

## FLASH

## Quick Take - PG&E's Pipeline Safety Practices Criticized in Independent Review Panel's San Bruno Explosion Report

Ticker	Rating	CUR	9 Jun 2011 Closing Price	Target Price	TTM Rel. Perf.	EPS			P/E			Yield
						2010A	2011E	2012E	2010A	2011E	2012E	
PCG	O	USD	41.96	49.00	-17.2%	3.42	3.46	3.58	12.3	12.1	11.7	4.3%
SPX			1289.00			85.28	100.06	113.38	15.1	12.9	11.4	2.0%

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

### Highlights

- On June 9<sup>th</sup>, 2011 the California Public Utilities Commission (CPUC) released the report of a panel of independent experts it appointed last year to investigate the San Bruno gas pipeline explosion and provide recommendations for enhancing gas transmission pipeline safety.
- The five-member Independent Review Panel was constituted in October 2010, and consisted of two academics, two former utility industry executives, and a utility industry union leader. The panel was led by a former university chancellor. With only one member of the panel having an engineering background, and none having field experience with natural gas pipeline operations, the panel appears to have relied heavily on an outside consulting firm (Jacobs Consultancy) for technical assistance.
- The report presents extensive and sharp criticisms of PG&E's corporate culture in general and pipeline integrity management in particular. The report identifies several factors that have weakened PG&E's safety culture:
  - organizational instability due to frequent senior executive changes;
  - the addition of excessive layers of management in reorganizations;
  - a leadership team comprised of senior executives with telecommunications, legal and finance backgrounds, but with few engineers or professionals with experience in gas pipeline operations; and
  - senior management's focus on financial performance rather than operations or safety.
- The report criticizes PG&E's gas pipeline integrity management program for an inadequate threat identification methodology, an excessive focus on technical compliance with the letter, rather than the spirit of pipeline integrity regulations, and lack of a strategy to upgrade its transmission lines to allow their inspection using in-line inspection tools (aka "smart pigs").
- On the positive side for PG&E, the report finds no "smoking gun" that would indicate gross negligence or malfeasance by PG&E's senior management or employees. Indeed, the report praises the quick reaction of rank-and-file PG&E employees who took the initiative to return to duty to close key pipeline valves, referring to these conscientious PG&E employees as "the true heroes of this tragedy". Rather, many of the recommendations made in the report are oriented towards upgrading PG&E's pipeline safety to a best-of-breed type benchmark, not to correct clear violations of state and federal pipeline safety guidelines.

- Also potentially favorable were the panel's observations regarding the probable cause of the San Bruno pipeline rupture. The panel believes that the defective weld on the ruptured pipe did not by itself cause the accident. Rather, the panel believes that third-party excavation activity performed in 2008 by the City of San Bruno to replace a sewer line that crossed the San Bruno pipeline might have aggravated a formerly stable welding defect.
- Finally, the CPUC itself also comes in for criticism in the report. The panel questions the ability of the CPUC staff to analyze the quality of risk management by pipeline operators, and criticizes the CPUC's lack of funding for integrity management training and continuing education. It also noted that the CPUC's safety enforcement regime has a "check the box" mindset, instead of following a performance-based approach focused on effectiveness of its regulatory oversight in monitoring and enhancing pipeline safety.

#### **Investment Conclusion**

While the report's sharp criticisms of PG&E's pipeline integrity management bolster the case for a hefty fine to be imposed on the company, the report does uncover a "smoking gun" that would indicate gross negligence or malfeasance by PG&E's senior management. Rather, many of the recommendations made in the report are oriented towards upgrading PG&E's pipeline safety to a best-of-breed type benchmark, not to correct clear violations of state and federal pipeline safety guidelines. Some of the organizational fixes recommended by the report have already been initiated by PG&E, such as the separation of management oversight of gas and electric operations, and the search for a new CEO with strong utility industry experience and the ability to refocus the corporate culture on operational excellence and safety.

Consequently, we do not believe the report will result in a fine significantly in excess of the \$400 million penalty we have already incorporated into our valuation of PG&E stock.

Our 12-18 month target price of \$49 is 17% above the current price of PG&E stock. 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 PG&E's trailing and forward earnings, dividend, EBITDA and book value. We also incorporate a \$1 per share discount for potential fines that might be levied by the CPUC as a result of the San Bruno pipeline explosion.

**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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Outperform: Stock will outpace the market index by more than 15 pp in the year ahead.

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### 12-Month Rating History as of 06/09/2011

#### Ticker Rating Changes

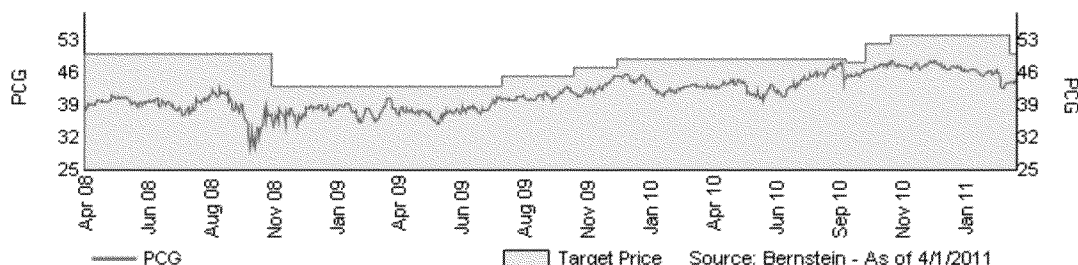
PCG O (RC) 03/22/07

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)
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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