FitchRatings

FITCH AFFIRMS PCG & PG&E'S RATINGS; OUTLOOK REVISED TO NEGATIVE

Fitch Ratings-New York-26 July 2011: Fitch Ratings has affirmed the ratings of the PG&E Corporation (PCG) and its primary operating utility subsidiary, Pacific Gas and Electric Company (PG&E), and revised the Rating Outlook to Negative from Stable. PCG and PG&E's ratings are summarized below:

PCG
--Long-term Issuer Default Rating (IDR) at 'A-';
--Short-term IDR at 'F1';
--Senior unsecured notes at 'A-';
--Senior unsecured bank facility at 'A-'.

PG&E
--Long-term Issuer Default Rating at 'A-';
--Short-term IDR at 'F1';
--Senior unsecured notes at 'A';
--Senior unsecured bank facility 'A';
--Preferred at 'BBB+';
--Commercial paper at 'F1'.

Approximately $12 billion of consolidated PCG debt is affected by today's rating action.

The Negative Rating Outlook reflects the challenges and uncertainties in the aftermath of the San Bruno natural gas pipeline exposure and fire, including:
--PCG's loss of the confidence of its key constituents in the aftermath of the San Bruno explosion and fire.
--The uncertain magnitude of future costs and fines related to the San Bruno accident and its ultimate impact on PCG's consolidated financials.
--The uncertain outcome of the pending rule making docket underway at the California Public Utility Commission (CPUC).

Key ratings drivers going forward include the outcome of the factors listed above, as well as:
--Continuation of a balanced regulatory regime in the state of California.
--Effective execution of PG&E's large capital program.
--Balanced funding of PG&E's capex consistent with proscribed CPUC policy.
--Consistency of utility capex with state and federal energy policy.

Intense federal and state regulatory scrutiny:
The operating environment for PG&E has become more challenging as the result of the San Bruno disaster. PG&E has come under significant regulatory scrutiny as a result of the accident and will continue to be subject to meaningful increases in operating and capital expense to comply with emerging regulatory pipeline safety requirements.

Higher operating costs will pressure 2011 credit metrics:
Fitch expects PG&E's credit metrics to weaken in 2011 reflecting higher unrecovered costs related to the San Bruno explosion and fire through the end of 2011. Based on Fitch's projections, post-2011 PG&E credit metrics are likely to rebound as higher costs related to pipeline system safety are expected to be recoverable in base rates.

Management has indicated that direct costs related to the San Bruno accident could approximate $350 - 550 million in 2011 and that operating costs will remain elevated due to higher costs to comply with evolving pipeline safety standards.

CPUC rulemaking will affect PG&E's creditworthiness:
The CPUC has convened a proceeding to adopt new rules on pipeline safety for all gas transmission pipeline operations, in the wake of the San Bruno disaster. As part of this proceeding, the CPUC is expected to consider the investment and cost associated with implementation of new safety standards and appropriate cost recovery mechanisms. The rulemaking will consider hydrostatic testing, pipeline replacement, and automatic shut-off valves.

Timing of the CPUC's rulemaking proceeding:
PG&E is expected to file its implementation plan in the proceeding on August 26, 2011. Hearings in the proceeding are scheduled for November and an ALJ proposed decision is expected in the first quarter of 2012.

A final CPUC decision is likely to be issued by the end of the first quarter 2012. The final order will address PG&E (and other state utilities) cost recovery to comply with its new rules.

CPUC May Levy Fines:
In addition, Fitch expects the company is likely to be fined by the CPUC, as a result of safety violations associated with the San Bruno accident. The magnitude of the fine is unclear and will be informed by the commission's ongoing investigation into the accident as well as the results of the National Transportation Safety Board (NTSB) investigation into the root cause of the disaster.

The CPUC investigation is expected to be completed in early 2012 and the NTSB should complete its work before year-end 2011.

Fitch notes that PG&E agreed to pay a $26 million fine in a stipulation with the CPUC, pending commission approval, in the 2008 Rancho Cordova explosion and a greater fine related to the San Bruno accident cannot be ruled out.

Third party liability:
PG&E management estimates that third party liability related to San Bruno will approximate $220 - 400 million. In 2010, PCG booked a charge to earnings to reflect the lower end of its estimated third party liability exposure and has not reflected any benefit for insurance coverage. PG&E's aggregate level of liability insurance for damages totals approximately $992 million of coverage with a $10 million deductible.

PCG CEO retired:
Earlier this year, PCG Chairman, President and CEO Peter Darbee announced his retirement effective on April 30. Darbee's departure from PG&E, while not sufficient in and of itself, is an important and necessary step in putting the San Bruno crisis behind the company, in Fitch's view. Darbee has been replaced on an interim basis by Lead Director Lee Cox until the search for a successor is completed.

Management has reacted to the San Bruno disaster by pledging to support the community's recovery, cooperating with ongoing investigations and revamping operations to improve safety to restore the confidence of its constituents.

Major management realignment at PG&E's natural gas operations: On May 5, 2011, PG&E announced a major realignment of its natural gas business under Nick Stavropoulos, Executive VP of Natural Gas Operations. Stavropoulos comes to PG&E via National Grid where he was head of the company's U.S. gas distribution operations for the past seven years.

Stavropoulos has more than 30 years of industry experience having started his career with Colonial Gas Company in 1979 and extensive experience working with regulators and other constituent groups to upgrade and replace dated pipeline systems.

Stavropoulos will lead the effort to overhaul PG&E's infrastructure and operating practices, improve safety and respond to ongoing investigations. He will report to PG&E President, Chris Johns.

Balanced regulatory environment:
PCG and PG&E's credit ratings also reflect the balanced regulatory environment in California, a manageable debt burden and solid earnings and cash flows. The ratings also recognize the challenges associated with the utility's large capital expenditure program. Fitch expects consolidated FFO-to-interest and FFO-to-debt ratios to fall below 5.0x and 20% in 2011, respectively, and to rebound to 5.0x - 5.4x and 21% - 24% during 2012 - 2015.

Bank lines renegotiated:
As of March 31, 2011, PCG had $240 million of cash and cash equivalents outstanding and no cash borrowings under its $187 million revolving credit facility. The utility had two revolving credit facilities totaling $1.9 billion and $750 million, respectively.

As of March 31, 2011, PG&E had $315 million letters of credit outstanding under its $1.9 billion bank agreement. Commercial paper outstanding at the utility was $1 billion at the end of the first quarter.

On May 31, 2011, PCG entered into a $300 million senior unsecured five-year revolving credit agreement, replacing its $187 million credit agreement. At the same time, PG&E entered into a $3 billion senior unsecured five year revolving credit agreement.

The utility's new credit agreement replaces its $1.9 billion and $750 million credit facilities, which were entered into in Feb. 2007 and June 2010, respectively. The new facilities expire May 2016.

Maturities are manageable with approximately $1.8 billion of long-term debt scheduled to mature 2011 - 2015.

No change for CA energy policy expected:
Governor Jerry Brown appointed three new CPUC commissioners earlier this year. Commissioner Florio has a background in consumer advocacy having served as a senior attorney at The Utility Reform Network since 1978. Commissioner Sandoval has a telecommunications background working most recently as an associate professor at Santa Clara University School of Law. Commissioner Ferron was a senior executive at Deutsche Bank before coming to the CPUC.

ROE trend uncertain:
Investors have expressed concerns that the new commission may push authorized returns lower in the utilities' upcoming cost-of-capital proceeding (CoC, which in California is separate from GRC proceedings). The next CoC is expected to be filed by the utilities in 2012, effective Jan. 1, 2013. If ROEs are adjusted downward, Fitch would expect the magnitude of such changes to be relatively modest in size.

Expect balanced regulatory environment to continue:
Recent political and regulatory changes are a source of uncertainty for investors. However, Fitch expects the Brown administration to work with the big three electric utilities with an eye toward implementation of state energy policy goals. Fitch expects the political/regulatory environment to remain balanced and committed to financially strong electric utilities.

Revenue decoupling, regulatory balancing accounts, forward looking test years and pre-approval of planned capital expenditures greatly reduce PG&E's exposure to regulatory lag and operating cash flow attrition, in Fitch's opinion.

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Applicable Criteria and Related Research:
--'Corporate Rating Methodology' (Aug. 16, 2010);
--'Recovery Ratings and Notching Criteria for Utilities' (May 12, 2011);
--Special Report: 'Rating North American Utilities, Power, Gas and Water Companies' (May 16, 2011)

Applicable Criteria and Related Research:
Corporate Rating Methodology - Amended
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=546646
Recovery Ratings and Notching Criteria for Utilities
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=628491
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