016	December 31, 2015
Total assets:		
Ethanol production	\$523,652	\$536,013
Marketing and distribution	130,689	107,069
Corporate assets	11,379	31,598
	\$665,720	\$674,680

3. INVENTORIES.

Inventories consisted primarily of bulk ethanol, corn, co-products, Low-Carbon Fuel Standard ("LCFS") credits and unleaded fuel, and are valued at the lower-of-cost-or-net realizable value, with cost determined on a first-in, first-out basis. Included in inventory is a \$1.5 million valuation adjustment as of June 30, 2016. Inventory balances consisted of the following (in thousands):

	June 30, 2016	December 31, 2015
Finished goods	\$35,543	\$31,153
LCFS credits	12,830	6,957
Raw materials	8,678	9,891
Work in progress	7,235	11,121
Other	1,642	1,698
Total	\$65,928	\$60,820

4. DERIVATIVES.

The business and activities of the Company expose it to a variety of market risks, including risks related to changes in commodity prices. The Company monitors and manages these financial exposures 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.

Commodity Risk – Cash Flow Hedges – The Company uses derivative instruments to protect cash flows from fluctuations caused by volatility in commodity prices for periods of up to twelve months in order to protect gross profit margins from potentially adverse effects of market and price volatility on ethanol sale and purchase commitments where the prices are set at a future date and/or if the contracts specify a floating or index-based price for ethanol. In addition, the Company hedges anticipated sales of ethanol to minimize its exposure to the potentially adverse effects of price volatility. These derivatives may be designated and documented as 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 cost of goods sold. For the three and six months ended June 30, 2016 and 2015, the Company did not designate any of its derivatives as cash flow hedges.

Commodity Risk – Non-Designated Hedges – The Company uses derivative instruments to lock in prices for certain amounts of corn and ethanol by entering into exchange-traded forward contracts for those commodities. These derivatives are not designated for special hedge accounting treatment. The changes in fair value of these contracts are recorded on the balance sheet and recognized immediately in cost of goods sold.

Non Designated Derivative Instruments – The classification and amounts of the Company’s derivatives not designated as hedging instruments are as follows (in thousands):

As of June 30, 2016				
Assets			Liabilities	
Type of Instrument	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Commodity contracts	Derivative instruments	\$13,299	Derivative instruments	\$12,166
		\$13,299		\$12,166

As of December 31, 2015				
Assets			Liabilities	
Type of Instrument	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Commodity contracts	Derivative instruments	\$2,081	Derivative instruments	\$1,848
		\$2,081		\$1,848

The classification and amounts of the Company’s recognized gains (losses) for its derivatives not designated as hedging instruments are as follows (in thousands):

			Realized Gains (Losses) Three Months Ended June 30,	
Type of Instrument	Statements of Operations Location		2016	2015
Commodity contracts	Cost of goods sold		\$(999)	\$264
			\$(999)	\$264

			Unrealized Gains (Losses) Three Months Ended June 30,	
Type of Instrument	Statements of Operations Location		2016	2015

Edgar Filing: Pacific Ethanol, Inc. - Form 10-Q

Commodity contracts	Cost of goods sold	\$1,227	\$(552)
		\$1,227	\$(552)

Realized Gains
(Losses)

Six Months
Ended June
30,

Type of Instrument	Statements of Operations Location	2016	2015
Commodity contracts	Cost of goods sold	\$(91)	\$149
		\$(91)	\$149

Unrealized
Gains (Losses)

Six Months
Ended June
30,

Type of Instrument	Statements of Operations Location	2016	2015
Commodity contracts	Cost of goods sold	\$900	\$(626)
		\$900	\$(626)

5. DEBT.

Long-term borrowings are summarized as follows (in thousands):

	June 30, 2016	December 31, 2015
Kinergy operating line of credit	\$62,045	\$61,003
Plant term debt	155,070	162,622
	217,115	223,625
Less unamortized discount	(1,688)	(2,299)
Less unamortized debt financing costs	(386)	(462)
Less short-term portion	–	(17,003)
Long-term debt	\$215,041	\$ 203,861

Kinergy Operating Line of Credit – As of June 30, 2016, Kinergy had an available borrowing base under its credit facility of \$12,955,000.

Plant Term Debt —On February 26, 2016, the Company retired the \$17,003,000 outstanding balance of the Pacific Ethanol West Plants' term debt by purchasing the lender's position for cash at par without any prepayment penalty. The purchase increased the amount of the term debt held by Pacific Ethanol to a combined \$58,766,000, which is eliminated upon consolidation. As a result, the Company has no continuing obligations to any third-party lender under the credit agreements associated with the Pacific Ethanol West Plants' term debt.

For the three and six months ended June 30, 2016, the Pacific Ethanol Central Plants elected to defer interest payments on their term debt in the aggregate amount of \$5,665,000 and \$9,451,000, which was added to the outstanding term debt balance.

At June 30, 2016, there were approximately \$135.2 million of net assets of the Company's subsidiaries that were not available to be transferred to the parent company in the form of dividends, loans or advances due to restrictions contained in the credit facilities of these subsidiaries.

6. COMMON STOCK AND WARRANTS.

Stock Incentive Plan – In June 2016, the Company’s shareholders approved the adoption of the 2016 Stock Incentive Plan to replace the expiring 2006 Stock Incentive Plan. The 2016 plan is similar to the 2006 plan and has a total of 1,150,000 shares of common stock authorized for issuance over the next ten years.

Warrant Exercises – During the three and six months ended June 30, 2015, certain holders exercised warrants and received an aggregate of 20,000 and 42,000 shares of the Company’s common stock upon payment of an aggregate of \$177,000 and \$368,000 in cash, respectively. There were no warrants exercised during the three and six months ended June 30, 2016.

Grants of Stock – In June 2016, the Company granted an aggregate of approximately 95,000 shares of restricted stock to non-employee members of the Company’s Board of Directors that vest on the earlier of (i) the date of the Company’s 2017 annual meeting of stockholders, or (ii) July 1, 2017, which had a grant date fair value of \$5.44 per share. In June 2016, the Company granted an aggregate of 253,000 shares of restricted stock to the Company’s executive officers and other eligible employees that vest in equal amounts on each of April 1, 2017, 2018 and 2019, which had a grant date fair value of \$5.44 per share.

7.COMMITMENTS AND CONTINGENCIES.

Sales Commitments – At June 30, 2016, the Company had entered into sales contracts with its major customers to sell certain quantities of ethanol and co-products. The Company had open indexed-price ethanol sales contracts for 261,372,000 gallons as of June 30, 2016 and open fixed-price ethanol sales contracts valued at \$10,501,000 as of June 30, 2016. The Company had open fixed-price co-product sales contracts valued at \$38,845,000 as of June 30, 2016 and open indexed-price co-product sales contracts for 10,300 tons as of June 30, 2016. These sales contracts are scheduled to be completed throughout 2016.

Purchase Commitments – At June 30, 2016, the Company had indexed-price purchase contracts to purchase 19,802,000 gallons of ethanol and fixed-price purchase contracts to purchase \$17,655,000 of ethanol from its suppliers. The Company had fixed-price purchase contracts to purchase \$30,691,000 of corn from its suppliers. These purchase commitments are scheduled to be satisfied throughout 2016.

Litigation – General – The Company is subject to various claims and contingencies in the ordinary course of its business, including those related to litigation, business transactions, employee-related matters, and others. When the Company is aware of a claim or potential claim, it assesses the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, the Company will record a liability for the loss. If the loss is not probable or the amount of the loss cannot be reasonably estimated, the Company discloses the claim if the likelihood of a potential loss is reasonably possible and the amount involved could be material. While there can be no assurances, the Company does not expect that any of its pending legal proceedings will have a material financial impact on the Company's operating results.

Pacific Ethanol, Inc., through a subsidiary acquired in its acquisition of Aventine, became involved in a pending lawsuit with Western Sugar Cooperative (“Western Sugar”) that pre-dated the Aventine acquisition.

On February 27, 2015, Western Sugar filed a complaint in the United States District Court for the District of Colorado (Case No. 1:15-cv-00415) naming Aventine Renewable Energy, Inc. (“ARE, Inc.”), one of Aventine's subsidiaries, as defendant. Western Sugar amended its complaint on April 21, 2015. ARE, Inc. purchased surplus sugar through a United States Department of Agriculture program. Western Sugar was one of the entities that warehoused this sugar for ARE, Inc. The suit alleges that ARE, Inc. breached its contract with Western Sugar by failing to pay certain penalty rates for the storage of its sugar or alternatively failing to pay a premium rate for storage. Western Sugar alleges that the penalty rates apply because ARE, Inc. failed to take timely delivery or otherwise cause timely shipment of the sugar. Western Sugar claims “expectation damages” in the amount of approximately \$8.6 million. ARE, Inc. filed answers to Western Sugar's complaint and amended complaint generally denying Western Sugar's allegations and asserting various defenses. The discovery phase of the case has just concluded, and the Company has filed a motion for summary judgment, seeking a determination that Western Sugar's claims fail as a matter of law.

The Company has evaluated the above case as well as other pending cases. The Company currently has recorded \$3.3 million as a litigation contingency liability with respect to these cases for amounts that are probable and estimable.

8. PENSION AND RETIREMENT BENEFIT PLANS.

The Company, through its acquisition of Aventine, has assumed a defined benefit pension plan (the “Pension Plan”) and a health care and life insurance plan (the “Postretirement Plan”).

The Pension Plan is noncontributory, and covers unionized employees at the Company's Pekin, Illinois facility, who fulfill minimum age and service requirements. Benefits are based on a prescribed formula based upon the employee's years of service. The Pension Plan, part of a collective bargaining agreement, covers only Union employees hired after November 1, 2010. The Company uses a December 31 measurement date for its Pension Plan. The Company's funding policy is to make the minimum annual contributions that are required by applicable regulations. As of December 31, 2015, the Pension Plan's accumulated projected benefit obligation was \$16.6 million, with a fair value of plan assets of \$12.6 million. The underfunded amount of \$4.0 million is recorded on the Company's consolidated balance sheet in other noncurrent liabilities. For the three months ended June 30, 2016, the Pension Plan's net periodic expense was \$29,000, comprised of \$172,000 in interest cost and \$56,000 in service cost, partially offset by \$199,000 of expected return on plan assets. For the six months ended June 30, 2016, the Pension Plan's net periodic expense was \$58,000, comprised of \$344,000 in interest cost and \$112,000 in service cost, partially offset by \$398,000 of expected return on plan assets.

The Postretirement Plan provides postretirement medical benefits and life insurance to certain “grandfathered” unionized employees. Employees hired after December 31, 2000 are not eligible to participate in the Postretirement Plan. The Postretirement Plan is contributory, with contributions required at the same rate as active employees. Benefit eligibility under the plan reduces at age 65 from a defined benefit to a defined collar cap based upon years of service. As of December 31, 2015, the Postretirement Plan’s accumulated projected benefit obligation was \$3.6 million and is recorded on the Company’s consolidated balance sheet in other noncurrent liabilities. The Company’s funding policy is to make the minimum annual contributions that are required by applicable regulations. For the three months ended June 30, 2016, the Postretirement Plan’s net periodic expense was \$47,000, comprised of \$35,000 of interest cost and \$12,000 of service cost. For the six months ended June 30, 2016, the Postretirement Plan’s net periodic expense was \$94,000, comprised of \$70,000 of interest cost and \$24,000 of service cost.

9. FAIR VALUE MEASUREMENTS.

The fair value hierarchy prioritizes the inputs used in valuation techniques into three levels, as follows:

- Level 1 – Observable inputs – unadjusted quoted prices in active markets for identical assets and liabilities;

- Level 2 – Observable inputs other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with market data; and

- Level 3 – Unobservable inputs – includes amounts derived from valuation models where one or more significant inputs are unobservable. For fair value measurements using significant unobservable inputs, a description of the inputs and the information used to develop the inputs is required along with a reconciliation of Level 3 values from the prior reporting period.

The Company records its warrants, issued from 2010 through 2013, at fair value using Level 3 inputs.

Warrants – The Company’s warrants are valued using a Monte Carlo Binomial Lattice-Based valuation methodology, adjusted for marketability restrictions.

Significant assumptions used and related fair values for the warrants as of June 30, 2016 were as follows:

Original Issuance	Exercise	Volatility	Risk	Term	Market	Warrants	Fair
	Price		Free	(years)	Discount	Outstanding	Value
			Interest				

Edgar Filing: Pacific Ethanol, Inc. - Form 10-Q

			Rate				
07/3/2012	\$ 6.09	50.7%	0.45%	1.01	19.8%	211,000	\$194,000
12/13/2011	\$ 8.43	51.9%	0.36%	0.45	13.8%	138,000	63,000
							\$257,000

Significant assumptions used and related fair values for the warrants as of December 31, 2015 were as follows:

Original Issuance	Exercise Price	Volatility	Risk Free Interest Rate	Term (years)	Market Discount	Warrants Outstanding	Fair Value
07/3/2012	\$ 6.09	49.1%	0.86%	1.51	22.9%	211,000	\$200,000
12/13/2011	\$ 8.43	48.4%	0.65%	0.95	18.3%	138,000	73,000
							\$273,000

The estimated fair value of the warrants is affected by the above underlying inputs. Observable inputs include the values of exercise price, stock price, term and risk-free interest rate. As separate inputs, an increase (decrease) in either the term or risk free interest rate will result in an increase (decrease) in the estimated fair value of the warrant.

Unobservable inputs include volatility and market discount. An increase (decrease) in volatility will result in an increase (decrease) in the estimated warrant value and an increase (decrease) in the market discount will result in a decrease (increase) in the estimated warrant fair value.

The volatility utilized was a blended average of the Company's historical volatility and implied volatilities derived from a selected peer group. The implied volatility component has remained relatively constant over time given that implied volatility is a forward-looking assumption based on observable trades in public option markets. Should the Company's historical volatility increase (decrease) on a go-forward basis, the resulting value of the warrants would increase (decrease).

The market discount, or a discount for lack of marketability, is quantified using a Black-Scholes option pricing model, with a primary model input of assumed holding period restriction. As the assumed holding period increases (decreases), the market discount increases (decreases), conversely impacting the value of the warrant fair value.

Other Derivative Instruments – The Company's other derivative instruments consist of commodity positions. The fair values of the commodity positions are based on quoted prices on the commodity exchanges and are designated as Level 1 inputs.

The following table summarizes recurring fair value measurements by level at June 30, 2016 (in thousands):

	Fair Value	Level 1	Level 2	Level 3
Assets:				
Derivative financial instruments (1)	\$13,299	\$13,299	\$ –	\$–
	\$13,299	\$13,299	\$ –	\$–
Liabilities:				
Warrants (3)	\$(257)	\$–	\$ –	\$(257)
Derivative financial instruments (4)	(12,166)	(12,166)	–	–
	\$(12,423)	\$(12,166)	\$ –	\$(257)

The following table summarizes recurring fair value measurements by level at December 31, 2015 (in thousands):

	Fair Value	Level 1	Level 2	Level 3
Assets:				
Derivative financial instruments (1)	\$2,081	\$2,081	\$–	\$–
Defined benefit plan assets (2)				

(pooled separate accounts):				
Large U.S. Equity	3,662	–	3,662	–
Small/Mid U.S. Equity	1,099	–	1,099	–
International Equity	1,525	–	1,525	–
Fixed Income	6,281	–	6,281	–
	\$14,648	\$2,081	\$12,567	\$–
Liabilities:				
Warrants (3)	\$(273)	\$–	\$–	\$(273)
Derivative financial instruments (4)	(1,848)	(1,848)	–	–
	\$(2,121)	\$(1,848)	\$–	\$(273)

-
- (1) Included in derivative instruments in the consolidated balance sheets.
- (2) Fair values of plan assets are determined annually and therefore are not included as of June 30, 2016. For further descriptions of these assets see the Company's Form 10-K for the year ended December 31, 2015.
- (3) Included in warrant liabilities at fair value in the consolidated balance sheets.
- (4) Included in derivative instruments in the consolidated balance sheets.

For fair value measurements using significant unobservable inputs (Level 3), a description of the inputs and the information used to develop the inputs is required along with a reconciliation of Level 3 values from the prior reporting period. The changes in the Company's fair value of its Level 3 inputs with respect to its warrants were as follows (in thousands):

Balance, December 31, 2015	\$273
Adjustments to fair value for the period	(16)
Balance, June 30, 2016	\$257

10. EARNINGS PER SHARE.

The following tables compute basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended June 30, 2016		
	Income Numerator	Shares Denominator	Per-Share Amount
Net income attributed to Pacific Ethanol	\$5,086		
Less: Preferred stock dividends	(315)		
Less: Income allocated to participating securities	(71)		
Basic income per share:			
Income available to common stockholders	\$4,700	42,191	\$ 0.11
Add: Options	-	38	
Diluted income per share:			
Income available to common stockholders	\$4,700	42,229	\$ 0.11

	Three Months Ended June 30, 2015		
	Income Numerator	Shares Denominator	Per-Share Amount
Net income attributed to Pacific Ethanol	\$1,010		
Less: Preferred stock dividends	(315)		
Less: Income allocated to participating securities	(18)		
Basic income per share:			
Income available to common stockholders	\$677	24,268	\$ 0.03
Add: Options	-	569	
Diluted income per share:			
Income available to common stockholders	\$677	24,837	\$ 0.03

	Six Months Ended June 30, 2016		
	Loss	Shares	Per-Share
	Numerator	Denominator	Amount
Net loss attributed to Pacific Ethanol	\$(8,140)		
Less: Preferred stock dividends	(630)		
Basic and diluted loss per share:			
Loss available to common stockholders	\$(8,770)	42,121	\$ (0.21)

	Six Months Ended June 30, 2015		
	Loss	Shares	Per-Share
	Numerator	Denominator	Amount
Net loss attributed to Pacific Ethanol	\$(3,370)		
Less: Preferred stock dividends	(627)		
Basic and diluted loss per share:			
Loss available to common stockholders	\$(3,997)	24,589	\$ (0.16)

There were an aggregate of 1,692,000 and 1,621,000 potentially dilutive weighted-average shares from the Company's warrants and shares of Series B Cumulative Convertible Preferred Stock outstanding for the three and six months ended June 30, 2016, respectively. These convertible securities were not considered in calculating diluted net income (loss) per share for the six months ended June 30, 2016, as their effect would have been anti-dilutive.

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 and growth strategies. The forward-looking statements and associated risks may include, relate to or be qualified by other important factors, including:

- fluctuations in the market price of ethanol and its co-products;
- fluctuations in the costs of key production input commodities such as corn and natural gas;
- the projected growth or contraction in the ethanol and co-product markets in which we operate;
- our strategies for expanding, maintaining or contracting our presence in these markets;
- anticipated trends in our financial condition and results of operations; and
- our ability to distinguish ourselves from our current and future competitors.

You are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this report, or in the case of a document incorporated by reference, as of the date of that document. We do not undertake to update, revise or correct any forward-looking statements, except as required by law.

Any of the factors described immediately above, or referenced from time to time in our filings with the Securities and Exchange Commission 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

We are a leading producer and marketer of low-carbon renewable fuels in the United States.

We own and operate eight strategically-located ethanol production facilities. Four of our plants are in the Western states of California, Oregon and Idaho, or the Pacific Ethanol West plants; and four of our plants are located in the Midwestern states of Illinois and Nebraska, or the Pacific Ethanol Central plants, acquired in our acquisition of Aventine Renewable Energy Holdings, Inc., or Aventine, on July 1, 2015. Our plants have a combined ethanol production capacity of 515 million gallons per year. We are the sixth largest producer of ethanol in the United States based on annualized volumes. We market all the ethanol and co-products produced at our eight plants as well as ethanol produced by third parties. On an annualized basis, we market over 800 million gallons of ethanol and over 1.5 million tons of ethanol co-products on a dry matter basis. Our business consists of two operating segments: a production segment and a marketing segment.

Our mission is to advance our position and significantly increase our market share as a leading producer and marketer of low-carbon renewable fuels in the United States. We intend to accomplish this goal in part by expanding our ethanol production capacity and distribution infrastructure, accretive acquisitions, lowering the carbon intensity of our ethanol, extending our marketing business into new regional and international markets, and implementing new technologies to promote higher production yields and greater efficiencies.

Production Segment

We produce ethanol and co-products at our eight production facilities described below. Our Pacific Ethanol West plants are located on the West Coast near their respective fuel and feed customers, offering significant timing, transportation cost and logistical advantages. Our Pacific Ethanol Central plants are located in the Midwest in the heart of the Corn Belt, benefit from low-cost and abundant feedstock production and allow for access to many additional domestic markets. In addition, our ability to load unit trains from the Pacific Ethanol Central plants allows for greater access to international markets.

	Facility Name	Facility Location	Estimated Annual Capacity (gallons)
<i>Pacific Ethanol West</i>	Magic Valley	Burley, ID	60,000,000
	Columbia	Boardman, OR	40,000,000
	Stockton	Stockton, CA	60,000,000
	Madera	Madera, CA	40,000,000
<i>Pacific Ethanol Central</i>	Aurora West	Aurora, NE	110,000,000
	Aurora East	Aurora, NE	45,000,000
	Pekin Wet	Pekin, IL	100,000,000
	Pekin Dry	Pekin, IL	60,000,000

We produce ethanol co-products at our eight production facilities such as wet distillers grains, or WDG, dry distillers grains with solubles, wet and dry corn gluten feed, condensed distillers solubles, corn gluten meal, corn germ, corn oil, distillers yeast and CO₂.

Marketing Segment

We market ethanol and co-products produced by our eight ethanol production facilities and market ethanol produced by third parties. We have extensive customer relationships throughout the Western and Midwestern United States. Our ethanol customers are integrated oil companies and gasoline marketers who blend ethanol into gasoline. Our customers depend on us to provide a reliable supply of ethanol, and manage the logistics and timing of delivery with very little effort on their part. Our customers collectively require ethanol volumes in excess of the supplies we produce at our eight production facilities. We secure additional ethanol supplies from third party plants in California and other third party suppliers in the Midwest where a majority of ethanol producers are located. We arrange for transportation, storage and delivery of ethanol purchased by our customers through our agreements with third-party service providers in the Western United States as well as in the Midwest from a variety of sources.

We market our distillers grains and other feed co-products to dairies and feedlots, in many cases located near our ethanol plants. These customers use our feed co-products for livestock as a substitute for corn and other sources of starch and protein. We sell our corn oil to poultry and biodiesel customers. We do not market co-products from other ethanol producers.

Current Initiatives and Outlook

During the second quarter of 2016, we experienced improved crush margins, which reflect ethanol and co-product sales prices relative to production inputs such as corn and natural gas. This improved margin environment was supported by strong gasoline demand in the U.S. market, with gasoline consumption hitting record highs due in part to lower fuel prices, which promoted growth in ethanol consumption. Further, corn prices have hit near 5-year lows and the new corn crop is expected to have high yields and record ending stocks.

We remain confident in the long-term demand for ethanol and its co-products, driven by its underlying economic fundamentals as a high-octane, low-carbon renewable fuel, our ability to execute and create value, and our market position. We are on-track to market more than 800 million gallons of ethanol in 2016 from our expanded production and marketing platform.

The regulatory environment continues to support the long-term demand for renewable fuels. Low-Carbon Fuel Standards in California and Oregon require refiners to reduce the carbon intensity of their fuels in increasing amounts to 10% by 2020 in California and by 2025 in Oregon. We believe this mandate will require a significant amount of low-carbon fuel to displace gasoline in the California and Oregon fuel supplies. Currently, we receive a \$0.05 per gallon premium over Midwest ethanol on each California production gallon sold into the California market. We expect to see a comparable premium for low-carbon ethanol we sell into the Oregon market. In addition, the national Renewable Fuel Standard continues to support the long-term demand for renewable fuels.

The footprint for 15% ethanol blended fuel, or E15, continues to grow, with a retailer announcing the rollout of E15 at more than 100 stores in the next three years, joining other retailers in bringing E15 to market.

We believe our production assets in two distinct markets yield significant benefits, including the ability to spread our commodity and basis price risks across diverse markets and the potential to benefit from regional pricing opportunities resulting from supply imbalances, logistical constraints and feedstock availability. This market diversity enabled us to partially mitigate the effects of the poor margin environment we experienced in the first quarter of 2016. In addition, despite lower distillers grains prices due to reduced demand from China, our diverse portfolio of high-value co-products, including corn oil which adds over \$0.05 per gallon of incremental operating income, provided strong returns and helped mitigate the poor crush margin cycle experienced during the first quarter.

We have undertaken a number of plant improvement initiatives to increase operating efficiencies, enhance yields, improve carbon scores and reduce costs to better position us for sustained profitable operations. We are on schedule to implement an industrial scale membrane system at our Madera facility that separates water from ethanol during the plant's dehydration process and begin commercial production in the third quarter. We expect this technology to increase operating efficiencies, lower production costs and reduce the carbon intensity of ethanol produced at our Madera facility. In the first quarter we began producing cellulosic ethanol at our Stockton plant and we are working with our technology provider and the Environmental Protection Agency, or EPA, to qualify this ethanol for special premiums over conventional ethanol. We are looking for additional regulatory certainty extending California's Low-Carbon Fuel Standard beyond 2020 to support the development of additional cellulosic ethanol projects. We are also working on cogeneration technology at our Stockton plant, which we expect to complete by the end of the third quarter that will convert process waste gas and natural gas into electricity and steam, lowering air emissions and energy costs. We continue to manage our capital spending, focusing on projects that present the highest potential value. Based on market conditions and capital resources, we have reduced our capital improvements budget from \$26.0 million to \$15.0 million for 2016. We also may finance capital expenditures through low-cost leases to further reduce our cost of capital, better match our investment profile and the long-term value of our assets, and preserve and improve our liquidity and capital resources.

Net exports of ethanol continue to be a positive factor for the industry. U.S. exports of ethanol are on track to exceed 2015 levels, with an expectation of up to one billion gallons exported in 2016. Ethanol remains the lowest cost and cleanest source of octane to meet the growing demand for octane worldwide.

Our goals for 2016 include leveraging our diverse base of production and marketing assets to expand our share of the renewable fuels and ethanol co-product markets; continuing to implement plant improvement initiatives that generate meaningful near-term returns; pursuing opportunities to further strengthen our balance sheet by reducing our cost of capital, efficiently managing cash and improving our overall liquidity position; and further lowering the carbon intensity of our ethanol by modifying existing operations and investing in new technologies such as co-generation, anaerobic digestion and solar power generation, all of which are directed at expanding our share of the renewable fuels market and delivering long-term, profitable growth.

Critical Accounting Policies

The preparation of our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, requires us to make judgments and estimates that may have a significant impact upon the portrayal of our financial condition and results of operations. We believe that of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management that can materially impact the portrayal of our financial condition and results of operations: revenue recognition; warrants and conversion features carried at fair value; impairment of long-lived and intangible assets; valuation of allowance for deferred taxes, derivative instruments, accounting for business combinations and allowance for doubtful accounts. These significant accounting principles are more fully described in “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies” in our Annual Report on Form 10-K for the year ended December 31, 2015.

Results of Operations

The following selected financial information should be read in conjunction with our consolidated financial statements and notes to our consolidated financial statements included elsewhere in this report, and the other sections of “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contained in this report.

Certain performance metrics that we believe are important indicators of our results of operations include:

	Three Months Ended			Six Months Ended		
	June 30,		Percentage	June 30,		Percentage
	2016	2015	Variance	2016	2015	Variance
Production gallons sold (in millions)	122.5	47.5	157.9%	235.4	92.1	155.6%
Third party gallons sold (in millions)	110.7	93.2	18.8%	204.4	184.3	10.9%
Total gallons sold (in millions)	233.2	140.7	65.7%	439.8	276.4	59.1%
Average sales price per gallon	\$1.72	\$1.76	(2.3)%	\$1.63	\$1.71	(4.7)%
Corn cost per bushel – CBOT equivalent	\$3.86	\$3.67	5.2%	\$3.76	\$3.77	(0.3)%
Average basis ⁽¹⁾	0.23	0.95	(75.8)%	0.28	0.94	(70.2)%
Delivered cost of corn	\$4.09	\$4.62	(11.5)%	\$4.04	\$4.71	(14.2)%
Total co-product tons sold (in thousands)	686.8	372.8	84.2%	1,348.2	728.1	85.2%
Co-product revenues as % of delivered cost of corn ⁽²⁾	34.2%	32.8%	4.3%	35.2%	33.3%	5.7%
Average CBOT ethanol price per gallon	\$1.58	\$1.58	–%	\$1.49	\$1.51	(1.3)%
Average CBOT corn price per bushel	\$3.91	\$3.66	6.8%	\$3.77	\$3.75	(0.5)%

(1) Corn basis represents the difference between the immediate cash price of delivered corn and the future price of corn for Chicago delivery.

(2) Co-product revenues as a percentage of delivered cost of corn shows our yield based on sales of co-products, including WDG and corn oil, generated from ethanol we produced.

Net Sales, Cost of Goods Sold and Gross Profit

The following table presents our net sales, cost of goods sold and gross profit in dollars and gross profit as a percentage of net sales (in thousands, except percentages):

	Three Months Ended		Variance in		Six Months Ended		Variance in	
	June 30,	2015	Dollars	Percent	June 30,	2015	Dollars	Percent
Net sales	\$422,860	\$227,621	\$195,239	85.8%	\$765,233	\$433,797	\$331,436	76.4%
Cost of goods sold	405,156	221,367	183,789	83.0%	746,460	428,530	317,930	74.2%
Gross profit	\$17,704	\$6,254	\$11,450	183.1%	\$18,773	\$5,267	\$13,506	256.4%
Percentage of net sales	4.2%	2.7%			2.5%	1.2%		

Net Sales

The increase in our net sales for the three and six months ended June 30, 2016 as compared to the same periods in 2015 was due to an increase in our total gallons and co-products sold, partially offset by a decrease in our average sales price per gallon. We increased both production and third party gallons sold, and our volume of co-products sold, for the three and six months ended June 30, 2016 as compared to the same period in 2015. The increases in volumes of our production gallons and co-products sold are primarily due to additional volumes from our new Pacific Ethanol Central plants in the Midwest. In addition, we expanded our customer base and our sales to a larger national footprint with the addition of regions we cover with our Midwest plants.

Three Months Ended June 30, 2016

On a consolidated basis, our average sales price per gallon decreased 2.3% to \$1.72 for the three months ended June 30, 2016 compared to our average sales price per gallon of \$1.76 for the same period in 2015. The average Chicago Board of Trade, or CBOT, ethanol price per gallon, remained flat at \$1.58 for the three months ended June 30, 2016 as compared to the average CBOT ethanol price per gallon for the same period in 2015.

Production Segment

Net sales of ethanol from our production segment increased by \$122.7 million, or 147%, to \$206.3 million for the three months ended June 30, 2016 as compared to \$83.6 million for the same period in 2015. Our total volume of production ethanol gallons sold increased by 75.0 million gallons, or 158%, to 122.5 million gallons for the three months ended June 30, 2016 as compared to 47.5 million gallons for the same period in 2015. Our production segment's average sales price per gallon decreased 5.1% to \$1.67 for the three months ended June 30, 2016 compared to our production segment's average sales price per gallon of \$1.76 for the same period in 2015. Of the additional 75.0 million gallons of ethanol sold in the three months ended June 30, 2016, an aggregate of 76.5 million gallons were attributable to production at our Midwestern plants which we acquired on July 1, 2015, slightly offset by 1.5 million fewer gallons produced at our Western plants. At our average sales price per gallon of \$1.67 for the three months ended June 30, 2016, we generated \$125.2 million in additional net sales from our production segment from the 75.0 million additional gallons of produced ethanol sold in the three months ended June 30, 2016 as compared to the same period in 2015. The decline of \$0.09 in our average sales price per gallon for the three months ended June 30, 2016 as compared to the same period in 2015 reduced our net sales of ethanol from our production segment by \$2.5 million.

Net sales of co-products increased \$39.2 million, or 156%, to \$64.3 million for the three months ended June 30, 2016 as compared to \$25.1 million for the same period in 2015. Our total volume of co-products sold increased by 0.3 million tons, or 75%, to 0.7 million tons for three months ended June 30, 2016 from 0.4 million tons for the same period in 2015. At our average sales price per ton of \$88.41 for the three months ended June 30, 2016, we generated

\$27.8 million in additional net sales from the 0.3 million additional tons of co-products sold in the three months ended June 30, 2016 as compared to the same period in 2015. In addition, the increase of \$22.37, or 34%, in our average sales price per ton for the three months ended June 30, 2016 as compared to the same period in 2015 increased net sales of co-products by \$11.4 million.

Marketing Segment

Net sales of ethanol from our marketing segment increased by \$31.3 million, or 27%, to \$148.3 million for the three months ended June 30, 2016 as compared to \$117.0 million for the same period in 2015. Our total volume of ethanol gallons sold by our marketing segment increased by 92.5 million gallons, or 66%, to 233.2 million gallons for the three months ended June 30, 2016 as compared to 140.7 million gallons for the same period in 2015. Our additional production gallons sold accounted for 75.0 million gallons of this increase, as noted above, and our additional third-party gallons sold accounted for 17.5 million gallons of this increase.

The increase in production gallons sold by our marketing segment contributed an additional \$1.3 million in net sales generated by our marketing segment, which were eliminated upon consolidation.

Our marketing segment's average sales price per gallon remained flat at \$1.77 for the three months ended June 30, 2016 compared to the same period in 2015. At our average sales price per gallon of \$1.77 for the three months ended June 30, 2016, we generated \$30.8 million in additional net sales from our marketing segment from the 17.5 million gallons in additional third-party ethanol sold in the three months ended June 30, 2016 as compared to the same period in 2015.

Six Months Ended June 30, 2016

On a consolidated basis, our average sales price per gallon decreased 4.7% to \$1.63 for the six months ended June 30, 2016 compared to our average sales price per gallon of \$1.71 for the same period in 2015. The average CBOT ethanol price per gallon declined 1.3% to \$1.49 for the six months ended June 30, 2016 compared to an average CBOT ethanol price per gallon of \$1.51 for the same period in 2015.

Production Segment

Net sales of ethanol from our production segment increased by \$216.8 million, or 138%, to \$373.7 million for the six months ended June 30, 2016 as compared to \$156.9 million for the same period in 2015. Our total volume of production ethanol gallons sold increased by 143.3 million gallons, or 156%, to 235.4 million gallons for the six months ended June 30, 2016 as compared to 92.1 million gallons for the same period in 2015. Our production segment's average sales price per gallon decreased 7.1% to \$1.58 for the six months ended June 30, 2016 compared to our production segment's average sales price per gallon of \$1.70 for the same period in 2015. Of the additional 143.3 million gallons of ethanol sold in the six months ended June 30, 2016, an aggregate of 147.2 million gallons were attributable to production at our Midwestern plants which we acquired on July 1, 2015, slightly offset by 3.9 million fewer gallons produced at our Western plants. At our average sales price per gallon of \$1.58 for the six months ended June 30, 2016, we generated \$226.4 million in additional net sales from our production segment from the 143.3 million additional gallons of produced ethanol sold in the six months ended June 30, 2016 as compared to the same period in 2015. The decline of \$0.12 in our average sales price per gallon for the six months ended June 30, 2016 as compared to the same period in 2015 reduced our net sales of ethanol from our production segment by \$9.6 million.

Net sales of co-products increased \$74.3 million, or 147%, to \$124.9 million for the six months ended June 30, 2016 as compared to \$50.6 million for the same period in 2015. Our total volume of co-products sold increased by 0.6 million tons, or 85%, to 1.3 million tons for six months ended June 30, 2016 from 0.7 million tons for the same period in 2015. At our average sales price per ton of \$87.87 for the six months ended June 30, 2016, we generated \$54.5 million in additional net sales from the 0.6 million additional tons of co-products sold in the six months ended June 30, 2016 as compared to the same period in 2015. In addition, the increase of \$20.16, or 30%, in our average sales price per ton for the six months ended June 30, 2016 as compared to the same period in 2015 increased net sales of co-products by \$19.8 million.

Marketing Segment

Net sales of ethanol from our marketing segment increased by \$35.6 million, or 16%, to \$258.1 million for the six months ended June 30, 2016 as compared to \$222.5 million for the same period in 2015. Our total volume of ethanol gallons sold by our marketing segment increased by 163.4 million gallons, or 59%, to 439.9 million gallons for the six

months ended June 30, 2016 as compared to 276.5 million gallons for the same period in 2015. Our additional production gallons sold accounted for 143.3 million gallons of this increase, as noted above, and our additional third-party gallons sold accounted for 20.1 million gallons of this increase, slightly offset by a decline of 2.0 million agent gallons.

The increase in production gallons sold by our marketing segment contributed an additional \$2.2 million in net sales generated by our marketing segment, which were eliminated upon consolidation.

Our marketing segment's average sales price per gallon decreased 0.6% to \$1.70 for the six months ended June 30, 2016 compared to \$1.71 for the same period in 2015. At our average sales price per gallon of \$1.70 for the six months ended June 30, 2016, we generated \$37.4 million in additional net sales from our marketing segment from the 20.1 million gallons in additional third-party ethanol sold in the six months ended June 30, 2016 as compared to the same period in 2015. However, the decline of \$0.01 in our average sales price per gallon for the six months ended June 30, 2016 as compared to the same period in 2015 reduced our net sales from third party ethanol sold by our marketing segment by \$1.8 million.

Cost of Goods Sold and Gross Profit

Our consolidated gross profit increased primarily due to higher commodity margins in the three and six months ended June 30, 2016 compared to the same periods in 2015.

Three Months Ended June 30, 2016

Our consolidated gross profit increased to \$17.7 million for the three months ended June 30, 2016 as compared to \$6.3 million for the same period in 2015, representing a gross margin of 4.2% for the three months ended June 30, 2016 as compared to 2.7% for the same period in 2015.

Production Segment

Our production segment increased our consolidated gross profit by \$8.6 million for the three months ended June 30, 2016 as compared to the same period in 2015. Of this amount, \$8.5 million is attributable to the 75.0 million gallon increase in production volumes sold in the three months ended June 30, 2016 as compared to the same period in 2015 and \$0.1 million in higher gross profit is attributed to higher production margins in the three months ended June 30, 2016 as compared to the same period in 2015.

Marketing Segment

Our marketing segment increased our consolidated gross profit by \$2.8 million for the three months ended June 30, 2016 as compared to the same period in 2015. Of this amount, \$0.8 million is attributable to additional gross profit from the 17.5 million gallon increase in third-party marketing volumes in the three months ended June 30, 2016 as compared to the same period in 2015 and \$2.0 million in higher gross profit is attributable to our higher margins per gallon for the three months ended June 30, 2016 as compared to the same period in 2015.

Six Months Ended June 30, 2016

Our consolidated gross profit increased to \$18.8 million for the six months ended June 30, 2016 as compared to \$5.3 million for the same period in 2015, representing a gross margin of 2.5% for the six months ended June 30, 2016 as compared to 1.2% for the same period in 2015.

Production Segment

Our production segment increased our consolidated gross profit by \$5.0 million for the six months ended June 30, 2016 as compared to the same period in 2015. Of this amount, \$6.0 million is attributable to the 143.3 million gallon increase in production volumes sold in the six months ended June 30, 2016 as compared to the same period in 2015, partially offset by \$1.0 million in lower gross profit attributed to slightly lower production margins in the six months ended June 30, 2016 as compared to the same period in 2015.

Marketing Segment

Our marketing segment increased our consolidated gross profit by \$8.5 million for the six months ended June 30, 2016 as compared to the same period in 2015. Of this amount, \$1.3 million is attributable to additional gross profit from the 20.1 million gallon increase in third-party marketing volumes in the six months ended June 30, 2016 as compared to the same period in 2015 and \$7.2 million in higher gross profit is attributable to our higher margins per gallon for the six months ended June 30, 2016 as compared to the same period in 2015.

Selling, General and Administrative Expenses

The following table presents our selling, general and administrative, or SG&A, expenses in dollars and as a percentage of net sales (in thousands, except percentages):

	Three Months Ended June 30,		Variance in		Six Months Ended June 30,		Variance in	
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
Selling, general and administrative expenses	\$6,148	\$3,993	\$2,155	54.0%	\$14,465	\$8,898	\$5,567	62.6%
Percentage of net sales	1.5%	1.8%			1.9%	2.1%		

Our SG&A expenses increased \$2.1 million to \$6.1 million for the three months ended June 30, 2016 as compared to \$4.0 million for the same period in 2015, however, SG&A expenses decreased as a percentage of net sales for the three months ended June 30, 2016 as compared to the same period in 2015. The increase in SG&A expenses is primarily due to the addition of our Pacific Ethanol Central operations, which were not included in the prior period results as the Aventine acquisition occurred on July 1, 2015. SG&A expenses were lower than our prior guidance of \$7.5 million in part due to lower professional fees.

Our SG&A expenses increased \$5.6 million to \$14.5 million for the six months ended June 30, 2016 as compared to \$8.9 million for the same period in 2015. The increase in SG&A expenses is primarily due to the addition of our Pacific Ethanol Central operations.

At current levels of operation, we expect our SG&A expenses will be approximately \$7.0 million to \$7.5 million per quarter through the end of 2016. In addition, we expect our capital expenditures to average \$7.5 million per quarter through 2016.

Interest Expense, net

The following table presents our interest expense, net in dollars and as a percentage of net sales (in thousands, except percentages):

	Three Months Ended	Variance in	Six Months Ended	Variance in
--	---------------------------	--------------------	-------------------------	--------------------

Edgar Filing: Pacific Ethanol, Inc. - Form 10-Q

	June 30,				June 30,			
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
Interest expense, net	\$6,536	\$1,005	\$5,531	550.3%	\$12,769	\$2,020	\$10,749	532.1%
Percentage of net sales	1.5%	0.4%			1.7%	0.5%		

Interest expense, net increased by \$5.5 million to \$6.5 million for the three months ended June 30, 2016 from \$1.0 million for the same period in 2015. Interest expense, net increased by \$10.8 million to \$12.8 million for the six months ended June 30, 2016 from \$2.0 million for the same period in 2015. The increase in interest expense, net for these periods is primarily related to the Pacific Ethanol Central plants' term debt that we assumed, on a consolidated basis, in connection with the Aventine acquisition.

Provision (Benefit) for Income Taxes

The following table presents our provision (benefit) for income taxes in dollars and as a percentage of net sales (in thousands, except percentages):

	Three Months Ended		Variance in		Six Months Ended		Variance in	
	June 30, 2016	2015	Dollars	Percent	June 30, 2016	2015	Dollars	Percent
Provision (benefit) for income taxes	\$(245)	\$530	\$775	NM	\$(245)	\$(2,170)	\$1,925	(88.7)%
Percentage of net sales	(0.1)%	0.2%			-%	0.5%		

For the six months ended June 30, 2016, we recorded a net loss on both a book and tax basis, and as such did not record a tax provision or benefit due to the uncertainty of utilizing the losses for 2016. In addition, we finalized our tax returns resulting in a tax benefit of \$0.2 million for the three and six months ended June 30, 2016. For the three and six months ended June 30, 2015, we recorded a provision for income taxes of \$0.5 million and a benefit of \$2.2 million, respectively, at an estimated effective tax rate of 33.5% and 38.6%, respectively.

Net Income (Loss) Available to Common Stockholders

The following table presents our net income (loss) available to common stockholders in dollars and as a percentage of net sales (in thousands, except percentages):

	Three Months Ended		Variance in		Six Months Ended		Variance in	
	June 30, 2016	2015	Dollars	Percent	June 30, 2016	2015	Dollars	Percent
Net income (loss) available to common stockholders	\$4,700	\$677	\$4,023	594.2%	\$(8,770)	\$(3,997)	\$(4,773)	119.4%
Percentage of net sales	1.1%	0.3%			(1.1)%	(0.9)%		

The increase in net income available to common stockholders for three months ended June 30, 2016, as compared to 2015, is due to improved operating and commodity margins. The increase in the net loss available to common stockholders for the six months ended June 30, 2016 as compare to 2015, was due to increased SG&A expenses and

interest expense in 2016.

Liquidity and Capital Resources

During the six months ended June 30, 2016, we funded our operations primarily from cash on hand, cash flow from operations, proceeds from cash collateralized letters of credit and proceeds from tax refunds. These funds were also used to make capital expenditures, capital lease payments and payments to fully extinguish our term loan balance associated with the Pacific Ethanol West plants.

Our current available capital resources consist of cash on hand and amounts available for borrowing under Kinery's credit facility. We expect that our future available capital resources will consist primarily of our remaining cash balances, amounts available for borrowing, if any, under Kinery's credit facility, cash generated from our operations and tax refunds related to prior years.

We believe that current and future available capital resources, revenues generated from operations, and other existing sources of liquidity, including our credit facilities, will be adequate to meet our anticipated working capital and capital expenditure requirements for at least the next twelve months.

Quantitative Quarter-End Liquidity Status

We believe that the following amounts provide insight into our liquidity and capital resources. The following selected financial information should be read in conjunction with our consolidated financial statements and notes to consolidated financial statements included elsewhere in this report, and the other sections of “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contained in this report (dollars in thousands):

	June 30, 2016	December 31, 2015	Change
Cash and cash equivalents	\$31,673	\$52,712	(40.0)%
Current assets	\$203,334	\$197,942	2.7%
Current liabilities	\$65,451	\$72,909	(10.2)%
Long-term debt, net of current portion	\$215,041	\$203,861	5.5%
Working capital	\$137,883	\$125,033	10.3%
Working capital ratio	3.11	2.71	14.8%

Restricted Net Assets

At June 30, 2016, we had approximately \$135.2 million of net assets at our subsidiaries that were not available to be transferred to the parent company in the form of dividends, loans or advances due to restrictions contained in the credit facilities of these subsidiaries.

Change in Working Capital and Cash Flows

Working capital increased to \$137.9 million at June 30, 2016 from \$125.0 million at December 31, 2015 as a result of an increase of \$5.4 million in current assets and a decrease of \$7.5 million in current liabilities.

Current assets increased primarily due to an increase of \$10.6 million in accounts receivable, \$5.1 million in inventory, \$4.3 million in prepaid inventory and \$11.2 million in derivative assets, all resulting primarily from our additional Pacific Ethanol Central operations, partially offset by decreases of \$21.0 million in cash and cash equivalents and \$4.5 million in income tax receivables.

Our cash and cash equivalents declined by \$21.0 million at June 30, 2016 as compared to December 31, 2015 due to \$3.5 million of cash used in our investing activities and \$18.6 million of cash used in our financing activities, partially offset by cash flows from operations of \$1.1 million, as discussed below.

Our current liabilities decreased primarily due to a decrease of \$17.0 million in current portion of long-term debt as we extinguished our Pacific Ethanol West plant debt and a decrease of \$1.6 million in accounts payable and accrued liabilities, partially offset by an increase of \$10.3 million in derivative liabilities due to increased open derivative positions at the end of the quarter.

Cash Provided by our Operating Activities

Cash provided by our operating activities decreased by \$10.3 million for the six months ended June 30, 2016 as compared to the same period in 2015. The decrease in cash provided by our operating activities is primarily due to a higher net loss caused by reduced margins in the first quarter of 2016 resulting from lower ethanol prices. Additional factors that contributed to the decrease in cash provided by our operating activities include:

an increase in accounts receivable of \$16.9 million primarily due to higher sales volumes attributable to our new Pacific Ethanol Central operations; and

an increase in inventory and prepaid inventory of \$12.7 million primarily due to higher sales volumes attributable to our new Pacific Ethanol Central operations.

These amounts were partially offset by:

an increase in depreciation and amortization of \$10.9 million due to additional assets subject to depreciation and amortization from our acquisition of Aventine;

a decrease in prepaid expenses and other assets of \$6.4 million primarily due to income tax refunds; and

· interest expense added to term debt of \$9.5 million.

Cash used in our Investing Activities

Cash used in our investing activities improved by \$8.7 million for the six months ended June 30, 2016 as compared to the same period in 2015. The improvement in cash used in our investing activities is primarily due to lower spending on capital projects and proceeds from cash collateralized letters of credit.

Cash used in our Financing Activities

Cash used in our financing activities increased by \$6.6 million for the six months ended June 30, 2016 as compared to the same period in 2015. The increase in cash used in our financing activities is primarily due to a \$17.0 million principal payment on our term debt associated with the Pacific Ethanol West plants, which was partially offset by a decline of \$10.0 million in payments on Kinergy's line of credit.

Kinergy Operating Line of Credit

Kinergy maintains an operating line of credit for an aggregate amount of up to \$75.0 million. The credit facility expires on December 31, 2020. Interest accrues under the credit facility at a rate equal to (i) the three-month London Interbank Offered Rate ("LIBOR"), plus (ii) a specified applicable margin ranging from 1.75% to 2.75%. The credit facility's monthly unused line fee is 0.25% to 0.375% of the amount by which the maximum credit under the facility exceeds the average daily principal balance during the immediately preceding month. Payments that may be made by Kinergy to Pacific Ethanol as reimbursement for management and other services provided by Pacific Ethanol to Kinergy are limited under the terms of the credit facility to \$1.5 million per fiscal quarter. Payments that may be made by Pacific Ag. Products, LLC, or PAP, to Pacific Ethanol as reimbursement for management and other services provided by Pacific Ethanol to PAP are limited under the terms of the credit facility to \$0.5 million per fiscal quarter. PAP, one of our indirect wholly-owned subsidiaries, markets our co-products and also provides raw material procurement services to our subsidiaries. The credit facility also includes the accounts receivable of PAP as additional collateral.

For all monthly periods in which excess availability falls below a specified level, Kinergy and PAP must collectively maintain a fixed-charge coverage ratio (calculated as a twelve-month rolling earnings before interest, taxes, depreciation and amortization (EBITDA) divided by the sum of interest expense, capital expenditures, principal payments of indebtedness, indebtedness from capital leases and taxes paid during such twelve-month rolling period) of at least 2.0 and are prohibited from incurring certain additional indebtedness (other than specific intercompany indebtedness). Kinergy's and PAP's obligations under the credit facility are secured by a first-priority security interest in all of their assets in favor of the lender. Kinergy and PAP believe they are in compliance with this covenant.

The following table summarizes Kinergy's financial covenants and actual results for the periods presented (dollars in thousands):

	Three Months Ended June 30, 2016		Years Ended December 31, 2015	
	2016	2015	2015	2014
Fixed Charge Coverage Ratio Requirement	2.00	2.00	2.00	2.00
Actual	16.00	10.27	10.02	17.66
Excess	14.00	8.27	8.02	15.66

Pacific Ethanol has guaranteed all of Kinery's obligations under the credit facility. As of June 30, 2016, Kinery had an outstanding balance of \$62.0 million and an available borrowing base under the credit facility of \$75.0 million, representing \$13.0 million of excess availability under the credit facility.

Pacific Ethanol Central Term Debt

On July 1, 2015, upon effectiveness of the Aventine acquisition, Aventine became one of our wholly-owned subsidiaries and, on a consolidated basis, the combined company became obligated with respect to Aventine's term loan. Aventine's creditors under Aventine's term loan have recourse solely against Aventine and its subsidiaries and not against Pacific Ethanol, Inc. or its other direct or indirect subsidiaries.

As of June 30, 2016, the term loan facility for the Pacific Ethanol Central plants had an outstanding balance of approximately \$155.1 million. Interest on the term loan facility accrues and may be paid in cash at a rate of 10.5% per annum or may be paid in-kind at a rate of 15.0% per annum by adding the interest to the outstanding principal balance. If we elect to pay interest in-kind, the interest is capitalized at the end of each quarter. For the three and six months ended June 30, 2016, we elected to defer interest payments on the term debt in the aggregate amount of \$5.7 million and \$9.5 million, respectively, which was added to the outstanding loan balance. The term loan facility matures on September 24, 2017. The term loan facility is secured through a first-priority lien on substantially all of Aventine's assets and contains customary financial covenants, and a requirement that Aventine maintain a cash balance of at least \$2.0 million.

We continue to evaluate and pursue opportunities to refinance the term debt for the Pacific Ethanol Central plants.

Contractual Obligations

There have been no material changes in the six months ended June 30, 2016 to the amounts presented in the table under the "Contractual Obligations" section in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation" of our Annual Report on Form 10-K for 2015.

Effects of Inflation

The impact of inflation was not significant to our financial condition or results of operations for the three and six months ended June 30, 2016 and 2015.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We are exposed to various market risks, including changes in commodity prices and interest rates as discussed below. Market risk is the potential loss arising from adverse changes in market rates and prices. In the ordinary course of business, we may enter into various types of transactions involving financial instruments to manage and reduce the impact of changes in commodity prices and interest rates. We do not expect to have any exposure to foreign currency risk as we conduct all of our transactions in U.S. dollars.

Commodity Risk

We produce ethanol and ethanol co-products. Our business is sensitive to changes in the prices of each of ethanol and corn. In the ordinary course of business, we may enter into various types of transactions involving financial instruments to manage and reduce the impact of changes in ethanol and corn prices. We do not enter into derivatives or other financial instruments for trading or speculative purposes.

We are subject to market risk with respect to ethanol pricing. Ethanol prices are sensitive to global and domestic ethanol supply, crude-oil supply and demand; crude-oil refining capacity; carbon intensity; government regulation; and consumer demand for alternative fuels. Our ethanol sales are priced using contracts that are either based on a fixed price or an indexed price tied to a specific market, such as CBOT or the Oil Price Information Service. Under these fixed-priced arrangements, we are exposed to risk of a decrease in the market price of ethanol between the time the price is fixed and the time the ethanol is sold.

We satisfy our physical corn needs, the principal raw material used to produce ethanol and ethanol co-products, based on supply-guaranteed contracts with our vendors. Generally, we determine the purchase price of our corn at the time we begin to grind that day's needs. Sometimes, we may also enter into contracts with our vendors to fix a portion of the purchase price of our corn requirements. As such, we are also subject to market risk with respect to the price of corn. The price of corn is subject to wide fluctuations due to unpredictable factors such as weather conditions, farmer planting decisions, governmental policies with respect to agriculture and international trade and global supply and demand. Under the fixed-price arrangements, we assume the risk of a decrease in the market price of corn between the time this price is fixed and the time the corn is utilized.

Ethanol co-products are sensitive to various demand factors such as numbers of livestock on feed, prices for feed alternatives, and supply factors, primarily production of ethanol co-products by ethanol plants and other sources.

As noted above, we may attempt to reduce the market risk associated with fluctuations in the price of ethanol or corn by employing a variety of risk management and hedging strategies. Strategies include the use of derivative financial instruments such as futures and options executed on the CBOT and/or the New York Mercantile Exchange, as well as the daily management of physical corn.

These derivatives are not designated for special hedge accounting treatment, and as such, the changes in the fair values of these contracts are recorded on the balance sheet and recognized immediately in cost of goods sold. We recognized losses of \$0.1 million and gains of \$0.1 million related to settled non-designated hedges as the change in the fair values of these contracts for the six months ended June 30, 2016 and 2015, respectively.

At June 30, 2016, we prepared a sensitivity analysis to estimate our exposure to ethanol and corn. Market risk related to these factors was estimated as the potential change in pre-tax income resulting from a hypothetical 10% adverse change in the prices of our expected ethanol and corn volumes. The results of this analysis as of June 30, 2016, which may differ materially from actual results, are as follows (in millions):

Commodity	Six Months Ended June 30, 2016	Unit of Measure	Approximate Adverse Change to Pre-Tax Income
Ethanol	439.80	Gallons	\$ 38.6
Corn	84.1	Bushels	\$ 34.0

Interest Rate Risk

We are exposed to market risk from changes in interest rates. Exposure to interest rate risk results primarily from our indebtedness that bears interest at variable rates. At June 30, 2016, all of our long-term debt of \$217.1 million was variable-rate in nature. Based on a 100 basis point (1.00%) change in the interest rate on our long-term debt, pre-tax income for the six months ended June 30, 2016 would be negatively impacted by approximately \$1.1 million.

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls and procedures also include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of June 30, 2016 that our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on the Effectiveness of Controls

Management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control systems are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in a cost-effective control system, no evaluation of internal control over financial reporting can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, have been or will be detected.

These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of a simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

We are 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 our 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 in any material respect our financial position, results of operations or cash flows.

We have evaluated all outstanding cases, including the following pending case and have recorded an aggregate \$3.3 million as a litigation contingency with respect to these cases for amounts that are probable and estimable.

Western Sugar Cooperative

Pacific Ethanol, Inc., through a subsidiary acquired in its acquisition of Aventine, became involved in a pending lawsuit with Western Sugar Cooperative (“Western Sugar”) that pre-dated the Aventine acquisition.

On February 27, 2015, Western Sugar filed a complaint in the United States District Court for the District of Colorado (Case No. 1:15-cv-00415) naming Aventine Renewable Energy, Inc. (“ARE, Inc.”), one of Aventine’s subsidiaries, as defendant. Western Sugar amended its complaint on April 21, 2015. ARE, Inc. purchased surplus sugar through a United States Department of Agriculture program. Western Sugar was one of the entities that warehoused this sugar for ARE, Inc. The suit alleges that ARE, Inc. breached its contract with Western Sugar by failing to pay certain penalty rates for the storage of its sugar or alternatively failing to pay a premium rate for storage. Western Sugar alleges that the penalty rates apply because ARE, Inc. failed to take timely delivery or otherwise cause timely shipment of the sugar. Western Sugar claims “expectation damages” in the amount of approximately \$8.6 million. ARE, Inc. filed answers to Western Sugar’s complaint and amended complaint generally denying Western Sugar’s allegations and asserting various defenses. The discovery phase of the case has just concluded, and we have filed a motion for summary judgment, seeking a determination that Western Sugar’s claims fail as a matter of law.

ITEM 1A. RISK FACTORS.

Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described below in addition to the other information contained in this Report and in our other filings with the Securities and Exchange Commission, including subsequent reports on Forms 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. If any of these known or unknown risks or uncertainties actually occurs with material adverse effects on Pacific Ethanol, our business, financial condition, results of operations and/or liquidity could be seriously harmed. In that event, the market price for our common stock will likely decline, and you may lose all or part of your investment.

Risks Related to our Business

We have incurred significant losses and negative operating cash flow in the past and we may incur losses and negative operating cash flow in the future, which may hamper our operations and impede us from expanding our business.

We have incurred significant losses and negative operating cash flow in the past. For the six months ended June 30, 2016 and 2015, we incurred consolidated net losses of \$8.1 million and \$3.5 million, respectively. For the year ended December 31, 2015, we incurred consolidated net losses of approximately \$18.9 million and incurred negative operating cash flow of \$26.8 million. For 2013 and 2012, we incurred consolidated net losses of \$1.2 million and \$43.4 million, respectively, and in 2012 incurred negative operating cash flow of \$20.8 million. We may incur losses and negative operating cash flow in the future. We expect to rely on cash on hand and cash, if any, generated from our operations and from future financing activities to fund all of the cash requirements of our business. Continued losses and negative operating cash flow may hamper our operations and impede us from expanding our business.

Our results of operations and our ability to operate at a profit is largely dependent on managing the costs of corn and natural gas and the prices of ethanol, distillers grains and other ethanol co-products, all of which are subject to significant volatility and uncertainty.

Our results of operations are highly impacted by commodity prices, including the cost of corn and natural gas that we must purchase, and the prices of ethanol, distillers grains and other ethanol co-products that we sell. Prices and supplies are subject to and determined by market and other forces over which we have no control, such as weather, domestic and global demand, supply shortages, export prices and various governmental policies in the United States and around the world.

As a result of price volatility of corn, natural gas, ethanol, distillers grains and other ethanol co-products, our results of operations may fluctuate substantially. In addition, increases in corn or natural gas prices or decreases in ethanol, distillers grains or other ethanol co-product prices may make it unprofitable to operate. In fact, some of our marketing activities will likely be unprofitable in a market of generally declining ethanol prices due to the nature of our business. For example, to satisfy customer demands, we maintain certain quantities of ethanol inventory for subsequent resale. Moreover, we procure much of our inventory outside the context of a marketing arrangement and therefore must buy ethanol at a price established at the time of purchase and sell ethanol at an index price established later at the time of sale that is generally reflective of movements in the market price of ethanol. As a result, our margins for ethanol sold in these transactions generally decline and may turn negative as the market price of ethanol declines.

No assurance can be given that corn or natural gas can be purchased at, or near, current or any particular prices or that ethanol, distillers grains or other ethanol co-products will sell at, or near, current or any particular prices. Consequently, our results of operations and financial position may be adversely affected by increases in the price of corn or natural gas or decreases in the price of ethanol, distillers grains or other ethanol co-products.

Over the past several years, the spread between ethanol and corn prices has fluctuated significantly. Fluctuations are likely to continue to occur. A sustained narrow spread, whether as a result of sustained high or increased corn prices or sustained low or decreased ethanol prices, would adversely affect our results of operations and financial position. Further, combined revenues from sales of ethanol, distillers grains and other ethanol co-products could decline below the marginal cost of production, which may force us to suspend production of ethanol, distillers grains and ethanol co-products at some or all of our plants.

Increased ethanol production may cause a decline in ethanol prices or prevent ethanol prices from rising, and may have other negative effects, adversely impacting our results of operations, cash flows and financial condition.

We believe that the most significant factor influencing the price of ethanol has been the substantial increase in ethanol production in recent years. According to the Renewable Fuels Association, domestic ethanol production capacity increased from an annualized rate of 1.5 billion gallons per year in January 1999 to a record 14.8 billion gallons in 2015. In addition, if ethanol production margins improve, we anticipate that owners of idle ethanol production facilities, many of which may be idled due to poor production margins, will restart operations, thereby resulting in more abundant ethanol supplies and inventories. Any increase in the demand for ethanol may not be commensurate with increases in the supply of ethanol, thus leading to lower ethanol prices. Also, demand for ethanol could be impaired due to a number of factors, including regulatory developments and reduced United States gasoline consumption. Reduced gasoline consumption has occurred in the past and could occur in the future as a result of increased gasoline or oil prices or other factors such as increased automobile fuel efficiency. Any of these outcomes could have a material adverse effect on our results of operations, cash flows and financial condition.

The market price of ethanol is volatile and subject to large fluctuations, which may cause our profitability or losses to fluctuate significantly.

The market price of ethanol is volatile and subject to large fluctuations. The market price of ethanol is dependent upon many factors, including the supply of ethanol and the price of gasoline, which is in turn dependent upon the price of petroleum which is highly volatile and difficult to forecast. For example, ethanol prices, as reported by the CBOT, ranged from \$1.31 to \$1.74 per gallon during the first six months of 2016, \$1.31 to \$1.69 per gallon during 2015 and \$1.50 to \$3.52 per gallon during 2014. Fluctuations in the market price of ethanol may cause our profitability or losses to fluctuate significantly.

Some of our marketing activities will likely be unprofitable in a market of generally declining ethanol prices due to the nature of our business.

Some of our marketing activities will likely be unprofitable in a market of generally declining ethanol prices due to the nature of our business. For example, to satisfy customer demands, we maintain certain quantities of ethanol inventory for subsequent resale. Moreover, we procure much of our inventory outside the context of a marketing arrangement and therefore must buy ethanol at a price established at the time of purchase and sell ethanol at an index price established later at the time of sale that is generally reflective of movements in the market price of ethanol. As a result, our margins for ethanol sold in these transactions generally decline and may turn negative as the market price of ethanol declines.

Disruptions in ethanol production infrastructure may adversely affect our business, results of operations and financial condition.

Our business depends on the continuing availability of rail, road, port, storage and distribution infrastructure. In particular, due to limited storage capacity at our plants and other considerations related to production efficiencies, our plants depend on just-in-time delivery of corn. The production of ethanol also requires a significant and uninterrupted supply of other raw materials and energy, primarily water, electricity and natural gas. The prices of electricity and natural gas have fluctuated significantly in the past and may fluctuate significantly in the future. Local water, electricity and gas utilities may not be able to reliably supply the water, electricity and natural gas that our plants need or may not be able to supply those resources on acceptable terms. Any disruptions in the ethanol production infrastructure, whether caused by labor difficulties, earthquakes, storms, other natural disasters or human error or malfeasance or other reasons, could prevent timely deliveries of corn or other raw materials and energy and may require us to halt production at one or more plants which could have a material adverse effect on our business, results of operations and financial condition.

We may engage in hedging transactions and other risk mitigation strategies that could harm our results of operations.

In an attempt to partially offset the effects of volatility of ethanol prices and corn and natural gas costs, we may enter into contracts to fix the price of a portion of our ethanol production or purchase a portion of our corn or natural gas requirements on a forward basis. In addition, we may engage in other hedging transactions involving exchange-traded futures contracts for corn, natural gas and unleaded gasoline from time to time. The financial statement impact of these activities is dependent upon, among other things, the prices involved and our ability to sell sufficient products to use all of the corn and natural gas for which forward commitments have been made. Hedging arrangements also expose us to the risk of financial loss in situations where the other party to the hedging contract defaults on its contract or, in the case of exchange-traded contracts, where there is a change in the expected differential between the

underlying price in the hedging agreement and the actual prices paid or received by us. As a result, our results of operations and financial condition may be adversely affected by fluctuations in the price of corn, natural gas, ethanol and unleaded gasoline.

Operational difficulties at our plants could negatively impact sales volumes and could cause us to incur substantial losses.

Operations at our plants are subject to labor disruptions, unscheduled downtimes and other operational hazards inherent in the ethanol production industry, including equipment failures, fires, explosions, abnormal pressures, blowouts, pipeline ruptures, transportation accidents and natural disasters. Some of these operational hazards may cause personal injury or loss of life, severe damage to or destruction of property and equipment or environmental damage, and may result in suspension of operations and the imposition of civil or criminal penalties. Our insurance may not be adequate to fully cover the potential operational hazards described above or we may not be able to renew this insurance on commercially reasonable terms or at all.

Moreover, our plants may not operate as planned or expected. All of these facilities are designed to operate at or above a specified production capacity. The operation of these facilities is and will be, however, subject to various uncertainties. As a result, these facilities may not produce ethanol and its co-products at expected levels. In the event any of these facilities do not run at their expected capacity levels, our business, results of operations and financial condition may be materially and adversely affected.

Future demand for ethanol is uncertain and may be affected by changes to federal mandates, public perception, consumer acceptance and overall consumer demand for transportation fuel, any of which could negatively affect demand for ethanol and our results of operations.

Although many trade groups, academics and governmental agencies have supported ethanol as a fuel additive that promotes a cleaner environment, others have criticized ethanol production as consuming considerably more energy and emitting more greenhouse gases than other biofuels and potentially depleting water resources. Some studies have suggested that corn-based ethanol is less efficient than ethanol produced from other feedstock and that it negatively impacts consumers by causing increased prices for dairy, meat and other food generated from livestock that consume corn. Additionally, ethanol critics contend that corn supplies are redirected from international food markets to domestic fuel markets. If negative views of corn-based ethanol production gain acceptance, support for existing measures promoting use and domestic production of corn-based ethanol could decline, leading to reduction or repeal of federal mandates, which could adversely affect the demand for ethanol. These views could also negatively impact public perception of the ethanol industry and acceptance of ethanol as an alternative fuel.

There are limited markets for ethanol beyond those established by federal mandates. Discretionary blending and E85 blending are important secondary markets. Discretionary blending is often determined by the price of ethanol versus the price of gasoline. In periods when discretionary blending is financially unattractive, the demand for ethanol may be reduced. Also, the demand for ethanol is affected by the overall demand for transportation fuel. Demand for transportation fuel is affected by the number of miles traveled by consumers and the fuel economy of vehicles. Market acceptance of E15 may partially offset the effects of decreases in transportation fuel demand. A reduction in the demand for ethanol and ethanol co-products may depress the value of our products, erode our margins and reduce our ability to generate revenue or to operate profitably. Consumer acceptance of E15 and E85 fuels is needed before ethanol can achieve any significant growth in market share relative to other transportation fuels.

If we fail to integrate successfully the businesses of Pacific Ethanol and Aventine our results of operations will be adversely affected.

The success of the Aventine acquisition will depend, in large part, on our ability to realize the anticipated benefits from combining the businesses of Pacific Ethanol and Aventine. To realize these anticipated benefits, we must successfully integrate the businesses of Pacific Ethanol and Aventine. This integration has been and will continue to be complex and time-consuming.

The failure to integrate successfully and to manage successfully the challenges presented by the integration process may result in our failure to achieve some or all of the anticipated benefits of the acquisition.

Potential difficulties that may be encountered in the integration process include the following:

- complexities associated with managing the larger, more complex, combined business;

- integrating personnel;

- potential unknown liabilities and unforeseen expenses, delays or regulatory conditions associated with the acquisition; and

- performance shortfalls as a result of the diversion of management's attention caused by integrating Pacific Ethanol's and Aventine's operations.

Our future results will suffer if we do not effectively manage our expanded operations.

Our business following the Aventine acquisition is significantly larger than the individual businesses of Pacific Ethanol and Aventine prior to the acquisition. Our future success depends, in part, upon our ability to manage our expanded business, which will pose substantial challenges for our management, including challenges related to the management and monitoring of new operations and associated increased costs and complexity. We cannot assure you that we will be successful or that we will realize the expected operating efficiencies, annual net operating synergies, revenue enhancements and other benefits currently anticipated to result from the acquisition.

Our level of indebtedness may make it more difficult for us to pay or refinance our debts and we may need to divert our cash flow from operations to debt service payments. Our indebtedness could limit our ability to pursue other strategic opportunities and could increase our vulnerability to adverse economic and industry conditions.

Our debt service obligations could have an adverse impact on our earnings and cash flows for as long as the indebtedness is outstanding. Our indebtedness could also have important consequences to holders of our common stock. For example, it could:

make it more difficult to pay or refinance our debts as they become due during adverse economic and industry conditions because any decrease in revenues could cause us to not have sufficient cash flows from operations to make our scheduled debt payments;

limit our flexibility to pursue other strategic opportunities or react to changes in our business and the industry in which we operate and, consequently, place us at a competitive disadvantage to our competitors who have less debt; or

require a substantial portion of our cash flows from operations to be used for debt service payments, thereby reducing the availability of our cash flows to fund working capital, capital expenditures, acquisitions, dividend payments and other general corporate purposes.

Based upon current levels of operations, we expect to generate sufficient cash on a consolidated basis to make all principal and interest payments when such payments become due under our existing credit facilities, indentures and other instruments governing our outstanding indebtedness, but there can be no assurance that we will be able to repay or refinance such borrowings and obligations.

If Kinergy fails to satisfy its financial covenants under its credit facility, it may experience a loss or reduction of that facility, which would have a material adverse effect on our financial condition and results of operations.

We are substantially dependent on Kinergy's credit facility to help finance its operations. Kinergy must satisfy monthly financial covenants under its credit facility, including fixed-charge coverage ratio covenants. Kinergy will be in default under its credit facility if it fails to satisfy any financial covenant. A default may result in the loss or reduction of the credit facility. The loss of Kinergy's credit facility, or a significant reduction in Kinergy's borrowing capacity under the facility, would result in Kinergy's inability to finance a significant portion of its business and would have a material adverse effect on our financial condition and results of operations.

The United States ethanol industry is highly dependent upon certain federal and state legislation and regulation and any changes in legislation or regulation could have a material adverse effect on our results of operations, cash flows and financial condition.

The EPA has implemented the national Renewable Fuel Standard, or national RFS, pursuant to the Energy Policy Act of 2005 and the Energy Independence and Security Act of 2007. The national RFS program sets annual quotas for the quantity of renewable fuels (such as ethanol) that must be blended into motor fuels consumed in the United States. The domestic market for ethanol is significantly impacted by federal mandates under the national RFS program for volumes of renewable fuels (such as ethanol) required to be blended with gasoline. Future demand for ethanol will be largely dependent upon incentives to blend ethanol into motor fuels, including the relative price of gasoline versus ethanol, the relative octane value of ethanol, constraints in the ability of vehicles to use higher ethanol blends, the national RFS, and other applicable environmental requirements. Any significant increase in production capacity above the national RFS minimum requirements may have an adverse impact on ethanol prices.

Legislation aimed at reducing or eliminating the renewable fuel use required by the national RFS has been introduced in the United States Congress. On January 21, 2015, the *Leave Ethanol Volumes at Existing Levels (LEVEL) Act* (H.R. 434) was introduced in the House. The bill would amend the national RFS by decreasing the required volume of renewable fuels in 2015-2022 to 7.5 billion gallons per year. On February 4, 2015, the *RFS Elimination Act* (H.R. 703) was introduced in the House of Representatives. The bill would fully repeal the national RFS. Also introduced on February 4, 2015, was the *RFS Reform Act* (H.R. 704), which prohibits corn-based ethanol from meeting the national RFS requirements, caps the amount of ethanol that can be blended into conventional gasoline at 10%, and requires the EPA to set requirements for cellulosic biofuels at actual production levels. On January 6, 2015, a bill (H.R. 21) was introduced in the House of Representatives to, among other things, vacate any waivers issued under the Clean Air Act to allow the sale of mid-level ethanol blends for use in motor vehicles. A mid-level ethanol blend is an ethanol-gasoline blend containing 10-20% of ethanol by volume that is intended to be used in any conventional gasoline-powered motor vehicle or nonroad vehicle or engine. On February 26, 2015, the *Corn Ethanol Mandate Elimination Act of 2015* (S. 577) was introduced in the Senate. The bill would eliminate corn ethanol as qualifying as a renewable fuel under the national RFS. *The American Energy Renaissance Act of 2015* (S. 791 and H.R. 1487), which was introduced in the Senate on March 18, 2015 and the House on March 19, 2015, would phase out the national RFS over a five-year period. The *Renewable Fuel Standard Repeal Act* (S. 1584), which would fully repeal the national RFS, was introduced in the Senate on June 16, 2015. All of these bills were assigned to a congressional committee, which will consider them before possibly sending any of them on to the House of Representatives or the Senate as a whole. Our operations could be adversely impacted if any legislation is enacted that reduces or eliminates the national RFS volume requirements or that reduces or eliminates corn ethanol as qualifying as a renewable fuel under the national RFS.

Under the provisions of the Clean Air Act, as amended by the Energy Independence and Security Act of 2007, the EPA has limited authority to waive or reduce the mandated national RFS requirements, which authority is subject to consultation with the Secretaries of Agriculture and Energy, and based on a determination that there is inadequate domestic renewable fuel supply or implementation of the applicable requirements would severely harm the economy or environment of a state, region or the United States. For 2016, the EPA reduced the national RFS from the statutory level of 15.0 billion gallons to 14.0 billion gallons. We believe that the EPA's decision to propose cuts to the congressionally established volumes is based on the EPA's perception that the nation's refueling infrastructure is currently unable to distribute the statutorily-required volumes to consumers. Our results of operations, cash flows and financial condition could be adversely impacted if the EPA further reduces the national RFS requirements from the statutory levels specified in the national RFS.

The ethanol production and marketing industry is extremely competitive. Many of our significant competitors have greater production and financial resources and one or more of these competitors could use their greater resources to gain market share at our expense. In addition, a number of Kinergy's suppliers may circumvent the marketing services we provide, causing our sales and profitability to decline.

The ethanol production and marketing industry is extremely competitive. Many of our significant competitors in the ethanol production and marketing industry, including Archer Daniels Midland Company and Valero Energy Corporation, have substantially greater production and/or financial resources. As a result, our competitors may be able to compete more aggressively and sustain that competition over a longer period of time. Successful competition will require a continued high level of investment in marketing and customer service and support. Our limited resources relative to many significant competitors may cause us to fail to anticipate or respond adequately to new developments and other competitive pressures. This failure could reduce our competitiveness and cause a decline in market share, sales and profitability. Even if sufficient funds are available, we may not be able to make the modifications and improvements necessary to compete successfully.

We also face increasing competition from international suppliers. Currently, international suppliers produce ethanol primarily from sugar cane and have cost structures that are generally substantially lower than our cost structures. Any increase in domestic or foreign competition could cause us to reduce our prices and take other steps to compete effectively, which could adversely affect our business, financial condition and results of operations.

In addition, some of our suppliers are potential competitors and, especially if the price of ethanol reaches historically high levels, they may seek to capture additional profits by circumventing our marketing services in favor of selling directly to our customers. If one or more of our major suppliers, or numerous smaller suppliers, circumvent our marketing services, our sales and profitability may decline.

Our ability to utilize net operating loss carryforwards and certain other tax attributes may be limited.

Federal and state income tax laws impose restrictions on the utilization of net operating loss, or NOL, and tax credit carryforwards in the event that an “ownership change” occurs for tax purposes, as defined by Section 382 of the Internal Revenue Code, or Code. In general, an ownership change occurs when stockholders owning 5% or more of a “loss corporation” (a corporation entitled to use NOL or other loss carryovers) have increased their ownership of stock in such corporation by more than 50 percentage points during any three-year period. The annual base limitation under Section 382 of the Code is calculated by multiplying the loss corporation’s value at the time of the ownership change by the greater of the long-term tax-exempt rate determined by the Internal Revenue Service in the month of the ownership change or the two preceding months.

As of December 31, 2015, we had \$137.6 million of federal NOLs that are limited in their annual use under Section 382 of the Code. Accordingly, our ability to utilize these NOL carryforwards may be substantially limited. These limitations could in turn result in increased future tax obligations, which could have a material adverse effect on our business, financial condition and results of operations.

The high concentration of our sales within the ethanol production and marketing industry could result in a significant reduction in sales and negatively affect our profitability if demand for ethanol declines.

We expect to be completely focused on the production and marketing of ethanol and its co-products for the foreseeable future. We may be unable to shift our business focus away from the production and marketing of ethanol to other renewable fuels or competing products. Accordingly, an industry shift away from ethanol or the emergence of new competing products may reduce the demand for ethanol. A downturn in the demand for ethanol would likely materially and adversely affect our sales and profitability.

We may be adversely affected by environmental, health and safety laws, regulations and liabilities.

We are subject to various federal, state and local environmental laws and regulations, including those relating to the discharge of materials into the air, water and ground, the generation, storage, handling, use, transportation and disposal of hazardous materials and wastes, and the health and safety of our employees. In addition, some of these laws and regulations require us to operate under permits that are subject to renewal or modification. These laws, regulations and permits can often require expensive pollution control equipment or operational changes to limit actual or potential impacts to the environment. A violation of these laws and regulations or permit conditions can result in substantial fines, natural resource damages, criminal sanctions, permit revocations and/or facility shutdowns. In addition, we have made, and expect to make, significant capital expenditures on an ongoing basis to comply with increasingly stringent environmental laws, regulations and permits.

We may be liable for the investigation and cleanup of environmental contamination at each of our plants and at off-site locations where we arrange for the disposal of hazardous substances or wastes. If these substances or wastes have been or are disposed of or released at sites that undergo investigation and/or remediation by regulatory agencies, we may be responsible under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, or other environmental laws for all or part of the costs of investigation and/or remediation, and for damages to natural resources. We may also be subject to related claims by private parties alleging property damage and personal injury due to exposure to hazardous or other materials at or from those properties. Some of these matters may require us to expend significant amounts for investigation, cleanup or other costs.

In addition, new laws, new interpretations of existing laws, increased governmental enforcement of environmental laws or other developments could require us to make significant additional expenditures. Continued government and public emphasis on environmental issues can be expected to result in increased future investments for environmental controls at our plants. Present and future environmental laws and regulations, and interpretations of those laws and regulations, applicable to our operations, more vigorous enforcement policies and discovery of currently unknown conditions may require substantial expenditures that could have a material adverse effect on our results of operations and financial condition.

The hazards and risks associated with producing and transporting our products (including fires, natural disasters, explosions and abnormal pressures and blowouts) may also result in personal injury claims or damage to property and third parties. As protection against operating hazards, we maintain insurance coverage against some, but not all, potential losses. However, we could sustain losses for uninsurable or uninsured risks, or in amounts in excess of existing insurance coverage. Events that result in significant personal injury or damage to our property or third parties or other losses that are not fully covered by insurance could have a material adverse effect on our results of operations and financial condition.

If we are unable to attract or retain key personnel, our ability to operate effectively may be impaired, which could have a material adverse effect on our business, financial condition and results of operations.

Our ability to operate our business and implement strategies depends, in part, on the efforts of our executive officers and other key personnel. Our future success will depend on, among other factors, our ability to retain our current key personnel and attract and retain qualified future key personnel, particularly executive management. In addition, the success of the Aventine acquisition will depend in part on our ability to retain key personnel. It is possible that these personnel might decide not to remain with us now that the acquisition is completed. If these key personnel terminate their employment, our business activities might be adversely affected and management's attention might be diverted from integrating the businesses of Pacific Ethanol and Aventine to recruiting suitable replacement personnel. We may be unable to locate suitable replacements for any such key personnel or offer employment to potential replacement personnel on reasonable terms. If we are unable to attract or retain key personnel, our ability to operate effectively may be impaired, which could have a material adverse effect on our business, financial condition and results of operations.

We depend on a small number of customers for the majority of our sales. A reduction in business from any of these customers could cause a significant decline in our overall sales and profitability.

The majority of our sales are generated from a small number of customers. During 2015, 2014 and 2013, four customers accounted for an aggregate of approximately \$538 million, \$659 million and \$521 million in net sales, representing 45%, 59% and 58% of our net sales, respectively, for those periods. We expect that we will continue to depend for the foreseeable future upon a small number of customers for a significant portion of our sales. Our agreements with these customers generally do not require them to purchase any specified amount of ethanol or dollar amount of sales or to make any purchases whatsoever. Therefore, in any future period, our sales generated from these customers, individually or in the aggregate, may not equal or exceed historical levels. If sales to any of these customers cease or decline, we may be unable to replace these sales with sales to either existing or new customers in a timely manner, or at all. A cessation or reduction of sales to one or more of these customers could cause a significant decline in our overall sales and profitability.

Our lack of long-term ethanol orders and commitments by our customers could lead to a rapid decline in our sales and profitability.

We cannot rely on long-term ethanol orders or commitments by our customers for protection from the negative financial effects of a decline in the demand for ethanol or a decline in the demand for our marketing services. The limited certainty of ethanol orders can make it difficult for us to forecast our sales and allocate our resources in a manner consistent with our actual sales. Moreover, our expense levels are based in part on our expectations of future sales and, if our expectations regarding future sales are inaccurate, we may be unable to reduce costs in a timely manner to adjust for sales shortfalls. Furthermore, because we depend on a small number of customers for a significant portion of our sales, the magnitude of the ramifications of these risks is greater than if our sales were less concentrated. As a result of our lack of long-term ethanol orders and commitments, we may experience a rapid decline in our sales and profitability.

There are limitations on our ability to receive distributions from our subsidiaries.

We conduct most of our operations through subsidiaries and are dependent upon dividends or other intercompany transfers of funds from our subsidiaries to generate free cash flow. Moreover, some of our subsidiaries are limited in their ability to pay dividends or make distributions to us by the terms of their financing arrangements.

Risks Related to Ownership of our Common Stock

Our stock price is highly volatile, which could result in substantial losses for investors purchasing shares of our common stock and in litigation against us.

The market price of our common stock has fluctuated significantly in the past and may continue to fluctuate significantly in the future. The market price of our common stock may continue to fluctuate in response to one or more of the following factors, many of which are beyond our control:

- fluctuations in the market prices of ethanol and its co-products;
- the cost of key inputs to the production of ethanol, including corn and natural gas;
- the volume and timing of the receipt of orders for ethanol from major customers;

- competitive pricing pressures;
- our ability to timely and cost-effectively produce, sell and deliver ethanol;
- the announcement, introduction and market acceptance of one or more alternatives to ethanol;
- losses resulting from adjustments to the fair values of our outstanding warrants to purchase our common stock;
- changes in market valuations of companies similar to us;
- stock market price and volume fluctuations generally;
- the possibility that the anticipated benefits from our acquisition of Aventine cannot be fully realized in a timely manner or at all;
- regulatory developments or increased enforcement;
- fluctuations in our quarterly or annual operating results;
- additions or departures of key personnel;
- our inability to obtain any necessary financing;
- our financing activities and future sales of our common stock or other securities; and
- our ability to maintain contracts that are critical to our operations.

Furthermore, we believe that the economic conditions in California and other Western states, as well as the United States as a whole, could have a negative impact on our results of operations. Demand for ethanol could also be adversely affected by a slow-down in the overall demand for oxygenate and gasoline additive products. The levels of our ethanol production and purchases for resale will be based upon forecasted demand. Accordingly, any inaccuracy in forecasting anticipated revenues and expenses could adversely affect our business. The failure to receive anticipated orders or to complete delivery in any quarterly period could adversely affect our results of operations for that period. Quarterly results are not necessarily indicative of future performance for any particular period, and we may not experience revenue growth or profitability on a quarterly or an annual basis.

The price at which you purchase shares of our common stock may not be indicative of the price that will prevail in the trading market. You may be unable to sell your shares of common stock at or above your purchase price, which may result in substantial losses to you and which may include the complete loss of your investment. In the past, securities class action litigation has often been brought against a company following periods of high stock price volatility. We may be the target of similar litigation in the future. Securities litigation could result in substantial costs and divert management's attention and our resources away from our business.

Any of the risks described above could have a material adverse effect on our results of operations or the price of our common stock, or both.

We may incur significant non-cash expenses in future periods due to adjustments to the fair values of our outstanding warrants. These non-cash expenses may materially and adversely affect our reported net income or losses and cause our stock price to decline.

From 2010 through 2013, we issued in various financing transactions warrants to purchase shares of our common stock. The warrants were initially recorded at their fair values, which are adjusted quarterly, generally resulting in non-cash expenses or income if the market price of our common stock increases or decreases, respectively, during the period. For example, due to the substantial increase in the market price of our common stock in the first quarter of 2014 and because the exercise prices of these warrants were, as of March 31, 2014, well below the market price of our common stock, the fair values of the warrants and the related non-cash expenses were significantly higher in the first quarter of 2014 than in prior quarterly periods, which resulted in an unusually large non-cash expense for the quarter. These fair value adjustments will continue in future periods until all of our warrants are exercised or expire. We may incur additional significant non-cash expenses in future periods due to adjustments to the fair values of our outstanding warrants resulting from increases in the market price of our common stock during those periods. These non-cash expenses may materially and adversely affect our reported net income or losses and cause our stock price to decline.

Upon the conversion or exercise of our outstanding derivative securities, if the resulting shares of common stock are resold into the market, or if a perception exists that a substantial number of shares may be issued and then resold into the market, the market price of our common stock and the value of your investment could decline significantly.

We have preferred stock, non-voting common stock and warrants outstanding that may be converted into or exercised for shares of our common stock. Sales of a substantial number of shares of our common stock underlying these derivative securities, or even the perception that these sales could occur, could adversely affect the market price of our common stock. As a result, you could experience a significant decline in the value of your investment.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

Unregistered Sales of Equity Securities

None.

Dividends

Our current and future debt financing arrangements may limit or prevent cash distributions from our subsidiaries to us, depending upon the achievement of specified financial and other operating conditions and our ability to properly service our debt, thereby limiting or preventing us from paying cash dividends.

For each of the three months ended June 30, 2016 and 2015, we declared and paid in cash an aggregate of \$0.3 million in dividends on our Series B Preferred Stock. We have never declared or paid cash dividends on our common stock and do not currently intend to pay cash dividends on our common stock in the foreseeable future. We currently anticipate that we will retain any earnings for use in the continued development of our business. The holders of our outstanding Series B Preferred Stock are entitled to dividends of 7% per annum, payable quarterly. Accumulated and unpaid dividends in respect of our Series B Preferred Stock must be paid prior to the payment of any dividends in respect of our common stock.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

<u>Exhibit Number</u>	<u>Description</u>
31.1	Certifications Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (*)
31.2	Certifications Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (*)
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (*)
101.INS	XBRL Instance Document (*)
101.SCH	XBRL Taxonomy Extension Schema (*)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase (*)
101.DEF	XBRL Taxonomy Extension Definition Linkbase (*)
101.LAB	XBRL Taxonomy Extension Label Linkbase (*)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase (*)

(*)

Filed herewith.

SIGNATURES

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

PACIFIC ETHANOL, INC.

Dated: August 5, 2016 By: /S/ BRYON T. MCGREGOR

Bryon T. McGregor
Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBITS FILED WITH THIS REPORT

<u>Exhibit Number</u>	<u>Description</u>
31.1	Certification Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification Required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

