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BERNSTEIN RESEARCH

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PCG : Our Thoughts After Meeting With CEO Tony Earley & Reviewing the CPUC Staff's Report on the Recordkeeping OII

Ticker	Rating	CUR	13 Mar 2012 Closing Price	Target Price	TTM Rel. Perf.	EPS 2011A	EPS 2012E	EPS 2013E	P/E 2011A	P/E 2012E	P/E 2013E	Yield
PCG	M	USD	43.51	45.00	-9.7%	3.58	3.25	3.19	12.2	13.4	13.6	4.2%
SPX			1395.95			97.97	105.89	119.19	14.2	13.2	11.7	2.0%

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

Highlights

PG&E CEO Anthony Earley visited our offices yesterday along with Gabe Togneri, Head of PG&E Investor Relations. This note recaps our takeaways from the meeting, compares PG&E's assumptions regarding San Bruno-related cost recovery with ours, and highlights the key risks to the company and its shareholders.

- PG&E CEO Tony Earley made clear that his top priority is to put all of the gas system issues emanating from the San Bruno pipeline explosion behind PG&E by the end of the year. The company hopes to achieve a global settlement involving fines and other commitments in Q3, prior to the two year anniversary of the San Bruno explosion (September 9).
- PG&E believes the California Public Utility Commission (CPUC) would support a settlement. While no substantial discussions have started, procedural discussions have been held with the various parties.
- In our opinion, if a comprehensive settlement were to be reached, the most likely framework would involve a stipulation of substantial fines to resolve the penalty phase of the three outstanding OII (Order Instituting Investigation) proceedings (**Exhibit 1**) and potentially some set of general principles with respect to rate payer and shareholder cost sharing for PG&E's proposed PSEP (Pipeline Safety Enhancement Plan) that is being considered under the OIR (Order Instituting Rulemaking) proceeding.
- At this stage, investors should be cautious. PG&E's public statements necessarily reflect management's negotiating position with the CPUC, its staff and the intervenors in the various proceedings. The actual outcome of any global settlement is likely to be far less favorable than these public positions.
- In **Exhibit 2**, we show that based on PG&E disclosures, total San Bruno costs are expected by management to range from $3.8 to $4.1 billion (pre-tax). This range assumes $200 million in fines, based on PG&E's announced provision to date; adjusted for a fine ranging from $500 million to $1 billion, which we think is more likely, total San Bruno costs could range from $4.1 to $4.9 billion.
- In **Exhibit 3**, we provide a breakdown of management's proposed recovery of San Bruno costs. Management has proposed $2.1 to $2.3 billion in cost recovery, implying $1.7 to $1.8 billion in costs absorbed by shareholders. In our base case scenario, we estimate recoverable costs will range from $1.7 to $1.9 billion, implying shareholder costs of $2.4 to $3.0 billion. The gap between management's views on recoverable costs and our base case scenario is $700 million to $1.2 billion pre-tax, which on an after-tax basis would be a range of $1.25 to $2.50 per share.

U.S. Utilities

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- It should be pointed out that there are several areas where PG&E's assumptions are materially less conservative than plausible: (i) $200 million in fines; (ii) recovery of its pipeline records integration capex ($103 million) and O&M ($40 million for 2013-2014); (iii) recovery of virtual all 2011 capex ($69 million) and 2012 capex ($384 million); (iv) recovery of cost increases it has experienced in hydrostatic testing (which could increase the 2013-2014 PSEP O&M costs by ~$230 million)
- Our base case is hardly the worst case outcome. In our base case, we have assumed that nearly $1 billion of the $1.4 billion in PSEP capex will be put into rate base and earn an 11.0% ROE. The CPUC could deny an equity return on this capex and only allow a debt return. In the worst case, the CPUC could deny any cost recovery on the PSEP capex (see our note of January 20, 2012 - PCG: Didn't We Pay for This Already? CPUC Report Pushes Pipeline Safety Costs Back to Shareholders; Downgrade to MP).
- Finally, our estimate of San Bruno costs does not take into account any shareholder cost sharing for Phase 2 of the PSEP. PG&E has estimated on a preliminary basis that Phase 2 PSEP costs could potentially be as high as $6.8 billion to $9.0 billion over ten or more years.

Investment Conclusion

While PG&E clearly seems to be a company on the mend, and a comprehensive settlement to resolve many of the outstanding issues would be a welcome development for investors, we do not view the potential for a short-term resolution within the next six months as an all-clear to adopt a bullish stance on the stock. We reiterate our market-perform rating and target price of $45 for PCG.

Details

Rebuilding a New PG&E

At our meeting yesterday, PG&E CEO Tony Earley spoke about the steps he has taken to turn around PG&E since assuming his role about six months ago. Organizationally, PG&E's structure has been revamped to separate the gas business from the electric business in order to allow clear lines of accountability and improve what Earley characterized as PG&E's historically "dysfunctional" decision making around gas operations and related recordkeeping, safety, and integrity management processes. Several hiring and replacement decisions have been made in the past year relating to key senior and middle-management personnel in the gas business, most prominently the hiring of Nick Stavropoulos as EVP of the newly created natural gas operations business unit.

Operationally, PG&E has made progress in successfully executing several large and ambitious initiatives in an environment of intense time pressure, having concluded 160 miles of hydrostatic testing and completing validation of the MAOP (maximum allowable operating pressure) for the ~1,800 miles of its gas transmission lines passing through highly populated areas, thereby addressing the safe operating pressure for the highest risk portion of its ~6,400 mile gas transmission system.

Earley has also launched a comprehensive operational benchmarking effort which has found PG&E to be largely in the bottom two quartiles in most areas. Currently the effort is to close the gap between PG&E and the average utility level, and eventually aim for top quartile performance.

PG&E has also sought to retool its customer strategy and repair its frayed relationship with its regulators at the CPUC. An example of the former is its recent change to its SmartMeter rollout strategy where it is allowing customers to opt-out for a monthly fee, instead of mandating a compulsory replacement. With its regulators the company feels it is moving in the right direction, although it expects that the CPUC will continue to have to take a strict and adversarial posture till PG&E is able to successfully resolve its gas transmission system issues.

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Potential for a Global Settlement

Earley made clear that his top priority is to put all of the gas system issues emanating from the San Bruno pipeline explosion behind PG&E by the end of the year. During PG&E's discussions with the CPUC Commissioners and in comments made by them to the investor community, the CPUC has expressed a strong desire to bring closure to the various San Bruno proceedings by the two year anniversary of the San Bruno explosion (September 9, 2012). Also, a trial date of July 23, 2012 has been set for the first of the approximately 100 lawsuits involving third-party claims of personal injury and property damage, which might result in an acceleration of settlement activity to resolve these claims. One wrongful death case and three cases involving substantial burns have already been settled.

The company believes that while a global settlement wrapping up all of the proceedings is probably not possible, a stipulation involving fines and other commitments could be reached in Q3. While no substantial discussions have started, procedural discussions have been held with the various parties.

Exhibit 1
PG&E: Gas Transmission Pipeline System Related Proceedings Pending at the CPUC

Investigative Proceedings		Rulemaking Proceeding	
Event	**Timing**	**Event**	**Timing**
Record Keeping OII:		**Gas Pipeline Safety OIR:**	
CPUC Legal Division's Report	March 12, 2012	Intervenor Testimony on PSEP	January 31, 2012
Intervenor Testimony	April 5, 2012	PG&E Rebuttal Testimony	February 28, 2012
PG&E Response	June 25, 2012	Evidentiary Hearings	March 12-23, 2012
Evidentiary Hearings	September 5-19, 2012	Opening & Reply Briefs	TBD
Opening Briefs	TBD	Decision Issued	TBD
Reply Briefs & Case Submitted	Mid-November 2012		
Decision Issued	Dec 2012 / Jan 2013		
Presiding Officer's Decision Final	February 2013		
San Bruno Explosion OII			
CPSD Testimony	March 16, 2012		
Intervenor Testimony	April 16, 2012		
PG&E Testimony	June 15, 2012		
Possible Stipulation of Facts	By August 10, 2012		
CPSD Rebuttal Testimony	August 10, 2012		
Prehearing Conference	August 29, 2012		
Discovery Cut-Off	September 7, 2012		
Evidentiary Hearings Start	September 24, 2012		
Pipleine Class Location OII:			
Update on Outstanding Issues	April 2, 2012		
Prehearing Conference	Mid-April 2012		
Scoping memo with schedule	TBD		

Source: CPUC, Company reports

Sizing up San Bruno Costs

In **Exhibit 2**, we show that based on PG&E disclosures, total San Bruno costs are expected by management to range from $3.8 to $4.1 billion (pre-tax). This range assumes $200 million in fines, based on PG&E's announced provision to date; adjusted for a fine ranging from $500 million to $1 billion, which we think is more likely, total San Bruno costs could range from $4.1 to $4.9 billion.

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Exhibit 2

PG&E: Total Estimated San Bruno Costs Based on PG&E Disclosures

Description	Amount	Comments
2010A Pipeline-related costs	$63	*Overhead (legal, regulatory), some pipeline*
2011A Pipeline-related costs	483	*PSEP and non-PSEP O&M, other overhead*
1. Pipeline Costs through 2011A	**$546**	
2. 2011E PSEP Capex	**$68**	*Excludes $1.4MM in costs expensed in 2011*
3. City of San Bruno Settlement	**$70 - $120**	*High end includes $50MM in restoration costs*
2012E PSEP O&M	$230	*Original PSEP O&M estimate*
2012E Non-PSEP Costs	$100 - $200	*Includes Post-1970 pipe, overhead*
Initial 2012E Pipeline Costs	$330 - $430	
Increase in 2012E Cost Estimate	120	*Per mile hydro test costs, carryover werk*
4. 2012E Pipeline Costs, Revised	**$450 - $550**	
5. 2012E PSEP Capex	**$384**	*Original PSEP Capex estimate*
2013-2014 PSEP O&M	$299	*Original PSEP O&M estimate*
2013-2014 PSEP Capex	980	*Original PSEP Capex estimate*
6. 2013E-2014E PSEP Costs	**$1,279**	
7. Operational Improvement	**$400**	*Both Gas & Electric, 1/3rd is accelerated work*
8. Aggregate Fines	**$200 - $200**	*PG&E accrual at low end of probable estimate*
9. Third-Party Liability Lawsuits	**$375 - $600**	*Low end already accrued*
Total Pipeline Costs (1-9)	**$3,772 - $4,147**	*Total spend from 9/9/2010 - 12/31/2014*

Source: Company reports, Bernstein analysis and estimates

In **Exhibit 3**, we break down management's view of recoverable costs. Management has proposed $2.1 to $2.3 billion in cost recovery, implying $1.7 to $1.8 billion in costs absorbed by shareholders. In our base case scenario, we estimate recoverable costs will range from $1.7 to $1.9 billion, which would imply shareholder costs of $2.4 to $3.0 billion. The gap between management's views on recoverable costs and our base case scenario is $700 million to $1.2 billion pre-tax, which on an after-tax basis would be a range of $1.25 to $2.50 per share.

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Exhibit 3
PG&E: Estimated Recoverable Costs and Shareholder Cost Absorption

	PG&E Mgmt.	SCB Base Case
Total Pipeline Costs (1-9)	**$3,772 - $4,147**	**$4,072 - $4,947**
1. Pipeline Costs through 2011A	$0	$0
2. 2011E PSEP Capex	68	0
3. City of San Bruno Settlement	0	0
4. 2012E Pipeline Costs	0	104
5. 2012E PSEP Capex	384	50
6. 2013E-2014E PSEP Costs	1,279	1,186
7. Operational Improvement	0	0
8. Aggregate Fines	0	0
9. Third-Party Liability Lawsuits	**375 - 600**	**375 - 600**
Total Cost Recovery	**$2,106 - $2,331**	**$1,715 - $1,940**
Shareholder Cost Absorption	**$1,666 - $1,816**	**$2,356 - $3,006**

Source: Bernstein analysis and estimates

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Our base case is hardly the worst case outcome. In our base case, we have assumed that nearly $1 billion of the $1.4 billion in PSEP capex will be put into rate base and earn an 11.0% ROE. The CPUC could deny an equity return on this capex and only allow a debt return. In the worst case, the CPUC could deny any cost recovery on the PSEP capex (see our note of January 20, 2012 - PCG: Didn't We Pay for This Already? CPUC Report Pushes Pipeline Safety Costs Back to Shareholders; Downgrade to MP).

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While PG&E clearly seems to be a company on the mend, and a comprehensive settlement to resolve many of the outstanding issues would be a welcome development for investors, we do not view the potential for a short-term resolution within the next six months as an all-clear to adopt a bullish stance on the stock. We reiterate our market-perform rating and target price of $45 for PCG.

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Valuation Methodology

Our valuation for PG&E reflects the results of a combination of valuation methodologies including: (1) a discounted cash flow model over the forecast period of 2013-16, and a terminal value in 2017, discounted back to present value using estimated weighted average cost of capital at 6.5%; (2) a discounted dividend model over the forecast period of 2013-16, and a terminal value in 2017, discounted back to present value using estimated cost of equity at 8.6%; and (3) a relative valuation technique that applies a set of key valuation metrics derived from comparable groups of regulated power utilities, to our estimates of a utility's future earnings, dividends, EBITDA and book value.

To discount our target price and valuation for potential fines that might be levied upon PG&E as a result of the San Bruno pipeline explosion we consider three different cost recovery scenarios for PG&E's gas pipeline related costs in combination with a range of $500 million to $1.0 billion for total fines and penalties. Averaging the implied valuation across these outcomes, we arrive at our current target price.

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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    Outperform: Stock will outpace the market index by more than 15 pp in the year ahead.

    Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

    Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

    Not Rated: The stock Rating, Target Price and estimates (if any) have been suspended temporarily.

- As of 03/12/2012, Bernstein's ratings were distributed as follows: Outperform - 39.2% (1.1% banking clients) ; Market-Perform - 50.1% (0.8% banking clients); Underperform - 10.6% (0.0% banking clients); Not Rated - 0.0% (0.0% banking clients). The numbers in parentheses represent the percentage of companies in each category to whom Bernstein provided investment banking services within the last twelve (12) months.
- Hugh Wynne maintains a long position in Duke Energy Corp. (DUK).

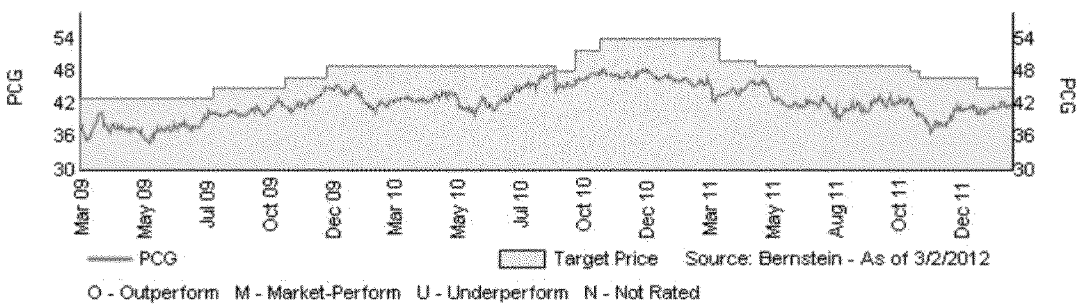
12-Month Rating History as of 03/13/2012

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)
02/27/09	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
05/05/11	O	49.00
11/04/11	O	48.00
11/15/11	O	47.00
01/20/12	M	45.00



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