

CA PUC meetings reasonable; prefer EIX over PCG



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CA regulators reasonable despite San Bruno pressures

Last week, we met with four of the five CPUC commissioners as well as several other PUC members. Significant public pressure in the wake of the San Bruno explosion is clearly weighing on the agency. Nonetheless, the commissioners remain focused on the large infrastructure needs in the state to meet the 33% renewable standard and increased safety/reliability, as well as the importance of healthy utilities to implement this. Gov Brown has given a consistent message to the new commissioners: the 33% renewable standard is a floor, not a ceiling.

San Bruno impacts...

San Bruno has clearly heightened the PUC focus on safety going forward – not just in the gas business but in all other areas. This may result in the PUC tracking rate case spending more closely, but may also create new investment opportunity. For PCG, San Bruno is a huge overhang on the company with several proceedings pending that could result in penalties and higher direct spending. At some point, PCG will see ratebase growth to enhance its gas system, but the transition from shareholder-funded spend to fix San Bruno to ratepayer-funded spend to achieve best-in-class safety is still uncertain.

ROE and other issues

On the cost of capital case in 2012, the commissioners generally noted that CA ROEs are on the higher end and will likely trend down, but not likely to industry averages recognizing the large investment need in the state. We continue to assume a 50bp reduction in 2013. On President Peevey, the Governor has indicated that he would like him there until at least the end of 2011. However, it is possible that one of the three new Comms might be named President afterward.

Prefer EIX to PCG to play California

We are upgrading EIX to Buy from Neutral after our CA trip. We see it as the best way to play the ratebase growth opportunities in CA. At this point, we would rather deal with the uncertain future of Edison Mission than the political/financial risk from San Bruno, and SCE trades at a lower embedded valuation than PCG. EIX's general rate case is a year behind PCG's, but we believe a settlement or reasonable outcome is likely.

PCG in the crosshairs though stock reflects it

Several commissioners mentioned that PCG will not be treated harsher than the other utilities due to San Bruno and our sense was that the GRC would likely be adopted. Nonetheless, there is clear concern on PCG's gas business operations and upcoming reports on San Bruno causes could be adverse. We have updated our estimates and price target to reflect higher San Bruno costs and a worse cost of capital decision. Even so, the stock valuation more than reflects these issues.

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Highlights from California meetings

Last week, we met with four of the five CPUC commissioners (Ferron, Florio, Sandoval and Simon) as well as several other PUC members. Significant public pressure in the wake of the San Bruno explosion is clearly weighing on the agency. However, outside of that, we still believe California remains a constructive regulatory environment with above average rate base growth at the utilities. In particular, the commissioners mentioned the need for healthy utilities to achieve the state's ambitious renewables targets.

San Bruno impacts...

San Bruno has clearly heightened the PUC focus on safety going forward – not just in the gas business but in all other areas. The San Bruno accident has turned the spotlight on the PUC, and it may take awhile for the PUC and PG&E to regain its credibility. One of the commissioners commented on the negative publicity the CPUC has gotten as a result of San Bruno, and feels that the CPUC has its back against the wall. Moreover, many commissioners emphasized the need for utilities to honor the public contract, that is to provide safe and reliable service, not just focus on compliance.

Next steps in San Bruno include a hearing on the show cause order and stipulation on Monday, April 11, 2011. It is unclear whether the stipulation in the current form will be passed, as some commissioners believe the \$3M fine (\$6M all-in) could be too low. The CPUC independent investigation is due in May and will likely include tough recommendations for all California utilities on safety. A final NTSB report is expected in August or September 2011, which will also give recommendations.

Sempra (SRE) is expected to file its gas records on April 15, 2011. From current indications it appears that SRE will compare favorably to PCG, further increasing the pressure on PCG to improve its operations.

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The current Order Instituting Investigation (OII) is expected to be done this year and will likely result in fines for PCG. We note that previous fines from the CPUC have been in the \$20-\$30M range, however it is unclear how large the PCG fine will be. One commissioner commented that he/she would need to see a substantial penalty to clear the air and move on to a discussion of safety.

At some point, PCG will see rate base growth to enhance its gas system, but the transition from shareholder-funded spend to fix San Bruno to ratepayer-funded spend to achieve best-in-class safety is still uncertain.

We have updated our estimates and price target to reflect higher San Bruno costs and a worse cost of capital decision. Even so, the PCG stock valuation more than reflects these issues.

PCG in the crosshairs though stock reflects it

Several commissioners mentioned that PCG will not be treated harsher than the other utilities due to San Bruno and our sense was that the GRC would likely be adopted. Nonetheless, there is clear concern on PCG's gas business operations and upcoming reports on San Bruno causes could be adverse. We have updated our estimates and price target to reflect higher San Bruno costs and a worse cost of capital decision. Please see our note on "[Quantifying San Bruno risks](#)". Even so, the stock valuation more than reflects these issues.

The commissioners remain focused on the large infrastructure needs in the state to meet the 33% renewable standard and increased safety/reliability, as well as the importance of healthy utilities to implement this.

On the cost of capital case in 2012, the commissioners generally noted that CA ROEs are on the higher end and will likely trend down, but not likely to industry averages recognizing the large investment need in the state. We continue to assume a 50bp reduction in 2013.

Rate base investments

The commission continues to support strong rate base growth at the utilities, particularly for safety and reliability and renewables growth. Renewables investments will likely be both utility owned generation, competitive PPAs along with increased transmission growth. The California State Assembly recently passed SB 2X1, which mandates that 33% of the state's power come from renewables by 2020. This is the most ambitious renewable standard in the country. Moreover, Governor Brown has communicated to his newly appointed Commissioners (Ferron, Florio, Sandoval) that 33% is a floor not a ceiling.

Many of the commissioners also mentioned the need to consider affordability when considering such large investments. We believe there will be some increased focus on renewable PPAs and targeting them to be more competitive.

In addition, many of the commissioners want a more complete feedback loop on where money allocated in rate cases is ultimately spent. We believe we may see additional filings from utilities in between rate cases providing updates to the CPUC on capital spend.

Bonus D&A case seems to be moving in right direction

There is currently an open proceeding to address how the bonus D&A tax benefits will be utilized by the California utilities. We believe this case is moving in the right direction, with most commissioners supportive of the status quo. Currently utilities spend the bonus D&A on additional investments that offsets the hit to rate base in latter years from increased deferred taxes.

Cost of capital cases in 2012

On the cost of capital case in 2012, the commissioners generally noted that CA ROEs are on the higher end and will likely trend down, but not likely to industry averages recognizing the large investment need in the state. We continue to assume a 50bp reduction in 2013. That said, all of the commissioners expressed support for the three year cost of capital mechanism; to this end, we expect the current mechanism to stay in place.

Performance mechanisms in ROEs?

A few of the commissioners mentioned including incentives in ROEs for performance. In our view the CPUC may propose a performance adjustor for reliability, safety and or management performance in the ROE calculations.

Update on CPUC Commissioners, Pres. Peevey

As a reminder, Commissioners Ferron, Florio and Sandoval need to still be confirmed by the Senate. As both Governor Brown is a Democrat and the CA Senate has a Democratic majority, confirmations are not expected until year end 2011. We remain watchful, as pending confirmations could impact their behavior.

Governor Brown has asked President Peevey to stay on at least through the end of 2011. In the past, new governors have named their commission appointments as President after having served for a year. Post year end, it is possible that Gov Brown may name one of the three new commissioners as President in 2012. If this is the case we would expect President Peevey to step down shortly thereafter, allowing Governor Brown to appoint a new CPUC member early in 2012.

The CPUC is now operating under new Bagley-Keene rules that limit communications among Commissioners. As a result of this, many commissioners may only be able to discuss items together at public meetings, which we believe may result in some modest delays in coming to a consensus on some issues.

Investment thesis

Edison International

Edison International's (EIX) utility, Southern California Edison (SCE), is a top growing utility in a constructive regulatory environment. This growth is currently muddled by a volatile and deteriorating earnings situation at Edison Mission Energy (EME), EIX's power generation company. However, we believe EME concerns are priced into the stock and see attractive utility valuation at these levels. Buy.

Price objective basis & risk

Edison International (EIX)

Our EIX price objective is \$43. We value SCE at \$43/share, based on 12.5x 2013E earnings, in-line with the regulated industry average. We see zero equity value at EME at current power prices even before adding environmental capex at the coal plants. For EME, in our view, the company cannot be worth negative value to EIX, but we also see a slim chance of material positive value barring a dramatic power market recovery. The downside risk for EIX is an unforeseen negative turn in California regulation. On the upside, a strong power market recovery could cause EME to be worth more than we currently expect.

PG&E Corporation (PCG)

Our \$48 price objective assumes an average P/E of 12.5x 2013E earnings, in line with the regulated utility average. Risks to our outlook are: 1) liability related to the San Bruno explosion, 2) approval of the settlement in the 2011 general rate case and 3) Any unforeseen changes to California regulation.

Link to Definitions

Energy

Click [here](#) for definitions of commonly used terms.

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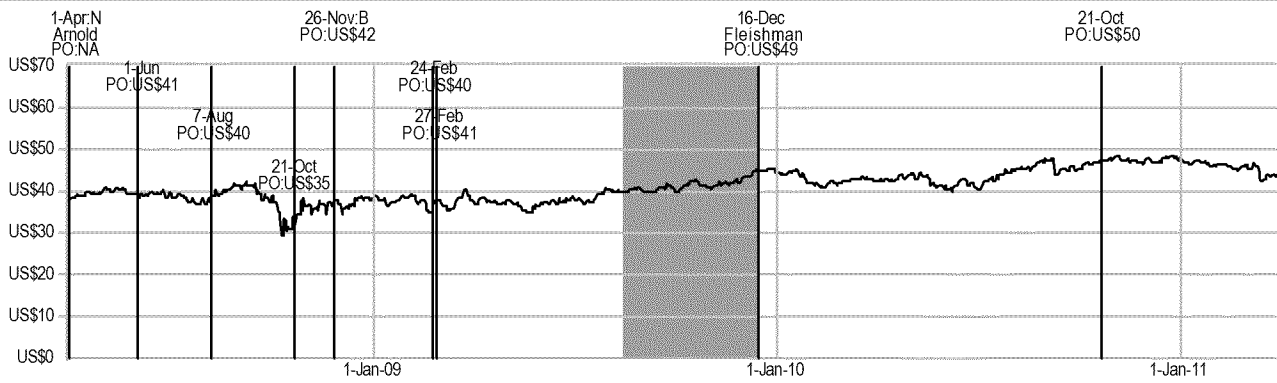
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US - Electric Utilities/Competitive Power Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	American Water Works	AWK	AWK US	Steve Fleishman
	CenterPoint Energy, Inc.	CNP	CNP US	Steve Fleishman
	Edison International	EIX	EIX US	Steve Fleishman
	GenOn Energy, Inc.	GEN	GEN US	Ameet I. Thakkar
	NextEra Energy	NEE	NEE US	Steve Fleishman
	NV Energy	NVE	NVE US	Steve Fleishman
	PG&E Corporation	PCG	PCG US	Steve Fleishman
	Public Service Enterprise Group Inc.	PEG	PEG US	Steve Fleishman
	Southern Company	SO	SO US	Steve Fleishman
	Westar Energy	WR	WR US	Steve Fleishman
	Wisconsin Energy	WEC	WEC US	Alex Kania
	Xcel Energy	XEL	XEL US	Steve Fleishman
NEUTRAL				
	Alliant Energy	LNT	LNT US	Steve Fleishman
	American Electric Power	AEP	AEP US	Steve Fleishman
	Calpine	CPN	CPN US	Ameet I. Thakkar
	CMS Energy	CMS	CMS US	Steve Fleishman
	Consolidated Edison	ED	ED US	Steve Fleishman
	Constellation Energy Group	CEG	CEG US	Ameet I. Thakkar
	Dominion Resources	D	D US	Steve Fleishman
	Duke Energy	DUK	DUK US	Steve Fleishman
	Northeast Utilities	NU	NU US	Steve Fleishman
	NRG Energy	NRG	NRG US	Ameet I. Thakkar
	NSTAR	NST	NST US	Steve Fleishman
	Pinnacle West	PNW	PNW US	Steve Fleishman
	Portland General Electric Company	POR	POR US	Steve Fleishman
	TECO Energy	TE	TE US	Steve Fleishman
	UIL Holdings	UIL	UIL US	Steve Fleishman
UNDERPERFORM				
	Ameren Corp	AEE	AEE US	Steve Fleishman
	DPL Inc.	DPL	DPL US	Steve Fleishman
	DTE Energy	DTE	DTE US	Steve Fleishman
	Entergy	ETR	ETR US	Steve Fleishman
	Exelon	EXC	EXC US	Steve Fleishman
	FirstEnergy	FE	FE US	Steve Fleishman
	Hawaiian Electric Industries	HE	HE US	Steve Fleishman
	SCANA Corp.	SCG	SCG US	Steve Fleishman
RSTR				
	PPL Corporation	PPL	PPL US	Steve Fleishman

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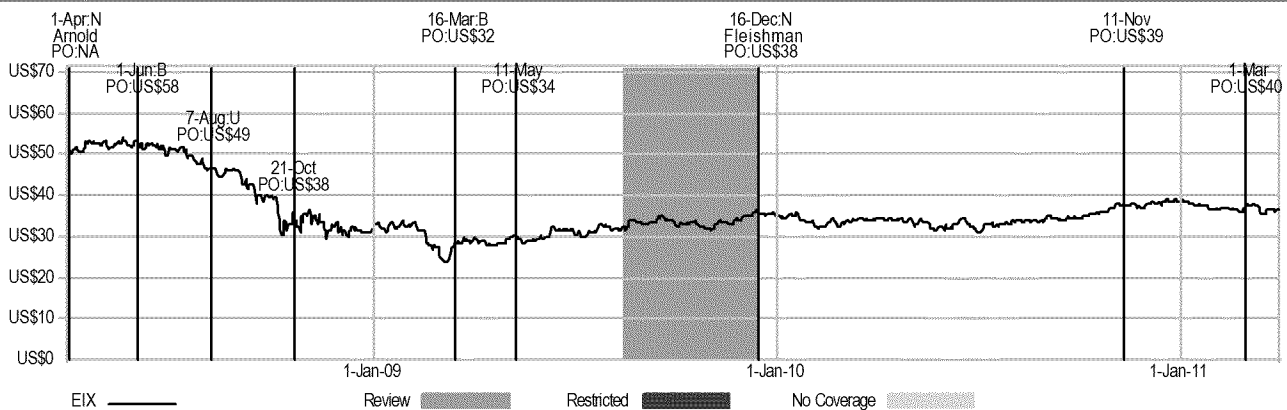
PCG Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR : No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of March 31, 2011 or such later date as indicated.

EIX Price Chart

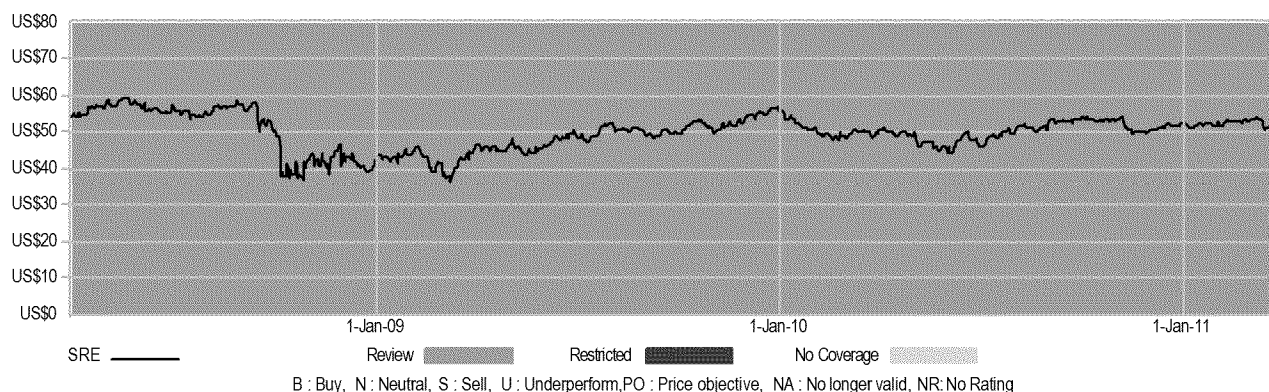


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SRE Price Chart



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Investment Rating Distribution: Energy Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	152	56.93%	Buy	90	64.29%
Neutral	65	24.34%	Neutral	26	50.98%
Sell	50	18.73%	Sell	17	38.64%

Investment Rating Distribution: Utilities Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	77	42.08%	Buy	33	47.83%
Neutral	53	28.96%	Neutral	33	68.75%
Sell	53	28.96%	Sell	18	38.30%

Investment Rating Distribution: Global Group (as of 01 Apr 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2009	53.66%	Buy	912	49.89%
Neutral	955	25.51%	Neutral	439	50.93%
Sell	780	20.83%	Sell	257	35.11%

* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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