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Hugh Wynne (Senior Analyst) • hugh.wynne@bernstein.com • +1-212-823-2692
Francois D. Broquin • francois.broquin@bernstein.com • +1-212-756-4051
Saurabh Singh • saurabh.singh@bernstein.com • +1-212-756-4113

FLASH

Quick Take - CPUC Accuses PG&E of "Willful Noncompliance" with Pipeline Records Order; Threatens Significant Fines

Ticker	Rating	CUR	16 Mar 2011 Closing Price	Target Price	TTM Rel. Perf.	EPS 2010A	EPS 2011E	EPS 2012E	P/E 2010A	P/E 2011E	P/E 2012E	Yield
PCG	O	USD	42.47	54.00	-10.1%	3.42	3.68	3.91	12.4	11.5	10.9	4.3%
SPX			1256.88			85.35	97.35	111.20	14.7	12.9	11.3	1.9%

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

Highlights

- Yesterday night (March 16th ET), the California Public Utilities Commission (CPUC) issued a strongly worded press release and letter to PG&E in which CPUC Executive Director Paul Clanon accused PG&E of a refusal to comply with the CPUC's January 3, 2011 directive to conduct a thorough search of its pipeline strength test records, in order to establish a valid maximum allowed operating pressure (MAOP) for the 1,800 miles of its ~6,000 mile gas transmission system that run through highly populated areas.
- The CPUC's January 3rd order originated from "urgent" safety recommendations issued by the National Transportation Safety Board (NTSB) as part of its ongoing investigation into the explosion of a PG&E gas transmission line last September in a residential area located in the city of San Bruno, CA. The explosion resulted in the tragic loss of eight lives, including the deaths of a long-time CPUC staffer and her 13-year-old daughter, and the destruction of or severe damage to 55 homes.
- Under the CPUC's January 3rd order, PG&E was first required to "aggressively and diligently" search for documentary records relating to the design, construction, inspection, testing and maintenance of its gas transmission lines in highly populated areas. PG&E was instructed to then use the records that were "traceable, verifiable, and complete" as a means to establish a valid MAOP for lines in areas that "have not had a MAOP established through prior hydrostatic testing". A hydrostatic pressure test is a is pipeline strength testing method in which the pipeline segment to be tested is shut down and filled with water at a pressure that stresses the pipe at 125% of the desired MAOP for a minimum of 8 hours.
- The CPUC had initially requested the results of the records search by February 1, 2011, but PG&E had sought and received an extension of the deadline to March 15th. In its report submitted on March 15th, PG&E interpreted the "traceable, verifiable, and complete" requirement as implying either the existence of "reliable records confirming the performance of a pressure test *or the determination of MAOP based on the historical high operating pressure*". The italicized part of the quote refers to the use of the highest *actual* operating pressure from July 1, 1965 through June 30, 1970 for pipelines installed prior to a federal pipeline safety law mandating pressure testing that went into effect on July 1, 1970. CPUC took severe umbrage at the italicized conclusion and accused PG&E of "willful noncompliance" that may put be "placing public safety in jeopardy".
- We have reviewed PG&E's 154-page filing at length, and we find PG&E's claim to have documented pressure test records or historical operating pressure records for 92% of its pipeline installed prior to the 1970 federal law and 93% for the pipeline installed on or after July 1, 1970 to _not_ provide us with great comfort. Our discomfort stems from the following issues:

U.S. Utilities

Hugh Wynne (Senior Analyst) • hugh.wynne@bernstein.com • +1-212-823-2692

(i) Not having full documentation of pressure testing post-1970 and missing any kind of pressure testing records (even partial pressure test records) for 7% of subsequent pipe installations is indicative of an inadequate record-keeping practice in itself;

(ii) 12% of the lines installed after California started requiring pressure testing starting on July 1, 1961 and prior to the July 1, 1970 federal regulation were missing any kinds of pressure testing records as well;

(iii) PG&E's definition of what constitutes a "complete" pressure test record seems potentially self-serving in that it appears to only include 4 out of 7 recordkeeping elements under federal law; and

(iv) PG&E seems to have included in its definition of pressure tests, test mediums other than water, although the CPUC/NTSB directives only intended to specify water as the test medium (hydrostatic pressure testing).

Investment Conclusion

PG&E's handling of the public and regulatory scrutiny in the aftermath of the San Bruno pipeline explosion, had been marked by a relatively adroit and adept series of actions that we thought had not only achieved their stated public good and policy objectives, but had also served to alleviate the political pressure on PG&E, and minimized the risk of a punitive response by the CPUC.

Unfortunately, PG&E now appears to have mishandled its response to the CPUC/NTSB directives. This misjudgment will deal a significant blow to PG&E's credibility with its state regulators, which is likely to result in a less constructive relationship related to matters involving not just its gas system, but also its other lines of business (electric generation and distribution). In light of the recent changes in the slate of Commissioners at the CPUC, all signs point to a harsher, more adversarial reception for PG&E at the CPUC in the future. We also now consider it likely that the CPUC will impose a substantial fine (possibly hundreds of millions of dollars), which we remind investors is not included in the $200 to $300 million guidance for 2011 provided during the Q4 earnings call by management for San Bruno shareholder costs. It is also likely that uncompensated gas transmission safety related O&M costs to be borne by shareholders will increase significantly and require management to raise its estimate of San Bruno costs, which it had already doubled since the initial $100 to $200 million guidance provided during the Q3 2010 earnings call.

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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 2012-16, and a terminal value in 2017, discounted back to present value using estimated weighted average cost of capital at 6.5%; (2) a discounted dividend model over the forecast period of 2012-16, and a terminal value in 2017, 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 our estimates of a utility's future earnings, dividends, 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. 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 targetprice.

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  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

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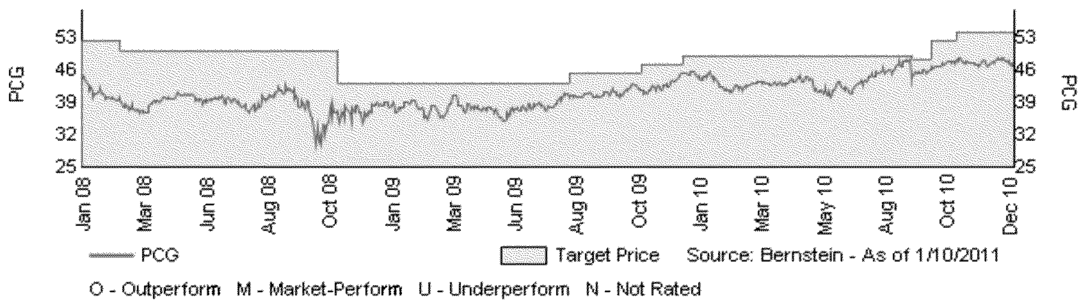
12-Month Rating History as of 03/16/2011

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)
12/11/07	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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