

## PCG: Crisis or Turning Point? What Does the Resignation of PG&E's CEO Mean for the Stock?

Ticker	Rating	CUR	21 Apr 2011 Closing Price	Target Price	TTM Rel. Perf.	EPS			P/E			Yield
						2010A	2011E	2012E	2010A	2011E	2012E	
PCG	O	USD	45.18	50.00	-6.2%	3.42	3.68	3.91	13.2	12.3	11.6	4.0%
SPX			1337.38			85.28	98.04	111.51	15.7	13.6	12.0	1.8%

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

### Highlights

- On April 21, PG&E Corporation (PG&E) announced that Peter Darbee will retire on April 30 from his positions of Chairman, CEO and President of PG&E. The compressed timetable of Darbee's departure suggests that his resignation was demanded by the board; the apparent approval of the California Public Utilities Commission (CPUC), suggests that the CPUC may have pressured PG&E to replace its CEO.
- Darbee's departure coincides with that of John Keenan, Chief Operating Officer of PG&E Corp.'s regulated utility subsidiary, Pacific Gas & Electric Company, whose resignation will also be effective April 30th. Also departing is Edward Salas, the utility's Senior Vice President of Engineering and Operations. PG&E does not plan to replace Keenan, but intends rather to appoint two senior vice presidents, each reporting the president of the utility, to run its electricity and gas businesses.
- Darbee's departure follows a series of costly decisions, the most damaging of which relate to PG&E's response to the San Bruno pipeline explosion. A chronology of events surrounding San Bruno appears in **Exhibit 1**. What this timeline shows is that PG&E's recordkeeping with respect to its older gas transmission pipelines was woefully inadequate; that it failed promptly to inform the California Public Utilities Commission (CPUC) of this fact, even when ordered by the CPUC to conduct an intensive search of these records to determine safe operating pressure for these lines; and that the company had to be threatened by the CPUC with fines before it committed to assemble the necessary records.

### Investment Conclusion

Taken in this context, the departures of Darbee and Keenan likely reflect the CPUC's frustration with PG&E's failure to cooperate in the Commission's urgent effort to ensure the safe operation of the company's gas pipeline system. In choosing Darbee's successor, PG&E thus has the opportunity to rebuild its relationship with the CPUC, strengthen its position with politicians and policy makers in California, and improve its standing with the press. If carried out effectively, therefore, the rebuilding of PG&E's leadership team could prove a turning point for the company and the stock.

The company faces important challenges in the year ahead, however, including (i) validating on an expedited basis the safe operating pressure of its older gas transmission lines, and (ii) managing the CPUC's Order Instituting Investigation into whether PG&E's recordkeeping was unsafe, whether it violated the law, and if so whether it contributed to the pipeline explosion at San Bruno.

A key risk, therefore, is that PG&E may lack the leadership and technical capacity required to complete the survey of its older lines and respond effectively to the CPUC's investigation. The company's regulated utility subsidiary has lost its Chief Operating Officer and its Senior Vice President of Engineering and

Operations, and is undertaking a search for the new head of its gas transmission and storage business. The utility's CEO, Christopher Johns, is not being considered for Darbee's position, and has been offered a puny retention award -- \$1 million in restricted stock units -- to stay on. And the new interim CEO of PG&E Corp., lead independent director Lee Cox, is a 70 year old veteran of the wireless telecommunications industry.

We are inclined, however, to view Darbee's departure as a turning point rather than a crisis. First, PG&E's managerial restructuring should, in the long run, materially enhance the company's operational focus and expertise. Second, having confronted and then bowed to the CPUC, we expect PG&E's relationship with its principal regulator to begin to improve. The company has had four months to collect and assess its pipeline records, and has proposed to the CPUC a timeline to complete its validation of Maximum Allowable Operating Pressure limits for its older lines. Third, but critically important, the broad parameters of California's fundamentally robust regulatory framework remain unchanged. On April 14<sup>th</sup>, the CPUC approved PG&E's gas transmission and storage rate case for the years 2011 through 2014, accepting unchanged a settlement reached by the company with CPUC staff and consumer groups in the weeks immediately prior to the San Bruno explosion. A settlement has also been reached in the company's 2011-2013 General Rate Case, which covers three quarters of PG&E's rate base, and is likely to be approved by the Commission in the weeks ahead. The conclusion of these rate cases will allow PG&E over the next three years to implement planned capital expenditures and revenue increases, driving EPS growth at an estimated 5% annual rate through 2013. Equally important, these settlements will allow the new management team the time to focus on upgrading personnel, procedures and operational performance.

Finally, while we fully expect the CPUC's Order Instituting Investigation will result in a sizeable fine and other unrecoverable costs for PG&E's shareholders (see our research note of March 24, [PCG: Reducing our Price Target to \\$50 on San Bruno Costs; Despite Its Damaged Credibility, PG&E Stock is Cheap](#)), our estimate of these costs (\$700 million, or \$1.50 per PCG share) is reflected in our 12-18 month target price of \$50 per PCG share. Our 12-18 month target prices thus remains 11% above the current market price of PCG stock, which itself yields 4.0%. We reiterate our outperform rating.

#### Details

*"The CPUC today learned of the resignation of Mr. Darbee from PG&E Corp. While obviously the company under his leadership has been responsible for several poor and consequential decisions, Mr. Darbee's commitment to PG&E and its constituents is unquestioned. As PG&E's Board of Directors recruits a successor, the CPUC urges the company to return to its roots by hiring the most technically competent person; someone with a long-standing history of performance in the energy industry."*

California Public Utilities Commission President Michael Peevey

#### Recent Developments

On April 21, 2011, PG&E Corporation (PG&E) announced that Peter Darbee had decided to retire as of April 30, 2011 from his positions of Chairman of the Board, Chief Executive Officer and President of PG&E Corporation. The compressed timetable of Darbee's departure suggests that his resignation was demanded by the board. The apparent approval of the California Public Utilities Commission (CPUC), as reflected in the quotation from CPUC President Michael Peevey above, further suggests that PG&E may have come under some pressure from the CPUC to replace its CEO.

Darbee's departure coincides with that of John Keenan, Senior Vice President and Chief Operating Officer of PG&E Corp.'s regulated utility subsidiary, Pacific Gas & Electric Company. PG&E filed a Form 8-K on April 6<sup>th</sup> announcing that it had entered into a severance agreement with Keenan, whose resignation will be effective the same day as Darbee's, April 30<sup>th</sup>. Also announced on April 6<sup>th</sup> was the departure of Edward Salas, Senior Vice President of Engineering and Operations. Pacific Gas & Electric does not plan to

replace Keenan as Chief Operating Officer, but rather plans to appoint two senior vice presidents, each reporting the president of the utility, to run its electricity and gas units. Geisha Williams, senior vice president of energy delivery, is expected to assume the position of head of electric operations, while the company is performing a search for the gas operations manager.

PG&E's board of directors has commenced a search for Darbee's successor. While the search is underway, the board has appointed C. Lee Cox, the board's lead independent director, as interim Chairman, CEO and President of PG&E Corporation. Cox, 70, has been a director of PG&E Corporation and Pacific Gas & Electric Company since 1996, lead director of PG&E Corporation and its utility subsidiary since 2004, and non-executive Chairman of the utility's Board of Directors since January 2008. Mr. Cox is retired Vice Chairman of AirTouch Communications, Inc., a wireless service provider created when PacTel Cellular was spun off from Pacific Telesis in 1994, and retired President and Chief Executive Officer of AirTouch Cellular, its cellular telephone company.

Christopher Johns, the President of PG&E Corp.'s regulated utility subsidiary, is not being considered to succeed Darbee. To encourage Johns to stay on as president of the utility, he has been granted a retention award consisting of restricted stock units with an aggregate value of \$1.0 million, one half of which will vest in two years and one half in three years, provided Johns remains an employee of PG&E on the vesting dates.

Because the board allowed Darbee to resign, rather than terminate him for cause, Darbee will be entitled to a retirement package of \$34.8 million, comprised of accumulated pension benefits (\$9.6 million), vested stock awards (\$21.2 million), deferred compensation (\$2.8 million), and bonus (\$1.2 million). Had Darbee been terminated for cause, he would have forfeited his vested stock awards and bonus, reducing his retirement package to \$12.4 million. On an after-tax basis, Darbee's retirement package is equivalent to six cents per PCG share; the company may already have accrued a portion of these costs, such as Darbee's accumulated pension benefits, against prior year earnings.

### Background

Darbee's departure follows a difficult year characterized by a series of public relations mishaps that seriously degraded the relationship of Pacific Gas & Electric with California politicians as well as its primary regulator, the California Public Utilities Commission. In the spring of 2010, PG&E contributed \$46 million to fund Proposition 16, a California ballot initiative that would have required municipalities seeking to establish municipal power districts, or to purchase power on behalf of their residents (community aggregation), to secure the approval, through election, of two thirds of the municipality's voters. Despite the substantial funding contributed by PG&E, and the hiring of some 15 political consultants to support the proposition, when Proposition 16 was brought to a vote on June 8 it was voted down, with the 5.3 million voters who cast their ballots voting 53% to 47% against the measure. Embarrassingly, in the service territory of Pacific Gas & Electric, the vote was 60% against.

During the campaign, Pacific Gas & Electric was reprimanded by the California Public Utilities Commission in a related matter, the company's efforts to discourage its customers in Marin County from doing business with Marin Clean Energy, a competing retail electric service provider that offered to supply customers with electricity from renewable resources. The CPUC found that the utility's telephone and direct-mail tactics violated state law, and ordered them to stop.

These actions, while both costly and embarrassing, pale into insignificance, however, compared to the PG&E's response to the explosion of its natural gas transmission line at San Bruno on September 9, 2010, an accident that killed eight people, injured 50 and destroyed or severely damaged 55 homes. A chronology of events surrounding the San Bruno pipeline explosion appears in **Exhibit 1**, and the critical developments in this chronology are described in greater detail below. What this timeline shows is that PG&E's

recordkeeping with respect to its older gas transmission pipelines was woefully inadequate; that it failed promptly to inform the CPUC of this fact, even when ordered by the CPUC to conduct an intensive search of these records to determine safe operating pressure for these lines; and that the company had to be threatened by the CPUC with fines before its committed to assemble the necessary records. Specifically:

- On January 3<sup>rd</sup>, the National Transportation Safety Board (NTSB) announced that its assessment of the pipe that ruptured at San Bruno showed that the segment had burst along a welded seam. The NTSB report noted that PG&E's records indicated that the pipe was seamless, and expressed concern that these inaccurate records may have caused PG&E to miscalculate the Maximum Allowable Operating Pressure (MAOP) for the pipeline segment.
- Also on January 3<sup>rd</sup>, the CPUC, acting on the NTSB's safety recommendations, instructed PG&E to validate the MAOPs for those of its gas transmission pipelines traversing heavily populated areas (high consequence areas) where MAOPs had not already been established using hydrostatic testing. Specifically, PG&E was instructed to conduct an intensive search for all design, construction, testing and maintenance records and to use these records to validate MAOPs based on the weakest component or pipeline segment.
- On February 24<sup>th</sup>, the CPUC issued an Order Instituting Investigation (OII) into PG&E's recordkeeping to determine whether it was unsafe, whether it violated the law, and if so whether deficient recordkeeping contributed to the pipeline explosion at San Bruno.
- On March 15, PG&E responded to the CPUC January 3<sup>rd</sup> order by submitting a report on its record search and MAOP validation. In the report, PG&E admitted its inability to validate MAOP on some 600 miles of pipeline, or one third of its pipeline miles in high consequence areas. Many of these lines were installed before 1961 and were thus of a similar vintage to the pipe which exploded at San Bruno. For these pipelines, PG&E proposed to substantiate MAOP based on maximum historic operating pressure – a standard called into serious doubt by the San Bruno explosion.
- In response, the CPUC on March 16<sup>th</sup> accused PG&E of willful non-compliance with its January 3<sup>rd</sup> order and threatened the company with fines. The CPUC subsequently issues an order to PG&E to show cause why it should not be found in contempt and why penalties should not be imposed for its failure to comply with the CPUC's Jan. 3 order.
- On March 21, PG&E submitted to the CPUC a supplement to its March 15th report, and requested approval of a compliance plan that would complete MAOP validation by year-end 2011. On March 24<sup>th</sup>, PG&E and the CPUC staff agreed to a stipulated outcome of the Commission's order to show cause that incorporates PG&E's compliance plan, requires PG&E to pay a \$3 million fine, and mandates a further \$3 million in fines if PG&E fails to meet the deadlines in its compliance plan.
- On April 18<sup>th</sup>, PG&E responds to the CPUC's Order Instituting Investigation of February 24<sup>th</sup> by stating that it would not have changed its operating and maintenance procedures for the San Bruno line had its records accurately shown the pipe to have a welded seam. For all pipelines of that vintage, whether seamless or seamed, PG&E explained that its practice was to set MAOP based on the maximum historic operating pressure.

Taken in this context, it appears to us that the departures of Peter Darbee and John Keenan, Chief Operating Officer of PG&E Corp.'s regulated utility subsidiary, likely reflect the growing frustration of the CPUC with PG&E's unwillingness to cooperate in the Commission's urgent effort to ensure the safe operation of the company gas pipeline system.

## Exhibit 1

## San Bruno Chronology: Summary of Key Developments

Date	Key Development
20-Aug-10	Settlement reached in PG&E's gas transmission and storage rate case ("Gas Accord V") between PG&E, the CPUC's Division of Ratepayer Advocates and representatives of commercial and residential customers
9-Sep-10	PG&E gas transmission pipeline (Line 132) ruptures at San Bruno, killing 8, injuring 50 and destroying or severely damaging 55 homes
13-Sep-10	PG&E ordered to reduce the maximum operating pressure (MOP) on Line 132 by 20% and complete an accelerated leak survey of all transmission lines
14-Oct-10	CPUC announces a 5-member Independent Review Panel to conduct a fact-finding investigation
14-Dec-10	NTSB issues preliminary findings that notes weld defects on longitudinal seams of the ruptured pipe
16-Dec-10	CPUC orders PG&E to reduce the MOP to 20% below Maximum Allowable Operating Pressure (MAOP) on all pipeline segments with welding characteristics similar to the San Bruno
3-Jan-11	NTSB notes that Line 132 burst on a weld seam although PG&E records indicated pipe was seamless; issues urgent safety recommendations
3-Jan-11	CPUC asks PG&E to perform a records search to validate MAOPs for highly populated pipeline segments lacking hydrostatic testing records
7-Jan-11	PG&E requests a deadline extension from February 1, 2011 to March 15, 2011 to validate MAOPs
1-Feb-10	Sempra informs CPUC of its intent to have SoCalGas and SDG&E validate their MAOPs for their gas transmission pipelines by April 15, 2011
24-Feb-11	CPUC issues an Order Instituting Investigation (OII) into PG&E's gas transmission pipeline recordkeeping to determine whether it was unsafe, whether it violated the law, and if so whether deficient recordkeeping contributed to the pipeline rupture in San Bruno; CPUC may impose fines for violations of up to \$20,000 per day
24-Feb-11	CPUC issues an Order Instituting Rulemaking (OIR) to establish a new model of gas pipeline safety regulation and associated ratemaking support
Mar 1-3, 2011	NTSB public hearings in San Bruno
15-Mar-11	PG&E submits report on its record search and MAOP validation to the CPUC; admits inability to validate MAOP on ~600 miles of pipe
16-Mar-11	CPUC accuses PG&E of "willful noncompliance" in its response and threatens to fine the company
21-Mar-11	PG&E submits supplement to March 15th report; requests approval of compliance plan that would complete MAOP validation by 2011 year-end
24-Mar-11	CPUC issues an order to PG&E to show cause why it should not be found in contempt and why penalties should not be imposed for its failure to comply with the CPUC's Jan. 3 order to search its records and validate MAOPs
24-Mar-11	PG&E and the CPUC Staff agree to stipulated outcome of the order to show cause, including a detailed compliance plan to complete the MAOP validation, setting specific milestones; PG&E agrees to pay \$3 million fine plus an additional \$3 million in milestones are not met
5-Apr-11	PG&E COO John Keenan and Senior Vice President of Engineering Edward Salas resign; utility announces plan to separate electric and gas operations and appoint a senior vice president to manage each
14-Apr-11	CPUC approves settlement in PG&E's gas transmission and storage rate case ("Gas Accord V"); CPUC requires PG&E to file semi-annual gas transmission safety report, with first report due in August
18-Apr-11	PG&E responds to OII by stating to the CPUC states that it would not have changed its operating and maintenance procedures for the San Bruno line had its records accurately shown the pipe to have a welded seam
21-Apr-11	PG&E CEO Peter Darbee announces his retirement effective April 30

Source: CPUC, SNL and Bernstein analysis

## Outlook

Taken in the of the above chronology, the departures of Darbee and Keenan likely reflect the CPUC's frustration with PG&E's failure to cooperate in the Commission's urgent effort to ensure the safe operation of the company's gas pipeline system. In choosing Darbee's successor, PG&E thus has the opportunity to rebuild its relationship with the CPUC, strengthen its position with politicians and policy makers in California, and improve its standing with the press. If carried out effectively, therefore, the rebuilding of PG&E's leadership team could prove a turning point for the company and the stock.

The company faces important challenges in the year ahead, however, including (i) validating on an expedited basis the safe operating pressure of its older gas transmission lines, and (ii) managing the CPUC's Order Instituting Investigation into whether PG&E's recordkeeping was unsafe, whether it violated the law, and if so whether it contributed to the pipeline explosion at San Bruno.

A key risk, therefore, is that PG&E may lack the leadership and technical capacity required to complete the survey of its older lines and respond effectively to the CPUC's investigation. The company's regulated utility subsidiary has lost its Chief Operating Officer and its Senior Vice President of Engineering and Operations, and is undertaking a search for the new head of its gas transmission and storage business. The utility's CEO, Christopher Johns, is not being considered for Darbee's position, and has been offered a puny retention award -- \$1 million in restricted stock units -- to stay on. And the new interim CEO of PG&E Corp., lead independent director Lee Cox, is a 70 year old veteran of the wireless telecommunications industry.

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Finally, while we fully expect the CPUC's Order Instituting Investigation will result in a sizeable fine and other unrecoverable costs for PG&E's shareholders (see our research note of March 24, [PCG: Reducing our Price Target to \\$50 on San Bruno Costs; Despite Its Damaged Credibility, PG&E Stock is Cheap](#)), our estimate of these costs (\$700 million, or \$1.50 per PCG share) is reflected in our 12-18 month target price of \$50 per PCG share. Our 12-18 month target prices thus remains 11% above the current market price of PCG stock, which itself yields 4.0%. We reiterate our outperform rating.

## 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 8.5%; 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 target price.

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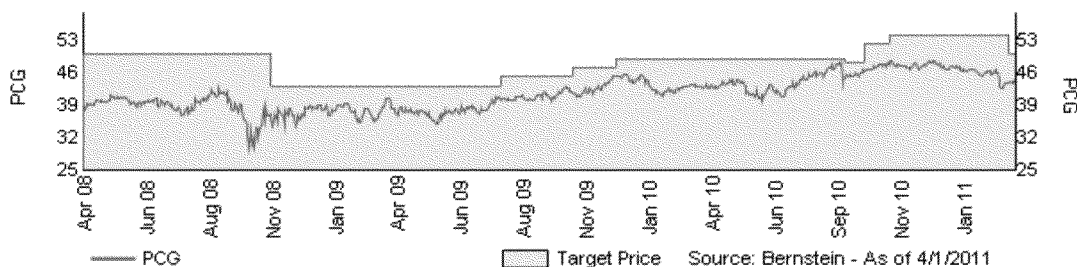
#### Ticker Rating Changes

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)
03/20/08	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
03/24/11	O	50.00



Source: Bernstein - As of 4/1/2011  
 O - Outperform M - Market-Perform U - Underperform N - Not Rated

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