

# Highlights from California PUC discussions; PCG update

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## California regulation stable for now

Over the past week we have held conference calls and meetings with Commissioners Bohn, Gruenich and Ryan of the California Public Utilities Commission (CPUC) as well as a meeting with the Executive Director, Paul Clanon. Despite the recent gas explosion, we found that the CPUC remains a professional, balanced regulatory commission despite a difficult period for the organization and PCG.

## Upcoming gubernatorial election is important

In our conversations, everyone agreed that President Peevey has played a critical role in the CPUC, particularly in the electric utility policy. To this end, the upcoming California governor election will be important as differing outcomes could well determine whether President Peevey remains. The election is currently tied; a Meg Whitman (R) win, could result in Peevey leaving the CPUC, a destabilizing event in our view.

## ROE set through 2012; downward pressure likely

As part of the California regulatory construct, equity ratios and ROEs are decided outside of the GRC and are set for three year periods. CA currently has higher ROEs than the national average. We believe there could be some downward pressure on this, and that these ROEs are likely to come down modestly when they are reviewed in a few years.

## PCG: challenging, but not a lost cause

The CPUC acknowledged that PG&E's customer relations have suffered over the past year due to Prop 16, smart meters and the recent gas explosion. However, in our discussions, they commented that the current rate case was not necessarily an appropriate place to address these issues. We believe PCG has handled the immediate aftermath of the crisis, including the \$100M fund set up for victims appropriately. Settlement talks on the GRC continue, and we believe it remains a possibility that a settlement or partial settlement will happen. We currently view the main risk to PCG as higher costs to address pipeline maintenance and legal issues, though we see these as manageable for the size of the company.

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Over the past week, we have met with various people at the CPUC

Despite the recent gas explosion, we found that the CPUC remains a professional, balanced regulatory commission

We are watchful of the upcoming governor election as the governor chooses the President of the CPUC; to date, President Peevey has been an important force on the commission, particularly for electric utilities

Basically, there is a possibility that 3 or 4 members of the CPUC could be new next year

## Highlights of California trip

Over the past week, we have had conversations with Commissioners Bohn, Gruenich and Ryan at the CPUC. We also met with Executive Director, Paul Clanon. Our discussions focused on the California regulatory environment, upcoming gubernatorial election, economy pressures, as well as the San Bruno gas explosion.

### California regulation stable for now

Despite the recent gas explosion, we found that the CPUC remains a professional, balanced regulatory commission despite a difficult period for the organization and PCG. The Commission understood that it was too early to know what caused the explosion, and did not unduly place the blame on PG&E. We believe PCG has handled the immediate aftermath of the crisis, including the \$100M fund set up for victims appropriately. Despite the current pressures, we believe California regulation remains reasonable for now.

### Upcoming governor election is very important

California has a gubernatorial election this year with current front runners Meg Whitman (R) and Jerry Brown (D). These candidates are both relatively even in the polls, though the latest polls have shown Meg Whitman ahead slightly. This gubernatorial election is critical as the governor chooses the president of the CPUC. President Peevey (D) has been on the CPUC for 8 years and has created a predictable regulatory template. We believe that if he is no longer President, he will likely not stay as a commissioner. President Peevey has been an important force on the commission, particularly for the electric utilities, in maintaining a reasonable regulatory environment. In our view, if he leaves, it will be destabilizing.

If Jerry Brown wins, we expect the CPUC to remain largely unchanged with President Peevey remaining. However, If Meg Whitman wins the election, there could be changes to the Commission, including the replacement of President Peevey. In addition, the new governor could impact state RPS goals (33% by 2020) by repealing an executive order signed by Governor Schwarzenegger. While both candidates have declared support for 33% RPS goals, we believe Meg Whitman could take a more measured approach to the development of renewables.

### New Commission members?

Currently, of the five current commissioners on the CPUC, Commissioners Bohn (R) and Gruenich's (D) terms are expiring at the end of 2010. In addition, Commissioner Ryan (D) was appointed to the CPUC by Governor Schwarzenegger in January 2010, but has not yet been confirmed by the California state senate, a majority Democratic body. By California law, she can serve for 12 months without a confirmation. We believe if Jerry Brown wins, the Senate may wait to give Brown the opportunity to appoint his own commissioner. That said, if Meg Whitman wins, the Senate could confirm Commissioner Ryan prior to year end. Basically, there is a possibility that 3 or 4 members of the CPUC (depending on President Peevey) could be new next year.

We believe ROEs are likely to come down modestly when they are reviewed in a few years

The CPUC was concerned but balanced in its reaction to PCG

We acknowledge some regulatory risk for PCG, but believe the impact to the GRC from the San Bruno explosion is limited

Settlement talks in the PCG GRC continue, the next update there is due on 9/17

Main concerns for us remain the cost pressures on inspection and maintenance work on the pipeline system as well as the public relations and legal aspects of the explosion

## ROE could face modest pressure later on

As part of the California regulatory construct, cost of capital (equity ratio) and ROEs are decided outside of the GRC and are set for three year periods. California currently has higher ROEs (mid 11%) than the national average (~10.5%). We believe there could be some downward pressure on this, and that these ROEs are likely to come down modestly when they are reviewed in a few years. That said, the conversations on ROE were constructive with the Commission understanding the need for healthy utilities and the need to earn a reasonable return on necessary investments.

## San Bruno Gas Explosion: CPUC response

As a reminder, on 9/9, a PCG gas pipeline exploded in San Bruno, CA, a suburb of San Francisco, killing at least 4 people with reports that another 3 people are missing and several more are injured. At least 38 homes were totally destroyed and damage occurred to a number of other homes.

In our conversations, the CPUC was concerned but balanced in its reaction to PCG. The Commissioners and Staff did not unduly blame PCG as the cause of the fire is unknown and under investigation by the National Transportation Safety Board (NTSB) and CPUC.

The CPUC acknowledges that PCG's customer reputation has been hurt by the gas explosion, but also Smart Meters and the failed Prop 16 initiative. Most importantly, in our discussions the Commissioners and their staff commented that they view the current GRC case separately from the explosion, and do not believe the GRC decision is not necessarily an appropriate place to address any potential PCG missteps. As we have noted, many key issues for shareholders are not up for review in the GRC, such as large rate base items that have been pre-approved as well as ROE and equity ratio. Thus, while we acknowledge some regulatory risk, we believe the impact to the GRC from the San Bruno explosion is limited.

Longer term, if causality in the San Bruno explosion is linked to PCG, the CPUC could undertake an overall review of the company, institute more strict oversight, institute a fine, and/or impact long-term ROE when it is next up for review.

## Settlement talks continue

Settlement talks in the PCG GRC continue, the next update there is due on 9/17. We believe it remains a possibility that a settlement or partial settlement could be reached. We note, the Commission encourages settlement. A settlement could also mitigate some of the workload pressures faced by intervenors and Staff next year when SoCal Edison and San Diego Gas & Electric file their rate cases.

## San Bruno Gas Explosion: PCG response

On Monday, PCG established a relief fund of up to \$100 million to assist residents of San Bruno that have been affected by the fire. It is still unclear what the cause of the rupture was.

In an 8-K, PCG noted its \$992M of full liability fire insurance after a \$10M deductible which is supposed to cover damage no matter who caused the fire. Though there had been reports of gas leak complaint calls, these call claims have not been substantiated as PCG has gone through its records. Main concerns for us remain the cost pressures on inspection and maintenance work on the pipeline system as well as the public relations and legal aspects of the explosion. That said, we think the gas pipeline business segment is relatively small compared to the overall size of the company.

## Price objective basis & risk

### Edison International (EIX, B-2-7, \$33.88)

Our EIX price objective is \$38. We value SCE at \$38/share, based on 13x 2011E earnings, a premium to the industry average. We see zero equity value at EME at current power prices even before adding environmental capex at the coal plants. For EME, in our view, the company cannot be worth negative value to EIX, but we also see a slim chance of material positive value barring a dramatic power market recovery. The downside risk for EIX is an unforeseen negative turn in California regulation. On the upside, a strong power market recovery could cause EME to be worth more than we currently expect.

### PG&E Corporation (PCG, A-1-7, \$45.48)

Our \$49 price objective assumes a premium P/E of 12.75x 2012E earnings to account for above average growth and high quality earnings. Risks to our outlook are: 1) outstanding 2011 general rate case and 2) Any unforeseen changes to California regulation.

## Link to Definitions

### Energy

Click [here](#) for definitions of commonly used terms.

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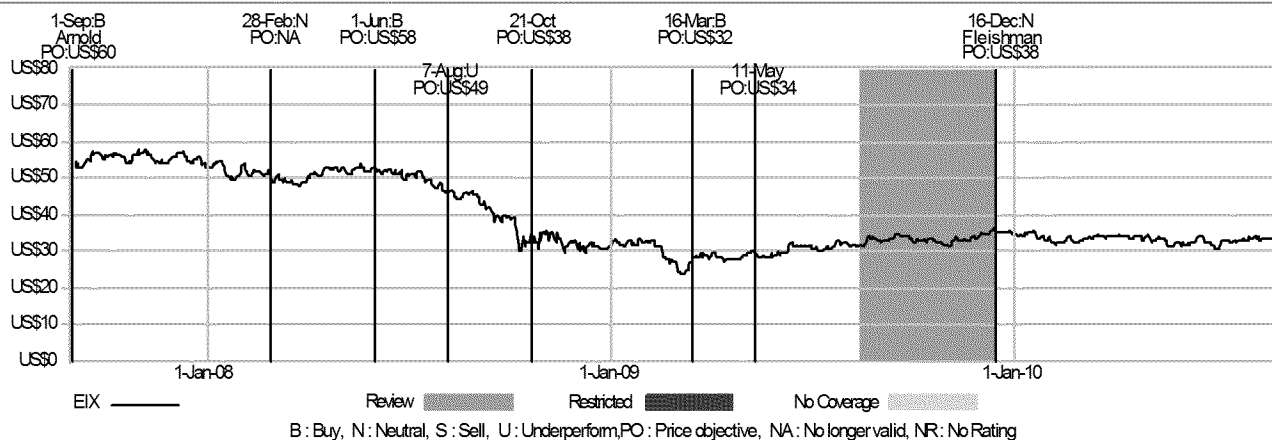
Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	American Water Works	AWK	AWK US	Steve Fleishman
	CenterPoint Energy, Inc.	CNP	CNP US	Steve Fleishman
	CMS Energy	CMS	CMS US	Steve Fleishman
	Mirant Corporation	MIR	MIR US	Ameet I. Thakkar
	NextEra Energy	NEE	NEE US	Steve Fleishman
	Northeast Utilities	NU	NU US	Steve Fleishman
	PG&E Corporation	PCG	PCG US	Steve Fleishman
	PPL Corporation	PPL	PPL US	Steve Fleishman
	Progress Energy	PGN	PGN US	Steve Fleishman
	Public Service Enterprise Group Inc.	PEG	PEG US	Steve Fleishman
	RRI Energy	RRI	RRI US	Ameet I. Thakkar
	Wisconsin Energy	WEC	WEC US	Alex Kania
	Xcel Energy	XEL	XEL US	Steve Fleishman
<b>NEUTRAL</b>				
	Alliant Energy	LNT	LNT US	Steve Fleishman
	Ameren Corp	AEE	AEE US	Steve Fleishman
	Calpine	CPN	CPN US	Ameet I. Thakkar
	Consolidated Edison	ED	ED US	Steve Fleishman
	Dominion Resources	D	D US	Steve Fleishman
	Edison International	EIX	EIX US	Steve Fleishman
	Entergy	ETR	ETR US	Steve Fleishman
	FirstEnergy	FE	FE US	Steve Fleishman
	NRG Energy	NRG	NRG US	Ameet I. Thakkar
	NSTAR	NST	NST US	Steve Fleishman
	Pinnacle West	PNW	PNW US	Steve Fleishman
	Portland General Electric Company	POR	POR US	Steve Fleishman

US - Electric Utilities/Competitive Power Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
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	TECO Energy	TE	TE US	Steve Fleishman
<b>UNDERPERFORM</b>				
	DPL Inc.	DPL	DPL US	Steve Fleishman
	DTE Energy	DTE	DTE US	Steve Fleishman
	Duke Energy	DUK	DUK US	Steve Fleishman
	Exelon	EXC	EXC US	Steve Fleishman
	Hawaiian Electric Industries	HE	HE US	Steve Fleishman
	NV Energy	NVE	NVE US	Steve Fleishman
	Southern Company	SO	SO US	Steve Fleishman

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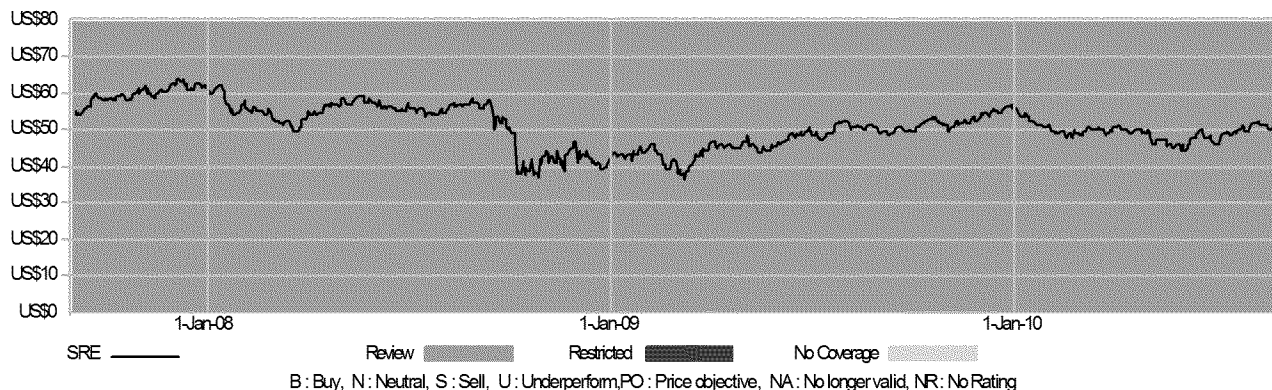
### EIX Price Chart



\*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of August 31, 2010 or such later date as indicated.

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### SRE Price Chart

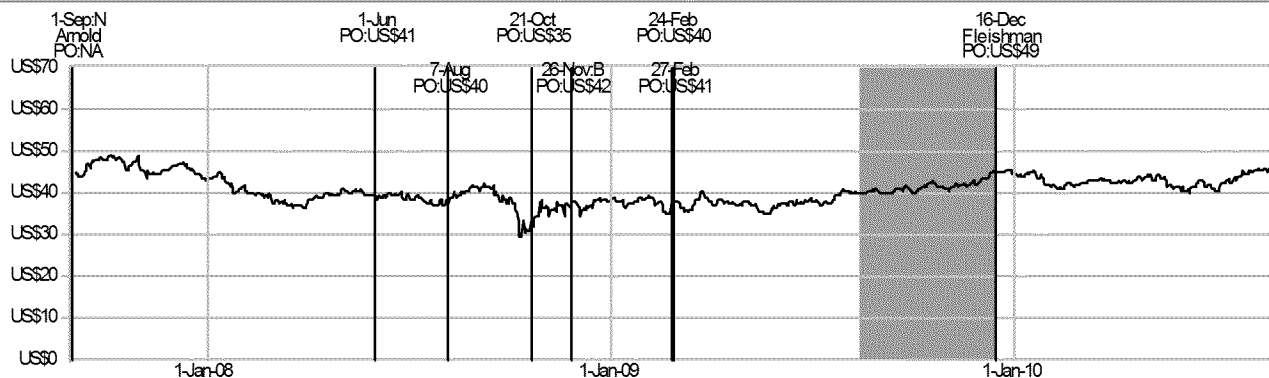


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PCG Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR : No Rating

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Investment Rating Distribution: Energy Group (as of 01 Jul 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	177	64.60%	Buy	116	72.96%
Neutral	48	17.52%	Neutral	18	47.37%
Sell	49	17.88%	Sell	26	57.78%

Investment Rating Distribution: Utilities Group (as of 01 Jul 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	74	42.77%	Buy	42	64.62%
Neutral	51	29.48%	Neutral	30	65.22%
Sell	48	27.75%	Sell	20	45.45%

Investment Rating Distribution: Global Group (as of 01 Jul 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1922	54.14%	Buy	1042	59.85%
Neutral	874	24.62%	Neutral	496	62.78%
Sell	754	21.24%	Sell	362	51.86%

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