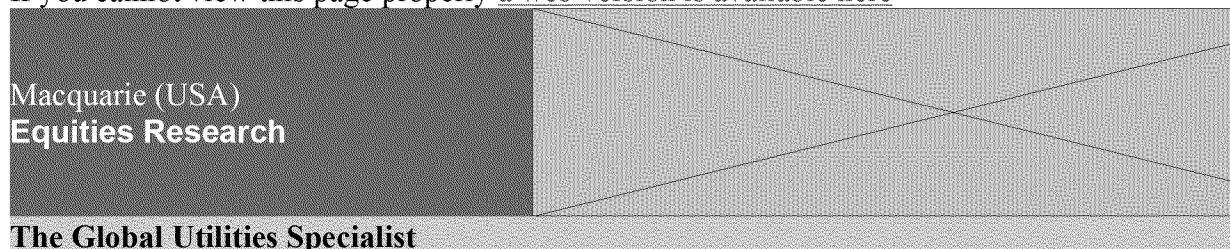


From: Cherry, Brian K
Sent: 11/29/2011 8:36:26 AM
To: mp1@cpuc.ca.gov (mp1@cpuc.ca.gov)
Cc:
Bcc:
Subject: FW: CA utilities - Always (regulatory) uphill battle

FYI

From: Angie Storozynski [mailto:angie.storozynski@macquarie.com]
Sent: Monday, November 28, 2011 07:34 PM
To: Investor Relations (mailbox)
Subject: CA utilities - Always (regulatory) uphill battle

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- In early November CA water utilities agreed to lower their 2012-2014 ROEs by 20-30 bps. If approved by CA utility regulators, this settlement will bode well for CA electric utilities whose 2013-2015 ROEs will be reset next year and whose consensus estimates imply a 100 bps ROE reduction. However, last night the ALJ decided to hold evidentiary hearings on the water utilities settlement to determine if it's in public interest given lower regulatory risk and low Treasury yields. We reiterate our Outperform rating on CA water and electric utilities under our coverage (AWK, EIX and PCG) though we are worried about the outcome of the hearings.

- Last night an Administrative Law Judge (ALJ) ordered hearings on the cost of capital settlement filed by four water utilities in CA in early November. The hearings will be held on January 23-25, 2012.

Impact

- **Proposed cost of capital settlement:** In early November four CA water utilities filed a settlement on their 2012-2014 cost of capital proceeding with the Division of Ratepayer Advocates (DRA) of the California Public Utilities Commission (CPUC). The parties settled for a 9.99% allowed ROE and equity ratios of 51.35% to 55%. Additionally, the agreement calls for a continuation of the current water cost of capital mechanism with a +/-100 bps dead band. If approved by the CPUC, the settlement would result in a 20 to 30bps reduction to currently allowed water ROEs in CA, which would be a

very constructive outcome for CA water utilities, including AWK.

- **Hearings on the settlement:** Last night the ALJ assigned to the case decided that evidentiary hearings were needed to determine if the proposed settlement was in the public interest. The ALJ wants the hearings to determine if the proposed 9.99% ROE is "appropriate" given "the combination of Commission policies with current economic conditions". The ALJ points out that the CPUC has insulated earnings of CA water utilities from lower water usages and allowed for full recovery of actual costs of service. Additionally, the ALJ emphasizes that the lowered regulatory risk came at the time of historically low Treasury yields. A 10% ROE implies an equity premium in excess of 7% which the ALJ calls "historically unprecedented".

Action and recommendation

- We reiterate our bullish stance on **AWK, EIX, PCG**, the water and electric utilities under our coverage with CA operations. All three trade at a significant PE discount to their peers which we believe more than reflects potential downside to allowed ROEs in CA.

Valuation and risks:

- American Water Works (AWK, US\$29.93, Outperform, TP US\$35): Our US\$35 TP is based on 17x our 2013 EPS. Risks include outcome of pending and future rate cases, cost controls, water consumption trends, and future market interest rates.

- Edison International (EIX, US\$38.12, Outperform, TP US\$44): Our US\$44 TP is based on 13.5x our 2013 regulated and parent EPS. Risks include outcome of pending general rate case, future allowed ROEs and equity ratio, future market interest rates.

- PG&E (PCG, US\$38.05, Outperform, TP US\$44): Our US\$44 TP is based on 13.8x our 2013 and 2014 EPS. Risks include regulatory penalties in CA and equity issuances related to them, recovery of pipeline capex and expenses, future allowed ROEs and equity ratio, future market interest rates..

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