Pacific Ethanol, Inc.
Form 10-Q
May 15, 2006

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

FORM 10-Q

(Mark One)
|X| QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended MARCH 31, 2006

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

Commission File Number: 0-21467

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

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

5711 N. WEST AVENUE
FRESNO, CALIFORNIA 93711
(Address of principal executive offices)

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

NOT APPLICABLE.
(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer | | Accelerated filer | | Non-accelerated filer |X|

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

As of May 10, 2006, there were 31,447,705 shares of Pacific Ethanol, Inc. common stock, $.001 par value per share, outstanding.

PART I
FINANCIAL INFORMATION

		PAGE
Item 1.	Financial Statements	
	Consolidated Balance Sheets as of March 31, 2006 (unaudited) and December 31, 2005	F-2
	Consolidated Statements of Operations and Other Comprehensive Income for the three months ended March 31, 2006 and 2005 (unaudited)	F-4
	Consolidated Statements of Cash Flows for the three months ended March 31, 2006 and 2005 (unaudited)	F-5
	Notes to Consolidated Financial Statements (unaudited)	F-7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operation	2
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	14
Item 4.	Controls and Procedures	15

PART II
OTHER INFORMATION

Item 1.	Legal Proceedings	17
Item 1A.	Risk Factors	19
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	19
Item 3.	Defaults Upon Senior Securities	19
Item 4.	Submission of Matters to a Vote of Security Holders	19
Item 5.	Other Information	19
Item 6.	Exhibits	20
Signatures		21
Exhibits Filed with this Report		

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

PACIFIC ETHANOL, INC.
CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2006 AND DECEMBER 31, 2005

ASSETS	March 31, 2006 (unaudited)	December 31, 2005
CURRENT ASSETS:		
Cash and cash equivalents	$ 4,200,902	$ 4,521,111
Investments in marketable securities	--	2,750,000
Accounts receivable (including $1,611,120 and $937,713 as of March 31, 2006 and December 31, 2005, respectively, from a related party)	7,955,170	4,947,538
Notes receivable - related party	240,336	135,995
Inventories	644,464	362,972
Prepaid expenses	872,906	626,575
Prepaid inventory	824,056	1,349,427
Derivative instruments	680,904	--
Other current assets	603,841	86,054
Total current assets	16,022,579	14,779,672
PROPERTY AND EQUIPMENT, NET	36,945,250	23,208,248
OTHER ASSETS:		
Goodwill	2,565,750	2,565,750
Intangible assets, net	7,392,281	7,568,723
Other assets	606,952	62,419
Total other assets	10,564,983	10,196,892
TOTAL ASSETS	$63,532,812	$48,184,812

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2006 AND DECEMBER 31, 2005

LIABILITIES AND STOCKHOLDERS' EQUITY	March 31, 2006 (unaudited)	December 31, 2005
CURRENT LIABILITIES:		
Current portion - related party note payable	$ 1,200,000	$ 1,200,000
Accounts payable - trade	5,701,705	4,755,235
Accounts payable - related party	13,244,401	6,411,618
Accrued retention - related party	2,674,079	1,450,500
Accrued payroll	187,848	433,887
Other accrued liabilities	3,583,860	3,422,565
Total current liabilities	26,591,893	17,673,805
RELATED-PARTY NOTES PAYABLE, NET OF CURRENT PORTION	2,059,778	1,995,576

Total Liabilities	28,651,671	19,669,381
COMMITMENTS AND CONTINGENCIES (NOTE 7)		
STOCKHOLDERS' EQUITY:		
Preferred stock, $0.001 par value; 10,000,000 shares authorized, no shares issued and outstanding as of March 31, 2006 and December 31, 2005	--	--
Common stock, $0.001 par value; 100,000,000 shares authorized, 30,549,888 and 28,874,442 shares issued and outstanding as of March 31, 2006 and December 31, 2005, respectively	30,550	28,874
Additional paid-in capital	49,710,101	43,697,486
Unvested consulting expense	(1,336,989)	(1,625,964
Accumulated other comprehensive income	674,208	--
Due from stockholders	(600)	(600
Accumulated deficit	(14,196,129)	(13,584,365
Total stockholders' equity	34,881,141	28,515,431
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 63,532,812	$ 48,184,812

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
AND OTHER COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED MARCH 31, 2006 AND 2005
(UNAUDITED)

	2006	2005
Net sales (including $5,859,853 and $353,058 for the three months ended March 31, 2006 and 2005, respectively, to a related party)	$ 38,239,167	$ 2,301,997
Cost of goods sold	35,913,920	2,254,370
Gross profit	2,325,247	47,627
Operating expenses:		
Selling, general and administrative expenses	2,984,084	743,233
Services rendered in connection with feasibility study	--	852,250
Loss from operations	(658,837)	(1,547,856)
Other income (expense), net	51,779	(107,853)

Loss before provision for income taxes	(607,058)	(1,655,709)
Provision for income taxes	4,705	1,600
Net loss	$ (611,763)	$ (1,657,309)
Other comprehensive income, net of tax:		
Cash flow hedges:		
Net change in the fair value of derivatives, net of tax	674,208	--
Comprehensive income (loss)	$ 62,445	$ (1,657,309)
Weighted Average Shares Outstanding	29,587,193	16,257,942
Net Loss Per Share	$ (0.02)	$ (0.10)

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2006 AND 2005
(UNAUDITED)

	2006	
OPERATING ACTIVITIES:		
Net loss	$ (611,763)	$
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Depreciation and amortization	274,172	
Non-cash compensation expense	333,752	
Non-cash consulting expense	267,375	
Non-cash services rendered in connection with feasibility study	--	
Changes in operating assets and liabilities:		
Accounts receivable	(3,007,632)	
Note receivable, related party	(104,341)	
Inventories	(281,492)	
Prepaid expenses and other assets	(1,315,347)	
Prepaid inventory	525,371	
Accounts payable and accrued expenses	861,726	
Accounts payable and accrued retention, related party	8,056,362	
Net cash provided by (used in) operating activities	4,998,183	
INVESTING ACTIVITIES:		

Additions to property, plant and equipment	(13,770,530)	
Proceeds from sale of available-for-sale investment	2,750,000	
Net cash acquired in acquisition of Kinergy, ReEnergy and Accessity	--	
Costs associated with share exchange transaction	--	
Net cash provided by (used in) investing activities	(11,020,530)	
FINANCING ACTIVITIES:		
Proceeds from sale of stock, net	--	
Proceeds from exercise of warrants and stock options	5,702,138	
Receipt of stockholder receivable	--	
Net cash provided by financing activities	5,702,138	
Net increase (decrease) in cash and cash equivalents	(320,209)	
Cash and cash equivalents at beginning of period	4,521,111	
Cash and cash equivalents at end of period	$ 4,200,902	$

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2006 AND 2005(CONTINUED)
(UNAUDITED)

Supplemental Information:		
Cash paid for interest	$ 176,533	$
Cash paid for taxes	$ 4,705	$
Non-Cash Financing and Investing activities:		
Conversion of debt to equity	$ --	$
Purchase of ReEnergy with stock	$ --	$
Shares contributed by stockholder in purchase of ReEnergy	$ --	$
Shares contributed by stockholder in purchase of Kinergy	$ --	$
Purchase of Kinergy with stock	$ --	$

See accompanying notes to consolidated financial statements.

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

BASIS OF PRESENTATION - The accompanying unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and reflect all adjustments, consisting solely of normal recurring adjustments, needed to fairly present the financial results for these interim periods. These financial statements include some amounts that are based on management's best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. The results of the operations for the three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the entire 2006 fiscal year.

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

LIQUIDITY - The Company believes that current and future available capital resources, revenues generated from operations, and other existing sources of liquidity, including the credit facilities the Company has and the Company's offering of Series A Preferred Stock and the available proceeds from its debt financing, will be adequate to meet the Company's anticipated working capital and capital expenditure requirements for at least the next twelve months. (See "Preferred Stock Financing" and "Debt Financing" in Note 10.)

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

Financial instruments that subject the Company to credit risk consist of cash balances maintained in excess of federal depository insurance limits and accounts receivable, which have no collateral or security. The accounts maintained by the Company at the financial institution are insured by the Federal Deposit Insurance Corporation (FDIC) up to $100,000. At March 31, 2006, the uninsured balance was $3,949,208 and at December 31, 2005 the uninsured balance was $4,048,476. The Company has not experienced any losses in such accounts and believes that it is not exposed to any significant risk of loss on cash.

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

During the three months ended March 31, 2006 and 2005, the Company had sales to gasoline refining and distribution companies representing 10% or more of total sales as follows:

	Three Months Ended March 31,	
	2006	2005
Customer A	22%	18%
Customer B	15%	10%
Customer C	11%	11%

As of March 31, 2006, the Company had receivables of approximately $3,572,590 from these customers, representing 45% of total accounts receivable.

During the three months ended March 31, 2006 and 2005, the Company had purchases from ethanol suppliers representing 10% or more of total purchases as follows:

	Three Months Ended March 31,	
	2006	2005
Vendor A	29%	--
Vendor B	24%	23%
Vendor C	16%	--
Vendor D	--	30%
Vendor E	--	12%

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

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES - The Company attempts to minimize its exposure to price risk by using derivative instruments. In 2006 the Company entered into derivative instruments to minimize its exposure to market volatility associated with certain purchase commitments. The Company accounts for its derivative transactions in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, as amended and interpreted. Derivative transactions, which can include forward contracts and futures positions on the New York Mercantile Exchange ("NYMEX"), are recorded on the balance sheet as assets and liabilities based on the derivative's fair value. Changes in the fair value of the derivative contracts are recognized currently in earnings unless specific hedge accounting criteria are met. If derivatives meet those criteria, the derivative's gains and losses offset related

results on the hedged item in the Statements of Operations and Other Comprehensive Income. The Company formally designates the derivative as a hedge and documents and assesses the effectiveness of derivatives associated with transactions that receive hedge accounting.

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

The Company believes the future cash flows to be received from its long-lived assets will exceed the assets' carrying values, and, accordingly, the Company has not recognized any impairment losses through March 31, 2006.

GOODWILL - Goodwill represents the excess of cost of an acquired entity over the net of the amounts assigned to net assets acquired and liabilities assumed. The Company accounts for its goodwill in accordance with SFAS No. 142, GOODWILL AND OTHER INTANGIBLE ASSETS, which requires an annual review for impairment or more frequently if impairment indicators arise. This review would include the determination of each reporting unit's fair value using market multiples and discounted cash flow modeling. The Company has adopted SFAS No. 142 guidelines for annual review of impairment of goodwill and has performed its annual review of impairment, and accordingly, the Company has not recognized any impairment losses through March 31, 2006.

STOCK-BASED COMPENSATION - On January 1, 2006 the Company adopted SFAS No. 123 (revised), SHARE-BASED PAYMENT ("SFAS No. 123R") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS No. 123R supersedes the Company's previous accounting under Accounting Principles Board ("APB") Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES, for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 107 relating to SFAS No.

123R. The Company has applied the provisions of SAB No. 107 in its adoption of SFAS 123R.

SFAS No. 123R requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statements of Operations and Other Comprehensive Income.

The Company adopted SFAS No. 123R using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's financial statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS No. 123R. In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123R. The stock-based compensation

expense related to employees or directors stock options and non-employees for the three months ended March 31, 2005 was $232,250 and $193,011, respectively. Stock-based compensation expense recognized under SFAS No. 123R for employees and directors and non-employees for the three months ended March 31, 2006 was $333,752 and $267,375, respectively.

The following table illustrates the effect on net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123R to stock-based awards granted under the Company's stock option plans for the three months ended March 31, 2005.

Net loss, as reported	$(1,657,309)
Compensation cost included in reported net income under the intrinsic value method	232,250
Total compensation cost under the fair value method for all awards	(232,250)
Pro forma net loss	$(1,657,309)
Basic and diluted net loss per share:	
As reported	$ (0.10)
Pro forma	$ (0.10)

The intrinsic value and fair value results are the same due to a weighted average exercise price of $0.01 for the awards.

There were no options granted during the quarter ended March 31, 2006. Previously granted options have been valued using the Black-Scholes option valuation model. Assumptions used in the Black-Scholes model (depending on the particular option grant being valued and its respective measurement date) were: expected volatility of 53.6% to 55.0%, risk-free interest rate of 3.9% to 4.5%, weighted average expected term of 5.5 to 10.0 years, and expected dividend yield of zero.

Stock-based compensation expense recognized in the Statement of Operations and Other Comprehensive Income for the quarter ended March 31, 2006 includes compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1, 2006 based on the fair value on the date of grant estimated in accordance with the pro forma provisions of SFAS No. 123. For stock-based awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method, which is consistent with how the prior-period pro formas were provided. The stock-based compensation expense recognized in the Statement of Operations and Other Comprehensive Income for the three months ended March 31, 2006 reflects the Company's estimate of no forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company's determination of the fair value of share-based payment awards to employees and directors on the date of grant using the Black-Scholes model is affected by the Company's stock price as well as assumptions regarding a number of complex variables. These variables include, but are not limited to the Company's expected stock price volatility over the term of the awards. The Company estimates the expected term of the awards using the simplified method provided in SAB No. 107.

As of March 31, 2006, the Company had two stock option plans: the Amended 1995 Incentive Stock Plan and the 2004 Stock Option Plan, both of which were carried over from Accessity as a result of the Share Exchange Transaction. Following is a summary of the status of the share-based payment plans for the three months ended March 31, 2006:

	2004 Plan		1995 Plan	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Balance at January 1, 2006	822,500	$ 7.78	105,000	$ 5.53
Granted	--	--	--	--
Exercised	(27,500)	$ 7.57	--	--
Forfeited	--	--	--	--

Balance at March 31, 2006	795,000	$ 7.78	105,000	$ 5.53
Options exercisable at March 31, 2006	130,000	$ 7.56	105,000	$ 5.53
Weighted average fair value of options granted during the three months ended March 31, 2006		--		--

The total proceeds to the Company from options exercised during the three months ended March 31, 2006 and March 31, 2005 was $208,075 and $0, respectively.

Following is a summary of non-vested shares as of March 31, 2006 and changes during the quarter:

	Number	Weighted Average Fair Value
Balance at December 31, 2005	665,000	$4.64
Granted during the quarter	--	--
Vested during the quarter	--	--
Forfeited during the quarter	--	--
Balance at March 31, 2006	665,000	$4.64

As of March 31, 2006, there was $3,088,350 of total unrecognized compensation cost related to non-vested share-based compensation arrangements, which is expected to be recognized over a weighted average period of 2.6 years.

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Compensation cost recorded as non-cash compensation expense for the three months ended March 31, 2006 and March 31, 2005 was $601,127 and $425,261, respectively.

Following is a summary of the status of all options outstanding at March 31, 2006 under the 1995 and 2004 Plans:

Exercise Price Range	Number	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Ex
$3.75 - $7.45	105,000	2.04	$ 5.53	105,000	
6.63	160,000	9.43	6.63	40,000	
7.01	5,000	9.27	7.01	5,000	
8.03	485,000	9.37	8.03	85,000	
8.25	115,000	9.27	8.25	--	
8.30	30,000	9.33	8.30	--	
	900,000	8.52	$ 7.52	235,000	

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The aggregate intrinsic value of options outstanding and exercisable at March 31, 2006 and March 31, 2005 was $12,661,750 and $3,509,750, respectively.

The Company accounts for stock options granted to non-employees in accordance with Emerging Issues Task Force ("EITF") Issue No. 96-18, ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES and SFAS No. 123R. Options granted to non-employees are analyzed under the guidelines of EITF Issue No. 96-18 to determine the appropriate date of measurement of fair value and method of recording the non-cash equity compensation expense.

REVENUE RECOGNITION - The Company derives revenue primarily from sales of ethanol. The Company's sales are based upon written agreements or purchase orders that identify the amount of ethanol to be purchased and the purchase price. Shipments are made to customers, either, directly from suppliers or from the Company's inventory to the customers by truck or rail. Ethanol that is shipped by rail originates primarily in the Midwest and takes from 10 to 14 days from date of shipment to be delivered to the customer or to one of four terminals in California and Oregon. For local deliveries, the product is shipped by truck and delivered the same day as shipment. Revenue is recognized upon delivery of ethanol to a customer's designated ethanol tank in accordance with SAB No. 104, REVENUE RECOGNITION, and the related EITF Issue No. 99-19, REPORTING REVENUE GROSS AS A PRINCIPAL VERSUS NET AS AN AGENT.

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

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

The Company has entered into certain contracts under which the Company may pay the owner of the ethanol the gross payments received by the Company from third parties for forward sales of ethanol less certain transaction costs and fees. From the gross payments, the Company may deduct transportation costs and expenses incurred by or on behalf of the Company in connection with the marketing of ethanol pursuant to the agreement, including truck, rail and terminal fees for the transportation of the facility's ethanol to third parties and may also

deduct and retain a marketing fee calculated after deducting these costs and expenses. (See Note 7.) For the three months ended March 31, 2006, the Company did not record revenues under these terms. If and when the Company does purchase and sell ethanol under these terms, the Company will evaluate the proper recording of the sales under EITF Issue No. 99-19.

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

2. SHARE EXCHANGE TRANSACTION:

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

The Share Exchange Transaction has been accounted for as a reverse acquisition whereby PEI California is deemed to be the accounting acquiror. The Company has consolidated the results of PEI California, Kinergy, and ReEnergy beginning March 23, 2005, the date of the Share Exchange Transaction. Accordingly, the Company's results of operations for the quarter ended March 31, 2005 consist of the operations of PEI California for that entire period and the operations of Kinergy and ReEnergy from March 23, 2005 through March 31, 2005. The Company's results of operations for the quarter ended March 31, 2006 consist of the Company's operations and the operations of all of its wholly-owned subsidiaries, including PEI California, Kinergy and ReEnergy.

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

On March 23, 2005, prior to the consummation of the Share Exchange Transaction, PEI California issued to 63 accredited investors in a

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

3. PROPERTY AND EQUIPMENT:

Property and equipment consisted of the following:

	March 31, 2006	December 31, 2005
Land	$ 515,298	$ 515,298
Facilities	4,234,703	4,234,703
Equipment and vehicles	373,520	373,520
Office furniture, fixtures and equipment	404,700	378,149
	5,528,221	5,501,670
Accumulated depreciation	(244,204)	(210,675)
	5,284,017	5,290,995
Construction in progress, Madera	30,727,935	17,917,253
Construction in progress, other	933,298	--
	$ 36,945,250	$ 23,208,248

As of March 31, 2006 and December 31, 2005, the Company had incurred costs of $30,727,935 and $17,917,253, respectively, under its Amended and Restated Phase 1 Design-Build Agreement and its Phase 2 Design-Build Agreement both dated November 2, 2005 with W.M. Lyles Co., a subsidiary of Lyles Diversified, Inc. ("LDI"), which has been included in construction in progress at March 31, 2006 and December 31, 2005, respectively. Included in this amount is a total of $1,701,202 and $1,306,499 related to the construction management fee of W.M. Lyles Co., of which $478,155 and $195,901 had not been paid at March 31, 2006 and December 31, 2005, respectively.

As of March 31, 2006 and December 31, 2005, the Company had accounts payable due to W.M. Lyles Co. of $13,244,402 and $6,411,618, respectively, related to the construction in progress of an ethanol plant. As of March 31, 2006 and December 31, 2005, the Company had accrued retention due to W.M. Lyles Co. of $2,674,079 and $1,450,500, respectively, related to the construction in progress of an ethanol plant. Included in construction in progress at March 31, 2006 and December 31, 2005 is capitalized interest of $572,158 and $343,793, respectively.

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

The Madera ethanol production facility is estimated to have a construction cost of approximately $55.3 million as follows: site work ($1.7 million); building and concrete ($7.0 million); site utilities ($1.1 million); equipment and tanks ($19.2 million); piping ($5.7 million); electrical ($3.7 million); and engineering, general conditions, and other ($16.9 million). In addition to the construction cost, the Madera project will require up to $10.2 million in additional funding for capital raising expenses, interest during construction, and working capital for a total project cost of approximately $65.5 million.

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

As of March 31, 2006 and December 31, 2005, property and equipment totaling $4,114,391 had not been placed in service. Depreciation expense was $33,529 for the three months ended March 31, 2006 and $85,250 for the year ended December 31, 2005.

4. ACCRUED LIABILITIES:

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

	March 31, 2006	December 31, 2005
Fire damage restoration in progress	$ 2,144,385	$ 3,157,969
Insurance policy premium financing	413,688	209,469
Bank overdraft	168,553	--
Other accrued liabilities	857,234	55,127
Total accrued liabilities	$ 3,583,860	$ 3,422,565

5. RELATED PARTY NOTES PAYABLE:

In connection with the acquisition of the grain facility in March 2003, on June 16, 2003 PEI California entered into a Term Loan Agreement (the "Loan Agreement") with LDI whereby LDI
loaned PEI California $5,100,000. On April 13, 2006, Pacific Ethanol Madera, LLC ("PEI Madera"), a second-tier subsidiary of the Company, and LDI entered into an Amended and Restated Loan Agreement (the "Amended and Restated Loan Agreement") whereby the Loan Agreement was assigned by the Company to PEI Madera. The Amended and Restated Loan Agreement currently carries a variable interest rate based on The Wall Street Journal Prime Rate (7.75% as of March 31, 2006) plus 2%. Principal payments are due annually in three equal installments beginning June 20, 2006 and ending June 20, 2008. The amounts owing under the Amended and Restated Loan Agreement are collateralized by a lien created by a deed of trust on the grain facility. The Amended and Restated Loan Agreement is described in further detail in the Company's Form 10-KSB for the year ended December 31, 2005.

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

6. STOCKHOLDERS' EQUITY:

PREFERRED STOCK - The Company has 10,000,000 shares of preferred stock authorized, 7,000,000 of which have been designated Series A Cumulative Redeemable Convertible Preferred Stock. As of March 31, 2006, no shares of preferred stock were issued and outstanding. (See "Preferred Stock Financing" in Note 10.)

COMMON STOCK - The Company has 100,000,000 shares of common stock authorized. As of March 31, 2006, 30,549,888 shares of common stock were issued and outstanding.

WARRANTS - The following table summarizes warrant activity for the three months ended March 31, 2006 and the year ended December 31, 2005:

	Number of Shares	Price per Share
Balance at January 1, 2005	124,587	$1.5000 - 5.00
Warrants granted	3,058,000	0.0001 - 5.00
Warrants exercised	(277,769)	0.0001 - 5.00
Warrants forfeited	--	--
Balance at December 31, 2005	2,904,818	0.0001 - 5.00
Warrants granted	--	--
Warrants exercised	(1,655,117)	0.0001 - 5.00
Warrants canceled	--	--
Warrants forfeited	--	--
Balance at March 31, 2006	1,249,701	$0.0001 - 5.00

The weighted average remaining contractual life and weighted average exercise price of all warrants outstanding and of warrants exercisable as of March 31, 2006 were as follows:

	Warrants Outstanding			Warrants
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable
$0.0001	115,001	2.98	$0.0001	--
$1.50	1,000	2.87	$1.50	1,000
$3.00	863,534	1.75	$3.00	863,534
$5.00	270,166	0.98	$5.00	270,166

1,249,701	1,134,700

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

7. COMMITMENTS AND CONTINGENCIES:

PURCHASE COMMITMENTS - During the three months ended March 31, 2006, the Company entered into purchase contracts with its major suppliers to acquire certain quantities of ethanol, at specified prices. The contracts generally run for six months from April through September, and from October through March. As of March 31, 2006, the outstanding balance on fixed price purchase contracts commencing April 1, 2006 or thereafter was $81,383,490. The Company has also entered into purchase contracts for delivery beginning April 2006 through March 2007 for 16,716,000 gallons of ethanol for which the purchase price will be determined by the market price at the transaction date.

SALES COMMITMENTS - During the three months ended March 31, 2006, the Company entered into sales contracts with its major customers to sell certain quantities of ethanol at specified prices. The contracts generally run for six months from April through September and from October through March. As of March 31, 2006, the outstanding balance on fixed price sales contracts with delivery commencing April 1, 2006 or thereafter was $74,960,115. The Company has also entered into sales contracts for delivery beginning April 2006 through December 2006 for 9,744,000 gallons of ethanol for which the sales price will be determined by the market price at the transaction date.

ETHANOL PURCHASE AND MARKETING AGREEMENT - On March 4, 2005, Kinergy entered into an Ethanol Purchase and Marketing Agreement with the owner of an ethanol production facility. The agreement was amended in April 2006 effective as of March 4, 2005. The agreement is effective for two years with automatic renewals for additional one-year periods. Kinergy has the exclusive right to market and sell all of the ethanol from the facility. Pursuant to the terms of the agreement, the purchase price of the ethanol may be negotiated monthly between Kinergy and the owner of the ethanol production facility without regard to the price at which Kinergy will re-sell the ethanol to its customers or Kinergy may pay the owner the gross payments received by Kinergy from third parties for forward sales of ethanol less certain transaction costs and fees and retain a 1.0% marketing fee calculated after deducting these costs and expenses. During the three months ended March 31, 2006, all purchases of ethanol from this facility were based on the monthly negotiated prices.

LITIGATION - GENERAL - The Company is subject to legal proceedings, claims and litigation arising in the ordinary course of business. While the amounts claimed may be substantial, the ultimate liability cannot presently be determined because of considerable uncertainties that exist. Therefore, it is possible that the outcome of those legal

proceedings, claims and litigation could adversely affect the Company's quarterly or annual operating results or cash flows when resolved in a future period. However, based on facts currently available, management believes such matters will not adversely affect the Company's financial position, results of operations or cash flows.

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

LITIGATION - GERALD ZUTLER - In January 2003, DriverShield CRM Corp., or DriverShield, then a wholly-owned subsidiary of the Company's predecessor, Accessity, was served with a complaint filed by Mr. Gerald Zutler, its former President and Chief Operating Officer, alleging, among other things, that DriverShield breached his employment contract, that there was fraudulent concealment of DriverShield's intention to terminate its employment agreement with Mr. Zutler, and discrimination on the basis of age and aiding and abetting violation of the New York State Human Rights Law. The complaint was filed in the Supreme Court of the State of New York, County of Nassau, Index No.: 654/03. Mr. Zutler is seeking damages aggregating $2.225 million, plus punitive damages and reasonable attorneys' fees. DriverShield's management believes that DriverShield properly terminated Mr. Zutler's employment for cause, and intends to vigorously defend this suit. An Answer to the complaint was served by DriverShield on February 28, 2003. In 2003, Mr. Zutler filed a motion to have DriverShield's attorney removed from the case. The motion was granted by the court, but was subsequently overturned by an appellate court. DriverShield has filed a claim with its insurance carrier under its directors and officers and employment practices' liability policy. The carrier has agreed to cover certain portions of the claim as they relate to Mr. Siegel, DriverShield's former Chief Executive Officer. The policy has a $50,000 deductible and a liability limit of $3.0 million per policy year. At the present time, the carrier has agreed to cover the portion of the claim that relates to Mr. Siegel and has agreed to a fifty percent allocation of expenses.

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

8. DERIVATIVES:

The Company from time to time conducts hedging activities using derivative instruments. The hedging activities are conducted to appropriately manage risk by minimizing the Company's exposure to price volatility on purchase contracts with suppliers where the price is to be set at a future date and/or if the purchase contract specifies a

floating or "index-based" price for ethanol that is based on either the NYMEX price of gasoline or, to a lesser extent, the Chicago Board of Trade price of ethanol.

The Company may utilize NYMEX unleaded gasoline futures contracts and other derivatives to reduce its exposure to unfavorable changes in NYMEX unleaded gasoline futures associated with its purchase commitments. The Company accounts for its use of these derivatives related to its hedging activities pursuant to SFAS No. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, in which the Company recognizes all of its derivative instruments in its statement of financial position as either assets or liabilities, depending on the rights or obligations under the contracts. Derivate instruments are measured at fair value, pursuant to the definition found in SFAS No. 107, DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS. Changes in

the derivative's fair value are recognized currently in earning unless specific hedge accounting criteria are met. Special accounting for qualifying hedges allows a derivative's gains and losses to offset related results on the hedged item in the income statement. Companies must formally document, designate and assess the effectiveness of transacts that receive hedge accounting.

The Company marked its derivative instruments to fair value at each period end. According to the Company's designation of the derivative, changes in the fair value of derivatives are reflected in net income or other comprehensive income.

The Company reviews its contracts to determine if the contracts meet the definition of derivatives pursuant to SFAS No. 133. At March 31, 2006, the company had futures contracts that qualified as derivatives and were formally documented and designated as cash flow hedges of specified purchases commitments anticipated to occur between April 2006 and September 2006. During the three months ended March 31, 2006, the Company recognized unrealized gains of $680,904 which were included in other comprehensive income. For the three months ended March 31, 2006, the Company recognized $6,696 in other income for the change in fair value of the ineffective portion of a derivative designated as a cash flow hedge. The consolidated balance sheet at March 31, 2006 includes an increase in other current assets of $680,904 as a result of unrealized gains.

The Company determined that the remainder of its derivative contracts qualified for the normal purchase and sale exemption and were designated and documented as such at March 31, 2006 and December 31, 2005.

9. RELATED PARTY TRANSACTIONS:

NOTES RECEIVABLE - On January 19, 2006, a management employee was advanced $91,699 at 5% interest, due and payable on or before July 19, 2006, for the withholding taxes due on the reportable gross taxable income related to a warrant exercise of 25,000 shares.

VOTING AGREEMENT - On November 14, 2005, William L. Jones, Neil M. Koehler, Ryan W. Turner, Kenneth J. Friedman and Frank P. Greinke, each of whom is, with the exception of Mr. Turner, who resigned in April 2006, a director and/or executive officer of the Company (the "Stockholders"), and the Company, entered into a Voting Agreement (the "Voting Agreement") with Cascade Investment, L.L.C. ("Cascade" or "Purchaser"). The Stockholders collectively hold an aggregate of

9,162,704 shares of the Company's common stock. The Voting Agreement provides that the Stockholders may not transfer their shares of the Company's common stock, and must keep their shares free of all liens, proxies, voting trusts or agreements, until the Voting Agreement is

terminated. The Voting Agreement provides that the Stockholders will each vote or execute a written consent in favor of the transactions contemplated by the Purchase Agreement between the Company and Purchaser (the "Transactions"). In addition, under the Voting Agreement, each Stockholder grants an irrevocable proxy to Neil M. Koehler to act as such Stockholder's proxy and attorney-in-fact to vote or execute a written consent in favor of the Transactions. The Voting Agreement is effective until the earlier of the approval of the Transactions by the Company's stockholders or the termination of the Purchase Agreement in accordance with its terms. The Transactions were approved by the stockholders on December 30, 2005.

RELATED CUSTOMER - On August 10, 2005, the Company entered into a 6-month sales contract with Southern Counties Oil Co., a company owned by a director of the Company. The contract period is from October 1, 2005 through March 31, 2006 for 5,544,000 gallons of fuel grade ethanol to be delivered ratably at approximately 924,000 gallons per month at varying prices based on delivery destinations in Arizona, Nevada and California. During the three months ended March 31, 2006, sales to Southern Counties Oil Co. totaled $5,859,853 and accounts receivable from Southern Counties Oil Co. at March 31, 2006 totaled $1,611,120.

10. SUBSEQUENT EVENTS:

AMENDMENT TO LDI TERM LOAN - On April 13, 2006, PEI Madera and LDI entered into an Amended and Restated Loan Agreement whereby the Loan Agreement was assigned by the Company to PEI Madera. The lien created by a deed of trust on PEI Madera's grain facility is subject and subordinate to the lien created by a deed of trust in favor of the lender under the construction loan with Hudson United Capital and Comerica Bank described below.

WARRANT EXERCISES - From April 1, 2006 through May 10, 2006, the Company issued 744,816 shares of common stock for the exercise of warrants and received proceeds of $2,300,832. Of these shares, 12,684 shares were issued pursuant to cashless exercises.

OPTION EXERCISES - From April 1, 2006 through May 10, 2006, the Company issued 153,000 shares of common stock for the exercise of options and received proceeds of $1,076,250.

ADVISORY FEE - On April 14, 2004, the Company entered into an agreement with Cagan-McAfee Capital Partners ("CMCP") and Chadbourn Securities, Inc., a related entity to CMCP, in connection with raising funding for and ethanol production facility. The Company terminated the consulting agreement on November 1, 2005 and pursuant to the terms of a Settlement Agreement, the Company paid Chadbourn $960,000 on April 13, 2006 in connection with the closing of the Company's offering of Series A Preferred Stock.

CONSULTING AGREEMENT - On April 27, 2005, the Company engaged a consulting firm to explore capital raising alternatives. The Company paid the consulting firm an initial engagement fee of $300,000 upon execution of its engagement agreement. The engagement agreement also requires an additional engagement fee, the amount of which is dependent

PACIFIC ETHANOL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

upon the number of the Company's projects to be financed. The additional engagement fee has a range of a minimum of $300,000 and a maximum of one-half of one percent (1/2%) of the capital raised, and is payable upon the occurrence of certain events. In addition, the Company is obligated to pay to the consulting firm an arrangement fee of 3% to 3.5% of the capital raised. For the three months ended March 31, 2006, the Company paid the consulting firm $56,599 in additional expenses. On April 3, 2006, the consulting firm waived any rights it may have had, if any, to be paid a fee in connection with the Closing of the Company's debt financing with Hudson United Capital and Comerica Bank and no additional fees were due to the consulting firm.

PREFERRED STOCK FINANCING - On April 13, 2006, the Company issued to Cascade, 5,250,000 shares of the Company's Series A Cumulative Redeemable Convertible Preferred Stock (the "Series A Preferred Stock"), at a price of $16.00 per share, for an aggregate purchase price of $84.0 million. Of the $84.0 million aggregate purchase price, $4.0 million was paid to the Company at closing and $80.0 million was deposited into a restricted cash account and will be disbursed in accordance with the Deposit Agreement described below. The Company is entitled to use the initial $4.0 million of proceeds for general working capital and must use the remaining $80.0 million for the construction or acquisition of one or more ethanol production facilities in accordance with the terms of the Deposit Agreement.

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

The holders of the Series A Preferred Stock have conversion rights initially equivalent to two shares of common stock for each share of Series A Preferred Stock. The conversion ratio is subject to customary antidilution adjustments. In addition, antidilution adjustments are to occur in the event that the Company issues equity securities at a price equivalent to less than $8.00 per share, including derivative securities convertible into equity securities (on an as-converted or

as-exercised basis). Certain specified issuances will not result in antidilution adjustments. The shares of Series A Preferred Stock are also subject to forced conversion upon the occurrence of a transaction that would result in an internal rate of return to the holders of the Series A Preferred Stock of 25% or more. Accrued but unpaid dividends on the Series A Preferred Stock are to be paid in cash upon any conversion of the Series A Preferred Stock.

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

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

In connection with the issuance of the Series A Preferred Stock, the Company entered into a Registration Rights and Stockholders Agreement (the "Rights Agreement") with Cascade. The Rights Agreement is to be effective until the holders of the Series A Preferred Stock, and their affiliates, as a group, own less than 10% of the Series A Preferred Stock issued under the purchase agreement with Cascade, including common stock into which such Series A Preferred Stock has been converted (the "Termination Date"). The Rights Agreement provides that holders of a majority of the Series A Preferred Stock, including common stock into which the Series A Preferred Stock has been converted, may demand and cause the Company, at any time after April 13, 2007, to register on their behalf the shares of common stock issued, issuable or that may be issuable upon conversion of the Series A Preferred Stock (the "Registrable Securities"). Following such demand, the Company is required to notify any other holders of the Series A Preferred Stock or Registrable Securities of the Company's intent to file a registration

statement and, to the extent requested by such holders, include them in the related registration statement. The Company is required to keep such registration statement effective until such time as all of the Registrable Securities are sold or until such holders may avail themselves of Rule 144(k) under the Securities Act of 1933, which requires, among other things, a minimum two-year holding period and requires that any holder availing itself of Rule 144(k) not be an affiliate of the Company. The holders are entitled to three demand registrations on Form S-1 and unlimited demand registrations on Form S-3; however, the Company is not obligated to effect more than two demand registrations on Form S-3 in any 12-month period.

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

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

The Company is in the process of evaluating the proper accounting treatment for the above factors and resulting impact on its consolidated financial statements.

DEBT FINANCING - On April 13, 2006, PEI Madera entered into a Construction and Term Loan Agreement (the "Construction Loan") with Comerica Bank ("Comerica") and Hudson United Capital ("Hudson") for a debt financing (the "Debt Financing"), from Hudson and Comerica (collectively, the "Lender"), in the aggregate amount of up to $34.0 million. The Debt Financing will provide a portion of the total financing necessary for the completion of the Company's ethanol production facility in Madera County, California (the "Project"). The Project cost is not to exceed approximately $65.5 million (the "Project Cost").

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

The Debt Financing will initially be in the form the Construction Loan that will mature on or before the Final Completion Date, after which the Debt Financing will be converted to a term loan (the "Term Loan"), that will mature on the seventh anniversary of the closing of the Term Loan. If the conversion does not occur and PEI Madera elects to repay the Construction Loan, then PEI Madera must pay a termination fee equal to 5.00% of the amount of the Construction Loan. The closing of the Term Loan is expected to be the Final Completion Date. The Construction Loan interest rate will float at a rate equal to the 30-day London Inter Bank Offered Rate ("LIBOR"), plus 3.75%. PEI Madera will be required to pay the Construction Loan interest monthly during the term of the Construction Loan. The Term Loan interest rate will float at a rate equal to the 90-day LIBOR plus 4.00%. PEI Madera will be required to purchase interest rate protection in the form of a LIBOR rate cap of no more than 5.50% from a provider on terms and conditions reasonably acceptable to Lender, and in an amount covering no less than 70% of the principal outstanding on any loan payment date commencing on the closing date through the fifth anniversary of the Term Loan. Loan repayments on the Term Loan are to be due quarterly in arrears for a

total of 28 payments beginning on the closing of the Term Loan and ending on its maturity date. The loan amortization for the Project will be established on the closing of the Term Loan based upon the operating cash projected to be available to PEI Madera from the Project as determined by closing pro forma projections. The Debt Financing will be the only indebtedness permitted on the Project. The Debt Financing will be senior to all obligations of the Project and PEI Madera other than direct Project operating expenses and expenses incurred in the ordinary course of business. All direct and out-of-pocket expenses of the Company or the Company's direct and indirect subsidiaries will be reimbursed only after the repayment of the Debt Financing obligations.

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

The Debt Financing is secured by: (a) a perfected first priority security interest in all of the assets of PEI Madera, including inventories and all right title and interest in all tangible and intangible assets of the Project; (b) a perfected first priority security interest in the Project's grain facility, including all of PEI Madera's and the Company's and its affiliates' right title and interest in all tangible and intangible assets of the Project's grain facility; (c) a pledge of 100% of the ownership interest in PEI Madera; (d) a pledge of the PEI Madera's ownership interest in the Project; (e) an assignment of all revenues produced by the Project and PEI Madera; (f) the pledge and assignment of the material Project documents, to the

extent assignable; (g) all contractual cash flows associated with such agreements; and (h) any other collateral security as Lender may reasonably request. In addition, the Construction Loan is secured by a completion bond provided by W.M. Lyles Co.

F-24

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

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

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

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

Any of the factors described above or in the "Risk Factors" section of our Annual Report on Form 10-KSB for the year ended December 31, 2005 could cause our financial results, including our net income or loss or growth in net income or loss to differ materially from prior results, which in turn could, among other things, cause the price of our common stock to fluctuate substantially.

OVERVIEW

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

Through our wholly-owned subsidiary, Kinergy Marketing, LLC, or Kinergy, we are currently engaged in the business of marketing ethanol in the Western United States. We provide transportation, storage and delivery of ethanol through third-party service providers. We sell ethanol primarily in California, Nevada, Arizona, Washington and Oregon and have extensive customer relationships throughout the Western United States and extensive supplier relationships throughout the Western and Midwestern United States. We do not currently produce any ethanol that we sell. Until we commence the production of ethanol, if at all, we expect our operations to consist primarily of the marketing and sale of ethanol produced by third-parties. Accordingly, we expect

that unless and until we complete the construction of our initial ethanol production facility in Madera County our consolidated net sales will consist solely of net sales generated by Kinergy. We anticipate that our net sales will grow in the long-term as demand for ethanol increases and as a result of our marketing agreements with third-party ethanol producers.

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

Through Pacific Ethanol Madera, LLC, or PEI Madera, a second-tier subsidiary of our wholly-owned subsidiary, Pacific Ethanol California, Inc., or PEI California, we are constructing an ethanol production facility in Madera County to begin the production and sale of ethanol and its co-products. In April 2006, we secured all the necessary financing to complete construction of this facility. See "Preferred Stock Financing" and "Debt Financing" below. We also intend to construct or otherwise acquire additional ethanol production facilities as financing resources and business prospects make the construction or acquisition of these facilities advisable.

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

Kinergy has two principal methods of conducting its ethanol marketing and sales activities: direct sales and inventory sales. Kinergy's first method of marketing and selling ethanol involves direct sales through which suppliers deliver ethanol directly via rail to Kinergy's customers. For direct sales, Kinergy typically matches ethanol purchase and sale contracts of like quantities and delivery periods. These back-to-back direct sales typically involve no price risks to Kinergy that otherwise may result from fluctuations in the market price of ethanol. Kinergy's second method of marketing and selling ethanol involves truck deliveries from inventory purchased by Kinergy in advance. For inventory sales, as with direct sales, Kinergy typically matches ethanol purchase and sale contracts of like quantities. However, timing differences do exist and consequently, a back-to-back inventory sale may lag by up to two or more weeks. This time lag results from inventory transit and turnover times. As a result, Kinergy may supply ethanol under new inventory sales contracts from existing inventory. These back-to-back inventory sales therefore involve some price risks to Kinergy resulting from potential fluctuations in the market price of ethanol.

We believe that the only consistent price risk to Kinergy is currently inventory risk. Management seeks to optimize transitions to new inventory sales contracts and reduce the effects of declining ethanol prices by managing inventory as carefully as possible to decrease inventory levels in anticipation of declining ethanol prices. In addition, management seeks to increase inventory levels in anticipation of rising ethanol prices. Because Kinergy decreases

inventory levels in anticipation of declining ethanol prices and increases inventory levels in anticipation of rising ethanol prices, it is subject to the risk of ethanol prices moving in unanticipated directions, which could result in declining or even negative gross profit margins over certain periods of time, but also enables Kinergy to potentially benefit from above-normal gross profit margins.

Over the past few years, the market price of ethanol has experienced significant fluctuations. The price of ethanol declined by approximately 25% from its 2004 average price per gallon in five months from January 2005 through May 2005 and reversed this decline and increased to approximately 55% above its 2004 average price per gallon in four months from June 2005 through September 2005. From September through December 2005, the price of ethanol trended downward, but reversed its trend in the first quarter of 2006 by rising approximately 16% above its 2005 average price per gallon.

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

Historically, Kinergy's gross profit margins have averaged between 2.0% and 4.4%. Kinergy's gross profit margins in the first quarter of 2006 and 2005 were 6.0% and 1.7%, respectively. We believe that Kinergy's future gross profit margins may be lower than average historical levels for two principal reasons. First, increased competition in the ethanol market may reduce margins. Second, Kinergy may, in some cases, engage in direct sale arrangements that typically result in lower gross margins. Historically, Kinergy's sales were comprised to a greater degree of inventory sales that often involved the buying and selling of ethanol based on anticipated trends in the market price of ethanol. These inventory sales represented higher-risk positions but enabled Kinergy to achieve higher margin levels, as compared to direct sales, as a result of correctly anticipating fluctuations in the market price of ethanol. As a result of highly-volatile ethanol prices, we are unable to estimate Kinergy's future gross profit margins from inventory sales. However, we believe that over longer periods of up to a year or more, our gross profit margin from inventory sales is unlikely to exceed our historic high average gross profit margin of 4.4%.

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

Kinergy's gross profit margin increased by 253% from 1.7% in the first quarter of 2005 to 6.0% in the first quarter of 2006. Kinergy's gross profit margin in the first quarter of 2005 is generally reflective of the contracted margins for that period. The increase in Kinergy's gross profit margin in the first quarter of 2006 is generally reflective of opportunistic buying and selling during a period of rapidly increasing market prices. Kinergy entered into fixed-price purchase contracts for the October 2005 through March 2006 contracting period and maintained a net long ethanol position going into the

first quarter of 2006. The decision to maintain a net long ethanol position was based on a confluence of factors, including management's expectation of increased prices of gasoline and petroleum and the acceleration of the phase-out of MTBE blending which we believed would result in a significant increase in demand for blending ethanol with gasoline.

SHARE EXCHANGE TRANSACTION

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

4

The Share Exchange Transaction has been accounted for as a reverse acquisition whereby PEI California is deemed to be the accounting acquiror. We have consolidated the results of PEI California, Kinergy, and ReEnergy beginning March 23, 2005, the date of the Share Exchange Transaction. Accordingly, our results of operations for the quarter ended March 31, 2005 consist of the operations of PEI California for that entire period and the operations of Kinergy and ReEnergy from March 23, 2005 through March 31, 2005. Our results of operations for the quarter ended March 31, 2006 consist of our operations and the operations of all of our wholly-owned subsidiaries, including PEI California, Kinergy and ReEnergy for that entire period.

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

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

PREFERRED STOCK FINANCING

GENERAL

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

CERTIFICATE OF DESIGNATIONS

The Certificate of Designations, Powers, Preferences and Rights of the Series A Cumulative Redeemable Convertible Preferred Stock, or Certificate of Designations, provides for 7,000,000 shares of preferred stock to be designated as Series A Cumulative Redeemable Convertible Preferred Stock. The Series A Preferred Stock ranks senior in liquidation and dividend preferences to our common stock. Holders of Series A Preferred Stock are entitled to quarterly cumulative dividends payable in arrears in cash in an amount equal to 5% of the purchase price per share of the Series A Preferred Stock; however, such dividends may, at our option, be paid in additional shares of Series A Preferred

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

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

The holders of Series A Preferred Stock vote together as a single class with the holders of our common stock on all actions to be taken by our stockholders. Each share of Series A Preferred Stock entitles the holder to the

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

DEPOSIT AGREEMENT

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

REGISTRATION RIGHTS AND STOCKHOLDERS AGREEMENT

In connection with the issuance of the Series A Preferred Stock, we entered into a Registration Rights and Stockholders Agreement, or Rights Agreement, with Cascade. The Rights Agreement is to be effective until the holders of the Series A Preferred Stock, and their affiliates, as a group, own less than 10% of the Series A Preferred Stock issued under the purchase agreement with Cascade, including common stock into which such Series A Preferred Stock has been converted (the "Termination Date"). The Rights Agreement provides that holders of a majority of the Series A Preferred Stock, including common stock into which the Series A Preferred Stock has been converted, may demand and cause us, at any time after April 13, 2007, to register on their behalf the shares of common stock issued, issuable or that may

be issuable upon conversion of the Series A Preferred Stock, or Registrable Securities. Following such demand, we are required to notify any other holders of the Series A Preferred Stock or Registrable Securities of our intent to file a registration statement and, to the extent requested by such holders, include them in the related registration statement. We are required to keep such registration statement effective until such time as all of the Registrable Securities are sold or until such holders may avail themselves of Rule 144(k), which requires, among other things, a minimum two-year holding period and requires that any holder availing itself of Rule 144(k) not be an affiliate of Pacific Ethanol. The holders are entitled to three demand registrations on Form S-1 and unlimited demand registrations on Form S-3; however, we are not obligated to effect more than two demand registrations on Form S-3 in any 12-month period.

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

registration rights.

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

DEBT FINANCING

OVERVIEW

On April 13, 2006, PEI California's second-tier subsidiary, Pacific Ethanol Madera LLC, or PEI Madera, entered into a Construction and Term Loan Agreement, or Construction Loan, with Hudson United Capital, or Hudson, and Comerica Bank, or Comerica. This debt financing, or Debt Financing, is in the aggregate amount of up to approximately $34.0 million and will provide a portion of the total financing necessary for the completion of our ethanol production facility in Madera County, or Project. The Project cost is not to exceed approximately $65.5 million, or Project Cost.

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

CONSTRUCTION LOAN AND TERM LOAN

The Debt Financing will initially be in the form of a construction loan, or Construction Loan, that will mature on or before the Final Completion Date, after which the Debt Financing will be converted to a term loan, or Term Loan, that will mature on the seventh anniversary of the closing of the Term Loan. If the conversion does not occur and PEI Madera elects to repay the Construction Loan, then PEI Madera must pay a termination fee equal to 5.00% of the amount of the Construction Loan. The closing of the Term Loan is expected to be the Final Completion Date. The Construction Loan interest rate will float at a rate equal to the 30-day London Inter Bank Offered Rate, or LIBOR, plus 3.75%. PEI Madera will be required to pay the Construction Loan interest monthly during the term of the Construction Loan. The Term Loan interest rate will float at a rate equal to the 90-day LIBOR plus 4.00%. PEI Madera will be required to purchase interest rate protection in the form of a LIBOR rate cap of no more than 5.50% from a provider on terms and conditions reasonably acceptable to Lender, and in an amount covering no less than 70% of the principal outstanding

on any loan payment date commencing on the first draw down date through the fifth anniversary of the Term Loan. Loan repayments on the Term Loan are to be due quarterly in arrears for a total of 28 payments beginning on the closing of the Term Loan and ending on its maturity date. The loan amortization for the Project will be established on the closing of the Term Loan based upon the operating cash projected to be available to PEI Madera from the Project as determined by closing pro forma projections. The Debt Financing will be the only secured indebtedness permitted on the Project. The Debt Financing will be senior

to all obligations of the Project and PEI Madera other than direct Project operating expenses and expenses incurred in the ordinary course of business. All direct and out-of-pocket expenses of Pacific Ethanol or our direct and indirect subsidiaries will be reimbursed only after the repayment of the Debt Financing obligations.

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

LENDER'S SECURITY INTEREST

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

CRITICAL ACCOUNTING POLICIES

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

REVENUE RECOGNITION

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

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

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

We have entered into certain contracts under which we may pay the owner of the ethanol the gross payments received by us from third parties for forward sales of ethanol less certain transaction costs and fees. From the gross payments, we may deduct transportation costs and expenses incurred by or on behalf of Pacific Ethanol in connection with the marketing of ethanol pursuant to the agreement, including truck, rail and terminal fees for the transportation of the facility's ethanol to third parties and may also deduct and retain a marketing fee calculated after deducting these costs and expenses. During 2005, we did not record revenues under these terms. If and when we do purchase and sell ethanol under these terms, we will evaluate the proper recording of the sales under EITF Issue No. 99-19.

INVENTORIES

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

INTANGIBLES, INCLUDING GOODWILL

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

We believe the future cash flows to be received from its long-lived assets will exceed the assets' carrying value, and, accordingly, we have not recognized any impairment losses through March 31, 2006.

Goodwill represents the excess of cost of an acquired entity over the net of the amounts assigned to net assets acquired and liabilities assumed. We account for our goodwill in accordance with SFAS No. 142, GOODWILL AND OTHER INTANGIBLE ASSETS, which requires an annual review for impairment or more frequently if impairment indicators arise. This review would include the determination of each reporting unit's fair value using market multiples and discounted cash flow modeling. We have adopted SFAS No. 142 guidelines for annual review of impairment of goodwill and has performed its annual review of impairment and accordingly, we have not recognized any impairment losses through March 31, 2006.

STOCK-BASED COMPENSATION

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

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

We account for the stock options granted to non-employees in accordance with EITF Issue No. 96-18, ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES and SFAS No. 123R.

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

We attempt to minimize our exposure to price risk by using derivative instruments. In 2006, we entered into derivative instruments in an attempt to minimize our exposure to market volatility associated with certain purchase commitments. We account for our derivative transactions in accordance with SFAS No. 133 "ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES", as amended and interpreted. Derivative transactions, which can include forward contracts and futures positions on the New York Mercantile Exchange ("NYMEX"), are recorded on the balance sheet as assets and liabilities based on the derivative's fair value. Changes in the fair value of the derivative contracts are recognized currently in earnings unless specific hedge accounting criteria are met. If derivatives meet those criteria, the derivative's gains and losses offset related results on the hedged item in the income statement. We formally designate each derivative as a hedge and document and assess the effectiveness of derivatives associated with transactions that receive hedge accounting.

RESULTS OF OPERATIONS

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

- The first two data columns in the table show the absolute results for each period presented.

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

- The last two columns in the table show the results for each period as a percentage of net sales.

THREE MONTHS ENDED MARCH 31, 2006 COMPARED TO THE THREE MONTHS ENDED MARCH 31, 2005

	THREE MONTHS ENDED MARCH 31, 2006	THREE MONTHS ENDED MARCH 31, 2005	DOLLAR VARIANCE FAVORABLE (UNFAVORABLE)	P (U
Net sales	$ 38,239,167	$ 2,301,997	$ 35,937,170	
Cost of sales	35,913,920	2,254,370	33,659,550	
Gross profit	2,325,247	47,627	2,277,620	
Selling, general and administrative expenses	2,984,084	743,233	2,240,851	
Feasibility study expensed in connection with acquisition of ReEnergy	--	852,250	(852,250)	
Loss from operations	(658,837)	(1,547,856)	889,019	
Total other income (expense)	51,779	(107,853)	159,632	
Loss from operations before income taxes	(607,058)	(1,655,709)	1,048,651	
Provision for income taxes	4,705	1,600	(3,105)	
Net loss	$ (611,763)	$ (1,657,309)	$ 1,045,546	

NET SALES. Net sales for the three months ended March 31, 2006 increased by $35,937,170 to $38,239,167 as compared to $2,301,997 for the three months ended March 31, 2005. We completed our acquisition of Kinergy on March 23, 2005. Accordingly, our results of operations for the quarter ended March 31, 2005 consist of the operations of PEI California for that entire period and the operations of Kinergy and ReEnergy from March 23, 2005 through March 31, 2005. Our results of operations for the quarter ended March 31, 2006 consist of our operations and the operations of all of our wholly-owned subsidiaries, including PEI California, Kinergy and ReEnergy for that entire period.

GROSS PROFIT. Gross profit for 2005 increased by $2,277,620 to $2,325,247 as compared to $47,627 for the three months ended March 31, 2005. Gross profit as a percentage of net sales increased to 6.1% for the three months

ended March 31, 2006 as compared to 2.1% for the three months ended March 31, 2005. This difference is almost entirely attributable to higher gross margins achieved by Kinergy.

Historically, Kinergy's gross profit margins have averaged between 2.0% and 4.4%. Kinergy's gross profit margin was 6.0% in the first quarter of 2006 as compared to 1.7% in the first quarter of 2005. Kinergy's gross profit margin in the first quarter of 2005 is generally reflective of the contracted margins for that period. The increase in Kinergy's gross profit margin in the first quarter of 2006 is generally reflective of opportunistic buying and selling during a period of rapidly increasing market prices. Kinergy entered into fixed-price purchase contracts for the October 2005 through March 2006 contracting period and maintained a net long ethanol position going into the first quarter of 2006. The decision to maintain a net long ethanol position was based on a confluence of factors, including management's expectation of increased prices of gasoline and petroleum and the acceleration of the phase-out of MTBE blending which we believed would result in a significant increase in demand for blending ethanol with gasoline.

We believe that Kinergy's future gross profit margins may be lower than historical levels for two principal reasons. First, increased competition in the ethanol market may reduce margins. Second, Kinergy may, in some cases, engage in direct sales arrangements that typically result in lower gross margins.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses for the three months ended March 31, 2006 increased by $2,240,851 to $2,984,084 as compared to $743,233 for the three months ended March 31, 2005. This increase was primarily due to $885,094 in additional legal, accounting and consulting fees, $176,442 in additional amortization of intangibles, $175,866 in additional non-cash compensation and non-cash consulting expenses, $555,831 in additional payroll expense related to the three executive employment agreements that became effective upon the consummation of the Share Exchange Transaction on March 23, 2005, the addition of two staff positions in May and June 2005, an employee promotion in May 2005, the addition of two executive positions in June 2005, the addition of two high-level ethanol plant management positions in September 2005, the addition of three staff positions in the fourth quarter of 2005, and the addition of three staff positions in the first quarter of 2006. The increase in selling, general and administrative expenses was also due to $22,482 in additional insurance expense related primarily to liability and property coverage for our Madera County construction site, a $88,121 increase in business travel expenses, a $95,602 increase in policy and investor relations expenses, a $17,496 increase in rents, a $9,044 increase in advertising and marketing expense, an $34,007 increase in dues and trade memberships, a $10,512 increase in telephone expense, a $44,324 increase in terminated project development expense, and the net balance of $126,030 related to various increases in other selling, general and administrative expenses.

We expect that over the near-term, our selling, general and administration expenses will increase as a result of, among other things, increased legal and accounting fees associated with increased corporate governance activities in response to the Sarbanes-Oxley Act of 2002, recently adopted rules and regulations of the Securities and Exchange Commission, increased employee costs associated with planned staffing increases, increased sales and marketing expenses, increased activities related to the construction of our Madera County ethanol production facility and increased activity in searching for and analyzing potential acquisitions.

FEASIBILITY STUDY EXPENSED IN CONNECTION WITH ACQUISITION OF REENERGY. Feasibility study expenses in connection with acquisition of ReEnergy for the three months ended March 31, 2006 were $0 as compared to $852,250 for the three months ended March 31, 2005. This amount arose in the connection with the acquisition of ReEnergy and relates to a feasibility study for an ethanol plant in Visalia, California. Based on this study, ReEnergy entered into an option to buy land for the ethanol plant. The option expired unexercised on December 15, 2005.

OTHER INCOME/(EXPENSE). Other income/(expense) increased by $159,632 to $51,779 for the three months ended March 31, 2006 as compared to ($107,853) for the three months ended March 31, 2005, primarily due to a $49,080 increase in interest income, a $19,595 decrease in other income, a net decrease of $138,492 in interest expense related to long-term debt, amortization of discount, and construction payables, net of capitalized interest related to our planned Madera County ethanol plant, and an increase of $8,345 in bank charges, finance charges, and short-term interest.

LIQUIDITY AND CAPITAL RESOURCES

During the three months ended March 31, 2006, we funded our operations primarily from our cash on hand, net income from the operations of Kinergy and net proceeds from the exercise of warrants and options to purchase shares of our common stock. As of March 31, 2006, we had negative working capital of $10,569,314, representing a decrease in working capital of $7,675,181 from negative working capital of $2,894,133 as of December 31, 2005. This decrease in working capital is primarily due to an increase in accounts payable to W.M. Lyles Co., a related party, for the construction of our Madera County ethanol production facility as well as an increase in accounts payable of Kinergy.

Our current available capital resources consist primarily of approximately $4.2 million in cash as of March 31, 2006. This amount was primarily raised through the exercise of outstanding warrants and options. We expect that our future available capital resources will consist primarily of any balance of the $4.2 million in cash as of March 31, 2006, cash generated from Kinergy's ethanol marketing business, if any, restricted and unrestricted proceeds from the issuance of our Series A Preferred Stock to Cascade, and any future debt and/or equity financings.

Accounts receivable increased $3,007,632 during the three months ended March 31, 2006 from $4,947,538 as of December 31, 2005 to $7,955,170 as of March 31, 2006. Kinergy's sales growth contributed substantially all of this increase.

Inventory balances increased $281,492 during the three months ended March 31, 2006, from $362,972 as of December 31, 2005 to $644,464 as of March 31, 2006. As of December 31, 2005, there was significant inventory in transit (prepaid inventory) due to logistical delays in delivery to our inventory terminal locations. The increased inventory balance as of March 31, 2006 reflects a return to a more typical balance between inventory in transit and actual inventory on hand.

Other current assets increased $517,787 during the three months ended March 31, 2006, from $86,054 as of December 31, 2005 to $603,841 as of March 31, 2006. The increase is primarily related to deposits for derivative instruments.

Total other assets increased $368,091 during the three months ended March 31, 2006 from $10,196,892 as of December 31, 2005 to $10,564,983 as of

March 31, 2006. The increase is primarily due to deferred financing fees related to our debt financing for the completion of our ethanol production facility in Madera County. See "Debt Financing" above.

Cash provided by our operating activities totaled $4,998,183 for the three months ended March 31, 2006 compared to cash used in our operating activities of $1,196,080 for the three months ended March 31, 2005. This $5,694,263 increase in cash provided by operating activities primarily resulted from an increase in accounts payable and accrued expenses.

Cash used in our investing activities totaled $11,020,530 for the three months ended March 31, 2006 as compared to $2,976,737 of cash provided in the three months ended March 31, 2005. Included in the results for the three months ended March 31, 2006 are $13,770,530 in cash used for additions to property, plant, and equipment primarily reflecting the Madera County plant construction and $2,750,000 in proceeds from sale of marketable securities.

Cash provided by our financing activities totaled $5,702,138 for the three months ended March 31, 2006 as compared to $18,962,854 for the three months ended March 31, 2005. The entire amount for the three months ended March 31, 2006 is related to gross proceeds from the exercise of warrants and stock options. The amount for the three months ended March 31, 2005 includes the proceeds from PEI California's private placement transaction in March 2005. See "Share Exchange Transaction" above.

On April 13, 2006, we issued to Cascade 5,250,000 shares of our Series A Preferred Stock at a price of $16.00 per share for an aggregate purchase price of $84.0 million. Of the $84.0 million aggregate purchase price, $4.0 million was paid to us at closing and $80.0 million has been deposited into a restricted cash account and will be disbursed in accordance with a Deposit Agreement. We are entitled to use the initial $4.0 million of proceeds for general working capital and must use the remaining $80.0 million for the construction or acquisition of one or more ethanol production facilities in accordance with the terms of the Deposit Agreement. Of the $80.0 million deposited into the restricted cash account, $20.0 million has been advanced to us for use in the construction of our Madera County ethanol plant. See "Preferred Stock Financing" above.

On April 13, 2006, PEI Madera entered into a Construction Loan with Hudson and Comerica for debt financing in the aggregate amount of up to approximately $34.0 million. We must use these loan proceeds for the construction of our Madera County ethanol production facility.

A portion of the proceeds from the Series A Preferred Stock financing and the entire amount of the approximately $34.0 million in Debt Financing are expected to be used as follows for a total cost of completion of our Madera County ethanol production facility estimated at approximately $55.3 million: site work ($1.7 million); building and concrete ($7.0 million); site utilities ($1.1 million); equipment and tanks ($19.2 million); piping ($5.7 million); electrical ($3.7 million); and engineering, general conditions, and other ($16.9 million). The above amounts do not include up to $10.2 million in additional funding required for capital raising expenses, interest expense during construction and working capital for a total project cost of approximately $65.5 million.

We have a $2.0 million revolving line of credit with Comerica Bank, or Comerica, that we use from time to time in connection with the operations of Kinergy. Principal amounts outstanding under the line of credit accrue interest,

on a per annum basis, at Comerica's "base rate" of interest plus 1.0%. Comerica's "base rate" of interest is currently the prime rate of interest and is subject to adjustment from time to time by Comerica. As of March 31, 2006, the interest rate on principal amounts outstanding under the line of credit would have been 8.75%. There were no balances outstanding on the line of credit as of March 31, 2006 and December 31, 2005.

On October 1, 2005, we issued an Irrevocable Standby Letter of Credit by Comerica Bank for any sum not to exceed a total of $400,000, leaving funds available of $1.6 million on the line of credit. The designated beneficiary of the letter of credit is one of our vendors, and the letter was initially valid through March 31, 2006. On April 1, 2006, the Irrevocable Standby Letter of Credit was extended to September 30, 2006.

We believe that current and future available capital resources, revenues generated from operations and other existing sources of liquidity, including the credit facilities we have, and our offering of Series A Preferred Stock and the available proceeds from the Debt Financing, will be adequate to meet our anticipated working capital and capital expenditure requirements for at least the next twelve months. If, however, our capital requirements or cash flow vary materially from our current projections, if unforeseen circumstances occur, or if we require a significant amount of cash to fund future acquisitions, we may require additional financing. Our failure to raise capital, if needed, could restrict our growth or hinder our ability to compete.

EFFECTS OF INFLATION

The impact of inflation and changing prices has not been significant on the financial condition or results of operations of either our company or our operating subsidiaries.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

INDEXED PURCHASE COMMITMENTS

We are exposed to market risks primarily related to volatility in unleaded gasoline prices associated with purchase commitments for ethanol. We utilize NYMEX commodity-based futures contracts to attempt to hedge our exposure to these market price fluctuations. As of March 31, 2006, we had entered into NYMEX futures contracts that will settle from April 2006 through September 2006. These contracts qualify as cash flow hedges, therefore, unrealized gains and losses in the fair value of these instruments are recognized in other comprehensive income. This accounting treatment is discussed further under Note 1 "Organization and Summary of Significant Accounting Policies" in our consolidated financial statements contained elsewhere in this report.

The fair value estimate is based on the difference between NYMEX market data available on March 31, 2006 and the applicable contract price, multiplied by the number of gallons stated in the futures contract. The time value component of the derivative value was not significant, and was therefore excluded from the calculation of fair value.

ITEM 4. CONTROLS AND PROCEDURES.

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

We conducted an evaluation, with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the

design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, as of March 31, 2006, to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities Exchange Commission's rules and forms, including to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of March 31, 2006, our disclosure controls and procedures were not effective at the reasonable assurance level due to the material weakness described below.

A material weakness is a control deficiency (within the meaning of the Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2) or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

On April 7, 2006, in connection with its audit of our consolidated financial statements for the year ended December 31, 2005, Hein & Associates LLP, our independent registered public accounting firm ("Hein"), advised management and our audit committee of the following matter that Hein considered to be a material weakness: The organization of our accounting department at that time did not provide us with the appropriate resources and adequate technical skills to accurately account for and disclose our activities.

Hein stated that this matter is evidenced by the following issues encountered in connection with its audit of our consolidated financial statements for the year ended December 31, 2005: (i) we were unable to provide accurate accounting for and disclosure of the Share Exchange Transaction, (ii) our closing procedures were not adequate and resulted in significant accounting adjustments, and (iii) we were unable to adequately perform the financial reporting process as evidenced by a significant number of suggested revisions and comments by Hein to our consolidated financial statements and related disclosures for the year ended December 31, 2005.

As a result of the identification of this matter by Hein, management evaluated, with consultation from our audit committee, in the second quarter of 2006 and as of March 31, 2006, the impact of our lack of appropriate resources and adequate technical skills in our accounting department and concluded, in the second quarter of 2006 and as of March 31, 2006, that the control deficiency that resulted in our lack of appropriate resources and adequate technical skills in our accounting department represented a material weakness and concluded that, as of March 31, 2006, our disclosure controls and procedures were not effective at the reasonable assurance level.

15

To initially address this material weakness, management performed additional analyses and other procedures to ensure that the financial statements included herein fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented.

REMEDIATION OF MATERIAL WEAKNESS

To remediate the material weakness in our disclosure controls and procedures identified above, we have done or intend to do the following

subsequent to March 31, 2006, in the periods specified below:

In the second quarter of 2006, we developed plans to alter the current organization of our accounting department to hire additional personnel to assist in our financial reporting processes, including a Director of Financial Reporting who has expertise in public company financial reporting compliance and at least one additional accounting supervisory support staff member who will report to our Controller and/or our Director of Financial Reporting.

In the second quarter of 2006, we successfully hired a Director of Financial Reporting who has expertise in public company financial reporting compliance. We also replaced one support staff member with a more well-qualified individual. We continue to seek to hire an additional accounting supervisory support staff member who will report to our Controller and/or our Director of Financial Reporting.

Our remediation plans also include exploring the advisability of seeking guidance from financial consultants who are certified public accountants with the requisite background and experience to assist us in identifying and evaluating complex accounting and reporting matters. In addition, we intend to define new internal processes for identifying and disclosing both routine and non-routine transactions and for researching and determining proper accounting treatment for those transactions. We plan to assign individuals with appropriate knowledge and skills to perform these processes and plan to provide those individuals with adequate technical and other resources to help ensure the proper application of accounting principles and the timely and appropriate disclosure of routine and non-routine transactions. We also intend to hire a General Counsel who will work with our Chief Financial Officer and Director of Financial Reporting to help ensure that our disclosures are timely and appropriate.

We believe that our current Director of Financial Reporting and our additional accounting supervisory support staff member, once hired, will contribute additional expertise to our team of finance and accounting personnel. In addition, we believe that, by replacing one support staff member with a more well-qualified individual, we have added an individual who will contribute additional expertise to our team of finance and accounting personnel. We also believe that our new position of General Counsel, once it is filled with a suitable candidate, will contribute additional expertise to help ensure that our reporting obligations are satisfied.

Management is unsure, at the time of the filing of this report, when the actions described above will remediate the material weakness also described above. Although management intends to hire one additional accounting supervisory support staff member and a General Counsel as soon as practicable, it may take an extended period of time until suitable candidates can be located and hired. Management is, however, optimistic that these personnel can be located and hired by the third quarter of 2006 and that the material weakness described above can be fully remediated by the fourth quarter of 2006. Until we hire an additional accounting supervisory support staff member, as planned, management may hire outside consultants to assist us in satisfying our financial reporting obligations.

Our Director of Financial Reporting has an annual base salary of $85,000, not including benefits and other costs of employment. Management believes that a suitable candidate for General Counsel will have an annual base salary in the range of $150,000 to $200,000, not including benefits and other costs of employment. Management also believes that a suitable candidate for our additional accounting supervisory support staff member will have an annual base salary in the range of $40,000 to $50,000, not including benefits and other costs of employment. Management is unable, however, to estimate our expenditures

related to fees, if any, that may be paid to financial consultants in connection with their guidance in identifying and evaluating complex accounting and reporting matters. Management is also unable to estimate our expenditures related to the development of new internal processes for identifying and disclosing both routine and non-routine transactions and for researching and determining proper accounting treatment for those transactions. Management is also unable to estimate our expenditures related to the hiring of other outside consultants, if any, to assist us in satisfying our financial reporting obligations. In addition, management is unable to estimate our expenditures related to higher fees to be paid to our independent auditors in connection with their review of this remediation.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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 our financial position, results of operations or cash flows.

BARRY SPIEGEL

On December 23, 2005, Barry J. Spiegel, a stockholder of Pacific Ethanol and former director of Accessity, filed a complaint in the Circuit Court of the 17th Judicial District in and for Broward County, Florida (Case No. 05018512), or the Spiegel Action, against Barry Siegel, Philip Kart, Kenneth Friedman and Bruce Udell, or collectively, the Defendants. Messrs. Siegel, Udell and Friedman are former directors of Accessity and Pacific Ethanol. Mr. Kart is a former executive officer of Accessity and Pacific Ethanol.

The Spiegel Action relates to the Share Exchange Transaction and purports to state the following five counts against the Defendants: (i) breach of fiduciary duty, (ii) violation of Florida's Deceptive and Unfair Trade Practices Act, (iii) conspiracy to defraud, (iv) fraud, and (v) violation of Florida Securities and Investor Protection Act. Mr. Spiegel is seeking $22.0 million in damages. On March 8, 2006, Defendants filed a motion to dismiss the Spiegel Action.

We have agreed with Messrs. Friedman, Siegel, Kart and Udell to advance the costs of defense in connection with the Spiegel Action. Under applicable provisions of Delaware law, we may be responsible to indemnify each of the Defendants in connection with the Spiegel Action. The final outcome of the Spiegel Action will most likely take an indefinite time to resolve.

GERALD ZUTLER

In January 2003, DriverShield CRM Corp., or DriverShield, then a wholly-owned subsidiary of our predecessor, Accessity, was served with a complaint filed by Mr. Gerald Zutler, its former President and Chief Operating Officer, alleging, among other things, that DriverShield breached his employment contract, that there was fraudulent concealment of DriverShield's intention to terminate its employment agreement with Mr. Zutler, and discrimination on the basis of age and aiding and abetting violation of the New York State Human Rights Law. The complaint was filed in the Supreme Court of the State of New York, County of Nassau, Index No.: 654/03. Mr. Zutler is seeking damages aggregating $2.225 million, plus punitive damages and reasonable attorneys' fees. DriverShield's management believes that DriverShield properly terminated Mr. Zutler's employment for cause, and intends to vigorously defend this suit. An Answer to the complaint was served by DriverShield on February 28, 2003. In 2003, Mr. Zutler filed a motion to have DriverShield's attorney removed from the case. The motion was granted by the court, but was subsequently overturned by an appellate court. DriverShield has filed a claim with its insurance carrier under its directors and officers and employment practices' liability policy. The carrier has agreed to cover certain portions of the claim as they relate to Mr. Siegel, DriverShield's former Chief Executive Officer. The policy has a $50,000 deductible and a liability limit of $3.0 million per policy year. At the present time, the carrier has agreed to cover the portion of the claim that relates to Mr. Siegel and has agreed to a fifty percent allocation of expenses.

MERCATOR GROUP, LLC

We filed a Demand for Arbitration against Presidion Solutions, Inc., or Presidion, alleging that Presidion breached the terms of the Memorandum of Understanding, or the MOU, between Accessity and Presidion dated January 17, 2003. We sought a break-up fee of $250,000 pursuant to the terms of the MOU alleging that Presidion breached the MOU by wrongfully terminating the MOU. Additionally, we sought out of pocket costs of its due diligence amounting to approximately $37,000. Presidion filed a counterclaim against us alleging that we had breached the MOU and therefore owe Presidion a break-up fee of $250,000. The dispute was heard by a single arbitrator before the American Arbitration Association in Broward County, Florida in late February 2004. During June 2004, the arbitrator awarded us the $250,000 break-up fee set forth in the MOU between us and Presidion, as well as our share of the costs of the arbitration and interest from the date of the termination by Presidion of the MOU, aggregating approximately $280,000. During the third quarter of 2004, Presidion paid us the full amount of the award with accrued interest. The arbitrator dismissed Presidion's counterclaim against us.

In 2003, we filed a lawsuit seeking damages in excess of $100 million as a result of information obtained during the course of the arbitration discussed above, against: (i) Presidion Corporation, f/k/a MediaBus Networks, Inc., Presidion's parent corporation, (ii) Presidion's investment bankers, Mercator Group, LLC, or Mercator, and various related and affiliated parties and (iii) Taurus Global LLC, or Taurus, (collectively referred to as the "Mercator Action"), alleging that these parties committed a number of wrongful acts, including, but not limited to tortuously interfering in the transaction between us and Presidion. In 2004, we dismissed this lawsuit without prejudice, which was filed in Florida state court. We recently refiled this action in the State of California, for a similar amount, as we believe this to be the proper jurisdiction. On August 18, 2005, the court stayed the action and ordered the parties to arbitration. The parties agreed to mediate the matter. Mediation took place on December 9, 2005 and was not successful. On December 5, 2005, we filed

a Demand for Arbitration with the American Arbitration Association. On April 6, 2006, a single arbitrator was appointed. The final outcome of the Mercator Action will most likely take an indefinite time to resolve. We currently have limited information regarding the financial condition of the defendants and the extent of their insurance coverage. Therefore, it is possible that we may prevail, but may not be able to collect any judgment. The share exchange agreement relating to the Share Exchange Transaction provides that following full and final settlement or other final resolution of the Mercator Action, after deduction of all fees and expenses incurred by the law firm representing us in this action and payment of the 25% contingency fee to the law firm, shareholders of record of Accessity on the date immediately preceding the closing date of the Share Exchange Transaction will receive two-thirds and we will retain the remaining one-third of the net proceeds from any Mercator Action recovery.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed under "Risk Factors" in our Annual Report on Form 10-KSB for the year ended December 31, 2005, which could materially affect our business, financial condition and results of operations. The risks described in our Annual Report on Form 10-KSB are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and results of operations.

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

UNREGISTERED SALES OF EQUITY SECURITIES

From January through March 2006, we issued an aggregate of 1,647,946 shares of our common stock upon the exercise of outstanding warrants, net of 7,171 shares of common stock deemed tendered back to us upon cashless exercises of certain of those warrants. In connection with the warrant exercises, other than cashless exercises, we received aggregate gross proceeds of $5,494,065.

Exemption from the registration provisions of the Securities Act of 1933 for the transactions described above is claimed under Section 4(2) of the Securities Act of 1933, among others, on the basis that such transactions did not involve any public offering and the purchasers were sophisticated or accredited with access to the kind of information registration would provide.

DIVIDENDS

We have never 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.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

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

None.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

Exhibit Number	Description
10.1	First Amendment to Pacific Ethanol, Inc. 2004 Stock Option Plan (1)
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 President 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 (*)

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* Filed herewith.

(1) Filed as an exhibit to the Registrant's Current Report on Form 8-K for January 26, 2006 (File No. 0-21467) filed with the Commission on February 1, 2006.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PACIFIC ETHANOL, INC.

Dated: May 15, 2006

By: /S/ WILLIAM G. LANGLEY

William G. Langley
Chief Financial Officer
(principal financial officer and duly authorized officer)

EXHIBITS FILED WITH THIS REPORT

Exhibit Number	Description
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 President and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted