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PCG: The NTSB Issues a San Bruno Update; Net Positive for PG&E but Regulators Will Have the Final Say

Ticker	Rating	CUR	12/14/2010 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	47.67	54.00	-6.2%	3.21	3.41	3.67	14.9	14.0	13.0	3.8%
SPX			1241.59			61.70	84.62	95.65	20.1	14.7	13.0	1.9%

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

Highlights

- On December 14th, the National Transportation Safety Board (NTSB) released an update on its ongoing investigation into the September 9th explosion of the PG&E gas transmission pipeline in San Bruno that resulted in eight fatalities and extensive property damage.
- Positively for PG&E, the NTSB found no evidence of external corrosion on the ruptured pipe, no evidence of damage caused by excavation activity, and no evidence of a pre-existing gas leak. No evidence was uncovered, in other words, that PG&E had been negligent in monitoring or maintaining the San Bruno pipeline segment.
- Negatively for PG&E, some of the longitudinal seams in the ruptured pipe were fusion-welded only from the outside of the pipe, not the inside. In order to understand this variance, the NTSB investigators are researching pipe welding standards in effect at the time the pipeline was installed in 1956.
- There are two possible downsides from this disclosure: i) if PG&E is found to have used incorrectly welded pipe at San Bruno, the CPUC could impose financial penalties on PG&E, and ii) the CPUC might require additional inspection of welding practices throughout the PG&E gas transmission pipeline network.
- We note that the NTSB investigation is ongoing, as are other investigations, including the safety phase of PG&E's gas transmission rate case before the California Public Utility Commission (CPUC) and a study of the explosion by a CPUC-appointed panel of independent experts. These investigations may yet turn up evidence of deficient design, construction, operation or maintenance that could result in penalties or unrecoverable costs for PG&E.
- It should be kept in mind that PG&E has already budgeted for some additional costs that will be borne by shareholders. In its Q3 2010 earnings call PG&E provided an estimate of $100 million to $150 million in direct costs expected to be incurred that will *not* be recoverable under the company's liability insurance.

Investment Conclusion

The preliminary findings of the NTSB in its San Bruno investigation appear to be positive for PG&E. The NTSB found no evidence of external corrosion on the ruptured pipe, no evidence of damage caused by excavation activity, and no evidence of a pre-existing gas leak. No evidence was uncovered, in other words, that PG&E had been negligent in monitoring or maintaining the San Bruno pipeline segment. The NTSB update thus supports our prior view that PG&E is at limited risk of incurring material penalties or unrecoverable costs arising from the San Bruno incident. We continue to expect, moreover, that almost all

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the third-party liability costs related to San Bruno will be recovered under PG&E's existing $992 million liability insurance policy after its $10 million deductible is met.

The NTSB investigation is ongoing, however, as are other investigations, including a safety phase of PG&E's gas transmission rate case before the California Public Utility Commission (CPUC) and the study of the explosion by a CPUC-appointed panel of independent experts. These investigations may yet turn up evidence of deficient design, construction, operation or maintenance that could result in penalties or unrecoverable costs for PG&E.

The next milestone for PG&E with respect to resolution of issues surrounding its gas pipeline system should be in February 2011 when the CPUC is expected to issue a decision on the proposed settlement of PG&E's 2011 GT&S rate case ("Gas Accord V"), followed by a decision on the safety phase of the rate case in March.

We reiterate our outperform rating on PCG and our price target of $54.

Details

On December 14th, the National Transportation Safety Board (NTSB) released an update on its ongoing investigation into the September 9th explosion of the PG&E gas transmission pipeline in San Bruno that resulted in eight fatalities and extensive property damage. This update follows the preliminary report released by the NTSB on October 13th.

NTSB Investigation Update

Positively for PG&E, the NTSB found no evidence of external corrosion on the ruptured pipe, no evidence of damage caused by excavation activity, and no evidence of a pre-existing gas leak. No evidence was uncovered, in other words, that PG&E had been negligent in monitoring or maintaining the San Bruno pipeline segment. The NTSB update thus supports our prior view that PG&E is at limited risk of incurring material penalties or unrecoverable costs arising from the San Bruno incident. We continue to expect, moreover, that almost all the third-party liability costs related to San Bruno will be recovered under PG&E's existing $992 million liability insurance policy after its $10 million deductible is met.

Negatively for PG&E, the NTSB report notes that while the ruptured pipeline segment was constructed of seam-welded pipe, PG&E's records indicate that the ruptured pipeline segment was constructed of seamless steel pipe. Additionally, some of the longitudinal seams in the pipe were fusion-welded only from the outside of the pipe, not the inside. In order to understand this variance, the NTSB investigators are researching pipe welding standards in effect at the time the pipeline was installed in 1956. There are two possible downsides from this disclosure: i) if PG&E is found to have used incorrectly welded pipe at San Bruno, the CPUC could impose financial penalties on PG&E, and ii) the CPUC might require additional inspection of welding practices throughout the PG&E gas transmission pipeline network.

Potential for Regulatory Penalties and Fines

We note that the NTSB investigation is ongoing, as are other investigations, including the safety phase of PG&E's gas transmission rate case before the California Public Utility Commission (CPUC) and a study of the explosion by a CPUC-appointed panel of independent experts. These investigations may yet turn up evidence of deficient design, construction, operation or maintenance that could result in penalties or unrecoverable costs for PG&E.

It should be kept in mind that PG&E has already budgeted for some additional costs that will be borne by shareholders. In its Q3 2010 earnings call PG&E provided an estimate of $100 million to $150 million in

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direct costs expected to be incurred that will *not* be recoverable under the company's liability insurance, related to items such as:

- potential CPUC directives related to inspections of PG&E's natural gas transmission network;
- the cost of outside legal counsel and technical experts to support the ongoing regulatory investigations; and
- seed financing of $10 million for an independent non-profit pipeline safety research center under PG&E's proposed Pipeline 2020 Program.

The two key avenues for determining any financial penalties or denial of cost recovery for additional pipeline safety and inspection requirements that might be imposed by the CPUC will be the resolution of the "Safety Phase" of PG&E's 2011 Gas Transmission & Storage (GT&S) rate case (expected in March 2011), and the results of the investigation by the independent panel constituted by the CPUC to conduct an independent study of the San Bruno explosion (timing unknown). We discussed the newly added "Safety Phase" of the GT&S rate case in our earlier note published on November 5th, 2010 ("***PCG: Raising Our Price Target to $54 on Strong Q3 Results & Management's Estimate of Total Costs for San Bruno***").

Were the independent panel to uncover material deficiencies in the design, construction, operation or maintenance of PG&E's gas pipeline system, the CPUC has had a relatively vigorous track record of imposing fines and restitution payments on its regulated utilities. As can be seen in **Exhibit 1**, the CPUC has since 1999 imposed fines and restitution payments totalling nearly $350 million on California's electric utilities.

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Exhibit 1

CPUC Levied Fines and Restitution Payments – 1999 to 2010 YTD

Year	Utility	CPUC Fine ($ MM)	Consumer Restitution ($ MM)	Total Payment	Description
1999	PG&E	$6.0	$22.7	$28.7	Settlement agreement resolving the Commission's investigation into PG&E's compliance with treeline clearance standards. Under the settlement, PG&E shareholders will fund up to $ 22.7 million in vegetation-related activities and programs over the next five years and make an immediate, one-time $ 6 million contribution to the California general fund. The settlement also establishes various forward-looking PG&E/CSD vegetation management inspection and compliance protocols.
2004	SCE	$0.7	$0.0	$0.7	The Commission examined Edison's electric line construction, operation, and maintenance practices during 1998 through 2000. This decision fined Edison for 30 violations relating to the requirements for the construction, operation, and maintenance of overhead and underground utility systems, and for 56 violations related to Edison's failure to identify unsafe conditions
2006	PG&E	$0.5	$6.0	$6.5	The Commission approved a settlement between PG&E, CPSD, and the City and County of San Francisco. This proceeding was opened after investigative reports on the 2003 fire at PG&E's Mission Substation were issued. The settlement requires PG&E shareholders to make payments totaling $6.5 million -- $6.0 million for five programs and projects to improve electric system reliability and the remainder to the State's General Fund.
2006	Sempra	$2.0	$105.7	$107.7	Resolved a complaint that the Sempra companies made certain representations before the Commission that allegedly resulted in inadequate resource planning and system capability culminating in periods of curtailment of natural gas service to certain SDG&E non-core customers in 2000 and 2001.
2007	PG&E	$0.0	$35.0	$35.0	This decision finds that Pacific Gas and Electric Company (PG&E) systematically violated its tariff Rule 9A by failing to issue bills at regular intervals based on actual metering data. The decision also finds that PG&E violated its tariff Rule 17.1 by issuing backbills related to: 1) periods of no bills ("delayed bills") and 2) periods of estimated bills, where the cause for the estimation was within PG&E's control, beyond the time limits permitted under the tariff. The Commission ordered PG&E to refund, at shareholder expense, approximately $35 million for these unauthorized charges.
2008	SCE	$30.0	$115.7	$145.7	This decision concludes that Southern California Edison Company (SCE) employees and management manipulated and submitted false data in claiming Performance Based Ratemaking (PBR) rewards. SCE is ordered to: 1) Refund ratepayers $28 million in PBR customer satisfaction rewards and forgo an additional $20 million in requested rewards; 2) Refund ratepayers all $20 million in PBR health and safety rewards and forgo an additional $15 million in requested rewards; 3) Refund ratepayers the portion of its 2003 to 2005 revenue requirement related to the utility's Results Sharing program that was affected by fraudulent data, which the decision finds to be $32,714,000; and, 4) Pay a fine of $30 million to the state General Fund.
2009	SCE	$0.0	$6.0	$6.0	In this decision, the Commission adopted the settlement agreement between Southern California Edison Company (SCE) and CPSD, which resolved all outstanding issues in Phase 2 of the Performance-Based Ratemaking (PBR) case.
2009	SDG&E	$0.5	$0.4	$0.9	The Commission adopted the settlement agreement between CPSD and SDG&E in which SDG&E acknowledged its failure to fully comply with Rule 8.3 and tendered an apology for imprecision in its communications with decision-makers in connection with certain ex parte meetings held during Phase 2. SDG&E commited to pay a total of $920,000 in shareholder funds.
2010	SDG&E	$14.4		$14.4	Settlement resolving the Commission's Orders Instituting Investigations 08-11-006 and 08-11-007 regarding the Witch, Rice and Guejito fires. Under the terms of the CPSD and SDG&E Agreement, SDG&E will pay $14,350,000 to the General Fund of the State of California. SDG&E will also reimburse CPSD up to an additional $400,000 in order to implement a computer work module to assist CPSD.
Total		**$54.0**	**$291.5**	**$345.5**	

Source: CPUC, Bernstein analysis

U.S. Utilities

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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 2012-15, and a terminal value in 2016, discounted back to present value using estimated weighted average cost of capital at 6.3%; (2) a discounted dividend model over the forecast period of 2012-15, and a terminal value in 2016, discounted back to present value using estimated cost of equity at 8.3%; 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

PG&E's valuation remains highly uncertain until the cost of its liability for the accident, the cost to survey its transmission grid, and the scale of any potential penalties imposed by the CPUC are known. Otherrisks 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.

The eventual resolution of the liabilities arising from the San Bruno explosion, and the extent to which these liabilities are covered under PG&E's liability insurance policy, could have a material impact on our forecasts and target price.

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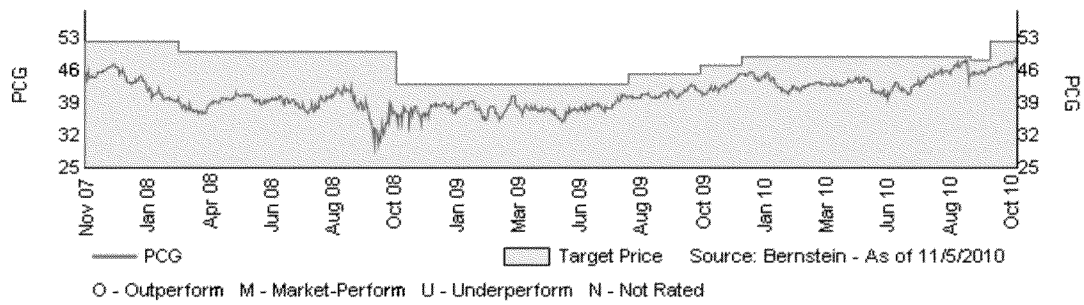
12-Month Rating History as of 12/14/2010

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)
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
09/13/10	O	48.00
10/06/10	O	52.00
11/05/10	O	54.00



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