PG&E CORP (PCG)

Is PCG Value or a Value Trap? We Think The Former. Buy. Target $47.25

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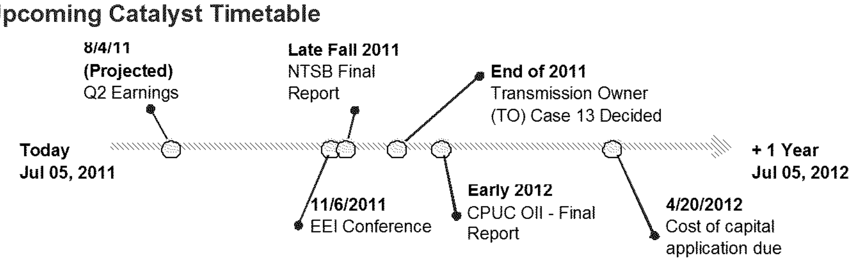
- **Investment Thesis:** We rate PCG a Buy, Medium Risk, with a $47.25 target price. The stock has been pummeled b y the continued financial overhang from last year's pipeline explosion--which also led to the resignation of the CEO Peter Darbee--negativ e EPS revisions for '12 due to other un-related headwinds, and increased CA regulatory risk in '13 due to the increasing certainty of a lower ROE and equity ratio being granted. All of that being s aid, we think these risks are priced-in, as Year-to-date PCG has underp erformed its peers by ~20%, trading at 12.2X '13 EPS (a 7.3% discount to peers) with a 4.3% yield.

- **We Expect Flat EPS Through 2013, Then Growth Resume s:** In '11 we forecast recurring EPS of $3.55/share (excluding pipeline related costs). In '12 we see earnings headwinds of a little more than $0.20/share from lower FERC rate base, lower CWIP b alances, and a higher effective tax rate. In '13 PG&E will probably have its ROE and equitv ratio reduced from the currently authorized 11.35%/52%. We also assume PCG issues $1 billion of common equity in '11 and '12 to fund un-recoverable costs related to pipeline relat ed matters. The stock appears to discount almost $1.5 billion of va lue destruction in excess of our estimate. We think that is extreme.

- **Key Drivers:** PCG estimates it will spend $300-$500m/yr on pipel ine related issues that are not recoverable in rates in '11 and 12. We assume $1 billion over two years. Every $300m of un recoverable expense reduces the value of PCG by $0.50 / share. We assume PG&E's authorized ROE falls a little over 50 basis points from 11.35% to 10.8% in '13. Every 25bp impact valuation by $1/share. We assume a 200 basis point reduction in equity rat io at PG&E. Every 100 basis points impacts valuation by $0.25/s hare.

- **Valuation:** Using our proprietary ISI Dividend Discount Model we value PCG at $47.25 / share, which is 13.5x our '13 consolidated EPS estimate of $3.50/ share, representing a 4% pre mium to our average target P/E multiple for the Regulated sub-g roup of 13.0x and a total return profile of 15% from current levels. We see upside of $1/ share from a satisfactory resolution to San Bruno r elated expenses.

Upcoming Catalyst Timetable



Summary Financial Data

Ticker	PCG
ISI Rating	BUY
Price Target	47.25
Market Cap ($ Bn)	17.1
Share Price (as at 7/1/11)	42.66
Shares Outstanding	400.7
2011 Dividend Per Share	1.82
Dividend Yield	4.3%
Payout Ratio	51.3%

	ISI Est.		%	Consensus	
	EPS	PE		EPS	PE
2011E	3.55	12.0x	1.0%	3.51	12.1x
2012E	3.65	11.7x	-1.2%	3.69	11.6x
2013E	3.50	12.2x	-5.1%	3.69	11.6x
2014E	3.65	11.7x	-2.3%	3.74	11.4x

	Div Yld	+	Price Return	=	Total Return
PCG	4.3%	+	10.8%	=	15.0%
Group Avg	4.2%	+	-2.4%	=	1.8%
Excess Total Retun					13.3%
Excess Return Ranking					1 of 18

Valuation and Risks

- Using our proprietary ISI Dividend Discount Model we value PCG at $47.25 / share, which is 13.5x our '13 consolidated EPS estimate of $3.50/ share, representing a 6% premium to our average target P/E multiple for the Regulated sub-group of 12.7x and a total return profile of 15%.
- We see downside to the current stock price assuming a more significant ROE reduction in '13 and $1500m of incremental unrecovered San Bruno costs post 2012.
- Assuming a more benign outcome in the Cost of Capital case in '12, no more San Bruno costs we see upside to $47/share.

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Stock Looks Attractively Priced Despite Near Term Risks

Review of San Bruno Pipeline Explosion

On September 9, 2010 a portion of Line 32 (a 30 inch underground transmission line), suddenly ruptured. The section of pipeline, installed in 1956, was located under the asphalt paving at the intersection of Glenview Drive and Earl Avenue in a residential area of San Bruno, California. The accident resulted in an explosion and fires which claimed 8 lives, destroyed 38 homes, and caused significant damage to another 70 homes.

The NTSB initiated an investigation into the accident which is still ongoing. On January 21, it released a metallurgical report, which indicated that the fabrication welds of the section of pipeline that failed did not meet either: 1) the engineering consensus standards applicable to natural gas transmission pipelines at the time, or 2) the PG&E specifications in effect at the time of construction. The agency has yet to reach any conclusions about what ultimately caused the material weakness to destabilize and cause the explosion. PG&E said that it expects the final report to be issued "sometime this fall"

On September 23, 2010, the CPUC approved a resolution calling for the formation of an Independent Review Panel of experts. After 7 months of work, the Panel released its findings on June 8, 2011. While the Panel deferred to the NTSB in determining the root cause of the accident, it did submit an analysis, agreeing with a previous assessment by INGAA (Interstate Natural Gas Association of America), which posited that an external force, most likely resulting from a 2008 sewer replacement project by the city of San Bruno, triggered the manufacturing defect to propagate and destabilize the pipeline.

The Panel also highlighted several institutional failings at both PCG and the CPUC and offered recommendations to strengthen Pipeline Integrity Management at both organizations. It concluded that "the explosion of the pipeline at San Bruno was a consequence of multiple weaknesses in PG&E's management and oversight of the safety of its gas transmission system" and that "the CPUC did not have the resources to monitor PG&E's performance in the pipeline integrity management adequately or the organizational focus that would have elevated concerns about PG&E's performance in a meaningful way"

Notable quotes from the report which would seem to implicate the management procedures at PG&E include the following:

"Management's focus in recent times appears to have been on the occupational safety of its employees and lacking an equivalent focus on the public safety aspects of its system"

"While we understand the entire pipeline industry has had challenges in digitizing and systematizing all of the engineering design, construction and operating data, we find PG&E's efforts inchoate"

.."it appears PG&E's program is not identifying all threats, as required by regulation; is not identifying the segments of highest risk and remediating significant anomalies; and hence is not taking programmatic actions to prevent or mitigate threats"

"..the goals [PG&E] sets for management compensation purposes, its investments and its practices do not suggest its focus is on achieving an industry leading pipeline safety and integrity program"

"We detected employee fatigue at the number and scope of reorganizations the company has undertaken in recent years. Frequently, employees cited poor communication and abundance of organizational silos that have impeded their ability to understand what work was being undertaken and hence the quality of the work"

"In the san Bruno situation, where the city was replacing the sewer system in proximate contact ot the natural gas pipeline, there was no on-going field supervision by PG&E of the work"

"To fail to inspect during major adjacent earth disturbance and then to fail to analyze the effect of that earth disturbance after-the-fact are examples of the operator pushing its luck."

"While the company has multiple stated goals, top management may be overly focused on financial performance. Clearly the company must be financially healthy to fulfill its mission, but when top management fouces on financial performance and does not appear to be engaged in operational safety and performance, leadership may dampen the willingness of the organization to challendge the priorities or resources put in place by upper management"

Actions of the CPUC

The CPUC is overseeing its own investigation into the San Bruno disaster. In February, 2011, the Commission issued an Order Instituting Investigation (OII) to examine PCG's pipeline record keeping practices. Because the OII will take into account the NTSB's final report, PG&E said that it does not expect the investigation to conclude until late 2011 or into 2012. The company has been responding to requests for information including submitting documents relating to pipeline maintenance procedures dating back to the 1950's.

In February the CPUC also issued an Order Instituting Rulemaking (OIR), intending to establish new standards for pipeline construction, maintenance and safety.

Initial Costs relating to the San Bruno Incident

From the date of the accident through the end of Q1, PCG spent $114m on San Bruno related costs. On its Q1 earnings call, the company said it expects total costs for 2011 to be in the range of $350 to $550m pre-tax, which will be reported as an item impacting comparability (IIC) and outside the company's adjusted operating earnings guidance. Expenditure for 2012 were expected to be "comparable to the levels experienced this year"

The bulk of the spending will be dedicated to 1) hydrostatic testing on 152 miles of pipeline, 2) respond to the various information requests (NTSB, CPUC, blue-ribbon Panel, etc), including the collection and digitize pipeline operating data, and to pay for external and 3) consultants and other professional fees.

None of the spending to date is expected to be recoverable in rates. In order for PCG to even have the opportunity to recover costs, a memorandum account must first be established by the CPUC. While PCG has applied for such an account, it has yet to be approved.

Once the OIR process is completed, incremental expenditure required to comply with any new pipeline standards will likely be recoverable in rates. There is considerable debate as to what the ultimate level of unrecoverable expenditure will be. Our model assumes that none of the expenditure incurred over the next two years (~$950m) will be recovered in rates, and that it will be funded entirely through parent equity issuances in 2011 and 2012.

Third Party Liability Claims

In addition to the PCG's liability for the expenses detailed above, 74 tort lawsuits on behalf of approximately 224 plaintiffs, including two class action lawsuits, have been filed against PG&E. The lawsuits seek compensation for personal injury and property damage and seek other relief. In 2010, Pacific Gas & Electric recorded a $220m provision for estimated third-party claims related to the San Bruno accident (including personal injury and property damage claims, damage to infrastructure, and other damage claims). In its Q1 10 Q, the company estimated that it may incur as much as $400 million for third-party claims, although it admitted that the estimate could vary widely when the findings of the NTSB and CPUC are ultimately released.

PCG maintains $992m of liability insurance for damages in excess of a $10 million deductible. While a significant portion of third-party claims will likely be recovered through insurance, no recoveries have been recorded through the end of Q1.

Departure of CEO Peter Darbee

On April 21, PG&E announced that the Board of Directors would elect a new Chairman, CEO and President to replace Peter Darbee, who retired effective April 30, 2011. Lead Director, Lee Cox, was named as interim Chairman, CEO and President. Cox stated in the announcement that "Peter concluded that ea change in leadership would create the best opportunity for PG&E to move ahead after a challenging year"

On its Q1 '11 earnings call on May 4th, interim Chairman Cox stated that all of the candidates had been selected and that a new CEO would be named "in the coming weeks"

EPS Outlook

We expect EPS growth from 2011 through 2013 to be relatively flat, resulting from a number of reasons.

First, the 2011 GRC rate settlement seems to "front end load" the annual rate increases in 2011 vs. '12/'13 as "authorized" rate base growth in 2011 is higher than in 12/13, but the company's capital expenditures appear to be consistent over three year GRC planning period, which implies that earnings growth and earned ROEs on will be higher in '11 than '12 and '13.

Secondly, PCG has CPUC approval to spend additional capital at the CA jurisdictional level to offset the impact of bonus depreciation, it has no such ability for its FERC regulated electric transmission assets. FERC rate base will be impacted by two years of bonus depreciation (2010 and 2011) in PCG's next transmission owners' (TO) case, expected to be filed in the July/ August timeframe and settled by mid 2012. We expect PCG's FERC rate base to be relatively flat at $3.5 Bn in '12 vs. '11.

Thirdly, PCG will likely have a a lower Construction Work in Progress Balance (+/-$1.5 Bn in 2011 vs. +/-$2.0 Bn for 2010). PCG earns AFUDC (non-cash earnings) at its authorized 11.35% and 52% equity ratio on its average CWIP balances.

Fourth, the company expects to have a higher effective tax rate in 2012 due to the lack of opportunity for tax settlements that came in for several years but have now run their course.

In the past, AFUDC and these tax items have offset unrecoverable O&M costs at the utility so it appeared that the company was earnings at or close to its authorized ROE.

Finally, unlike most other regulatory regimes, California has bifurcated its rate cases into two separate proceedings; a general rate case, and a cost of capital proceeding. The general rate cases (typically every three years) deal with issues such as the level of operating costs and capital spending. They are based on future test years, and have a true-up mechanism (attrition revenue) to cover budgeted cost increases throughout the GRC planning period. The cost of capital proceeding sets capital structures and authorizes returns on debt and equity for a five year period. A mechanism allows for automatic adjustment to the authorized returns within that 5 year period based on the movements of a Utilities Corporate Bond Index. Revenue increases in the GRC will be based on the capital structures and ROEs set in the last cost of capital proceeding.

PCG is currently authorized an 11.35% ROE on a 52% equity layer. Based on recent rate case activity, this is about 100 bp higher than the national average. While the California regulatory regime will probably continue to be among the more constructive environments in the country (both to preserve its image post the California Energy Crisis, as well as to encourage the significant amount of capital spending that the states energy policy initiatives will require), we believe that authorized ROEs are likely to come down. We assume a 60bp reduction to 10.75% in our model. In our view, such an outcome would still be considered positive in that the ROE would be above the national average, and that rates will likely be locked in for 5 years (subject to the adjustment mechanism discussed above)

Nonetheless, an ROE reduction in 2013 would be yet another drag on earnings growth. We estimate that every 25bp reduction in authorized ROEs would be worth $0.09 of EPS and about $1 per share of value.

We also believe a reduction in equity ratio (from 52% to 50%) is likely. PCG's equity ratio is higher than both of the state's other Investor Owned Utilities (EIX's common equity ratio is 48%, while Sempra's is 49%). We model a reduction in the common equity ratio to 50% beginning in 2013. All else equal, this would lead to a $0.13 reduction in EPS, however we assume that the reduced equity layer will free-up cash for stock repurchases (or it will defray future equity issuance), such that the bulk of the EPS impact will be off-set.

Valuation

Despite the flat EPS profile and the risks related to the San Bruno incident, we believe the stock is attractively priced. Our $47.25 target price assumes 1) $950m in unrecoverable San Bruno related costs in 2011 and 2012 funded through incremental equity issuance 2) flat earnings growth through 2013 due to the issues discussed above and 3) a reduction in authorized ROEs from 11.35% to 10.75%. Using our proprietary Dividend Discount Model, we derive a 13.5x multiple on 2013 EPS, which assumes a modest level of rate base growth post 2014 (~4.5%) and long term earned ROEs of 10.9%.

PCG Financial Summary

EPS Breakdown by Division FYE December 31,	2010A	2011E	2012E	2013E	2014E
PCG	3.45	3.58	3.70	3.50	3.68
Parent / Other	-0.02	-0.03	-0.05	0.00	-0.03
Consolidated	3.42	3.55	3.65	3.50	3.65

Valuation and Leverage Statistics FYE December 31,	2010A	2011E	2012E	2013E	2014E
Price to Earnings	12.2x	11.7x	11.4x	11.9x	11.4x
EV / EBITDA	6.9x	6.2x	6.1x	6.4x	6.3x
Dividend Yield	4.4%	4.4%	4.4%	4.4%	4.4%
Return on Average Equity	12.3%	12.1%	11.9%	10.8%	10.8%
Return on Capital Employed	6.4%	7.3%	7.4%	6.8%	6.7%
LT Debt / Total Cap	46%	50%	49%	51%	51%
Total Debt / Total Cap	53%	50%	49%	51%	51%
Net Debt / EBITDA	3.0x	2.6x	2.6x	2.9x	2.9x
FFO / Total Debt	27%	28%	28%	25%	25%

Summary Consolidated Income Statement FYE December 31,	2010A	2011E	2012E	2013E	2014E
Regulated Electric Revenue	10,644	11,466	11,808	11,857	12,114
Regulated Gas Revenue	3,196	3,211	3,211	3,211	3,211
Unregulated Generation Revenue	0	0	0	0	0
Other	1	1	0	0	0
Total Operating Revenue	**13,841**	**14,678**	**15,019**	**15,068**	**15,325**
Purchased Power / Fuel	-5,189	-5,170	-5,170	-5,170	-5,170
Gross Margin	**8,652**	**9,508**	**9,849**	**9,898**	**10,155**
Operating and Maintenance	4,432	4,782	4,939	5,037	5,136
Taxes Other Than Income	0	0	0	0	0
Other	-8,871	-9,564	-9,878	-10,073	-10,272
EBITDA	**4,213**	**4,727**	**4,910**	**4,862**	**5,019**
Depreciation and Amortization	-1,905	-1,978	-2,023	-2,063	-2,099
Operating Income	**2,308**	**2,749**	**2,887**	**2,798**	**2,920**
Interest Expense	-650	-665	-673	-731	-777
Interest and Other Income	2	149	205	226	232
Other Expense	0	-336	-500	0	0
Income from Con't Ops, Bef Tax	**1,660**	**1,897**	**1,919**	**2,293**	**2,376**
Income Tax	-547	-705	-710	-848	-879
Equity Income	0	0	0	0	0
Minority Interest	0	0	0	0	0
Preferred Stock Dividends	-14	-14	-14	-14	-14
Ajdustments / Other					
Net Income (Operating)	**1,331**	**1,422**	**1,506**	**1,437**	**1,483**
Diluted Shares Outstanding	389	401	413	411	406
Adjusted / Operating EPS	**3.42**	**3.55**	**3.65**	**3.50**	**3.65**
Dividends Per Diluted Share	1.82	1.82	1.82	1.82	1.82
Payout Ratio	53%	51%	50%	52%	50%

Summary Consolidated Statement of Cash Flow FYE December 31,	2010A	2011E	2012E	2013E	2014E
Net Income (GAAP)	1,099	1,178	1,195	1,431	1,483
Depreciation and Amortization	2,151	2,084	2,083	2,121	2,154
Other Operating Cash Flow	-44	1,025	509	-99	-107
Cash Flow From Operations	**3,206**	**4,286**	**3,787**	**3,453**	**3,530**
Total Subsidiary Capex[1]	-3,802	-3,774	-3,882	-3,498	-3,498
Parent / Other Capex	0	-15	-20	-20	-20
Total Capital Expenditure	**-3,802**	**-3,789**	**-3,902**	**-3,518**	**-3,518**
Acquisitions	-51	0	0	0	0
Disposals	0	0	0	0	0
Other Investment Cash Flow	-4	62	0	0	0
Cash Flow From Investing	**-3,857**	**-3,727**	**-3,902**	**-3,518**	**-3,518**
Debt Issuance	862	-182	0	0	0
Securitised Debt Issuance	-404	-102	0	0	0
Subsidiary Debt Issuance	1,353	-363	516	1,302	773
Parent Debt Issuance	0	0	0	0	0
Revolver Issuance	0	103	-215	10	-20
Preferred Equity Issuance	0	0	0	0	0
Common Equity Issuance - DRIP	0	250	250	0	0
Common Equity Issuance	303	195	315	0	0
Common Equity Reductions	0	0	0	-500	0
Dividends to Common Equity	-662	-723	-751	-747	-740
Other Financing Cash Flow	-1,037	122	0	0	0
Cash Flow From Financing	**415**	**-700**	**115**	**65**	**13**
Increase / (Decrease) in Cash	**-236**	**-141**	**0**	**0**	**25**

Summary Consolidated Balance Sheet - Assets FYE December 31,	2010A	2011E	2012E	2013E	2014E
Parent Cash and Equivalents	240	100	100	100	125
Subsidiary Cash and Equivalents	51	50	50	50	50
Accounts Receivable	944	922	922	922	922
Inventories	357	292	292	292	292
Other Current Asets	3,950	4,017	4,017	4,017	4,017
Total Current Assets	**5,542**	**5,381**	**5,381**	**5,381**	**5,406**
Total Net PP&E In Service	31,449	31,682	33,500	34,897	36,262
CWIP	0	1,563	1,650	1,743	1,841
Total Net PP&E	**31,449**	**33,245**	**35,151**	**36,641**	**38,103**
Capitalized Interest	0	31	75	121	170
Investments	0	0	0	0	0
Net Goodwill	0	0	0	0	0
Other Intangible Assets	0	0	0	0	0
Long Term Deferred Tax Assets	0	0	0	0	0
Stranded Cost Assets	0	0	0	0	0
Other Regulatory Assets	0	0	0	0	0
Other Non-Current Assets	9,034	8,916	8,916	8,916	8,916
Total Assets	**46,025**	**47,573**	**49,523**	**51,059**	**52,594**

Summary Consolidated Balance Sheet - Liabilities and Equity FYE December 31,	2010A	2011E	2012E	2013E	2014E
Subsidiary Short Term Debt	1,662	0	0	0	0
Parent Short Term Debt	0	0	0	0	0
Short Term Securitized Debt	0	0	0	0	0
Accounts Payable	2,509	2,716	2,716	2,716	2,716
Other Current Liabilities	3,014	3,596	4,196	4,196	4,196
Total Current Liabilities	**7,185**	**6,312**	**6,912**	**6,912**	**6,912**
Subsidiary Long Term Debt	10,557	11,856	12,372	13,674	14,447
Long Term Parent Debt	349	349	349	349	349
Parent Debt (Revolver)	210	225	10	20	0
Long Term Securitized Debt	423	321	321	321	321
Long Term Deferred Tax Liabilities	5,547	5,721	5,721	5,721	5,721
Provisions	0	0	0	0	0
Other Non-Current Liabilities	10,220	10,393	10,433	10,473	10,513
Total Liabilities	**34,491**	**35,177**	**36,118**	**37,470**	**38,263**
Minority Interests	0	0	0	0	0
Preferred Equity	252	252	252	252	252
Common Equity	11,282	12,144	13,153	13,337	14,080
Total Liabilities and Equity	**46,025**	**47,573**	**49,523**	**51,059**	**52,594**

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Buy Low Risk ETR	**Buy Medium Risk ETR**	**Buy High Risk ETR**
>+10%	>+15%	>+20%
Hold Low Risk ETR	**Hold Medium Risk ETR**	**Hold High Risk ETR**
0% to +10%	-5% to +15%	-10% to +20%
Sell Low Risk ETR	**Sell Medium Risk ETR**	**Sell High Risk ETR**
<0%	<-5%	<-10%

ISI has assigned a rating of BUY to 45% of the securities rated as of 3/31/11.
ISI has assigned a rating of HOLD to 51% of the securities rated as of 3/31/11.
ISI has assigned a rating of SELL to 4% of the securities rated as of 3/31/11

RISK RATING
Our risk ratings are based on an assessment of underlying business mix (regulated vs. merchant), state regulatory risk and financial strength