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PCG: Updating EPS Estimates Following Recent Regulatory Decisions; Reiterate Outperform

Estimate Change in Bold

Ticker	Rating	CUR	5/26/2010 Closing Price	Target Price	TTM Rel. Perf.	EPS 2009A	EPS 2010E	EPS 2011E	P/E 2009A	P/E 2010E	P/E 2011E	Yield
PCG	O	USD	41.21	49.00	-4.5%	3.21	**3.36**	**3.65**	12.8	12.3	11.3	4.4%
OLD							3.36	3.67				
SPX			1067.95			61.70	83.20	98.56	17.3	12.8	10.8	2.0%

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

Highlights

- We are revising our financial forecast for PCG to reflect the impact of two recent regulatory decisions: (i) a proposed decision by an Administrative Law Judge with respect to the approved level of capital expenditures for PG&E's Cornerstone Program to improve electric distribution reliability, and (ii) FERC's decision with respect to the revenue requirement for PG&E's electric transmission business.
- Our 2010 EPS estimate remains unchanged at $3.36, but we have cut our 2011 EPS estimate from $3.67 to $3.65. Longer-term, we now expect PG&E to realize 9.2% annual growth in rate base through 2013 (vs. 9.5% previously), contributing to a 6.3% annual growth in earnings per share (vs. 6.6% previously).
- On May 25th, Administrative Law Judge (ALJ) Fukutome issued a Proposed Decision (PD) regarding PG&E's Cornerstone Program to improve the reliability of its electric distribution system. ALJ Fukutome authorized only $357 million of capital expenditures over 2010-2013, well below the $2 billion requested by PG&E over 2010-2016. The PD permits PG&E, however, to seek approval for the remainder through the regular General Rate Case (GRC) process as part of PG&E's 2014 GRC. The California Public Utilities Commission (CPUC) will render its final decision within the next month.
- On March 31st, PG&E filed a settlement agreement with the Federal Energy Regulatory Commission (FERC) relating to its twelfth Transmission Owner (TO) rate case (TO12). The settlement agreement would authorize an annual revenue requirement of $875 million, $71 million less than PG&E's request of $946 million, but $99 million higher than the prior TO11 settlement. PG&E expects the settlement to allow it proceed with its planned 2010 transmission capex of $800 million. If accepted by FERC, therefore, the settlement would not affect our forecasts of rate base growth or future earnings.

Investment Conclusion

Based on the capital expenditure program proposed by PG&E in its 2011 GRC, and our assessment of the CPUC's decision in previous rate cases, we forecast PG&E's total CapEx at $4.2 billion in 2010, $4.0 billion in 2011, $4.0 billion in 2012, and $3.9 billion in 2013. These figures include capital expenditures under the 2011 GRC as well as CapEx related to gas and power transmission assets subject to separate rate cases before the CPUC and the Federal Energy Regulatory Commission (FERC). Our estimate of PG&E's capital expenditure is forecast to drive growth in rate base (including FERC regulated rate base) of 9.2% p.a. through 2013. We expect PG&E's combined CPUC and FERC regulated rate base to rise from $19.8 billion in 2009 to $21.6 billion in 2010, $24.3 billion in 2011, $26.3 billion in 2012, and $28.2 billion in 2013. Given PG&E's plans for equity issuance, we expect this 9.2% annual growth in the rate base to

U.S. Utilities

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contribute 6.5% annual growth in earnings per share through 2013. As PG&E stock currently yields 4.4%, shareholders could enjoy annual returns in excess of 10% through 2013.

Not only is PG&E among the most rapidly growing regulated utilities in the United States, but California's regulatory regime is exceptionally supportive of its growth. The state's regulatory framework combines high allowed ROEs (11.35% for PG&E), linked to utility bond yields through 2012; forward looking rate cases that schedule rate increases in anticipation of future capital expenditure, thus eliminating regulatory lag and allowing utilities to realize their allowed ROEs; rapid rate base growth, reflecting the state's energy policy priorities, including enhanced reliability, increased renewable generation and environmental protection; and automatic recovery through balancing accounts of fuel, purchased power and other operating expenses, including pension costs.

We reiterate our outperform rating on PG&E with a price target of $49.

Details

Revised Earnings Forecast

We are revising our financial forecast for PCG to reflect the impact of two recent regulatory decisions: (i) a proposed decision by an Administrative Law Judge with respect to the approved level of capital expenditures for PG&E's Cornerstone Program to improve electric distribution reliability, and (ii) FERC's decision with respect to the revenue requirement for PG&E's electric transmission business.

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Our revised forecast of PG&E's earnings is presented in **Exhibit 1**. Our 2010 EPS estimate remains unchanged at $3.36, but we are reducing our 2011 EPS estimate to $3.65 from $3.67.

Our revised estimates are at the low end of management's guidance range of $3.35-$3.50 in 2010 and $3.65-$3.85 in 2011. Conservative assumptions in our forecast include (i) no O&M (operations & maintenance) expense savings that might benefit net income, and (ii) no benefit to cash flow from lower tax payments in 2010 and 2011 due to bonus depreciation, which could reduce the need for equity issuance. Our model assumes $150 million of equity issuance in 2010 and $450 million in 2011. Were bonus depreciation to reduce future tax payments, the company estimates the positive impact to cash flow could be as much as $400 million in 2010 and $340 million in 2011, potentially eliminating the need for equity issuance in these years.

Our longer-term EPS estimates exhibit a greater decline as we now expect 2012 EPS to be $3.90 vs. the prior estimate of $3.93 and 2013 EPS to be $4.10 vs. the prior estimate of $4.15, reducing the annual growth in earnings per share through 2013 to 6.3% from 6.6%

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Exhibit 1
PG&E: Annual Income Statement — Historical and Forecast Earnings

	2008	2009	2010E	2011E	2012E	2013E
Electric Revenue	$10,738	$10,257	$10,828	$11,593	$12,238	$12,838
Natural Gas Revenue	3,890	3,142	3,234	3,463	3,655	3,835
Operating Revenues	$14,628	$13,399	$14,062	$15,056	$15,893	$16,673
Cost of Electricity	$4,425	$3,711	$3,740	$3,860	$3,984	$4,112
Cost of Natural Gas	2,090	1,291	1,414	1,605	1,698	1,764
COGS	$6,515	$5,002	$5,155	$5,466	$5,683	$5,875
Gross Profit	$8,113	$8,397	$8,907	$9,590	$10,211	$10,797
O&M Expense	4,201	4,346	4,522	4,751	4,993	5,246
EBITDA	$3,912	$4,051	$4,385	$4,839	$5,218	$5,551
Operating D&A	1,651	1,752	1,816	1,950	2,081	2,210
Operating Income	$2,261	$2,299	$2,569	$2,889	$3,138	$3,341
Other Income (Expense)	($4)	$67	$111	$67	$67	$67
Interest Income	94	33	10	9	9	9
Interest Expense	(728)	(705)	(767)	(830)	(885)	(920)
Income Before Taxes	$1,623	$1,694	$1,924	$2,135	$2,328	$2,498
Effective Tax Rate	26%	27%	33%	33%	33%	33%
Income Tax Expense	$(425)	$(460)	$(635)	$(705)	$(768)	$(824)
Preferred Dividends	(14)	(14)	(14)	(14)	(14)	(14)
After-Tax Non-Recuring Items	(103)	1	0	0	0	0
Estimated After-Tax Energy Efficiency Gain	0	0	13	10	10	10
Net Income	$1,081	$1,221	$1,288	$1,427	$1,556	$1,669
Convertible Add-back (After-Tax)	27	17	8	0	0	0
Shares Outstanding — Basic (million)	357	368	378	391	399	407
Shares Outstanding — Diluted (million)	377	386	386	391	399	407
Operating EPS ($)	$2.95	$3.21	$3.36	$3.65	$3.90	$4.10

Source: Bernstein analysis

Cornerstone Program

The Proposed Decision by ALJ Fukutome with respect to the Cornerstone program authorizes only $357 million of capital expenditures over 2010-2013, or 18% of the $2 billion in capital expenditures requested by PG&E for Cornerstone over the 2010-2016 period (**Exhibit 2**). The PD permits PG&E to seek approval for further capex beyond 2013 through its 2014 GRC proceeding. If therefore we were to compare the $357 million in capital expenditures approved through 2013 to the $1,163 million requested by PG&E over the same time period, 31% of the requested amount was authorized.

We had earlier modeled in $1 billion in aggregate capital expenditures for Cornerstone (vs. the $2 billion requested by PG&E), of which we assumed $785 million would be spent over the 2010-2013 period ($100 million being spent in 2010, $285 million in 2011, $200 million in 2012, and $200 million in 2013). We have now reduced our estimates of Cornerstone spending to match the amounts authorized in the PD, and our revised capex forecast is shown in Exhibits **3** & **4**. This reduction in capex reduces our forecast annual growth in rate base to 9.2% from the earlier 9.5% (**Exhibit 5**)

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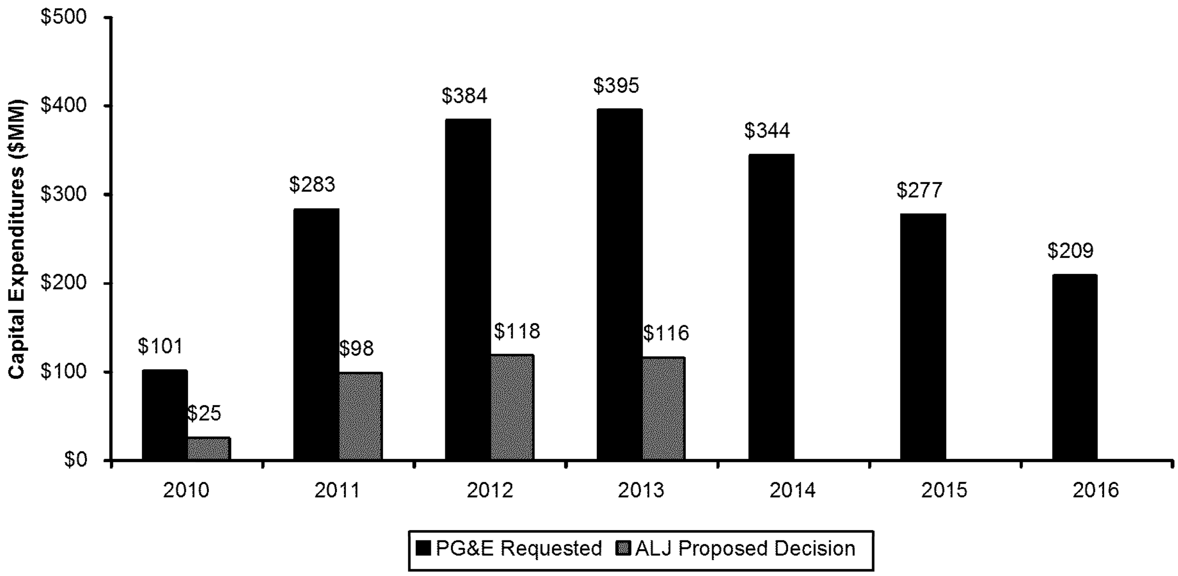
Exhibit 2

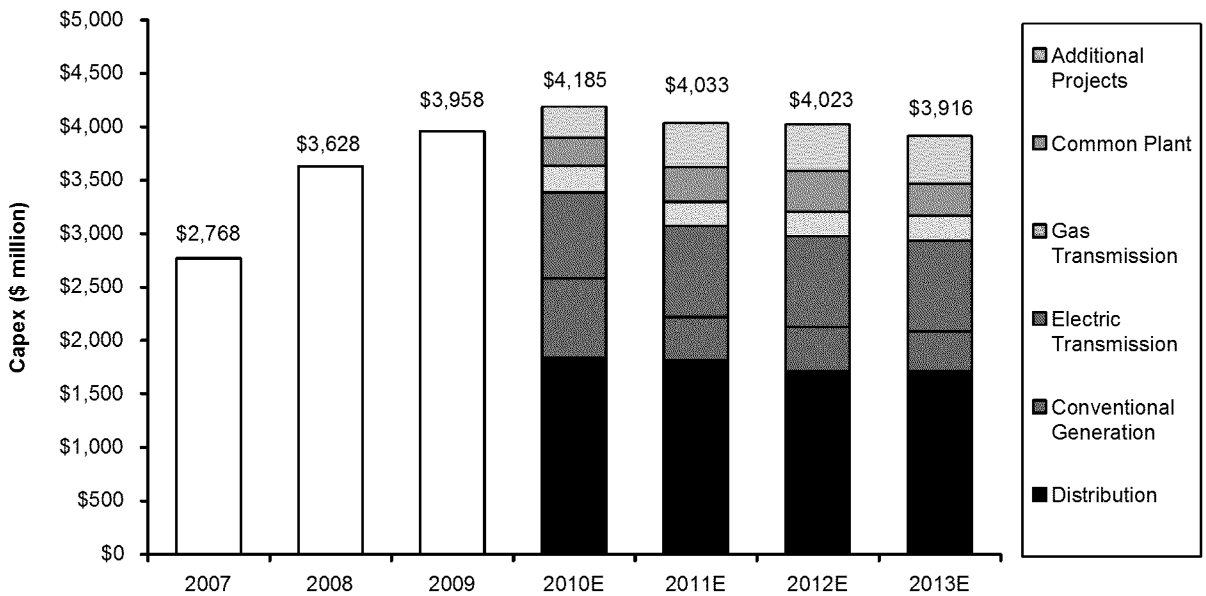
Capital Expenditures Requested by PG&E vs. Authorized Level in the ALJ's Proposed Decision



Source: Proposed Decision of ALJ Fukutome in Application A.08-05-023

Exhibit 3

PG&E: Capital Expenditure Forecast (2010E-13E)



Source: Company reports and Bernstein analysis

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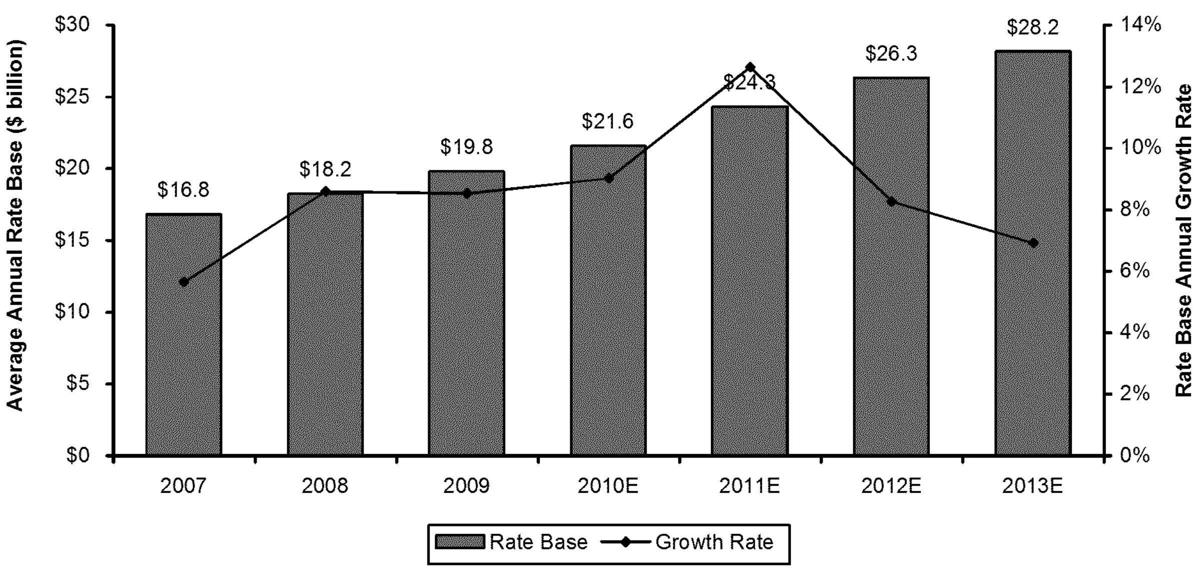
Exhibit 4
PG&E: Detailed Breakup of Capital Expenditure Forecast

($ in millions)	2010E	2011E	2012E	2013E
Electric and Gas Distribution	$1,300	$1,650	$1,710	$1,711
Conventional Generation	750	405	415	374
Common Plant	265	330	380	303
GRC Subtotal	$2,315	$2,385	$2,504	$2,387
Electric Transmission	800	850	850	850
Gas Transmission & Storage	250	225	231	233
SmartMeter	535	165	0	0
Dynamc Pricing	100	10	0	0
Total - Existing Projects	$4,000	$3,635	$3,585	$3,470
Additional Projects:				
Cornerstone Program	$25	$98	$118	$116
Solar PV Project	160	300	320	330
Total CapEx	$4,185	$4,033	$4,023	$3,916

Source: Company reports and Bernstein analysis

Exhibit 5
PG&E: Estimated Rate Base Growth (2010-13E)



Source: Company reports and Bernstein analysis

Aside from the purely quantitative aspects of the decision we were struck by the relatively stern tone in the comments made by the ALJ in the PD. The PD states that a key reason for denying PG&E'sproposed level of expenditures for Cornerstone was the utility's failure to provide adequate justification for the outlays. By providing an apparently superior assessment of the costs and benefits of the various projects proposed by

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the PG&E, the intervenors in the case were able to persuade the ALJ that a much lower level of capital outlay would achieve the bulk of the projected reliability benefits. Clearly, the ALJ felt that a capital expenditure project of this scale required more complete and professional substantiation than was provided by PG&E in its application. Additionally, the ALJ stated that PG&E should in future seek approval for projects of this magnitude through the regular GRC proceeding process rather than through separate proceedings. We have presented a selection of some relevant comments from the Proposed Decision in **Exhibit 6**.

Exhibit 6
Selected Comments by the ALJ in the Proposed Decision on the Cornerstone Program

- *"A broad policy such as the desirability of maintaining or improving electric distribution reliability can only be implemented at the program or project level if there is demonstrated need for the particular programs or projects. PG&E has the burden to demonstrate such need for Cornerstone. After considering the evidence, we conclude that the need for Cornerstone has not been demonstrated."*
- *"With respect to future proceedings, PG&E should address all electric distribution reliability matters in an integrated fashion through the GRC process."*
- *"PG&E should implement a process to determine an appropriate path to take with respect providing an appropriate level of reliability to customers. That includes determining whether it would be necessary and appropriate to propose a large scale project such as Cornerstone, something more moderate, or nothing at all."*
- *"In any case, PG&E should be ready to justify the path it chooses. Basic to that justification process is a VOS study. We left it up to PG&E as to whether it should conduct a new VOS study as part of the process for justifying the need for Cornerstone, and PG&E chose not to conduct one."*

Source: Proposed Decision of ALJ Fukutome in Application A.08-05-023

Electric Transmission Rate Case

PG&E filed a settlement agreement for its FERC TO12 rate case on March 31st. As a reminder, the annual FERC TO rate case proceeding determines the revenue requirement for PG&E's Electric Transmission business and allows PG&E to earn a rate of return for capital expenditures related to adding transmission capacity, and recover costs related to performing maintenance and replacement work in its substations.

The filed settlement would authorize an annual revenue requirement of $875 million for 2010-2011. The original request in its FERC TO12 filing in July 2009 had been $946 million, an increase of $170 million over the prior TO11 settlement of $776 million for 2009-2010, so the settlement represents an authorization of 58% of the requested increase (**Exhibit 7**). PG&E expects the settlement to allow it proceed with its planned 2010 transmission capex of $800 million. If accepted by FERC, therefore, the settlement would not affect our forecasts of rate base growth or future earnings.

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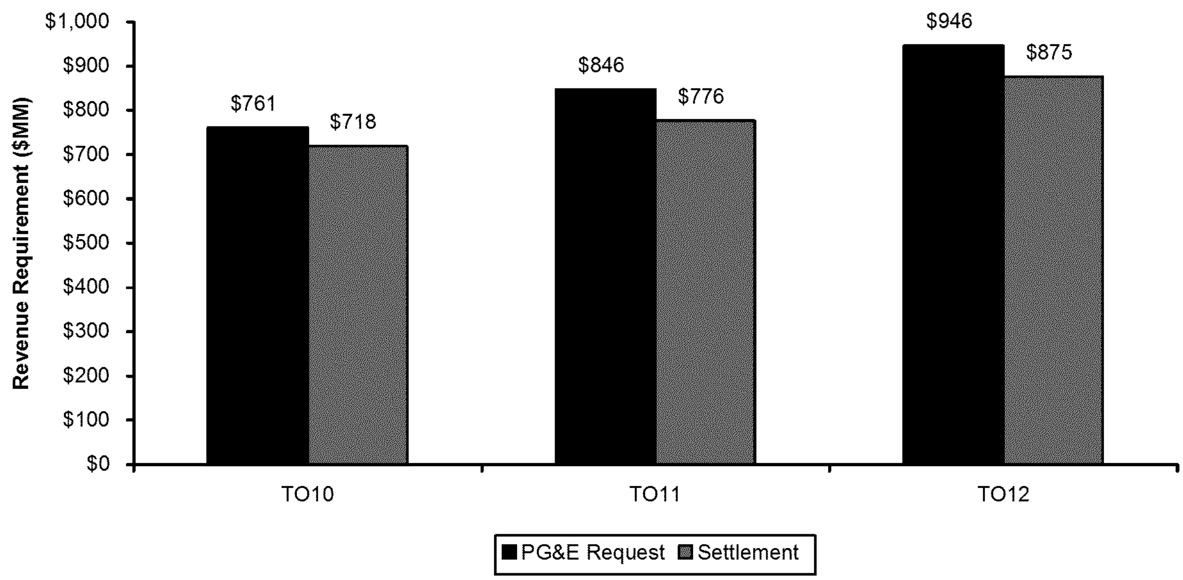
Exhibit 7
PG&E: Recent FERC Transmission Owner (TO) Rate Case Settlements



Source: Company reports and Bernstein analysis

Conclusion: Reiterate Outperform with a Price Target of $49

Based on the capital expenditure program proposed by PG&E in its 2011 GRC, and our assessment of the CPUC's decision in previous rate cases, we forecast PG&E's total CapEx at $4.2 billion in 2010, $4.0 billion in 2011, $4.0 billion in 2012, and $3.9 billion in 2013. These figures include capital expenditures under the 2011 GRC as well as CapEx related to gas and power transmission assets subject to separate rate cases before the CPUC and the Federal Energy Regulatory Commission (FERC). Our estimate of PG&E's capital expenditure is forecast to drive growth in rate base (including FERC regulated rate base) of 9.2% p.a. through 2013. We expect PG&E's combined CPUC and FERC regulated rate base to rise from $19.8 billion in 2009 to $21.6 billion in 2010, $24.3 billion in 2011, $26.3 billion in 2012, and $28.2 billion in 2013. Given PG&E's plans for equity issuance, we expect this 9.2% annual growth in the rate base to contribute 6.5% annual growth in earnings per share through 2013. As PG&E stock currently yields 4.4%, shareholders could enjoy annual returns in excess of 10% through 2013.

Not only is PG&E among the most rapidly growing regulated utilities in the United States, but California's regulatory regime is exceptionally supportive of its growth. The state's regulatory framework combines high allowed ROEs (11.35% for PG&E), linked to utility bond yields through 2012; forward looking rate cases that schedule rate increases in anticipation of future capital expenditure, thus eliminating regulatory lag and allowing utilities to realize their allowed ROEs; rapid rate base growth, reflecting the state's energy policy priorities, including enhanced reliability, increased renewable generation and environmental protection; and automatic recovery through balancing accounts of fuel, purchased power and other operating expenses, including pension costs.

We reiterate our outperform rating on PG&E with a price target of $49.

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Disclosure Appendix

Valuation Methodology

Our target price for PG&E reflects the results of a combination of valuation methodologies including: (1) a discounted cash flow model over the forecast period of 2011-15, and a terminal value in 2016, discounted back to present value using estimated weighted average cost of capital at 6.4%; (2) a discounted dividend model over the forecast period of 2011-15, and a terminal value in2016, discounted back to present value using estimated cost of equity at 8.4%; and (3) a relative valuation technique that applies a set of key valuation metrics, derived from comparable groups of regulated power utilities, to PG&E's 2011 and 2012 earnings, dividend, EBITDA and book value.

Risks

The risks to our target price for PG&E are primarily related to the upcoming 2011 GRC, which will set PG&E's rates and rate base for the period of 2011 through 2013, and thus determine PG&E's earnings for the period. Our EPS forecasts for 2010 and beyond, and thus our target price for PG&E, also could be put at risk by significant revisions to projected capital expenditures over our forecast period, corresponding to regulatory decisions. Longer-term risks include a reduction by the CPUC of PG&E's allowed ROE and equity ratio.

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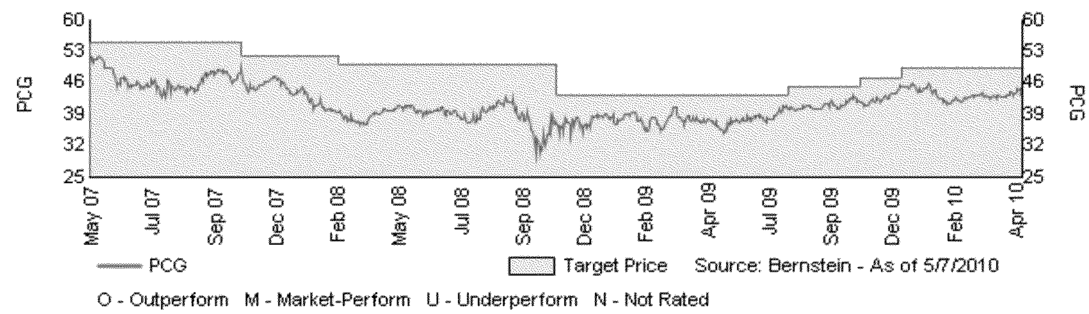
12-Month Rating History as of 05/26/2010

Ticker	Rating Changes
PCG	O (RC) 03/22/07

Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated
Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

PCG / PG&E Corp

Date	Rating	Target(USD)
03/22/07	O	55.00
11/02/07	O	52.00
02/25/08	O	50.00
11/07/08	O	43.00
08/06/09	O	45.00
10/30/09	O	47.00
12/18/09	O	49.00



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