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Sent: 4/12/2011 12:05:30 PM
To: mfl@cpuc.ca.gov (mfl@cpuc.ca.gov)
Cc:
Bcc:
Subject: FW: Analyst Reports (BofA Merrill) - CA PUC Meetings and Quantifying San Bruno Risks

FYI

From: Togneri, Gabriel
Sent: Tuesday, April 12, 2011 10:18 AM
To: Officers of Pacific Gas and Electric; Officers of PG&E Corporation
Cc: Investor Relations (list); Lee, Wondy
Subject: Analyst Reports (BofA Merrill) - CA PUC Meetings and Quantifying San Bruno Risks

BofA Merrill lead analyst Steve Fleishman issued two reports this morning. One report focus on his meetings with the CPUC last week and implications for CA utilities generally. The other report is more specific to PCG and risks associated with the ongoing gas pipeline issues.

In the first report, "CA PUC Meetings Reasonable; Prefer EIX over PCG", Fleishman notes that the CPUC remains focused on the large infrastructure needs in the state and he believes that California continues to be a constructive regulatory environment, with the commissioners mentioning the need for healthy utilities to achieve the state's ambitious renewables targets. On specific issues, Fleishman reports:

Rate Base Investments – The commission continues to support strong rate base growth, particularly for safety, reliability, and renewables growth. Many of the commissioners also mentioned the need to consider affordability and this would indicate increased focus on renewable PPAs and targeting them to be more competitive.

Cost of Capital – Commissioners noted that CA ROEs are on the higher end and are likely to trend down, but not likely to industry averages recognizing the large investment needs in the state. All commissioners expressed support for a three-year cost of capital mechanism and Fleishman expects the current mechanism to stay in

place.

Bonus D&A – Based on what he heard in his meetings, Fleishman believes this is moving in the right direction, with most commissioners supportive of having utilities spend the bonus D&A cash on additional investments that offsets the hit to rate base in latter years from increased deferred taxes.

CPUC Commissioner Update – The report states that Gov. Brown has asked President Peevey to stay at least through the end of 2011, and that it's possible one of the other commissioners will be named as president by the governor in 2012. It further speculates that under such a scenario President Peevey may step down from the commission allowing Gov. Brown to appoint a new commissioner in 2012. The report also notes that the CPUC is now operating under new Bagley-Keene rules that limit communications among Commissioners to public meetings, which Fleishman believes could result in some modest delays in coming to consensus on issues.

In the second report, "Quantifying San Bruno; Major Risk Priced In. Maintain Buy", Fleishman states that he believes San Bruno and its ramifications will likely get worse before it gets better. He has adjusted his estimates to reflect an additional \$500 million of non-recoverable costs in addition to the \$300 million previously assumed (a combination of direct costs and penalties). This has implications for the amount of equity issued to keep the capital structure at the authorized level, and dilutes his earnings estimates by about \$0.10 on an annualized basis. In 2013, he also assumes that the equity ratio is lowered to 48% as part of the cost of capital review, consistent with other CA utilities, and that the ROE is lowered by 50 bps to 10.85%. Eventually, he believes PCG will see rate base growth to enhance the gas system, but the transition from shareholder-funded spend to "fix" the gas system to customer-funded spend to achieve best-in-class safety is uncertain.

As a result of the assumptions above, his EPS estimates for 2011-2014 are now \$3.65/\$3.80/\$3.79/\$3.88 compared to his previous estimates of \$3.65/\$3.89/\$3.95/\$4.05. He lowers his price target to \$48, based on the industry average 12.5x 2013 EPS.

In trading today, we are currently at \$43.80, down about 0.6%. This appears to be in the range that other regulated utility stocks are trading. The Dow Jones Utilities are

down 0.35%.

Gabe

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