

## California Cruisin' v2.0

### ■ UBS hosts constructive meetings with Commissioner Florio and others

Key takeaways from meeting with Florio: 1) wants to remain a consensus builder; 2) will try to minimize rate increases and maximize ratepayer dollar, i.e. do more with less; 3) supports the dynamic element of the cost of capital process but admits that California ROEs are "pretty high"; 4) believes in adopting more private sector approaches and improved metrics for energy efficiency; and 5) CA needs to balance capex spending with needs to replace aging (pipeline) infrastructure.

### ■ PCG GRC decision finally in sight?

PCG's pending GRC settlement might be heard in late March provided the ALJ decision and a proposed alternate are issued sometime next week as expected. DRA and TURN want to implement staggered proceedings for future rate cases given complexities and staffing burdens impacting EIX and SRE timelines.

### ■ Support for settlements remains

Commissioner Florio, David Ashuckian, Deputy Director of the DRA and key staffers for Peevey and Simon, all continue to support negotiated rate proceeding settlements so long as the deals continue to move in the direction of state policy.

### ■ 33% renewable portfolio standard (RPS) legislation gaining traction

SB 2x likely to be passed this year and continues to build momentum within the state. CPUC likely to begin a more selective process for signing RPS PPA's given that the state believes the IOUs are sufficiently procured to meet the standard. Florio opines that gone are the days of "signing anything at any cost." All but PCG appear to have met the 33% RPS; how much materializes is a key question.

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## Key Takeaways

### ■ Cost of capital is the key near-term investor focus

Commissioner Florio stated that he supports the current cost of capital methodology and the dynamic element of the COC process, but “doesn’t want massive rate increases if we can avoid it.” Further, he admits that he hasn’t looked specifically at it [sic: COC] recently, and that the state’s allowed ROE of 11.35% is “pretty high.” Examining the state’s relative risk profile, he asks why a state with a long standing history of decoupling and full fuel/PPA recovery should authorize a premium ROE relative to peers. The COC proceeding, which unilaterally sets allowed returns and is bifurcated from general rate case proceedings, is slated to be taken up for consideration in the middle of 2012.

### ■ PG&E rate case decision near?

An ALJ and alternate PD are currently being worked on for potential release next week suggesting at least mid-March before the commission can consider PCG’s pending settlement. The alternate PD is expected to discuss ratemaking treatment for PCGs’ legacy meters as it migrates towards smart meters, likely leaving intact the existing settlement with parties. The ALJ decision and the proposed alternate must be submitted simultaneously and statute requires a 30 day gestation period before the CPUC can render a decision.

### ■ Renewables ratebasing remains an option, but with a twist

The utilities are being given the option to ratebase up to 8.25% of the 33% RPS requirement contemplated in SB 2x, which is currently weaving its way through the legislature. Traditional cost of service ratemaking will be the hurdle in approving such requests, but this method provides an avenue for the CPUC to remain educated on the cost structure of renewables when considering PPA options. The CPUC remains keenly concerned about the disconnect between lower cost structures for renewables (i.e. lower solar module pricing) without a commensurate decline in PPA pricing. Finally, CPUC officials described slowing the pace of PPA announcements in an attempt to not stir up increased competition and in light of nominally contracting for all 33% for the 2020, with fully nine years left to achieve the target. Commissioner Florio indicated that future contracts will face greater scrutiny for approval. Further, despite the current pricing/cost mismatch with existing PPAs, Florio noted that it is a dangerous road to try to abrogate existing contracts.

### ■ Pipeline safety is key issue for next several years

The San Bruno pipeline explosion is causing heightened awareness of the state’s aging infrastructure. PCG is expected to be allowed to recover future pipeline safety-related investments but it will be subject to significant oversight. All costs for the San Bruno pipeline explosion are expected to be taken up in PCG’s next general rate case (2014); at this time, there is no discussion of creating interim balancing accounts.

CPUC officials suggested the gas transmission and storage (GTS) ratemaking proceeding would likely see a PD issued soon, likely leaving intact the existing settlement with parties. A final vote on this issue is tentatively being targeted for the commission meeting on March 24<sup>th</sup>. On the safety side of the GTS case,

a PD is expected in late March (with a corresponding commission vote in April). Given the limited scope/filings on this side of the GTS case, we believe the CPUC will choose to open a generic rulemaking docket (OIR/OII) to evaluate future investment and practices in pipeline safety; specifically, we believe the utilities will be afforded less flexibility to re-allocate authorized capital away from maintenance work.

■ **Hints of a change in leadership**

During our meeting, Commissioner Florio suggested he could take over as case officer of the San Bruno pipeline investigation from Chairman Peevey. This suggests to us that Chairman Peevey may in fact be starting the first of a series of docket reassignments so he can transition out of the commission. We discussed this possibility in our note entitled *Cruisin' California* dated December 9, 2010.

■ **Who is No. 5?**

The timing of the fifth and final commissioner appointment by Governor Brown remains a closely guarded secret. However, based upon our discussions today, we continue to believe that former CEC commissioner John L. Geesman is near or at the top of the short list. While Mr. Geesman brings a wealth of financial and energy experience (banker and CEC commissioner), we note that he has been an outspoken critic of the state's utilities. All parties at the CPUC expressed a uniform desire to see a decision made swiftly to allow for a return to business as usual, and specifically for outstanding cases to be delegated.

■ **No foxes in the hen house**

Commissioner Florio confirmed that he will recuse himself from all pending proceedings that are before the CPUC that he presided over given his recent history as the senior attorney for TURN (the Utility Reform Network) or until those issues have been decided. He is then free to participate on subsequent proceedings as there is no state of limitations before he is allowed to participate.

■ **Potential for SDG&E rate case to be delayed**

Given the substantial workload involved with concurrently processing both the SCE and SDG&E general rate cases, we believe the schedule on the SDG&E case could yet be staggered by a 5-6 month period allowing for interveners to appropriately review each case. While this could potentially have a near-term cash flow impact, we believe GRC rates would remain retroactive, per usual practice, to Jan 1<sup>st</sup> 2012 for both cases.

■ **Smart meters could regain focus**

We believe the focus of late on the complexity of PG&E's dynamic pricing could lead to renewed headline risk related to the Smart meter deployment in California. PG&E tentatively plans to put in place dynamic rates for its commercial and industrial customers on November 1<sup>st</sup>. Ultimately, we believe more steady seasonal Time-of-Use (TOU) rates will be adopted as a transition plan for all customers. While simplifying the process, a shift to a more basic TOU program would reduce the ultimate benefits of the meters. DRA cited roughly 65% of the cost of smart meters was recoverable through immediate cost offsets, with the balance to be achieved from more efficient energy usage.

■ **Energy Efficiency incentives could yet evolve**

All parties at the CPUC seemingly agreed that the current approach to EE led to inefficient debate and metric targeting, rather than focusing on real reductions. Several parties honed in on the need to more effectively incorporate the private sector into EE, rather than leaning on the state IOUs to more effectively achieve targets. Further, parties remained focused on reducing the complexity of the EE incentive program, with Commissioner Florio citing the success of its natural gas hedging incentive program as an approach to emulate.

*For additional details, please see our notes dated December 9, 2010, entitled "Cruisin' California," January 21, 2011, "CPUC End Game Begins", and February 11, 2011, "California's Renewable Nuggets" for additional information on Californiaregulatory and legislative matters.*

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Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrators. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted in the company's risk management operations. Major external factors, which affect our valuation, are environmental risks. Environmental capex could escalate if stricter emission standards are implemented. We believe a nuclear accident or a change in the Nuclear Regulatory Commission/Environment Protection Agency regulations could have a negative impact on our estimates.

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Buy	Buy	49%	40%
Neutral	Hold/Neutral	42%	35%
Sell	Sell	8%	21%
UBS Short-Term Rating	Rating Category	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Buy	less than 1%	14%
Sell	Sell	less than 1%	0%

1: Percentage of companies under coverage globally within the 12-month rating category.

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UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
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Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
<b>PG&amp;E Corporation</b> <sup>2, 4, 5, 6a, 16</sup>	PCG.N	Neutral	N/A	US\$46.21	14 Feb 2011
<b>Sempra Energy</b> <sup>2, 4, 5, 6a, 6b, 6c, 7, 16, 22</sup>	SRE.N	Buy	N/A	US\$53.09	14 Feb 2011

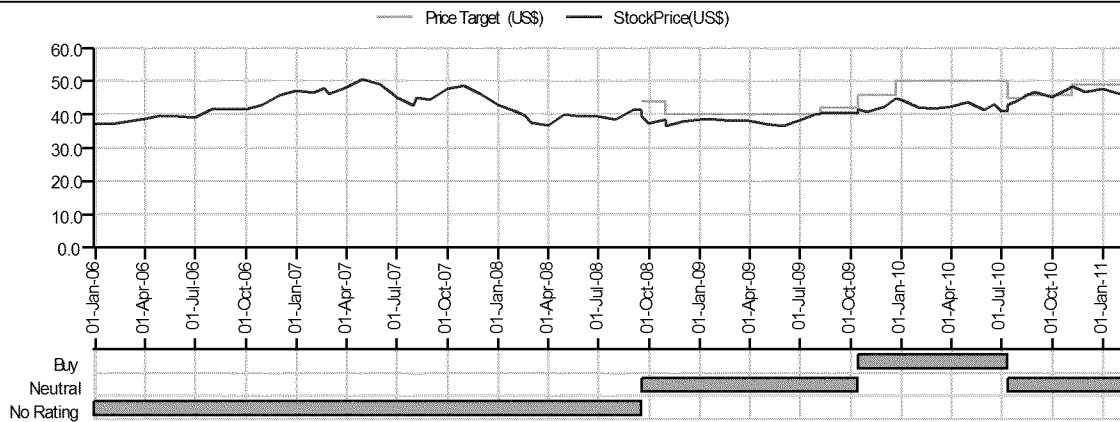
Source: UBS. All prices as of local market close.

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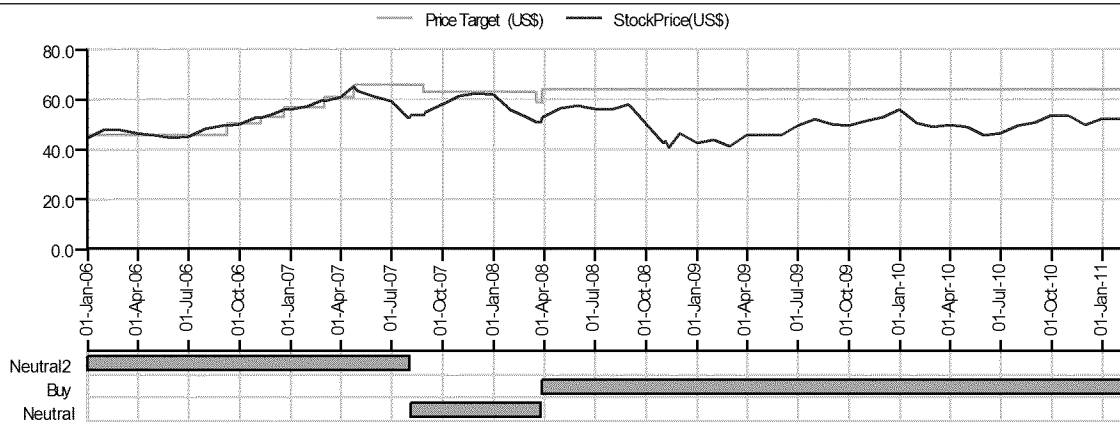
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

**PG&E Corporation (US\$)**



Source: UBS; as of 14 Feb 2011

**Sempra Energy (US\$)**



Source: UBS; as of 14 Feb 2011

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