Utility Risk Explained

SOUTHERN CALIFORNIA EDISON®
An EDISON INTERNATIONAL® Company

Utilities need investors to help fund capital improvement projects, which could cost millions of dollars upfront. Customers then pay for those investments over the life of the asset, which helps spread the cost over multiple (i.e., 5 to 45) years. Customers also pay a regulated rate of return to the investors to compensate them for the risks they take.

What Risks Does Southern California Edison (SCE) Face? Key Examples Include:

- **More Regulatory/Legislative Demands** – California has some of the most ambitious public policies in the nation (e.g., Renewables Portfolio Standard). This type of environment increases our costs and regulatory uncertainty. For instance, it makes forecasting the level of capital expenditures or the change in operating costs more difficult. As such, increased uncertainty creates risk for which investors must be compensated. Otherwise, investors will simply take their money elsewhere.
- **One-Off Laws or Penalties** – California has more compliance requirements than most other states. In addition, California has laws that are not common in most other states. For example, the wildfire inverse condemnation law imposes strict liability for fire damage to private property caused by a utility's electric facilities. This impacts the company's ability to obtain insurance at competitive prices and increases the chance of penalties. Such one-off laws often results in unplanned increases in costs.
- **High Debt-Equivalents** – In general, as a company increases its use of debt, the risk for equity investors increases because debt has a senior claim on a company's earnings and assets. The 2000-2001 energy crisis required SCE to enter into power contracts, usually long-term, to purchase power (rather than in the real-time market). These long-term power contracts work in ways similar to debt. Therefore, SCE is considered to have more debt or "debt equivalents" than utilities outside of California.
- **Less Diversification** – Unlike the other large California utilities which are both gas and electric (PG&E, SEMPRA), SCE is only an electric utility. Because having a diverse portfolio serves to decrease the level of specific risk (or systematic risk) SCE's focus on electricity potentially elevates the risk for investors.

A reasonable Return on Equity (ROE) level is needed to attract the large amounts of capital SCE needs to maintain and upgrade its infrastructure for the reliability of Southern California's power delivery grid. Without an ROE that compensates investors for the risk they take, the company is required to assume more debt, which increases risk even more.

For more information, call (626) 302-2255.

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