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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended June 30, 2006

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-2313

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**SOUTHERN CALIFORNIA EDISON COMPANY**

(Exact name of registrant as specified in its charter)

**California**  
(State or other jurisdiction of  
incorporation or organization)

**95-1240335**  
(I.R.S. Employer  
Identification No.)

**2244 Walnut Grove Avenue**  
(P. O. Box 800)

**Rosemead, California**  
(Address of principal executive offices)

**91770**  
(Zip Code)

**(626) 302-1212**

(Registrant's telephone number, including area code)

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

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class	Outstanding at July 31, 2006
Common Stock, no par value	434,888,104

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# SOUTHERN CALIFORNIA EDISON COMPANY

## INDEX

	<b><u>Page No.</u></b>
<b>Part I. Financial Information:</b>	
Item 1. Financial Statements:	1
Consolidated Statements of Income – Three and Six Months Ended June 30, 2006 and 2005	1
Consolidated Statements of Comprehensive Income – Three and Six Months Ended June 30, 2006 and 2005	1
Consolidated Balance Sheets – June 30, 2006 and December 31, 2005	2
Consolidated Statements of Cash Flows – Six Months Ended June 30, 2006 and 2005	4
Notes to Consolidated Financial Statements	5
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	27
Item 3. Quantitative and Qualitative Disclosures About Market Risk	46
Item 4. Controls and Procedures	46
<b>Part II. Other Information:</b>	
Item 6. Exhibits	47
Signature	48

**SOUTHERN CALIFORNIA EDISON COMPANY**

**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**CONSOLIDATED STATEMENTS OF INCOME**

<b>In millions</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(Unaudited)			
<b>Operating revenue</b>	\$ <b>2,521</b>	\$ 2,203	\$ <b>4,739</b>	\$ 4,110
Fuel	<b>237</b>	265	<b>548</b>	520
Purchased power	<b>769</b>	743	<b>1,783</b>	1,131
Provisions for regulatory adjustment clauses – net	<b>(10)</b>	(41)	<b>(371)</b>	24
Other operation and maintenance	<b>639</b>	570	<b>1,254</b>	1,169
Depreciation, decommissioning and amortization	<b>300</b>	231	<b>552</b>	454
Property and other taxes	<b>51</b>	47	<b>105</b>	97
Net gain on sale of utility property and plant	<b>(1)</b>	—	<b>(1)</b>	—
<b>Total operating expenses</b>	<b>1,985</b>	1,815	<b>3,870</b>	3,395
<b>Operating income</b>	<b>536</b>	388	<b>869</b>	715
Interest and dividend income	<b>15</b>	10	<b>30</b>	20
Other nonoperating income	<b>19</b>	18	<b>46</b>	35
Interest expense – net of amounts capitalized	<b>(102)</b>	(96)	<b>(199)</b>	(198)
Other nonoperating deductions	<b>(9)</b>	(11)	<b>(21)</b>	(18)
<b>Income before tax and minority interest</b>	<b>459</b>	309	<b>725</b>	554
Income tax	<b>145</b>	58	<b>228</b>	124
Minority interest	<b>67</b>	85	<b>117</b>	132
<b>Net income</b>	<b>247</b>	166	<b>380</b>	298
Dividends on preferred and preference stock not subject to mandatory redemption	<b>13</b>	5	<b>25</b>	6
<b>Net income available for common stock</b>	\$ <b>234</b>	\$ 161	\$ <b>355</b>	\$ 292

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

<b>In millions</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(Unaudited)			
Net income	\$ <b>247</b>	\$ 166	\$ <b>380</b>	\$ 298
Other comprehensive income, net of tax:				
Amortization of cash flow hedges	<b>4</b>	1	<b>4</b>	2
<b>Comprehensive income</b>	\$ <b>251</b>	\$ 167	\$ <b>384</b>	\$ 300

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

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**CONSOLIDATED BALANCE SHEETS**

<b>In millions</b>	<b>June 30, 2006</b>	<b>December 31, 2005</b>
	(Unaudited)	
<b>ASSETS</b>		
Cash and equivalents	\$ 90	\$ 143
Restricted cash	48	57
Margin and collateral deposits	126	178
Receivables, less allowances of \$29 and \$33 for uncollectible accounts at respective dates	1,026	849
Accrued unbilled revenue	490	291
Inventory	241	220
Trading and price risk management assets	41	237
Regulatory assets	740	536
Other current assets	69	92
<b>Total current assets</b>	<b>2,871</b>	<b>2,603</b>
Nonutility property – less accumulated provision for depreciation of \$601 and \$569 at respective dates	1,065	1,086
Nuclear decommissioning trusts	2,943	2,907
Other investments	79	80
<b>Total investments and other assets</b>	<b>4,087</b>	<b>4,073</b>
Utility plant, at original cost:		
Transmission and distribution	16,845	16,760
Generation	1,446	1,370
Accumulated provision for depreciation	(4,600)	(4,763)
Construction work in progress	1,256	956
Nuclear fuel, at amortized cost	175	146
<b>Total utility plant</b>	<b>15,122</b>	<b>14,469</b>
Regulatory assets	2,904	3,013
Trading and price risk management assets	13	42
Other long-term assets	346	503
<b>Total long-term assets</b>	<b>3,263</b>	<b>3,558</b>
<b>Total assets</b>	<b>\$ 25,343</b>	<b>\$ 24,703</b>

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

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**CONSOLIDATED BALANCE SHEETS**

<b>In millions, except share amounts</b>	<b>June 30, 2006</b>	<b>December 31, 2005</b>
	(Unaudited)	
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Short-term debt	\$ 518	\$ —
Long-term debt due within one year	247	596
Accounts payable	794	898
Accrued taxes	426	242
Accrued interest	125	106
Counterparty collateral	30	183
Customer deposits	188	183
Book overdrafts	171	257
Accumulated deferred income taxes – net	121	5
Trading and price risk management liabilities	171	87
Regulatory liabilities	710	681
Other current liabilities	485	723
<b>Total current liabilities</b>	<b>3,986</b>	<b>3,961</b>
<b>Long-term debt</b>	<b>5,052</b>	<b>4,669</b>
Accumulated deferred income taxes – net	2,759	2,815
Accumulated deferred investment tax credits	115	119
Customer advances and other deferred credits	558	550
Trading and price risk management liabilities	94	101
Power-purchase contracts	47	64
Accumulated provision for pensions and benefits	539	500
Asset retirement obligations	2,660	2,621
Regulatory liabilities	2,787	2,962
Other long-term liabilities	279	284
<b>Total deferred credits and other liabilities</b>	<b>9,838</b>	<b>10,016</b>
<b>Total liabilities</b>	<b>18,876</b>	<b>18,646</b>
Commitments and contingencies (Notes 3 and 4)		
<b>Minority interest</b>	<b>390</b>	<b>398</b>
Common stock, no par value (434,888,104 shares outstanding at each date)	2,168	2,168
Additional paid-in capital	361	361
Accumulated other comprehensive loss	(12)	(16)
Retained earnings	2,631	2,417
<b>Total common shareholder's equity</b>	<b>5,148</b>	<b>4,930</b>
<b>Preferred and preference stock</b>		
<b>not subject to mandatory redemption</b>	<b>929</b>	<b>729</b>
<b>Total shareholders' equity</b>	<b>6,077</b>	<b>5,659</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 25,343</b>	<b>\$ 24,703</b>

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

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

<b>In millions</b>	<b>Six Months Ended</b>	
	<b>2006</b>	<b>2005</b>
	(Unaudited)	
<b>Cash flows from operating activities:</b>		
Net income	\$ 380	\$ 298
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation, decommissioning and amortization	552	454
Other amortization	35	47
Minority interest	117	132
Deferred income taxes and investment tax credits	5	(133)
Regulatory assets – long-term	112	214
Regulatory liabilities – long-term	(174)	(127)
Trading and price risk management assets – long-term	29	(32)
Trading and price risk management liabilities – long-term	(7)	73
Other assets	10	45
Other liabilities	(17)	47
Margin and collateral deposits – net of collateral received	(100)	28
Receivables and accrued unbilled revenue	(224)	(272)
Trading and price risk management assets – short-term	196	(35)
Trading and price risk management liabilities – short-term	84	39
Inventory and other current assets	12	(33)
Regulatory assets – short-term	(204)	(199)
Regulatory liabilities – short-term	29	276
Accrued interest and taxes	203	192
Accounts payable and other current liabilities	(271)	(75)
<b>Net cash provided by operating activities</b>	<b>767</b>	<b>939</b>
<b>Cash flows from financing activities:</b>		
Long-term debt issued and issuance costs	822	983
Long-term debt repaid	(681)	(1,041)
Issuance of preference stock	196	395
Redemption of preferred stock	—	(148)
Rate reduction notes repaid	(116)	(116)
Short-term debt financing – net	517	60
Change in book overdrafts	(86)	15
Shares purchased for stock-based compensation	(60)	(63)
Proceeds from stock option exercises	23	33
Excess tax benefits related to stock option exercises	9	—
Minority interest	(125)	(115)
Dividends paid	(154)	(74)
<b>Net cash provided (used) by financing activities</b>	<b>345</b>	<b>(71)</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(1,089)	(774)
Proceeds from nuclear decommissioning trust sales	1,461	1,006
Purchases of nuclear decommissioning trust investments	(1,544)	(1,057)
Customer advances for construction and other investments	7	11
<b>Net cash used by investing activities</b>	<b>(1,165)</b>	<b>(814)</b>
<b>Net increase (decrease) in cash and equivalents</b>	<b>(53)</b>	<b>54</b>
<b>Cash and equivalents, beginning of period</b>	<b>143</b>	<b>122</b>
<b>Cash and equivalents, end of period</b>	<b>\$ 90</b>	<b>\$ 176</b>

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

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Management's Statement**

In the opinion of management, all adjustments, including recurring accruals, have been made that are necessary for a fair statement of the financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States for the periods covered by this quarterly report on Form 10-Q. The results of operations for the period ended June 30, 2006 are not necessarily indicative of the operating results for the full year.

The quarterly report should be read in conjunction with Southern California Edison Company's (SCE) Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission.

**Note 1. Summary of Significant Accounting Policies**

***Basis of Presentation***

SCE's significant accounting policies were described in Note 1 of "Notes to Consolidated Financial Statements" included in its 2005 Annual Report. SCE follows the same accounting policies for interim reporting purposes, with the exception of the change in accounting for stock-based compensation (discussed below in "New Accounting Pronouncements").

Certain prior-period amounts were reclassified to conform to the June 30, 2006 financial statement presentation.

***Income Taxes***

SCE's effective tax rate from net income was 37% and 38% for the three- and six-month periods ended June 30, 2006, respectively, as compared to 26% and 29% for the same periods in 2005. The increased effective tax rate resulted from reductions made to the income tax reserve in 2005 which have not recurred in 2006. The 2005 reserve reductions were made to reflect progress in settlement negotiations relating to income tax audits.

***Mohave Generating Station Shutdown***

Mohave obtained all of its coal supply from the Black Mesa Mine in northeast Arizona, located on lands of the Navajo Nation and Hopi Tribe (the Tribes). This coal was delivered from the mine to Mohave by means of a coal slurry pipeline, which requires water from wells located on lands belonging to the Tribes in the mine vicinity. Uncertainty over a post-2005 coal and water supply has prevented SCE and other Mohave co-owners from making approximately \$1.1 billion in Mohave-related investments (SCE's share is \$605 million), including the installation of enhanced pollution-control equipment required by a 1999 air-quality consent decree in order for Mohave to operate beyond 2005. Accordingly, the plant ceased operations, as scheduled, on December 31, 2005, consistent with the provisions of the consent decree.

On June 19, 2006, SCE announced that it had decided not to move forward with its efforts to return Mohave to service. SCE's decision was not based on any one factor, but resulted from the conclusion that in light of all the significant unresolved challenges related to returning the plant to service, the plant could not be returned to service in sufficient time to render the necessary investments cost-effective for SCE's customers. Two of the Mohave co-owners, Nevada Power Company and the Los Angeles Department of Water & Power (DWP), announced that they had reached this same conclusion, while the fourth co-owner, Salt River Project Agricultural Improvement and Power District, has advised SCE that it is still assessing its interest in putting together a successor owner group to allow continued coal operations. All of the co-

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

owners have agreed to work together to evaluate options for disposition of the plant, which conceivably could include, among other potential options, sale of the plant “as is” to a power plant operator, decommissioning and sale to a developer, and decommissioning and apportionment of the land among the owners. At this time, SCE continues to work with the water and coal suppliers to the plant to determine if more clarity around the provision of such services can be provided to any potential acquirer.

Following the suspension of Mohave operations at the end of 2005, the plant’s workforce was reduced from over 300 employees to approximately 224 employees. The impacted employees were notified in April 2006 and the workforce reduction was completed by June 30, 2006. In July 2006, the co-owners decided to further reduce the workforce to 65 employees before the end of 2006. Termination costs for the June terminations of approximately \$7 million (SCE’s share) were recorded in the second quarter and deferred in a balancing account authorized in the 2006 General Rate Case (GRC) decision. SCE indicated in July 2006 that it will ensure that remaining Mohave employees are considered for job placement opportunities elsewhere within the company. The amount of termination costs for the second workforce reduction will depend on the success of this effort. Due to this uncertainty, SCE management is unable to predict the amount of termination costs, if any, of the second workforce reduction at this time. However, SCE management believes these costs and other costs associated with the cessation of operations (excluding decommissioning) will range from zero to \$14 million (SCE’s share). These additional costs will be recorded and deferred in the Mohave balancing account in late 2006. SCE expects to recover amounts in this balancing account in future rate-making proceedings.

As of June 30, 2006, SCE had a Mohave regulatory asset of approximately \$77 million representing unamortized capital costs, and a Mohave regulatory liability for revenue collected for future removal costs of approximately \$21 million. Based on the 2006 GRC decision, SCE is allowed to continue to earn its authorized rate of return on the Mohave investment and receive rate recovery for amortization, costs of removal, and operating and maintenance expenses, subject to balancing account treatment, during the three-year 2006 rate case cycle. SCE expects to file a notification with the California Public Utilities Commission (CPUC) regarding the status of Mohave by the end of 2006, and the CPUC may institute an investigation to determine whether to reduce SCE’s rates. At this time, SCE does not anticipate that the CPUC will order a rate reduction. In the past, the CPUC has allowed full recovery of investment for similarly situated plants. However, in a December 2004 decision, the CPUC noted that SCE would not be allowed to recover any unamortized plant balances if SCE could not demonstrate that it took all steps to preserve the “Mohave-open” alternative. SCE believes that it will be able to demonstrate that SCE did everything reasonably possible to return Mohave to service and that its unamortized costs are probable of future rate recovery. However, SCE cannot predict the outcome of any future CPUC action.

***New Accounting Pronouncements***

A new accounting standard requires companies to use the fair value accounting method for stock-based compensation. SCE implemented the new standard in the first quarter of 2006 and applied the modified prospective transition method. Under the modified prospective method, the new accounting standard was applied effective January 1, 2006 to the unvested portion of awards previously granted and will be applied to all prospective awards. Prior financial statements were not restated under this method. The new accounting standard resulted in the recognition of expense for all stock-based compensation awards. Prior to January 1, 2006, SCE used the intrinsic value method of accounting, which resulted in no recognition of expense for its stock options.

Prior to adoption of the new accounting standard, SCE presented all tax benefits of deductions resulting from the exercise of stock options as a component of operating cash flows under the caption “Other liabilities” in the consolidated statements of cash flows. The new accounting standard requires the cash flows resulting from the tax benefits that occur from estimated tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The \$9 million excess tax benefit is classified as a financing cash inflow in 2006.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Due to the adoption of this new accounting standard, SCE recorded a cumulative effect adjustment that increased net income by less than \$1 million, net of tax, in the first quarter of 2006 mainly to reflect the change in the valuation method for performance shares classified as liability awards and the use of forfeiture estimates.

In April 2006, the Financial Accounting Standards Board (FASB) issued a Staff Position that specifies how a company should determine the variability to be considered in applying the accounting standard for consolidation of variable interest entities. The pronouncement states that such variability shall be determined based on an analysis of the design of the entity, including the nature of the risks in the entity, the purpose for which the entity was created, and the variability the entity is designed to create and pass along to its interest holders. This new accounting guidance is effective prospectively beginning July 1, 2006, although companies have until December 31, 2006 to elect retrospective application. SCE has not yet selected a transition method.

In July 2006, the FASB issued an interpretation relating to accounting for uncertainty in income taxes. This interpretation clarifies the accounting for uncertain tax positions. An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position by determining if the weight of the available evidence indicates it is more likely than not, based solely on the technical merits, that the position will be sustained on audit. The effective date is January 1, 2007. SCE is currently assessing the potential impact of the interpretation on its financial condition.

***Regulatory Assets and Liabilities***

Regulatory assets included in the consolidated balance sheets are:

In millions	June 30, 2006	December 31, 2005
	(Unaudited)	
<b>Current:</b>		
Regulatory balancing accounts	\$ 382	\$ 355
Direct access procurement charges	104	113
Energy derivatives	164	—
Purchased-power settlements	40	53
Other	50	15
	<b>740</b>	<b>536</b>
<b>Long-term:</b>		
Flow-through taxes – net	1,118	1,066
Rate reduction notes – transition cost deferral	355	465
Unamortized nuclear investment – net	451	487
Nuclear-related asset retirement investment – net	284	292
Unamortized coal plant investment – net	96	97
Unamortized loss on reacquired debt	320	323
Direct access procurement charges	5	40
Energy derivatives	81	58
Environmental remediation	83	56
Purchased-power settlements	22	39
Other	89	90
	<b>2,904</b>	<b>3,013</b>
<b>Total regulatory assets</b>	<b>\$ 3,644</b>	<b>\$ 3,549</b>

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Regulatory liabilities included in the consolidated balance sheets are:

In millions	June 30, 2006	December 31, 2005
	(Unaudited)	
<b>Current:</b>		
Regulatory balancing accounts	\$ 519	\$ 370
Direct access procurement charges	104	113
Energy derivatives	—	136
Other	87	62
	<b>710</b>	<b>681</b>
<b>Long-term:</b>		
Asset retirement obligation	561	584
Costs of removal	2,134	2,110
Direct access procurement charges	4	39
Employee benefits plans	88	229
	<b>2,787</b>	<b>2,962</b>
<b>Total regulatory liabilities</b>	<b>\$ 3,497</b>	<b>\$ 3,643</b>

***Related Party Transactions***

Four Edison Mission Energy (EME) subsidiaries have 49% to 50% ownership in partnerships that sell electricity generated by their project facilities to SCE under long-term power purchase agreements with terms and pricing approved by the CPUC. Beginning March 31, 2004, SCE consolidates these projects (see “Variable Interest Entities” disclosed in Note 1 of “Notes to Consolidated Financial Statements” included in SCE’s 2005 Annual Report). These variable interest projects hold \$26 million in long-term debt due to EME with an interest rate of 5%, due in October 2008. This is included in long-term debt on the consolidated balance sheet.

SCE holds \$153 million in notes receivable from affiliates, due in June 2007 comprising of a \$78 million note receivable from EME with an interest rate of London Interbank Offered Rate plus 0.275%; and a 4.4%, \$75 million note receivable from Edison International. The \$75 million note receivable was previously due from a subsidiary of Edison Capital and was transferred and assigned to Edison International in May 2006. Both notes receivable are included in receivables on the consolidated balance sheet.

***Stock-Based Compensation***

SCE’s stock-based compensation plans primarily include the issuance of Edison International stock options and performance shares. Edison International usually does not issue new common stock for equity awards earned. Rather, a third party is used to facilitate the exercise of stock options and the purchase and delivery of outstanding common stock for settlement of performance shares earned. The amount of cash used to settle stock options exercised was \$16 million and \$31 million for the quarters ended June 30, 2006 and 2005, respectively, and \$45 million and \$55 million for the six months ended June 30, 2006 and 2005, respectively. The amount of cash used to settle performance shares classified as equity awards was less than \$1 million and zero for the quarters ended June 30, 2006 and 2005, respectively and \$19 million and \$10 million for the six months ended June 30, 2006 and 2005, respectively. Edison International has approximately 13.7 million shares remaining for future issuance under its stock-based compensation plans, which are described more fully in Note 2.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Prior to January 1, 2006, SCE accounted for these plans using the intrinsic value method. Upon grant, no stock-based compensation cost for stock options was reflected in net income, as the grant date was the measurement date, and all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Previously, stock-based compensation cost for performance shares was remeasured at each reporting period and related compensation expense was adjusted. Previously, SCE did not capitalize stock-based compensation cost related to both unvested awards and new awards. As discussed in “New Accounting Pronouncements” above, effective January 1, 2006, SCE implemented a new accounting standard that requires companies to use the fair value accounting method for stock-based compensation resulting in the recognition of expense for all stock-based compensation awards. SCE recognizes stock-based compensation expense on a straight-line basis over the vesting period. SCE is capitalizing a portion of its stock-based compensation cost related to both unvested awards and new awards. SCE recognizes stock-based compensation expense for awards granted to retirement-eligible participants as follows: for stock-based awards granted prior to January 1, 2006, SCE recognized stock-based compensation expense over the explicit vesting period and accelerated any remaining unrecognized compensation expense when a participant actually retired; for awards granted or modified after January 1, 2006, to participants who are retirement-eligible or will become retirement-eligible prior to the end of the normal vesting period for the award, stock-based compensation will be recognized on a prorated basis over the initial year or over the period between the date of grant and the date the participant first becomes eligible for retirement. If SCE recognized stock-based compensation expense for awards granted prior to January 1, 2006, over a period to the date the participant first became eligible for retirement, stock-based compensation expense would have decreased by less than a million for the quarter ended June 30, 2006, would have increased \$2 million for the quarter ended June 30, 2005, would have decreased \$1 million for the six months ended June 30, 2006 and would have increased \$2 million for the six months ended June 30, 2005.

Total stock-based compensation expense (reflected in the caption “Other operation and maintenance” on the consolidated statements of income) was \$6 million and \$14 million for the three months ended June 30, 2006, and 2005, respectively and was \$12 million and \$23 million for the six months ended June 30, 2006, and 2005, respectively. The income tax benefit recognized in the income statement was \$2 million and \$5 million for the three months ended June 30, 2006, and 2005, respectively and was \$5 million and \$9 million for the six months ended June 30, 2006, and 2005, respectively. Total stock-based compensation cost capitalized for the three and six months ended June 30, 2006, was \$1 million and \$2 million, respectively.

The following table illustrates the effect on net income available for common stock if SCE had used the fair-value accounting method for the quarter and six months ended June 30, 2005.

In millions	<b>Three Months Ended June 30,</b>	<b>Six Months Ended June 30,</b>
	2005	2005
	(Unaudited)	
Net income available for common stock, as reported	\$ 161	\$ 292
Add: stock-based compensation expense using the intrinsic value accounting method – net of tax	8	14
Less: stock-based compensation expense using the fair-value accounting method – net of tax	6	11
<b>Pro forma net income available for common stock</b>	<b>\$ 163</b>	<b>\$ 295</b>

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***Supplemental Accumulated Other Comprehensive Loss Information***

SCE previously disclosed in Note 1 of “Notes to Consolidated Financial Statements” included in SCE’s 2005 Annual Report, that the unrealized losses on cash flow hedges relate to SCE’s interest rate swap. The swap terminated on January 5, 2001 and the related debt originally matured in 2008. This debt was redeemed in April 2006. The remaining balance of \$4 million, net of tax, will no longer be reflected in accumulated other comprehensive income.

***Supplemental Cash Flows Information***

In millions	Six Months Ended June 30,	
	2006	2005
	(Unaudited)	
<b>Cash payments for interest and taxes:</b>		
Interest – net of amounts capitalized	\$ 146	\$ 168
Tax payments	29	44
<b>Non-cash investing and financing activities:</b>		
Details of debt exchange:		
Pollution-control bonds redeemed	—	\$ (204)
Pollution-control bonds issued	—	204
Funds held in trust	—	—
Dividends declared but not paid	\$ 73	—

**Note 2. Compensation and Benefit Plans**

***Pension Plans***

SCE previously disclosed in Note 6 of “Notes to Consolidated Financial Statements” included in SCE’s 2005 Annual Report that it expects to contribute approximately \$51 million to its pension plan in 2006. As of June 30, 2006, \$32 million in contributions have been made. SCE anticipates that its original expectation will be met by year-end 2006.

Expense components are:

In millions	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(Unaudited)			
Service cost	\$ 26	\$ 25	\$ 51	\$ 49
Interest cost	43	40	85	80
Expected return on plan assets	(57)	(54)	(113)	(108)
Special termination benefits	4	—	4	—
Net amortization and deferral	4	6	9	12
Expense under accounting standards	20	17	36	33
Regulatory adjustment – deferred	(1)	(2)	(3)	(4)
<b>Total expense recognized</b>	<b>\$ 19</b>	<b>\$ 15</b>	<b>\$ 33</b>	<b>\$ 29</b>

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Due to the Mohave shutdown, SCE has incurred costs for special termination benefits. See “Mohave Generating Station Shutdown” in Note 1 for further information.

***Postretirement Benefits Other Than Pensions***

SCE previously disclosed in Note 6 of “Notes to Consolidated Financial Statements” included in SCE’s 2005 Annual Report that it expects to contribute approximately \$77 million to its postretirement benefits other than pensions plans in 2006. As of June 30, 2006, \$12 million in contributions have been made. SCE anticipates that its original expectation will be met by year-end 2006.

Expense components are:

In millions	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(Unaudited)			
Service cost	\$ 12	\$ 11	\$ 24	\$ 22
Interest cost	30	30	61	60
Expected return on plan assets	(27)	(26)	(54)	(51)
Special termination benefits	3	—	3	—
Amortization of unrecognized prior service costs	(8)	(7)	(15)	(14)
Amortization of unrecognized loss	12	12	23	24
<b>Total expense</b>	<b>\$ 22</b>	<b>\$ 20</b>	<b>\$ 42</b>	<b>\$ 41</b>

Due to the Mohave shutdown, SCE has incurred costs for special termination benefits. See “Mohave Generating Station Shutdown” in Note 1 for further information.

***Stock-Based Compensation***

***Stock Options***

Under various plans, SCE may grant stock options at exercise prices equal to the average of the high and low price at the grant date and other awards related to or with a value derived from Edison International common stock to directors and certain employees. Options generally expire 10 years after the grant date and vest over a period of four years of continuous service, with expense recognized evenly over the vesting period, except for awards granted to retirement-eligible participants, as discussed in “Stock-Based Compensation” in Note 1. Stock-based compensation expense associated with stock options (including amounts capitalized) was \$7 million for the three months ended June 30, 2006 and \$12 million for the six months ended June 30, 2006 (including amounts capitalized). Under prior accounting rules, there was no comparable expense recognized for the same period in 2005. See “Stock-Based Compensation” in Note 1 for further discussion.

Beginning with awards made in 2003, stock options accrue dividend equivalents for the first five years of the option term. Unless transferred to non-qualified deferral plan accounts, dividend equivalents accumulate without interest. Dividend equivalents are paid only on options that vest, including options that are unexercised. Dividend equivalents are paid in cash after the vesting date. Edison International has discretion to pay certain dividend equivalents in shares of Edison International common stock. Additionally, Edison International will substitute cash awards to the extent necessary to pay tax withholding or any government levies.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The fair value for each option granted was determined as of the grant date using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model requires various assumptions noted in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(Unaudited)			
Expected terms (in years)	<b>9 to 10</b>	9 to 10	<b>9 to 10</b>	9 to 10
Risk-free interest rate	<b>4.3% – 4.5%</b>	4.2% – 4.3%	<b>4.3% – 4.5%</b>	4.2% – 4.3%
Expected dividend yield	<b>2.6% – 2.8%</b>	2.5% – 2.8%	<b>2.4% – 2.8%</b>	2.5% – 3.1%
Weighted-average expected dividend yield	<b>2.7%</b>	2.7%	<b>2.4%</b>	3.1%
Expected volatility	<b>16.8% – 17.5%</b>	18.7% – 19.2%	<b>16.2% – 17.5%</b>	18.7% – 19.6%
Weighted-average volatility	<b>17.2%</b>	18.9%	<b>16.3%</b>	19.6%

The expected term of options granted is based on the actual remaining contractual term of the options. The risk-free interest rate for periods within the contractual life of the option is based on a 52-week historical average of the 10-year semi-annual coupon U.S. Treasury note. In 2006, expected volatility is based on the historical volatility of Edison International's common stock for the recent 36 months. Prior to January 1, 2006, expected volatility was based on the median of the most recent 36 months historical volatility of peer companies because Edison International's historical volatility was impacted by the California energy crisis.

A summary of the status of Edison International stock options granted to SCE employees is as follows:

	Stock Options	Weighted-Average		Aggregate Intrinsic Value
		Exercise Price	Remaining Contractual Term (Years)	
	(Unaudited)			
Outstanding at December 31, 2005	8,587,248	\$ 23.22		
Granted	1,191,665	\$ 44.23		
Expired	—	—		
Forfeited	(10,408)	\$ 31.00		
Exercised	(1,061,580)	\$ 21.93		
Outstanding at June 30, 2006	8,706,925	\$ 26.20		
Vested and expected to vest at June 30, 2006	8,335,086	\$ 25.99	6.60	\$ 116,420,314
Exercisable at June 30, 2006	4,601,113	\$ 22.14	5.21	\$ 81,980,331

The weighted-average grant-date fair value of options granted during the quarters ended June 30, 2006 and 2005 was \$13.68 and \$13.29, respectively. The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 and 2005 was \$14.45 and \$11.71, respectively. The total intrinsic value of options exercised during the quarters ended June 30, 2006 and 2005, was \$7 million and \$13 million, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005, was \$22 million and \$21 million, respectively. At June 30, 2006, there was \$32 million of total unrecognized compensation cost related to stock options, net of expected forfeitures. That cost is expected to be recognized over a weighted-average period of approximately two years. The fair value of options vested for the quarters and six months ended June 30, 2006 and 2005 was \$3 million and \$4 million, respectively.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Cash received from options exercised for the quarters ended June 30, 2006 and 2005, was \$9 million and \$18 million, respectively, and for the six months ended June 30, 2006 and 2005, was \$23 million and \$33 million, respectively. The estimated tax benefit from options exercised for the six months ended June 30, 2006 and 2005, was \$9 million and \$9 million, respectively.

*Performance Shares*

A target number of contingent performance shares were awarded to executives in January 2004, January 2005 and March 2006, and vest at the end of December 2006, 2007 and 2008, respectively. Dividend equivalents associated with these performance shares accumulate without interest and will be payable in cash following the end of the performance period when the performance shares are paid, although Edison International has discretion to pay certain dividend equivalents in Edison International common stock. The vesting of Edison International's performance shares is dependent upon a market condition and three years of continuous service subject to a prorated adjustment for employees who are terminated under certain circumstances or retire, but payment cannot be accelerated. The market condition is based on Edison International's common stock performance relative to the performance of a specified group of companies at the end of a three-calendar-year period. The number of performance shares earned is determined based on Edison International's ranking among these companies. Dividend equivalents will be adjusted to correlate to the actual number of performance shares paid. Performance shares earned are settled half in cash and half in common stock; however, Edison International has discretion under certain of the awards to pay the half subject to cash settlement in common stock. Additionally, cash awards are substituted to the extent necessary to pay tax withholding or any government levies. The portion of performance shares settled in cash is classified as a share-based liability award. The fair value of these shares is remeasured at each reporting period and the related compensation expense is adjusted. The portion of performance shares payable in common stock is classified as a share-based equity award. Compensation expense related to these shares is based on the grant-date fair value. Performance shares expense is recognized ratably over the vesting period based on the fair values determined, except for awards granted to retirement-eligible participants, as discussed in "Stock-Based Compensation" in Note 1. Stock-based compensation expense associated with performance shares (including amounts capitalized) was \$1 million and \$11 million for the three months ended June 30, 2006 and 2005, respectively, and \$2 million and \$17 million for the six months ended June 30, 2006 and 2005, respectively.

The performance shares' fair value is determined using a Monte Carlo simulation valuation model. The Monte Carlo simulation valuation model requires a risk-free interest rate and an expected volatility rate assumption. The risk-free interest rate is based on a 52-week historical average of the three-year semi-annual coupon U.S. Treasury note and is used as proxy for the expected return for the specified group of companies. Volatility is based on the historical volatility of Edison International's common stock for the recent 36 months. Historical volatility for each company in the specified group is obtained from a financial data services provider.

Edison International's risk-free interest rate and expected volatility used to determine the grant date fair values for the 2006 and 2005 performance shares classified as share-based equity awards was 4.1% and 16.2%, respectively, and 2.7% and 27.7%, respectively. The portion of performance shares classified as share-based liability awards are revalued at each reporting period. The risk-free interest rate and expected volatility rate used to determine the fair value as of June 30, 2006 was 4.5% and 17.2%, respectively.

The total intrinsic value of performance shares settled during the quarters ended June 30, 2006 and 2005, was \$1 million and zero, respectively, which included cash paid to settle the performance shares classified as liability awards for the three months ended June 30, 2006 and 2005, of \$1 million and zero, respectively. The total intrinsic value of performance shares settled during the six months ended June 30, 2006 and 2005, was \$38 million and \$21 million, respectively, which included

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

cash paid to settle the performance shares classified as liability awards for the six months ended June 30, 2006 and 2005, of \$9 million and \$5 million, respectively. At June 30, 2006, there was \$7 million (based on the June 30, 2006 fair value of performance shares classified as liability awards) of total unrecognized compensation cost related to performance shares. That cost is expected to be recognized over a weighted-average period of less than 2 years. The fair values of performance shares vested during the quarters and six-month periods ended June 30, 2006 and 2005, were less than \$1 million and zero, respectively.

A summary of the status of Edison International nonvested performance shares granted to SCE employees and classified as equity awards is as follows:

	Performance Shares	Weighted-Average Grant-Date Fair Value	
		(Unaudited)	
Nonvested at, December 31, 2005	146,280	\$	39.08
Granted	47,240	\$	53.12
Forfeited	(1,697)	\$	36.53
Paid out	(5,057)	\$	39.77
<b>Nonvested at June 30, 2006</b>	<b>186,766</b>	<b>\$</b>	<b>42.58</b>

The weighted-average grant-date fair value of performance shares classified as equity awards granted during the six months ended June 30, 2005, was \$46.09.

A summary of the status of Edison International nonvested performance shares granted to SCE employees and classified as liability awards (the current portion is reflected in the caption "Other current liabilities" and the long-term portion is reflected in "Accumulated provision for pensions and benefits" on the consolidated balance sheets) is as follows:

	Performance Shares	Weighted-Average Fair Value	
		(Unaudited)	
Nonvested at, December 31, 2005	146,400		
Granted	47,307		
Forfeited	(1,699)		
Paid out	(5,058)		
<b>Nonvested at June 30, 2006</b>	<b>186,950</b>	<b>\$</b>	<b>76.06</b>

**Note 3. Contingencies**

In addition to the matters disclosed in these Notes, SCE is involved in other legal, tax and regulatory proceedings before various courts and governmental agencies regarding matters arising in the ordinary course of business. SCE believes the outcome of these other proceedings will not materially affect its results of operations or liquidity.

**2006 General Rate Case (GRC) Proceeding**

In December 2004, SCE filed its application for a 2006 GRC and subsequently revised its requested 2006 base rate revenue requirement to \$3.96 billion, an increase of \$465 million over SCE's 2005 base rate revenue. When a one-time credit of

## **SOUTHERN CALIFORNIA EDISON COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

\$140 million from an existing balancing account overcollection was applied, SCE's requested increase was \$325 million. SCE also proposed revised base rate revenue increases of \$108 million for 2007 and \$113 million for 2008.

On May 11, 2006, the CPUC issued its final decision authorizing an increase of \$274 million over SCE's 2005 base rate revenue, retroactive to January 12, 2006. When the one-time credit of \$140 million from an existing balancing account overcollection was applied, SCE's authorized increase was \$134 million. The CPUC also authorized increases of \$74 million in 2007 and \$104 million in 2008. The decision substantially approved SCE's request to continue its capital investment program for infrastructure replacement and expansion, with authorized revenue in excess of costs for this program subject to refund. In addition, the decision provided for balancing accounts for pensions, postretirement medical benefits and certain incentive compensation expenses.

During the second quarter of 2006, SCE implemented the 2006 GRC decision and resolved an outstanding regulatory issue which resulted in a pre-tax benefit of approximately \$175 million. The implementation of the 2006 GRC decision retroactive to January 12, 2006 mainly resulted in revenue of \$50 million related to the revenue requirement for the period January 12, 2006 through May 31, 2006, partially offset by the implementation of the new depreciation rates resulting in increased depreciation expense of approximately \$25 million for the period January 12, 2006 through May 31, 2006. In addition, there was a favorable resolution of a one-time issue related to a portion of revenue collected during the 2001–2003 period for state income taxes. SCE was able to determine through the 2006 GRC decision and other regulatory proceedings that the level of revenue collected during the period was appropriate, and as a result recorded a pre-tax gain of \$135 million.

#### ***Environmental Remediation***

SCE is subject to numerous environmental laws and regulations, which require it to incur substantial costs to operate existing facilities, construct and operate new facilities, and mitigate or remove the effect of past operations on the environment.

SCE believes that it is in substantial compliance with environmental regulatory requirements; however, possible future developments, such as the enactment of more stringent environmental laws and regulations, could affect the costs and the manner in which business is conducted and could cause substantial additional capital expenditures. There is no assurance that additional costs would be recovered from customers or that SCE's financial position and results of operations would not be materially affected.

SCE records its environmental remediation liabilities when site assessments and/or remedial actions are probable and a range of reasonably likely cleanup costs can be estimated. SCE reviews its sites and measures the liability quarterly, by assessing a range of reasonably likely costs for each identified site using currently available information, including existing technology, presently enacted laws and regulations, experience gained at similar sites, and the probable level of involvement and financial condition of other potentially responsible parties. These estimates include costs for site investigations, remediation, operations and maintenance, monitoring and site closure. Unless there is a probable amount, SCE records the lower end of this reasonably likely range of costs (classified as other long-term liabilities) at undiscounted amounts.

SCE's recorded estimated minimum liability to remediate its 24 identified sites is \$82 million. The ultimate costs to clean up SCE's identified sites may vary from its recorded liability due to numerous uncertainties inherent in the estimation process, such as: the extent and nature of contamination; the scarcity of reliable data for identified sites; the varying costs of alternative cleanup methods; developments resulting from investigatory studies; the possibility of identifying additional sites; and the time periods over which site remediation is expected to occur. SCE believes that, due to these uncertainties, it is reasonably possible that cleanup costs could exceed its recorded liability by up to \$117 million. The upper limit of this range

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

of costs was estimated using assumptions least favorable to SCE among a range of reasonably possible outcomes. In addition to its identified sites (sites in which the upper end of the range of costs is at least \$1 million), SCE also has 31 immaterial sites whose total liability ranges from \$4 million (the recorded minimum liability) to \$10 million.

The CPUC allows SCE to recover environmental remediation costs at certain sites, representing \$32 million of its recorded liability, through an incentive mechanism (SCE may request to include additional sites). Under this mechanism, SCE will recover 90% of cleanup costs through customer rates; shareholders fund the remaining 10%, with the opportunity to recover these costs from insurance carriers and other third parties. SCE has successfully settled insurance claims with all responsible carriers. SCE expects to recover costs incurred at its remaining sites through customer rates. SCE has recorded a regulatory asset of \$83 million for its estimated minimum environmental-cleanup costs expected to be recovered through customer rates.

SCE's identified sites include several sites for which there is a lack of currently available information, including the nature and magnitude of contamination and the extent, if any, that SCE may be held responsible for contributing to any costs incurred for remediating these sites. Thus, no reasonable estimate of cleanup costs can be made for these sites.

SCE expects to clean up its identified sites over a period of up to 30 years. Remediation costs in each of the next several years are expected to range from \$11 million to \$25 million. Recorded costs for the twelve months ended June 30, 2006 were \$14 million.

Based on currently available information, SCE believes it is unlikely that it will incur amounts in excess of the upper limit of the estimated range for its identified sites and, based upon the CPUC's regulatory treatment of environmental remediation costs, SCE believes that costs ultimately recorded will not materially affect its results of operations or financial position. There can be no assurance, however, that future developments, including additional information about existing sites or the identification of new sites, will not require material revisions to such estimates.

***Federal and State Income Taxes***

Edison International received Revenue Agent Reports from the Internal Revenue Service (IRS) in August 2002 and in January 2005 asserting deficiencies in federal corporate income taxes with respect to audits of its 1994–1996 and 1997–1999 tax years, respectively. Many of the asserted tax deficiencies are timing differences and, therefore, amounts ultimately paid (exclusive of penalties), if any, would benefit SCE as future tax deductions.

The IRS Revenue Agent Report for the 1997–1999 audit also asserted deficiencies with respect to a transaction entered into by an SCE subsidiary which may be considered substantially similar to a listed transaction described by the IRS as a contingent liability company. While Edison International intends to defend its tax return position with respect to this transaction, the tax benefits relating to the capital loss deductions will not be claimed for financial accounting and reporting purposes until and unless these tax losses are sustained.

In April 2004, Edison International filed California Franchise Tax amended returns for tax years 1997 through 2002 to abate the possible imposition of new California penalty provisions on transactions that may be considered as listed or substantially similar to listed transactions described in an IRS notice that was published in 2001. These transactions include the SCE subsidiary contingent liability company transaction described above. Edison International filed these amended returns under protest retaining its appeal rights.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

***Federal Energy Regulatory Commission (FERC) Refund Proceedings***

In 2000, the FERC initiated an investigation into the justness and reasonableness of rates charged by sellers of electricity in the California Power Exchange (PX) and California Independent System Operator (ISO) markets. On March 26, 2003, the FERC staff issued a report concluding that there had been pervasive gaming and market manipulation of both the electric and natural gas markets in California and on the West Coast during 2000–2001 and describing many of the techniques and effects of that market manipulation. SCE is participating in several related proceedings seeking recovery of refunds from sellers of electricity and natural gas who manipulated the electric and natural gas markets. SCE is required to refund to customers 90% of any refunds actually realized by SCE net of litigation costs, except for the El Paso Natural Gas Company settlement agreement (see discussion in Note 9 of “Notes to Consolidated Financial Statements” in Edison International’s 2005 Annual Report), and 10% will be retained by SCE as a shareholder incentive. A brief summary of the various settlements is below:

- In November 2005, the FERC approved a settlement agreement among SCE, Pacific Gas and Electric (PG&E) and San Diego Gas & Electric (SDG&E) and several governmental entities, and Enron Corporation and a number of its affiliates (collectively Enron), most of which are debtors in Chapter 11 bankruptcy proceedings pending in New York. In January 2006, SCE received cash settlement proceeds of \$4 million and anticipates receiving approximately \$5 million in additional cash proceeds assuming certain contingencies are satisfied. SCE also received an allowed, unsecured claim against one of the Enron debtors in the amount of \$241 million. In February 2006, SCE received a partial distribution of \$10 million of its allowed claim. In April 2006, SCE received a distribution on its allowed bankruptcy claim against one of the Enron debtors of approximately \$29 million, and 196,245 shares of common stock of Portland General Electric Company with an aggregate value of approximately \$5 million. The remaining amount of the allowed claim that will actually be realized will depend on events in Enron’s bankruptcy that impact the value of the relevant debtor estate.
- In December 2005, the FERC approved a settlement agreement among SCE, PG&E, SDG&E, several governmental entities and certain other parties, and Reliant Energy, Inc. and a number of its affiliates. In January 2006, SCE received its \$65 million share of the settlement proceeds. In March 2006, SCE received an additional \$61 million.

On November 19, 2004, the CPUC issued a resolution authorizing SCE to establish an energy settlement memorandum account (ESMA) for the purpose of recording the foregoing settlement proceeds from energy providers and allocating them in accordance with a settlement agreement. The resolution provides a mechanism whereby portions of the settlement proceeds recorded in the ESMA are allocated to recovery of SCE’s litigation costs and expenses in the FERC refund proceedings described above and the 10% shareholder incentive. Remaining amounts for each settlement are to be refunded to ratepayers through the energy resource recovery account mechanism. During 2005, SCE recognized \$23 million in shareholder incentives related to the FERC refunds described above.

On August 2, 2006, the United States Court of Appeals for the Ninth Circuit issued an opinion regarding the scope of refunds issued by the FERC. The Ninth Circuit widened the time period during which refunds could be issued to include the summer of 2000 for tariff violations and broadened the categories of transactions that could be subject to refund. The Ninth Circuit also held that the FERC’s company-specific, nonpublic investigations could not prevent parties from seeking relief through litigation. As a result of this decision, SCE may be able to recover additional refunds from sellers of electricity who manipulated the electric markets.

***Investigations Regarding Performance Incentives Rewards***

SCE is eligible under its CPUC-approved performance-based ratemaking (PBR) mechanism to earn rewards or penalties based on its performance in comparison to CPUC-approved standards of customer satisfaction, employee injury and illness reporting, and system reliability.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

SCE has been conducting investigations into its performance under these PBR mechanisms and has reported to the CPUC certain findings of misconduct and misreporting as further discussed below.

*Customer Satisfaction*

SCE received two letters in 2003 from one or more anonymous employees alleging that personnel in the service planning group of SCE's transmission and distribution business unit altered or omitted data in attempts to influence the outcome of customer satisfaction surveys conducted by an independent survey organization. The results of these surveys are used, along with other factors, to determine the amounts of any incentive rewards or penalties for customer satisfaction. SCE recorded aggregate customer satisfaction rewards of \$28 million for the years 1998, 1999 and 2000. Potential customer satisfaction rewards aggregating \$10 million for the years 2001 and 2002 are pending before the CPUC and have not been recognized in income by SCE. SCE also anticipated that it could be eligible for customer satisfaction rewards of approximately \$10 million for 2003.

Following its internal investigation, SCE proposed to refund to ratepayers \$7 million of the PBR rewards previously received and forgo an additional \$5 million of the PBR rewards pending that are both attributable to the design organization's portion of the customer satisfaction rewards for the entire PBR period (1997–2003). In addition, SCE also proposed to refund all of the approximately \$2 million of customer satisfaction rewards associated with meter reading. As a result of these findings, SCE accrued a \$9 million charge in 2004 for the potential refunds of rewards that have been received.

SCE has taken remedial action as to the customer satisfaction survey misconduct by disciplining employees and terminating the employment of employees, including several supervisory personnel, updating system process and related documentation for survey reporting, and implementing additional supervisory controls over data collection and processing. Performance incentive rewards for customer satisfaction expired in 2003 pursuant to the 2003 GRC.

*Employee Injury and Illness Reporting*

In light of the problems uncovered with the customer satisfaction surveys, SCE conducted an investigation into the accuracy of SCE's employee injury and illness reporting. The yearly results of employee injury and illness reporting to the CPUC are used to determine the amount of the incentive reward or penalty to SCE under the PBR mechanism. Since the inception of PBR in 1997, SCE has received \$20 million in employee safety incentives for 1997 through 2000 and, based on SCE's records, may be entitled to an additional \$15 million for 2001 through 2003.

On October 21, 2004, SCE reported to the CPUC and other appropriate regulatory agencies certain findings concerning SCE's performance under the PBR incentive mechanism for injury and illness reporting. SCE disclosed in the investigative findings to the CPUC that SCE failed to implement an effective recordkeeping system sufficient to capture all required data for first aid incidents.

As a result of these findings, SCE proposed to the CPUC that it not collect any reward under the mechanism and return to ratepayers the \$20 million it has already received. Therefore, SCE accrued a \$20 million charge in 2004 for the potential refund of these rewards. SCE has also proposed to withdraw the pending rewards for the 2001–2003 time frames.

SCE has taken remedial action to address the issues identified, including revising its organizational structure and overall program for environmental, health and safety compliance, disciplining employees who committed wrongdoing and terminating an employee. SCE submitted a report on the results of its investigation to the CPUC on December 3, 2004.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*CPUC Investigation*

On June 15, 2006, the CPUC instituted a formal investigation to determine whether and in what amounts to order refunds or disallowances of past and potential PBR rewards for customer satisfaction, injury and illness reporting, and system reliability portions of PBR. The CPUC also may consider whether to impose additional penalties on SCE.

Also on June 15, 2006, the Consumer Protection and Safety Division (CPSD) of the CPUC also issued its report regarding SCE's PBR program. In that report, the CPSD recommended that the CPUC order SCE to (1) implement the commitments SCE made in its internal investigations to refund and forgo earned and pending rewards totaling \$14 million for the service planning and meter reading customer satisfaction components of PBR and totaling \$35 million for the safety component of PBR; (2) pay an additional \$56 million, based on the assumption that, absent the data falsification and inadequate recordkeeping, SCE's planning and meter reading customer satisfaction performance would have incurred the maximum PBR penalty (\$21 million), and its safety performance would have incurred the maximum PBR penalty (\$35 million); (3) investigate the other customer satisfaction components of SCE's PBR program, including phone center, in-person services, and field delivery services, and order SCE to refund an as yet unquantified amount; (4) refund other, as yet unquantified, ratepayer costs; and (5) pay as yet unquantified statutory fines for alleged improper administration of the PBR program and alleged filing of misleading information. If imposed, such fines could range from \$500 to \$20,000 per day for each action determined to be a violation, over the seven years during which the PBR program was in effect.

Evidentiary hearings which will address the planning and meter reading components of customer satisfaction, safety, issues related to SCE's administration of the survey, and statutory fines associated with those matters are scheduled to take place in the fourth quarter of 2006. A schedule has not been set to address the other components of customer satisfaction, system reliability, and other issues. SCE cannot predict the outcome of these matters or estimate the potential amount of any additional refunds, disallowances, or penalties that may be required.

*ISO Disputed Charges*

On April 20, 2004, the FERC issued an order concerning a dispute between the ISO and the Cities of Anaheim, Azusa, Banning, Colton and Riverside, California over the proper allocation and characterization of certain transmission service related charges. The order reversed an arbitrator's award that had affirmed the ISO's characterization in May 2000 of the charges as Intra-Zonal Congestion costs and allocation of those charges to schedule coordinators in the affected zone within the ISO transmission grid. The April 20, 2004 order directed the ISO to shift the costs from schedule coordinators in the affected zone to the responsible participating transmission owner, SCE. The potential cost to SCE, net of amounts SCE expects to receive through the PX, SCE's schedule coordinator at the time, is estimated to be approximately \$20 million to \$25 million, including interest. On April 20, 2005, the FERC stayed its April 20, 2004 order during the pendency of SCE's appeal filed with the Court of Appeals for the D.C. Circuit. On March 7, 2006, the Court of Appeals remanded the case back to the FERC at the FERC's request and with SCE's consent. A decision is expected in late 2006. The FERC may require SCE to pay these costs, but SCE does not believe this outcome is probable. If SCE is required to pay these costs, SCE may seek recovery in its reliability service rates.

*Navajo Nation Litigation*

In June 1999, the Navajo Nation filed a complaint in the United States District Court for the District of Columbia (D.C. District Court) against Peabody Holding Company (Peabody) and certain of its affiliates, Salt River Project Agricultural Improvement and Power District, and SCE arising out of the coal supply agreement for the Mohave Generating Station (Mohave). The complaint asserts claims for, among other things, violations of the federal Racketeer Influenced and Corrupt

## **SOUTHERN CALIFORNIA EDISON COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Organizations statute, interference with fiduciary duties and contractual relations, fraudulent misrepresentation by nondisclosure, and various contract-related claims. The complaint claims that the defendants' actions prevented the Navajo Nation from obtaining the full value in royalty rates for the coal supplied to Mohave. The complaint seeks damages of not less than \$600 million, trebling of that amount, and punitive damages of not less than \$1 billion, as well as a declaration that Peabody's lease and contract rights to mine coal on Navajo Nation lands should be terminated. SCE joined Peabody's motion to strike the Navajo Nation's complaint. In addition, SCE and other defendants filed motions to dismiss. The D.C. District Court denied these motions for dismissal, except for Salt River Project Agricultural Improvement and Power District's motion for its separate dismissal from the lawsuit.

Certain issues related to this case were addressed by the United States Supreme Court in a separate legal proceeding filed by the Navajo Nation in the United States Court of Federal Claims against the United States Department of Interior. In that action, the Navajo Nation claimed that the Government breached its fiduciary duty concerning negotiations relating to the coal lease involved in the Navajo Nation's lawsuit against SCE and Peabody. On March 4, 2003, the Supreme Court concluded, by majority decision, that there was no breach of a fiduciary duty and that the Navajo Nation did not have a right to relief against the Government. Based on the Supreme Court's conclusion, SCE and Peabody brought motions to dismiss or for summary judgment in the D.C. District Court action but the D.C. District Court denied the motions on April 13, 2004.

The Court of Appeals for the Federal Circuit, acting on a suggestion filed by the Navajo Nation on remand from the Supreme Court's March 4, 2003 decision held, in an October 24, 2003 decision, that the Supreme Court's decision was focused on three specific statutes or regulations and therefore did not address the question of whether a network of other statutes, treaties and regulations imposed judicially enforceable fiduciary duties on the United States during the time period in question. On March 16, 2004, the Federal Circuit issued an order remanding the case against the Government to the Court of Federal Claims, which considered (1) whether the Navajo Nation previously waived its "network of other laws" argument and, (2) if not, whether the Navajo Nation can establish that the Government breached any fiduciary duties pursuant to such "network." On December 20, 2005, the Court of Federal Claims issued its ruling and found that although there was no waiver, the Navajo Nation did not establish that a "network of other laws" created a judicially enforceable trust obligation. The Navajo Nation filed a notice of appeal from this ruling on February 14, 2006. The Navajo Nation's opening brief was filed on June 7, 2006 and the Government filed its brief on July 20, 2006. No date for oral argument has been set.

Pursuant to a joint request of the parties, the D.C. District Court granted a stay of the action in that court to allow the parties to attempt to resolve, through facilitated negotiations, all issues associated with Mohave. Negotiations are ongoing and the stay has been continued until further order of the court.

SCE cannot predict the outcome of the 1999 Navajo Nation's complaint against SCE, the impact on the complaint of the Supreme Court's decision and the December 2005 Court of Federal Claims ruling in the Navajo Nation's suit against the Government, or the impact on the facilitated negotiations of SCE's recently announced decision to discontinue efforts to return Mohave to service.

#### ***Nuclear Insurance***

Federal law limits public liability claims from a nuclear incident to \$10.8 billion. SCE and other owners of San Onofre Nuclear Generating Station (San Onofre) and Palo Verde Nuclear Generating Station (Palo Verde) have purchased the maximum private primary insurance available (\$300 million). The balance is covered by the industry's retrospective rating plan that uses deferred premium charges to every reactor licensee if a nuclear incident at any licensed reactor in the United States results in claims and/or costs which exceed the primary insurance at that plant site. Federal regulations require this

## **SOUTHERN CALIFORNIA EDISON COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

secondary level of financial protection. The Nuclear Regulatory Commission exempted San Onofre Unit 1 from this secondary level, effective June 1994. The current maximum deferred premium for each nuclear incident is \$101 million per reactor, but not more than \$15 million per reactor may be charged in any one year for each incident. The maximum deferred premium per reactor and the yearly assessment per reactor for each nuclear incident will be adjusted for inflation on a 5-year schedule. The next inflation adjustment will occur on August 31, 2008. Based on its ownership interests, SCE could be required to pay a maximum of \$199 million per nuclear incident. However, it would have to pay no more than \$30 million per incident in any one year. Such amounts include a 5% surcharge if additional funds are needed to satisfy public liability claims and are subject to adjustment for inflation. If the public liability limit above is insufficient, federal regulations may impose further revenue-raising measures to pay claims, including a possible additional assessment on all licensed reactor operators.

Property damage insurance covers losses up to \$500 million, including decontamination costs, at San Onofre and Palo Verde. Decontamination liability and property damage coverage exceeding the primary \$500 million also has been purchased in amounts greater than federal requirements. Additional insurance covers part of replacement power expenses during an accident-related nuclear unit outage. A mutual insurance company owned by utilities with nuclear facilities issues these policies. If losses at any nuclear facility covered by the arrangement were to exceed the accumulated funds for these insurance programs, SCE could be assessed retrospective premium adjustments of up to \$42 million per year. Insurance premiums are charged to operating expense.

#### ***Procurement of Renewable Resources***

California law requires SCE to increase its procurement of renewable resources by at least 1% of its annual retail electricity sales per year so that 20% of its annual electricity sales are procured from renewable resources by no later than December 31, 2017. The Joint Energy Action Plan adopted in 2003 by the CPUC and the California Energy Commission (CEC) accelerated the deadline to 2010.

SCE entered into a contract with Calpine Energy Services, L.P. (Calpine) to purchase the output of certain existing geothermal facilities in northern California. On January 30, 2003, the CPUC issued a resolution approving the contract. SCE interpreted the resolution as authorizing SCE to count all of the output of the geothermal facilities towards the obligation to increase SCE's procurement from renewable resources and counted the entire output of the facilities toward its 1% obligation in 2003, 2004 and 2005. On July 21, 2005, the CPUC issued a decision stating that SCE can only count procurement pursuant to the Calpine contract towards its 1% annual renewable procurement requirement if it is certified as "incremental" by the CEC. On February 1, 2006, the CEC certified approximately 25% and 17% of SCE's 2003 and 2004 procurement, respectively, from the Calpine geothermal facilities as "incremental." A similar outcome is anticipated with respect to the CEC's certification review for 2005.

On August 26, 2005, SCE filed an application for rehearing and a petition for modification of the CPUC's July 21, 2005 decision. On January 26, 2006, the CPUC denied SCE's application for rehearing of the decision. On May 25, 2006, the CPUC issued a decision denying SCE's petition for modification.

SCE could have deficits in meeting its renewable procurement obligations for 2003 and 2004. However, based on the CPUC's rules for compliance with renewable procurement targets, SCE may have until 2007 to make up these deficits before becoming subject to penalties for those years or may not have deficits at all. The CEC's and the CPUC's treatment of the output from the geothermal facilities could also result in SCE being deemed to be out of compliance in 2005 and 2006.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Under current CPUC decisions, potential penalties for SCE's failure to achieve its renewable procurement obligations for any year will be considered by the CPUC in the context of the CPUC's review of SCE's annual compliance filing. Under the CPUC's current rules, the maximum penalty for failing to achieve renewable procurement targets is \$25 million per year. SCE cannot predict whether it will be assessed penalties.

***Scheduling Coordinator Tariff Dispute***

SCE serves as a scheduling coordinator for the Los Angeles DWP over the ISO-controlled grid. In late 2003, SCE began charging the DWP under a tariff subject to refund for FERC-authorized charges incurred by SCE on the DWP's behalf. The scheduling coordinator charges are billed to the DWP under a FERC tariff that remains subject to dispute. The DWP has paid the amounts billed under protest but requested that FERC declare that SCE was obligated to serve as the DWP's scheduling coordinator without charge. The FERC accepted SCE's tariff for filing, but held that the rates charged to the DWP have not been shown to be just and reasonable and thus made them subject to refund and further review by the FERC. As a result, SCE could be required to refund all or part of the amounts collected from the DWP under the tariff. As of June 30, 2006, SCE has accrued a \$31 million charge to earnings for the potential refunds. If the FERC ultimately rules that SCE may not collect the scheduling coordinator charges from the DWP and requires the amounts collected to be refunded to the DWP, SCE would attempt to recover the scheduling coordinator charges from all transmission grid customers through another regulatory mechanism. However, the availability of other recovery mechanisms is uncertain, and ultimate recovery of the scheduling coordinator charges cannot be assured.

***Settlement Agreement with Duke Energy Trading and Marketing, LLC***

On May 10, 2006, SCE filed an application with the CPUC for approval of a settlement agreement between SCE and Duke Energy Trading and Marketing, LLC (DETM) that resolves disputes arising from DETM's termination of certain bilateral power supply contracts in early 2001. Under the settlement, DETM will make principal and interest payments to SCE of approximately \$75 million, which SCE proposes will be refunded to ratepayers through the energy resource recovery account mechanism. The settlement, once approved, will also permit \$58 million in liabilities that SCE had previously recorded with respect to the DETM terminated contracts to be reversed, which will result in an equivalent gain being recorded by SCE. SCE's application to the CPUC requests that this gain not be refunded to ratepayers since these liabilities were not funded by ratepayers. The recorded liabilities consist of \$40 million in cash collateral received from DETM in 2000 and \$18 million in power purchase payments that SCE, in light of DETM's termination of the bilateral contracts, withheld for energy delivered by DETM in January 2001. A decision on SCE's application for approval of the settlement is not expected until the end of 2006 or early 2007. SCE cannot predict the outcome of this matter.

***Spent Nuclear Fuel***

Under federal law, the United States Department of Energy (DOE) is responsible for the selection and construction of a facility for the permanent disposal of spent nuclear fuel and high-level radioactive waste. The DOE did not meet its obligation to begin acceptance of spent nuclear fuel not later than January 31, 1998. It is not certain when the DOE will begin accepting spent nuclear fuel from San Onofre or other nuclear power plants. Extended delays by the DOE have led to the construction of costly alternatives and associated siting and environmental issues. SCE has paid the DOE the required one-time fee applicable to nuclear generation at San Onofre through April 6, 1983 (approximately \$24 million, plus interest). SCE is also paying the required quarterly fee equal to 0.1¢-per-kWh of nuclear-generated electricity sold after April 6, 1983. On January 29, 2004, SCE, as operating agent, filed a complaint against the DOE in the United States Court of Federal Claims seeking damages for the DOE's failure to meet its obligation to begin accepting spent nuclear fuel from San Onofre. The case

## **SOUTHERN CALIFORNIA EDISON COMPANY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

was stayed through April 7, 2006, when SCE and the DOE filed a Joint Status Report in which SCE sought to lift the stay and the government opposed lifting the stay. On June 5, 2006, the Court of Federal Claims lifted the stay on SCE's case and established a discovery schedule. A Joint Status Report is due on September 7, 2007 regarding further proceedings in this case presumably including establishing a trial date.

SCE has primary responsibility for the interim storage of spent nuclear fuel generated at San Onofre. Spent nuclear fuel is stored in the San Onofre Units 2 and 3 spent fuel pools and the San Onofre independent spent fuel storage installation where all of Unit 1's spent fuel located at San Onofre is stored. There is now sufficient space in the Unit 2 and 3 spent fuel pools to meet plant requirements through mid-2007 and mid-2008, respectively. In order to maintain a full core off-load capability, SCE is planning to begin moving Unit 2 and 3 spent fuel into the independent spent fuel storage installation by early 2007.

In order to increase on-site storage capacity and maintain core off-load capability, Palo Verde has constructed a dry cask storage facility. Arizona Public Service, as operating agent, plans to continually load casks on a schedule to maintain full core off-load capability for all three units.

#### **Note 4. Commitments**

The following is an update to SCE's commitments. See Note 8 of "Notes to Consolidated Financial Statements" included in SCE's 2005 Annual Report for a detailed discussion.

#### ***Fuel Supply Commitments***

During the first quarter of 2006, the nuclear fuel commitments increased due to the additional costs associated with uranium enrichment and fuel fabrication services. SCE's additional nuclear fuel commitments are currently estimated to be: 2006 – \$9 million; 2007 – \$6 million; 2008 – \$4 million; 2009 – \$8 million; and 2010 – \$2 million.

#### ***Leases and Power-Purchase Contracts***

During the second quarter of 2006, SCE modified and extended two power-purchase contracts. Since unit-specific contracts (signed or modified after June 30, 2003) in which SCE takes virtually all of the output of a facility are generally considered to be leases under accounting rules, as a result of this modification SCE reclassified these power-purchase contracts to operating lease commitments. SCE's power purchase obligations in 2006 and 2007 decreased and operating lease obligations increased by \$11 million and \$19 million, respectively. As a result of the extension of the contracts the operating lease commitments increased in 2008 and 2009 by \$23 million for each year.

#### ***Indemnities***

In connection with the acquisition of Mountainview, SCE agreed to indemnify the seller with respect to specific environmental claims related to SCE's previously owned San Bernardino Generating Station, divested by SCE in 1998 and reacquired as part of the Mountainview acquisition. The generating station has not operated since 2001. SCE retained certain responsibilities with respect to environmental claims as part of the original divestiture of the station. The aggregate liability for either party to the purchase agreement for damages and other amounts is a maximum of \$60 million. This indemnification for environmental liabilities expires on or before March 12, 2033. SCE has not recorded a liability related to this indemnity.

SCE provides other indemnifications through contracts entered into in the normal course of business. These are primarily indemnifications against adverse litigation outcomes in connection with underwriting agreements, and specified

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

environmental indemnities and income taxes with respect to assets sold. SCE's obligations under these agreements may be limited in terms of time and/or amount, and in some instances SCE may have recourse against third parties for certain indemnities. The obligated amounts of these indemnifications often are not explicitly stated, and the overall maximum amount of the obligation under these indemnifications cannot be reasonably estimated. SCE has not recorded a liability related to these indemnities.

**Note 5. Business Segments**

SCE's reportable business segments include the rate-regulated electric utility segment and the variable interest entities (VIEs) segment. The VIEs were consolidated as of March 31, 2004. Additional details on the VIE segment are in Note 1 of "Notes to Consolidated Financial Statements" included in SCE's 2005 Annual Report. The VIEs are gas-fired power plants that sell both electricity and steam. The VIE segment consists of non-rate-regulated entities (all in California). SCE's management has no control over the resources allocated to the VIE segment and does not make decisions about its performance.

SCE's business segment information including all line items with VIE activities, is:

In millions	Electric Utility	VIEs	Eliminations	SCE
	(Unaudited)			
<b>Balance Sheet Items as of June 30, 2006:</b>				
Cash and equivalents	\$ 12	\$ 78	\$ —	\$ 90
Accounts receivable – net	994	140	(108)	1,026
Inventory	222	19	—	241
Other current assets	67	2	—	69
Nonutility property – net of depreciation	734	331	—	1,065
Other long-term assets	337	9	—	346
<b>Total assets</b>	<b>24,872</b>	<b>579</b>	<b>(108)</b>	<b>25,343</b>
Accounts payable	783	119	(108)	794
Accrued interest	124	1	—	125
Other current liabilities	483	2	—	485
Long-term debt	4,998	54	—	5,052
Asset retirement obligations	2,647	13	—	2,660
Minority interest	—	390	—	390
<b>Total liabilities and shareholders' equity</b>	<b>24,872</b>	<b>579</b>	<b>(108)</b>	<b>25,343</b>
<b>Balance Sheet Items as of December 31, 2005:</b>				
Cash and equivalents	\$ 23	\$ 120	\$ —	\$ 143
Accounts receivable – net	794	174	(119)	849
Inventory	202	18	—	220
Other current assets	88	4	—	92
Nonutility property – net of depreciation	741	345	—	1,086
Other long-term assets	493	10	—	503
<b>Total assets</b>	<b>24,151</b>	<b>671</b>	<b>(119)</b>	<b>24,703</b>
Accounts payable	813	204	(119)	898
Other current liabilities	721	2	—	723
Long-term debt	4,615	54	—	4,669
Asset retirement obligations	2,608	13	—	2,621
Minority interest	—	398	—	398
<b>Total liabilities and shareholders' equity</b>	<b>24,151</b>	<b>671</b>	<b>(119)</b>	<b>24,703</b>

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

In millions	Electric Utility	VIEs	Eliminations*	SCE
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Three Months Ended June 30, 2006:</b>				
Operating revenue	\$ 2,435	\$ 263	\$ (177)	\$ 2,521
Fuel	76	161	—	237
Purchased power	946	—	(177)	769
Other operation and maintenance	613	26	—	639
Depreciation, decommissioning and amortization	291	9	—	300
Total operating expenses	1,966	196	(177)	1,985
Operating income	469	67	—	536
Minority interest	—	67	—	67
<b>Net income</b>	<b>247</b>	<b>—</b>	<b>—</b>	<b>247</b>
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Six Months Ended June 30, 2006:</b>				
Operating revenue	\$ 4,535	\$ 572	\$ (368)	\$ 4,739
Fuel	163	385	—	548
Purchased power	2,151	—	(368)	1,783
Other operation and maintenance	1,202	52	—	1,254
Depreciation, decommissioning and amortization	534	18	—	552
Total operating expenses	3,783	455	(368)	3,870
Operating income	752	117	—	869
Minority interest	—	117	—	117
<b>Net income</b>	<b>380</b>	<b>—</b>	<b>—</b>	<b>380</b>
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Three Months Ended June 30, 2005:</b>				
Operating revenue	\$ 2,101	\$ 323	\$ (221)	\$ 2,203
Fuel	60	205	—	265
Purchased power	964	—	(221)	743
Other operation and maintenance	546	24	—	570
Depreciation, decommissioning and amortization	222	9	—	231
Total operating expenses	1,798	238	(221)	1,815
Operating income	303	85	—	388
Minority interest	—	85	—	85
<b>Net income</b>	<b>166</b>	<b>—</b>	<b>—</b>	<b>166</b>
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Six Months Ended June 30, 2005:</b>				
Operating revenue	\$ 3,907	\$ 597	\$ (394)	\$ 4,110
Fuel	122	398	—	520
Purchased power	1,525	—	(394)	1,131
Other operation and maintenance	1,121	48	—	1,169
Depreciation, decommissioning and amortization	435	19	—	454
Total operating expenses	3,324	465	(394)	3,395
Operating income	583	132	—	715
Minority interest	—	132	—	132
<b>Net income</b>	<b>298</b>	<b>—</b>	<b>—</b>	<b>298</b>

\* VIE segment revenue includes sales to the electric utility segment, which is eliminated in revenue and purchased power in the consolidated statements of income.

**SOUTHERN CALIFORNIA EDISON COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 6. Liabilities and Lines of Credit**

Short-term debt is used to finance fuel inventories, balancing account undercollections and general, temporary cash requirements. At June 30, 2006, the outstanding short-term debt and weighted-average interest rate was \$518 million at 5.35%. This short-term debt is supported by a credit line.

**Note 7. Preferred and Preference Stock Not Subject to Mandatory Redemption**

In January 2006, SCE issued two million shares of 6.0% Series C preference stock (non-cumulative, \$100 liquidation value) and received net proceeds of \$197 million. The Series C preference stock may not be redeemed prior to January 31, 2011. After January 31, 2011, SCE may, at its option, redeem the shares in whole or in part. The Series C preference stock has the same general characteristics as the Series A and B preference stock. Additional details on preference stock are in Note 4 of "Notes to Consolidated Financial Statements" included in SCE's 2005 Annual Report.

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

### INTRODUCTION

This Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A) for the three- and six-month periods ended June 30, 2006 discusses material changes in the financial condition, results of operations and other developments of Southern California Edison Company (SCE) since December 31, 2005, and as compared to the three- and six-month periods ended June 30, 2005. This discussion presumes that the reader has read or has access to SCE's MD&A for the calendar year 2005 (the year-ended 2005 MD&A), which was included in SCE's 2005 annual report to shareholders and incorporated by reference into SCE's Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission.

This MD&A contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements reflect SCE's current expectations and projections about future events based on SCE's knowledge of present facts and circumstances and assumptions about future events and include any statement that does not directly relate to a historical or current fact. Other information distributed by SCE that is incorporated in this report, or that refers to or incorporates this report, may also contain forward-looking statements. In this report and elsewhere, the words "expects," "believes," "anticipates," "estimates," "projects," "intends," "plans," "probable," "may," "will," "could," "would," "should," and variations of such words and similar expressions, or discussions of strategy or of plans, are intended to identify forward-looking statements. Such statements necessarily involve risks and uncertainties that could cause actual results to differ materially from those anticipated. Some of the risks, uncertainties and other important factors that could cause results to differ, or that otherwise could impact SCE, include, but are not limited to:

- the ability of SCE to recover its costs in a timely manner from its customers through regulated rates;
- decisions and other actions by the California Public Utilities Commission (CPUC) and other regulatory authorities and delays in regulatory actions;
- market risks affecting SCE's energy procurement activities;
- access to capital markets and the cost of capital;
- changes in interest rates and rates of inflation;
- governmental, statutory, regulatory or administrative changes or initiatives affecting the electricity industry, including the market structure rules applicable to each market and environmental regulations that could require additional expenditures or otherwise affect the cost and manner of doing business;
- risks associated with operating nuclear and other power generating facilities, including operating risks, nuclear fuel storage, equipment failure, availability, heat rate and output;
- the availability of labor, equipment and materials;
- the ability to obtain sufficient insurance, including insurance relating to SCE's nuclear facilities;
- effects of legal proceedings, changes in or interpretations of tax laws, rates or policies, and changes in accounting standards;
- the cost and availability of coal, natural gas, fuel oil, nuclear fuel, and associated transportation;
- the ability to provide sufficient collateral in support of hedging activities and purchased power and fuel;
- general political, economic and business conditions;
- weather conditions, natural disasters and other unforeseen events; and
- changes in the fair value of investments and other assets.

Additional information about risks and uncertainties, including more detail about the factors described above, are discussed throughout this MD&A and in the “Risk Factors” section included in Part I, Item 1A of SCE’s Annual Report on Form 10-K for the year ended December 31, 2005. Readers are urged to read this entire report, including the information incorporated by reference, and carefully consider the risks, uncertainties and other factors that affect SCE’s business. Forward-looking statements speak only as of the date they are made and SCE is not obligated to publicly update or revise forward-looking statements. Readers should review future reports filed by SCE with the Securities and Exchange Commission.

This MD&A includes information about SCE, an investor-owned utility company providing electricity to retail customers in central, coastal and southern California. SCE is regulated by the CPUC and the Federal Energy Regulatory Commission (FERC).

This MD&A is presented in eight major sections. The MD&A begins with a discussion of current developments. The remaining sections of the MD&A include: liquidity; regulatory matters; other developments; market risk exposures; results of operations and historical cash flow analysis; new accounting pronouncements; and commitments, guarantees and indemnities.

## **CURRENT DEVELOPMENTS**

### **2006 General Rate Case Proceeding**

On May 11, 2006, the CPUC issued its final decision authorizing an increase of \$274 million over SCE’s 2005 base rate revenue, retroactive to January 12, 2006. The CPUC also authorized increases of \$74 million in 2007 and \$104 million in 2008. See “Regulatory Matters—Current Regulatory Developments—2006 General Rate Case Proceeding” for further discussion.

### **2006 FERC Rate Case**

On July 6, 2006, the FERC approved a settlement that set a revenue requirement of \$312 million, which increases SCE’s revenue requirement by \$26 million over current base transmission rates. See “Regulatory Matters—Current Regulatory Developments—2006 FERC Rate Case” for further discussion.

### **Mohave Generating Station and Related Proceedings**

On June 19, 2006, SCE announced that it had decided not to move forward with its efforts to return Mohave to service. SCE’s decision was not based on any one factor, but resulted from the conclusion that in light of all the significant unresolved challenges related to returning the plant to service, the plant could not be returned to service in sufficient time to render the necessary investments cost-effective for SCE’s customers. See “Regulatory Matters—Current Regulatory Developments—Mohave Generating Station and Related Proceedings” for further discussion.

## **LIQUIDITY**

### **Overview**

As of June 30, 2006, SCE had cash and equivalents of \$90 million (\$78 million of which was held by SCE’s consolidated Variable Interest Entities). As of June 30, 2006, long-term debt, including current maturities of long-term debt, was \$5.3 billion. In December 2005, SCE replaced its \$1.25 billion credit facility with a \$1.7 billion five-year senior secured credit facility. The security pledged (first and refunding mortgage bonds) for the new facility can be removed at SCE’s discretion. If SCE chooses to remove the security, the credit facility’s pricing will change to an unsecured basis per the terms of the credit facility agreement. As of June 30, 2006, SCE’s credit facility supported \$236 million in letters of credit and \$518 million of commercial paper outstanding, leaving \$946 million available under the credit facility.

SCE's estimated cash outflows during the twelve-month period following June 30, 2006 consist of:

- Debt maturities of approximately \$247 million of rate reduction notes that have a separate nonbypassable recovery mechanism approved by state legislation and CPUC decisions;
- Projected capital expenditures primarily to replace and expand distribution and transmission infrastructure and construct generation assets;
- Dividend payments to SCE's parent company. SCE made dividend payments to Edison International of \$71 million on January 16, 2006, and \$60 million on both April 28, 2006 and July 24, 2006;
- Fuel and procurement-related costs (see "Regulatory Matters—Current Regulatory Developments—Energy Resource Recovery Account Proceedings"); and
- General operating expenses.

SCE expects to meet its continuing obligations, including cash outflows for operating expenses, including power-procurement, through cash and equivalents on hand, operating cash flows and short-term borrowings, when necessary. Projected capital expenditures are expected to be financed through operating cash flows and the issuance of short-term and long-term debt and preferred equity.

SCE's liquidity may be affected by, among other things, matters described in "Regulatory Matters."

### **Credit Ratings**

At June 30, 2006, SCE's credit rating on long-term senior secured debt from Standard & Poor's Rating Services and Moody's Investors Service were BBB+ and A3, respectively. At June 30, 2006, SCE's short-term (commercial paper) credit ratings from Standard & Poor's and Moody's were A-2 and P-2, respectively.

### **Dividend Restrictions and Debt Covenants**

The CPUC regulates SCE's capital structure and limits the dividends it may pay Edison International. In SCE's most recent cost of capital proceeding, the CPUC set an authorized capital structure for SCE which included a common equity component of 48%. SCE determines compliance with this capital structure based on a 13-month weighted-average calculation. At June 30, 2006, SCE's 13-month weighted-average common equity component of total capitalization was 49%. At June 30, 2006, SCE had the capacity to pay \$152 million in additional dividends based on the 13-month weighted-average method. Based on recorded June 30, 2006 balances, SCE's common equity to total capitalization ratio, for rate-making purposes, was 49%. SCE had the capacity to pay \$156 million of additional dividends to Edison International based on June 30, 2006 recorded balances.

SCE has a debt covenant in its credit facility that requires a debt to total capitalization ratio of less than or equal to 0.65 to 1 to be met. At June 30, 2006, SCE's debt to total capitalization ratio was 0.47 to 1.

### **Margin and Collateral Deposits**

SCE has entered into certain margining agreements for power and gas trading activities in support of its procurement plan as approved by the CPUC. SCE's margin deposit requirements under these agreements can vary depending upon the level of unsecured credit extended by counterparties and brokers and changes in market prices relative to contractual commitments, and other factors. At June 30, 2006, SCE had a net deposit of \$183 million (consisting of \$106 million in cash and reflected in "Margin and collateral deposits" on the balance sheet and \$77 million in letters of credit) with a broker. In addition, SCE has deposited \$179 million (consisting of \$20 million in cash and reflected in "Margin and collateral deposits" on the balance sheet and \$159 million in letters of credit) with other brokers and counterparties. Cash deposits with brokers and counterparties earn interest at various rates.

Margin and collateral deposits in support of power contracts and trading activities fluctuate with changes in market prices. Future margin and collateral requirements may be higher or lower than the margin collateral requirements as of June 30, 2006, based on future market prices and volumes of contractual and trading activity.

## **REGULATORY MATTERS**

### **Current Regulatory Developments**

This section of the MD&A describes significant regulatory issues that may impact SCE's financial condition or results of operation.

#### ***Impact of Regulatory Matters on Customer Rates***

SCE is concerned about high customer rates, which were a contributing factor that led to the deregulation of the electric services industry during the mid-1990s. At January 1, 2005, SCE's system average rate for bundled customers was 12.2¢-per-kilowatt-hour. As of December 31, 2005, the system average rate was 12.6¢-per-kilowatt-hour. On January 1, 2006, SCE implemented a rate change that resulted in a system average rate of 13.7¢-per-kilowatt-hour. Of the 1.1¢ rate increase, 1¢ was due to the implementation of the California Department of Water Resources' (CDWR) 2006 revenue requirement approved by the CPUC on December 1, 2005.

SCE implemented another rate change on February 4, 2006. As a result, SCE's system average rate increased to 14.3¢-per-kilowatt-hour. The rate increase was due to a 1.2¢ increase resulting from the implementation of SCE's 2006 Energy Resource Recovery Account (ERRA) forecast discussed below, partially offset by a decrease of 0.7¢ due to spreading of the revenue requirement over a larger customer base resulting from forecast sales growth. In addition, the rate change includes authorized increases in funding for energy efficiency programs.

As of June 4, 2006, SCE's system average rate was 14.5¢-per-kilowatt-hour after increases associated with demand response program funding and FERC transmission-related rates. Except for residential rates, on August 1, 2006, SCE implemented in rates the 2006 General Rate Case (GRC) decision and modified the FERC-jurisdictional base transmission-related rates for the revised revenue requirement approved in the settlement discussed below. To mitigate the impact of further rate increases on residential customers during a period of record heat conditions in Southern California, on July 26, 2006, the CPUC granted SCE's request to defer the residential rate increase to November 1, 2006. On July 27, 2006, SCE filed an advice letter with the CPUC seeking approval of the mechanism in which SCE will collect the authorized revenue earned during this three-month deferral period. SCE's current system average rate, as of August 1, 2006, is approximately 14.7¢-per-kWh.

#### ***2006 General Rate Case Proceeding***

On December 21, 2004, SCE filed its application for a 2006 GRC and subsequently revised its requested 2006 base rate revenue requirement to \$3.96 billion, an increase of \$465 million over SCE's 2005 base rate revenue. When a one-time credit of \$140 million from an existing balancing account overcollection was applied, SCE's requested increase was \$325 million. SCE also proposed revised base rate revenue increases of \$108 million for 2007 and \$113 million for 2008.

On May 11, 2006, the CPUC issued its final decision authorizing an increase of \$274 million over SCE's 2005 base rate revenue, retroactive to January 12, 2006. When the one-time credit of \$140 million from an existing balancing account overcollection was applied, SCE's authorized increase was \$134 million. The CPUC also authorized increases of \$74 million in 2007 and \$104 million in 2008. The decision substantially approved SCE's request to continue its capital investment program for infrastructure replacement and expansion, with authorized revenue in excess of costs for this program subject to refund. In addition, the decision provided for balancing accounts for pensions, postretirement medical benefits and certain incentive compensation expense.

During the second quarter of 2006, SCE implemented the 2006 GRC decision and resolved an outstanding regulatory issue which resulted in a pre-tax benefit of approximately \$175 million. The implementation of the 2006 GRC decision retroactive

to January 12, 2006 mainly resulted in revenue of \$50 million related to the revenue requirement for the period January 12, 2006 through May 31, 2006, partially offset by the implementation of the new depreciation rates resulting in increased depreciation expense of approximately \$25 million for the period January 12, 2006 through May 31, 2006. In addition, there was a favorable resolution of a one-time issue related to a portion of revenue collected during the 2001–2003 period for state income taxes. SCE was able to determine through the 2006 GRC decision and other regulatory proceedings that the level of revenue collected during that period was appropriate, and as a result recorded a pre-tax gain of \$135 million (reflected in the caption “provisions for regulatory adjustments clauses—net” on the income statement). See “Regulatory Matters—Impact of Regulatory Matters on Customer Rates” for further discussion.

### ***2007 Cost of Capital Proceeding***

On March 27, 2006, SCE initiated proceedings requesting the CPUC to waive the requirement that SCE file a 2007 cost of capital application and instead file its next such application in 2007 for year 2008. If SCE’s waiver application is granted, SCE’s authorized capital structure, return on common equity of 11.6% and overall rate of return on capital of 8.77% will not change for 2007. On July 14, 2006, the CPUC issued a proposed decision granting SCE’s waiver application. SCE anticipates a final CPUC decision on its waiver application by the third quarter of 2006.

### ***2006 FERC Rate Case***

SCE’s electric transmission revenue and wholesale and retail transmission rates are subject to authorization by the FERC. On November 10, 2005, SCE filed proposed revisions to the 2006 base transmission rates, which would increase SCE’s revenue requirement by \$65 million, or 23%, over current base transmission rates and requested an effective date of January 10, 2006. On May 30, 2006, the FERC authorized an effective date for the new rates of June 4, 2006. On July 6, 2006, the FERC approved a settlement that set a revenue requirement of \$312 million, which increases SCE’s revenue requirement by \$26 million over current base transmission rates. SCE’s original effective date request was not resolved by the settlement. On July 31, 2006, the FERC denied SCE’s request for rehearing on the effective date issue. SCE is currently considering its options to appeal. See “Regulatory Matters—Impact of Regulatory Matters on Customer Rates.”

### ***Energy Resource Recovery Account Proceedings***

As discussed under the heading “Regulatory Matters—Current Regulatory Developments—Energy Resource Recovery Account Proceedings” in the year-ended 2005 MD&A, the Energy Resource Recovery Account (ERRA) is the balancing account mechanism to track and recover SCE’s fuel and procurement-related costs. If the ERRA balancing account incurs an overcollection or undercollection in excess of 4% of SCE’s prior year’s generation revenue, the CPUC has established a “trigger” mechanism, whereby SCE must file an application in which it can request an emergency rate adjustment if the ERRA overcollection or undercollection exceeds 5% of SCE’s prior year’s generation revenue. In February 2006, the ERRA was undercollected by \$206 million, which was 5.16% of SCE’s prior year’s generation revenue. On April 14, 2006, SCE filed an ERRA trigger application. In its application, SCE forecast that the ERRA undercollection would be eliminated by the end of June 2006 as a result of the implementation of the CPUC’s January 2005 ERRA decision (see “Regulatory Matters—Current Regulatory Developments—Energy Resource Recovery Account Proceedings—ERRA Forecast” in the year-ended 2005 MD&A for further discussion) and no further rate action by the CPUC will be necessary. On June 29, 2006, the CPUC issued a decision authorizing SCE to maintain its currently authorized ERRA rates to reduce its undercollected balance. As of June 30, 2006, the ERRA was undercollected by \$27 million, which was 0.68% of SCE’s prior year’s generation revenue.

### ***Resource Adequacy Requirements***

Under the CPUC's resource adequacy framework, all load-serving entities in California have an obligation to procure sufficient resources to meet their expected customers' needs on a system-wide basis with a 15–17% reserve level. In addition, on June 6, 2006, the CPUC adopted local resource adequacy requirements.

Effective February 16, 2006, SCE was required to demonstrate that it had procured sufficient resources to meet 90% of its June—September 2006 system resource adequacy requirement. SCE believes that it has met this requirement. Effective in May 2006, SCE was required to demonstrate that it has met 100% of its system resource adequacy requirement one month in advance of expected need. A month-ahead showing demonstrating that SCE has procured 100% of its system resource adequacy requirement will be required every month thereafter. The system resource adequacy requirements provide for penalties of 150% of the cost of new monthly capacity for failing to meet the system resource adequacy requirements in 2006, and a 300% penalty in 2007 and beyond. SCE believes it has procured sufficient resources to meet its expected system resource adequacy requirements for 2006.

Under the local resource adequacy requirements, SCE must demonstrate that it has procured 100% of its requirement within defined local areas. The CPUC is currently in the process of determining the amount of local capacity SCE will need to meet the requirement. SCE must make a preliminary showing regarding its local resource adequacy in September 2006, and a final compliance showing for 2007, by October 31, 2006. The local resource adequacy requirements provide for penalties of 100% of the cost of new monthly capacity for failing to meet the local resource adequacy requirements. SCE believes it has procured sufficient resources to meet its expected local resource adequacy requirements for 2006 and 2007.

### ***Procurement of Renewable Resources***

California law requires SCE to increase its procurement of renewable resources by at least 1% of its annual retail electricity sales per year so that 20% of its annual electricity sales are procured from renewable resources by no later than December 31, 2017. The Joint Energy Action Plan adopted in 2003 by the CPUC and the California Energy Commission (CEC) accelerated the deadline to 2010.

SCE entered into a contract with Calpine Energy Services, L.P. (Calpine) to purchase the output of certain existing geothermal facilities in northern California. On January 30, 2003, the CPUC issued a resolution approving the contract. SCE interpreted the resolution as authorizing SCE to count all of the output of the geothermal facilities towards the obligation to increase SCE's procurement from renewable resources and counted the entire output of the facilities toward its 1% obligation in 2003, 2004 and 2005. On July 21, 2005, the CPUC issued a decision stating that SCE can only count procurement pursuant to the Calpine contract towards its 1% annual renewable procurement requirement if it is certified as "incremental" by the CEC. On February 1, 2006, the CEC certified approximately 25% and 17% of SCE's 2003 and 2004 procurement, respectively, from the Calpine geothermal facilities as "incremental." A similar outcome is anticipated with respect to the CEC's certification review for 2005.

On August 26, 2005, SCE filed an application for rehearing and a petition for modification of the CPUC's July 21, 2005 decision. On January 26, 2006, the CPUC denied SCE's application for rehearing of the decision. On May 25, 2006, the CPUC issued a decision denying SCE's petition for modification.

SCE could have deficits in meeting its renewable procurement obligations for 2003 and 2004. However, based on the CPUC's rules for compliance with renewable procurement targets, SCE may have until 2007 to make up these deficits before becoming subject to penalties for those years or may not have deficits at all. The CEC's and the CPUC's treatment of the output from the geothermal facilities could also result in SCE being deemed to be out of compliance in 2005 and 2006.

Under current CPUC decisions, potential penalties for SCE's failure to achieve its renewable procurement obligations for any year will be considered by the CPUC in the context of the CPUC's review of SCE's annual compliance filing. Under the CPUC's current rules, the maximum penalty for failing to achieve renewable procurement targets is \$25 million per year. SCE cannot predict whether it will be assessed penalties.

### ***Request for Offers from Renewable and New Generation Resources***

SCE periodically conducts competitive solicitations for natural gas and wholesale electric energy supplies. On July 14, 2006, SCE requested proposals for power purchase contracts from renewable energy resources, with bids due in September 2006. The contract lengths will be 10, 15 or 20 years. On July 21, 2006, SCE announced that it will request proposals for long-term power purchase contracts with terms of up to 10 years from new generating facilities that could come online within the next several years. SCE anticipates issuing the request for proposals in September 2006 and soliciting up to 1,500 MW of new generation. In the 3rd quarter of 2006, SCE expects to solicit proposals for five-year contracts from all sources.

### ***Mohave Generating Station and Related Proceedings***

Mohave obtained all of its coal supply from the Black Mesa Mine in northeast Arizona, located on lands of the Navajo Nation and Hopi Tribe (the Tribes). This coal was delivered from the mine to Mohave by means of a coal slurry pipeline, which requires water from wells located on lands belonging to the Tribes in the mine vicinity. Uncertainty over a post-2005 coal and water supply has prevented SCE and other Mohave co-owners from making approximately \$1.1 billion in Mohave-related investments (SCE's share is \$605 million), including the installation of enhanced pollution-control equipment required by a 1999 air-quality consent decree in order for Mohave to operate beyond 2005. Accordingly, the plant ceased operations, as scheduled, on December 31, 2005, consistent with the provisions of the consent decree.

On June 19, 2006, SCE announced that it had decided not to move forward with its efforts to return Mohave to service. SCE's decision was not based on any one factor, but resulted from the conclusion that in light of all the significant unresolved challenges related to returning the plant to service, the plant could not be returned to service in sufficient time to render the necessary investments cost-effective for SCE's customers. Two of the Mohave co-owners, Nevada Power Company and the Los Angeles Department of Water & Power, announced that they had reached this same conclusion, while the fourth co-owner, Salt River Project Agricultural Improvement and Power District, has advised SCE that it is still assessing its interest in putting together a successor owner group to allow continued coal operations. All of the co-owners have agreed to work together to evaluate options for disposition of the plant, which conceivably could include, among other potential options, sale of the plant "as is" to a power plant operator, decommissioning and sale to a developer, and decommissioning and apportionment of the land among the owners. At this time, SCE continues to work with the water and coal suppliers to the plant to determine if more clarity around the provision of such services can be provided to any potential acquirer.

Following the suspension of Mohave operations at the end of 2005, the plant's workforce was reduced from over 300 employees to approximately 224 employees. The impacted employees were notified in April 2006 and the workforce reduction was completed by June 30, 2006. In July 2006, the co-owners decided to further reduce the workforce to 65 employees before the end of 2006. Termination costs for the June terminations of approximately \$7 million (SCE's share) were recorded in the second quarter and deferred in a balancing account authorized in the 2006 GRC decision. SCE indicated in July 2006 that it will ensure that remaining Mohave employees are considered for job placement opportunities elsewhere within the company. The amount of termination costs for the second workforce reduction will depend on the success of this effort. Due to this uncertainty, SCE management is unable to predict the amount of termination costs, if any, of the second workforce reduction at this time. However, SCE management believes these costs and other costs associated with the cessation of operations (excluding decommissioning) will range from zero to \$14 million (SCE's share). These additional costs will be recorded and deferred in the Mohave balancing account in late 2006. SCE expects to recover amounts in this balancing account in future rate-making proceedings.

As of June 30, 2006, SCE had a Mohave regulatory asset of approximately \$77 million representing unamortized capital costs, and a Mohave regulatory liability for revenue collected for future removal costs of approximately \$21 million. Based on the 2006 GRC decision, SCE is allowed to continue to earn its authorized rate of return on the Mohave investment and receive rate recovery for amortization, costs of removal, and operating and maintenance expenses, subject to balancing account treatment, during the three-year 2006 rate case cycle. SCE expects to file a notification with the CPUC regarding the status of Mohave by the end of third quarter 2006, and the CPUC may institute an investigation to determine whether to reduce SCE's rates. At this time, SCE does not anticipate that the CPUC will order a rate reduction. In the past, the CPUC has allowed full recovery of investment for similarly situated plants. However, in a December 2004 decision, the CPUC noted that SCE would not be allowed to recover any unamortized plant balances if SCE could not demonstrate that it took all steps to preserve the "Mohave-open" alternative. SCE believes that it will be able to demonstrate that SCE did everything reasonably possible to return Mohave to service and that its unamortized costs are probable of future rate recovery. However, SCE cannot predict the outcome of any future CPUC action.

#### ***San Onofre Nuclear Generating Station Steam Generators***

As discussed under the heading "Regulatory Matters—Current Regulatory Developments—San Onofre Nuclear Generating Station Steam Generators" in the year-ended 2005 MD&A, on December 15, 2005, the CPUC issued a final decision on SCE's application for replacement of SCE's San Onofre Nuclear Generating Station (San Onofre) Units 2 and 3 steam generators. SCE provided its acceptance of the decision to the CPUC on March 6, 2006. On June 15, 2006, the CPUC granted a limited rehearing of the decision in response to an Application for Rehearing filed by The Utility Reform Network and California Earth Corps challenging the cost effectiveness of the steam generator replacement project. The limited rehearing is to focus on the appropriate calculation of the net present benefits of the steam generator replacement project.

The city of Anaheim opted out of the project and agreed to transfer its 3.16% share of San Onofre to SCE. In March 2006, SCE filed applications to the Nuclear Regulatory Commission (NRC) and the FERC requesting authority to transfer Anaheim's share to SCE. Also, in March 2006, SCE filed an application with the CPUC requesting rate recovery for Anaheim's share of San Onofre operating and decommissioning costs. In April 2006, the FERC granted SCE authority to transfer Anaheim's share to SCE. The transfer of Anaheim's share is contingent upon receipt of regulatory approvals.

On April 13, 2006, SCE and San Diego Gas & Electric Company (SDG&E) settled a dispute regarding SDG&E's decision to opt out of steam generator replacement. As a result, on April 14, 2006, SDG&E applied to the CPUC to participate in the steam generator replacement and retain its 20% share of San Onofre contingent upon CPUC adoption of its application subject to certain conditions including, operating and maintenance expense balancing account and an 11.6% return on equity for SDG&E's San Onofre capital investment. If the CPUC's decision is not acceptable to SDG&E, it may file an application with the CPUC to opt out of steam generator replacement and have its ownership share of San Onofre reduced.

#### ***Palo Verde Nuclear Generating Station Steam Generators***

SCE owns a 15.8% interest in the Palo Verde Nuclear Generating Station (Palo Verde). During 2003, the Palo Verde Unit 2 steam generators were replaced. During 2005, the Palo Verde Unit 1 steam generators were replaced. In addition, the Palo Verde owners have approved the manufacture and installation of steam generators in Unit 3. SCE expects that replacement steam generators will be installed in Unit 3 in 2008. SCE's share of the costs of manufacturing and installing all of the replacement steam generators at Palo Verde is estimated to be approximately \$115 million. The CPUC approved the replacement costs for Unit 2 in the 2003 GRC. The final decision in the 2006 GRC proceeding authorized SCE to recover the replacement costs for Units 1 and 3.

#### ***FERC Refund Proceedings***

As discussed under the heading "SCE: Regulatory Matters—Current Regulatory Developments—FERC Refund Proceedings" in the year-ended 2005 MD&A, SCE is participating in several related proceedings seeking recovery of refunds

from sellers of electricity and natural gas who manipulated the electric and natural gas markets. SCE is required to refund to customers 90% of any refunds actually realized by SCE, net of litigation costs, and 10% will be retained by SCE as a shareholder incentive.

In November 2005, SCE and other parties entered into a settlement agreement with Enron Corporation and a number of its affiliates (collectively Enron), most of which are debtors in Chapter 11 bankruptcy proceedings pending in New York. In April 2006, SCE received a distribution on its allowed bankruptcy claim against one of the Enron debtors of approximately \$29 million, and 196,245 shares of common stock of Portland General Electric Company with an aggregate value of approximately \$5 million. In December 2005, the FERC approved a settlement agreement among SCE, Pacific Gas and Electric Company, SDG&E, several governmental entities and certain other parties, and Reliant Energy, Inc. and a number of its affiliates. In March 2006, SCE received an additional \$61 million.

On August 2, 2006, the United States Court of Appeals for the Ninth Circuit issued an opinion regarding the scope of refunds issued by the FERC. The Ninth Circuit widened the time period during which refunds could be issued to include the summer of 2000 for tariff violations and broadened the categories of transactions that could be subject to refund. The Ninth Circuit also held that the FERC's company-specific, nonpublic investigations could not prevent parties from seeking relief through litigation. As a result of this decision, SCE may be able to recover additional refunds from sellers of electricity who manipulated the electric markets.

#### ***Holding Company Order Instituting Rulemaking***

On October 27, 2005, the CPUC issued an order instituting rulemaking to allow the CPUC to re-examine the relationships of the major California energy utilities with their parent holding companies and nonregulated affiliates. On June 29, 2006, the CPUC issued an opinion amending the October 2005 order. The opinion elaborates the CPUC's reasons for opening the order instituting rulemaking and invites comment on a number of perceived problems and potential solutions relating to the relationships between utilities, holding companies and nonregulated energy affiliates. The opinion also includes the CPUC staff proposals for revisions to the affiliate transaction rules and the utility executive salary reporting rules. The CPUC stated that it expects to issue draft rules for comment in the third quarter 2006. SCE has filed a response, along with the other California utilities and their holding company parents, on August 7, 2006. The CPUC has stated that it intends to conclude this rulemaking in November 2006. SCE cannot predict the outcome of this proceeding.

#### ***Investigations Regarding Performance Incentives Rewards***

SCE is eligible under its CPUC-approved performance-based ratemaking (PBR) mechanism to earn rewards or penalties based on its performance in comparison to CPUC-approved standards of customer satisfaction, employee injury and illness reporting, and system reliability.

SCE has been conducting investigations into its performance under these PBR mechanisms and has reported to the CPUC certain findings of misconduct and misreporting as further discussed below.

#### ***Customer Satisfaction***

SCE received two letters in 2003 from one or more anonymous employees alleging that personnel in the service planning group of SCE's transmission and distribution business unit altered or omitted data in attempts to influence the outcome of customer satisfaction surveys conducted by an independent survey organization. The results of these surveys are used, along with other factors, to determine the amounts of any incentive rewards or penalties for customer satisfaction. SCE recorded aggregate customer satisfaction rewards of \$28 million for the years 1998, 1999 and 2000. Potential customer satisfaction rewards aggregating \$10 million for the years 2001 and 2002 are pending before the CPUC and have not been recognized in income by SCE. SCE also anticipated that it could be eligible for customer satisfaction rewards of approximately \$10 million for 2003.

Following its internal investigation, SCE proposed to refund to ratepayers \$7 million of the PBR rewards previously received and forgo an additional \$5 million of the PBR rewards pending that are both attributable to the design organization's portion of the customer satisfaction rewards for the entire PBR period (1997–2003). In addition, SCE also proposed to refund all of the approximately \$2 million of customer satisfaction rewards associated with meter reading. As a result of these findings, SCE accrued a \$9 million charge in the caption "Other nonoperating deductions" on the income statement in 2004 for the potential refunds of rewards that have been received.

SCE has taken remedial action as to the customer satisfaction survey misconduct by disciplining employees and terminating the employment of employees, including several supervisory personnel, updating system process and related documentation for survey reporting, and implementing additional supervisory controls over data collection and processing. Performance incentive rewards for customer satisfaction expired in 2003 pursuant to the 2003 GRC.

#### *Employee Injury and Illness Reporting*

In light of the problems uncovered with the customer satisfaction surveys, SCE conducted an investigation into the accuracy of SCE's employee injury and illness reporting. The yearly results of employee injury and illness reporting to the CPUC are used to determine the amount of the incentive reward or penalty to SCE under the PBR mechanism. Since the inception of PBR in 1997, SCE has received \$20 million in employee safety incentives for 1997 through 2000 and, based on SCE's records, may be entitled to an additional \$15 million for 2001 through 2003.

On October 21, 2004, SCE reported to the CPUC and other appropriate regulatory agencies certain findings concerning SCE's performance under the PBR incentive mechanism for injury and illness reporting. SCE disclosed in the investigative findings to the CPUC that SCE failed to implement an effective recordkeeping system sufficient to capture all required data for first aid incidents.

As a result of these findings, SCE proposed to the CPUC that it not collect any reward under the mechanism and return to ratepayers the \$20 million it has already received. Therefore, SCE accrued a \$20 million charge in the caption "Other nonoperating deductions" on the income statement in 2004 for the potential refund of these rewards. SCE has also proposed to withdraw the pending rewards for the 2001–2003 time frames.

SCE has taken remedial action to address the issues identified, including revising its organizational structure and overall program for environmental, health and safety compliance, disciplining employees who committed wrongdoing and terminating an employee. SCE submitted a report on the results of its investigation to the CPUC on December 3, 2004.

#### *System Reliability*

In light of the problems uncovered with the PBR mechanisms discussed above, SCE conducted an investigation into the third PBR metric, system reliability. On February 28, 2005, SCE provided its final investigatory report to the CPUC concluding that the reliability reporting system is working as intended.

#### *CPUC Investigation*

On June 15, 2006, the CPUC instituted a formal investigation to determine whether and in what amounts to order refunds or disallowances of past and potential PBR rewards for customer satisfaction, injury and illness reporting, and system reliability portions of PBR. The CPUC also may consider whether to impose additional penalties on SCE.

Also on June 15, 2006, the Consumer Protection and Safety Division (CPSD) of the CPUC also issued its report regarding SCE's PBR program. In that report, the CPSD recommended that the CPUC order SCE to (1) implement the commitments

SCE made in its internal investigations to refund and forgo earned and pending rewards totaling \$14 million for the service planning and meter reading customer satisfaction components of PBR and totaling \$35 million for the safety component of PBR; (2) pay an additional \$56 million, based on the assumption that, absent the data falsification and inadequate recordkeeping, SCE's planning and meter reading customer satisfaction performance would have incurred the maximum PBR penalty (\$21 million), and its safety performance would have incurred the maximum PBR penalty (\$35 million); (3) investigate the other customer satisfaction components of SCE's PBR program, including phone center, in-person services, and field delivery services, and order SCE to refund an as yet unquantified amount; (4) refund other, as yet unquantified, ratepayer costs; and (5) pay as yet unquantified statutory fines for alleged improper administration of the PBR program and alleged filing of misleading information. If imposed, such fines could range from \$500 to \$20,000 per day for each action determined to be a violation, over the seven years during which the PBR program was in effect.

Evidentiary hearings which will address the planning and meter reading components of customer satisfaction, safety, issues related to SCE's administration of the survey, and statutory fines associated with those matters are scheduled to take place in the fourth quarter of 2006. A schedule has not been set to address the other components of customer satisfaction, system reliability, and other issues. SCE cannot predict the outcome of these matters or estimate the potential amount of any additional refunds, disallowances, or penalties that may be required.

#### ***Settlement Agreement with Duke Energy Trading and Marketing, L.L.C.***

On May 10, 2006, SCE filed an application with the CPUC for approval of a settlement agreement between SCE and Duke Energy Trading and Marketing, L.L.C. (DETM) that resolves disputes arising from DETM's termination of certain bilateral power supply contracts in early 2001. Under the settlement, DETM will make principal and interest payments to SCE of approximately \$75 million, which SCE proposes will be refunded to ratepayers through the ERRA mechanism. The settlement, once approved, will also permit \$58 million in liabilities that SCE had previously recorded with respect to the DETM terminated contracts to be reversed, which will result in an equivalent gain being recorded by SCE. SCE's application to the CPUC requests that this gain not be refunded to ratepayers since these liabilities were not funded by ratepayers. The recorded liabilities consist of \$40 million in cash collateral received from DETM in 2000 and \$18 million in power purchase payments that SCE, in light of DETM's termination of the bilateral contracts, withheld for energy delivered by DETM in January 2001. A decision on SCE's application for approval of the settlement is not expected until the end of 2006 or early 2007. SCE cannot predict the outcome of this matter.

## **OTHER DEVELOPMENTS**

### **Environmental Matters**

SCE is subject to numerous federal and state environmental laws and regulations, which require them to incur substantial costs to operate existing facilities, construct and operate new facilities, and mitigate or remove the effect of past operations on the environment. SCE believes that its operating affiliates are in substantial compliance with existing environmental regulatory requirements.

The domestic power plants owned or operated by SCE, in particular its coal-fired plant, may be affected by recent developments in federal and state environmental laws and regulations. These laws and regulations, including those relating to sulfur dioxide (SO<sub>2</sub>) and nitrogen oxide (NO<sub>x</sub>) emissions, mercury emissions, ozone and fine particulate matter emissions, regional haze, water quality, and climate change, may require significant capital expenditures at these facilities. The developments in certain of these laws and regulations are discussed in more detail below. These developments will continue to be monitored to assess what implications, if any, they will have on the operation of domestic power plants owned or operated by SCE, or the impact on SCE's results of operations or financial position.

For a discussion of SCE's environmental matters, refer to "Other Developments—Environmental Matters" in the year-ended 2005 MD&A. There have been no significant developments with respect to environmental matters affecting SCE since the filing of SCE's annual report on Form 10-K, except as follows:

### ***Environmental Remediation***

SCE records its environmental remediation liabilities when site assessments and/or remedial actions are probable and a range of reasonably likely cleanup costs can be estimated. SCE reviews its sites and measures the liability quarterly, by assessing a range of reasonably likely costs for each identified site using currently available information, including existing technology, presently enacted laws and regulations, experience gained at similar sites, and the probable level of involvement and financial condition of other potentially responsible parties. These estimates include costs for site investigations, remediation, operations and maintenance, monitoring and site closure. Unless there is a probable amount, SCE records the lower end of this reasonably likely range of costs (classified as other long-term liabilities) at undiscounted amounts.

SCE's recorded estimated minimum liability to remediate its 24 identified sites is \$82 million. The ultimate costs to clean up SCE's identified sites may vary from its recorded liability due to numerous uncertainties inherent in the estimation process, such as: the extent and nature of contamination; the scarcity of reliable data for identified sites; the varying costs of alternative cleanup methods; developments resulting from investigatory studies; the possibility of identifying additional sites; and the time periods over which site remediation is expected to occur. SCE believes that, due to these uncertainties, it is reasonably possible that cleanup costs could exceed its recorded liability by up to \$117 million. The upper limit of this range of costs was estimated using assumptions least favorable to SCE among a range of reasonably possible outcomes. In addition to its identified sites (sites in which the upper end of the range of costs is at least \$1 million), SCE also has 31 immaterial sites whose total liability ranges from \$4 million (the recorded minimum liability) to \$10 million.

The CPUC allows SCE to recover environmental remediation costs at certain sites, representing \$32 million of its recorded liability, through an incentive mechanism (SCE may request to include additional sites). Under this mechanism, SCE will recover 90% of cleanup costs through customer rates; shareholders fund the remaining 10%, with the opportunity to recover these costs from insurance carriers and other third parties. SCE has successfully settled insurance claims with all responsible carriers. SCE expects to recover costs incurred at its remaining sites through customer rates. SCE has recorded a regulatory asset of \$83 million for its estimated minimum environmental-cleanup costs expected to be recovered through customer rates.

SCE's identified sites include several sites for which there is a lack of currently available information, including the nature and magnitude of contamination and the extent, if any, that SCE may be held responsible for contributing to any costs incurred for remediating these sites. Thus, no reasonable estimate of cleanup costs can be made for these sites.

SCE expects to clean up its identified sites over a period of up to 30 years. Remediation costs in each of the next several years are expected to range from \$11 million to \$25 million. Recorded costs for the twelve months ended June 30, 2006 were \$14 million.

Based on currently available information, SCE believes it is unlikely that it will incur amounts in excess of the upper limit of the estimated range for its identified sites and, based upon the CPUC's regulatory treatment of environmental remediation costs, SCE believes that costs ultimately recorded will not materially affect its results of operations or financial position. There can be no assurance, however, that future developments, including additional information about existing sites or the identification of new sites, will not require material revisions to such estimates.

## **Navajo Nation Litigation**

In June 1999, the Navajo Nation filed a complaint in the United States District Court for the District of Columbia (D.C. District Court) against Peabody Holding Company (Peabody) and certain of its affiliates, Salt River Project Agricultural Improvement and Power District, and SCE arising out of the coal supply agreement for Mohave. The complaint asserts claims for, among other things, violations of the federal Racketeer Influenced and Corrupt Organizations statute, interference with fiduciary duties and contractual relations, fraudulent misrepresentation by nondisclosure, and various contract-related claims. The complaint claims that the defendants' actions prevented the Navajo Nation from obtaining the full value in royalty rates for the coal supplied to Mohave. The complaint seeks damages of not less than \$600 million, trebling of that amount, and punitive damages of not less than \$1 billion, as well as a declaration that Peabody's lease and contract rights to mine coal on Navajo Nation lands should be terminated. SCE joined Peabody's motion to strike the Navajo Nation's complaint. In addition, SCE and other defendants filed motions to dismiss. The D.C. District Court denied these motions for dismissal, except for Salt River Project Agricultural Improvement and Power District's motion for its separate dismissal from the lawsuit.

Certain issues related to this case were addressed by the United States Supreme Court in a separate legal proceeding filed by the Navajo Nation in the United States Court of Federal Claims against the United States Department of Interior. In that action, the Navajo Nation claimed that the Government breached its fiduciary duty concerning negotiations relating to the coal lease involved in the Navajo Nation's lawsuit against SCE and Peabody. On March 4, 2003, the Supreme Court concluded, by majority decision, that there was no breach of a fiduciary duty and that the Navajo Nation did not have a right to relief against the Government. Based on the Supreme Court's conclusion, SCE and Peabody brought motions to dismiss or for summary judgment in the D.C. District Court action but the D.C. District Court denied the motions on April 13, 2004.

The Court of Appeals for the Federal Circuit, acting on a suggestion filed by the Navajo Nation on remand from the Supreme Court's March 4, 2003 decision held, in an October 24, 2003 decision that the Supreme Court's decision was focused on three specific statutes or regulations and therefore did not address the question of whether a network of other statutes, treaties and regulations imposed judicially enforceable fiduciary duties on the United States during the time period in question. On March 16, 2004, the Federal Circuit issued an order remanding the case against the Government to the Court of Federal Claims, which considered (1) whether the Navajo Nation previously waived its "network of other laws" argument and, (2) if not, whether the Navajo Nation can establish that the Government breached any fiduciary duties pursuant to such "network." On December 20, 2005, the Court of Federal Claims issued its ruling and found that although there was no waiver, the Navajo Nation did not establish that a "network of other laws" created a judicially enforceable trust obligation. The Navajo Nation filed a notice of appeal from this ruling on February 14, 2006. The Navajo Nation's opening brief was filed on June 7, 2006 and the Government filed its reply brief on July 20, 2006. No date for oral argument has been set.

Pursuant to a joint request of the parties, the D.C. District Court granted a stay of the action in that court to allow the parties to attempt to resolve, through facilitated negotiations, all issues associated with Mohave. Negotiations are ongoing and the stay has been continued until further order of the court.

SCE cannot predict the outcome of the 1999 Navajo Nation's complaint against SCE, the impact on the complaint of the Supreme Court's decision and the December 2005 Court of Federal Claims ruling in the Navajo Nation's suit against the Government, or the impact on the facilitated negotiations of SCE's recently announced decision to discontinue efforts to return Mohave to service.

## **Palo Verde Nuclear Generating Station Outage**

Between December 2005 when Palo Verde Unit 1 returned to service from its refueling and steam generator replacement outage and March 21, 2006, Palo Verde Unit 1 operated at between 25% and 32% power level. The need to operate at a reduced power level was due to the vibration level in one of the unit's shutdown cooling lines. On March 21, 2006, Arizona

Public Service, the operating agent for Palo Verde Unit 1, decided to remove the unit from service completely. The vibration problem was resolved and Palo Verde Unit 1 was returned to service on July 7, 2006. Incremental replacement power costs are expected to be recovered through the ERRR rate-making mechanism.

## MARKET RISK EXPOSURES

SCE's primary market risks include fluctuations in interest rates, commodity prices and volumes, and counterparty credit. Fluctuations in interest rates can affect earnings and cash flows. Fluctuations in commodity prices and volumes and counterparty credit losses may temporarily affect cash flows, but are not expected to affect earnings due to expected recovery through regulatory mechanisms. SCE uses derivative financial instruments, as appropriate, to manage its market risks. See "Market Risk Exposures" in the year-ended 2005 MD&A for a complete discussion of SCE's market risk exposures.

### Commodity Price Risk

The following table summarizes the net fair values for outstanding physical and financial derivative investments used at SCE to mitigate its exposures to commodity price risk:

In millions	June 30, 2006		December 31, 2005	
	Assets	Liabilities	Assets	Liabilities
Energy options and tolling arrangements	\$ —	\$ 20	\$ 25	\$ —
Forward physicals (power)	—	92	—	49
Gas options, swaps, and forward arrangements	—	132	105	—
Total	\$ —	\$ 244	\$ 130	\$ 49

## RESULTS OF OPERATIONS AND HISTORICAL CASH FLOW ANALYSIS

The following subsections of "Results of Operations and Historical Cash Flow Analysis" provide a discussion on the changes in various line items presented on the Consolidated Statements of Income, as well as a discussion of the changes on the Consolidated Statements of Cash Flows.

### Results of Operations

#### *Net Income Available for Common Stock*

SCE's net income available for common stock was \$234 million and \$355 million for the three- and six-month periods ended June 30, 2006, respectively, compared with earnings of \$161 million and \$292 million for the comparable periods in 2005. The increase for both periods is primarily due to the resolution of an outstanding state income tax issue, higher revenue associated with the implementation of the 2006 GRC decision and the return on investment earned by SCE's Mountainview plant, partially offset by higher operating and income tax expenses.

#### *Operating Revenue*

SCE's retail sales represented approximately 89% of operating revenue for both the three- and six-month periods ended June 30, 2006, respectively, compared to approximately 83% for both comparable periods in 2005. Due to warmer weather during the summer months, operating revenue during the third quarter of each year is generally significantly higher than other quarters.

The following table sets forth the major changes in operating revenue:

In millions	<b>Three Months Ended June 30, 2006 vs. 2005</b>	<b>Six Months Ended June 30, 2006 vs. 2005</b>
<b>Operating Revenue</b>		
Rate changes (including unbilled)	\$ 356	\$ 457
Sales volume changes (including unbilled)	15	91
Deferred revenue	49	234
Sales for resale	(109)	(198)
SCE's variable interest entities	(16)	—
Other (including intercompany transactions)	23	45
<b>Total</b>	<b>\$ 318</b>	<b>\$ 629</b>

Total operating revenue increased by \$318 million and \$629 million for the three and six months ended June 30, 2006, respectively (as shown in the table above). The increases resulting from rate changes for both periods was mainly due to the rate change implemented on February 4, 2006 arising from SCE's 2006 ERRR decision (see "Regulatory Matters—Current Regulatory Developments—Energy Resource Recovery Account Proceedings—ERRR Forecast" in the year-ended 2005 MD&A for further discussion). The increases in operating revenue resulting from sales volume changes was mainly due to an increase in kilowatt-hours (kWh) sold, including SCE providing a greater amount of energy to its customers from its own sources in 2006, compared to 2005. The change in deferred revenue for the three-month period reflects deferral of approximately \$73 million of revenue in 2006, compared to deferral of approximately \$122 million in 2005 due to lower overcollections in 2006. The change in deferred revenue for the six-month period ended June 30, 2006 reflects the recognition of approximately \$34 million of revenue in 2006 due to balancing account undercollections, compared to the deferral of approximately \$200 million of revenue in 2005 due to balancing account overcollections. Operating revenue from sales for resale represents the sale of excess energy. Excess energy from SCE sources which may exist at certain times is resold in the energy markets. Sales for resale revenue decreased due to a lesser amount of excess energy in 2006, as compared to 2005. Revenue from sales for resale is refunded to customers through the ERRR rate-making mechanism and does not impact earnings. SCE's variable interest entities revenue represents the recognition of revenue resulting from the consolidation of SCE's variable interest entities.

Amounts SCE bills and collects from its customers for electric power purchased and sold by the CDWR to SCE's customers, CDWR bond-related costs and a portion of direct access exit fees are remitted to the CDWR and none of these collections are recognized as revenue by SCE. These amounts were \$553 million and \$1.1 billion for the three- and six-month periods ended June 30, 2006, respectively, compared to \$409 million and \$919 million for the same respective periods in 2005.

### ***Operating Expenses***

#### ***Fuel Expense***

SCE's fuel expense decreased \$28 million for the three months ended June 30, 2006 and increased \$28 million for the six months ended June 30, 2006, as compared to the same periods in 2005. The quarter and year-to-date variances were due to lower fuel expense of approximately \$15 million and \$35 million for the three- and six-month periods ended June 30, 2006 at SCE's Mohave Generating Station resulting from the plant shutdown on December 31, 2005 (see "Regulatory Matters—Mohave Generating Station and Related Proceedings" for further discussion); lower nuclear fuel expense of \$10 million and \$15 million for the three- and six-month periods ended June 30, 2006 resulting from a planned refueling and maintenance outage at SCE's San Onofre Unit 2; lower fuel expense of \$45 million and \$15 million for the three- and six-month periods ended June 30, 2006 related to SCE's consolidated variable interest entities; and higher fuel expense of \$40 million and \$95 million for the three- and six-month periods ended June 30, 2006 resulting from SCE's newly constructed

Mountainview project which became operational in December 2005. The year-to-date variance also reflects a Department of Energy settlement refund of approximately \$10 million related to crude oil overcharges. The settlement refund was returned to ratepayers through the ERRA mechanism.

#### *Purchased-Power Expense*

Purchased-power expense increased \$26 million and \$652 million for the three- and six-month period ended June 30, 2006 respectively, as compared to the same periods in 2005. The quarterly increase was mainly due to increased firm energy purchases of approximately \$80 million, lower energy settlement refunds of approximately \$95 million in 2006, compared to 2005 and increased purchase power expense of \$45 million related to SCE's variable interest entities. These increases were partially offset by lower net realized and unrealized losses on economic hedging transactions of approximately \$105 million and lower expenses of approximately \$30 million related to power purchased from qualifying facilities (QF) as discussed further below. The year-to-date increase was mainly due higher net realized and unrealized losses related to economic hedging transactions of approximately \$450 million in 2006, as compared to 2005, higher firm energy purchases of approximately \$115 million and lower energy settlement refunds of approximately \$85 million.

Federal law and CPUC orders required SCE to enter into contracts to purchase power from QFs at CPUC-mandated prices. Energy payments to gas-fired QFs are generally tied to spot natural gas prices. Effective May 2002, energy payments for most renewable QFs were converted to a fixed price of 5.37¢-per-kWh until April 2007. Average spot natural gas prices were higher during 2006 as compared to 2005. The higher expenses related to power purchased from QFs were mainly due to higher average spot natural gas prices, partially offset by lower kWh purchases.

#### *Provisions for Regulatory Adjustment Clauses—Net*

Provisions for regulatory adjustment clauses—net increased \$31 million for the three-month period ended June 30, 2006 and decreased \$395 million for the six-month period ended June 30, 2006, as compared to the same periods in 2005. The increase for the three-month period was mainly due to lower net unrealized losses of approximately \$190 million related to economic hedging transactions (mentioned above in purchased-power expense) that, if realized, would be recovered from ratepayers, and higher net overcollections of purchase-power, fuel, and operation and maintenance expenses of approximately \$60 million. These increases were partially offset by the resolution of the one-time issue related to a portion of revenue collected during the 2001–2003 period related to state income taxes. SCE was able to determine through the 2006 GRC decision and other regulatory proceedings that the level of revenue collected during that period was appropriate, and as a result recorded a pre-tax gain of \$135 million. The decrease for the six-month period ended June 30, 2006 was mainly due to the implementation of the 2006 GRC decision and higher net unrealized losses of approximately \$295 million related to economic hedging transactions, partially offset by net overcollections of purchased-power, fuel, and operation and maintenance expenses of approximately \$80 million in 2006, compared to net undercollections of approximately \$30 million in 2005.

#### *Other Operation and Maintenance Expense*

SCE's other operation and maintenance expense increased \$69 million and \$85 million for the three- and six-month periods ended June 30, 2006, respectively, as compared to the same periods in 2005. The quarter and year-to-date increases were mainly due to higher generation-related costs of approximately \$10 million for the quarter ended June 30, 2006 and \$40 million for the year-to-date ended June 30, 2006 primarily resulting from the planned refueling and maintenance outage at SCE's San Onofre Unit 2, an increase in reliability costs of \$45 million and \$20 million for the three- and six-month periods ended June 30, 2006 related to must-run offer units (reliability costs are being recovered through regulatory mechanisms approved by the FERC). As a result of implementation of the 2006 GRC, beginning in May 2006, costs related to Mohave shutdown, postretirement benefits other than pensions, pensions and results sharing are being recovered through a balancing account mechanism.

### *Depreciation, Decommissioning and Amortization Expense*

SCE's depreciation, decommissioning and amortization expense increased \$69 million and \$98 million for the three- and six-month periods ended June 30, 2006, respectively, as compared to the same periods in 2005. The increases in 2006 are mainly due to an increase in depreciation expense resulting from additions to transmission and distribution assets, as well as an increase of approximately \$25 million resulting from the implementation of the new depreciation rates approved in the 2006 GRC decision for the period January 12, 2006 through May 31, 2006, and higher investment earnings from SCE's nuclear decommissioning trusts. The nuclear decommissioning trust investment earnings are also recorded in operating revenue and as a result, have no impact on net income.

### ***Other Income and Deductions***

#### *Interest and Dividend Income*

SCE's interest and dividend income increased \$5 million and \$10 million for the three- and six-month periods ended June 30, 2006, respectively, as compared to the same periods in 2005. The 2006 increases were mainly due to higher interest income resulting from higher balancing account undercollections and higher short-term interest rates in 2006 as compared to 2005.

#### *Other Nonoperating Income*

SCE's other nonoperating income increased \$11 million for the six-months ended June 30, 2006, as compared to the same period in 2005, mainly due to an increase in incentive rewards related to the efficient operation of Palo Verde and corporate-owned life insurance proceeds. The incentive rewards approved by the CPUC for the efficient operation of Palo Verde were \$13 million in the first quarter of 2006 and \$10 million in the first quarter of 2005.

### ***Income Tax***

SCE's effective tax rate from net income was 37% and 38% for the three- and six-month periods ended June 30, 2006, respectively, as compared to 26% and 29% for the same periods in 2005. The increased effective tax rate resulted from reductions made to the income tax reserve in 2005 which have not recurred in 2006. The 2005 reserve reductions were made to reflect progress in settlement negotiations relating to income tax audits.

### **Historical Cash Flow Analysis**

The "Historical Cash Flow Analysis" section of this MD&A discusses consolidated cash flows from operating, financing and investing activities.

#### ***Cash Flows from Operating Activities***

Net cash provided by operating activities was \$767 million for the six-month period ended June 30, 2006, compared to \$939 million for the comparable period in 2005. The 2006 change in cash provided by operating activities from continuing operations was mainly due to a change in working capital items resulting from the timing of cash receipts and disbursements.

#### ***Cash Flows from Financing Activities***

SCE's short-term debt is normally used for working capital requirements. Long-term debt is used mainly to finance the utility's rate base. External financings are influenced by market conditions and other factors.

Financing activities in 2006 included activities related to the rebalancing of SCE's capital structure and rate base growth.

- In January 2006, SCE issued \$500 million of first and refunding mortgage bonds which consisted of \$350 million of 5.625% bonds due in 2036 and \$150 million of floating rate bonds due in 2009. The proceeds from this issuance were used to redeem \$150 million of variable rate first and refunding mortgage bonds due in January 2006 and \$200 million of its 6.375% first and refunding mortgage bonds due in January 2006.
- In January 2006, SCE issued two million shares of 6% Series C preference stock (noncumulative, \$100 liquidation value) and received net proceeds of \$197 million.
- In April 2006, SCE issued \$331 million of tax-exempt bonds which consisted of \$196 million of 4.10% bonds which are subject to remarketing in April 2013 and \$135 million of 4.25% bonds which are subject to remarketing in November 2016. The proceeds from this issuance were used to call and redeem \$196 million of tax-exempt bonds due February 2008 and \$135 million of tax-exempt bonds due March 2008.
- Financing activities in 2006 also included dividend payments of \$131 million made to Edison International.

Financing activities in 2005 also included activities related to the rebalancing of SCE's capital structure.

- In January 2005, SCE issued \$650 million of first and refunding mortgage bonds which consisted of \$400 million of 5% bonds due in 2016 and \$250 million of 5.55% bonds due in 2036. The proceeds from this issuance were used to redeem the remaining \$50,000 of its 8% first and refunding mortgage bonds due February 2007 (Series 2003A) and \$650 million of the \$966 million 8% first and refunding mortgage bonds due February 2007 (Series 2003B).
- In April 2005, SCE issued 4,000,000 shares of Series A preference stock (noncumulative, 100% liquidation value) and received net proceeds of approximately \$394 million. Approximately \$81 million of the proceeds was used to redeem all the outstanding shares of its \$100 cumulative preferred stock, 7.23% Series, and approximately \$64 million of the proceeds was used to redeem all the outstanding shares of its \$100 cumulative preferred stock, 6.05% Series.
- In June 2005, SCE issued \$350 million of 5.35% first and refunding mortgage bonds due in 2035 (Series 2005E). A portion of the proceeds from this issuance were used to redeem \$316 million of its 8% first and refunding mortgage bonds due in 2007 (Series 2003B).
- Financing activities in 2005 also include dividend payments of \$71 million made to Edison International.

### ***Cash Flows from Investing Activities***

Cash flows from investing activities are affected by capital expenditures and funding of nuclear decommissioning trusts.

Investing activities in 2006 reflect \$1.1 billion in capital expenditures at SCE, primarily for transmission and distribution assets, including approximately \$50 million for nuclear fuel acquisitions and \$8 million related to the Mountainview project.

Investing activities in 2005 reflect \$774 million in capital expenditures at SCE, primarily for transmission and distribution assets, including approximately \$21 million for nuclear fuel acquisitions and \$87 million related to the Mountainview project.

### **NEW ACCOUNTING PRONOUNCEMENTS**

A new accounting standard requires companies to use the fair value accounting method for stock-based compensation. SCE implemented the new standard in the first quarter of 2006 and applied the modified prospective transition method. Under the modified prospective method, the new accounting standard was applied effective January 1, 2006 to the unvested portion of

awards previously granted and will be applied to all prospective awards. Prior financial statements were not restated under this method. The new accounting standard resulted in the recognition of expense for all stock-based compensation awards. Prior to January 1, 2006, SCE used the intrinsic value method of accounting, which resulted in no recognition of expense for its stock options.

Prior to adoption of the new accounting standard, SCE presented all tax benefits of deductions resulting from the exercise of stock options as a component of operating cash flows under the caption "Other liabilities" in the consolidated statements of cash flows. The new accounting standard requires the cash flows resulting from the tax benefits that occur from estimated tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The \$9 million excess tax benefit is classified as a financing cash inflow in 2006.

Due to the adoption of this new accounting standard, SCE recorded a cumulative effect adjustment that increased net income by less than \$1 million, net of tax, in the first quarter of 2006 mainly to reflect the change in the valuation method for performance shares classified as liability awards and the use of forfeiture estimates.

In April 2006, the Financial Accounting Standards Board (FASB) issued a Staff Position that specifies how a company should determine the variability to be considered in applying the accounting standard for consolidation of variable interest entities. The pronouncement states that such variability shall be determined based on an analysis of the design of the entity, including the nature of the risks in the entity, the purpose for which the entity was created, and the variability the entity is designed to create and pass along to its interest holders. This new accounting guidance is effective prospectively beginning July 1, 2006, although companies have until December 31, 2006 to elect retrospective application. SCE has not yet selected a transition method.

In July 2006, the FASB issued an interpretation relating to accounting for uncertainty in income taxes. This interpretation clarifies the accounting for uncertain tax positions. An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position by determining if the weight of the available evidence indicates it is more likely than not, based solely on the technical merits, that the position will be sustained on audit. The effective date is January 1, 2007. SCE is currently assessing the potential impact of the interpretation on its financial condition.

## **COMMITMENTS, GUARANTEES AND INDEMNITIES**

The following is an update to SCE's commitments, guarantees and indemnities. See the section, "Commitments, Guarantees and Indemnities," in the year-ended 2005 MD&A for a detailed discussion.

### ***Fuel Supply Commitments***

During the first quarter of 2006, the nuclear fuel commitments increased due to the additional costs associated with uranium enrichment and fuel fabrication services. SCE's additional nuclear fuel commitments are currently estimated to be: 2006 – \$9 million; 2007 – \$6 million; 2008 – \$4 million; 2009 – \$8 million; and 2010 –\$2 million.

### ***Leases and Power-Purchase Contracts***

During the second quarter of 2006, SCE modified and extended two power-purchase contracts. Since unit-specific contracts (signed or modified after June 30, 2003) in which SCE takes virtually all of the output of a facility are generally considered to be leases under accounting rules, as a result of this modification SCE reclassified these power-purchase contracts to operating lease commitments. SCE's power purchase obligations in 2006 and 2007 decreased and operating lease obligations increased by \$11 million and \$19 million, respectively. As a result of the extension of the contracts the operating lease commitments increased in 2008 and 2009 by \$23 million for each year.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Information responding to Part I, Item 3 is included in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations," under the heading "Market Risk Exposures," is incorporated herein by this reference.

### **Item 4. Controls and Procedures**

#### *Disclosure Controls and Procedures*

SCE's management, under the supervision and with the participation of the company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of SCE's disclosure controls and procedures (as that term is defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period, SCE's disclosure controls and procedures are effective.

#### *Internal Control Over Financial Reporting*

There were no changes in SCE's internal control over financial reporting (as that term is defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, SCE's internal control over financial reporting.

## PART II—OTHER INFORMATION

### Item 4. Submission of Matters to a Vote of Security Holders

At SCE's Annual Meeting of Shareholders on April 27, 2006, shareholders elected twelve nominees to the Board of Directors. The number of broker non-votes for each nominee was zero. The number of votes cast for and withheld from each Director-nominee were as follows:

Name	Number of Votes	
	For	Withheld
John E. Bryson	452,603,566	129,972
France A. Cordova	452,645,838	87,700
Charles B. Curtis	452,591,506	142,032
Alan J. Fohrer	452,606,566	126,972
Bradford M. Freeman	452,069,082	664,456
Bruce Karatz	452,603,118	130,420
Luis G. Nogales	452,028,394	705,144
Ronald L. Olson	452,647,966	85,572
James M. Rosser	452,647,972	85,566
Richard T. Schlosberg, III	452,063,064	670,474
Robert H. Smith	452,069,428	664,110
Thomas C. Sutton	452,067,388	666,150

### Item 6. Exhibits

- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act
- 32 Statement Pursuant to 18 U.S.C. Section 1350

\* Incorporated herein by reference pursuant to Rule 12b-32.

**SIGNATURE**

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

SOUTHERN CALIFORNIA EDISON  
COMPANY  
(Registrant)

By           /s/ LINDA G. SULLIVAN            
**LINDA G. SULLIVAN**  
**Vice President and Controller**  
**(Duly Authorized Officer and**  
**Principal Accounting Officer)**

Dated: August 8, 2006