

California Utilities

Downgrading EIX and PCG to Neutral on Anticipated Regulatory Uncertainty in CA

EIX, EIX US
Downgrade to: Neutral
Previous: Overweight
\$37.30

Price Target: \$37.00

PCG, PCG US
Downgrade to: Neutral
Previous: Overweight
\$46.72

Price Target: \$51.00

We are downgrading shares of Edison International (EIX) and PG&E Corp. (PCG) following recent changes in the makeup of the California Public Utilities Commission (CPUC), as we anticipate California's regulatory environment to remain mired in uncertainty for some time as the new Commission takes its final shape and sets new priorities. Although the stocks have already underperformed YTD relative to the UTY utility index, we expect the regulatory overhang to cause the stocks to trade sideways until greater regulatory clarity emerges.

- **Fear of a more consumer-friendly CPUC may well be realized.** It was not clear to us that California Governor Jerry Brown was going to go down the path of appointing a less supportive Commission, so we held on to our Overweight rating on the stocks; however, based on his appointments Wednesday night, it appears this may have been wrong. Governor Brown announced the appointment of Michael Florio and Catherine Sandoval to two of three vacant seats on the California Public Utilities Commission (CPUC). With these appointments, we believe investors' fear that the Governor could swing the PUC too much in the direction of pro-consumer/ anti-corporate interests may well have been realized. Michael Florio has been a senior staff attorney for The Utility Reform Network (TURN), an industry watchdog, since 1989 and has been viewed by investors as potentially the most negative candidate for the utilities. Although we do not anticipate an instant change in energy policy in the state, we anticipate that more consumer-friendly policies could be detrimental for the California utilities, and could impair their ability to recover the significant capital investments that the utilities are looking to make in the next several years.
- **Potential conflict of interest in some rate cases could jeopardize Florio's confirmation.** We note that Florio's position as an attorney arguing against the state utilities in recent and pending rate cases could limit his ability to review such cases from the other side of the bench. We are not aware of prior precedent but believe the possibility that Florio may have to recuse himself from some cases to avoid conflict of interest could hinder his confirmation, or the functioning of the Commission.
- **Sandoval may be more business friendly, but lack of utility experience could be a drawback.** Catherine Sandoval, a Santa Clara University law professor, comes from a telecom industry background. Although her telecom M&A experience could be indicative of business-friendly policies, we are concerned about her lack of understanding of and experience in the utility industry, at least initially, as we believe she faces a steeper learning curve.

Electric Utilities & IPPs

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Our Clean Tech analyst Chris Blansett also views the recent CPUC changes as a negative event for the advancement of renewable energy in and around California. For additional details, please refer to his note published this morning: "Alternative Energy: The Appointment of New Utility Commissioners in California Could Slow the Pace of Large-Scale Renewable Energy Projects in the US" [Click here](#).

See page 7 for analyst certification and important disclosures.

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- **Unprecedented turnover at the CPUC heightens regulatory risk.** Following last week's resignation of Nancy Ryan (she was never confirmed by the Senate, and was appointed as head of the PUC Staff instead) and the departure of outgoing Commissioners Dian Grueneich and John Bohn, three out of the five PUC seats had been vacated. This marks the first time that a new governor has had the ability to appoint a majority of the CPUC and the California Energy Commission (CEC), thereby having the ability to re-shape the state's energy policy. Since energy policy had not been a campaign issue for Governor Brown, we do not expect a major shift in California's energy policies, but we anticipate the uncertainty until the CPUC sets new priorities to weigh on California utility stocks.
- **Uncertainty around new chairman could throw a wrench into the situation.** Arguably, an additional point of uncertainty that we are unable to caveat based on existing information is whether current PUC President Michael Peevey may be asked to step down if the incoming Governor appoints a new President. In the event that this occurs, we believe it is possible that Peevey could step down from the PUC altogether, thereby vacating yet another seat on the PUC. We caution that his potential departure from the PUC would create additional turnover and could allow for an even greater shift in California's overall regulatory framework. This, in our view, would be perceived as a negative by the market. Recall that Peevey has extensive experience in the utility industry, which many observers had perceived as quintessential for his reasonable and even-keeled stewardship of the Commission.
- **Moving to the sidelines despite YTD underperformance.** Although EIX and PCG have underperformed the UTY index by 400-500 bps YTD, we expect the lingering regulatory uncertainty about the CPUC's policy direction to weigh on the stocks in the next several months. With a rate case settlement currently pending Commission approval, we believe PCG is in an even more disadvantaged position. Accordingly, we recommend that investors remain on the sidelines until the regulatory headwinds dissipate and greater regulatory clarity emerges.

Edison International (EIX)

Valuation and Price Target

We are lowering our December 2011 price target for EIX modestly to \$37 per share from \$39 previously, as detailed in Table 1 below. While we had previously assigned in-line valuation to EIX shares on supportive regulation in CA offset by headwinds at the unregulated businesses, we now believe a modest valuation discount is more appropriate in light of the recent changes at the CPUC and what we anticipate to be several weeks, if not months, of regulatory uncertainty before we get further clarity on CPUC priorities and future course of action.

Table 1: EIX Price Target Derivation

Tkr	JPM Rtg	2011E EPS	Group P/E	Prem/(Disc)	Justified '11 P/E	New PT	Prior PT	Rationale for Premium/(Discount) Used for Valuation & PT Derivation
EIX	N	3.00	13.0x	-5%	12.3x	\$37	\$39	Our modest valuation discount reflects Edison's business mix and concerns over California's regulatory regime. While EIX derives ~70% of its EPS from its utility, which benefits from attractive investment opportunities that drive above-average rate base and EPS growth, we believe this is partly offset by regulatory headwinds in California. Also partly offsetting the utility's growth trajectory is discounted valuation on the balance of Edison's merchant operations to account for their inherent volatility.

Source: J.P. Morgan estimates. Price target end date is December 2011. J.P. Morgan ratings: OW = Overweight; N = Neutral; UW = Underweight

Risks to Our Rating

We present risks to our rating in Table 2.

Table 2: Risks to Our Rating for EIX

Tkr	Risks to Our Rating
EIX	Our Neutral rating could be wrong if EIX receives a more or a less favorable rate case outcome than we expect, its pipeline of investment at the utility falters or accelerates, electricity demand falls/improves sharply or new power plant capacity is added to the system, it is unable to meet its IL environmental limits with its current plan, or commodity prices rise or fall sharply. Furthermore, there could be upside to our Neutral rating if regulatory uncertainty in California dissipates following the recent changes in the makeup of the CPUC.

Source: J.P. Morgan.

Edison International (EIX;EIX US)

Company Data	
Price (\$)	37.30
Date Of Price	26 Jan 11
52-week Range (\$)	39.37 - 30.37
Mkt Cap (\$ mn)	12,152.75
Fiscal Year End	Dec
Shares O/S (mn)	326
Price Target (\$)	37.00
Price Target End Date	31 Dec 11

	2009A	2010E	2011E	2012E
EPS Reported (\$)				
Q1 (Mar)	0.79	0.82A		
Q2 (Jun)	0.78	0.62A		
Q3 (Sep)	1.09	1.46A		
Q4 (Dec)	0.59	0.55		
FY	3.25	3.45	3.00	3.20
Bloomberg EPS FY (\$)	3.01	3.50	3.03	2.78
P/E FY	11.5	10.8	12.4	11.7

Source: Company data, Bloomberg, J.P. Morgan estimates. Note: Official estimates rounded to the nearest \$0.05 per share. 'Bloomberg' above denotes Bloomberg consensus estimates.

PG&E Corp. (PCG)

Valuation and Price Target

We are lowering our December 2011 price target for PCG to \$51 per share from \$62 previously, as illustrated in Table 3 below. While we had previously assigned premium valuation to PCG shares on supportive regulation in CA, we believe modestly discounted valuation is more appropriate now in light of the recent changes at the CPUC and what we anticipate to be several weeks, if not months, of regulatory uncertainty before we get further clarity on CPUC priorities and future course.

Table 3: PCG Price Target Derivation

Tkr	JPM Rtg	2011E EPS	Group P/E	Prem/ (Disc)	Justified '11 P/E	New PT	Prior PT	Rationale for Premium/(Discount) Used for Valuation & PT Derivation
PCG	N	3.80	14.3x	-5%	13.5x	\$51	\$62	Our discounted peer group multiple reflects regulatory uncertainty resulting from recent changes at the PUC, which we expect to weigh on the stock, even though California has traditionally offered some of the most constructive regulation in the US. With a rate case settlement approval currently pending at the PUC, we believe there is risk to PG&E's estimated above-average EPS growth of ~8%, and recommend that investors remain on the sidelines until greater regulatory clarity emerges.

Source: J.P. Morgan estimates. Price target end date is December 2011. J.P. Morgan ratings: OW = Overweight; N = Neutral; UW = Underweight

Risks to Our Rating

We present risks to our rating in Table 4.

Table 4: Risk to our Ratings for Regulated Utility Stocks

Tkr	Risks to Our Rating
PCG	There could be upside to our Neutral rating if regulatory uncertainty in California dissipates following the recent changes in the makeup of the CPUC. Conversely, there could be downside to our rating if PCG is found to be materially liable for its recent pipeline accident and the liability is not covered by its insurance, its regulatory environment deteriorates, its pipeline of investment opportunities is weaker than we expect, or PCG is not able to maintain its cost structure.

Source: J.P. Morgan.

Company Data	
Price (\$)	46.72
Date Of Price	26 Jan 11
52-week Range (\$)	48.63 - 34.95
Mkt Cap (\$ mn)	18,255.93
Fiscal Year End	Dec
Shares O/S (mn)	391
Price Target (\$)	51.00
Price Target End Date	31 Dec 11

PG&E Corp. (PCG;PCG US)

	2009A	2010E	2011E	2012E
EPS Reported (\$)				
Q1 (Mar)	0.66	0.79A		
Q2 (Jun)	0.83	0.91A		
Q3 (Sep)	0.93	1.00A		
Q4 (Dec)	0.80	0.75		
FY	3.20	3.45	3.80	4.00
Bloomberg EPS FY (\$)	3.19	3.43	3.71	3.90
P/E FY	14.6	13.5	12.3	11.7

Source: Company data, Bloomberg, J.P. Morgan estimates. Note: Official estimates rounded to the nearest \$0.05 per share. 'Bloomberg' above denotes Bloomberg consensus estimates.

Edison International: Summary of Financials

Income Statement - Annual	FY09A	FY10E	FY11E	FY12E	Income Statement - Quarterly	1Q10A	2Q10A	3Q10A	4Q10E
Sales	12,361	12,921	13,234	13,747	Sales	-	-	-	-
COGS	4,268	4,470	4,664	4,775	COGS	-	-	-	-
D&A	1,418	1,549	1,674	1,770	D&A	-	-	-	-
Operations and maintenance	4,387	4,494	4,740	4,917	Operations and maintenance	-	-	-	-
Other expenses	-	-	-	-	Other expenses	-	-	-	-
Total operating expenses	10,073	10,513	11,078	11,462	Total operating expenses	-	-	-	-
Other income / (expense)	111	93	93	93	Other income / (expense)	-	-	-	-
EBIT	2,399	2,501	2,248	2,377	EBIT	-	-	-	-
EBITDA	3,817	4,049	3,922	4,147	EBITDA	-	-	-	-
Interest expense	751	798	850	871	Interest expense	-	-	-	-
Income tax provision	(98)	570	414	452	Income tax provision	-	-	-	-
Tax rate	(5.9%)	33.5%	29.6%	30.0%	Tax rate	-	-	-	-
Discontinued operations and other	(7)	0	0	0	Discontinued operations and other	-	-	-	-
Preferred dividends	-	-	-	-	Preferred dividends	-	-	-	-
Net income	1,739	1,132	985	1,054	Net income	-	-	-	-
Total non-recurring items	(7)	0	0	0	Total non-recurring items	-	-	-	-
Net income (Recurring)	1,746	1,132	985	1,054	Net income (Recurring)	-	-	-	-
Diluted shares outstanding	327	327	327	327	Diluted shares outstanding	-	-	-	-
Diluted EPS	3.25	3.45	3.00	3.20	Diluted EPS	-	-	-	-
DPS (\$)	1.24	1.31	1.37	1.44	DPS (\$)	-	-	-	-
Payout ratio	23.2%	37.6%	45.4%	44.6%	Payout ratio	-	-	-	-
Balance Sheet and Cash Flow Data	FY09A	FY10E	FY11E	FY12E	Ratio Analysis	FY09A	FY10E	FY11E	FY12E
Cash and cash equivalents	1,877	506	204	204	Sales growth	(12.4%)	4.5%	2.4%	3.9%
Current assets	2,553	2,553	2,553	2,553	EBITDA growth	1.3%	6.1%	(3.1%)	5.7%
PP&E	27,113	30,259	33,484	35,419	EBIT growth	(2.3%)	4.2%	(10.1%)	5.8%
Non-current assets	9,901	10,001	10,101	10,201	Net income (recurring) growth	49.1%	(35.1%)	(13.0%)	7.0%
Total assets	41,444	43,319	46,342	48,377	COGS growth	(28.8%)	4.7%	4.3%	2.4%
Current liabilities	10,437	12,067	12,067	11,567	Total operating expenses growth	(13.1%)	4.4%	5.4%	3.5%
Long-term Debt	907	907	907	907	Diluted EPS growth	50.3%	(35.5%)	(13.0%)	6.7%
Preferred stock	16,214	16,214	16,214	16,214	Gross margin	65.5%	65.4%	64.8%	65.3%
Other non-current liabilities	258	258	258	258	Operating margin	19.4%	19.4%	17.0%	17.3%
Common equity	9,841	10,547	11,085	11,669	Debt / Capital (book)	-	-	-	-
Total liabilities & equity	41,444	43,319	46,342	48,377	Times interest earned	3.2	3.1	2.6	2.7
Net income	1,739	1,132	985	1,054	FFO / Interest	2.4	4.5	4.3	4.4
D&A	1,418	1,549	1,674	1,770	FFO / Debt	16.5%	29.8%	24.9%	23.8%
Change in working capital	2,001	0	0	0	ROE	17.7%	10.7%	8.9%	9.0%
Change in other assets	99	1,669	1,794	1,890	Return on invested capital (ROIC)	6.1%	3.7%	3.1%	3.3%
Net operating cash flow	3,045	2,801	2,779	2,944					
Cash flow from investing activities	(2,359)	(4,915)	(5,119)	(3,925)					
Net common equity issued/(repurchased)	(3)	0	0	0					
Net debt issued/(repurchased)	(2,382)	1,168	2,486	1,451					
Common dividends paid	404	426	447	470					
Other financing activity	(140)	0	0	0					
Cash flow from financing activities	(2,929)	742	2,038	981					
Increase/(decrease) in cash	(2,243)	(1,371)	(302)	0					
Cash at beginning of the period	3,916	1,673	302	0					
Cash at end of the period	1,673	302	(0)	0					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

PG&E Corp.: Summary of Financials

Income Statement - Annual	FY09A	FY10E	FY11E	FY12E	Income Statement - Quarterly	1Q10A	2Q10A	3Q10A	4Q10E
Sales	13,399	14,064	14,599	15,067	Sales	-	-	-	-
COGS	5,002	5,090	5,162	5,234	COGS	-	-	-	-
D&A	1,752	1,826	1,928	2,002	D&A	-	-	-	-
Operations and maintenance	4,346	4,348	4,391	4,523	Operations and maintenance	-	-	-	-
Other expenses	-	-	-	-	Other expenses	-	-	-	-
Total operating expenses	11,100	11,264	11,481	11,759	Total operating expenses	-	-	-	-
Other income / (expense)	67	53	53	53	Other income / (expense)	-	-	-	-
EBIT	2,366	2,853	3,172	3,361	EBIT	-	-	-	-
EBITDA	4,118	4,679	5,100	5,363	EBITDA	-	-	-	-
Interest expense	672	714	755	778	Interest expense	-	-	-	-
Income tax provision	460	804	909	971	Income tax provision	-	-	-	-
Tax rate	27.2%	37.6%	37.6%	37.6%	Tax rate	-	-	-	-
Discontinued operations and other	0	0	0	0	Discontinued operations and other	-	-	-	-
Preferred dividends	-	-	-	-	Preferred dividends	-	-	-	-
Net income	1,234	1,335	1,508	1,612	Net income	-	-	-	-
Total non-recurring items	0	0	0	0	Total non-recurring items	-	-	-	-
Net income (Recurring)	1,234	1,335	1,508	1,612	Net income (Recurring)	-	-	-	-
Diluted shares outstanding	386	382	394	397	Diluted shares outstanding	-	-	-	-
Diluted EPS	3.20	3.45	3.80	4.00	Diluted EPS	-	-	-	-
DPS (\$)	1.68	1.80	1.92	2.06	DPS (\$)	-	-	-	-
Payout ratio	51.8%	52.4%	50.6%	51.0%	Payout ratio	-	-	-	-
Balance Sheet and Cash Flow Data	FY09A	FY10E	FY11E	FY12E	Ratio Analysis	FY09A	FY10E	FY11E	FY12E
Cash and cash equivalents	1,160	633	633	822	Sales growth	(8.4%)	5.0%	3.8%	3.2%
Current assets	4,497	4,497	4,497	4,497	EBITDA growth	5.8%	13.6%	9.0%	5.2%
PP&E	28,892	30,536	32,383	32,781	EBIT growth	5.5%	20.6%	11.2%	6.0%
Non-current assets	8,396	8,396	8,396	8,396	Net income (recurring) growth	4.2%	8.2%	13.0%	6.9%
Total assets	42,945	44,062	45,909	46,496	COGS growth	(23.2%)	1.8%	1.4%	1.4%
Current liabilities	6,471	6,116	6,798	5,252	Total operating expenses growth	(10.2%)	1.5%	1.9%	2.4%
Long-term Debt	10,723	11,581	12,281	13,481	Diluted EPS growth	(3.3%)	7.9%	10.1%	5.3%
Preferred stock	252	252	252	252	Gross margin	62.7%	63.8%	64.6%	65.3%
Other non-current liabilities	15,166	14,762	14,339	14,339	Operating margin	17.7%	20.3%	21.7%	22.3%
Common equity	10,333	11,351	12,239	13,172	Debt / Capital (book)	52.2%	50.9%	51.8%	50.1%
Total liabilities & equity	42,945	44,062	45,909	46,496	Times interest earned	3.5	4.0	4.2	4.3
Net income	1,234	1,335	1,508	1,612	FFO / Interest	6.7	5.4	5.5	5.6
D&A	1,752	1,826	1,928	2,002	FFO / Debt	39.2%	32.1%	31.2%	32.5%
Change in working capital	(814)	0	0	0	ROE	11.9%	11.8%	12.3%	12.2%
Change in other assets	766	0	0	0	Return on invested capital (ROIC)	4.1%	4.3%	4.7%	5.0%
Net operating cash flow	3,039	3,147	3,422	3,600					
Cash flow from investing activities	(3,336)	(3,470)	(3,775)	(2,400)					
Net common equity issued/(repurchased)	219	397	150	150					
Net debt issued/(repurchased)	1,363	485	1,363	77					
Common dividends paid	(590)	(700)	(756)	(815)					
Other financing activity	(387)	(386)	(404)	(423)					
Cash flow from financing activities	605	(204)	353	(1,012)					
Increase/(decrease) in cash	308	(527)	0	189					
Cash at beginning of the period	219	527	0	0					
Cash at end of the period	527	0	0	189					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec

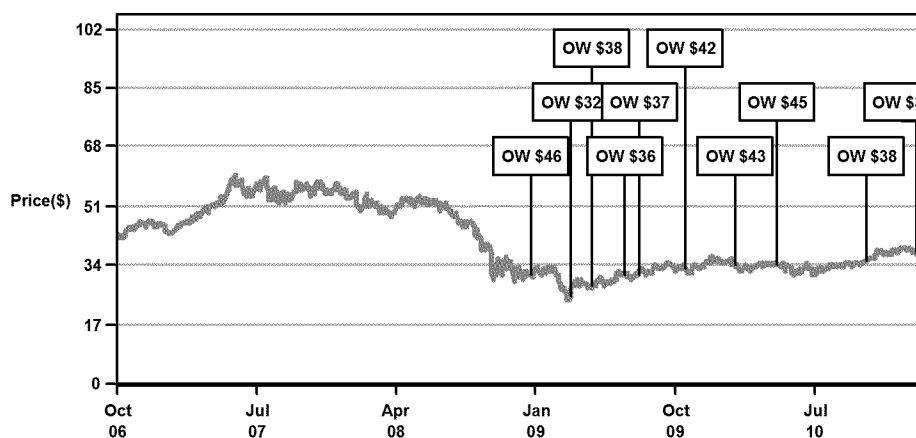
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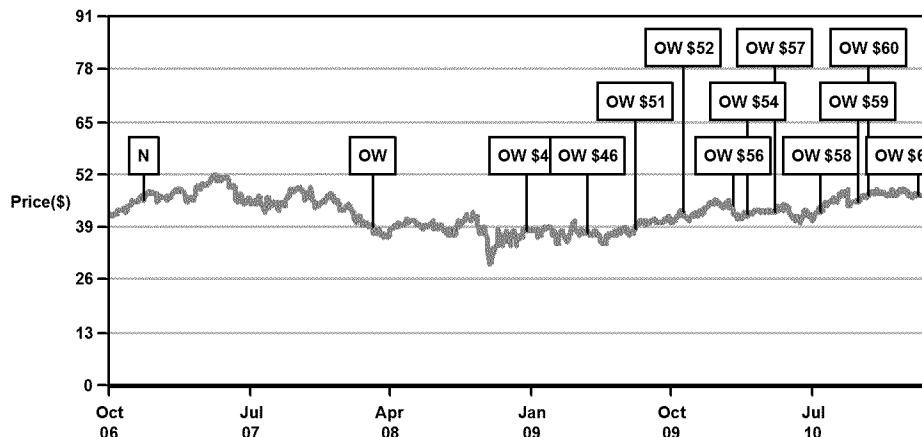
Edison International (EIX) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
23-Dec-08	OW	30.91	46.00
12-Mar-09	OW	25.21	32.00
20-Apr-09	OW	28.07	38.00
26-Jun-09	OW	31.29	36.00
22-Jul-09	OW	31.18	37.00
22-Oct-09	OW	33.08	42.00
26-Jan-10	OW	34.10	43.00
20-Apr-10	OW	33.85	45.00
12-Oct-10	OW	35.43	38.00
20-Jan-11	OW	37.62	39.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

PG&E Corp. (PCG) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
08-Dec-06	N	45.88	-
26-Feb-08	OW	39.24	-
23-Dec-08	OW	38.05	45.00
20-Apr-09	OW	37.40	46.00
22-Jul-09	OW	38.45	51.00
22-Oct-09	OW	42.55	52.00
26-Jan-10	OW	44.37	56.00
26-Feb-10	OW	41.92	54.00
20-Apr-10	OW	42.75	57.00
16-Jul-10	OW	42.56	58.00
29-Sep-10	OW	45.19	59.00
19-Oct-10	OW	46.91	60.00
24-Jan-11	OW	46.94	62.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Feb 11, 2004 - Sep 07, 2004. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

Explanation of Equity Research Ratings and Analyst(s) Coverage Universe:

J.P. Morgan uses the following rating system: **Overweight** [Over the next six to twelve months, we expect this stock will outperform the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe.] **Neutral** [Over the next six to twelve months, we expect this stock will perform in line with the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe.] **Underweight** [Over the next six to twelve months, we expect this stock will underperform the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe.] J.P. Morgan Cazenove's UK Small/Mid-Cap dedicated research analysts use the same rating categories; however, each stock's expected total return is compared to the expected total return of the FTSE All Share Index, not to those analysts' coverage universe. A list of these analysts is available on request. The analyst or analyst's team's coverage universe is the sector and/or country shown on the cover of each publication. See below for the specific stocks in the certifying analyst(s) coverage universe.

Coverage Universe: **Andrew Smith:** AGL Resources (AGL), Ameren Corp (AEE), American Electric Power (AEP), American Water Works (AWK), Black Hills Corp. (BKH), CMS Energy Corp (CMS), CenterPoint Energy (CNP), Consolidated Edison (ED), Constellation Energy Group (CEG), Covanta Holding Corp. (CVA), Dominion Resources (D), Duke Energy Corp. (DUK), Dynegy, Inc. (DYN), Edison International (EIX), Entergy Corp. (ETR), Exelon Corp. (EXC), Integrys Energy Group (TEG), NRG Energy (NRG), NextEra Energy Inc. (NEE), Northeast Utilities (NU), PG&E Corp. (PCG), Pepco Holdings (POM), Progress Energy (PGN), Sempra Energy (SRE), Southern Company (SO), UIL Holdings Corporation (UIL), Vectren Corp (VVC), Wisconsin Energy Corp (WEC), Xcel Energy (XEL)

J.P. Morgan Equity Research Ratings Distribution, as of December 31, 2010

	Overweight (buy)	Neutral (hold)	Underweight (sell)
J.P. Morgan Global Equity Research Coverage	46%	42%	12%
IB clients*	53%	50%	38%
JPMS Equity Research Coverage	43%	49%	8%
IB clients*	71%	63%	59%

*Percentage of investment banking clients in each rating category.

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