SouthwestUtilities Tour Notes

KeyTakeaways from California, Arizona and Nevada

- Industry Overview

- **Last week we hosted our 7th Annual Southwest Utilities Tour.** We held meetings with PCG, EIX, SRE, PNW, SWX, NVE, the CPUC and the PUCN.
- **CPUC:** We are generally more constructive on the CPUC's regulatory outlook, after having discussions with Commissioners Ferron, Simon, and Florio. The Commissioners were careful to conceptually delineate between penalties, cost allocation of pipeline integrity, and future investment needs. We view this as a constructive sign that the impact of San Bruno (and the recently conducted NTSB hearings) should have less effect on future rate proceedings than initially thought.
- **PCG:** Incoming CEO Anthony Earley's initial focus is on accurately assessing where improvements to operations can be made and finding where interests of the CPUC and PG&E are aligned. While we retain our Hold rating and $46 target price, we believe the investment outlook has modestly improved. A more positive stance might be merited if regulators follow through in clearly demarking penalties versus ratemaking.
- **SRE:** Sempra's new CEO Deborah Reed and the management team have restructured the reporting segments to better showcase its international assets and to refocus on the core regulated business. Asset sales and an investment in liquefaction are on the drawing board. We are moderately more positive on multiple expansion of the company over time. We reiterate our Buy rating and $60 target price.
- **EIX:** Southern California Edison's rate case is proceeding largely on track to be resolved sometime around year end. Beyond the rate case, we believe management is primarily focused on securing a reasonable allowed ROE, with less emphasis on its comparatively low equity ratio. We continue to rate EIX Hold, with a $40 target price.
- **NVE:** We believe reducing debt may be the path of least resistance following the rate case. An immediate dividend increase following the rate case does not appear likely nor politically prudent in our view. Transmission line opportunities to California appear stymied by conflicting views of renewable import/export potential held by the California and Nevada Governors. We retain our Hold rating and $17 target price.
- **SWX:** Management's strategy of lowering costs and improving regulatory relationships continues to stay the course. An ALJ decision for an Arizona settlement should come in October with a final Commission decision in December 2011. Pipeline construction could be incremental to our current outlook, while the next potential change to the dividend should come in February 2012. We rate SWX Buy with a $45 target price.
- **PNW:** The recent outage extending into San Diego was kicked off by Pinnacle, but the magnitude of the outage cannot be explained by the line error alone. FERC/NERC, the CPUC, and the affected utilities are investigating. It is our sense that reparations from Pinnacle will not be sought by the California utilities, alleviating a minor concern. The rate case is proceeding on schedule, with no major hiccups seen in any of the technical conferences thus far. We rate PNW Buy with a $49 target price.
- **PUCN:** Commissioner Burthenshaw is cognizant that allowed rates of returns appear to be trending towards key thresholds of consideration. As with the CPUC, Nevada found the NTSB hearings were sobering but not unsurprising.

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Southwest Utilities Tour Notes

CPUC Is Focused On Both Past Events & Future Investment Needs In A Balanced Manner

We held meetings with CPUC Commissioners Ferron, Florio and Simon. We generally walked away more constructive on the CPUC, in that we believe the effect of San Bruno will be handled in a more reasonable manner than we initially thought.

1) All three Commissioners seemed to signal a preference for a fixed dollar amount to be borne by shareholders as part of the OIR rather than ratemaking considerations that might have an impact on future rate cases. We sensed a strong desire to reduce capital market uncertainty over the scope of potential non recoverable gas integrity expenses and capital expenditures. This is constructive because a majority of the Commission recognizes the need to delineate the impact of San Bruno from future investment needs and rate adjustments.

2) All three Commissioners expressed openness towards maintaining the concept of tying allowed rates of return to bond yields. This is constructive because there was some uncertainty as to whether the current cost of capital mechanism, a more predictable mechanism, would be maintained beyond the current expiration date at the end of 2012. There may be some tightening of the return sensitivity to bond yields, but the Commission indicated they may allow structure of the mechanism remain intact.

3) The recently released NTSB final conclusions, which had a harsh tone for Pacific Gas & Electric and the state regulators, was both sobering and not unexpected to the Commissioners. The Commissioners largely expected a harsh view and believe active steps are already being taken to address the NTSB's concerns. This is constructive as it signals the NTSB's conclusions and harsh tone do not portend a change in Commission thinking from current expectations – the Commission is already adjusting and taking steps to improve public safety.

4) All three Commissioners acknowledged that allowed rates of return would likely fall given lower bond yields. Yet, given infrastructure needs in the state, all three seemed to signal that the State's above average needs (still driven by AB32) would require above average returns. This is in line with current Street expectations.

5) All three Commissioners agree with the view that voters continue to desire more green energy investments even though this leads to above average rates. Notably, with the Commission seeing solar PV levelized price proposals now below combined cycle gas turbines, the Commissioners noted the choice between more renewables and higher rates may be easier to bear than in prior years.

6) Our meetings indicated there appears to be no push by the Governor's office to contemplate electricity taxes as a way of closing California's budget deficit. According to Commissioner Ferron (who worked closely with Governor Brown's election campaign) the Governor opposed an oil & gas exploration tax which signals a likely opposition to the notion of a utility tax. This is notable point in our view, as the ongoing fiscal situation in Europe has begun prompting similar questions on this side of the Atlantic.

7) There is a desire by the Commission to make sure the broader public understands the penalties to be assessed on PG&E (OII) before any finalization of gas integrity expenditures and how they are to be allocated between ratepayors and the company (OIR). Since the OIR calendar appears to be progressing faster than the OII, the staff recommendations in the OII (slated for February 2012) may take on more significance to the broader public. A proposed decision in the OII is not slated till 3Q12.

PCG: New CEO & Improved Regulatory Outlook Are Positives

New Management - We met with Tony Earley on his first day. We walked away with the following impressions: 1) His top priority is to make an accurate and objective assessment of how well PG&E's operating metrics compare to other utilities. 2) He wants to get more familiar with his team's strengths and weaknesses. While his exposure to PG&E executives has been very limited, from what he sees he does not see major changes at this time. 3) He wants to see where the CPUC's interests and PG&E's interests are aligned. He will be meeting with the Commissioners over the next few weeks. 4) His initial rate thought is that streamlining O&M can help mitigate the impact of necessary capital expenditures to meet AB32 requirements. 5) With regards to the company's stance on San Bruno and other safety/policy issues, his view is that the Company is in no position to take a hard stance. That said, regulators need to be reasonable, given the need to attract capital to achieve the state's aggressive policy mandates.

Overall, the NTSB conclusions are sobering and not unexpected to PG&E executives. The Company believes it has been closely involved with the several investigations over San Bruno, such that the concrete recommendations in the report (while significant) are not surprising versus expectations. Moreover they do not represent risks to either the PSEP proposal in the OIR.

Conclusion - We attribute PCG's current trading discount to concerns over whether ultimate penalties/company nonrecoverability of costs in the wake of San Bruno will lead to more long lasting impairment of returns in California. For the time being, this discount is merited, since the penalty and PSEP allocation headlines could still be negative catalysts. However, following our trip we believe State regulators are trending towards a more fixed delineation of dollar exposure from San Bruno, and should eschew longer lasting discounts to ratemaking. The next 12 months should begin to resolve much of these issues, and so would keep an eye out for more opportunities to be constructive on the name, all else being equal.

We continue to hold a $46 target and Hold rating on PCG. But, if state regulators move to quickly dollar delimit the effect of San Bruno, then our 1.0x target multiple discount could come under reconsideration.

SRE: New CEO Update; Pipeline Integrity Plan Good for Investors but Delays Large Dividend Boost

New Management Team – The company is restructuring their business units to isolate all international earnings into one segment. Management believes this segment, which includes distribution utilities in Peru, Chile and Mexico and pipeline and LNG assets in Mexico, is not being valued appropriately. These assets could make up 30% of total company wide earnings. Most investors tend to apply a discount to these earnings because of the lack of visibility surrounding other peer group investments. However, if SRE can demonstrate that it generates higher returns on capital from this business unit and if we see a change in the tax code that allows for the repatriations of capital from abroad in an efficient manner, we believe there is room for multiple expansion in this business. We currently value these assets at book value. Separately, the company is currently evaluating options on all its domestic gas assets (excluding its California utilities). The potential to turn Cameron into a liquefaction facility is also on the table. This could be accomplished though a JV. The company is also evaluating a change in the accounting of its renewable energy tax credits, which is likely to smooth earnings and cash flows over a long period of time. This had been a source of investor consternation.

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SoCal Gas Pipeline Integrity – Generally speaking, SoCal Gas is NOT viewed in the same light as PG&E by the regulators; however all California utilities are being painted with a broad brush at this time given the current rate case cycle and the potential investments in pipeline integrity. SoCal gas is recommending a $3.1 billion capital program for pipeline integrity ($300 mm of which is O&M). This investment program will limit the amount of dividends investors may have been expecting up to the parent. We expect this entire investment to be recoverable in rates. Therefore, the investment is accretive to shareholders, but it does put off a large potential near-term boost in the corporate dividend.

Conclusion – We walked away from our meetings with the CPUC and Sempra meetings with a modestly more constructive view on California and Sempra's restructuring plans. We believe the new CEO's focus on its core utility assets should eventually result in the long awaited multiple expansion the company has been aspiring for following the sale of its commodity trading business, albeit this will take some time. If the company can execute on asset sales or JVs where cash can be brought back to the company at a higher multiple than what SRE stock is trading at, then we should see an acceleration of this multiple expansion. There is precedence for this (i.e. Dominion). We maintain our Buy rating and $60 target price.

EIX: Southern California Edison Rate Case Is Steady As She Goes

We met with Ron Litzinger and senior executives of Southern California Edison (we did not meet with executives of the Edison International parent and Edison Mission merchant segment).

The rate case is proceeding largely on track. The case is proceeding about a month behind the prior rate case's schedule, but still within expected deadlines sometime around year end. Minor additional color: higher insurance costs of $40 million as a result of wildfires have been included in the GRC filing. The management team sees little chance of the GRC schedule spilling over and interfering with the COC expected schedule.

Much of the investor inquiry focused on the cost of capital proceedings to be filed in either April or May 2012. It is our sense that management is focused more on the allowed ROE and less on the equity ratio for the upcoming proceedings, although this is very early in the process. The dividend payout ratio to the parent is not expected at this time to change from 45% after the rate case, given considerable investment requirements in Southern California Edison's territory.

Conclusion – We rate EIX Hold with a $40 target price. The stock trades at a discount to its regulated utility value largely on a still uncertain California regulatory environment and also due to a slightly lower than average dividend yield (commensurate with SCE's considerable infrastructure needs). As with PCG, our view of the California regulatory environment has moderately improved following our meetings with the CPUC. More concrete actions taken by the CPUC could prompt our revision of our "California discount" in our assessment of EIX.

NVE: Investment Thesis Still Shifting From Rate Case To Post-Case Strategy

We met with Michael Yackira and the senior management team of NV Energy. Much of the discussion centered on management's strategy following the current rate case. We forecast the company will be in a positive distributable cash flow position following the rate case, making NVE a capital allocation story.

We walked away with the view that a dividend raise immediately following the rate case should not be expected. Not only is it politically imprudent, but the dividend is historically adjusted in 3Q – meaning the next potential change could be in 3Q12. A dividend raise would also conflict with other potential uses of cash that better align with a utility with historically above average growth rates. We believe debt deleveraging might be the preferred strategy by management, given that transmission line investment to California is under uncertain recovery status and also given that the Las Vegas and Reno infrastructure requirements will be somewhat muted following the rate case. Some combination of all of the above might be considered, but we believe our expectations of a dividend raise are now more tempered from before.

Following the rate case, one upcoming issue is a legal merger of the Nevada Power and Sierra Pacific entities. Although the two utilities have been largely operating as one entity (with most operating benefits already being recognized and realized), the legal merger raises some rate questions, many of which need to be addressed in the next year: 1) How will Hoover Dam subsidies in southern Nevada be treated under a single entity? 2) Which rate cycle calendar will be adopted? Management is not yet in a position to answer these questions, but we expect these questions will become more prevalent over the next 12 months. We expect FERC and DOE filings by year end. The merger is not expected to affect consolidated results, but could lead to rate setting implications and politics in the future.

Better utilization of generation assets could lead to reduced rate impacts in the future. Management is exploring the possibility of more effectively and efficiently using generation TWH sales off-system to generate ratepayer refunds in the future. NV Energy is not looking to off system sales as a direct source of profits – income would flow back to ratepayers. At present, spark spreads and basis differentials do not make this a material prospect, but in the future off system sales might be more beneficial in leading to rate reductions for NV Energy ratepayers. We would view successful execution of this strategy positively, as it would allow more headroom on future base rate increases.

Conclusion – We continue to rate NVE Hold with a target price of $17. We believe the stock's discounted PE largely reflects a regulatory environment that historically experiences lag, an anemic Las Vegas demographic growth outlook, and a below average dividend yield. Capital uses are partially constrained, i.e., infrastructure needs are low, California opportunities have no clearly structured recovery mechanism, and a significant dividend uplift near term is politically imprudent and potentially not in the best interests of a utility that historically has significant growth needs. That said, the management team has successfully maneuvered the company into a positive free cash flow and distributable cash flow position. More clarity over strategy following the rate case could lead to a reassessment of the story.

SWX: Strategy on Course; AZ Settlement Moving Along; Reiterate Buy

Management Meeting – Management's core business strategy over the last eight years remains intact. Managing the regulatory agenda has been key to SWX over the last eight years. The process has taken almost decade, but it is paying dividends. The core strategy of: 1) building a constructive relationship with regulators and consumer groups; 2) managing costs; and 3) focusing on customer satisfaction has narrowed the gap between the achieved and allowed rate of returns for its utilities. See our recent upgrade note of SWX at https://www.citigroupgeo.com/pdf/SNA85550.pdf.

Arizona – We expect an ALJ decision on SWX's settlement in Arizona to be between $52 and $59 million in October. The difference will be whether SWX gets decoupling. We do not believe the ALJ will deviate from these two outcomes. A full Commission decision is expected in December.

Pipeline Construction – SWX's subsidiary, NPL Construction, has the ability to take advantage of the current investment in pipeline and distribution line integrity taking place across the entire country. The subsidiary represents between 10% and 15% of earnings and has the ability to grow with SWX's regulated earnings. We have not included these increases in our estimates. The subsidiary is self-funding and has not required parent capital in the past.

Dividend Policy – SWX management understands that its dividend payout is below its peer group average. With the slowdown in customer growth in CA, AZ and NV, a more constructive regulatory environment in these states and an improved balance sheet, we believe the Board and management have the ability to grow the dividend at a higher pace than earnings growth. We will likely hear a decision in February next year.

Recommendation – SWX remains one of our preferred small/midcap utilities. We maintain our Buy rating and $45 target price.

PNW: Outage & Rate Case Update

We met with CFO Jim Hatfield and several members of Pinnacle West's senior executive team. Not much has changed since our very recent last meeting with management (see note at https://www.citigroupgeo.com/pdf/SNA87145.pdf), but we still picked up the following takeaways:

1) The 9/9/11 outage affecting San Diego is still being investigated, although it does appear that neither California nor the California utilities will be seeking to recover costs from Pinnacle West. Pinnacle West has already acknowledged as having tripped the initial event that led to the outage, but executives from Pinnacle, San Diego Gas & Electric, and Southern California Edison all agreed that the initial trip should not have had a cascading event into much of Southern California. A FERC/NERC investigation is taking place, along with a cross-utility consortium to explain the causes of the outage. We walked away with the impression that the two California utilities would not attempt to recover outage costs from Pinnacle West; rather they are working collectively to understand why the outage was as large as it was.

2) The monthly technical conference (part of the rate case proceedings) on decoupling came and went without a major hiccup. Stakeholders to the conference seemed to ask more questions about its purpose than actively opposing it. As a reminder, in our prior PNW note, we noted that decoupling was one of the major rate mechanisms proposed in this rate case (the other two being an infrastructure tracker and a 100% fuel clause).

We continue to rate PNW Buy with a $49 target price. We continue to view PNW as an attractive defensive story with little industrial power exposure, a historically above average growth outlook, muted sales expectations, and a discounted valuation.

PUCN: Nevada Outlook Remains Stable

We met with Chairman Alaina Burtenshaw to discuss the Nevada regulatory outlook. A few major points: 1) Like the CPUC, Chairman Burtenshaw viewed the NTSB report as strict and also not unexpected. We walked away with the impression that the PUCN is not likely to materially change its thinking following the NTSB's final report. 2) Allowed rates of return nationally are encroaching on key thresholds for different stakeholders. 3) She generally believes that electric utilities are somewhat underequitized relative to their risk profile. 4) She remains as concerned as in our last year meeting about the soft Nevada economy.

Companies mentioned in this report include:

Edison International (EIX.N; US$37.76; 2M)

NV Energy (NVE.N; US$14.74; 2H)

PG&E Corp (PCG.N; US$42.55; 2L)

Pinnacle West Capital Corp (PNW.N; US$44.21; 1M)

Sempra Energy (SRE.N; US$53.32; 1M)

Southwest Gas Corp (SWX.N; US$36.66; 1M)

Appendix A-1

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