

June 27, 2011

PG&E

(PCG-NYSE)

Stock Rating: Market Perform
Industry Rating: Market Perform

Electric Utilities and Independent Power

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Notes From the Road: Update on San Bruno Exposure

Event

We recently spoke with Kent Harvey, CFO of PG&E Corp., regarding the ongoing impact of the San Bruno pipeline explosion. This is a protracted process of investigation and rule-making and not likely to be resolved until 2012, at the earliest.

Impact

While the California commission's investigation is not yet complete, new rule-makings have already resulted in significant incremental costs associated with data verification and testing. We would expect PG&E's estimated direct costs of \$350-\$550 million could be increased as new rules are established. At this time, it is not clear what portion of these and other costs will have to be absorbed by the utility since the CPUC ordered PG&E to provide a cost-sharing proposal in its filing on replacement costs and a recovery mechanism due on August 26, 2011.

Forecasts

No change to our estimates at this time.

Valuation

We expect PCG shares to trade within a relatively narrow band while the uncertainty related to recovery of costs associated with the San Bruno explosion overhangs the stock.

Recommendation

We reiterate our **MARKET PERFORM** rating on the shares.

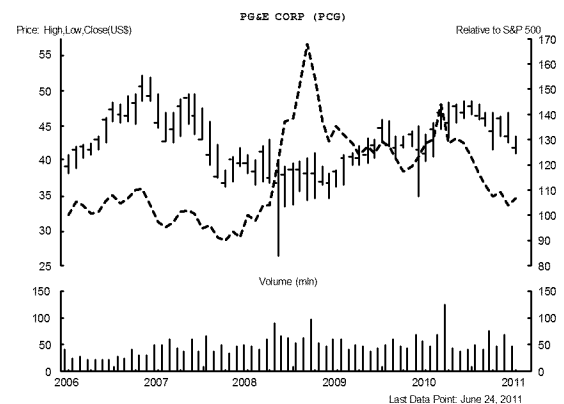
Securities Info

Price (24-Jun)	\$41.81	Target Price	\$46
52-Wk High/Low	\$49/\$41	Dividend	\$1.82
Mkt Cap (mm)	\$16,638	Yield	4.4%
Shs O/S (mm, BASIC)	398.0	Float O/S (mm)	397.3
Options O/S (mm)	31.1	ADVOL (30-day, 000s)	2,894

Selected Bonds Iss	Ind Prc	Rat'g	Mths/S&P	YTW	Spread
Pacific G&E 4.8% '14	110	A3 / BBB+		1.18%	53bp
Pacific G&E 6.1% '34	108	A3 / BBB+		5.40%	123bp

Bond data from Bloomberg.

Price Performance



Valuation/Financial Data

(FY-Dec.)	2009A	2010A	2011E	2012E
EPS Pro Forma	\$3.20	\$3.42	\$3.53	\$3.73
P/E			11.8x	11.2x
First Call Cons.			\$3.51	\$3.70
EPS GAAP	na	na	na	\$3.92
FCF	-\$2.07	-\$0.99	-\$0.23	\$0.40
P/FCF			nm	104.5x
EBITDA (\$mm)	\$4,160	\$4,346	\$4,795	\$5,148
EV/EBITDA			5.4x	5.1x
Rev. (\$mm)	\$15,128	\$13,902	\$14,345	\$14,851
EV/Rev			1.8x	1.8x
FCF after Div. (\$mm)	-\$1,357	-\$1,255	-\$638	-\$617
Quarterly EPS	1Q	2Q	3Q	4Q
2010A	\$0.79	\$0.91	\$1.02	\$0.70
2011E	\$0.58A	na	na	na

Balance Sheet Data (31-Mar)

Net Debt (\$mm)	\$9,421	Total Debt/EBITDA	2.7x
Total Debt (\$mm)	\$13,079	EBITDA/IntExp	6.0x
Net Debt/Cap.	37.8%	Price/Book	1.5x

Notes: All values in US\$.

Source: BMO Capital Markets estimates, Bloomberg, FactSet, Global Insight, Reuters, and Thomson Financial.

Please refer to pages 4 to 8 for Important Disclosures, including the Analyst's Certification.

Key Points

Earlier today, we spoke with PG&E Corp.'s CFO Kent Harvey regarding the ongoing investigation of the San Bruno pipeline explosion and the impact on the company. We do not expect the full effect of the investigation and rule-makings to be known until 2012, at the earliest, and as such, we remain cautious on PCG shares at this time.

Some of the highlights gleaned from our discussion include the following:

NTSB report. The final National Transportation Safety Board (NTSB) report will be issued in September. The California commission (CPUC) is expected to incorporate the NTSB findings into its own ongoing investigation.

CPUC actions. Almost immediately following the accident, the CPUC formed an independent review panel to investigate the explosion. The panel recently issued a highly critical, although even-handed and not unexpected report largely focused on what it saw as the absence of a "safety culture" at PG&E. The utility will file its response in July; we would expect the response to focus on learning from the mistakes of the past.

With the independent review largely complete, the CPUC has begun two proceedings that will continue into 2012.

- **Investigation.** The CPUC will review all record-keeping and all regulatory requirements. PG&E expects fines could be levied by the commission. *Resolution is not expected until 2012*, since the CPUC likely will consider the NTSB's final report in September.
 - To date, the review of the record-keeping revealed that the San Bruno pipeline had a longitudinal seam with a flaw although the electronic records showed the pipe was seamless. Root cause analysis is underway to determine what other factors led to the failure at the time of the explosion. There is currently no clear conclusion to this question although there has been much speculation.
- **Rulemaking.** As a result of the ongoing investigation, the CPUC already issued a rule that all older pipelines that were not required to undergo hydrostatic testing must now be tested. *This is a very expensive and invasive undertaking* (must be done in late spring-early fall). PG&E has identified 152 miles of pipe that share similar attributes with the San Bruno pipeline and it has begun the testing phase. So far, no pipes have failed, but PG&E expects that some will since they are being tested under extreme pressure.

As the investigation continues, the CPUC will issue more rules on replacement, which could be extremely expensive. The commission has ordered that all California natural gas utilities file proposals on replacement costs and recovery mechanisms by August 26, 2011. The commission ordered that PG&E include a cost-sharing element in its proposal. PG&E will make the case that its shareholders have already borne a significant portion of the costs since there is presently

no mechanism for cost recovery (it has yet to receive a CPUC decision on its request to create a regulatory account for these costs).

PG&E has estimated direct costs of \$350-\$550 million (increased twice from the original estimate and could go higher as the commission continues its review). These costs are roughly divided one-third each for

- records work and data verification;
- hydrostatic testing; and,
- all else, including legal costs.

It appears to us that incremental penalties will likely be incurred by PG&E. An as-yet-unspecified sharing mechanism on costs creates a negative cloud over the company, in our view, particularly given the significant expenses (operating and capital) that are potentially involved (although no specific cost estimates were provided beyond the direct costs discussed above).

Third-party litigation. In addition to the CPUC's review process, PG&E is also involved in third-party litigation. It is beginning the mediation process along with its insurers and hopes to settle some of the larger claims first. PG&E has estimated third-party litigation costs of \$220-\$400 million. It has booked \$220 million and as settlements are achieved it will likely book additional amounts. Insurance is expected to cover the majority of the expenses, although there will be some amount that the insurers will not pay.

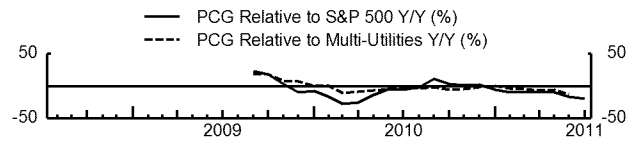
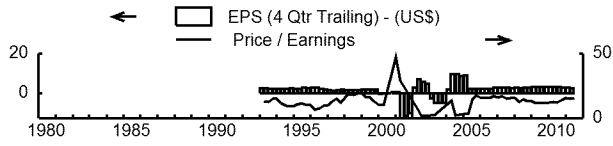
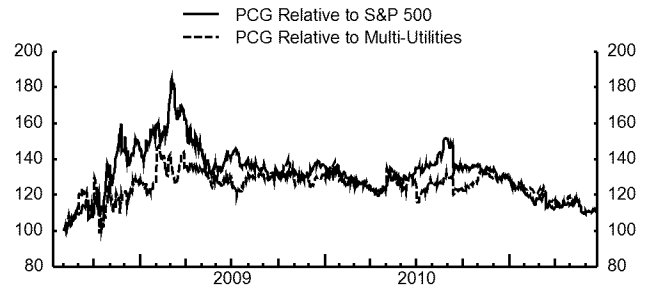
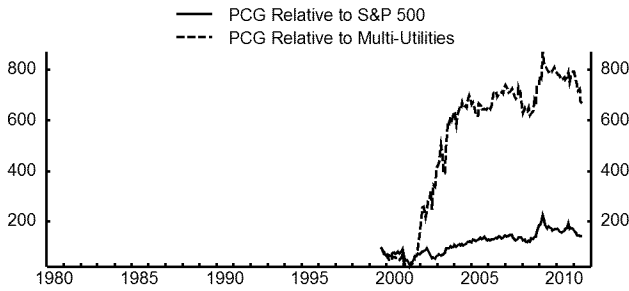
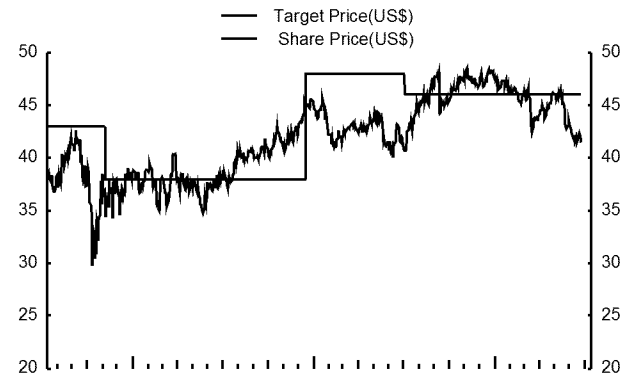
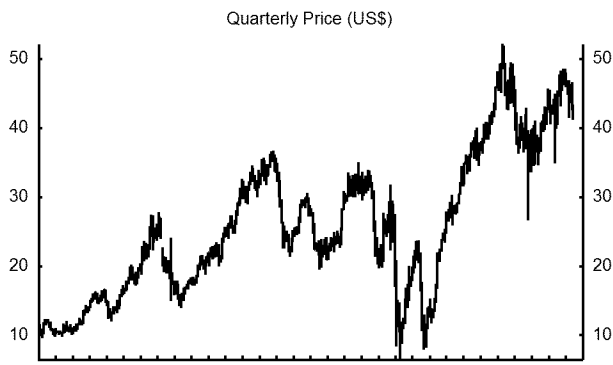
To date, the third-party and direct costs have been excluded from PG&E's ongoing earnings outlook. However, once rate-making issues have been resolved (including the aforementioned cost sharing), the company will fold some of the direct costs related to ongoing operations (oversight, etc.) into operating costs.

Other potential exposure. Recently, the Department of Justice, along with the California Attorney General, among others indicated that a review has begun to determine if civil and/or criminal charges should be filed against PG&E.

Other companies mentioned (priced as of the close on June 24, 2011):

Edison International (EIX, \$38.70, **MARKET PERFORM**)
Sempra Energy (SRE, \$51.91, **MARKET PERFORM**)

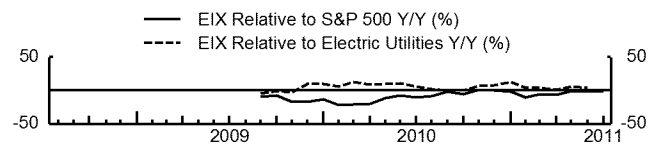
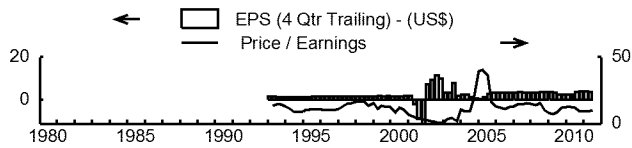
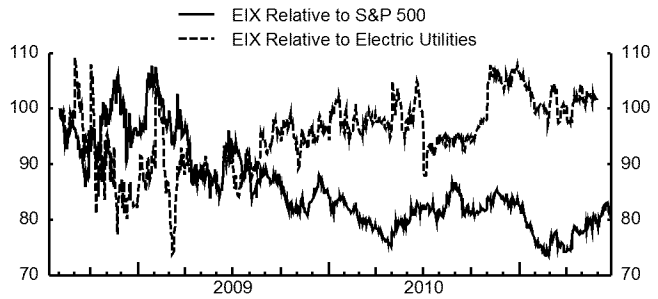
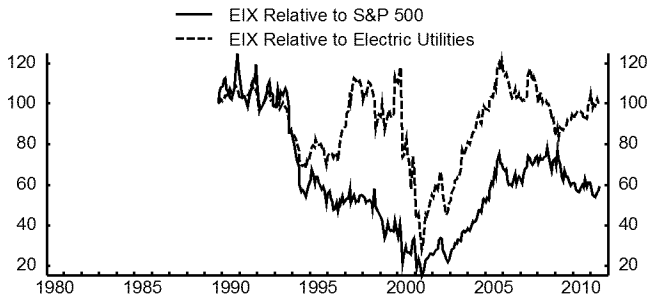
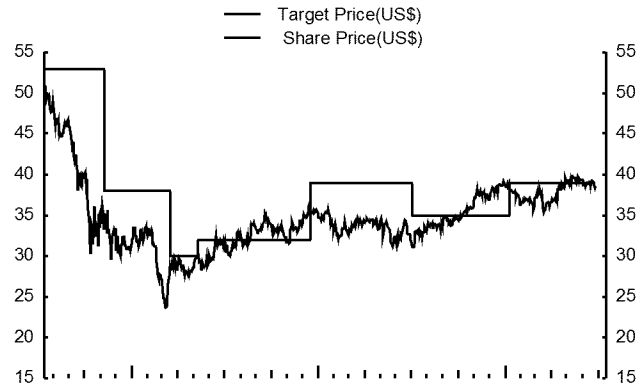
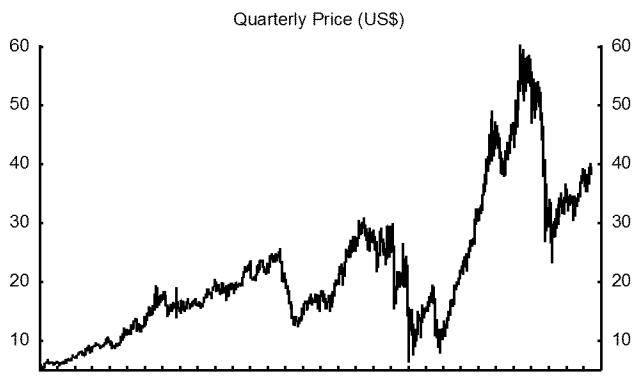
PG&E CORP (PCG)



PCG - Rating as of 2-Nov-07 = Mkt

Last Daily Data Point: June 23, 2011

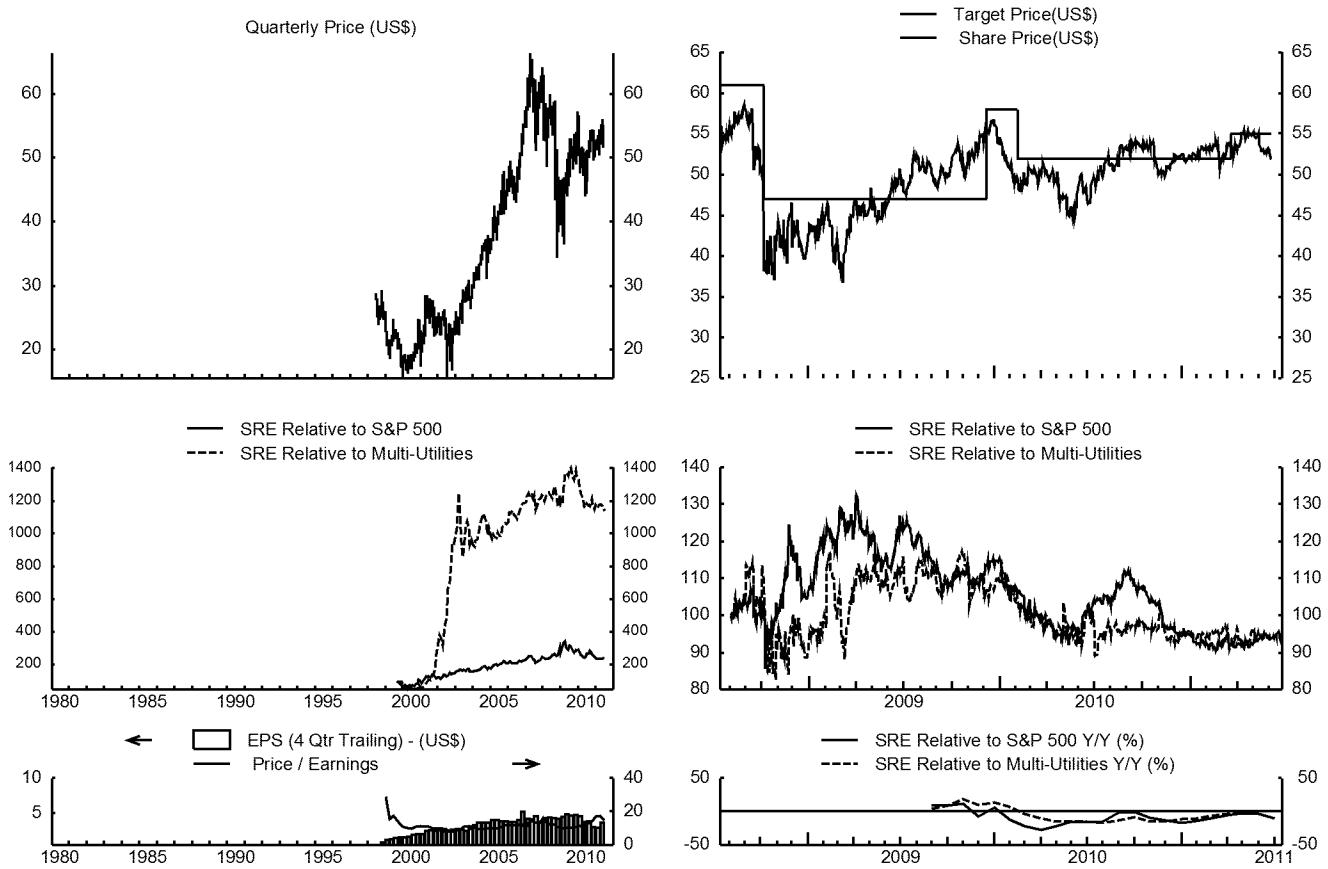
EDISON INTL (EIX)



EIX - Rating as of 7-Mar-00 = Mkt

Last Daily Data Point: June 24, 2011

SEMPRA ENERGY CORP (SRE)



SRE - Rating as of 12-Oct-06 = Mkt

Last Daily Data Point: June 24, 2011

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Hold	Market Perform	62.9%	12.5%	58.6%	56.8%	49.0%	41.3%
Sell	Underperform	2.9%	13.3%	2.9%	4.1%	2.5%	5.5%

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OP = Outperform - Forecast to outperform the market;

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(S) = speculative investment;

NR = No rating at this time;

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