

From: Cherry, Brian K  
Sent: 12/19/2011 9:56:23 AM  
To: 'Florio, Michel Peter' (mike.florio@cpuc.ca.gov)  
Cc:  
Bcc:  
Subject: FW: Fitch Downgrade

Mike - FYI

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**From:** Bijur, Nicholas M.  
**Sent:** Monday, December 19, 2011 9:55 AM  
**To:** Earley Jr., Anthony; Harvey, Kent M; Pruett, Greg S.; Frizzell, Roger; Dore, Jay; [Redacted]  
[Redacted]; Togneri, Gabriel; Murnhy, Margaret; Bottorff, Thomas E; Cherry, Brian K; Rogers, Sienna; Thomason, David S; [Redacted]  
**Cc:** Banking and Money Management Department  
**Subject:** Fitch Downgrade

FYI

Fitch Ratings-New York-16 December 2011: Fitch Ratings has downgraded the ratings of the PG&E Corporation (PCG) and its primary operating utility subsidiary, Pacific Gas and Electric Company (PG&E) as follows:

#### PCG

- Long-term Issuer Default Rating (IDR) to 'BBB+' from 'A-';
- Short-term IDR to 'F2' from 'F1';
- Senior unsecured notes to 'BBB+' from 'A-';
- Senior unsecured bank facility to 'BBB+' from 'A-'.

#### PG&E

- Long-term Issuer Default Rating to 'BBB+' from 'A-';
- Short-term IDR to 'F2' from 'F1';
- Senior unsecured notes to 'A-' from 'A';
- Senior unsecured bank facility 'A-' from 'A';
- Preferred to 'BBB' from 'BBB+';
- Commercial paper 'F2' from 'F1'.

More than \$12 billion of consolidated PCG debt is affected by today's rating action. The Rating Outlook is Stable.

The Ratings and Stable Outlook reflect the challenges and uncertainties in the aftermath of the San Bruno natural gas pipeline explosion and fire, including:

- PCG's loss of the confidence of its key constituents due to the disaster;
- 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);
- Concern that the criminal investigation may further complicate the CPUC's investigation of PG&E natural gas safety records.

Fitch believes these uncertainties and their financial consequences will be resolved within the current rating category, supporting the Stable Outlook.

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;
- Execution of management's commitment to issue a total of \$1 billion of common equity 2011 - 2012;
- Consistency of utility capex with state and federal energy policy.

Rating Downgraded, Outlook Stable:

The credit rating downgrade and Stable Outlook reflect continued uncertainty regarding regulatory and legal investigations underway into the 2010 San Bruno explosion and fire and lower operating earnings in 2012.

Specifically, the downgrade reflects uncertainty regarding CPUC investigations into the utility's natural gas operational practices and a nascent criminal investigation into the San Bruno disaster.

Notwithstanding financial pressure from the San Bruno pipeline explosion and fire, PG&E's credit metrics remain strong. Fitch estimates consolidated debt-to-EBITDA of approximately 3 times (x) and EBITDA-to-interest 6x during 2011 - 2013.

Fitch believes PG&E and its parent, PCG, will be able to absorb reasonable worst-case outcomes within the 'BBB+' rating category.

Delay in CPUC pipeline rulemaking:

Fitch previously assumed that a final CPUC order in the natural gas pipeline-testing and replacement implementation proceeding would be forthcoming in first quarter 2012. Fitch now expects the rulemaking to be finalized around mid-year, further pressuring net earnings in 2012.

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 meaningfully higher operating and capital expense to comply with emerging regulatory pipeline safety requirements.

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. Through the third quarter 2011, Fitch calculates that PG&E has recorded direct costs of \$366 million related to the San Bruno disaster.

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 filed its implementation plan in August 2011. Hearings in the proceeding are scheduled for March 2012, and Fitch believes final CPUC decision could be issued around mid-year. The final order will address PG&E 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. Fitch believes PG&E will be able to absorb the expected fine and maintain its current strong credit profile. However, worse-than-expected outcomes for the utility's creditworthiness as the result of the commission investigation cannot be ruled out. The CPUC investigation is expected to be completed in early 2013.

Fitch notes that PG&E paid a \$38 million fine in its CPUC-approved settlement of the 2008 Rancho Cordova explosion. The ultimate amount agreed to by PG&E and approved by the CPUC was greater by \$12 million than the amount initially filed with the commission in the proposed settlement.

Third party liability:

PG&E management has raised its most recent estimates of third party liability exposure related to San Bruno to \$375 million - \$600 million from \$220 - 400 million.

In 2010, PCG booked a charge of \$220 million (the lower end of its previous range) to reflect third party liability exposure and \$155 million during the nine months ended Sept. 30, 2011. PG&E's aggregate level of liability insurance for damages totals approximately \$992 million of coverage with a \$10 million deductible.

Management changes:

Fitch believes the selection of Tony Earley to succeed former PCG chairman of the board, CEO, and president, Peter Darbee, is a constructive development. In addition, PG&E announced a major realignment of its natural gas business under Nick Stavropoulos, Executive VP of Natural Gas Operations in June 2011. Stavropoulos has more than 30 years of industry

experience and will lead the effort to address safety and improve operations.

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.

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.

#### Manageable Debt Burden:

The ratings consider PG&E's manageable debt burden and strong EBITDA credit metrics relative to debt and interest expense levels. Fitch estimates consolidated debt-to-EBITDA of approximately 3x and EBITDA-to-interest of more than 6x during 2011 - 2013.

#### Bank lines renegotiated:

As of Sept. 30, 2011, PCG had \$277 million of cash and cash equivalents outstanding and \$75 million drawn on its \$300 million revolving credit facility. The utility had availability of \$1.9 billion under its \$3 billion credit facility. Management has increased its borrowing capacity under its credit facilities by approximately \$425 million.

As of Sept. 30, 2011, PG&E had \$335 million of letters of credit outstanding under its \$3 billion bank agreement. Commercial paper outstanding at the utility was \$801 million at the end of the third quarter.

In May 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 \$1.94 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 2012 - 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 concern 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.

Balanced regulatory environment expected 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 believes the political/regulatory environment will 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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**From:** Harvey, Kent M

**Sent:** Wednesday, December 14, 2011 5:03 PM

**To:** Earley Jr., Anthony

**Cc:** Bijur, Nicholas M.; Pruett, Greg S.; Frizzell, Roger

**Subject:** Fitch rating

Tony:

FYI, Nick Bijur heard today that Fitch is reviewing our credit rating as early as tomorrow and believes we'll likely be downgraded to A-. (They currently have us at A, one notch higher than Moody's and three notches higher than S&P, and have had us on negative outlook for several months.) As you know, Fitch is not nearly as influential as the other two agencies, and we don't expect any significant market reaction.

This information is confidential until Fitch makes an announcement.

Kent