EQUITY RESEARCH

RBC Capital Markets

RBC Capital Markets, LLC
Shelby Tucker, CFA (Analyst)
(212) 428-6462
shelby.tucker@rbccm.com
Insoo Kim (Associate)
(212) 905-2995
insoo.kim@rbccm.com
Ellen Ngai, CFA (Associate)
(212) 558-0412
ellen.ngai@rbccm.com

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California Regulation Update

Highlights from Meetings with CPUC

We believe that the regulatory outlook for California will be somewhat challenging in the near term but could stabilize after San Bruno and San Onofre Nuclear Generation Stations (SONGS). Recent meetings with the California Public Utilities Commission (CPUC) and Monday's signing of Assembly Bill 327 by Governor Brown suggest that the CPUC remains committed to attracting capital to support utility investment and will have the tools to balance rate recovery with desired public policy. In the meantime, both the San Bruno proceedings and, to a lesser extent, the SONGS retirement remain distractions that are likely to garner political heat and might create additional jitters among investors. We remain upbeat about Sempra Energy (SRE, Outperform), but are currently more cautious on PG&E (PCG, Sector Perform) and Edison International (EIX, Sector Perform).

San Bruno: President Peevey and to a lesser extent Commissioner Florio suggested that a final commission decision will be no later than the spring of 2014. Both commissioners have indicated that they want to put San Bruno behind them before they rule on Pacific Gas & Electric's (PacGas) general rate case (GRC). All parties, including the Division of Ratepayers Advocates (DRA), strongly believe that a strong credit rating for PacGas is important, although how a strong credit is defined is a little murky. The two presiding commissioners (Peevey and Florio) would like to reach a unanimous decision among all five commissioners; a 5-0 vote was not a critical consideration for Commissioner Ferron.

SONGS: Most commissioners suggested that SONGS is likely to be relatively straightforward, although they would not opine on the regulatory treatment. The Energy Division (ED), led by Ed Randall, suggested that if SONGS remains in rate base then the utility (SoCalEd) should not recover purchased power costs. President Peevey is confident that SONGS will be mostly resolved by the end of his term, at the end of 2014.

AB327: The Bill returns much authority to the CPUC to make rate design changes and address the imbalance on low-income customers due to net metering. Views were mixed on whether the CPUC would peruse the full $10/month residential customer fixed charge, and the DRA expects to advocate for a minimum bill instead. We note that the Bill also provides a path forward to remove the net metering cap; however, we believe that the CPUC now has the tools to counteract the negative impacts of customers leaving the grid to use distributed generation.

PacGas GRC: Commissioner Florio, who is the presiding commissioner for the PacGas GRC, wants San Bruno to be decided before providing a recommendation. He and others want to reach a GRC decision that would be untainted by San Bruno. He is comfortable allowing the assigned administrative law judge (ALJ) more time to file a recommendation. However, he also has concerns about the rate at which recent GRCs have been decided and would like to see more timely decision coming from the CPUC.

We continue to favor Sempra over the other two California utilities although our preference has little to do with California. We believe Sempra has an attractive asset diversification program that focuses mainly on natural gas infrastructure investments and Latin America growth prospects. The next catalyst for the stock will likely be receiving the non-free trade agreement approval for its Cameron liquefied natural gas (LNG) facility later this year. We are hesitant to invest in PG&E at this time while we await a decision from the ALJs on the San Bruno matter. Political pressure is high and could have an effect on that decision. While we believe that SONGS will be a manageable event for SoCalEd, it will still take a while to be resolved. As a result, we are concerned that the stock could be stuck in limbo over the next 9–12 months.

Priced as of prior trading day's market close, EST (unless otherwise noted).
All values in USD unless otherwise noted.
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At the California Public Utilities Commission (CPUC), We Met with the Following Groups and Commissioners:

- DRA (Division of Ratepayers Advocates) – Joe Como, Interim Director, Linda Serizawa, Interim Deputy Director for Energy, and other members of the DRA Staff.
- Energy Division – Ed Randolph, Energy Division Director, and Staff. The Energy Division advises the Commission, develops and administers energy policy, and ensures compliance with Commission decisions and statutory mandates.
- President Mike Peevey and Staff
- Commissioner Mark Ferron and Staff
- Commissioner Mike Florio and Staff
- Commissioner Carla Peterman and Staff

New AB327 gives CPUC More Authority over Setting Rate Design. This is the first broad rewriting of the California Public Utilities Code since the 2000–2001 energy crisis. The passage of AB327 returns much of the authority that was lost after the energy crisis. The bill was approved by Governor Jerry Brown on October 7. The key provisions are:

- Removes net metering suspension that would have occurred at year-end, codifies how to measure the net metering cap per utility (the limits will not be less than: SDG&E – 607 MW, SoCalEd – 2,240 MW, PG&E – 2,409 MW) and provides a path to remove the net metering cap.
- Allows the CPUC to adjust the current residential tiered rate structure.
- Allows for the CPUC to determine a fixed charge of up to $10 per residential customer per month or $5/month for qualified low-income customers beginning 1/1/2015, with annual increases capped by the Consumer Price Index.
- The CPUC may allow utilities to offer time-of-use pricing, and beginning 1/1/2018 the CPUC may require the utilities to utilize time-of-use pricing as a default.
- The electric utilities must provide a distributed resource plan to the CPUC by 7/1/2015.
- Puts the 33% RPS (Renewable Portfolio Standard) by 2020 as a floor rather than ceiling.

The Implications and Implementation of AB327 Dominated Conversations. Generally, parties viewed the return of authority to the CPUC positively. The Commissioners will be using the tools from AB327 to address net metering, distributed generation, and rate tier issues. There was concern from parties about being able to finish three large rate design cases along with the current work load. However, parties believe it would be feasible to complete the residential rate redesign if a universal framework is developed rather than three separate designs. Fine-tuning to accommodate the different customer class mix for each utility could occur in the second phase of upcoming GRCs. Modest changes to rate design can be made in 2014. Major changes cannot go into effect before 1/1/2015.

The DRA indicated that it had supported all rate design issues in the Bill but may oppose some aspects in litigation. The DRA warned that investors should not be surprised if the DRA opposes the fixed charge during litigation. The DRA believes that a minimum bill is a better solution. The DRA also wants to implement changes with AB327 gradually, especially the time-of-use rates.

San Bruno Will Continue to Drag into 2014. The ALJ recommendation is expected in late November. Commissioner Peevey indicated that he expects San Bruno to be resolved no later than the spring of 2014, likely around March. It is unlikely that a CPUC decision will come quickly after the ALJ recommendation because at least one commissioner will not start to review the San Bruno record until after the ALJ recommendation. We note that if an appeal is filed to the ALJ recommendation, this triggers an exemption that allows the commissioners to discuss the case in closed session. All parties seemed to expect the exemption to be triggered and for the appeal to be filed close to the end of the 30-day period. Most parties mentioned that San Bruno continues to be "politically charged", which is the primary cause of the delays.

The commissioners and DRA were concerned about the financial health of PG&E moving forward and will not put the company in financial jeopardy, but they indicated that the penalty will be substantial. The DRA would also be against a large fine that negatively affects ratepayers. The commissioners were split on the importance of a unanimous vote on San Bruno.

PG&E Rate Case Decision after San Bruno. Most parties indicated that the GRC (general rate case) decision would come after San Bruno; otherwise, parties did not expect San Bruno to impact the GRC decision. Parties seemed to indicate a decision around mid-year. One commissioner indicated that San Bruno will not be as delayed as the SCE (Southern California Edison) and Sempra rate cases. The commissioner also mentioned that if delays of that length were to reoccur, the CPUC may give interim cash revenue increases in addition to the retroactive rate increases. However, it seems unlikely that such delays would reoccur given the unique situation last time with four new Commissioners.

DRA's two biggest issues with the rate case are: 1) management incentives of which 50% pass to ratepayers; and 2) $400 million in accounting differences. DRA also indicated that it would prefer recovery after spending, not prior to spending. DRA is concerned that PG&E will spend money in places other than that approved or underspend.

San Onofre Nuclear Generating Station (SONGS) Less Contentious and Less Politically Charged; Expect Outcome to Be Based on Historical Precedent. Southern California Edison (SCE), subsidiary of Edison International (EIX), announced the early retirement of SONGS in November 2012. As compared with San Bruno, the Commissioners believe that the SONGS retirement will be resolved quickly and with less media scrutiny. Commissioner Peevey believes that SONGS will be mostly resolved by the end of 2014.

The Energy Division stated that either SONGS will stay in rate base (to receive a return **on** investment) **or** SCE will receive recovery of replacement power costs; to receive both would be double dipping. The Energy Division confirmed EIX's view that past precedent shows that no longer used and useful assets would still receive a return **of** investment, with a potential to receive a debt return on the investment in some cases. We are uncertain as to how the CPUC would approach recovery **of** investment outside of rate base, but accelerated depreciation is one option.

We note that EIX guidance removes SONGS from rate base and assumes no debt return, in line with a conservative view on precedent. We also note that EIX has taken a $575 million asset impairment of net investment in SONGS of $2,096 million. Additionally, as of May 31, 2013, SONGS replacement power costs since 1/1/2012 total $650 million and authorized revenues collected for SONGS total $804 million.

Potential Ratings Agency Downgrade of California. All parties agreed that California needs strong utilities and would not take any action that would damage the credit profile of the companies. The DRA did not see a situation where the ratings agencies would take a more negative view on California and downgrade all California utilities due to regulation.

Resource Adequacy Unlikely to Lead to Capacity Markets. The Energy Division does not foresee capacity markets in California. We believe that California would be against a federal rule mandating capacity markets due to the fear that the rule would reduce California's ability to meet their own state goals regarding energy efficiency, demand response, and distributed generation. The Energy Division does not believe that the current commissioners would support a capacity market. Also note that the last time, the CPUC unanimously rejected a capacity market. Although the commission is concerned for reliability, a capacity market does not seem necessary.

Changes at the Commission. Commissioner Peevey indicated that he expects to leave the CPUC at the end of 2014 at the conclusion of his term. We also note that Commissioner Ferron's term ends at the end of 2014; we expect Commissioner Ferron to be reappointed. We believe that Commissioner Peterman or Ferron could be appointed as the next president. One commissioner noted that there have not been radical changes at the Commission since Governor Brown's appointments. The slow down in GRC decisions was to be expected with so many new commissioners and San Bruno, but the commissioner did not believe that the direction of the commission has changed.

Companies Mentioned

Edison International (NYSE: EIX; $47.15; Sector Perform)
PG&E Corporation (NYSE: PCG; $40.92; Sector Perform)
Sempra Energy (NYSE: SRE; $85.23; Outperform)

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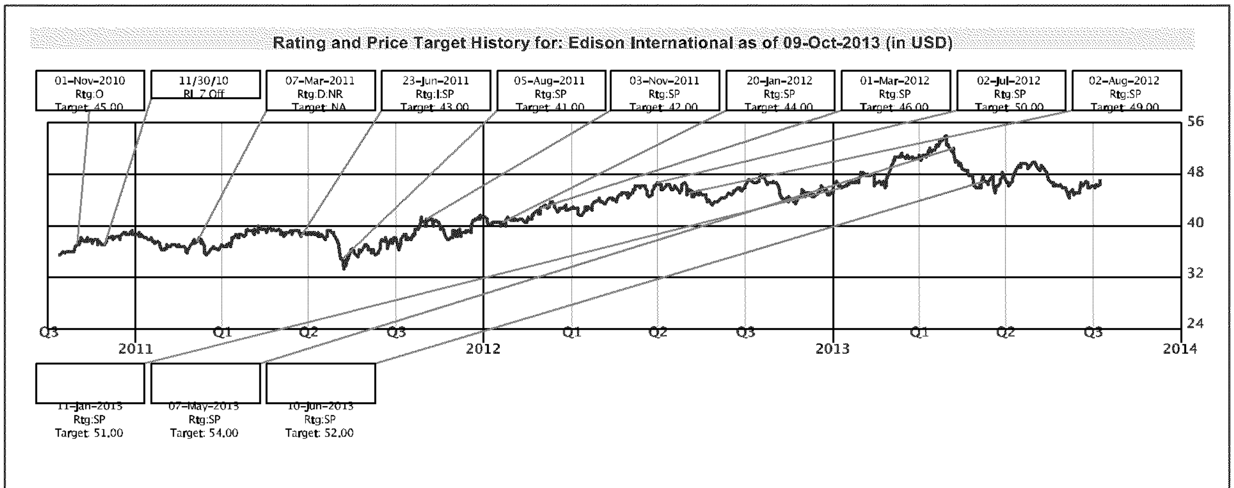

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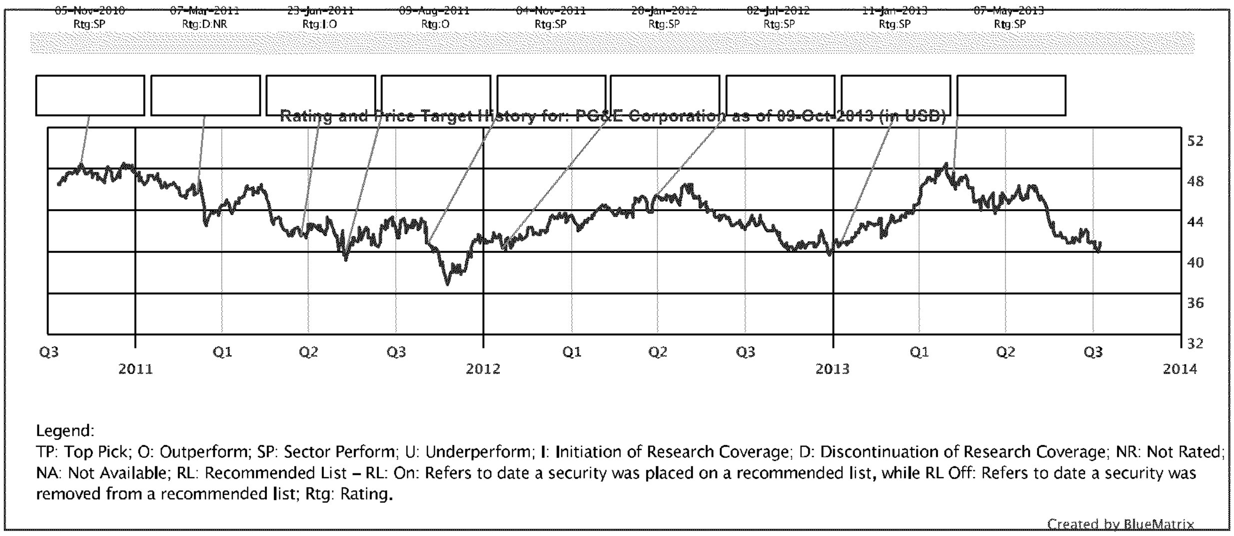

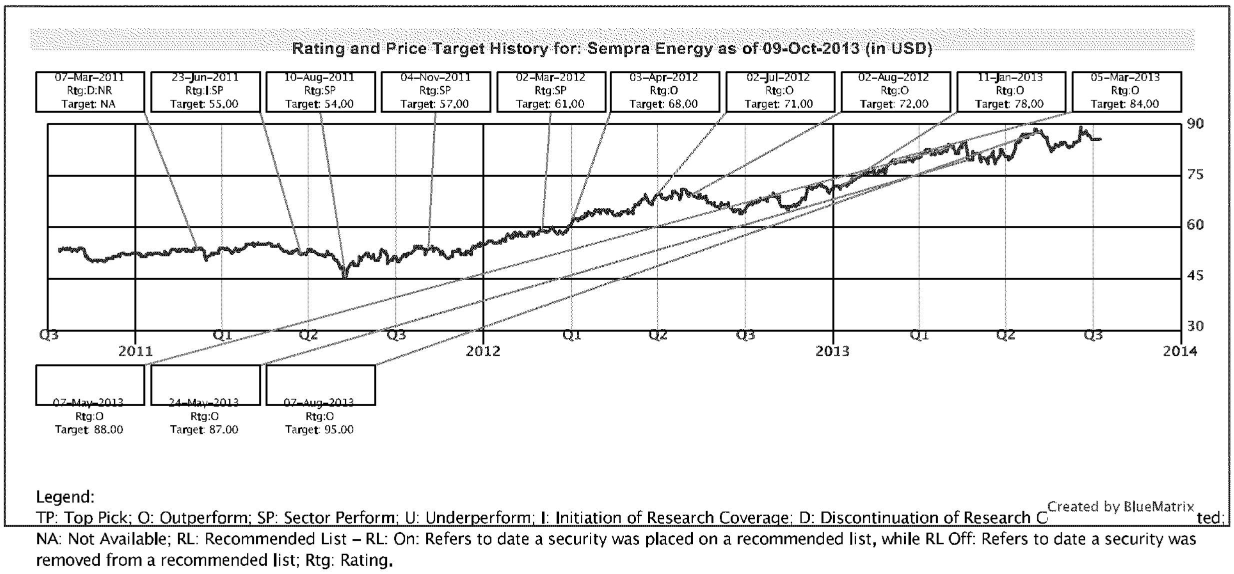

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