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December 29, 2017

Mr. Timothy J. Sullivan
Executive Director
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

SUBJECT: Letter of notification establishing a Z-Factor for costs associated with incremental wildfire-related liability insurance.

Dear Mr. Sullivan:

This letter of Z-Factor notification is being submitted under the terms of SCE's Preliminary Statement of its tariffs, Section AAA (5); and SCE's Test Year 2015 General Rate Case Decision, D. 15-11-021.

BACKGROUND

The wildfires in southern California have brought widespread damage to homes, property and landscapes in just a few recent weeks. The Thomas Fire has destroyed 273,400 acres in Ventura and Santa Barbara counties as of December 23, 2017. The Thomas fire is the largest acreage wildfire ever experienced in California causing widespread damage. These extraordinary winter fires are unusual and the years of construction and growing population density at the wildlands interface often results in greater damages in the wake of new wildfires. Governor Brown proclaimed a State of Emergency in Ventura and Santa Barbara Counties on December 5, 2017 and December 7, 2017, respectively, "due to the effects of the Thomas fire, which has damaged critical infrastructure, destroyed hundreds of homes and caused the evacuation of residents." Governor Brown also proclaimed a State of Emergency in Los Angeles County on December 5, 2017 "due to the effects of the Creek and Rye fires, which have threatened critical infrastructure, destroyed homes and caused the evacuation of residents."

Currently, the investigations of the causes of the December southern California wildfires are ongoing and responsibility has not yet been determined. Nonetheless, should responsibility in an inverse condemnation environment ultimately be assigned to SCE for a significant portion of the losses associated with these wildfires, there is a real risk SCE could exhaust its wildfire coverage at a time when the market for wildfire insurance is contracting. As it may not be possible to obtain additional coverage this low in the insurance tower in the future if SCE's existing coverage is exhausted, it was prudent to obtain a crucial $300 million layer of additional coverage this year while the market permits.

Prolonged drought conditions and shifting weather patterns in California resulting from climate change have increased the duration of the wildfire season and the risk of severe wildfire events. These factors, together with the unique application of inverse condemnation in California, have combined to make it unattractive for insurers to offer wildfire liability insurance to investor-owned utilities in California. Some insurance companies have dropped out of the California utility wildfire insurance market, others are reducing the amount of wildfire insurance they are willing to sell in California, and we understand that still others are indicating they may drop out of California if there is another large wildfire attributed to utility facilities. As insurance companies continue to reduce or eliminate their wildfire liability coverage, premiums have increased sharply and available insurance is decreasing. Some of SCE's general liability insurance policies cover both wildfire and non-wildfire exposures, but the majority are earmarked to either wildfire or non-wildfire. Since wildfire coverage is more limited in availability and much more expensive than non-wildfire coverage, SCE buys separate coverage so that non-wildfire claims will not use up the expensive wildfire insurance.

Given the foregoing circumstances and those described below, SCE concluded that prudence dictated the acquisition of additional wildfire insurance coverage in the face of both the possibility that its current coverage could be exhausted and the likelihood that acquiring insurance next year, when SCE would typically renew, may be significantly more expensive due to the diminishing general liability and wildfire insurance market in California for investor-owned utilities, to the extent even available. Failing to purchase additional insurance coverage could force SCE to pay future claims on a "dollar-for-dollar" basis from authorized revenues, rather than seeking reimbursement from its insurers. Incurring these kinds of incremental expenses for future occurrences could impair SCE's ability to conduct previously planned work on the electric system and/or drive-up financing costs for company operations.

The purchase of replacement insurance coverage at the end of 2017 through the transaction described below did not duplicate the forecast of insurance coverage previously planned for 2018. In discussions with SCE's insurance broker over the last week, SCE has learned that $300 million of coverage equivalent to this week's purchase may not be available in 2018 when SCE customarily renews insurance. SCE forecast expenses of $14.070 million for property insurance and $92.427 million for liability insurance in its Test Year 2018 General Rate Case. However, because of the diminishing, collapsing general liability and wildfire insurance market noted above, even if equivalent coverage were available next year, it would be significantly more expensive than was contemplated in the general rate case forecast. Any revenue requirement authorized in SCE's 2018 GRC will be put to use buying additional coverage, in a market stressed by insurers withdrawing and any who remain demanding steep premiums to compensate for the heightened risk.

Through the transfer of funds on December 29, 2017, SCE secured additional insurance from the one insurer that our broker identified as willing to provide coverage this low in the wildfire insurance tower. The term of the insurance contract is from December 31, 2017 through December 30, 2018 for a new limit of $300 million. The premium paid on December 29, 2017, was $120.9 million, including required fees. SCE incurred the obligation and paid for the coverage in 2017, consistent with the Z-Factor's intent. The Post-Test Year Ratemaking section of SCE's tariffs[1] does not require or contemplate authorization of a memorandum account to go forward with the Z-Factor.

Recovery of incremental insurance expense is subject to a one-time deductible of $10 million. Specifically, SCE's preliminary statement declares that "SCE will bear the risk of all potential Z-Factors which do not have a financial impact on SCE of more than $10 million. The $10 million threshold amount is also applied as a deductible on a one-time basis to each Z-Factor authorized for recovery by the Commission. The deductible amount is only applied in the first year's ratemaking treatment for the Z-Factor."[2]

Upon payment by SCE for the additional insurance, SCE will debit the Base Revenue Requirement Balancing Account (BRRBA) for December, net of the $10 million deductible and capitalization, plus taxes, etc. This BRRBA entry for the revenue requirement of the annual premium will be excluded from the January 1, 2018, consolidated rate change previously approved by the Commission. SCE is required to secure Commission approval in a future advice letter before commencing cost recovery of the Z-Factor expense. SCE plans to file this advice letter in the first quarter of 2018. Given the magnitude of the premium, SCE proposes to amortize the cost recovery of the annual insurance premium over 12 months through the BRRBA balancing account upon receiving Commission approval. The insurance coverage will follow customary accounting and ratemaking, with monthly revenues and expenses recognized, offset somewhat by regulatory lag.

SCE's Preliminary Statement directs SCE that "[i]n order to receive recovery of a Z-Factor, SCE shall include in its request for recovery of the revenue requirement associated with the Potential Z-Factor in an Advice Filing."[3] This upcoming advice filing will include declarations or testimony demonstrating the reasonableness of SCE's actions securing the additional coverage in 2017.

Z FACTOR ELIGIBILITY

Section AAA (5) of SCE's Preliminary Statement describes the process for establishing a Z-Factor. Specifically, section a (4) requires SCE to "…show how the Potential Z-Factor meets the Z-Factor Criteria per D. 94-06-011." The section below answers the questions stated in D. 94-06-011, conformed to apply to an electric utility.

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[1] SCE Tariff Preliminary Statement, Section AAA

[2] SCE Preliminary Statement, AAA. Post Test Year Ratemaking Mechanism (PTYR), Sheet 3, Section 5. C.

[3] Ibid, Section 5. b

1. Is the event creating the cost at issue exogenous?

   Yes, these fires are unprecedented because they are occurring late in the year over a few short weeks and the devastation brought about (especially by the Thomas fire) could not have been predicted. Each year, SCE buys as much insurance as is commercially available in the markets at an acceptable price. The company buys from various insurers, progressively building a “tower” of overall coverage. The tower is comprised of segments of insurance coverage for a range of damages, each with specific terms and conditions and premium prices.

   This strategy, followed by most corporations, is designed to realize optimal coverage for likely losses and progressively buying additional segments of coverage with greater dollar values of coverage, aligning the greater coverage with improbable need of having to file a claim. This strategy permits SCE to optimize the coverage for most likely claims at the lowest reasonable price.

   The availability and cost of wildfire insurance is also an exogenous circumstance because SCE cannot dictate or influence the price of premiums or the deductibles. The cost of insurance premiums is strongly influenced by the California courts’ application of inverse condemnation to investor-owned utilities, the number and severity of recent wildfire occurrences within the wildland-urban interface, and the insurers’ perception of risk in the California market for all utilities. These outside factors dictate the availability and price of wildfire insurance, not SCE.

2. Did the event causing the cost occur after late 1989?

   Yes.

3. Is the cost clearly beyond management’s control?

   Yes, please see the response to Question 1.

4. Is the cost a normal cost of doing business even if it is increased by an exogenous event?

   No, the magnitude of these fires and SCE’s potential full limit loss of current coverage is not a normal expense that could have been anticipated and incorporated in SCE’s Test Year 2015 GRC forecast. While the presence of wildfire damage from year to year is a foreseeable expense, the cumulative effects of the sharp increase in the frequency and magnitude of the wildfires, the growing amount of property damage in the wake of each wildfire, and the declining availability of wildfire liability insurance in the California market could not have been anticipated.

5. Does the event have a disproportionate impact on the company?

   Yes, the anticipated cost of insurance premiums would have a significant impact on SCE's operations. If the company does not augment its insurance coverage it would face the specter of reallocating authorized revenues to pay claims, thus deferring planned, critical work in the coming years. If SCE was unable to delay planned work, funding the stepped-up number of claims from revenues earmarked for bond payments and earnings, then SCE's cost of financing company operations would become more expensive. This phenomenon would impede SCE's opportunity to earn its authorized return on capital investments, causing future capital investment to be scaled back or be more expensive to SCE customers. This latter, negative scenario would have long-lasting impacts on SCE's financing costs as the investment community would view California as an increased risk.

6. Is the cost caused by the event reflected in the economy-wide inflation factor used in the GRC?

   No, such costs are not within the escalation factors adopted by the Commission in D.15-11-021, SCE's test year 2015 General Rate Case.

7. Does the event have a major impact on the utility's overall costs?

   Yes, please see responses to Questions 4 & 5.

8. Can actual costs be used to measure the financial impact of the event or can the costs be determined with reasonable certainty and minimal controversy?

   Yes, SCE will establish segregated accounting for these incremental insurance premium expenses.

9. Are the costs proposed for Z Factor treatment reasonable?

   SCE will demonstrate that its actions were reasonable because it sought coverage through a reputable insurance broker to replenish the insurance coverage from those carriers who might remain in the California utility wildfire liability insurance market. Given the number and severity of California wildfires in 2017, SCE's broker identified only one insurer who would sell insurance to SCE this low in the wildfire tower at a price considered reasonable under the circumstances. SCE purchased the additional insurance because it recognized it might reach full limit loss of current coverage, although investigations of the fires' causes are ongoing.

For questions, please contact me at (626) 302-4177 or by electronic mail at Russell.Worden@sce.com.

Southern California Edison Company

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RGW

cc:

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