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## Research Update:

# DRAFT: PG&E Corp. Outlook Is Revised To Negative Reflecting A Potential Weakening Of The Business And Financial Risk Profiles

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**DRAFT**

## Research Update:

# DRAFT: PG&E Corp. Outlook Is Revised To Negative Reflecting A Potential Weakening Of The Business And Financial Risk Profiles

## Overview

- We have revised the outlook to negative from stable on holding company PG&E Corp. and utility subsidiary Pacific Gas & Electric Co.
- We affirmed all of the short-term and long-term ratings including the 'BBB' corporate credit rating.
- We've maintained the business and financial risk profiles as "strong" and "significant", respectively.
- The negative outlook reflects our views that there is at least a one in three probability that the financial penalties from the San Bruno pipeline explosion will be at the California Public Utilities Commission staff's most recent revised recommendation of approximately \$2.25 billion, the company will have ongoing difficulty managing regulatory risk, and the company's willingness or ability to issue equity could be limited. Under this scenario, the penalty is partially financed with debt and funds from operations (FFO) to debt gradually decreases to below 15%. Thereby increasing the risk of a modest downgrade.

## Rating Action

On Aug. 27, 2013, Standard & Poor's Ratings Services revised its outlook to negative from stable on PG&E Corp. and Pacific Gas & Electric Co. The outlook revision reflects our view that there is a one in three probability that both the company's business and financial risk profiles could weaken during the next 12 months and, if sustained, could result in a lower rating. At the same time, we affirmed our 'BBB' corporate credit ratings on PG&E Corp. and Pacific Gas & Electric Co.

## Rationale

In recent comments with regard to potential San-Bruno related penalties, a senior PG&E executive noted that under certain circumstances there exists the remote possibility of a bankruptcy filing if the company can't raise sufficient capital. While we view this outcome as highly unlikely based on current information, we nevertheless view the comments revealing. These comments, in our view, raise the probability that at some point the company's willingness or ability to issue equity for the full amount of out of pocket costs and fines could be limited.

The collective scenario below reflects the reasons for our revision of the outlook to negative.

- The Commission authorizes out of pocket costs and fines from the San Bruno pipeline explosion that are equal to the California Public Utilities Commission (CPUC) staff's most recently revised recommendation. (For more information, see "Bulletin: Revised Recommended Penalty Is Unfavorable For Pacific Gas & Electric Co.'s Credit Quality But Does Not Affect Ratings", published July 17, -2013, on RatingsDirect).

This decision indicates a possible weakening of our assessment of the California regulatory jurisdiction and could have ratings implications for all of the utilities regulated by the CPUC. While in the ordinary course of businesses, the California regulatory jurisdiction has demonstrated a "more credit supportive" environment, political pressure subject to items outside the normal course of business, would necessitate our re-evaluation of the California regulatory jurisdiction.

- The company has ongoing difficulties managing regulatory risk that extends to its general rate case filing and beyond, which would indicate a further weakening of PG&E's ability to manage regulatory risk and would affirm our categorization of the company's "strong" business risk profile for the longer term.
- The company's willingness or ability to issue equity for the full amount of out of pocket costs and fines could be limited, which would result in a longer-term weakening of the financial measures so that FFO to debt gradually decreases to less than 15%.

Should all of the above occur, we would most probably lower the company's corporate credit rating one notch.

The current ratings on PG&E reflect our opinion of its consolidated credit profile, including its strong business risk profile and significant financial risk profile.

The current ratings also reflects our base-case scenario including the following key assumptions:

- Material fines and out-of-pocket costs are offset by equity issuances so that the company retains its regulated capital structure.
- The company receives a rate order from its 2014 general rate case that allows the company to earn close to its allowed return on equity.
- The company's historical financial measures including FFO to debt of about 23% is indicative that there is cushion at the current rating level.

We consider the business risk profile strong, based on our assessment of the company's monopoly rate-regulated electric and natural gas distribution businesses that provide an essential service, offset by the risks exposed by the September 2010 San Bruno gas transmission explosion. We expect that the company will require multiple years to rebuild its reputation and regulatory relationships. Our assessment of the company's management and governance as "fair" reflects PG&E's evolving strategic challenges and the more recent developments that indicate that the company's ability to effectively manage these risks may be more difficult than originally contemplated.

We view PG&E's financial risk profile as "significant", reflecting our base-case forecast that suggests a weakening of cash flow measures during this year and then a gradual improvement starting in 2014 so that FFO to debt is consistently higher than 17%. The weaker cash flow measures partially reflect our expectation of material fines and out-of-pocket costs not recoverable in customer rates related to the San Bruno pipeline explosion.

## Liquidity

PG&E and Pacific Gas and Electric Co. have adequate liquidity and can more than cover its needs for the next year, even if cash flow decreases.

We base our liquidity assessment on the following factors and assumptions:

- The company's consolidated liquidity sources (including cash, FFO, and credit facility availability) exceed its uses by about 1.25x during the next 12 months.
- Consolidated long-term debt maturities are material, with about \$1.3 billion maturing in 2014.
- Even if consolidated EBITDA decreases by 15%, we believe net sources will be well in excess of liquidity requirements.
- The company has good relationships with its banks, in our assessment, and has a good standing in the credit markets, having access to the capital markets during the 2009 credit crisis.

For our analysis, we assumed consolidated liquidity of about \$5 billion during the next 12 months, primarily consisting of FFO and availability under the credit facilities, partially offset by a potential penalty. We estimate the company will use about \$4 billion during the same period for maintenance capital spending, debt maturities, working capital needs, and shareholder dividends.

## Recovery analysis

We rate the senior unsecured debt at PG&E Corp. one rating notch lower than the corporate credit rating because of structural subordination because priority obligations exceed 20% of total assets.

## Outlook

The negative outlook reflects our view that there is at least a one in three probability that the financial penalties from the San Bruno pipeline explosion will be at the CPUC staff's most recent revised recommendation, the company will have ongoing difficulty managing regulatory risk, and the company's willingness or ability to issue equity could be limited. Under this scenario, the company will finance part of the penalty with debt and FFO to debt gradually decreases to below 15%.

We would downgrade the company if all of the above occurs. Under the above scenario, the company's business risk profile would remain strong for the

longer term reflecting its inability to effectively manage regulatory risk. In addition, we would expect a longer-term weakening of the financial measures due to a higher percentage of debt and weaker cash flow.

We would revise the outlook to stable if any of the above risks do not materialize. This would lead to a combination of a more stabilized business risk profile and financial measures that are more align with our base case scenario of FFO to debt minimally greater than 17%.

## Related Criteria And Research

- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Key Credit Factors: Business And Financial Risks In The Investor-Owned Utilities Industry, Nov. 26, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Assessing U.S. Utility Regulatory Environments, Nov. 11, 2007

## Ratings List

Ratings Affirmed; Outlook Revised

	To	From
PG&E Corp. Corporate Credit Rating	BBB/Negative/--	BBB/Stable/--
Pacific Gas and Electric CO. Corporate Credit Rating	BBB/Negative/A-2	BBB/Stable/A-2

Ratings Affirmed

PG&E Corp. Senior Unsecured	BBB-
Pacific Gas & Electric Co. Senior Unsecured	BBB
Commercial Paper	A-2

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