

PCG : New Disclosures of Poor Record Keeping and Inspection Practices

| Ticker | Rating | CUR | 5 Jul 2011 Closing Price | Target Price | TTM Rel. Perf. | EPS | | | P/E | | | Yield |
|--------|--------|-----|--------------------------------|-----------------|----------------------|-------|-------|--------|-------|-------|-------|-------|
| | | | | | | 2010A | 2011E | 2012E | 2010A | 2011E | 2012E | |
| PCG | O | USD | 42.14 | 49.00 | -27.4% | 3.42 | 3.46 | 3.58 | 12.3 | 12.2 | 11.8 | 4.3% |
| SPX | | | 1337.88 | | | 85.28 | 99.75 | 113.11 | 15.7 | 13.4 | 11.8 | 1.9% |

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

Highlights

In a Form 8-K filed on July 1st, 2011, PG&E disclosed two recent filings with the California Public Utilities Commission (CPUC) that revealed new shortcomings in its record keeping and inspection practices related to its natural gas transmission pipeline network as well as its electric distribution system.

- With respect to its gas transmission network, PG&E sent a letter to the CPUC on June 30th describing a review of its system for designating the location of its gas transmission pipelines by reference to the population density of the areas they traverse. This designation is based on a four-point scale ranging from Class 1 (lowest population density) to Class 4 (highest population density).
- PG&E found that while some 550 miles of its gas transmission pipe had shifted from one class to another over time, the company had failed to change its designation of the pipe. Of this total, 172 miles should have had their class designation raised to reflect an increase in population density in proximity to the pipe (**Exhibit 1**). A higher class designation, in turn, would have required PG&E to observe stricter limits on Maximum Allowable Operating Pressure (MAOP) in respect of this pipe.
- PG&E believes that 7.5 miles of its gas transmission lines were operating at a MAOP higher than federal pipeline safety regulations allow, and has reduced the pressure on ~3.5 miles where it could do so without immediate customer impact. The remaining 4 miles requires more careful planning and phasing of the pressure reductions due to customer impacts, including on gas-fired power plants.
- The strong statement issued by CPUC Executive Director Paul Clanon in response to the letter (**Exhibit 3**) suggests that the CPUC may open another investigation, in addition to the ongoing San Bruno OII ("Order Instituting Investigation") proceeding, and may as a result impose further fines on PG&E. In addition, PG&E may face third-party liability exposure resulting from customer disruptions on the remaining 4 miles of gas transmission lines that require pressure reductions, particularly relating to the loss of generation capacity and output at the affected power plants.
- With respect to its electric distribution system, PG&E disclosed in an annual compliance report filed on July 1st that, as a result of an internal company investigation, it believes that certain employees and contractors engaged in falsification of inspection records related to underground equipment, claiming to have examined underground enclosures that were unlikely to have ever been opened. The problem appears to be limited to its San Jose division (**Exhibit 2**), and PG&E plans to re-inspect all enclosures in San Jose previously reported to have been inspected in 2010 and 2011 by October 14th, 2011.
- The disclosure of falsified inspection reports now extends PG&E's safety problems outside the realm of its relatively smaller scale natural gas transmission and storage operations (at \$1.5 billion, less than

8% of rate base¹) to its much larger electric distribution system (at \$12.4 billion, nearly 63% of 2009 rate base) (see the comments of CPUC Executive Director Paul Clanon in **Exhibit 3**). While the costs of re-inspecting the underground enclosures in San Jose and any associated fine are unlikely to be material, this assumes that the CPUC agrees with PG&E that the inspection issues are predominantly at the San Jose division and not across PG&E's electric distribution system.

Investment Conclusion

We continue to believe that our assumption of a \$1 per share discount (~\$400 million) is adequate to account for the totality of fines that are likely to result from the currently pending CPUC investigations into the San Bruno and Rancho Cordova explosions, the task force of federal and state prosecutors pursuing a criminal investigation into the San Bruno explosion, and any new investigations that might arise from the recent disclosures. Our view is predicated on recent precedent. In particular, the CPUC's investigation into the Rancho Cordova explosion, where the scale of loss of life and injury was roughly an eighth of that in San Bruno, resulted in a proposed fine on PG&E of \$26 million (see our June 21, 2011 report: "*PCG: CPUC Staff Proposes \$26 million Fine in Investigation of 2008 Rancho Cordova Gas Explosion*"), suggesting that a fine of some \$200 million might be expected for an explosion of the size of San Bruno. Other criminal investigations into gas pipeline explosions of similar gravity to San Bruno have resulted in fines and civil penalties in a range of \$100-\$110 million (see our June 14, 2011 report: "*Quick Take - PCG: Federal & State Prosecutors are Pursuing a Criminal Investigation of the San Bruno Explosion*"). The sum of these two estimates, at some \$300 million, remains within our \$400 million estimate for total San Bruno penalties.

Nonetheless, PG&E's July 1st disclosure of new shortcomings in its record keeping and inspection practices, related to both its natural gas transmission and electric distribution systems, highlights two risks that bear monitoring. These are: (i) PG&E's exposure to third-party liability arising from customer disruptions due to pressure reductions on the reclassified pipeline miles, future hydrostatic testing, or CPUC mandated pressure reductions; and (ii) a broadening of the inspection issues at PG&E's San Jose division to its electric distribution system at large.

We rate PG&E outperform with a \$49 price target, 16% above its July 5, 2011 closing price of \$42.14.

Details

In a Form 8-K filed on July 1st, 2011, PG&E disclosed two recent filings with the California Public Utilities Commission (CPUC) that revealed new shortcomings in its record keeping and inspection practices related to its natural gas transmission pipeline network as well as its electric distribution system.

Gas Transmission Pipeline Classification Issues

With respect to its gas transmission network, PG&E sent a letter to the CPUC on June 30th describing a review of its system for designating the location of its gas transmission pipelines by reference to the population density of the areas they traverse. This designation is based on a four-point scale ranging from Class 1 (lowest population density) to Class 4 (highest population density). PG&E found that while some 550 miles of its gas transmission pipe had shifted from one class to another over time, the company had failed to change its designation of the pipe. Of this total, 172 miles should have had their class designation raised to reflect an increase in population density in proximity to the pipe (**Exhibit 1**). A higher class designation, in turn, would have required PG&E to observe stricter limits on Maximum Allowable Operating Pressure (MAOP) in respect of this pipe.

¹ Based on 2009 weighted average rate base of \$19.8 billion; 2010 rate base was \$21.1 billion, but its composition has not been disclosed, although it is likely to be quite similar to that for 2009 rate base.

Federal regulations allow a gas pipeline operator a 24-month window to detect a change in class location, and it is unclear how many of the 172 miles experiencing an upward revision of their class location designation were within this window and for how many miles this window had expired.

(PG&E is still reviewing its records for another 100 miles of pipe, so the mileage numbers provided above are subject to minor revisions. It should also be noted that the 5,767 miles of gas transmission pipeline miles shown in **Exhibit 1** are based on the federal criteria (as established by FERC) defining a transmission pipeline. The CPUC's applies a more expansive definition of transmission pipeline -- a pipeline where the operating pressure is more than 60 pounds per square inch gauge (psig) -- resulting in PG&E's gas transmission network being counted at approximately 6,700 miles.)

Exhibit 1

PG&E: Summary of Gas Transmission Pipeline Miles by Location Designation

| Category | Total Pipe | No Change | Class Changed Up | Class Changed Down |
|-----------------|-------------------|------------------|-------------------------|---------------------------|
| Class 1 | 3,679 | 3,360 | 107 | 0 |
| Class 2 | 401 | 292 | 64 | 217 |
| Class 3 | 1,685 | 1,565 | 1 | 158 |
| Class 4 | 2 | 0 | 0 | 4 |
| Total | 5,767 | 5,216 | 172 | 378 |

Source: PG&E's Class Location Study Report, June 30, 2011

PG&E believes that 7.5 miles of its gas transmission lines were operating at a MAOP higher than federal pipeline safety regulations allow, and has reduced the pressure on ~3.5 miles where it could do so without immediate customer impact. The remaining 4 miles requires more careful planning and phasing of the pressure reductions due to customer impacts, including on gas-fired power plants.

The strong statement issued by CPUC Executive Director Paul Clanon in response to PG&E's June 30th letter (**Exhibit 3**) suggests that the CPUC may open another investigation, in addition to the ongoing San Bruno OII ("Order Instituting Investigation") proceeding, and may as a result impose further fines on PG&E. In addition, PG&E may face third-party liability exposure resulting from customer disruptions on the remaining 4 miles of gas transmission lines that require pressure reductions, particularly relating to the loss of generation capacity and output at the affected power plants.

Electric Distribution System Inspection Issues

With respect to its electric distribution system, PG&E disclosed in an annual compliance report filed on July 1st that as a result of an internal company investigation it believes that certain employees and contractors falsified inspection records related to underground equipment, claiming to have examined underground enclosures that were unlikely to have ever been opened. The problem appears to be limited to its San Jose division (**Exhibit 2**), and PG&E plans to re-inspect all enclosures in San Jose previously reported to have been inspected in 2010 and 2011 by October 14th, 2011.

As background, PG&E and other utilities are required under CPUC General Order 165 (first adopted in 1997) to conduct inspections of their overhead and underground electric distribution network to identify

structural problems and safety hazards, and file an annual compliance report. All underground electrical distribution equipment is required to be subjected to a "Detailed" inspection (vs. a more cursory visual "Patrol" inspection) on a 3-year cycle, and overhead distribution equipment on a 5-year cycle.

In November 2010 PG&E received a tip from an employee alleging that some contractors hired to conduct underground enclosure inspections in its San Jose division had not opened enclosures that they claimed to have inspected. PG&E launched an internal investigation and examined 273 enclosures in its San Jose division and 1,143 enclosures in its other 18 divisions. It found that in San Jose, 73 enclosures might not have been opened at all, or were otherwise subject to suspect inspections, while in the other 18 divisions only 7 enclosures appeared to be subject to suspect inspections, with 13 divisions appearing to have no instances of unopened enclosures (**Exhibit 2**).

Exhibit 2

PG&E: Summary of Underground Enclosure Inspections Investigation

| | San Jose Division | Other 18 Divisions |
|--|--|--|
| Sample Size (Underground Enclosures) | 273 | 1,143 |
| Description (Sampling Population) | 6,888 underground enclosures inspected during an unspecified period during 2010-2011 | 25,254 underground enclosures inspected during March to mid-May 2011 |
| Unopened or Suspect Enclosure Inspections | 73 | 7 |
| % of Sample Suspect | 26.7% | 0.6% |

Source: PG&E's General Order 165 Compliance Plan for 2012 and Annual Compliance Report for 2010, July 1, 2012

CPUC's Comments on PG&E's Disclosures

While it remains to be seen what actions the CPUC's Commissioners might take in response to these disclosures, the reaction of the CPUC's Executive Director, Paul Clanon, suggests that the CPUC may open another investigation, in addition to the ongoing San Bruno OII, and may as a result impose further fines on PG&E. (See **Exhibit 3**, which presents Clanon's comments as quoted on the CPUC website and in a couple of local newspaper reports).

Exhibit 3

CPUC: Selected Comments by Executive Director Paul Clanon

- *"We hope we're nearing the end of the revelations about PG&E's poor safety efforts. This is a serious failure with serious safety repercussions. PG&E faces another investigation and more potential fines. How PG&E reacts to this discovery now and in the weeks ahead is a chance to show us and the public that it's a new company and operating safely is its first priority."*

- *"PG&E's safety problems run deeper than natural gas pipelines. I am encouraged that PG&E took immediate action when this matter was brought to their attention and that they will now inspect, or re-inspect, all underground enclosures. I hope PG&E builds on this to demonstrate that they are now putting safety first."*

Source: CPUC Website; Newspaper Reports

We continue to believe that our assumption of a \$1 per share discount (~\$400 million) is adequate to account for the totality of fines that are likely to result from the currently pending CPUC investigations into the San Bruno and Rancho Cordova explosions, the task force of federal and state prosecutors pursuing a criminal investigation into the San Bruno explosion, and any new investigations that might arise from the recent disclosures. Our view is predicated on recent precedent. In particular, the CPUC's investigation into the Rancho Cordova explosion, where the scale of loss of life and injury was roughly an eighth of that in San Bruno, resulted in a proposed fine on PG&E of \$26 million (see our June 21, 2011 report: "*PCG: CPUC Staff Proposes \$26 million Fine in Investigation of 2008 Rancho Cordova Gas Explosion*"), suggesting that a fine of some \$200 million might be expected for an explosion of the size of San Bruno. Other criminal investigations into gas pipeline explosions of similar gravity to San Bruno have resulted in fines and civil penalties in a range of \$100-\$110 million (see our June 14, 2011 report: "*Quick Take - PCG: Federal & State Prosecutors are Pursuing a Criminal Investigation of the San Bruno Explosion*"). The sum of these two estimates, at some \$300 million, remains within our \$400 million estimate for total San Bruno penalties.

Nonetheless, PG&E's July 1st disclosure of new shortcomings in its record keeping and inspection practices, related to both its natural gas transmission and electric distribution systems, highlights two risks that bear monitoring. These are: (i) PG&E's exposure to third-party liability arising from customer disruptions due to pressure reductions on the reclassified pipeline miles, future hydrostatic testing, or CPUC mandated pressure reductions; and (ii) a broadening of the inspection issues at PG&E's San Jose division to its electric distribution system at large.

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 6.6%; (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 San Bruno explosion, 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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12-Month Rating History as of 07/05/2011

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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