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Research Update:

# PG & E Corp. And Utility Ratings Lowered To 'BBB'; Outlook Stable

**Primary Credit Analyst:**
Anne Selting, San Francisco (1) 415-371-5009;anne_selting@standardandpoors.com

**Secondary Contact:**
Tony Bettinelli, San Francisco (1) 415-371-5067;antonio_bettinelli@standardandpoors.com

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Research Update:

# PG&E Corp. And Utility Ratings Lowered To 'BBB'; Outlook Stable

## Overview

- Standard & Poor's Ratings Services has lowered the corporate credit ratings on PG&E Corp. and its electric utility subsidiary Pacific Gas and Electric Co. (PG&E) to 'BBB' from 'BBB+'. We lowered the rating to 'BBB-' from 'BBB' on PG&E Corp.'s senior unsecured debt. We also lowered the rating to 'BBB' from 'BBB+' on PG&E's senior unsecured debt. In addition, we lowered the utility's preferred stock rating to 'BB+' from 'BBB-'. We affirmed the short-term rating on the utility at 'A-2'. The outlook is stable.
- Our rating action reflects what we view will be a multiyear rebuilding of the company's natural gas operations, customer reputation, and regulatory relationships following the 2010 San Bruno, Calif. gas transmission explosion that resulted from the utility's inadequate controls.
- Executive management changes at the firm position the company to improve its gas transmission infrastructure and to overhaul its safety culture. Management's commitment to fund any penalties imposed by the California Public Utilities Commission with equity issuances should buffer the credit impact of unexpected costs not funded by ratepayers that could arise during the next few years.
- The stable outlook reflects that we anticipate the company will gradually repair its image and reform its operations while achieving cash flow projections in line with our base case expectations of funds from operations to debt of 20% and adjusted debt to capitalization in the area of 58%.

## Rating Action

Standard & Poor's Ratings Services lowered its corporate credit ratings (CCR) to 'BBB' from 'BBB+' on PG&E Corp. and electric and gas utility subsidiary Pacific Gas and Electric Co. (PG&E). We also lowered our rating on PG&E Corp.'s senior unsecured debt to 'BBB-' from 'BBB'.

The rating on the utility's senior unsecured debt was lowered to 'BBB' from 'BBB+'. The rating on its preferred stock was lowered to 'BB+' from 'BBB-'. The utility's short-term rating is affirmed at 'A-2'. The outlook is stable.

## Rationale

The 'BBB' CCR on PG&E Corp. and its electric and gas utility subsidiary Pacific Gas and Electric Co. (PG&E) reflects our view of a significant consolidated financial profile and a strong business profile that continues to be weighed



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down by the San Bruno, Calif. gas transmission pipeline explosion of September 2010.

The rating actions reflect our view of the company's multiyear rebuilding of its natural gas operations, customer reputation, and regulatory relationships following the 2010 San Bruno gas transmission explosion that resulted from the utility's inadequate controls. The 'BBB' rating captures our view that the company is at the beginning of this process.

The September final report issued by the National Transportation Safety Board (NTSB), which was tasked with investigating the blast that killed eight and damaged or destroyed 70 homes, laid virtually all the blame on PG&E. The NTSB concluded that "multiple and recurring deficiencies in PG&E operational practices indicate a systemic problem." Weaknesses that have been identified include the company's recordkeeping and gas integrity pipeline program, both of which the company has been working diligently to correct through key changes in management and sizable out-of-pocket spending to test and strengthen its gas transmission system. Yet as the company has acknowledged, every facet of its business is likely to be under intense scrutiny for years to come.

Key management changes made this year, including the appointment of a new CEO at PG&E Corp. in September and the hire of a new leader of its gas business in June, have helped to deliver a credible plan to correct the company's operational shortcomings. At the same time, the rebuilding of its relationships with the public and regulators will be a slow process, and the company is in a major transition as it begins to lay the foundations needed to build a stronger safety culture.

Our rating action also reflects our expectation that the financial profile, while remaining significant, will weaken under our base case projections through 2013 and could be subject to additional stress as the company works through the financial, legal, and regulatory aftermath of the accident. We anticipate that the company will incur at least $1.3 billion in out-of-pocket costs and fines -- not recoverable in customer rates.

This total includes:

- At least $413 million anticipated this year in out-of-pocket costs, mostly for record validation and testing of the company's gas transmission lines;
- $243 million in 2012 and $213 million in 2013 which includes amounts for a variety of self-funded gas and electric projects volunteered by the company in its recent earnings call; and
- A $38 million fine recently approved by the CPUC involving a 2008 natural gas leak that killed one in a suburb of Sacramento.

This figure also reflects our assumption that the CPUC will levy a fine on the company of approximately $400 million sometime in the next two years due to recordkeeping lapses. None of these costs will be recouped from ratepayers.



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Although the financial profile may sustain additional out-of-pocket costs or fines that are larger than we anticipate, management's commitment to issue equity to pay any future fines backstops the consolidated significant financial profile. Delays in resolving the fine at the CPUC could extend the resolution of this issue well into 2013. The CPUC's response to date for the San Bruno explosion suggests that regulatory rulings and ratemaking will continue to be constructive, offering the company an opportunity to resume its historically solid financial performance after 2013, when fines and out-of-pocket costs and fines to remedy its gas operations are behind it. Our baseline forecast is that adjusted, consolidated funds from operations (FFO) to total debt will be slightly above 20% in 2012, and adjusted debt to total capitalization in the area of 58%. These numbers will in part be sustained by the deferred tax benefits from bonus depreciation.

## Liquidity

We view parent and utility liquidity on a consolidated basis. Consolidated liquidity is adequate under Standard & Poor's corporate liquidity methodology, which categorizes liquidity in five standard categories. (See "Methodology and Assumptions: Liquidity Descriptors for Global Corporate Issuers," published Sept. 28, 2011 on RatingsDirect on the Global Credit Portal.) This assessment takes into consideration projected sources of consolidated liquidity as well as the company's operating cash flow and available bank lines against projected uses, necessary capital expenditures, debt maturities, and common dividends.

On a consolidated basis, we expect the company's liquidity sources over the next 12 months to exceed its uses by more than 1.2x. This calculation includes a potential call on the company's liquidity from four revenue bonds (California Infrastructure and Economic Development Banks' refunding revenue bonds series 2009A, 2009B, 2009C, and 2009D) that are backed by bank letters of credit. Under our joint support methodology, if the bank becomes insolvent, the investors can put the obligation back to the utility. As a result, we have included this as a potential use of utility liquidity in our calculations.

In May, PG&E Corp. and the utility entered into new five-year credit facilities that are $300 million for the parent and $3 billion for the utility. Total capacity under the two revolving facilities was nearly $2.1 billion as of Sept. 30, 2011. Last month, the utility also issued $250 million in floating senior unsecured notes due next year to support its gas and power hedging transactions and $250 million of 30-year senior unsecured notes.

Both revolving credit facilities require PG&E Corp. and the utility to maintain total debt to consolidated capitalization of at most 65%, measured quarterly. The corporation is further bound by the requirement to own, directly or indirectly, 80% of common stock and at least 70% of voting capital stock of the utility.



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### Recovery analysis

PG&E Corp.'s senior unsecured debt is structurally subordinated to utility obligations and is thus rated 'BBB-' -- that is, one notch below the utility's senior unsecured debt. The utility's unsecured debt is capped at its CCR. The utility does not issue first mortgage bonds (FMBs). As a result, it is not eligible for notching above its CCR under our FMB criteria.

## Outlook

The stable outlook reflects that we anticipate the company will continue repairing its business practices and produce cash flow projections in line with our base case expectations of FFO to total debt of 20% and adjusted debt to capitalization in the area of 58% next year. We could lower the ratings if leverage exceeds 60% and FFO to total debt falls to less than 15% on a sustained basis. We could raise the ratings if financial performance meets our base case expectations and the business profile strengthens, which would be evidenced by improved operations for the utility's gas transmission system and refocused efforts on building safety into the corporate culture, and continued constructive regulatory outcomes.

## Related Criteria And Research

- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Analytical Methodology, April 15, 2008

## Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

| | To | From |
|---|---|---|
| PG&E Corp. | | |
| Corporate Credit Rating | BBB/Stable/NR | BBB+/Negative/NR |
| Pacific Gas & Electric Co. | | |
| Corporate Credit Rating | BBB/Stable/A-2 | BBB+/Negative/A-2 |

Downgraded

| | To | From |
|---|---|---|
| PG&E Corp. | | |
| Senior Unsecured (1 issue) | BBB- | BBB |
| Pacific Gas & Electric Co. | | |
| Senior Unsecured (16 issues) | BBB | BBB+ |
| Preferred Stock (10 issues) | BB+ | BBB- |

Ratings Affirmed



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| Pacific Gas & Electric Co. | |
|---|---|
| Senior Unsecured (1 issue) | A-2 |
| Commercial Paper (1 issue) | A-2 |

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.



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