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

**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 September 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)

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**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)

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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 October 31, 2006
<b>Common Stock, no par value</b>	<b>434,888,104</b>

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# SOUTHERN CALIFORNIA EDISON COMPANY

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**SOUTHERN CALIFORNIA EDISON COMPANY**  
**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**CONSOLIDATED STATEMENTS OF INCOME**

<b>In millions</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(Unaudited)			
<b>Operating revenue</b>	\$ <b>3,079</b>	\$ 3,084	\$ <b>7,818</b>	\$ 7,195
Fuel	<b>286</b>	296	<b>836</b>	817
Purchased power	<b>1,036</b>	502	<b>2,819</b>	1,633
Provisions for regulatory adjustment clauses – net	<b>115</b>	766	<b>(256)</b>	790
Other operation and maintenance	<b>662</b>	670	<b>1,916</b>	1,838
Depreciation, decommissioning and amortization	<b>254</b>	234	<b>806</b>	688
Property and other taxes	<b>53</b>	48	<b>158</b>	144
Net gain on sale of utility property and plant	—	—	<b>(1)</b>	—
<b>Total operating expenses</b>	<b>2,406</b>	2,516	<b>6,278</b>	5,910
<b>Operating income</b>	<b>673</b>	568	<b>1,540</b>	1,285
Interest and dividend income	<b>14</b>	15	<b>44</b>	35
Other nonoperating income	<b>13</b>	33	<b>61</b>	68
Interest expense – net of amounts capitalized	<b>(98)</b>	(91)	<b>(297)</b>	(289)
Other nonoperating deductions	<b>(12)</b>	(35)	<b>(32)</b>	(54)
<b>Income before tax and minority interest</b>	<b>590</b>	490	<b>1,316</b>	1,045
Income tax	<b>187</b>	52	<b>416</b>	176
Minority interest	<b>127</b>	151	<b>244</b>	283
<b>Net income</b>	<b>276</b>	287	<b>656</b>	586
Dividends on preferred and preference stock not subject to mandatory redemption	<b>13</b>	7	<b>38</b>	14
<b>Net income available for common stock</b>	\$ <b>263</b>	\$ 280	\$ <b>618</b>	\$ 572

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

<b>In millions</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(Unaudited)			
Net income	\$ <b>276</b>	\$ 287	\$ <b>656</b>	\$ 586
Other comprehensive income, net of tax:				
Amortization of cash flow hedges	—	—	<b>4</b>	2
<b>Comprehensive income</b>	\$ <b>276</b>	\$ 287	\$ <b>660</b>	\$ 588

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

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

<b>In millions</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	(Unaudited)	
<b>ASSETS</b>		
Cash and equivalents	\$ 158	\$ 143
Restricted cash	60	57
Margin and collateral deposits	66	178
Receivables, less allowances of \$29 and \$33 for uncollectible accounts at respective dates	1,299	849
Accrued unbilled revenue	426	291
Inventory	230	220
Accumulated deferred income taxes – net	292	—
Trading and price risk management assets	67	237
Regulatory assets	556	536
Other current assets	71	92
<b>Total current assets</b>	<b>3,225</b>	<b>2,603</b>
Nonutility property – less accumulated provision for depreciation of \$617 and \$569 at respective dates	1,055	1,086
Nuclear decommissioning trusts	3,061	2,907
Other investments	75	80
<b>Total investments and other assets</b>	<b>4,191</b>	<b>4,073</b>
Utility plant, at original cost:		
Transmission and distribution	17,212	16,760
Generation	1,458	1,370
Accumulated provision for depreciation	(4,710)	(4,763)
Construction work in progress	1,331	956
Nuclear fuel, at amortized cost	170	146
<b>Total utility plant</b>	<b>15,461</b>	<b>14,469</b>
Regulatory assets	2,774	3,013
Trading and price risk management assets	29	42
Other long-term assets	338	503
<b>Total long-term assets</b>	<b>3,141</b>	<b>3,558</b>
<b>Total assets</b>	<b>\$ 26,018</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>September 30, 2006</b>	<b>December 31, 2005</b>
	(Unaudited)	
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Long-term debt due within one year	\$ 247	\$ 596
Accounts payable	761	898
Accrued taxes	741	242
Accrued interest	88	106
Counterparty collateral	32	183
Customer deposits	191	183
Book overdrafts	227	257
Accumulated deferred income taxes – net	—	5
Trading and price risk management liabilities	137	87
Regulatory liabilities	1,287	681
Other current liabilities	566	723
<b>Total current liabilities</b>	<b>4,277</b>	<b>3,961</b>
<b>Long-term debt</b>	<b>4,991</b>	<b>4,669</b>
Accumulated deferred income taxes – net	2,719	2,815
Accumulated deferred investment tax credits	114	119
Customer advances and other deferred credits	600	550
Trading and price risk management liabilities	173	101
Power-purchase contracts	39	64
Accumulated provision for pensions and benefits	568	500
Asset retirement obligations	2,679	2,621
Regulatory liabilities	2,880	2,962
Other long-term liabilities	281	284
<b>Total deferred credits and other liabilities</b>	<b>10,053</b>	<b>10,016</b>
<b>Total liabilities</b>	<b>19,321</b>	<b>18,646</b>
Commitments and contingencies (Notes 3 and 4)		
<b>Minority interest</b>	<b>415</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	370	361
Accumulated other comprehensive loss	(12)	(16)
Retained earnings	2,827	2,417
<b>Total common shareholder's equity</b>	<b>5,353</b>	<b>4,930</b>
<b>Preferred and preference stock not subject to mandatory redemption</b>	<b>929</b>	<b>729</b>
<b>Total shareholders' equity</b>	<b>6,282</b>	<b>5,659</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 26,018</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>Nine Months Ended</b>	
	<b>2006</b>	<b>2005</b>
	September 30,	
	(Unaudited)	
<b>Cash flows from operating activities:</b>		
Net income	\$ 656	\$ 586
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation, decommissioning and amortization	806	688
Other amortization	60	72
Minority interest	244	283
Deferred income taxes and investment tax credits	(354)	(273)
Regulatory assets – long-term	117	372
Regulatory liabilities – long-term	(151)	(92)
Trading and price risk management assets – long-term	13	(102)
Trading and price risk management liabilities – long-term	72	50
Other assets	18	11
Other liabilities	32	33
Margin and collateral deposits – net of collateral received	(38)	271
Receivables and accrued unbilled revenue	(433)	(519)
Trading and price risk management assets – short-term	171	(390)
Trading and price risk management liabilities – short-term	50	(13)
Inventory and other current assets	(4)	(40)
Regulatory assets – short-term	(20)	7
Regulatory liabilities – short-term	606	773
Accrued interest and taxes	480	192
Accounts payable and other current liabilities	(234)	105
<b>Net cash provided by operating activities</b>	<b>2,091</b>	<b>2,014</b>
<b>Cash flows from financing activities:</b>		
Long-term debt issued and issuance costs	491	980
Long-term debt repaid	(351)	(1,041)
Issuance of preference stock	196	592
Redemption of preferred stock	—	(148)
Rate reduction notes repaid	(177)	(177)
Short-term debt financing – net	—	(88)
Change in book overdrafts	(31)	39
Shares purchased for stock-based compensation	(75)	(95)
Proceeds from stock option exercises	31	50
Excess tax benefits related to stock option exercises	11	—
Minority interest	(228)	(241)
Dividends paid	(227)	(224)
<b>Net cash used by financing activities</b>	<b>(360)</b>	<b>(353)</b>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(1,615)	(1,295)
Proceeds from nuclear decommissioning trust sales	2,145	1,581
Purchases of nuclear decommissioning trust investments	(2,253)	(1,657)
Customer advances for construction and other investments	7	72
<b>Net cash used by investing activities</b>	<b>(1,716)</b>	<b>(1,299)</b>
<b>Net increase in cash and equivalents</b>	<b>15</b>	<b>362</b>
<b>Cash and equivalents, beginning of period</b>	<b>143</b>	<b>122</b>
<b>Cash and equivalents, end of period</b>	<b>\$ 158</b>	<b>\$ 484</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 September 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 September 30, 2006 financial statement presentation.

***Derivative Instruments and Hedging Activities***

SCE records its derivative instruments on its consolidated balance sheets at fair value unless they meet the definition of a normal purchase or sale. The normal purchases and sales exception requires, among other things, physical delivery in quantities expected to be used or sold over a reasonable period in the normal course of business. SCE enters into contracts for power and gas options, as well as swaps and futures, in order to mitigate its exposure to increases in natural gas and electricity pricing. These transactions are pre-approved by the California Public Utilities Commission (CPUC) or executed in compliance with CPUC-approved procurement plans. The derivative instrument fair values are marked to market at each reporting period. Any fair value changes for recorded derivatives are recorded in purchased-power expense and offset through the provision for regulatory adjustment clauses; therefore, fair value changes do not affect earnings. Hedge accounting is not used for these transactions due to this regulatory accounting treatment.

SCE recorded net unrealized losses of \$9 million and \$351 million, for the three- and nine-month periods ended September 30, 2006, respectively, compared to net unrealized gains of \$504 million and \$457 million, for the same periods in 2005, respectively.

***Income Taxes***

SCE's effective tax rates from net income was 42% and 40% for the three- and nine-month periods ended September 30, 2006, respectively, as compared to 16% and 24% for the same periods in 2005. The increased effective tax rate resulted primarily from recording a \$61 million benefit, including \$45 million of interest income, in the third quarter of 2005 relating to a settlement with the Internal Revenue Service (IRS) on tax issues and pending affirmative claims relating to Edison International's 1991-1993 tax years. Additional increases to the effective tax rate resulted from reductions made to the income tax reserve in 2005 to reflect the issuance of new IRS regulations and progress in settlement negotiations relating to tax audits other than the 1991-1993 IRS audit and adjustments made to tax balances in 2005.

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

*New Accounting Pronouncements*

A new accounting standard, Statement of Financial Accounting Standards (SFAS) No. 123(R), 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 \$11 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 (FSP), FSP FIN 46(R)-6, 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 was 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. Applying the guidance of FSP FIN 46(R)-6 had no effect on the financial statements for the three months ended September 30, 2006.

In July 2006, the FASB issued an interpretation (FIN 48) 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 for SCE is January 1, 2007. SCE is currently assessing the potential impact of FIN 48 on its financial condition.

In September 2006, the FASB issued a new accounting standard on fair value measurements (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value and expands the disclosures on fair value measurements. SCE will adopt SFAS No. 157 on January 1, 2008. SCE is currently evaluating the impact of adopting SFAS No. 157 on its financial statements.

In September 2006, the FASB issued SFAS No. 158, which amends the accounting by employers for defined benefit pension plans and postretirement benefits other than pensions. SFAS No. 158 requires companies to recognize the overfunded or underfunded status of a defined benefit pension or other postretirement plan as an asset or liability in its balance sheet; the asset or liability is offset through other comprehensive income. SCE will record regulatory assets or liabilities instead of charges or credits to other comprehensive income for its postretirement benefit plans that are recoverable in utility rates, in accordance with accounting principles for rate-regulated enterprises. The standard also requires companies to align the measurement dates for their plans to their fiscal year-ends; SCE already has a fiscal year-end measurement date for all of its postretirement plans. SCE will

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

adopt SFAS No. 158 prospectively on December 31, 2006. Had SFAS No. 158 been effective as of December 31, 2005, SCE would have recorded additional postretirement benefit liabilities of \$739 million, additional regulatory assets of \$723 million, and a reduction to accumulated other comprehensive income (a component of shareholder's equity) of \$11 million, net of tax. SCE is currently assessing the impact of this standard on its 2006 financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The new guidance requires additional quantitative testing to determine whether a misstatement is material. SCE will implement SAB No. 108 for the filing of its Annual Report on Form 10-K for the year-ended December 31, 2006. SCE is currently assessing the impact, if any, of the adoption of SAB No. 108.

In September 2006, the FASB's Emerging Issues Task Force (EITF) reached a consensus for Issue No. 06-5, which clarifies the accounting for purchases of life insurance, including corporate-owned life insurance. The new guidance states that policyholders should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract, and specifies that contractual limitations should be considered when determining the realizable amounts. The new guidance is effective January 1, 2007, and retrospective application or a cumulative effect adjustment is permitted to transition to the new guidance. SCE is currently evaluating the impact, if any, of adopting EITF Issue No. 06-5.

***Regulatory Assets and Liabilities***

Regulatory assets included in the consolidated balance sheets are:

In millions	September 30, 2006	December 31, 2005
	(Unaudited)	
<b>Current:</b>		
Regulatory balancing accounts	\$ 294	\$ 355
Direct access procurement charges	85	113
Energy derivatives	110	—
Purchased-power settlements	32	53
Other	35	15
	<b>556</b>	<b>536</b>
<b>Long-term:</b>		
Flow-through taxes – net	1,022	1,066
Rate reduction notes – transition cost deferral	275	465
Unamortized nuclear investment – net	444	487
Nuclear-related asset retirement investment – net	280	292
Unamortized coal plant investment – net	109	97
Unamortized loss on reacquired debt	315	323
Direct access procurement charges	—	40
Energy derivatives	143	58
Environmental remediation	85	56
Purchased-power settlements	15	39
Other	86	90
	<b>2,774</b>	<b>3,013</b>
<b>Total regulatory assets</b>	<b>\$ 3,330</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	September 30, 2006	December 31, 2005
	(Unaudited)	
<b>Current:</b>		
Regulatory balancing accounts	\$ 1,089	\$ 370
Direct access procurement charges	85	113
Energy derivatives	—	136
Other	113	62
	<b>1,287</b>	<b>681</b>
<b>Long-term:</b>		
Asset retirement obligations	650	584
Costs of removal	2,142	2,110
Direct access procurement charges	—	39
Employee benefits plans	88	229
	<b>2,880</b>	<b>2,962</b>
<b>Total regulatory liabilities</b>	<b>\$ 4,167</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. 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 \$1 million for the quarter ended September 30, 2006, would have increased \$1 million for the quarter ended September 30, 2005, would have decreased \$3 million for the nine months ended September 30, 2006 and would have increased \$4 million for the nine months ended September 30, 2005.

Total stock-based compensation expense (reflected in the caption “Other operation and maintenance” on the consolidated statements of income) was \$8 million and \$15 million for the three months ended September 30, 2006, and 2005, respectively and was \$19 million and \$38 million for the nine months ended September 30, 2006, and 2005, respectively. The income tax benefit recognized in the income statement was \$3 million and \$6 million for the three months ended September 30, 2006, and 2005, respectively and was \$8 million and \$16 million for the nine months ended September 30, 2006, and 2005, respectively. Total stock-based compensation cost capitalized for the three and nine months ended September 30, 2006, was \$2 million and \$4 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 nine months ended September 30, 2005.

In millions	<b>Three Months Ended September 30,</b>	<b>Nine Months Ended September 30,</b>
	2005	2005
		(Unaudited)
Net income available for common stock, as reported	\$ 280	\$ 572
Add: stock-based compensation expense using the intrinsic value accounting method – net of tax	9	23
Less: stock-based compensation expense using the fair-value accounting method – net of tax	7	19
<b>Pro forma net income available for common stock</b>	<b>\$ 282</b>	<b>\$ 576</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	Nine Months Ended September 30,	
	2006	2005
	(Unaudited)	
<b>Cash payments for interest and taxes:</b>		
Interest – net of amounts capitalized	\$ 266	\$ 279
Tax payments	297	329
<b>Noncash investing and financing activities:</b>		
Details of debt exchange:		
Pollution-control bonds redeemed	\$ (331)	\$ (452)
Pollution-control bonds issued	331	452
Funds held in trust	—	—
Dividends declared but not paid	69	—

**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 September 30, 2006, \$32 million in contributions have been made. Additional funding in 2006 could be lower than anticipated, depending on the funded status at year-end and tax-deductible funding limitations.

Net pension cost recognized is calculated under the actuarial method used for ratemaking. The difference between pension costs calculated for accounting and ratemaking is deferred.

Expense components are:

In millions	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(Unaudited)			
Service cost	\$ 25	\$ 24	\$ 76	\$ 73
Interest cost	42	40	127	120
Expected return on plan assets	(56)	(54)	(169)	(162)
Special termination benefits	4	—	8	—
Net amortization and deferral	5	6	14	18
Expense under accounting standards	20	16	56	49
Regulatory adjustment – deferred	(2)	(2)	(5)	(6)
<b>Total expense recognized</b>	<b>\$ 18</b>	<b>\$ 14</b>	<b>\$ 51</b>	<b>\$ 43</b>

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Due to the Mohave Generating Station (Mohave) shutdown, SCE has incurred costs for special termination benefits. See “Mohave Shutdown” in Note 7 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 September 30, 2006, \$18 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 September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
			(Unaudited)	
Service cost	\$ 11	\$ 12	\$ 35	\$ 34
Interest cost	31	30	92	90
Expected return on plan assets	(27)	(26)	(81)	(77)
Special termination benefits	3	—	6	—
Amortization of unrecognized prior service costs	(7)	(7)	(22)	(21)
Amortization of unrecognized loss	12	12	35	36
<b>Total expense</b>	<b>\$ 23</b>	<b>\$ 21</b>	<b>\$ 65</b>	<b>\$ 62</b>

Due to the Mohave shutdown, SCE has incurred costs for special termination benefits. See “Mohave Shutdown” in Note 7 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 \$6 million for the three months ended September 30, 2006 and \$18 million for the nine months ended September 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 nonqualified 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.

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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 September 30,		Nine Months Ended September 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>4.5% – 4.7%</b>	4.1% – 4.2%	<b>4.3% – 4.7%</b>	4.1% – 4.3%
Expected dividend yield	<b>2.5% – 2.8%</b>	2.1% – 2.5%	<b>2.4% – 2.8%</b>	2.1% – 3.1%
Weighted-average expected dividend yield	<b>2.6%</b>	2.4%	<b>2.4%</b>	3.1%
Expected volatility	<b>15.9% – 17.2%</b>	15.8% – 18.1%	<b>15.9% – 17.5%</b>	15.8% – 19.6%
Weighted-average volatility	<b>16.4%</b>	18.0%	<b>16.3%</b>	19.5%

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	1,226,516	\$ 44.14		
Expired	—	—		
Forfeited	(18,126)	\$ 34.31		
Exercised	(1,412,411)	\$ 21.92		
Outstanding at September 30, 2006	8,383,227	\$ 26.43		
Vested and expected to vest at September 30, 2006	8,014,652	\$ 26.22	6.41	\$ 121,822,710
Exercisable at September 30, 2006	4,259,873	\$ 22.17	4.95	\$ 82,002,555

The weighted-average grant-date fair value of options granted during the quarters ended September 30, 2006 and 2005 was \$13.72 and \$14.23, respectively. The weighted-average grant-date fair value of options granted during the nine months ended September 30, 2006 and 2005 was \$14.43 and \$11.74, respectively. The total intrinsic value of options exercised during the quarters ended September 30, 2006 and 2005, was \$7 million and \$16 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005, was \$29 million and \$38 million, respectively. At September 30, 2006, there was \$26 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 ended September 30, 2006 and 2005 was zero and for the nine months ended September 30, 2006 and 2005 was \$3 million and \$4 million, respectively.

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The amount of cash used to settle stock options exercised was \$15 million and \$33 million for the quarters ended September 30, 2006 and 2005, respectively, and \$60 million and \$87 million for the nine months ended September 30, 2006 and 2005, respectively. Cash received from options exercised for the quarters ended September 30, 2006 and 2005, was \$8 million and \$16 million, respectively, and for the nine months ended September 30, 2006 and 2005, was \$31 million and \$50 million, respectively. The estimated tax benefit from options exercised for the nine months ended September 30, 2006 and 2005, was \$11 million and \$15 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 \$3 million and \$13 million for the three months ended September 30, 2006 and 2005, respectively, and \$5 million and \$30 million for the nine months ended September 30, 2006 and 2005, respectively. Cash used to settle performance shares classified as equity awards was zero for the quarters ended September 30, 2006 and 2005, respectively and \$19 million and \$10 million for the nine months ended September 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 September 30, 2006 was 4.7% and 16.5%, respectively.

The total intrinsic value of performance shares settled during the quarters ended September 30, 2006 and 2005, including cash paid to settle the performance shares classified as liability awards was zero for both periods. The

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total intrinsic value of performance shares settled during the nine months ended September 30, 2006 and 2005, was \$38 million and \$21 million, respectively, which included cash paid to settle the performance shares classified as liability awards for the nine months ended September 30, 2006 and 2005, of \$9 million and \$5 million, respectively. At September 30, 2006, there was \$5 million (based on the September 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 approximately one year. The fair values of performance shares vested during the quarters ended September 30, 2006 and 2005, was zero. The fair values of performance shares vested during the nine-month ended September 30, 2006 and 2005 was 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	47,445	\$ 53.00
Forfeited	(1,792)	\$ 37.34
Paid out	(5,057)	\$ 39.77
Nonvested at September 30, 2006	186,876	\$ 42.56

The weighted-average grant-date fair value of performance shares classified as equity awards granted during the nine months ended September 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	47,513	
Forfeited	(1,796)	
Paid out	(5,058)	
Nonvested at September 30, 2006	187,059	\$ 81.81

**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 \$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.

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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 regulatory proceedings (including the 2006 GRC decision) that the level of revenue collected during that 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 23 identified sites is \$84 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 \$116 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 32 immaterial sites whose total liability ranges from \$4 million (the recorded minimum liability) to \$8 million.

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The CPUC allows SCE to recover environmental remediation costs at certain sites, representing \$35 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 \$85 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 September 30, 2006 were \$13 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. Edison International has also submitted affirmative claims to the IRS and state tax agencies which are being addressed in administrative proceedings. Any benefits would be recorded when a settlement is reached or as part of the implementation of FIN 48.

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.

***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

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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 or who benefited from the manipulation by receiving inflated market prices. 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.

During the course of the refund proceedings, the FERC ruled that governmental power sellers, like private generators and marketers that sold into the California market, should refund the excessive prices they received during the crisis period. However, on September 21, 2005, the United States Court of Appeals for the Ninth Circuit (Ninth Circuit) ruled that the FERC does not have authority directly to enforce its refund orders against governmental power sellers. The Court, however, clarified that its decision does not preclude SCE or other parties from pursuing civil claims against the governmental power sellers. On March 16, 2006, SCE, Pacific Gas and Electric Company (PG&E) and the California Electricity Oversight Board jointly filed suit in federal court against several governmental power sellers, seeking refunds based on the reduced prices set by the FERC for transactions during the crisis period. SCE cannot predict whether it may be able to recover any additional refunds from governmental power sellers as a result of this suit.

In November 2005, SCE and other parties entered into a settlement agreement with Enron Corporation and a number of its affiliates, most of which are debtors in Chapter 11 bankruptcy proceedings pending in New York. In April 2006, SCE received an additional distribution on its allowed bankruptcy claim 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 October 2006, SCE received another distribution on its allowed bankruptcy claim of approximately \$20 million and 17,040 shares of Portland General Electric Company stock, with an aggregate value of less than \$1 million. Additional distributions are expected but SCE cannot currently predict the amount or timing of such distributions.

In December 2005, the FERC approved a settlement agreement among SCE, PG&E, San Diego Gas & Electric, 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 as part of the settlement.

On August 2, 2006, 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. As a result of this decision, SCE may be able to recover additional refunds from sellers of electricity during the crisis with whom settlements have not been reached.

In November 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.

***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.

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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.

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*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.

In June 2006, the Consumer Protection and Safety Division (CPSD) of the CPUC issued its report regarding SCE's PBR program, recommending that the CPUC impose various refunds and penalties on SCE. Subsequently, in September 2006, the CPSD and other intervenors, such as the CPUC's Division of Ratepayer Advocates and The Utility Reform Network filed testimony on these matters recommending various refunds and penalties to be imposed upon SCE. On October 16, 2006, SCE filed testimony opposing the various refund and penalty recommendations of the CPSD and other intervenors. Based on SCE's proposal for refunds and the combined recommendations of the CPSD and other intervenors, the potential refunds and penalties could range from \$32 million up to \$396 million. 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. At this time, SCE cannot predict the outcome of these matters or reasonably estimate the potential amount of any additional refunds, disallowances, or penalties that may be required above the lower end of the range.

*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 scheduling coordinators in the affected zone within the ISO transmission grid. The April 20, 2004 order directed the ISO to shift the costs from scheduling 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 scheduling 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 by March 2007. 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.

*Midway-Sunset Cogeneration Company*

San Joaquin Energy Company, a wholly owned subsidiary of EME, owns a 50% general partnership interest in Midway-Sunset Cogeneration Company (Midway-Sunset), which owns a 225-MW cogeneration facility near Fellows, California. Midway-Sunset is a party to several proceedings pending at the FERC because Midway-Sunset was a seller in the PX and ISO markets during 2000 and 2001, both for its own account and on behalf of SCE and PG&E, the utilities to which the majority of Midway-Sunset's power was contracted for sale. As a seller into the PX and ISO markets, Midway-Sunset is potentially liable for refunds to purchasers in these markets. See discussion above in "Federal Energy Regulatory Commission (FERC) Refund Proceedings".

The claims asserted against Midway-Sunset for refunds related to power sold into the PX and ISO markets, including power sold on behalf of SCE and PG&E, are estimated to be less than \$70 million for all periods under

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consideration. Midway-Sunset did not retain any proceeds from power sold into the PX and ISO markets on behalf of SCE and PG&E in excess of the amounts to which it was entitled under the pre-existing power sales contracts, but instead passed through those proceeds to the utilities. Since the proceeds were passed through to the utilities, EME believes that PG&E and SCE are obligated to reimburse Midway-Sunset for any refund liability that it incurs as a result of sales made into the PX and ISO markets on their behalves.

During this period, amounts SCE received from Midway-Sunset were credited to SCE's customers against power purchase expenses through the ratemaking mechanism in place at that time. SCE believes that any net amounts reimbursed to Midway-Sunset would be substantially recoverable from its customers through current regulatory mechanisms. SCE does not expect any reimbursement to Midway-Sunset to have a material impact on earnings.

***Navajo Nation Litigation***

The Navajo Nation filed a complaint in June 1999 in the U.S. District Court for the District of Columbia (District Court), against SCE, among other defendants, 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 Organization (RICO) statute, interference with fiduciary duties and contractual relations, fraudulent misrepresentations 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.

In April 2004, the District Court dismissed SCE's motion for summary judgment and concluded that a related 2003 U.S. Supreme Court decision in a related lawsuit by the Navajo Nation against the U.S. Government did not preclude the Navajo Nation from pursuing its RICO and intentional tort claims.

Pursuant to a joint request of the parties, the D.C. District Court granted a stay of the action on October 5, 2004 to allow the parties to attempt to negotiate a resolution of the issues associated with Mohave with the assistance of a facilitator. An initial, organizational session was held with the facilitator on October 14, 2004 and negotiations are on-going. On July 28, 2005, the District Court issued an order removing the case from its active calendar, subject to reinstatement at the request of any party.

SCE cannot predict the outcome of the 1999 Navajo Nation's complaint against SCE, the ultimate impact on the complaint of the Supreme Court's 2003 decision and the on-going litigation by the Navajo Nation against the Government in the related case, 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 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.

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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. Recently enacted legislation, which will become effective on January 1, 2007, will amend existing law to accelerate the overall target from 2017 to 2010.

SCE previously entered into a contract with Calpine Energy Services, L.P. to purchase the output of certain existing geothermal facilities in northern California. Under previous CPUC decisions and reporting and compliance methodology, SCE was only able to count procurement pursuant to the Calpine contract towards its annual renewable target to the extent the output was certified as "incremental" by the California Energy Commission. On October 19, 2006, the CPUC issued a decision that revised the reporting and compliance methodology, and permitted SCE to count the entire output pursuant to its Calpine contract towards satisfaction of its annual renewable procurement target thus meeting its renewable procurement obligations for 2003, 2004, 2005 and 2006. The decision also implemented a "cumulative deficit banking" feature which would carry forward and accumulate annual deficits until the deficit has been satisfied at a later time through actual deliveries of eligible renewable energy.

Under the new methodology, SCE could have deficits in meeting its renewable procurement obligations for 2007, but will be in compliance for 2003 through 2006. SCE believes it may be able to demonstrate that it should not be penalized for the 2007 deficit through the CPUC's flexible compliance rules.

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 the FERC declare that SCE was obligated to serve as the DWP's scheduling coordinator without charge. The FERC accepted SCE's

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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 September 30, 2006, SCE has accrued a \$36 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 September 21, 2006, the CPUC approved a settlement agreement between SCE and Duke Energy Trading and Marketing, LLC (Duke) that resolved disputes arising from Duke's termination of certain bilateral power supply contracts in early 2001. Under the settlement, Duke made a \$77 million principal and interest payment to SCE in October 2006, which will be refunded to ratepayers through the energy resource recovery account mechanism. The settlement also permitted \$58 million in liabilities that SCE had previously recorded with respect to the Duke terminated contracts to be reversed, which resulted in an equivalent benefit recorded by SCE in the third quarter of 2006. The CPUC agreed that these liabilities should not be refunded to ratepayers. The recorded liabilities consisted of \$40 million in cash collateral received from Duke in 2000 and \$18 million in power purchase payments that SCE, in light of Duke's termination of the bilateral contracts, withheld for energy delivered by Duke in January 2001.

***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 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.

There are now sufficient dry casks and modules available to the independent spent fuel storage installation to meet plant requirements through 2008. SCE, as operating agent, plans to continually load casks on a schedule to maintain full core off-load capability for both units in order to meet the plant requirements after 2008 until 2022 (the end of the current Nuclear Regulatory Commission operating license).

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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***

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. At September 30, 2006, SCE had eight power contracts that were classified as operating leases and one capital lease (executed in late 2005). The leases have varying terms, provisions and expiration dates. The capital lease (net commitment of \$13 million) is reported as a long-term obligation on the consolidated balance sheet under the caption "Other long-term liabilities."

Estimated remaining commitments for noncancelable operating leases, including power purchases, vehicles, office space, and other equipment at September 30, 2006 are:

In millions	Power Contracts Operating Leases	Other Operating Leases
	(Unaudited)	
October through December 2006	\$ 46	\$ 7
2007	308	36
2008	284	33
2009	228	29
2010	204	22
Thereafter	—	65
<b>Total</b>	<b>\$ 1,070</b>	<b>\$ 192</b>

***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.

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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 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 September 30, 2006:</b>				
Cash and equivalents	\$ 50	\$ 108	\$ —	\$ 158
Accounts receivable – net	1,264	151	(116)	1,299
Inventory	213	17	—	230
Other current assets	65	6	—	71
Nonutility property – net of depreciation	728	327	—	1,055
Other long-term assets	330	8	—	338
<b>Total assets</b>	<b>25,517</b>	<b>617</b>	<b>(116)</b>	<b>26,018</b>
Accounts payable	746	131	(116)	761
Accrued interest	87	1	—	88
Other current liabilities	563	3	—	566
Long-term debt	4,937	54	—	4,991
Asset retirement obligations	2,666	13	—	2,679
Minority interest	—	415	—	415
<b>Total liabilities and shareholders' equity</b>	<b>25,517</b>	<b>617</b>	<b>(116)</b>	<b>26,018</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>

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In millions	Electric Utility	VIEs	Eliminations*	SCE
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Three Months Ended September 30, 2006:</b>				
Operating revenue	\$ 2,989	\$ 327	\$ (237)	\$ 3,079
Fuel	113	173	—	286
Purchased power	1,273	—	(237)	1,036
Other operation and maintenance	644	18	—	662
Depreciation, decommissioning and amortization	245	9	—	254
Total operating expenses	2,443	200	(237)	2,406
Operating income	546	127	—	673
Minority interest	—	127	—	127
<b>Net income</b>	<b>276</b>	<b>—</b>	<b>—</b>	<b>276</b>
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Nine Months Ended September 30, 2006:</b>				
Operating revenue	\$ 7,524	\$ 899	\$ (605)	\$ 7,818
Fuel	277	559	—	836
Purchased power	3,424	—	(605)	2,819
Other operation and maintenance	1,847	69	—	1,916
Depreciation, decommissioning and amortization	779	27	—	806
Total operating expenses	6,228	655	(605)	6,278
Operating income	1,296	244	—	1,540
Minority interest	—	244	—	244
<b>Net income</b>	<b>656</b>	<b>—</b>	<b>—</b>	<b>656</b>
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Three Months Ended September 30, 2005:</b>				
Operating revenue	\$ 2,968	\$ 406	\$ (290)	\$ 3,084
Fuel	71	225	—	296
Purchased power	792	—	(290)	502
Other operation and maintenance	649	21	—	670
Depreciation, decommissioning and amortization	225	9	—	234
Total operating expenses	2,551	255	(290)	2,516
Operating income	417	151	—	568
Minority interest	—	151	—	151
<b>Net income</b>	<b>287</b>	<b>—</b>	<b>—</b>	<b>287</b>
(Unaudited)				
<b>Income Statement Items for the</b>				
<b>Nine Months Ended September 30, 2005:</b>				
Operating revenue	\$ 6,876	\$ 1,003	\$ (684)	\$ 7,195
Fuel	193	624	—	817
Purchased power	2,317	—	(684)	1,633
Other operation and maintenance	1,770	68	—	1,838
Depreciation, decommissioning and amortization	660	28	—	688
Total operating expenses	5,874	720	(684)	5,910
Operating income	1,002	283	—	1,285
Minority interest	—	283	—	283
<b>Net income</b>	<b>586</b>	<b>—</b>	<b>—</b>	<b>586</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.

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**Note 6. Preferred and Preference Stock Not Subject to Mandatory Redemption**

In January 2006, SCE issued two million shares of 6.0% Series C preference stock (noncumulative, \$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.

**Note 7. Mohave 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 required 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 other Mohave co-owners, Nevada Power Company and the Los Angeles Department of Water & Power, made similar announcements, while the fourth co-owner, Salt River Project Agricultural Improvement and Power District (SRP), has announced that it is pursuing the possibility of putting together a successor owner group, which would include SRP, to pursue continued coal operations. All of the co-owners are evaluating the range of 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 of the property 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 will be reduced from over 300 employees to approximately 65 employees by the end of 2006. Approximately \$7 million in termination costs were recorded in the second quarter and an additional \$9 million were recorded in the third quarter (both SCE's share). Both amounts were deferred in a balancing account authorized in the 2006 GRC decision. SCE expects to recover amounts in this balancing account in future rate-making proceedings.

As of September 30, 2006, SCE had a Mohave net regulatory asset of approximately \$89 million representing unamortized capital costs and inventory, partially offset by revenue collected for future removal costs. 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. On October 5, 2006, SCE submitted a formal notification to the CPUC regarding the out-of-service status of Mohave, pursuant to California law requiring such notice to the CPUC whenever a plant has been out of service for nine consecutive months. SCE also reported to the CPUC on Mohave's status numerous times previously. Pursuant to the statute the CPUC may institute an investigation to determine whether to reduce SCE's rates. At this time, SCE does not

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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, which it further believes would permit its unamortized costs to be recovered in future rates. However, SCE cannot predict the outcome of any future CPUC action.

## 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 nine-month periods ended September 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 nine-month periods ended September 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, output, and availability and cost of spare parts and repairs;
- 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 outcome of disputes with the Internal Revenue Service (IRS) and other tax authorities regarding tax positions taken by Edison International;
- 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;
- the risk of counter-party default in hedging transactions or fuel contracts;

- 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**

This section is intended to be a summary of those current developments that management believes are of most importance since year-end December 31, 2005. This section is not intended to be an all-inclusive list of all current developments. Further details of each current development discussed below can be found in this MD&A, along with discussions of liquidity, market risk exposures, and other matters.

### **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.

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

On August 24, 2006, the CPUC issued a final decision granting SCE’s request to waive the requirement that SCE file a 2007 cost of capital application and instead file its next application in 2007 for year 2008. As a result, SCE’s authorized capital structure, return on common equity of 11.60% and overall rate of return on capital of 8.77%, will not change for 2007. See “Regulatory Matters—Current Regulatory Developments—2007 Cost of Capital 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 2006 base transmission rates (which were authorized in 2003). 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.

### **Peaker Plant Generation Projects**

On August 15, 2006, the CPUC issued a ruling addressing electric reliability needs in Southern California for the summer of 2007 and directing, among other things, that SCE pursue new utility-owned peaker generation (which would be available on notice during peak demand periods) that would be online in time for the summer of 2007. SCE is currently pursuing the construction and siting of up to five combustion turbine peaker plants, each with a capacity of approximately 45 MW. SCE expects to spend a total of approximately \$250 million on these projects. See "Regulatory Matters—Current Regulatory Developments—Peaker Plant Generation Projects" for further discussion.

## **LIQUIDITY**

### **Overview**

As of September 30, 2006, SCE had cash and equivalents of \$158 million (\$108 million of which was held by SCE's consolidated Variable Interest Entities). As of September 30, 2006, long-term debt, including current maturities of long-term debt, was \$5.2 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 September 30, 2006, SCE's credit facility supported \$189 million in letters of credit, leaving \$1.5 billion available under the credit facility.

SCE's estimated cash outflows during the twelve-month period following September 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 (see "Regulatory Matters—Current Regulatory Developments—Peaker Plant Generation Projects");
- 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 each of April 28, 2006, July 24, 2006 and October 26, 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 September 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. On October 16, 2006, Moody's Investors Service raised SCE's senior secured credit rating from A3 to A2. At September 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 (see "Edison International (Parent): Liquidity" for further discussion). 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 September 30, 2006, SCE's 13-month weighted-average common equity component of total capitalization was 50%. At September 30, 2006, SCE had the capacity to pay \$164 million in additional dividends based on the 13-month weighted-average method. Based on recorded September 30, 2006 balances, SCE's common equity to total capitalization ratio, for rate-making purposes, was 50%. SCE had the capacity to pay \$260 million of additional dividends to Edison International based on September 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 September 30, 2006, SCE's debt to total capitalization ratio was 0.44 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 September 30, 2006, SCE had a net deposit of \$148 million (consisting of \$36 million in cash and reflected in "Margin and collateral deposits" on the balance sheet and \$112 million in letters of credit) with a broker. In addition, SCE has deposited \$107 million (consisting of \$30 million in cash and reflected in "Margin and collateral deposits" on the balance sheet and \$77 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 September 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. On January 1, 2006, SCE implemented a rate change that resulted in a system average rate of 13.7¢-per-kilowatt-hour (kWh). 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 California Public Utilities Commission (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-kWh. 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-kWh 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 deferral period over a twelve month period beginning January 1, 2007. On October 19, 2006, the CPUC approved SCE's request to further defer the residential increase to January 1, 2007 and approved the recovery mechanism. Under regulatory accounting, SCE is entitled to recognize revenue based on amounts authorized. As a result, the revenue associated with the residential rate increase is recognized as earned; however, collection is being deferred until January 1, 2007. On October 1, 2006, SCE implemented a rate increase modifying the FERC-jurisdictional rates to recover costs approved by the FERC associated with the ancillary services and losses SCE has incurred in administering wholesale transmission contracts after implementation of the restructured California electric industry. SCE's current system average rate, as of October 1, 2006, is approximately 14.8¢-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 regulatory proceedings, including the 2006 GRC decision, 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 application in 2007 for year 2008. On August 24, 2006, the CPUC issued a final decision granting SCE's waiver application and, as a result, SCE's authorized capital structure, return on common equity of 11.60% and overall rate of return on capital of 8.77%, will not change for 2007.

### ***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 2006 base transmission rates (which were authorized in 2003) 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 (SCE's request for rehearing on the effective date issue was subsequently denied). 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 2006 base transmission rates. 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 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.

At the end of July 2006, the ERRA was overcollected by \$231 million, which was 5.79% of SCE's prior year's generation revenue. As of September 30, 2006, the ERRA was overcollected by \$449 million, which was 11.2% of SCE's prior year's generation revenue. In addition, SCE forecasts that the overcollection will remain above the 5% threshold for the remainder of 2006.

As a result of the July 2006 overcollection, on September 1, 2006, SCE filed an ERRA trigger application proposing that no further rate action be taken and that SCE be allowed to maintain its currently authorized ERRA rates for the remainder of 2006 and to consolidate any ERRA rate change with other rate changes to become effective on January 1, 2007. SCE received no opposition to this proposal and anticipates a favorable CPUC decision by the end of 2006.

### ***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. Beginning in May 2006, SCE is required to demonstrate every month that it has met 100% of its system resource adequacy requirement one month in advance of expected need. 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 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. During the third quarter of 2006, the CPUC established the amount of local capacity necessary for SCE to meet its local resource adequacy requirements. SCE made a showing of compliance with its local resource adequacy requirements for 2007 on November 2, 2006. SCE believes it has procured sufficient resources to meet its expected local resource adequacy requirements for 2007.

### ***Peaker Plant Generation Projects***

On August 15, 2006, the CPUC issued a ruling addressing electric reliability needs in Southern California for the summer of 2007 and directing, among other things, that SCE pursue new utility-owned peaker generation (which would be available on notice during peak demand periods) that would be online in time for the summer of 2007. SCE is currently pursuing the construction and siting of up to five combustion turbine peaker plants, each with a capacity of approximately 45 MW. SCE expects to spend a total of approximately \$250 million on these projects. SCE submitted an advice letter to the CPUC seeking recovery of these costs. A decision on this filing is expected in November 2006. After the peaker plants are in operation, SCE will be required to submit a review application to determine the reasonableness of the costs. If the CPUC finds any of the costs to be unreasonable, appropriate rate adjustments will be made.

### ***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. Recently enacted legislation, which will become effective on January 1, 2007, will amend existing law to accelerate the overall target from 2017 to 2010.

SCE previously entered into a contract with Calpine Energy Services, L.P. to purchase the output of certain existing geothermal facilities in northern California. Under previous CPUC decisions and reporting and compliance methodology, SCE was only able to count procurement pursuant to the Calpine contract towards its annual renewable target to the extent the output was certified as “incremental” by the California Energy Commission (CEC). On October 19, 2006, the CPUC issued a decision that revised the reporting and compliance methodology, and permitted SCE to count the entire output pursuant to its Calpine contract towards satisfaction of its annual renewable procurement target thus meeting its renewable procurement obligations for 2003, 2004, 2005 and 2006. The decision also implemented a “cumulative deficit banking” feature which would carry forward and accumulate annual deficits until the deficit has been satisfied at a later time through actual deliveries of eligible renewable energy.

Under the new methodology, SCE could have deficits in meeting its renewable procurement obligations for 2007, but will be in compliance for 2003 through 2006. SCE believes it may be able to demonstrate that it should not be penalized for the 2007 deficit through the CPUC’s flexible compliance rules.

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 Resources***

SCE is engaged in several initiatives to meet the requirement that it procure renewable resources, including formal solicitations approved by the CPUC, bilateral negotiations with individual projects and other initiatives. On July 14, 2006, SCE requested proposals for power purchase contracts from renewable energy resources, with

bids received in September 2006. SCE is currently reviewing these bids in order to conduct further negotiations with selected bidders in an attempt to enter into final contracts. The contract lengths will be 10, 15 or 20 years.

### ***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 required 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 other Mohave co-owners, Nevada Power Company and the Los Angeles Department of Water & Power, made similar announcements, while the fourth co-owner, Salt River Project Agricultural Improvement and Power District (SRP), has announced that it is pursuing the possibility of putting together a successor owner group, which would include SRP, to pursue continued coal operations. All of the co-owners are evaluating the range of 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 of the property 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 will be reduced from over 300 employees to approximately 65 employees by the end of 2006. Approximately \$7 million in termination costs were recorded in the second quarter and an additional \$9 million were recorded in the third quarter (both SCE's share). Both amounts were deferred in a balancing account authorized in the 2006 GRC decision. SCE expects to recover amounts in this balancing account in future rate-making proceedings.

As of September 30, 2006, SCE had a Mohave net regulatory asset of approximately \$89 million representing unamortized capital costs and inventory, partially offset by revenue collected for future removal costs. 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. On October 5, 2006, SCE submitted a formal notification to the CPUC regarding the out-of-service status of Mohave, pursuant to California law requiring such notice to the CPUC whenever a plant has been out of service for nine consecutive months. SCE also reported to the CPUC on Mohave's status numerous times previously. Pursuant to the statute 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, which it further believes would permit its unamortized costs to be recovered in future rates. 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. 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. SCE expects the CPUC to issue its decision affirming the cost effectiveness of the steam generator replacement project during the fourth quarter of 2006.

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. SCE received authority to acquire Anaheim’s share from the FERC in April 2006 and from the NRC in September 2006. SCE expects to receive authority to recover Anaheim’s share of San Onofre operating and decommissioning costs from the CPUC during the fourth quarter of 2006. The transfer of Anaheim’s share is expected to occur in late 2006.

On April 14, 2006, San Diego Gas & Electric Company (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 authorization of an 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 by the end of 2007. 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 “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 during the energy crisis in California in 2000–2001 or who benefited from the manipulation by receiving inflated market prices. 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.

During the course of the refund proceedings, the FERC ruled that governmental power sellers, like private generators and marketers that sold into the California market, should refund the excessive prices they received during the crisis period. However, on September 21, 2005, the United States Court of Appeals for the Ninth Circuit (Ninth Circuit) ruled that the FERC does not have authority directly to enforce its refund orders against governmental power sellers. The Court however, clarified that its decision does not preclude SCE or other parties

from pursuing civil claims against the governmental power sellers. On March 16, 2006, SCE, Pacific Gas and Electric Company (PG&E) and the California Electricity Oversight Board jointly filed suit in federal court against several governmental power sellers, seeking refunds based on the reduced prices set by the FERC for transactions during the crisis period. SCE cannot predict whether it may be able to recover any additional refunds from governmental power sellers as a result of this suit.

In November 2005, SCE and other parties entered into a settlement agreement with Enron Corporation and a number of its affiliates, most of which are debtors in Chapter 11 bankruptcy proceedings pending in New York. In April 2006, SCE received an additional distribution on its allowed bankruptcy claim 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 October 2006, SCE received another distribution on its allowed bankruptcy claim of approximately \$20 million and 17,040 shares of Portland General Electric Company stock, with an aggregate value of less than \$1 million. Additional distributions are expected but SCE cannot currently predict the amount or timing of such distributions.

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 March 2006, SCE received an additional \$61 million as part of the settlement.

On August 2, 2006, 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. As a result of this decision, SCE may be able to recover additional refunds from sellers of electricity during the crisis with whom settlements have not been reached.

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

On October 27, 2005, the CPUC issued an Order Instituting Rulemaking (OIR) 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 OIR 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 included the CPUC staff proposals for revisions to the affiliate transaction rules and the utility executive compensation reporting rules. Finally, the opinion expanded the process for the OIR to include participation of interested third parties through filed comments, a workshop, and oral argument. Respondent utilities and holding companies and other interested parties have completed briefings and a workshop to discuss the issues raised in the amended order.

On October 10, 2006, the CPUC issued a proposed decision that would amend the affiliate transaction rules and the executive compensation reporting rules. SCE and Edison International oppose some of the rule changes because they significantly alter relationships between the public utilities and their holding companies and nonregulated affiliates without clear evidentiary support; reduce operational efficiencies and increase regulatory compliance costs; and unnecessarily interfere with corporate governance and oversight. The CPUC has stated that it intends to conclude this rulemaking by the end of 2006. Edison International 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.

In June 2006, the Consumer Protection and Safety Division (CPSD) of the CPUC issued its report regarding SCE's PBR program, recommending that the CPUC impose various refunds and penalties on SCE. Subsequently, in September 2006, the CPSD and other intervenors, such as the CPUC's Division of Ratepayer Advocates and The Utility Reform Network filed testimony on these matters recommending various refunds and penalties to be imposed upon SCE. On October 16, 2006, SCE filed testimony opposing the various refund and penalty recommendations of the CPSD and other intervenors. Based on SCE's proposal for refunds and the combined recommendations of the CPSD and other intervenors, the potential refunds and penalties could range from \$32 million up to \$396 million. 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. At this time, SCE cannot predict the outcome of these matters or reasonably estimate the potential amount of any additional refunds, disallowances, or penalties that may be required above the lower end of the range.

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

On September 21, 2006, the CPUC approved a settlement agreement between SCE and Duke Energy Trading and Marketing, LLC (Duke) that resolved disputes arising from Duke's termination of certain bilateral power supply contracts in early 2001. Under the settlement, Duke made a \$77 million principal and interest payment to SCE in October 2006, which will be refunded to ratepayers through the ERRRA mechanism. The settlement also permitted \$58 million in liabilities that SCE had previously recorded with respect to the Duke terminated contracts to be reversed, which resulted in an equivalent benefit recorded by SCE in the third quarter of 2006 (reflected in the caption "Purchased power" on the income statement). The CPUC agreed that these liabilities should not be refunded to ratepayers. The recorded liabilities consisted of \$40 million in cash collateral received from Duke in 2000 and \$18 million in power purchase payments that SCE, in light of Duke's termination of the bilateral contracts, withheld for energy delivered by Duke in January 2001.

## **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:

### ***California Greenhouse Gas Emissions Legislation***

In September 2006, California's Governor Schwarzenegger signed two bills into law regarding greenhouse gas emissions. The first, known as Assembly Bill 32 or the California Global Warming Solutions Act of 2006, establishes a comprehensive program of regulatory and market mechanisms to achieve reductions of greenhouse gases. Assembly Bill 32 requires the California Air Resources Board to develop regulations and market mechanisms targeted to reduce California's greenhouse gas emissions to 1990 levels by 2020. Mandatory caps will begin in 2012 and will be reduced incrementally each year so that emissions of greenhouse gases will be reduced to the 1990 levels by 2020. The second bill, known as Senate Bill 1368, requires the CEC to develop and adopt by regulation a greenhouse gas emissions performance standard for long-term procurement of electricity by local publicly owned utilities. The CEC must adopt the standard on or before June 30, 2007 and it must be consistent with the standard to be adopted by the CPUC for load-serving entities under their jurisdiction on or before February 1, 2007. For more information on the CPUC standard, refer to "Other Developments—Environmental Matters—Environmental Matters Affecting SCE—Climate Change" in the year-ended 2005 MD&A. Edison International is not able at this time to predict the final form of these rules or provide an estimate of their financial impact.

### ***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 23 identified sites is \$84 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 \$116 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 32 immaterial sites whose total liability ranges from \$4 million (the recorded minimum liability) to \$8 million.

The CPUC allows SCE to recover environmental remediation costs at certain sites, representing \$35 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 \$85 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 September 30, 2006 were \$13 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 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. Edison International has also submitted affirmative claims to the IRS and state tax agencies which are being addressed in administrative proceedings. Any benefits would be recorded when a settlement is reached or as part of the implementation of a Financial Accounting Standards Board (FASB) interpretation related to accounting for uncertainty in income taxes (FIN 48).

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.

### **Midway-Sunset Cogeneration Company**

San Joaquin Energy Company, a wholly owned subsidiary of EME, owns a 50% general partnership interest in Midway-Sunset Cogeneration Company (Midway-Sunset), which owns a 225 MW cogeneration facility near Fellows, California. Midway-Sunset is a party to several proceedings pending at the FERC because Midway-Sunset was a seller in the PX and ISO markets during 2000 and 2001, both for its own account and on behalf of SCE and PG&E, the utilities to which the majority of Midway-Sunset's power was contracted for sale. As a seller into the PX and ISO markets, Midway-Sunset is potentially liable for refunds to purchasers in these markets. See "Regulatory Matters—Current Regulatory Developments—FERC Refund Proceedings."

The claims asserted against Midway-Sunset for refunds related to power sold into the PX and ISO markets, including power sold on behalf of SCE and PG&E, are estimated to be less than \$70 million for all periods under consideration. Midway-Sunset did not retain any proceeds from power sold into the PX and ISO markets on behalf of SCE and PG&E in excess of the amounts to which it was entitled under the pre-existing power sales contracts, but instead passed through those proceeds to the utilities. Since the proceeds were passed through to the utilities, EME believes that PG&E and SCE are obligated to reimburse Midway-Sunset for any refund liability that it incurs as a result of sales made into the PX and ISO markets on their behalves.

During this period, amounts SCE received from Midway-Sunset were credited to SCE's customers against power purchase expenses through the ratemaking mechanism in place at that time. SCE believes that any net amounts reimbursed to Midway-Sunset would be substantially recoverable from its customers through current regulatory mechanisms. SCE does not expect any reimbursement to Midway-Sunset to have a material impact on earnings.

### **Navajo Nation Litigation**

The Navajo Nation filed a complaint in June 1999 in the U.S. District Court for the District of Columbia (District Court), against SCE, among other defendants, 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 Organization (RICO) statute, interference with fiduciary duties and contractual relations, fraudulent misrepresentations 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.

In April 2004, the District Court dismissed SCE's motion for summary judgment and concluded that a 2003 U.S. Supreme Court decision in a related lawsuit by the Navajo Nation against the U.S. Government did not preclude the Navajo Nation from pursuing its RICO and intentional tort claims.

Pursuant to a joint request of the parties, the District Court granted a stay of the action on October 5, 2004 to allow the parties to attempt to negotiate a resolution of the issues associated with Mohave with the assistance of a facilitator. An initial, organizational session was held with the facilitator on October 14, 2004 and negotiations are on-going. On July 28, 2005, the District Court issued an order removing the case from its active calendar, subject to reinstatement at the request of any party.

SCE cannot predict the outcome of the 1999 Navajo Nation's complaint against SCE, the ultimate impact on the complaint of the Supreme Court's 2003 decision and the on-going litigation by the Navajo Nation against the Government in the related case, 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 and Inspection**

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 ERRA rate-making mechanism.

The Nuclear Regulatory Commission (NRC) has held three special inspections of Palo Verde, between March 2005 and October 2006. A follow-up to the first inspection resulted in a finding that Palo Verde had not established adequate measures to ensure that certain corrective actions were effective. The second recent

inspection identified five apparent violations that may require increased NRC regulatory oversight. The initial results of the most recent inspection concerning the failure of an emergency backup generator at Palo Verde Unit 3 are expected to be available in mid-November 2006. Multiple findings by the NRC of a need for increased regulatory oversight could increase the number of corrective actions Palo Verde would be required to take, thereby increasing costs. SCE cannot predict what corrective actions will have to be taken to satisfy these NRC inspection findings or the cost to Palo Verde's co-owners, including SCE.

## 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	September 30, 2006		December 31, 2005	
	Assets	Liabilities	Assets	Liabilities
Energy options and tolling arrangements	\$ 14	\$ —	\$ 25	\$ —
Forward physicals (power)	—	121	—	49
Gas options, swaps and forward arrangements	—	146	105	—
<b>Total</b>	<b>\$ 14</b>	<b>\$ 267</b>	<b>\$ 130</b>	<b>\$ 49</b>

SCE records its derivative instruments on its consolidated balance sheets at fair value unless they meet the definition of a normal purchase or sale. The normal purchase and sales exception requires, among other things, physical delivery in quantities expected to be used or sold over a reasonable period in the normal course of business. SCE enters into contracts for power and gas options, as well as swaps and futures, in order to mitigate its exposure to increases in natural gas and electricity pricing. These transactions are pre-approved by the CPUC or executed in compliance with CPUC-approved procurement plans. The derivative instrument fair values are marked to market at each reporting period. Any fair value changes for recorded derivatives are recorded in purchased-power expense and offset through the provision for regulatory adjustment clauses; therefore, fair value changes do not affect earnings. Hedge accounting is not used for these transactions due to this regulatory accounting treatment.

SCE recorded net unrealized losses of \$9 million and \$351 million, for the three- and nine-month periods ended September 30, 2006, respectively, compared to net unrealized gains of \$504 million and \$457 million, for the same periods in 2005, respectively. The 2006 quarter and year-to-date unrealized losses were primarily due to changes in both the gas and power portfolios, as well as decreases in the gas and power forward market prices.

## 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 \$263 million and \$618 million for the three- and nine-month periods ended September 30, 2006, respectively, compared with net income of \$280 million and \$572 million for the comparable periods in 2005. The quarter and year-to-date variances reflect the impact of higher net revenue associated with the GRC decision and earnings from SCE’s Mountainview plant, partially offset by higher income tax expense. Net income available for common stock for the three- and nine-month periods ended September 30, 2006 include a \$24 million benefit from a generator settlement in 2006 (see “Regulatory Matters—Current Regulatory Developments—Settlement Agreement with Duke Energy Trading and Marketing, LLC”). Net income available for common stock for the nine-month period ended September 30, 2006, also include an \$81 million benefit from the resolution of an outstanding state income tax issue (see “Regulatory Matters—Current Regulatory Developments—2006 General Rate Case Proceeding” for further discussion of this benefit). Net income available for common stock for the three- and nine-month periods ended September 30, 2005 include a \$61 million benefit from an IRS tax settlement and a \$4 million generator refund incentive.

#### *Operating Revenue*

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

In millions	Three Months Ended September 30, 2006 vs. 2005	Nine Months Ended September 30, 2006 vs. 2005
<b>Operating revenue</b>		
Rate changes (including unbilled)	\$ 593	\$ 986
Sales volume changes (including unbilled)	211	297
Balancing account (over) undercollections	(675)	(371)
Sales for resale	(116)	(314)
SCE’s variable interest entities	(26)	(25)
Other (including intercompany transactions)	8	50
<b>Total</b>	<b>\$ (5)</b>	<b>\$ 623</b>

SCE’s retail sales represented approximately 90% of operating revenue for both the three- and nine-month periods ended September 30, 2006, respectively, compared to approximately 85% 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.

Total operating revenue decreased \$5 million and increased \$623 million for the three and nine months ended September 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, June 4, 2006, and August 1, 2006 (see “Regulatory Matters—Current Regulatory Developments—Impact of Regulatory Matters on Customer Rates” for further discussion of these rate changes). The increases in operating revenue resulting from sales volume changes was mainly due to an increase in kilowatt-hours (kWh) sold resulting from record heat conditions experienced in the third quarter of 2006, as well as SCE providing a greater amount of energy to its customers from its own sources in 2006, compared to 2005. Balancing account (over) undercollections

represents the difference between authorized revenue and recorded revenue subject to regulatory balancing account mechanisms. Recorded revenue (reflected in revenue from rate changes and sales volume changes in the table above) exceeded authorized revenue by approximately \$767 million and \$663 million in the three- and nine-month periods ended September 30, 2006, respectively, compared to approximately \$92 million and \$292 million in the same periods in 2005, respectively, due to higher balancing account overcollections in 2006, compared to 2005. 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 ERRA 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. The year-to-date increase in other revenue was due to higher investment earnings from SCE's nuclear decommissioning trusts. The nuclear decommissioning trust investment earnings are offset in depreciation, decommissioning and amortization expense and as a result, have no impact on net income.

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 \$686 million and \$1.8 billion for the three- and nine-month periods ended September 30, 2006, respectively, compared to \$534 million and \$1.5 billion for the same respective periods in 2005.

### ***Operating Expenses***

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

SCE's fuel expense decreased \$10 million for the three months ended September 30, 2006 and increased \$19 million for the nine months ended September 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 \$25 million and \$60 million for the three- and nine-month periods ended September 30, 2006, respectively, 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 fuel expense of \$50 million and \$65 million for the three- and nine-month periods ended September 30, 2006, respectively, related to SCE's consolidated variable interest entities; and higher fuel expense of \$65 million and \$165 million for the three- and nine-month periods ended September 30, 2006, respectively, resulting from SCE's newly constructed Mountainview project which became operational in December 2005. The year-to-date variance also reflects lower nuclear fuel expense of \$15 million resulting from a planned refueling and maintenance outage at SCE's San Onofre Unit 2.

#### ***Purchased-Power Expense***

Purchased-power expense increased \$534 million and \$1.2 billion for the three- and nine-month period ended September 30, 2006, respectively, as compared to the same periods in 2005. The quarterly and year-to-date increases were mainly due to net realized and unrealized losses of \$120 million and \$630 million in the three- and nine-month periods ended September 30, 2006, respectively, compared to net realized and unrealized gains of \$585 million and \$530 million in the same periods in 2005, respectively (see "Market Risk Exposures—Commodity Price Risk" for further discussion). The quarter increase was partially offset by lower firm energy purchases of approximately \$40 million, lower power purchased from qualifying facilities (QF) of approximately \$45 million (as further discussed below) and higher energy settlement refunds of approximately \$115 million in 2006, compared to 2005. The year-to-date increase was also due to increased firm energy purchases of approximately \$75 million and a decrease in power purchased from QFs of approximately \$40 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 decreased \$651 million and \$1.0 billion for the three- and nine-month periods ended September 30, 2006, as compared to the same periods in 2005. The decreases for both periods were mainly due to net unrealized losses related to economic hedging transactions (mentioned above in purchased-power expense) of approximately \$10 million and \$350 million for the three- and nine-month periods ended September 30, 2006, respectively, that, if realized, would be recovered from ratepayers, compared to unrealized gains of \$505 million and \$455 million for the same periods in 2005, respectively (see “Market Risk Exposures—Commodity Price Risk” for further discussion). The decreases also reflect lower net overcollections of purchase-power, fuel, and operation and maintenance expenses of approximately \$155 million and \$40 million for the three- and nine-month periods ended September 30, 2006. The year-to-date decrease was also due to 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.

#### *Other Operation and Maintenance Expense*

SCE’s other operation and maintenance expense increased \$78 million for the nine-month period ended September 30, 2006, as compared to the same period in 2005. The year-to-date increase was mainly due to higher generation-related costs of approximately \$50 million primarily resulting from the planned refueling and maintenance outage at SCE’s San Onofre Unit 2, higher transmission and distribution maintenance cost of approximately \$15 million, partially offset by a decrease of \$15 million in reliability costs related to must-run offer units (reliability costs are being recovered through regulatory mechanisms approved by the FERC). In addition, as a result of implementation of the 2006 GRC, beginning in May 2006, costs related to the 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 \$20 million and \$118 million for the three- and nine-month periods ended September 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 \$15 million and \$50 million for the three- and nine-month periods ended September 30, 2006, respectively, resulting from the implementation of the new depreciation rates approved in the 2006 GRC decision, 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 \$9 million for the nine-month period ended September 30, 2006, as compared to the same period in 2005. The 2006 increase was 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 decreased \$20 million and \$7 million for the three- and nine-month periods ended September 30, 2006, as compared to the same periods in 2005. The decrease in both periods was mainly due to a \$15 million incentive recorded in 2005 related to demand-side management and energy efficiency performance for the portion of the incentive previously collected in rates, but which were deferred. There was no comparable incentive in 2006. Also recorded in other nonoperating income are incentive rewards approved by the CPUC for the efficient operation of Palo Verde of \$15 million in the first quarter of 2006 and \$10 million in the first quarter of 2005.

### *Other Nonoperating Deductions*

Other nonoperating deductions decreased \$23 million and \$22 million for the three- and nine-month periods ended September 30, 2006, respectively, mainly due to a 2005 penalty accrual of \$26 million under the system reliability performance mechanism for 2005.

### **Income Tax**

SCE's effective tax rates from net income was 42% and 40% for the three- and nine-month periods ended September 30, 2006, respectively, as compared to 16% and 24% for the same periods in 2005. The increased effective tax rate resulted primarily from recording a \$61 million benefit, including \$45 million of interest income, in the third quarter of 2005 relating to a settlement with the IRS on tax issues and pending affirmative claims relating to Edison International's 1991–1993 tax years. Additional increases to the effective tax rate resulted from reductions made to the income tax reserve in 2005 to reflect the issuance of new IRS regulations and progress in settlement negotiations relating to tax audits other than the 1991–1993 IRS audit and adjustments made to tax balances in 2005.

### **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 \$2.1 billion for the nine-month period ended September 30, 2006, compared to \$2.0 billion for the comparable period in 2005. The 2006 change in cash provided by operating activities from continuing operations was mainly due to an increase in cash collected from SCE's customers due to increased rates (see "Regulatory Matters—Current Regulatory Developments—Impact of Regulatory Matters on Customer Rates") and increased sales volume due to warmer weather in 2006, as compared to 2005, which contributed to higher balancing account overcollections in 2006, as compared to 2005. The 2006 increase was almost entirely offset by lower net margin and collateral deposits due to a decrease in forward market prices at September 30, 2006, compared to December 31, 2005. Margin and collateral deposits received from counterparties decreased \$151 million in 2006, compared to an increase of \$354 million in 2005. Margin and collateral deposit posted to counterparties decreased \$112 million in 2006, compared to an increase of \$83 million in 2005.

#### ***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.
- Financing activities in 2006 also included dividend payments of \$191 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 \$214 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 \$1.6 billion in capital expenditures at SCE, primarily for transmission and distribution assets, including approximately \$63 million for nuclear fuel acquisitions.

Investing activities in 2005 reflect \$1.3 billion in capital expenditures at SCE, primarily for transmission and distribution assets, including approximately \$43 million for nuclear fuel acquisitions and \$111 million related to the Mountainview project.

#### **NEW ACCOUNTING PRONOUNCEMENTS**

A new accounting standard, Statement of Financial Accounting Standards (SFAS) No. 123(R), 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 \$11 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 FASB issued a Staff Position (FSP), FSP FIN 46(R)-6, 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 was 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. Applying the guidance of FSP FIN 46(R)-6 had no effect on the financial statements for the three months ended September 30, 2006.

In July 2006, the FASB issued an interpretation (FIN 48) 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 for SCE is January 1, 2007. SCE is currently assessing the potential impact of FIN 48 on its financial condition.

In September 2006, the FASB issued a new accounting standard on fair value measurements (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value and expands the disclosures on fair value measurements. SCE will adopt SFAS No. 157 on January 1, 2008. SCE is currently evaluating the impact of adopting SFAS No. 157 on its financial statements.

In September 2006, the FASB issued SFAS No. 158, which amends the accounting by employers for defined benefit pension plans and postretirement benefits other than pensions. SFAS No. 158 requires companies to recognize the overfunded or underfunded status of a defined benefit pension or other postretirement plan as an asset or liability in its balance sheet; the asset or liability is offset through other comprehensive income. SCE will record regulatory assets or liabilities instead of charges or credits to other comprehensive income for its postretirement benefit plans that are recoverable in utility rates, in accordance with accounting principles for rate-regulated enterprises. The standard also requires companies to align the measurement dates for their plans to their fiscal year-ends; SCE already has a fiscal year-end measurement date for all of its postretirement plans. SCE will adopt SFAS No. 158 prospectively on December 31, 2006. Had SFAS No. 158 been effective as of December 31, 2005, SCE would have recorded additional postretirement benefit liabilities of \$739 million, additional regulatory assets of \$723 million, and a reduction to accumulated other comprehensive income (a component of shareholder's equity) of \$11 million, net of tax. SCE is currently assessing the impact of this standard on its 2006 financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The new guidance requires additional quantitative testing to determine whether a misstatement is material. SCE will implement SAB No. 108 for the filing of its Annual Report on Form 10-K for the year-ended December 31, 2006. SCE is currently assessing the impact, if any, of the adoption of SAB No. 108.

In September 2006, the FASB's Emerging Issues Task Force (EITF) reached a consensus for Issue No. 06-5, which clarifies the accounting for purchases of life insurance, including corporate-owned life insurance. The new guidance states that policyholders should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract, and specifies that contractual limitations should be considered when determining the realizable amounts. The new guidance is effective January 1, 2007, and retrospective application or a cumulative effect adjustment is permitted to transition to the new guidance. SCE is currently evaluating the impact, if any, of adopting EITF Issue No. 06-5.

## 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*

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. At September 30, 2006, SCE had eight power contracts that were classified as operating leases and one capital lease (executed in late 2005). The leases have varying terms, provisions and expiration dates. The capital lease (net commitment of \$13 million) is reported as a long-term obligation on the consolidated balance sheet under the caption "Other long-term liabilities."

Estimated remaining commitments for noncancelable operating leases, including power purchases, vehicles, office space, and other equipment at September 30, 2006 are:

In millions	Power Contracts Operating Leases	Other Operating Leases
	(Unaudited)	
October through December 2006	\$ 46	\$ 7
2007	308	36
2008	284	33
2009	228	29
2010	204	22
Thereafter	—	65
Total	\$ 1,070	\$ 192

### **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.

## **Item 6. Exhibits**

### **Southern California Edison Company**

- 10.1 Amendment to Equity Compensation Plan, 2000 Equity Plan, and Officer Long-Term Incentive Compensation Plan, adopted September 7, 2006 (File No. 1-9936, filed as Exhibit 10.01 to Edison International's Form 10-Q for the quarter ended September 30, 2006)\*
- 10.2 First Amendment to Credit Agreement among Southern California Edison Company and JPMorgan Chase Bank, N.A., as Administrative Agent, Citicorp North America, Inc., as Syndication Agent, and Credit Suisse First Boston, Lehman Commercial Paper Inc., and Wells Fargo Bank, N.A., as Documentation Agents, dated as of October 18, 2006 (File No. 1-2313, filed as Exhibit 10.1 to Southern California Edison's Form 8-K, dated October 18, 2006 and filed on October 24, 2006)\*
- 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

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



**CERTIFICATION**

I, ALAN J. FOHRER, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended September 30, 2006, of Southern California Edison Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2006

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/s/ ALAN J. FOHRER  
ALAN J. FOHRER  
Chief Executive Officer

**CERTIFICATION**

I, THOMAS M. NOONAN, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the quarter ended September 30, 2006, of Southern California Edison Company;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2006

/s/ THOMAS M. NOONAN  
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THOMAS M. NOONAN  
Senior Vice President and Chief Financial Officer

**STATEMENT PURSUANT TO 18 U.S.C. SECTION 1350, AS  
ENACTED BY SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 (the "Quarterly Report"), of Southern California Edison Company (the "Company"), and pursuant to 18 U.S.C. Section 1350, as enacted by Section 906 of the Sarbanes-Oxley Act of 2002, each of the undersigned certifies, to the best of his knowledge, that:

1. The Quarterly Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

November 3 , 2006

/s/ ALAN J. FOHRER

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**Alan J. Fohrer**  
**Chief Executive Officer**  
**Southern California Edison Company**

/s/ THOMAS M. NOONAN

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**Thomas M. Noonan**  
**Chief Financial Officer**  
**Southern California Edison Company**

This statement accompanies the Quarterly Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

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